



ASIAN FINANCIAL INTEGRATION: GENERATING SUSTAINABILITY WITHIN THE REGION

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1.0 Preamble

Greater regional financial integration, as an essential part of closer regional cooperation, is vital for funding Asia's vast development initiatives. A primary goal of schemes implemented to foster regional integration is to narrow the development gaps between the different participants and bring about a regional cohesiveness by optimizing the deployment of resources. Regional cooperation assisted by a regional financial architecture would be able to assist in narrowing these development gaps and strengthen through physical connectivity, the ability to finance high priority infrastructure projects in regions lagging behind and in those with missing links in connectivity.

One of the reasons that the region's Central Banks invested their growing savings and foreign exchange reserves in United States treasury bills was this precise lack of a well-developed regional financial architecture. A well-developed regional cooperative structure would not only help prevent and manage crises, but also assist in closing the infrastructure development gaps and unleash the potential aggregate demand in the region's lesser developed partners. In addition, it would allow Asian investors to reach other markets in the region and thereby divert funds from economies of surplus to those short of capital. With an inherent knowledge of the risks and rewards associated with investment opportunities existing within the region, the players in local markets will be more adept at the efficient allocation of resources when compared to outsiders. In addition, the implementation of global financial standards, stronger regulation and oversight would also help create competition and reforms in domestic markets.

Therefore within this context, this paper begins by looking at the current status of financial markets and financial integration in the Asian region. It then examines the existing initiatives of financial cooperation underway within the region and the progress that has been made so far. The paper will also discuss issues and challenges in developing and integrating financial and capital markets of the region to facilitate more intra-regional capital flows, and the way forward towards greater regional financial integration. The overview provided here is based on ADB (2010) and ESCAP (2011).



2.0 Development of Asian Financial Markets

The promise of regional financial integration hinges to a great extent on the stability of Asia's financial markets as well as their ability to effectively handle the region's vast domestic savings. By and large, Asian economies have rallied since the 1997/1998 financial crisis, but while they are more entrenched and stronger, they are still relatively underdeveloped. The recent global financial crisis illustrated that Asian financial systems are intermittently linked with global ones and that a healthy national balance sheet, including high domestic savings, low foreign debt and large foreign reserves, will not be able to shelter Asia from crises occurring outside the region.

Following the Asian financial crisis of 1997-98, authorities across the region focussed on the development and restructuring of the banking sector and to a certain degree, on building capital markets and as a result, many of the region's countries have made progress on reforming their banking systems – the incidences of non-performing assets have fallen and the return on assets has risen. In addition, supervisory and regulatory regimes have been strengthened and internal governance has been improved. Most countries have gone further by allowing foreign banks to open branches, thereby increasing competition and motivating innovation. Despite these steps forward, bigger leaps need to be made as banking systems remain vulnerable to the fluctuations in the global financial market as well as to the weakness of domestic institutions and regulations.

Capital markets, on the other hand, have developed differently. One group of more sophisticated markets, i.e., Hong Kong, Republic of Korea, Malaysia and Singapore, have been more successful at reforming and entrenching the domestic bond markets as well as to some extent, at strengthening their equity markets. In Central Asia, Kazakhstan's financial system can also be considered to be relatively well developed. However in the rest of Asia, as illustrated in Table 1, capital markets have developed at a much slower rate and their financial systems remain largely dominated by banks. Three main factors have been identified as having affected progress: 1) fiscal deficits in many countries, 2) an inability to reform and restructure contractual savings institutions, and 3) a reluctance to allow foreign financial intermediaries to help build markets.

Table 1: Structure of Financial Systems in Selected Asian Economies (% of GDP)

Economy	Bank Deposits		Equity Market		Bond Market		Insurance Premiums		Total Financial Assets	
	1990	2006	1990	2006	1990	2005	1990	2005	1990	2005/06
PRC	75.6*	177.8	2.4*	60.4	5.9	34.1	0.8	2.7	84.7	275.0
India	31.4	53.2	10.4	76.2	19.8	33.0	1.5	3.2	63.1	165.6
Indonesia	30.0	34.7	4.5	30.4	0.1*	20.3	0.9	1.5	35.4	87.0
Korea	32.6	66.1	48.2	88.2	44.3	102.0	11.0	10.5	136.1	266.8
Malaysia	80.6	115.9	100.7	141.0	69.9	90.5	3.0	5.6	254.2	352.9
Pakistan	23.6	34.0	6.7	35.8	29.0*	29.7	0.8	0.7	60.0	100.2
Philippines	24.7	46.7	20.6	46.7	25.8*	38.9	2.0	1.5	73.1	133.8
Thailand	62.9	93.9	29.2	64.3	9.8	41.3	1.7	3.6	103.6	203.1
Hong Kong	205.6*	251.5	105.2	527.9*	1.5	27.7	3.0	9.9	315.3	817.1
Japan	177.3	190.4	122.6	93.2*	86.4	191.5	8.5	10.6	394.7	485.6
Singapore	74.3	107.5	95.9	163.5*	27.7	57.8	3.0*	8.8	201.0	337.6
Taipei, China	-	-	104.6	134.8*	16.6	55.9	-	14.2	121.2	204.8

Notes:

- data not available.

