

ASIAN SHADOW FINANCIAL REGULATORY COMMITTEE

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Financial Integration in the Asia-Pacific Region

Regional financial integration is seen as an important way to promote an efficient allocation of resources supportive of economic development and financial stability in a region. The creation of a regional bond market became a popular subject of discussion among financial policymakers after the East Asian financial crisis in 1997-1998. The abrupt reversal of capital flows over a span of several months raised questions about the wisdom of relying on short-term bank financing from outside the region, and the need to set aside a sufficient amount of foreign reserves to prevent or mitigate the adverse consequences of such sudden capital outflows. Capital outflows from the region during the crisis amounted to slightly over US\$100B, equivalent to nearly 5 percent of the pre-crisis domestic savings in the five leading economies of the region. In contrast to the events during the East Asian financial crisis, as of March 2004, the total amount of foreign exchange reserves accumulated by the economies in the region exceeded \$2.1 trillion. There is concern about the continuing accumulation of foreign reserves in the region because they reflect a serious trans-Pacific current account imbalance. Concern among policymakers about using these savings to advance the economic growth of countries in the region through the development of efficient primary and secondary markets has led to several Asian Bond Market Initiatives.

The Asian Bond Market Initiatives have been spearheaded by a number of public-sector organizations, including:

- A 17-member Asian Cooperation Dialogue (ACD) which promotes public awareness of various related initiatives to secure public support;
- The APEC Regional Bond Market Development Initiative;
- The ASEAN+3 Initiative which is designed to facilitate access to the market by a wide variety of issuers and create an environment conducive to developing bond markets;
- The Asian Bond Fund (ABF) Initiative by the 11-member Executives' Meeting of East Asia Pacific Central Banks (EMEAP); and
- The Pacific Economic Cooperation Council (PECC) Finance Forum Initiative for Asian Bond Markets.

EMEAP's ABFs are schemes whereby economies in the region contribute foreign reserves to a fund managed by the Bank for International Settlements which then purchases dollar- and local currency-denominated bonds issued by governments and quasi-sovereigns in the region. These initiatives represent an important step for increasing the demand for such bonds.

Asian Bond Market Initiatives spearheaded by ASEAN+3 are focused on upgrading and harmonizing in domestic markets rating practices, accounting standards, insolvency procedures, regulatory and supervisory procedures. The Asian Basket Currency Bond Corporation which has been considered by ASEAN+3 may be an interesting first small step for exchange rate coordination among participating economies.

The proposed Asian Bond Bank considered by the PECC Finance Forum is a promising first step towards operationalizing credit enhancement and credit guarantee mechanisms for both domestic and regional market development of fixed-income securities.

ASFRC members observe the following realities of domestic and regional market activities:

- The role of bond markets in mobilizing domestic resources remains limited in the region which is characterized by bank-based financial systems.
- The development of domestic bond markets is still at an early stage in some East Asian Economies.
- The public sector has been the driving force of the Asian Bond Market Initiatives although private sector participation is critically important.
- Foreign investment in domestic bond markets in Asia remains insignificant, while the participation of foreign institutional investors is essential in developing domestic and regional markets.
- The supply of fixed-income securities is limited in both domestic and regional markets because of a small number of issuers with high credit ratings.
- Small- and medium-sized enterprises have limited access to both capital market financing and bank financing whereas they account for the majority of economic activities in each of East Asian Economies.
- Regional and global bond market activities are more integrated than normally acknowledged.
- Asian borrowers tend to use global financial centers rather than Asian financial centers.

An important issue to be addressed is whether countries in the region are better off pursuing measures to enhance regional financial integration versus attempting to become more integrated with global financial markets. To further the goals of the ASEAN+3 Initiative, for example, efforts are being directed toward the creation of standardized debt instruments, the establishment of regional ratings agencies, settlement systems, etc. These measures raise the cost of issuing bonds by requiring an additional financial infrastructure even as they attempt to increase regional financial integration. Liberalization of capital markets by individual countries to access global markets is a more efficient way for emerging markets to raise funds. This requires not only strengthening domestic financial institutions and regulatory agencies but also harmonizing regulatory regimes across countries based on global standards.

The desire to use the foreign exchange reserves in the region for the development of economies in the region through the redistribution of reserves by a scheme such as the ABF needs to be assessed. One issue is the optimal way to finance investment in emerging markets. It is less costly to raise funds in the global financial market in which the necessary financial infrastructure already exists. The small amount involved in the ABF schemes suggests that it neither provides a stable source of development funds for the region nor allows a large amount of dollar reserves from the region to be recycled elsewhere. Furthermore, from the perspective of central banks or governments in the region, purchasing US Treasury securities may be a better strategy rather than investing their dollar reserves in emerging market securities.

In view of the foregoing, East Asian Economies should be realistic in their expectations on the outcomes of the Asian Bond Market Initiatives because:

- The regional financial architecture will evolve over a long period of time;
- Coordination of monetary, fiscal, and exchange rate policies may take even longer;

- Any attempt in economies with bank-based financial systems to eliminate hurdles impeding regional bond market activities and harmonization of the legal and regulatory framework may face political resistance from establishments favoring the status quo.

The ASFRC believes that the development of domestic bond markets is better served by market-based reforms and strengthening institutions in individual economies than by the narrow pursuit of regional integration of financial markets.

Major Recommendations

- a. East Asian Economies should strive to liberalize their capital accounts and eliminate legal and institutional impediments to facilitating access to global markets rather than to create sheltered regional bond markets. A regional bond market must be a part of the global market rather than being a segmented and isolated market.
- b. East Asian Economies should strengthen domestic market institutions and build the necessary financial market infrastructure to support the development of domestic bond markets.
- c. To ensure a more stable supply of funds for the development needs of the region, from a short-term perspective, the regional market initiative should focus on a more realistic and practical agenda of credit enhancement and credit support for small- and medium-sized enterprises and for bridging the credit gaps of sovereign and quasi-sovereign borrowers.
- d. From a long-term perspective, a formal policy dialogue is needed among East Asian Economies for cooperation on fiscal, monetary, and exchange rate policies, and capital account and trade liberalization. Existing policy dialogues are partial in terms of covering either geographical or policy issues.