ASEAN FINANCIAL INTEGRATION: OPPORTUNITIES, RISKS, AND CHALLENGES

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Abstract

ASEAN economies have become more financially integrated over the past decade. Both de-facto integration and regional agreements under the ASEAN Economic Community (AEC) have resulted in increasing financial links among countries in the region. Regional initiatives in financial services liberalization, capital market development, and capital account liberalization have also been contributing to the deepening of regional financial markets. In fact, by end-2015, ASEAN countries have completed 87% of all measures under the AEC Blueprint, to achieve free flow of services and freer flow of capital in the finance sector. However, while regional financial integration is clearly increasing, ASEAN economies seem to be more integrated with global financial markets than with their regional neighbors, as suggested both by quantity-based and price-based measures of integration. This is due to limited opportunity for risk diversification within the region, absence of adequate liquidity, lack of adequate financial infrastructure links, and gap in regulatory quality among countries particularly the need to harmonize/maintain minimum standards and regulations. Thus, to further deepen financial integration in ASEAN, it is crucial that: (a) policies that promote the development of financial markets should continue to be a priority; (b) ASEAN should aim to strengthen the implementation of programs at the national level; (c) monitoring of regional financial integration should be pursued with greater urgency; and (d) since regional financial integration is not an end by itself, but a policy instrument designed to achieve development goals, greater macroeconomic and policy coordination is needed.

I. Introduction

Financial globalization – that trend characterized by increasing integration of capital markets and international financial transactions – has increased over the years, as evident in the rapid accumulation of both external assets and liabilities by countries across the world since the early 1990s (IMF, 2005). Although global financial integration has proceeded more rapidly in developed countries than in emerging markets – due perhaps to various factors such as differences in access to information technology and the ability to reduce regulatory barriers – the fact remains that financial globalization has provided opportunities for adjustment to external imbalances. For instance, it may be argued that financial globalization allows greater diversification, leading to deeper financial markets and increased resilience to external shocks. It also allows countries to take advantage of additional savings generated by financial flows, thereby leading to higher investment and capital accumulation.

However, financial globalization has also brought new challenges and risks – particularly the risks associated with exposure to financial market uncertainties. In recent years, global financial stability risks have remained considerable as evident in the 2008 global financial crisis and 2010 Euro zone sovereign debt crisis. Due to increased global linkages many countries became more vulnerable to external shocks, which, in turn, exerted a significant impact on the output and volatility of capital flows. For example, in Asia, where the degree of financial integration is broadly comparable with other regions in the world, financial spillovers in equity markets have remained substantial even after the global financial crisis, suggesting that financial markets in the region and around the world have become increasingly integrated. This is important because as trade flows in Asia continue to increase, via regional production networks and value chains, strong financial market linkages are crucial to support the various components of trade integration.

Against this backdrop, this chapter will examine the opportunities, as well as the trends and challenges, of financial integration in Asia, particularly in ASEAN[1]. In this era of increased financial globalization, no country is immune from the transmission of financial sector shocks. Like other regions in the world, ASEAN is affected by the global financial uncertainty because the financial markets of ASEAN countries are very much integrated with the rest of the world.

II. Overview of financial integration

There is no standard definition of financial integration, although the term is often associated with greater financial openness, and cross-border movement of capital and financial services. One view looks at financial integration in terms of the law of one price, where assets with the same risk should have expected a return regardless of their locations. Assuming investors face no discrimination, they will try to exploit these opportunities until prices converge and the law of one price is restored. Another view looks at financial integration in terms of a process in which a country's financial markets have become more closely integrated with those of other countries. This implies a single set of rules for market participants, equal access to financial instruments or services, and equal treatment in the market.

Financial integration can be achieved in a number of ways. It can emerge as a result of formal agreements, like a membership in a regional integration agreement. It can also occur de facto, i.e., in the absence of explicit agreements, like in the case of foreign bank entry in domestic markets. Nonetheless, these two forms of financial integration are complementary. Formal financial integration at the regional level may increase financial links with the rest of the world. For example, as countries link their financial markets, they may decide to harmonize standards and regulations that will further attract increased foreign participation within the group but also from the rest of the world, as in the case of foreign banks establishing

[1] ASEAN was established in 1967 by five countries (Indonesia, Malaysia, Philippines, Singapore and Thailand; collectively known as ASEAN5) mainly for political reasons. Since then the Association has expanded to its current ten members (ASEAN5, Brunei Darussalam, Cambodia, Lao PDR, Myanmar, and Viet Nam), and has broadened its thrust toward greater economic cooperation, beginning with the Declaration of ASEAN Concord in 1976.

their subsidiaries or branches abroad.

Financial integration can be measured by price and quantity indicators. One way is by using direct price or yield comparisons of various financial instruments. This constitutes a direct test of the "law of one price" which in turn must hold if financial integration is complete. Quantity-based measures of financial integration, on the other hand, are simple ratios intended to capture the extent of cross-border activities. The traditional indicator is to consider the savings-investment correlation, i.e., if the financial markets are well integrated, the correlation between investment and savings should be low. Other quantity-based measures are the ratio of total stocks of foreign assets and liabilities to GDP and the ratio of capital flows to GDP. While quantity-based measures are simpler to use, data availability is a problem.

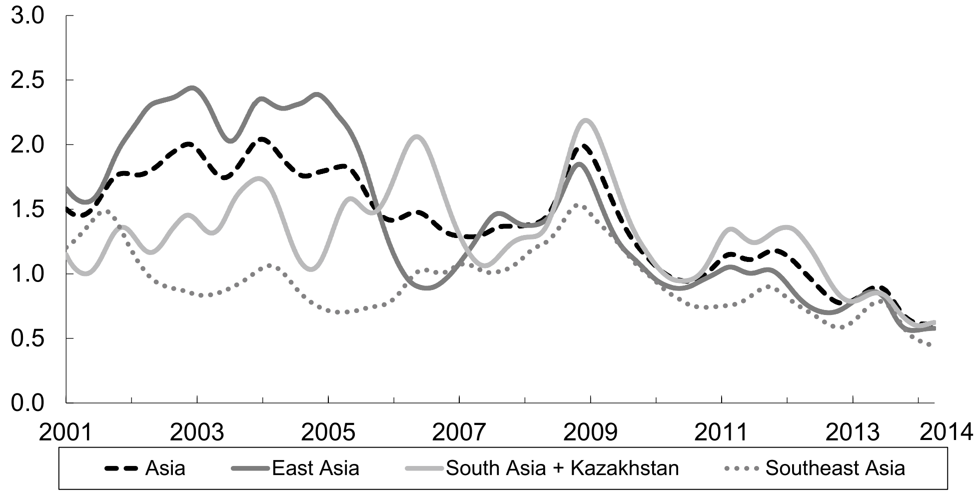
III. Evidence of financial integration in Asia

In Asia, financial integration has increased over the years but not to the same degree as trade integration which is far more advanced. Around 60 percent of trade flows in Asia are within the region, but only 20 percent of financial transaction flows are directed at the region. Despite this, conditions for financial integration in Asia have improved considerably. Since the Asian financial crisis, the region has managed to accumulate enormous amounts of foreign reserves. Foreign capital continued to pour in through foreign direct and portfolio investments, thereby supporting the region's huge trade flows. Asian financial markets have also become deeper, as evident in the significant increase in local currency-denominated bonds across the region.

