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Financial Integration in Emerging Asian Economies

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Abstract. Financial integration in emerging Asia proliferated since the financial crisis in 1997-1998. However, its progress still considered slow as compared to those European economies. East Asia focuses its financial integration with global economies rather than with regional economies. Overall, financial integration could bring both benefits as well as costs. For instance, it helps in improving risk-adjusted growth and lowering systematic risk but in the meantime created "domino-effects". Few policies are recommended in order to enhance the effectiveness of financial integration as well as the markets such as accelerating capital market development, management control of cross-border portfolio investment as well as enhancing regional safety networks.

Keywords: Financial integration, costs and benefits, emerging Asia and policies

1. Introduction

Financial integration in emerging Asia proliferated since the financial crisis in 1997-1998. The first Asian Bond Fund (ABF) was established in 2003 followed another creation in 2005. Asian bond markets continue to grow but still require a long journey before achieving the resilience of US treasury markets. There are also international reserve swaps and repurchase agreements for emergency assistance from bilateral to multilateral. For instance, Chiang Mai Initiative was established in 2000 which consists of ASEAN+3 nations (Rose, 2012).

2. Financial Integration Trends in Emerging Asian Economies

Most scholars mention that Asia's financial integration still remains lower compared to those in Europe. East Asia focuses its financial integration with global economies rather than with regional economies (Jeon, Y., & Yang, 2005). Economic performance in East Asia was measured using stock price index to explore the extent of global and regional integration. Results show that East Asian economies still subject to asymmetric shocks even after years of liberalization and regional integration compared to European nations. Another study regarding economic growth in East Asia was conducted using data at aggregate-economy and micro-firm levels. Results show that trade openness and FDI inflows particularly in the 1970s and 1980s have a positive effect on GDP growth (Ahn & Lee, 2007). The Asian region's aggregate savings tend to exceed its aggregate investment. However, most of the savings are invested outside the region, especially in more advanced economies (Park & Lee, 2011).

Two major financial integrations are Chiang Mai Initiative (CMI) and Asian Bond Markets Initiative (ABMI). CMI was first conceived on May 2000 at the 33rd Annual Meeting of the Board of Governors of the Asian Development Bank (ADB) in Chiang Mai, Thailand. It is a multilateral currency swap arrangement among the ten members of the ASEAN, the People's Republic of China, Japan, and South Korea. Furthermore, ASEAN+3 Finance Ministers agreed in May 2006 to have CMI Multilateralisation (CMIM) to enhance the effectiveness of Bilateral Swap Agreements (BSAs). While ABMI was launched in 2003 which aimed to develop and deepen local currency bond markets in ASEAN+3 countries and to establish a proper functioning regional bond markets for issuers and investors.

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Table 1.0 summarizes the major development of Chiang Mai Initiative (CMI) and Agreement on the Asian Bond Markets Initiative (ABMI). Figure 1.0 shows in and out financial flows in emerging Asia economies. Even though various restrictions imposed on cross-border capital flows, capital accounts in Asia still appears to be fairly open due to the increasing amount of financial flows. Figure 2.0 demonstrates Foreign Direct Investment Inflows in emerging Asian nations. It shows that the People's Republic of China (PRC) as dominant recipient within the region, receiving about 44% of the region's FDI flows in 2007–09.

3. Pros and Cons of Financial Integration

Portfolio diversification could allow idiosyncratic risks sharing across countries, insurance facilitation of income against country-specific shocks and consumption smoothing over time (Garcia-Herrero, Yang, & Wooldridge, 2008). Financial integration is also said to bring direct and indirect benefits which consist of improving risk-adjusted growth, growth opportunities and lowering systemic risk (Nicolò, Gianni, & Juvenal, 2010). Besides that, type of external assets and liabilities as well as on the countries' characteristics could influence the effects of financial integration on economic growth. Those countries with good institutions and developed financial markets could benefit more from financial integration (Osada, Mitsuhiro, & Saito, 2010).

However, financial market integration also causes risk that relates to the "domino effects" - real exposures on participants operating in other segments and inaccurate information received. Market segment can be easily transmitted to other markets and potentially poses systemic instability. At the global level, high degree of capital flows' concentration and misallocation may impede economic growth and worsen domestic distortions. It may also cause the loss of macroeconomic stability; pro-cyclical nature of short-term capital flows and the risk of sudden reversals (Dadush, Uri, Dasgupta, & Ratha, 2000).