Source: ADB 2010, using data from the Financial Structure Database, CEIC.

CEIC = China Economic Information Center; GDP = Gross Domestic Product;

PRC = People's Republic of China.



* PRC and Hong Kong, China 1990 bank deposit data from CEIC. Viet Nam 2006 bank deposit data for 2005. PRC 1990 equity market data for 1992. Hong Kong, China; Japan; Singapore; and Taipei, China 2006 equity market data from 2005. Pakistan and Philippines 1990 bond market data do not include private bonds. Indonesia 1990 bond market data for 1991. Hong Kong, China 1990 insurance premium data from CEIC is for 1991.

Asian economies have strengthened their balance sheets and have become more enduring of external shocks through the sustenance of current account surpluses and the accumulation of foreign currency reserves. However, this very same factor i.e., the build-up of reserves, reflect the inability of the region's financial system to handle funds effectively. Surplus savings have instead, been channelled through US and European financial centres after which they are often reinvested in Asia. Hence, Asia has become not only a major exporter of capital, but also the biggest recipient of private capital inflows. In the event that Asia's financial markets and institutions could be more developed, a significant portion of the region's savings could be directly channelled into productive investments, including infrastructure, within Asia itself, while at the same time offering higher returns to savers. Therefore, it remains clear that Asia needs to redouble its efforts to develop national and regional capital markets – with special emphasis on bond markets.

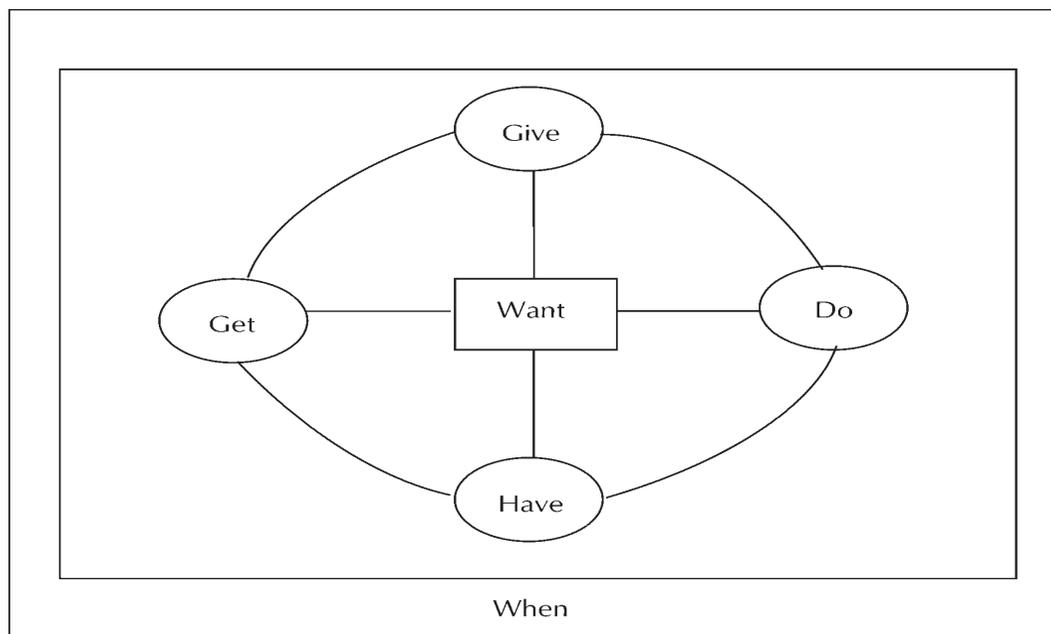
3.0 Financial Integration in Asia

Despite the increase of trade and investment integration, particularly across East Asia – encouraged by the development of regional production networks, the region remains far less integrated financially. In fact, most Asian financial markets are more closely integrated with those in the US and Europe than they are with their regional neighbours. This is hardly surprising when you consider the fact that the domestic finance sector remains underdeveloped as a result of decades of bank dominated financial intermediation and government directed lending.

There are two broad measures that exist to determine the extent to which markets are financially integrated: 1) price indicators, and 2) quantity-based. After adjustment for risk, assets that are traded freely across a region should be priced similarly because greater financial integration should be accompanied by a closer co-movement of prices. This in turn, results in a higher share of financial assets being traded within the region and therefore held by regional investors. Price convergence can be measured by looking at the coefficient of variation of bond and money market rates.¹ The variation of bond market, lending market and money market rates have declined since the early 2000s to 2007, suggesting that financial integration in Asia has deepened (as illustrated in Figure 1). A sharp increase observed in 2008/9, however, gives rise to some concern.

¹Coefficient of variation is a measure of dispersion calculated as the standard deviation of bond market rates divided by the mean.