Although there is evidence of increasing integration in financial markets, those linkages are relatively stronger with advanced economies outside the region than among Asian economies. There are various factors that explain the limited integration of financial markets in Asia. One is the lack of adequate liquidity in Asian financial markets due to the existence of segmented, small, and illiquid financial markets in Asia, thereby resulting in investors preferring to access the major financial markets in developed countries, which offer a greater choice of financial instruments for risk-sharing. Stringent regulations and policies on some cross-border financial transactions also impede Asian-wide integration of financial markets. For example, differences in capital account and tax regimes across countries in Asia are often found to discourage cross-border equity and bond holdings, as they raise the costs of entering and exiting financial positions.

Despite these limitations, evidence suggests that Asian financial markets have become increasingly more integrated over the last three decades. Both quantity- and price-based indicators confirm this. Figure 1 and Figure 2 show the cross-country standard deviations of monthly equity/stock market returns and of 10-year bond yields across groups of economies in Asia. These price indicators are used to measure the extent of integration in financial markets in terms of co-movements of financial-asset returns. If there is a large discrepancy as measured by dispersion, those markets are not fully integrated. As shown in Figure 1, con-

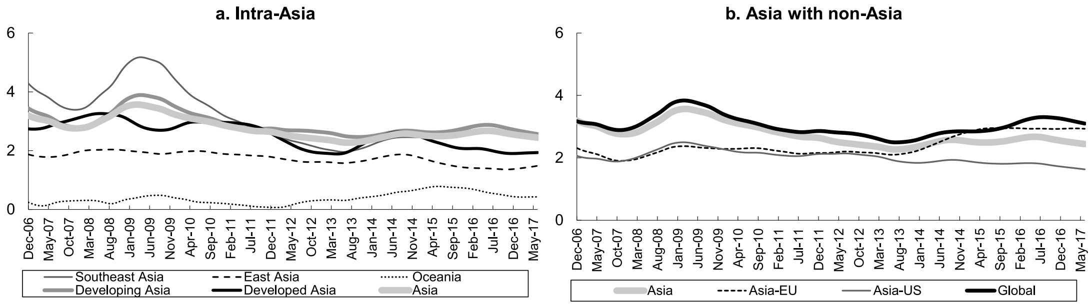
Figure 1. Cross-Market Dispersion of Equity Returns (%)



Note: Cross-market standard deviation of daily stock market returns, de-trended using Hodrick-Prescott filter. Asia includes East Asia, South Asia plus Kazakhstan, and Southeast Asia. East Asia includes the People's Republic of China; Hong Kong, China; Japan; the Republic of Korea; Mongolia; and Taipei,China. South Asia includes Bangladesh, India, Pakistan, and Sri Lanka. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, and Viet nam. Data until 31 March 2014.

Source: ADB calculations using data from Bloomberg. Asian Economic Integration Report. April 2014

Figure 2. σ-Convergence of 10-Year Government Bond Yields—Asia



EU = European Union, US = United States.

Notes:

(i) Values refer to the unweighted mean of individual economy's σ-convergence, included in the subregion. Each economy's σ-convergence is the simple mean of all its pairwise standard deviation. Data are filtered using Hodrick-Prescott method.

(ii) East Asia includes the People's Republic of China; Hong Kong, China; Japan; the Republic of Korea; and Taipei,China. Southeast Asia includes Indonesia, Malaysia, the Philippines, Singapore, and Thailand. Oceania includes Australia and New Zealand. Developed Asia includes Japan and Oceania. Developing Asia includes Southeast Asia and East Asia. Asia includes Developed Asia and Developing Asia. Global includes Asia, Colombia, the EU, Mexico, and the US.

Sources: ADB calculations using data from Bloomberg; CEIC; and methodology by Espinoza et al (2010), and Park (2013).

vergence is highest in Southeast Asia (as shown by the lowest standard deviations in returns), thereby suggesting strongest co-movement and degree of intra-regional financial integration compared to other sub-regional markets. In terms of bond yields, convergence is most marked in East Asia and ASEAN-4 (Indonesia, Malaysia, Philippines, and Thailand) as indicated by the steep decline in coefficient of variation, which means that spreads in those countries started to move closer to each other.

Volume indicators show rising trends of financial integration as well. Asia's cross-border asset holdings grew by 27% to US$14.5 trillion in 2015 from US$11.4 trillion in 2010 (Table 1). The bulk of these assets are bank claims (US$4.1 trillion), followed by portfolio debt assets (US$3.5 trillion), stock of outward foreign direct investment (US$3.6 trillion), and portfolio equity assets (US3.2 trillion). Although intra-regional shares of cross-border assets also increased for all asset types over the years, indicating gradual financial integration, the majority of the region's asset holdings are still directed at the rest of the world. The same trends are evident in Asia's cross-border liabilities, which increased by 31 percent to US$15.1 trillion in 2015 (Table 2). There was a gradual increase in the intra-regional share of total cross-border liabilities, suggesting an increase in the level of regional financial integration. However, Asia's financial linkages on liabilities with the rest of the world are stronger than in the region.

Reflecting the developments in Asia, financial integration in ASEAN is also far from

Table 1. Cross-Border Assets — Asia (USD billion, %)

	2010		2015	
	Total	**Intra-Asia (%)**	**Total**	**Intra-Asia (%)**
FDI	2,505	35.3	3,635	39.4
Bank	3,383	16.3	4,112	22.1
Debt	3,611	11.9	3,634	16.7
Equity	2,001	24.2	3,214	20.0
All	**11,499**		**14,594**	

FDI = foreign direct investment. Notes: FDI assets refer to outward FDI holdings. Bank assets refer to bank claims of Asian economies. Asia includes all 48 ADB regional members for which data are available as of December 2015.
Sources: ADB calculations using data from International Monetary Fund. Coordinated Portfolio Investment Survey.
http://cpis.imf.org (accessed September 2017); International Monetary Fund. Coordinated Direct Investment Survey.
http://cdis.imf.org (accessed February 2017); and Bank for International Settlements. Locational Banking Statistics.
https://www.bis.org/statistics/bankstats.htm (accessed May 2017).
ADB. Asian Economic Integration Report. May 2017

Table 2. Cross-Border Liabilities — Asia (USD billion, %)

	2010		2015	
	Total	Intra-Asia (%)	Total	Intra-Asia (%)
FDI	4,848	42.9	6,863	44.3
Bank	2,093	19.2	2,294	23.0
Debt	1,672	25.7	2,250	27.0
Equity	2,902	16.7	3,706	17.4
All	**11,514**		**15,114**	

FDI = foreign direct investment.
Notes: FDI liabilities refer to inward FDI holdings. Asia includes all 48 ADB regional members for which data are available as of December 2015.
Sources: ADB calculations using data from International Monetary Fund. Coordinated Portfolio Investment Survey.
http://cpis.imf.org (accessed September 2017); IMF. Coordinated Direct Investment Survey.
http://cdis.imf.org (accessed February 2017); and Bank for International Settlements. Locational Banking Statistics.
https://www.bis.org/statistics/bankstats.htm (accessed May 2017).
ADB. Asian Economic Integration Report. May 2017

complete. ASEAN financial markets are still more integrated with the global markets than with the region. One factor evidencing this is the size of the cross-border portfolio holdings (equities and debt) of ASEAN-5 countries. In 2014, it was estimated that of the overall debt portfolio held by ASEAN5 countries that year, around 72.1 percent were in advanced markets (particularly the United States and Europe) and only 24 percent of those investments were in Asia. Despite this, however, conditions for financial integration have become more favorable over the years. The region's foreign exchange reserves, accumulated since 2000, reached US$754 billion in 2016 as funding sources became more diversified. The size of emerging Asia's local currency bond market climbed to around US$11 trillion in 2016.[2] Furthermore, the total FDI inflows in the region increased to US$136 billion in 2014 from US$21 billion in 2000. More importantly, intra-regional FDI flows accounted for almost 18 percent of the total FDI, from 6 percent in 2000.