4. Policies Implications and Suggestions

4.1. Accelerate Capital Market Development

Authorities in charge should prepare a detailed blueprint and concrete action plan for Asian bond markets development both at the national as well as regional level. They should also launch Asian common (offshore) bond markets as soon as possible in some countries within the region with developed bond markets (Jang, 2011).

Furthermore, Asia should enhance cross-border payment and international links of settlement systems in order to achieve more efficient resource mobilization. This initiative could also support the use of savings within the region and rebalance financial resources toward regional development (Arner & Schou-Zibell, 2010).

4.2. Management Control of Cross-Border Portfolio Investments

Those markets with a relatively large financial system and are open to foreign investors like Korea felt the recent crisis first and most intensely. Supervision and regulatory frameworks need to be improved in these countries to reduce the negative effects of sudden reversals in capital flows (Eichengreen, 2010).

4.3. Enhancing Regional Safety Networks

The regional liquidity support mechanism (CMI/CMIM) promoted by the ASEAN+3 has well progressed during the last two years. However, there is a need to enlarge the size of the fund for sufficient liquidity support, and make CMIM more flexible and functional in practical application (Jang, 2011).

Moreover, new facilities such as the ASEAN+3 Macroeconomic Research Office (AMRO) and Credit Guarantee and Investment Facility (CGIF) should be established to achieve optimal functioning. The AMRO must works not only as a subsidiary of the CMIM but also as a leading institution of regional financial architecture and to be an effective surveillance mechanism in the region. Besides that, member nations should share and enhance information channels among themselves to improve AMRO's effectiveness and minimize the costs due to information asymmetries (Kim & Yang, 2010).

5. Conclusion

East Asia seems to focus on regional trade liberalization than enhancing in financial and monetary development. Overall, financial integration could bring long run benefits include greater risk diversification, efficient capital allocation; attract foreign investment and so on. However, transaction costs could increase due to information asymmetries.

Lastly, emerging Asian economies should establish local currency bond markets in order to efficiently channel the region's enormous resources; to moderate the global shortage of sound and liquid financial assets and reduce the probability of currency depreciation. This initiative is believed to lessen the huge inflows into US debt securities; reduce dependence on foreign currency debt and its currency mismatches for those economies with low foreign reserves (Park & Lee, 2011)

Table 1: Major Progress of CMI and ABMI

Major Progress on CMI/CMIM	**Major Progress on ABMI**
• Agreement to promote the CMI (May 2000) • CMI multi-lateralization (CMIM) (May 2006) • Enlarged to US$120 billion swap agreement; establishment of an independent and regional surveillance unit called ASEAN+3 Macroeconomic Research Office (AMRO), and a potential increase in the IMF de-linked portion above the current limit of 20 percent • Agreement on all the main components of the CMIM—including the individual country contributions, borrowing accessibility, establishment of an advisory panel of experts in addition to an independent surveillance unit • CMIM agreement signed on 28 December 2009 and took effect on March 2010.	• Agreement on the Asian Bond Markets Initiative (ABMI) (August 2003) • Issuance of cross-country primary collateralized bond obligations (CBOs) (December 2006) • New ABMI Roadmap focused on (i) promoting issuance of local currency-denominated bonds, (ii) facilitating demand for local currency denominated bonds, (iii) improving regulatory frameworks, and (iv) improving bond markets-related infrastructure • Agreement on establishment of the Credit Guarantee and Investment Facility (CGIF) • Establishment of the Asian Bond Market Forum (ABMF) (September 2010)

Source: Author's compilation from ASEAN+3 Finance Ministers' Meeting Statements, various years Available at: http://www.aseansec.org/