Figure 1: Variation Coefficient of Bond Market, Lending Market and Money Market Rates in Asia, 2000-2009



Sources: Asia Regional Integration Centre, using data from Bloomberg. [<http://aric.adb.org/indicator.php>].

Note: The coefficient of variation measure is calculated for ASEAN, ASEAN+3, Asia, East Asia, Emerging East Asia-14, East Asia-15, NIEs-4, SAARC, and Southeast Asia.

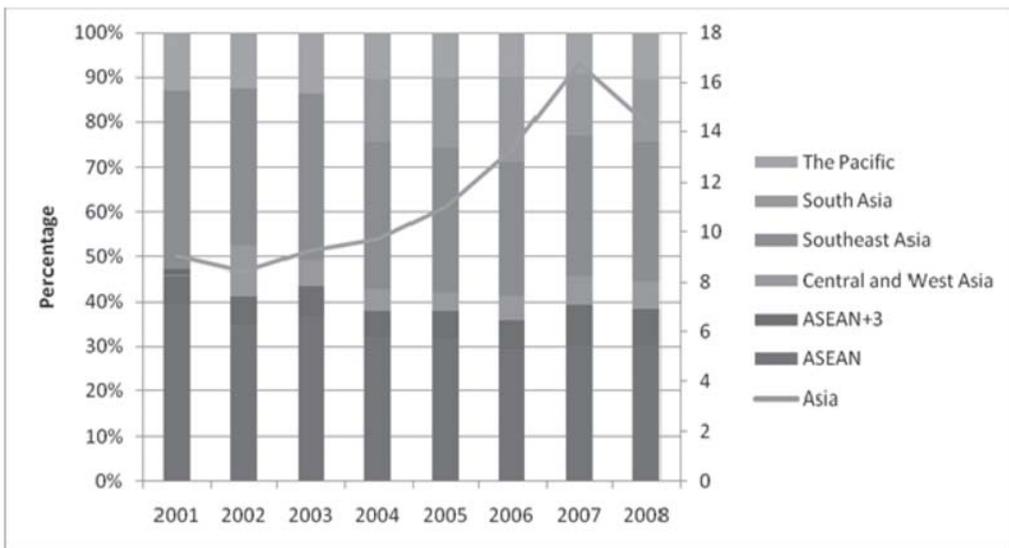
Nonetheless, it is encouraging to note that price convergence in terms of yields on financial assets gives a positive picture. According to the ADB (2010), the variation of cross-market yield spreads between long-term government bonds and US treasuries have sharply declined from 1.28 in April 2001 to 0.6 in April 2007.² At the beginning of the global credit crisis in 2007 yield spreads spiked again, however, since then they have declined to a certain degree.

Equity returns, despite their divergence during the recent crisis, have now converged to some extent, as well. The crisis underscored the interconnectedness of and spillovers between the global, regional and national price movements. Since Asian equity markets have a relatively high level of foreign participation, they remain susceptible to sudden shifts in capital flows as well as developments in the US market. According to the ADB (2010), while correlations between Asian and US stock markets have increased over time, the relationships between the individual Asian markets have increased even more.



Regional financial integration is increasing according to quantity indicators as well. Figure 2 shows how portfolio shares have evolved between 2001 and 2008 within the region.³ Despite a marginal decline to 14 per cent in 2008 - reflecting the impact of the global economic crisis, the share of portfolio assets in Asia have almost doubled from 9 per cent in 2001 to 17 per cent in 2007. Similarly, the contribution of portfolio assets to the region have increased from ASEAN+3 (6.4 per cent to 12.4 per cent), Central Asia (0 per cent to 9.4 per cent) and Southeast Asia (40.8 per cent to 43.4 per cent) between 2000 and 2007. South Asia however, is a notable exception, where the shares have declined from 26.4 per cent in 2006 to 17.8 per cent in 2008. Figures for the years 2009 and 2010, unfortunately, are not as yet available – although they are expected to reflect the strong recovery made by the Asian markets, post-global economic crisis.

Figure 2: Portfolio Share in Asia and Asian Sub-regions (Percentage, 2001-2008)



Sources: Asia Regional Integration Centre, using data from Bloomberg and IMF Coordinated Portfolio Investment Survey. [<http://aric.adb.org/indicator.php>]

Notes: The line graph for Asia refers to the portfolio assets in Asia as a percentage of total Portfolio assets. For the Sub-regions, the bar values refer to each Sub-region's share of portfolio assets out of total assets in Asia.

²The value declined from 1.28 in April 2001 to a low of 0.6 in April 2007 and increased to 1.15 in late 2008 and 0.85 in December 2009.

³Portfolio share is the percentage of intra-regional portfolio assets to total portfolio assets held by countries in the region. A higher share indicates a higher degree of integration.



Asia includes the 47 regional member countries of ADB. However, data is available only for a sub-set of countries. Data for South Asia is available only from 2004.