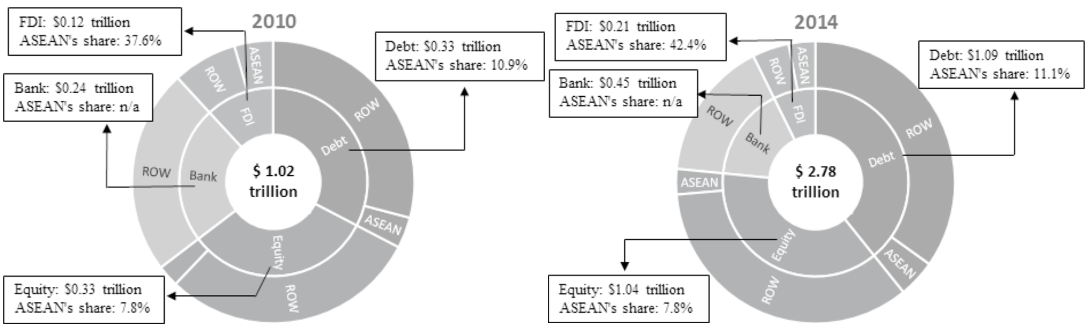
To measure the extent of integration in ASEAN financial markets, trends in direct investment, portfolio and bank claims across the ASEAN countries are examined. The total cross-border assets in ASEAN increased from US$1 trillion in 2010 to US$2.7 trillion in 2014 (Figure 3), with the bulk of asset holdings invested in portfolio debt (US$1.1 trillion)

[2] Emerging Asia includes the People's Republic of China, Hong Kong, China, Indonesia, Republic of Korea, Malaysia, Philippines, Singapore, Thailand, and Viet Nam.

and outward foreign direct investment (US$.2 trillion). However, as expected, most of these asset investments were directed in the rest of the world, indicating limited financial integration in the region. ASEAN economies were mostly linked via stock of outward foreign direct investment, with intra-share holdings of 42%, but not in their asset holdings of portfolio debt and portfolio equity. Intra-regional shares for these asset types remained small at 11.1% and 7.8%, respectively.

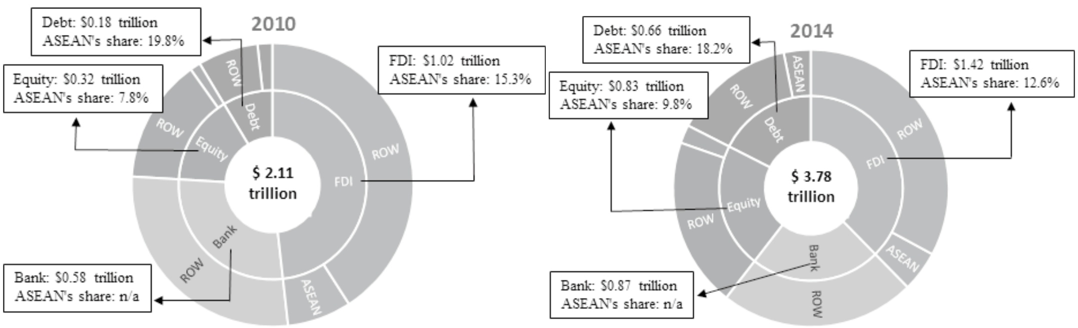
In 2014, ASEAN's gross cross-border liabilities reached US$3.7 trillion and exceeded its cross-border assets (US$2.7 trillion), highlighting the region's attractiveness as an investment destination. Most of these investments were in inward foreign direct investment (Figure 4). However, as in cross-border asset holdings, ASEAN's financial linkages on liabilities remained limited, as evident in intra-regional shares that continued to be small, and

Figure 3. Cross-border assets – ASEAN



Source: Author's calculations using data from IMF's Coordinated Portfolio Investment Survey and Coordinated (accessed September 2016) Direct Investment Survey (accessed April 2016) , and Bank for International Settlements Banking Statistics (accessed September 2016).
FDI = Foreign direct investment; ROW = rest of the world; n/a = data not available.

Figure 4. Cross-border liabilities – ASEAN



Source: Author's calculations using data from IMF's Coordinated Portfolio Investment Survey and Coordinated (accessed September 2016) Direct Investment Survey (accessed April 2016) , and Bank for International Settlements Banking Statistics (accessed September 2016).
FDI = Foreign direct investment; ROW = rest of the world; n/a = data not available.
Notes: FDI liabilities refer to FDI inward holdings. FDI stock data available only for 2009-2014.

even declining.

IV. Roadmap for Monetary and Financial Integration of ASEAN

In ASEAN, the main vehicle for pursuing integration is the Roadmap for Monetary and Financial Integration of ASEAN, which was endorsed by the ASEAN Finance Ministers in 2003. The Roadmap was developed to support the establishment of the ASEAN Economic Community (AEC) as the end-goal of regional economic integration by 2015. Under the AEC, the integration of financial markets is an important priority. Such integration is envisioned in terms of facilitating free flow of services and freer flow of capital in the region.

Since then activities have been directed toward financial services liberalization, capital market development, and capital account liberalization to facilitate the integration of ASEAN financial markets. While progress has been made since 2003, it is still difficult to attribute recent financial conditions to these initiatives since financial integration in ASEAN has also occurred de facto (due to increased financial globalization in the 1990s). Nonetheless, the following provides an overview of ASEAN initiatives in the various areas of financial integration.

Financial Services Liberalization

Financial services liberalization in ASEAN means opening up of the financial services sub-sectors in the region to enable more efficient provision of financial services. Under a regional agreement called the ASEAN Framework Agreement on Services (AFAS),[3] restrictions on the financial services sector, including banking and insurance, have been gradually eliminated through progressive liberalization, both in terms of improvement in market access and national treatment.

Under AFAS, financial services will be opened up to market players across the region, with a view to enhancing the efficiency and competitiveness of the services sector. AFAS uses a similar approach to that in GATS. It allows countries to engage in rounds of negotiations where each country commits to opening a specific sub-sector within the finance sector within each country. Liberalization can be in different modes of supply, covering both market access and national treatment commitments. Since formal negotiations for the liberalization of financial services first started in 1998, ASEAN has already completed six rounds of negotiations[4]. The outputs of such negotiations are contained in the packages of services commitments that countries have agreed to implement to facilitate free movement of financial services in the region, including those sub-sectors that have been committed for further

[3] AFAS, signed by the ASEAN Economic Ministers in Bangkok on 15 December 1995, aims to: (a) enhance cooperation in services among ASEAN member countries to improve the efficiency and competitiveness of ASEAN services industries; (b) eliminate substantial barriers to trade in services; and (c) liberalize trade in services by expanding the depth and scope of liberalization beyond those undertaken under the General Agreement on Trade in Services (GATS) of the World Trade Organization.

liberalization by 2015 (Table 3).