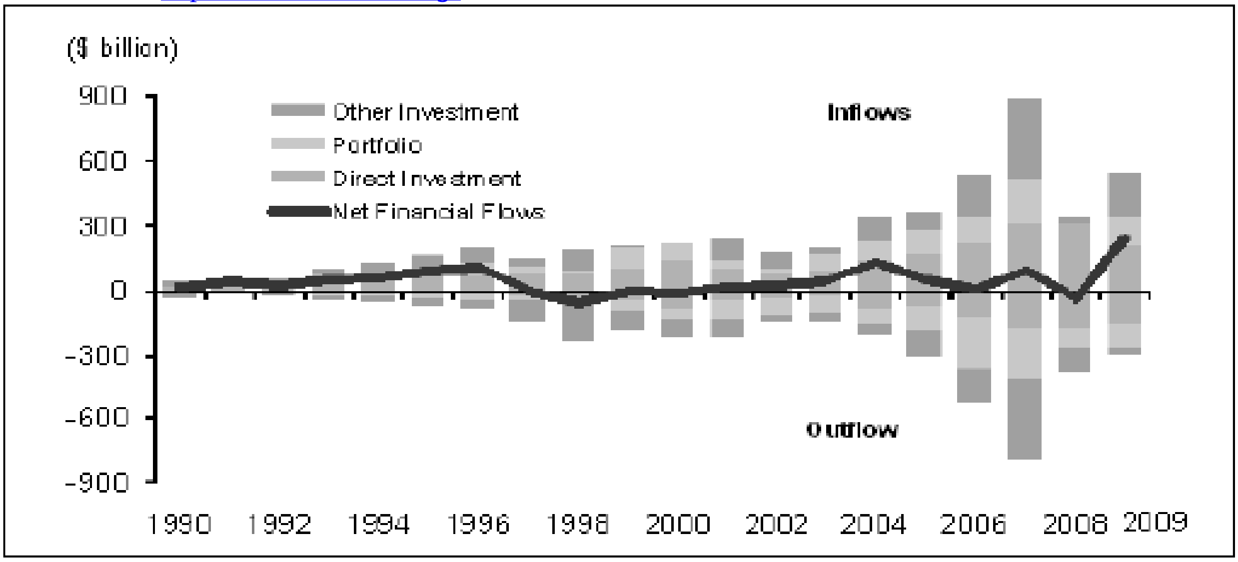

Figure 1: Financial Account Flows (Emerging Asia)

Emerging Asia includes the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam.

Note: Data for Hong Kong, China and Viet Nam start in 1998 and 1996, respectively.

Other investments include financial derivatives.

Source: (Park & Lee, 2011) - calculations using data from International Financial Statistics and World Economic Outlook Database, International Monetary Fund

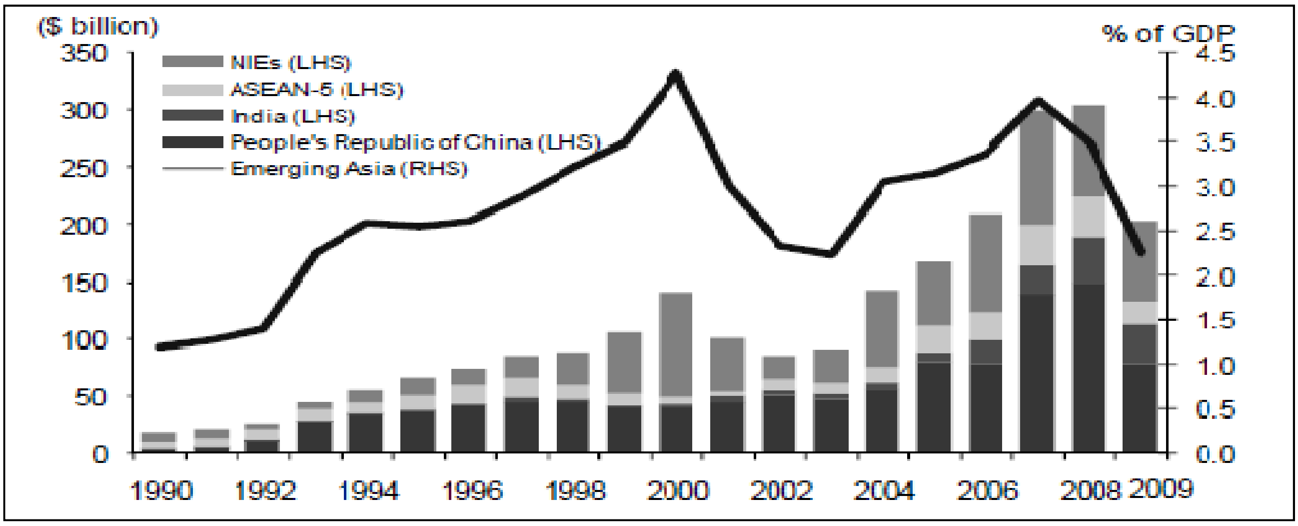

Figure 2: Foreign Direct Investment Inflows (Emerging Asia)

ASEAN = Association of South East Asian Nations. ASEAN-5 = Indonesia; Malaysia; the Philippines; Thailand; and Viet Nam. Emerging Asia = the People's Republic of China; Hong Kong, China; India; Indonesia; the Republic of Korea; Malaysia; the Philippines; Singapore; Taipei, China; Thailand; and Viet Nam. NIEs = newly industrialized economies. It includes Hong Kong, China; the Republic of Korea; Singapore; and Taipei, China.

Source: (Park & Lee, 2011) – calculations using data from International Financial Statistics and World Economic Outlook Database, International Monetary Fund.

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