Price indicators, however give a mixed picture because where bond (and money) markets rates have increased in the recent past, bond yield rates have declined. Quantity indicators show that while financial integration in Asia has generally risen in recent years – it still remains low, reflecting the fact that Asian markets remain more strongly integrated with global ones than with each other. This is in part as a result of the underdeveloped nature of various national markets and a lack of institutions. Several studies have suggested that this is also as a result of the wide disparities that exist between the income levels of different partners within the region as well as the policy variables. Therefore in order to improve the integration of the region's financial markets, financial cooperation among Asian countries needs strengthening.

4.0 Existing Initiatives of Financial Cooperation

The importance of a regional financial architecture led to the setting up of the Asian Development Bank (ADB) by the members of ESCAP in the mid-1960s, as a regional multilateral development bank to provide its member states with development financing. In addition, the ESCAP framework also created the Asian Clearing Union, which was set up in the mid-1970s to facilitate intra-regional trade through the periodic settlement of debits and credits accumulated by each member against the other members, using a unit of account. However, it was only in 1997, in the aftermath of the Asian financial crisis, that the emphasis was placed on regional financial integration and cooperation. Since then, several notable initiatives have been launched, particularly the Asian Bond Markets Initiative (ABMI),⁴ the Asian Bond Funds (ABF), and the Chiang Mai Initiative.

4.1 Regional Bond Markets

A major outcome of the policy discussions of the post-1997 East Asian financial crisis focussed on the development of regional bond markets as a method for financial cooperation. These could provide a relatively more stable source of debt financing than bank loans and two initiatives have been taken in this regard.

⁴This was a primary initiative under the financial cooperation of Asian Cooperation Dialogue set up in 2002.



4.2 Asian Bond Fund

This fund was established with the aim of further enhancing the underdeveloped bond markets of the member economies by enhancing the efficiency of financial intermediation while promoting financial stability, by the Executives Meeting of East Asia-Pacific Central Banks (EMEAP), an association of the Central Banks of several economies in the region (Australia; China; Hong Kong; Indonesia; Japan; the Republic of Korea; New Zealand; the Philippines; Singapore; and Thailand). The first stage of the fund was launched in 2003 with the members of EMEAP voluntarily contributing towards a US\$1 Billion fund which invested in bonds denominated in the dollars issued by sovereign and quasi-sovereign borrowers from eight EMEAP members, and was managed by the Bank for International Settlements. (BIS) The second stage of the fund, which was launched in 2005, invested US\$2 billion in local currency bonds issued by sovereign and quasi-sovereign borrowers from eight EMEAP members. In addition, a further US\$2 billion have been allocated for the Pan Asian Bond Index Fund, which again, invests in local currency sovereign and quasi-sovereign bonds. The remaining funds have been allocated to eight individual market funds that invest in their respective local-currency bond markets, including sovereign and quasi-sovereign issues.

4.3 Asian Bond Market Initiative (ABMI)

This initiative was launched in 2003 by ASEAN+3 to develop local currency bond markets to make private savings available for regional investment needs. The Asian Bond Market Initiative involved the promotion of domestic reforms to help expand the size of nation and regional bond markets, attracting regional and foreign investors, and strengthening bond markets' infrastructure. Specific working groups, within the first five years after the creation of ABMI, addressed issues

Box 1: Credit Guarantee and Investment Facility

An important outcome of ABMI and the collaboration between ASEAN+3 and ADB, which was gradually developed since 2005, was the establishment of the Credit Guarantee and Investment Facility (CGIF). As a trust fund of the ADB, the ASEAN+3 Finance Ministers approved the creation of the credit guarantee and investment mechanism in Bali, in May 2009. The CGIF facility was approved by the ADB's Board of Directors in April 2010, with an initial capital of US\$ 700 million. The 10 ASEAN countries will contribute US\$ 7 million each, while the ADB will contribute US\$ 130 million. Japan and the PRC will contribute US\$ 200 million each while the Republic of Korea will contribute US\$ 100 million.

The CGIF's goal will be to promote the development of Asian bond markets by providing guarantees for investors and make it easier for firms to issue local currency bonds with longer maturities. In the long run, it is expected to promote the reconciliation of standards and practices for bond issuance in the region and help mobilize its savings to finance long-term investment in local currencies, particularly for regional infrastructure as well as other key areas. This, therefore, will make great headway in the drive towards regional financial market integration and make Asia less vulnerable to external shocks while boosting economic growth.

Source: ADB, 2010.

such as establishing a credit guarantee mechanism, strengthening domestic credit rating agencies, disseminating information on national and regional bond markets and policies, assessing the feasibility of a regional foreign exchange clearing and settlement system, and creating new securitized debt instruments. In addition, a data and information portal named AsianBondsOnline was created as a one stop hub for institutional investors. These efforts have to be supported by relevant infrastructure and regulatory frameworks and in this connection, the recently endorsed credit guarantee and investment facility by ASEAN+3 can be considered an important development (see Box 1). These initiatives are expected to help channel money for regional investment needs and reduce the currency and maturity mismatches – issues that made the region more vulnerable to external shocks in the past.