Based on the consolidated fifth package of services commitments (Table 4), ASEAN countries have committed 276 financial services sub-sectors for liberalization under AFAS, or an increase of 70 percent compared to commitments made in earlier rounds. Most of these commitments are in capital markets, banking, and insurance sub-sectors – and quite markedly, there has been a progressive liberalization of those commitments across sub-sec-

Table 3. ASEAN financial services sub-sectors identified for liberalization by 2015

Sub-sectors	B	C	I	L	MY	MR	P	S	T	V
Insurance										
Life Insurance			√				√			
Non-life Insurance	√	√	√		√		√	√		√
Reinsurance and Retrocession	√	√	√		√		√	√		√
Insurance Intermediation		√	√		√		√	√		√
Services Auxiliary to Insurance	√	√	√		√		√	√		√
Banking										
Acceptance of Deposits		√		√						√
Lending of All Types		√		√						√
Financial Leasing		√		√						√
All Payment and Money Transmission Services		√		√						√
Guarantees and Commitments		√		√		√				√
Capital Market										
Trading for Own Account	√		√		√		√	√	√	
Participation in Issues of All Kind of Securities			√				√			
Asset Management			√				√	√	√	
Settlement and Clearing Services for Financial Assets			√				√	√	√	
Others										
Provision and Transfer of Financial Information						√	√			
Advisory, Intermediation and Other Auxiliary Financial Services							√	√	√	√

Source: ASEAN Secretariat (2007). AEC Blueprint 2015

Table 4. Number of financial services sub-sectors committed - ASEAN

Financial Services Sub-sectors	GATS	AFAS 2nd Package (consolidated)	AFAS 5th Package (consolidated)
Insurance	68	18	70
Banking	62	37	75
Capital Market	84	17	100
Others	21	10	31
Total	235	82	276

Source: ERIA (unpublished report, 2012)

[4] Although the first round of negotiations for services liberalization under AFAS started on 1 January 1996, negotiations only covered air transport, business services, maritime transport, telecommunication, and tourism, under the ASEAN Economic Ministers (AEM) process. Actual negotiation for financial services began only in the second round when the negotiation was transferred to the ASEAN Finance Ministers (AFM) process in 1999. Since then, six rounds of negotiations and packages of services commitments were completed in 2002 (second round), 2005 (third), 2008 (fourth), 2011 (fifth), and 2013 (sixth). The seventh round of negotiations was launched in 2014 and was completed in 2016, but the protocol for the seventh package of commitments is yet to be signed.

tors over the years. For example, as shown in Table 5, the overall liberalization rate for commitments made in the fifth package is 59 percent compared to those commitments made in the second package (54 percent) and under the GATS multilateral arrangement (53 percent). This means that, in line with the AFAS mandate, ASEAN countries submitted increasingly higher levels of commitments to eliminate substantial barriers to trade in financial services, thereby establishing the initial conditions for integrating their financial markets within the region (ERIA 2013).[5]

In light of the dominance of banking and insurance services in ASEAN, work has intensified in the liberalization and integration of these sub-sectors. Progress is underway to establish ASEAN Qualified Banks that will pave the way for semi-integrated banking in the region by 2020. In insurance, the ASEAN Insurance Integration Framework was finalized and agreed upon to guide the progressive liberalization to ensure more competitive insurance markets and greater choice for consumers. Under this Framework, ASEAN countries have agreed to prioritize the liberalization of cross-border supply of Marine, Aviation and Goods in International Transit (MAT) insurance. Further development in the regional integration of insurance services would meaningfully support trade, investment, and economic integration under the AEC.

So far there has also been a broader indication that the quality of financial services in the region has improved over the years, thereby further justifying why the region needs to further pursue financial integration. As shown in Table 6, ASEAN has considerably improved its global rankings in indicators of access to/quality of financial services in the region such as "ease of access to credit" and "soundness of banks." However, ASEAN rankings are still below those of other emerging markets like the BIC countries (Brazil, India, China, and South Africa), indicating that ASEAN countries need to further improve the quality of their financial services to fully benefit from financial globalization.

Table 5. Liberalization rates for ASEAN financial sub-sectors (%)

Financial Sub-sectors	GATS	AFAS 2nd Package (Consolidated)	AFAS 5th Package (Consolidated)
Insurance	57.19	59.56	66.03
Banking	52.76	55.20	60.40
Capital Market	51.73	37.29	54.70
Others	53.36	63.34	54.30
Total	53.76	53.85	58.86

Source: ERIA (unpublished report, 2012)

5 For example, in the same study by ERIA, it was found that in insurance, the high liberalization rate was accounted for by scheduling new sub-sectors and easing restrictions for both services auxiliary to insurance and insurance intermediation. In the case of banking, the higher liberalization rate was contributed through the easing of restrictions for both payment and money transmission and guarantees and commitments.

Table 6. ASEAN rankings in quality of financial services (2008-2012)

	Ease of Access to Credit		Soundness of Banks	
	2008	2016	2008	2016
Brunei	62	86	61	91
Cambodia	107	76	125	92
Indonesia	65	26	121	72
Malaysia	15	25	50	44
Philippines	89	46	72	43
Singapore	11	3	13	8
Thailand	44	34	75	35
Viet Nam	91	83	113	117
Lao PDR	-	70	-	84
Average ASEAN (excl. Myanmar)	60.5	49.9	78.8	65.1
Brazil	77	85	24	38
India	42	39	51	75
China	99	36	108	79
South Africa	31	12	15	2
Average BICS	62.3	43	49.5	48.5

Source: Global Competitiveness Report (GCR), WEF; 2008, 2016
Figures indicate ranking between 2008 and 2016. Total number of countries covered in Global Competitiveness Report are 134 in 2008 and 144 in 2016, respectively.
The rankings are based on the scores from the GCR's executive opinion polls, where they were asked to rank access to credit from "1" (very difficult) to "7" (very easy). Similarly, they were asked to rank the soundness of banks from "1" (insolvent may need bailout) to "7" (generally healthy with sound balance sheets).

Capital Market Development

ASEAN capital markets have grown rapidly since the Asian financial crisis. Although banks still dominate the region's financial systems, bonds and equities now account for an increasing share of financial assets in ASEAN. The development of deep, liquid and efficient capital markets will enable the region to channel its huge savings into productive investments and diversify the sources of funding for economic development.

Despite its increasing importance, there are challenges in developing and integrating regional capital markets. One key challenge is the diverse level of capital market development across countries. In ASEAN bond markets, diversity in market development is occurring; some markets are well developed while, some are still being developed. Others remain largely incipient. Equities markets are concentrated only in ASEAN-5 and Viet Nam, while institutional investment – particularly in insurance, pension funds and mutual funds - is still small. To a large extent, though, the differences in the level of development prevent ASEAN capital markets from realizing their upward potential.

Another challenge is that ASEAN capital markets remain fragmented, which limits the quality of their financial intermediation. While the region's capital markets have continued to develop, ASEAN capital markets are more connected with the rest of the world than within the region. Cross-border capital market transactions are still fragmented, thereby depriving the region's own markets of much needed additional depth and liquidity that may exist in a more integrated platform. In addition, integration is made difficult by considerable barriers that prevent the capital markets from realizing economies of scale and efficient market intermediation.

Recognizing these challenges, the goal of capital market development is to deepen and integrate regional capital markets by promoting ASEAN as an asset class, facilitating intra-regional investment flows, and recycling regional savings. This can be achieved by strengthening market access, linkages and liquidity through various initiatives that help the efficiency and capacity of regional capital markets. In terms of approach, this will be implemented through mutual recognition and harmonization of rules and regulations and the linkage of market infrastructure.

In general, the integration of capital markets in ASEAN is undertaken mainly through the development of equities (stocks) and bond markets, by addressing market gaps and facilitating the implementation of capital building programs.

As regards the integration of equity markets, an Implementation Plan for ASEAN Capital Markets Integration[6] (Plan) was developed in 2009 to guide the development and implementation of initiatives aimed at achieving greater capital market connectivity. Under the Plan, integration is envisaged in terms of three important priority areas: (a) creating an enabling environment for regional integration; (b) creating a market infrastructure and regionally focused products and intermediaries; and (c) strengthening the implementation process. Each area is also guided by key initiatives and strategies to support the Plan (Figure 5).

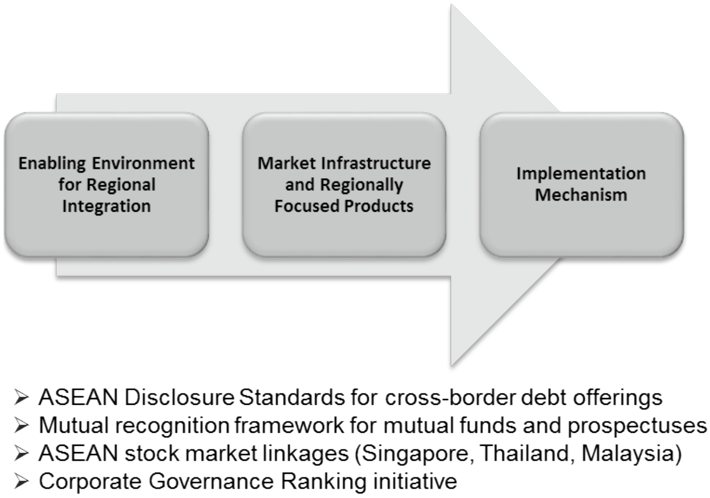
To realize the Plan, various initiatives have been developed to further enhance the integration of capital markets. One is the development of a common prospectus framework that will allow issuers to register and use a single prospectus prepared in accordance with the ASEAN Disclosure Standards for primary offerings of plain debt or equity across countries through a streamlined review process[7]. Efforts have also been increased to harmonize accounting standards, enhance mutual recognition of capital market professionals, and enhance the legal and dispute resolution framework – all in support of vibrant and well-functioning regional capital markets.

Another initiative is the mutual recognition of collective investment schemes (CIS). Under the ASEAN CIS Framework that was developed in October 2013 and operationalized in August 2014, investment schemes authorized in one jurisdiction maybe recognized and offered in all other participating jurisdictions. Three countries (Malaysia, Singapore and Thai-

[6] The Implementation Plan was a key initiative of the ASEAN Capital Market Forum (ACMF), a forum for heads of securities regulators in ASEAN established in 2004. The AMCF developed the Plan to support the objectives of the AEC Blueprint 2015. The Plan was endorsed by the ASEAN Finance Ministers on 9 April 2009.

[7] The Streamlined Review Framework for the ASEAN Common Prospectus, established on 3 March 2015, officially came in the force on 2 September 2015 in three participating countries (Malaysia, Singapore, and Thailand). The Framework aims to synchronize the review of offering/listing the application and registration of prospectuses, thereby facilitating offerings across multiple ASEAN jurisdictions of equity securities and plain debt securities.

Figure 5. Capital Market Implementation Plan



Source: Rillo (2015)

land) are currently implementing the scheme, and to date, 13 funds have received authorization as a Qualifying CIS under the Framework and have been allowed to be offered to retail investors in these countries.

Furthermore, to enhance the transparency of publicly listed companies, the ASEAN Corporate Scorecard was launched in 2011 based on the corporate governance principles of the Organization for Economic Cooperation and Development. Along these lines the ASEAN Star Index (a selection of the ASEAN Top 180 blue chip stocks) was also created to further promote ASEAN as an asset class. Three annual assessments of ASEAN public-listed companies using the Scorecard have been carried out to date.

Despite this progress, the integration of capital markets still depends on the speed with which the various obstacles to freer movement of capital are removed. Unfortunately, as shown in Table 7, those obstacles still exist. Compared to 2008, and based on the global rankings, the quality of the regulatory framework of ASEAN capital markets, on average, has deteriorated over the last eight years. Many ASEAN countries have continued to perform poorly in the regulation of securities exchange relative to the other emerging markets (BICS). Interestingly, ASEAN's ranking in venture capital availability has improved substantially, with all countries moving up the ranks. However, there's still a need to look at the removal of legal impediments to facilitate the integration of capital markets. As of 2016, ASEAN's overall ranking in protecting the legal rights of investors has slipped further, and has noticeably deteriorated in many ASEAN countries.

Capital Account Liberalization

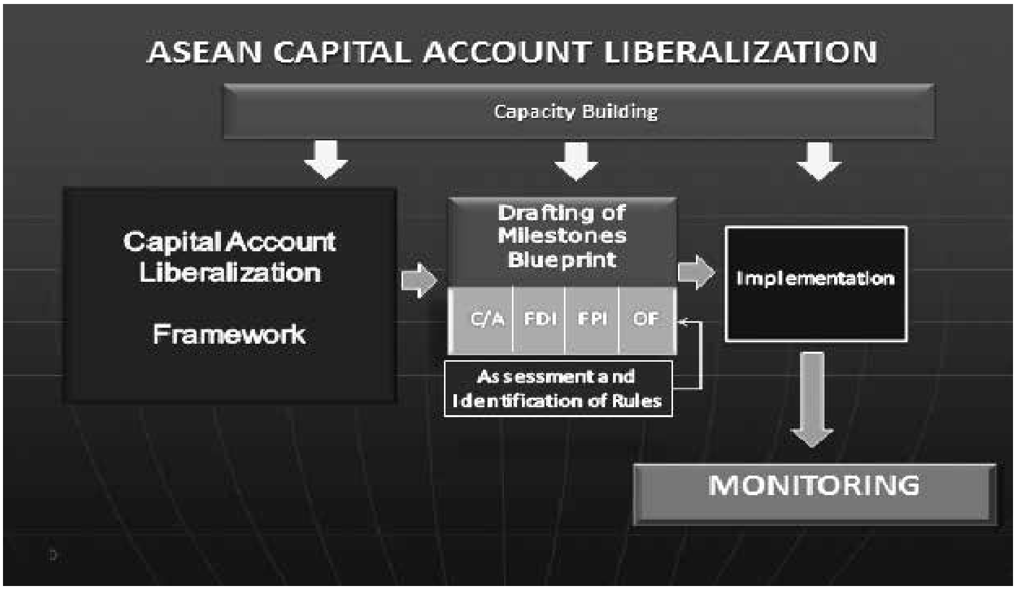
Under the capital account liberalization framework (Figure 6), financial integration in

Table 7. ASEAN Capital Markets Rankings 2008-2016

	Legal Rights Index		Venture Capital Ability		Regulation of Security Exchanges		
	2008	2016	2008	2016	2008	2016	
Brunei	29	86	78	61	101	73	
Cambodia	128	4	95	66	130	117	
Indonesia	52	68	41	20	37	60	
Malaysia	8	28	18	6	32	30	
Philippines	93	97	77	65	66	40	
Singapore	3	20	12	3	7	1	
Thailand	52	97	53	31	36	45	
Viet Nam	29	28	59	43	81	102	
Lao PDR	-	46	-	63	-	104	
Average ASEAN (excl. Myanmar)	49.25	52.67	54.13	39.78	61.25	63.56	
Brazil	119	108	79	95	28	54	
India	29	46	27	9	25	58	
China	93	86	49	14	109	57	
South Africa	52	68	29	53	5	3	
Average BICS	73.25	77.00	46.00	42.75	41.75	43.00	

Source: Global Competitiveness Report (GCR), WEF; 2008, 2016
Figures indicate ranking between 2008 and 2016. Total number of countries covered in Global Competitiveness Report are 134 in 2008 and 144 in 2016, respectively.