4.4 The Chiang Mai Initiative (CMI)

The CMI was developed to establish a system of SWAP arrangements within the ASEAN+3 countries to provide emergency assistance in times of crisis, in Chiang Mai, on the 6th May 2000. It covers the basic principles and operational procedures of SWAP transactions. This is designed to provide liquidity support for member countries that experience short-run balance-of-payments deficits in order to prevent an extreme crisis or systematic failure as well as to stave off regional contagion - similar to that which occurred during the Asian financial crisis in 1997. CMI is an emergency support facility, similar to other regional and international 'lender of last resort' facilities.



CMI was initially not well received among experts on account of its bilateral nature and the small size of the arrangements. Since 2000, however, it has made great progress and has now adopted a collective decision making procedure for SWAP activations. An important step was the 2009 Bali Agreement which allowed ASEAN+3 countries to decide their relative weights in the financial contribution and introduced a bias in favour of smaller economies. The Bali Agreement also initiated a flexible decision making structure in order to bolster the fund's effectiveness and to prevent any of the 'Plus Three' countries individually, or ASEAN as a group, to hold veto power. The ASEAN+3 Finance Ministers agreed that consensus was required on decisions of a fundamental nature, such as reviews of membership, size, borrowing multipliers, terms of lending and IMF conditionality ratios, while lending issues can be decided through a simple majority - but in a weighted voting system which is linked to contributions, similar to the system in place at the IMF.

As of May 2006, the ASEAN+3 countries began work on the multilateralization of the CMI - which was realized in 2010, after which it became the Chiang Mai Initiative Multilateralization, or CMIM. The CMIM has a total pool of US\$ 120 billion, supplementing the existing international financing arrangements. The 'Plus Three' countries - China, Japan and the Republic of Korea, contributed 80 per cent of the pool, while the balance 20 per cent was provided by the ASEAN countries. In addition, they have reached agreement on several other pertinent issues including the funding of the SWAPs through self-managed reserve pooling and legally binding contractual agreements. The ASEAN+3 Macroeconomic Research Office (AMRO) was established in 2011 in Singapore as an independent surveillance unit to monitor macroeconomic and financial conditions, detect emerging vulnerabilities and support CMIM decision -making. The AMRO will therefore allow the CMIM to rely more on its own assessments with regard to lending decisions, about both the amount and any specific conditionality. This would reduce the moral hazard and mitigating concerns of problems leading to balance of payment difficulties that may require structural adjustments. As a result, under the CMIM, a country can draw up to 20 per cent of its quota for up to six months without being subject to IMF conditionality, while anything over this limit would be tied to an IMF agenda.

The maximum amount that each country is allowed to borrow from the CMIM is based on the contributions multiplied by a borrowing multiplier which is skewed towards smaller economies. For instance, Brunei Darussalam, Cambodia, Lao PDR, Myanmar and Viet Nam are allowed a quota 5 times that of their contributions while Hong Kong, China; Indonesia; Malaysia; Singapore and Thailand are allowed 2.5 times theirs. The Republic of Korea's borrowing multiplier is 1.0 while Japan and the rest of the PRC are allowed 0.5 (Table 2). The full statement released at a Finance Ministers' meeting held in Bali in 2009⁵ included details about voting rights, decision-making rules, and operational aspects such as the activation of short-term liquidity in the event of a sovereign financial emergency.

⁵For the full text see, www.asean.org/22536.htm

Table 2: CMIM Contributions, Borrowing Multipliers and Voting Power

Members	Financial Contributions		Borrowing Arrangements		Voting Power			
	\$ Billion	% Share	Multiplier	Quota (\$ Bn)	No. of Basic Votes	No. of Votes based on Contributions	Total No. of Votes	% Share
PRC	38.40	32.00					40.00	28.41
China	34.20	28.50	0.50	17.10	1.60	34.20	35.80	25.43
Hong Kong	4.20	3.50	2.50	10.50	0.00	4.20	4.20	2.98
Japan	38.40	32.00	0.50	19.20	1.60	38.40	40.00	28.41
Korea	19.20	16.00	1.00	19.20	1.60	19.20	20.80	14.77
Plus 3 Countries	96.00	80.00			4.80	96.00	100.80	71.59
Brunei	0.03	0.03	5.00	0.20	1.60	0.03	1.63	1.16
Cambodia	0.12	0.10	5.00	0.60	1.60	0.12	1.72	1.22
Indonesia	4.55	3.79	2.50	11.36	1.60	4.55	6.15	4.37
Lao PDR	0.03	0.03	5.00	0.20	1.60	0.03	1.63	1.16
Malaysia	4.55	3.79	2.50	11.36	1.60	4.55	6.15	4.37
Myanmar	0.06	0.05	5.00	0.30	1.60	0.06	1.66	1.18
Philippines	4.55	3.79	2.50	11.36	1.60	4.55	6.15	4.37
Singapore	4.55	3.79	2.50	11.36	1.60	4.55	6.15	4.37
Thailand	4.55	3.79	2.50	11.36	1.60	4.55	6.15	4.37
Vietnam	1.00	0.83	5.00	5.00	1.60	1.00	2.60	1.85
ASEAN	24.00	20.00			16.00	24.00	40.00	28.41
ASEAN+3	120.0	100.0			20.80	120.00	140.80	100.00

Note: PRC = People's Republic of China; Lao PDR = Lao People's Democratic Republic.