Figure 6. ASEAN capital account liberalization framework



Source: Rillo (2015)

ASEAN is supported by removing legal and administrative impediments to the movement of capital. The goal is to ensure that capital can move freely across countries, and that issuers can raise capital anywhere and investors can invest anywhere in the region. In such a market, anyone would be able to trade in ASEAN capital market products freely in any ASEAN market at a competitive fee from a single access point, with capital market intermediaries being able to provide services throughout ASEAN based on home country approval. Using a phased or gradual approach, capital account liberalization is to be preceded by an assessment and identification of rules relating to current account, foreign direct investment, portfolio investment, and other types of capital flows. Thus, in line with the commitment under the AEC Blueprint[8], the country program for capital account liberalization is expected to lead to a more liberal capital account regime, but not necessarily a fully open capital account.

Since the Roadmap was formulated in 2003, all ASEAN countries, except Myanmar, have adopted Article VIII of the IMF Articles of Agreement for the convertibility of their current accounts. The processes of assessment and identification of rules in the current account, foreign direct investments, portfolio investments and other flows have been completed. Based on these assessments, countries have developed individual capital account liberalization heat maps to assess the level of openness of the capital account regime in ASEAN. The heat maps will be updated regularly to monitor the developments in the capital account regime in each ASEAN country.

Individual milestones blueprints, which contain the countries' plans and timelines for progressively liberalizing their capital account regimes, have also been drafted by each country. Together with the heat maps, the implementations of the milestones blueprints are regularly monitored using a monitoring tool that allows countries to keep track of: (a) the accomplishments of milestones and some pre-conditions needed to achieve liberalization targets; (b) developments in the heat maps vis-à-vis the achievements in the milestones blueprint; and (c) the target level of liberalization and gaps.

Finally, in line with the guiding principles of ensuring adequate safeguards and macroeconomic stability in the process of opening up the capital account, a policy mechanism has been developed among ASEAN countries. Policy dialogues allow countries to keep track of the trends in capital flows among their individual economies, with the aim identifying possible risks and exchanging ideas and experiences in applying a safeguard mechanism to ensure macroeconomic, financial and monetary stability. In addition to policy dialogues, capacity-building activities have been regularly conducted to support the capital account liberalization process in the region.

V. ASEAN Financial Integration Framework

In 2011, ASEAN central bank governors adopted the ASEAN Financial Integration Framework (AFIF) to provide a general approach to the liberalization and integration initiatives under the AEC.[9] The AFIF aims to have a *semi-integrated financial market*[10] by 2020

[8] According to the AEC Blueprint, overall capital account liberalization should be guided by the following principles: (a) ensuring an orderly capital account liberalization consistent with member countries' national agenda and the readiness of the economy; (b) allowing adequate safeguards against potential macroeconomic instability and systemic risk that may arise from the liberalization process, including the right to adopt necessary measures to ensure macroeconomic stability; and (c) ensuring the benefits of liberalization to be shared by all ASEAN countries.

and is built on the following initiatives: financial services liberalization including banking integration, capital account liberalization, capital market development, and a harmonized payment and settlement system. The ASEAN central bank governors agreed on the end-goal of financial integration which recognizes that: (a) each ASEAN country has its own initial conditions; and (b) each country may define its own milestones and timelines for achieving the common end goal of financial integration. Recognizing differences in conditions, some countries may be able to achieve the end goal earlier, while some may follow later.

ASEAN Banking Integration Framework

One key initiative under AFIF is the integration of banking services in the region to be pursued more comprehensively under the ASEAN Banking Integration Framework (ABIF). ABIF calls for the creation of a semi-integrated banking in the region to provide improved banking services to corporates, thereby facilitating trade and investment and contributing to the region's economic growth. In addition, ABIF is envisioned to achieve greater coherence of banking regulations to all ASEAN countries, promote greater regional strength on the banking sector, and enhance the core competencies of stakeholders in ASEAN banking sector and financial system. It has been observed that there has been a substantial number of non-ASEAN based banks run operations in ASEAN, but only a handful of ASEAN-ASEAN bank ventures have operated through acquisition. This reflects a lack of synergy among ASEAN member banks.

Thus, under ABIF, ASEAN banks will be given greater market access and operational flexibility through the creation of Qualified ASEAN Banks (QABs) from each ASEAN country. QABs will have similar flexibility to operate like a domestic bank in host countries, subject to prudential safeguards and reciprocal arrangements. Each ASEAN country is eligible to nominate its own QAB(s) subject to criteria proposed for QABs.

ABIF is guided by five key principles (Figure 7). It is supposed to be outcome driven in the sense that the establishment of QABs will contribute to deeper financial intermediation in the region, thereby contributing to increased regional financial stability and economic growth. It is comprehensive since the framework focuses on four critical areas for integration i.e., prudential principles, financial stability infrastructure, and capacity building. ABIF also tries to be inclusive by allowing all ASEAN countries to join the framework based on their readiness and ability to integrate the banking sector. Finally, the flexibilities granted to

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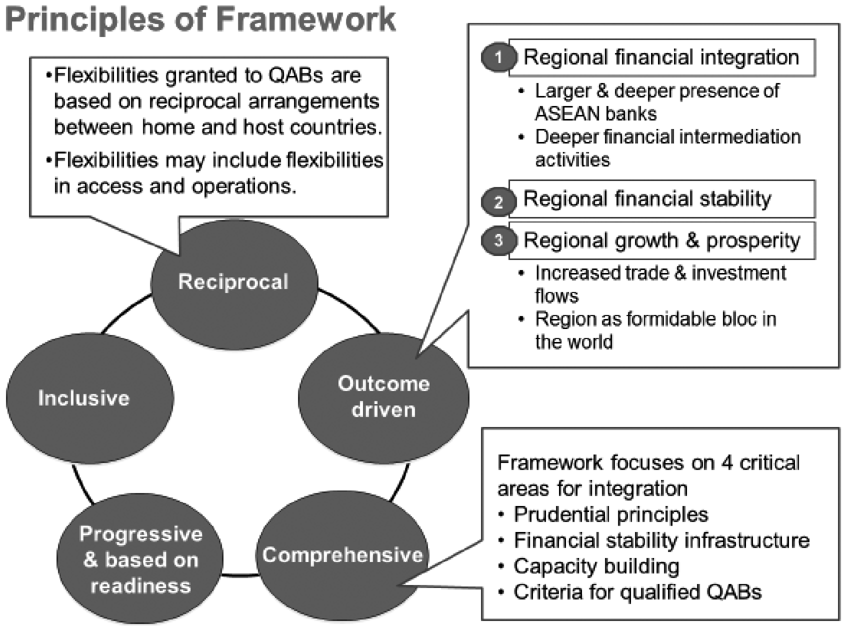
[9] Half way toward the AEC 2015 deadline, the central bank governors found the integration process quite slow. To push the integration agenda from the banking side, the governors came up with the idea of an ASEAN Financial Integration Framework (AFIF) with a revised end date of 2020 with a view for achieving financial integration.

[10] As mentioned under AFIF, ASEAN aims to have a semi-integrated financial market by 2020. AFIF is also built on the following broad thrusts: (a) a semi-integrated single banking market within ASEAN; (b) differentiated milestones for ASEAN5 (Indonesia, Malaysia, Philippines, Singapore and Thailand) and BCLMV (Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Viet Nam), reflecting different development, timelines, and readiness; (c) clear pre-conditions for individual member countries; (d) progress and structure of liberalization underpinned by financial stability; (e) shared responsibility among member states in ensuring financial stability; and (f) integrated payments and settlement systems to support trade, capital and retail transactions.

Figure 7. Key principles of ASEAN Banking Integration Framework (ABIF)



Source: Rillo (2015)

QABs are based on reciprocal arrangements between home and host countries. Flexibilities may also include flexibility in terms of access and operations.

Based on ABIF implementing guidelines, home countries must nominate a QAB candidate as per the criteria for QABs. The nominated QABs will then be assessed by a task force on ABIF (comprising the central bank and finance officials of ASEAN countries) who will then approve the nominated QABs based on home country and international standards, e.g., the nominated QABs must be among the top three domestic banks, stable and with good track record, and with an adequate capital level equivalent to Basel III standards. Based on selected QABs, both the home and host countries will negotiate bilaterally the conditions for a QAB to operate as a domestic bank, including a reciprocal agreement on market access and national treatment, as well as prudential and supervisory regulations.[11]

To date, ASEAN has formulated guidelines for a monitoring and reporting mechanism on the progress of bilateral arrangements under ABIF, while baseline intra-regional indicators to monitor progress are being formulated. By the end of 2019, at least two ABIF arrangements and at least two QABs are targeted to be concluded and established, respectively.

[11] Certainly, the actual bilateral negotiations between the host and home countries for the establishment of QABs will be more complicated as they involve bilateral meetings on regulatory landscape scanning and convergence of prudential regulations among banking regulators. In addition, they require consultation meetings and policy dialogues with various stakeholders including the private sector. The progress of bilateral arrangements is also reported to and be monitored by the Task Force on ABIF, which is tasked to periodically assess and confirm new QABs.

ASEAN payment and settlement system

In relation to banking, one critical aspect is the presence of appropriate financial infrastructures like payments and settlements. Thus, under the AFIF, the Working Committee on Payment and Settlement System (WC-PSS) was established in 2011 to implement initiatives that will prepare the ASEAN payment and settlement system to be ready to support the overall financial integration agenda under the AFIF and AEC. This has consequently led to the adoption of the ASEAN Payments Vision, which states that "ASEAN Payments aim to foster integrated, safe, and efficient payment and settlement systems in the region that enable businesses and individuals to make or receive cross-border electronic payments with greater convenience."

Since then the WC-PSS has formulated prioritized policy recommendations in the development and harmonization of an ASEAN payment and settlement system in five areas, namely trade settlement, money remittances, retail payment systems, capital market settlement, and standardization. Each area is handled by a task force that is responsible for preparing action plans to implement the recommended milestones and timelines of the ASEAN Payments Vision.[12]

For example, in trade settlement, the Principles for Product Transparency and Disclosure of Bank Charges were developed and have been implemented in Malaysia, Philippines, Singapore and Thailand. A study on the use of local currency for international trade settlement has been conducted, and revealed, among other things, the potential demand for in the use of renminbi. Malaysia, Singapore, Philippines, Thailand and Lao PDR have appointed renminbi clearing banks and/or entered into bilateral swap arrangements with the People's Bank of China. Meanwhile, Malaysia and Thailand have commenced the operation of a local-currency settlement framework to promote the use of ringgit and baht for settlement of bilateral trade.

With regard to money remittance, the goal is to promote consumer protection, education of migrant workers, compliance with international standards, and infrastructure development for money remittance. To this end, the Basic Principles on the Pre-Departure Orientation Program for Migrant Workers have been developed. The development of an existing APN linkage is also being explored to enable remittance through cross-border fund transfer.

In terms of retail payments system, efforts are underway in Indonesia, Malaysia, Philippines, Singapore, Thailand, and Viet Nam to increase safety in the use of payment cards through the implementation of chip-based cards. The Asian Payment Network (APN) has been encouraged to expand the existing ATM services cash withdrawal and balance inquiry services to include credit transfers and point-of-sale. To date, there are 21 bilateral linkages

[12] When the WC-PPS was established in 2011, five task forces were representing each priority area. However, to better align the activities across various areas, the five TFs were streamlined into three, beginning in 2016. The re-aligned TFs are: TF1 (Payment System Interlinkages and Interoperability), TF2 (Capital Market Settlement), and TF3 (Harmonization and Standardization).

formed between ACHs (involving at least one ASEAN country) via the APN.

Meanwhile, the focus on capital market settlement is to ensure that the discussions on payment and settlement are well entrenched in the various capital market initiatives. Finally, to create awareness on international standards related to payment and settlement, ASEAN is in the process of adopting the ISO20022 as a common standard for fund transfers in the region, with a view to fostering interoperability and enhancing efficiency in cross-border payments.

VI. AEC 2025 Vision of Financial Integration

While financial integration under AEC 2015 has made considerable progress, as the foregoing discussion has shown, it appears that more efforts are still needed to achieve an integrated community. Realizing that regional economic integration is still a work in progress, a new the AEC 2025 Blueprint was adopted during the ASEAN Summit in November 2015, to further consolidate the integration agenda.

Under this new mandate, integration in the financial sector is envisaged under the first characteristic of the AEC Blueprint 2025 – a highly integrated and cohesive economy – where finance remains a critical input in creating a single integrated market and production networks, characterized by seamless movement of goods, services, investment, capital and skilled labor. However, unlike in 2015 where the end-goal was simply the integration of financial markets, the AEC 2025 end-goal now encompasses more different objectives such as financial stability and financial inclusion.

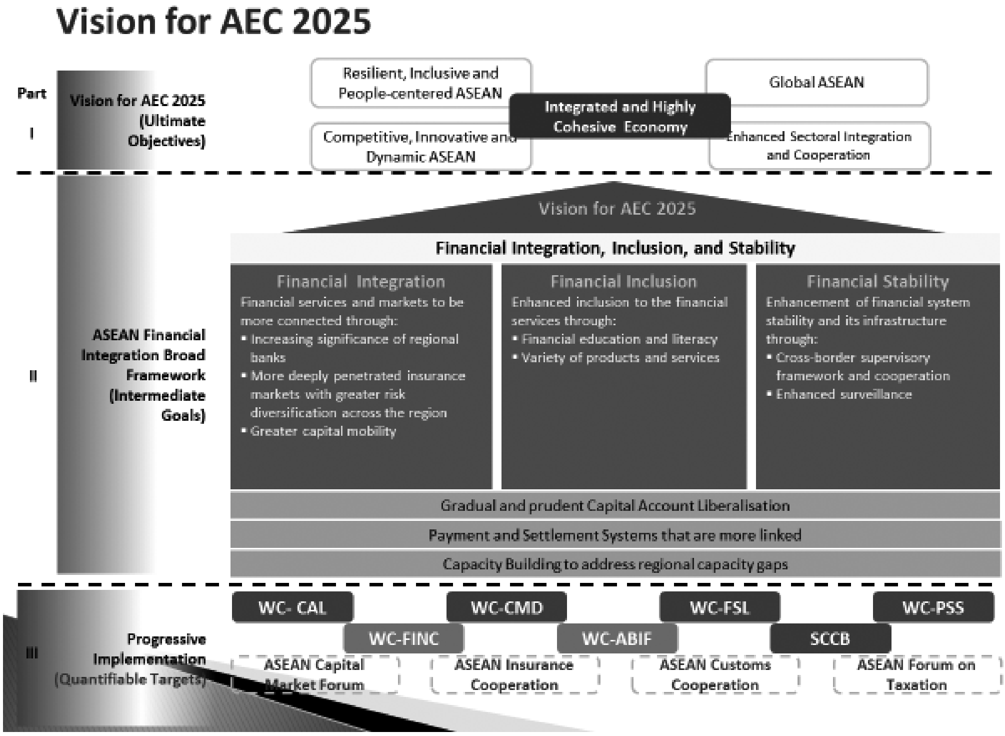
As shown in Figure 8, financial integration is still being pursued in terms of increasing role played by regional banks and more integrated insurance markets, supported by deeper capital markets and greater capital mobility. As ASEAN economies become more financially integrated, a greater variety of financial products and services should be made available to a wider community, thereby improving wide access to the financial system. This financial inclusion can be further achieved through financial education and literacy. Meanwhile, to ensure financial stability, the necessary infrastructure to support regional financial system will be continuously enhanced by ensuring that the necessary cross-border arrangements are in place. These arrangements may cover consolidated supervision, systemic risk surveillance, recovery and resolution planning for regionally systemic banks, and crisis management frameworks.