Source: ADB 2010 based on data from ASEAN Secretariat.

The CMIM agreement sets a practical example for addressing other priority areas for regional cooperation, for example, enhanced intergovernmental discourse has spurred further cooperation in trade, investment and importantly – financial supervision and regulation. This new institutional model could be used for speeding up financial market development – for instance, to set up a fund to invest in developing regional bond markets, and thereby make better use of the region's huge saving to help finance its massive investment requirements. While the CMIM could eventually add new crisis prevention functions, it could also expand to include all East Asia Summit (EAS) members, i.e., include India, Australia and New Zealand as well as other countries in the region as well.



4.5 Sub-regional Investment Funds

ASEAN Infrastructure Fund (AIF)

The AIF is an initiative taken in September 2011 by ASEAN to mobilize resources for infrastructure development in association with the ADB. The fund has an sanctioned capital of US\$ 485.2 million - consisting of US\$ 335.2 million from ASEAN Member States and the remaining US\$ 150 million from the ADB. The total lending commitment of the AIF through to 2020 will be approximately US\$ 4 billion, and with a projected 70 per cent co-financing by the ABD, it is expected to leverage more than US\$13 billion in infrastructure financing by 2020.

SAARC Development Fund (SDF)

Set up in Bhutan in 2010 as part of a SAARC financial cooperation initiative, the SDF has an authorized capital of US\$ 1 billion special drawing rights (SDRs) and paid up capital of US\$200 million. The fund is expected to finance a number of social, economic and infrastructure projects in the sub-region, which includes the preparation of feasibility studies. India and Bhutan have provided their full quota of the assessed subscription and India has sent an additional US\$100 million as its voluntary contribution for Projects on Social Development. Other member states are expected to forward their respective subscriptions in due course. Meanwhile, China, as an observer of SAARC has proposed the contribution of US\$300,000 to the SAARC Development Fund.

While the SDF charter has a condition to levy interest on the borrowings by members, the interest rates are yet to be worked out. The highest governing body of the fund will consist of the Finance Ministers of the eight member states, who will meet once a year.

Other Initiatives

Several other initiatives are taking shape for regional cooperation in the fields of finance and macroeconomic policy. The frameworks of groups such as ASEAN, SAARC, ASEAN+3, East Asian Summit and the Asian Cooperation Dialogue identify finance as a key area of cooperation. In this instance, cooperation takes the form of periodic meetings of Finance Ministers and Central Bank Governors as well as the exchange of information and expertise. In addition, Central Banks have formed four groupings with variations of members, namely: South East Asia, Australia and New Zealand (SEANZA); South East Asian Central Banks (SEACEN); Network of Central Bank Governors and Finance Secretaries of the SAARC Region (SAARC Finance); and Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). All of these groups promote cooperation between members through capacity building and the sharing of expertise. The Asian Exim Banks Forum was formed in 1996, with membership comprising of the export credit agencies of Australia, China, India, Indonesia, Japan, the Republic of Korea, Malaysia, the Philippines and Thailand. This forum goes beyond the sharing of information and training resources, to foster mutual cooperation among its members by facilitating lines of credit on a mutual basis. In addition, some countries in the region such as Japan and India, have instituted bilateral SWAP arrangements that are not covered under CMI.

5.0 Challenges in Developing and Integrating Financial and Capital Markets

While several steps have been taken in the area of financial cooperation in the region, they remain in their infancy and therefore have limited scope and coverage. While CMIM is an important initiative in the development of a regional crisis response facility, it should be seen as a work in progress. The reasons for this view are that firstly, the overall size of the fund is relatively small when compared to the bailouts offered during recent crises. In a hypothetical regional crisis in which a group of countries need emergency financial support, US\$120 billion will be insufficient. During the 1997/1998 crisis, Asian countries required between US\$40 billion and US\$60 billion in liquidity support and yet, the largest ASEAN economies (Indonesia, Malaysia, the Philippines, Singapore and Thailand) have individual access to less than US\$12 billion from CMIM funds (see Table 1). ASEAN+3 countries have the ability to increase the fund size by tapping their international reserves - CMIM amounts to less than 3 per cent of the nearly US\$4.2 trillion in international reserves that they had accumulated by the end of 2009 (ADB, 2010).

Secondly, only 20 per cent of liquidity is available for a country without IMF conditionality. This precise reason would have kept certain countries such as Indonesia, the Republic of Korea and Singapore, who required liquidity support from the CMI during the 2008/9 crisis from approaching it. Instead, they preferred to raise emergency financing from Japan and the United States on a bilateral basis. Thirdly, and finally, the expansion of CMIM membership to cover other key countries, need to be initiated in order to make it truly regional.

Member countries might have to move away from self-insurance in the form of foreign reserves, in order to facilitate an increase to the CMIM fund, and move funds towards this regional support facility instead. The future of the CMIM as a regional fund for monetary cooperation, an Asian Monetary Fund, that will be able to fully cater for emergency liquidity needs, is going to depend on how the CMIM's membership and size evolve and how diligently the AMRO performs regional surveillance.

While the ABF and the ABMI have also been important initiatives towards the development of regional financial markets, they are still quite modest in scale to make a significant impact when compared to the size of the region's economy. In addition the development of local currency bond markets in East Asia remain uneven because the larger economies tend to have bigger bond markets (as well as adequately capitalized banking systems) while some countries' bond markets are under-capitalized, as measured by the ratio of total bonds to GDP. While East Asian governments' inclination towards running fiscal surpluses before the 2008/9 crisis was admirable on a macroeconomic perspective, it has not been conducive towards the development of markets for government bonds.



At the same time, while enhanced policies and increased issuances have boosted primary bond markets, liquidity in secondary markets remains a concern. A recent survey conducted by AsianBondsOnline found that participants in both government and corporate bond markets agree to the fact that increasing the diversity of the investor base and improving tax treatment were critical to improving liquidity in local currency bond markets.⁶

The SAARC Development Fund and the ASEAN Infrastructure Fund, while being important initiatives for the expansion of options for infrastructure financing facilities in the region, are again, at a modest scale. As well as enhancing the depth of domestic bond markets in the region, among other possibilities, it is important to facilitate cross-border listings to enhance the access of the region's least developed countries to capital markets. At present, the progress that has already been made is by and large, limited to East Asia, probably as a result of underdeveloped financial and capital markets in other Asian sub-regions that lack the necessary resources to establish initiatives to strengthen their markets.

Another hurdle to overcome is the need to develop and liberalize the domestic financial markets that will act as building blocks for larger regional markets – particularly those of the contractual savings institutions – the pensions and provident funds, social security institutions and insurance companies that hold most of the long-term savings that are the foundation of bond and equity markets. Equally important is the need for national authorities to synchronize domestic law, regulations, financial standards and access rules for foreign financial institutions and products. It is often observable that a desire to protect domestic players seems to override efforts to foster competition and create regional markets. In addition, jurisdictional rivalries and competition among the numerous public institutions responsible for the financial system have also resulted in delayed progress.

6.0 Towards a Regional Financial Architecture for Asia

The need for a better regional financing architecture, which not only could assist in the management of a financial crisis but also provide an adequate supply of development finance, is therefore essential in order to narrow existing development gaps. Many studies have illustrated the wide infrastructure gaps prevalent in the Asian region. Similar gaps exist in social infrastructure and achievement of the Millennium Development Goals, as shown in the Economic and Social Survey of Asia and the Pacific 2010. Estimates suggest that infrastructure gaps will require a massive US\$8 trillion in investments over 10 years. Closing the gaps in the achievement of the Millennium Development Goals is estimated to require a further US\$639 billion in investments. In order to sustain the region's dynamism in the future, appropriate mechanisms need to be put in place to mobilize the region's savings and channelling them towards these unmet development needs.

⁶Another survey of ASEAN+3 countries' bond markets identified major obstacles to cross border transactions as currency exchange restrictions; a lack of uniform rating requirements; cash repatriation restrictions; withholding taxes; and investor registration processes.

The elements of a possible regional financial architecture proposed by ESCAP (2011) include the following:

6.1 Development Finance and Capital Markets Integration

The region needs to develop its financial architecture for development financing which should include systems of intermediation between its large savings and its unmet investment need. This lack of an appropriate mechanism is the reason that the region's foreign exchange reserves have been invested in securities issued by Western Governments such as US treasury bills.

One option would be to create a large infrastructure development fund – managed by a regional institution. An ADB study in 2009 showed that if a similar fund secured a mere 5 per cent of the region's reserves of over US\$5 trillion, it could provide start-up capital of US\$250 billion in addition to its ability to borrow from the Central Banks. Such an institution should be able to issue securities to enable the region's Central Banks to maintain surplus reserves with it. This pooling of reserves could assist the region in meeting some of its investment needs.

Another way in which capital flows could be facilitated within the region is through the integration of the region's capital markets and the development of its regional bond markets. A framework needs to be developed to enable cross-border listings in the region so that corporate entities in countries with underdeveloped capital markets could raise capital in other regional markets.

6.2 Closer Cooperation between Central Banks and Financing Institutions

As previously mentioned, several cooperative bodies of Central Banks have been set up in the region in order to facilitate the coordination, exchange of information and cooperation in training and capacity-building between them. However, a need remains for a broader regional body that could facilitate region-wide information sharing and assist in the closing or narrowing of capacity gaps. In this light, the Asian Exim Banks Forum could step up to create an apex regional trade finance institution, for which it has developed an initial concept in order to facilitate cooperation in trade finance.