To implement the AEC 2025 vision of financial integration, strategic action plans are being developed. As can be seen in Table 8, by 2025, ASEAN is committed to strengthening financial integration through various measures, accompanied by key milestones and targets.

VII. Challenges and Risks in Financial Integration

ASEAN economies have become more financially integrated over the past decade. As shown by the foregoing analysis, both de-facto integration and regional agreements under

Figure 8. AEC 2025 financial integration agenda



Source: ASEAN Secretariat (2015). AEC Blueprint 2025

Table 8. AEC 2025 Strategic Actions Plans for Financial Integration 2016-2025

End-Goal	Policy Actions
1. Greater role of Qualified ASEAN Banks	Conclude agreements under ASEAN Banking Integration Framework
2. More integrated financial services sector	Progressive liberalization of financial services under AFAS
3. Interconnected ASEAN stock markets	Enhance ASEAN exchange connectivity to support more trading activity
4. Deep and liquid capital markets	Make available benchmarks, adopt ASEAN Disclosure, make available
	post trade bond prices
5. Improve access to capital markets	Use of contractual clauses in project documents, introduce
	government-bascked risk mitigating back stop
6. Greater private sector engagement	Increased private sector participation during meetings
7. Facilitate cross-border collective investment scheme	Enhance market access of funds under ASEAN CIS Framework
8. Substantail liberalization of capital account	Enhance CAL heat map methodology as a monitoring tool
9. Achieve financial inclusion targets	Public awareness campaign for insurance
10. Promote retail access to bond markets	Granting retail investors access to purchase government bonds
11. Improvements in consumer welfare	Promote efficiency, innovation and use of regional currency
12. Greater coherence of banking regulations to support integration	Enhancing regulatory transparency, standards and coherence
13. Greater regional strength on banking sector	Promoting cooperation on supervisory and crisis recovery/resolution
14. Promote financial stability coordination	Continue publication of financial safeguard measures
15. Maintain financial stability and deepen bond markets	Sharing of risk mitigation mechanisms
16. Convergence of prudential regulation	Consistency in principles of regulation. Compliance to international
	standards, promote appropriate regulatory framework
17. Strengthen policy dialogue on capital flow statistics/measures	Institutionalize policy dialogues on CAL, safeguard measures

Source: ASEAN Secretariat (2015). AEC Blueprint 2025 the AEC have resulted in increasing financial links among countries in the region. Regional initiatives have also been contributing to the deepening of regional financial markets. In fact, by end-2015, ASEAN countries have completed 87% of all measures under the AEC Blueprint, to achieve free flow of services and freer flow of capital in the finance sector.

However, while regional financial integration is clearly increasing, ASEAN economies seem to be more integrated with global financial markets than with their regional neighbors, as suggested both by quantity-based and price-based measures of integration. One reason for this is the limited opportunity for risk diversification within the region. According to the IMF the trade-offs between the benefits of risk sharing and the risks of contagion from greater financial integration are found to be less favorable in Asia, and in particular among ASEAN economies, than in advanced markets. This echoes the previous findings regarding why financial integration within ASEAN is lagging.

However, while the quality of financial integration varies across ASEAN countries, the upshot is that the quality of financial integration can be improved, thereby making financial markets more resilient in the face of shocks external to the ASEAN region.

Aside from limited risk diversification, the absence of adequate liquidity in the region forces domestic investors to access the major financial centers elsewhere. The lack of adequate financial infrastructure links in the region (such as payments, settlement, and clearing) is also a concern, since it limits the movement of capital and investment across countries. Another challenge is the gap in regulatory quality among countries particularly the need to harmonize/maintain minimum standards and regulations. There is a need to increase the transparency and quality of regulations to enhance investor confidence. Finally, non-supervisory restrictions on the access of foreign intermediaries to domestic financial markets should be reduced or eliminated to encourage more competition and enhance market efficiency.

Since financial integration is a market-driven process, it is only logical that regional institutions be developed over time to enforce rules and monitor the progress of implementation. ASEAN has taken steps to develop its institutional support for integration, including the development of an enhanced dispute settlement mechanism. But more steps are needed. One critical form of institutional support is the strengthening of the mechanism for private sector consultation. Formal consultations with private sector and regional authorities may still be used, but new strategies to involve the private sector in the integration process should be explored. This involves having regular consultations with market players particularly in communicating changes in regulations related to the market. At the same time, there should be greater coordination among agencies in the country to ensure that important regional and national initiatives affecting the financial markets are clearly communicated with key market players.

VIII. Conclusion: Opportunities and Moving Forward

Against this background, it is important that policymakers in ASEAN continue to take concrete measures to deepen financial integration in the region. So far the various initiatives, such as the development of Asian bond markets and other capital markets have already led to a notable expansion of the investor base. But more is needed. Combining these initiatives and on-going efforts to establish a more integrated economic community by 2025, through measures that facilitate free flows of goods, services, investments and skilled labor, along with market measures like deepening liquidity, can help ensure that the benefits of financial integration are maximized for ASEAN.

Therefore, it is important that **policies that promote the development of financial markets should continue to be a priority**. Major policy options include, for example, developing harmonized market standards and rules, to engender financial development via, for example, facilitating the creation of institutional investors, and region-wide portfolio investments, strengthening trading rules and platforms, improving payment and settlement, and harmonizing accounting standards and regulations. The on-going initiatives in ASEAN are encouraging, but more efforts are needed to ensure that these initiatives achieve their end-objectives of deeper financial integration.

Second, to ensure that deeper financial integration is realized by 2025 and beyond, **ASEAN should aim to strengthen the implementation of programs at the national level**. ASEAN member states have been urged to ensure that regional commitments are transposed into national commitments through appropriate domestic processes. It is crucial to build the capacity of member countries to participate in the integration process by ensuring that integration milestones are consistent with their specific economic conditions and constraints, to enable policymakers to follow through on their commitments.

Third, given the limited degree of financial integration in the region, **the monitoring of regional financial integration should be pursued with greater urgency**. Although policy makers in the region have shown their political support and commitment, obstacles to deeper financial integration need to be continuously addressed to ensure that the various milestones and targets are being met. The establishment of the ASEAN Integration Monitoring Office within the ASEAN Secretariat is a step in the right direction, but this has to be complemented by well-developed mechanisms at a country level to ensure that monitoring is effectively carried out both at the country and regional levels. More systematic monitoring reports need to be developed to help identify obstacles to fostering more financial integration in ASEAN.

Finally, since regional financial integration is not an end in itself, but a policy instrument designed to achieve development goals, **greater macroeconomic and policy coordination is needed**. In this regard, there is a need to promote convergence in macroeconomic policy objectives, such as through regional surveillance, peer review, policy discussions, and market consultations. In particular, the coordination of trade and financial policies is crucial to ensure that both kinds of policies support each other. It goes without saying that both financial and trade integration should go hand in hand. To facilitate trade, financial instruments are needed to hedge the risks of trade and investment flows. In the same way, financial integration is needed to facilitate specialization and exploitation of economies of scale, which are related to trade. Without significant integration of financial systems, deeper integration of trade and investment is unlikely to happen.

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