6.3 Management for Crisis Prevention

In this area, it is important to build further on the CMIM and expand its scope and coverage. In order to make the CMIM truly representative regionally, membership needs to cover other significant countries such as Australia, India and the Russian Federation. In addition to improving representativeness, the combined foreign exchange reserves of over US\$5 trillion, the region will have the ability to considerably expand the size of the CMIM pool. The final goal should be to make CMIM into a well endowed and truly regional crisis response facility that could reduce pressure on governments to build large foreign exchange reserves to protect their economies against speculative attacks and liquidity crises.



6.4 Exchange Rate Management Cooperation

An area where regional financial architecture could make a positive contribution is in the coordination of exchange rates. When economies of the region increasingly trade with each other, a currency management system will be needed that facilitates trade and macroeconomic stability and that discourages competitive currency devaluations. One option that could be considered is a basket parity relative to a number of reserve currencies, including key currencies of the region instead of the dollar alone, and a set of weights determined on the basis of regional trade shares.

6.5 Capacity Building in Public- Private Partnerships

Asia's enormous resource requirement for infrastructure development makes it clear that a strong commitment from the private sector is required. The private sector contributions are not needed to merely bridge funding gaps but also to overcome the public sector's limited delivery capacity while taking advantage of its efficiency and advanced technology. In lieu of this, governments are increasingly turning to Public-Private Partnerships (PPPs) to build up and control both economic and social infrastructure.

Several governments have made extensive advancement in the areas of institutional development, capacity building, streamlining administrative processes and financing and approving new projects. Important steps include: formulating PPP policy frameworks (Bangladesh, India, Indonesia and the Republic of Korea); enacting new laws or amending existing ones to foster a PPP supportive environment (Cambodia, Fiji, Indonesia, the Philippines, the Republic of Korea, Turkey, Viet Nam and many states in India); establishing institutional mechanisms to furnish government grant/support to PPP projects (Bangladesh, India, the Republic of Korea); establishing special infrastructure financing institutions (Bangladesh, India, Indonesia, the Russian Federation); creating special PPP units in Government (Australia, Bangladesh, Fiji, India, Indonesia, Malaysia, Pakistan, the Republic of Korea, Sri Lanka, Turkey); and streamlining administrative processes (India, the Republic of Korea), among others. As a consequence, there has been a considerable increase in PPPs for infrastructure. Between 2005 and 2009, 826 projects worth about US\$204 billion reached financial closure. However, a few countries – China, India the Russian Federation and Turkey, accounted for the bulk (82 per cent) of these projects.

Governments have been reinvigorating PPPs as a part of their stimulus packages, in the aftermath of the global financial crisis. These have been, on occasion, through policy and fiscal measures – including debt guarantees, direct financial stakes, tax free bonds, lower-equity capital requirements and sharing interest rate risks. In addition, international financing institutions have been supporting the establishment of PPPs - particularly the International Finance Corporation, (IFC) the private sector arm of the World Bank, created a global US\$ 300 billion equity fund and a loan financing trust to support PPPs.

Capacity building is indispensable in order to enable the fuller exploitation of PPPs for infrastructure development in the region. This would include the transmission of a better understanding of PPPs at the policymaking level with a clear policy on risk sharing, capacity for developing bankable projects and managing contracts, standardized administrative processes and project documents, clear legal and regulatory regimes and the availability of long-term finance. At this level, it might be helpful to draw upon the expertise of countries which have started earlier through regional cooperation for sharing development experiences and capacity building – regional organizations such as ESCAP and ADB may be able to assist in such an endeavour. In order to promote such participation, sector level reforms are needed to create an enabling legal and regulatory environment.

7.0 Concluding Remarks

At its 66th session, in May 2010, in Incheon, Republic of Korea, the G20 Commission mandated the ESCAP secretariat to assist member countries to elaborate the elements of a regional financial architecture and it is currently engaged in further work on the subject. The development of a regional financial architecture would enable a unique regional perspective on the reform of the international financial architecture.

The crucial need for a mechanism to mobilize the region's savings towards developing strong financial and capital markets cannot be stressed enough, especially in the light of the fragile global financial system and the huge infrastructure needs in the Asian region. Even though monetary and financial integration and cooperation in the region is modest when compared to trade and investment integration, the current initiatives, with particular reference to the CMIM, seem headed towards closer and more institutionalized macroeconomic and financial cooperation. However these initiatives appear to be centred on East Asia, while other Asian sub-regions remain poorly connected financially. Many of these economies are characterized by their underdeveloped financial and capital markets - hence, the possibility of forming sub-regional initiatives remains remote – which is why the need remains for the building of a region-wide financial institution that would foster closer regional collaboration needed to support regional capital markets. In the long run, Asia needs a regional financial system that matches the strength, global competitiveness and agility of its production sector. Such a system would need to be able to organize and divert a larger portion of its surpluses of domestic savings and foreign exchange reserves within the region itself in a manner that is likely to meet the region's need for higher investment, particularly for infrastructure projects, raise returns and reduce risks to savers.



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