ERIA-DP-2013-27

ERIA Discussion Paper Series

Financial Integration Challenges in ASEAN beyond 2015

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November 2013

Abstract: Financial integration challenges in ASEAN beyond 2015 can be grouped into two broad classes. The first classes of challenges are the regulatory and infrastructure challenges of financial market integration itself. The second pertains to monetary and fiscal policy regimes and how they are impacted by as well as how they impact on an integrated financial market in the region. The paper focuses on the integration in banking sector and the discussion in it considers the implications that the integration measures or strategies have on monetary policy of a country.

Keywords: Economic integration, Monetary Policy, Fiscal Policy, Financial Aspects of Economic Integration, ASEAN

JEL classification: F15, E52, E62, F36, N25

1. Introduction

Financial integration challenges in ASEAN beyond 2015 can be grouped into two broad classes. The first classes of challenges are the regulatory and infrastructure challenges of financial market integration itself. The second pertains to monetary and fiscal policy regimes and how they are impacted by as well as how they impact on an integrated financial market in the region. The paper draws from analytical literature and experiences of other countries (e.g. EU) to provide insights into how ASEAN should approach financial integration and manage the policy demands of a financially integrated region. The paper focuses on the integration in banking sector and the discussion in it considers the implications that the integration measures or strategies have on monetary policy of a country.

2. Literature Review

Financial integration brings some economic benefits. It helps global rebalancing. "If the degree of financial integration of Asia were to increase to a level implied by its trade integration, current account surpluses in the region would fall by about 1 percent of GDP on average. Greater financial integration in Asia can help induce more competition and provide financial access to underserved households and firms thereby reducing financing constraints hampering consumption and investment." (Pongsaparn and Unteroberdoerster, 2011). Financial integration should also bring an increase on investment. "A 10 percent increase in the availability of finance would increase investment rates of small and medium-sized firms and those operating in the services sector by about 2 percent."(Nabar and Syed, 2010). In terms of consumption, "Improving household's access to financial services provides a net boost to consumption. For China, further financial reforms, including improving household's access to financial services, would raise private consumption by about 5 percent of GDP." (Jain-Chandra and Chamon, 2011). Also, in terms of allocative efficiency and economic diversification, "Cross-border banking, for instance, tends to improve overall economic performance by ensuring that productive capital is channeled towards the most efficient firms, thereby reducing the risk of crises stemming from the mispricing of investment risk."[1].

In Asia, financial linkages are deepening. According to the ADB Asian Bonds Monitor, the size of the Asian bond market (excluding Japan) has grown from USD 600 billion in 2000[2] to USD 6.5 trillion at the end 2012.[3] Contractual savings institutions (CSIs)— pension funds, insurance companies, and social security institutions— have become an increasingly important investor class in the emerging East Asian bond market in recent years. In the PRC, Malaysia, and the Republic of Korea, CSI holdings of corporate bonds have become a key factor supporting corporate bond market growth. Foreign investors' interest in the region's LCY government bond market remains strong. The Republic of Korea, Malaysia, and Thailand experienced an increase in the share of foreign holdings of their respective LCY government bonds at end-December 2011 compared with end-December 2010. In the case of Indonesia, the share of foreign holdings leveled off at end-2011 after having risen sharply in recent years (albeit still very high at about 30 per cent). Cross-border portfolio debt holdings in Asia remain low, although they have improved in recent years. Analysis shows a strong home bias among investors. Prior to the global financial crisis (GFC), investors had a clear bias for investing in global markets vis-à-vis regional markets. However, after the GFC they remain indifferent between global and regional markets.

Yet, financial integration has lagged behind trade integration. "Compared to the world norm, most Asian economies' rapid expansion into global trade has not been matched by their role in international finance. This appears to hold in particular for the emerging economies of South East Asia, including Malaysia, Thailand, the Philippines, and Indonesia."(Pongsaparn and Unteroberdoerster, 2011). "Stock-takings show that Asia's portfolio investment is mostly interregional, FDI is mostly intraregional but dominated by Japan and round-tripping Hong Kong, China, and PRC. In banking sector, the level of cross-border banking in Asia is stable and comparable to other emerging markets, but three times lower than in the Euro area." (Pongsaparn and Unteroberdoerster, 2011). To some extent, the low degree of financial integration can be accounted for by capital restrictions, which, indirectly, also inhibit overall financial development. (Pongsaparn and Unteroberdoerster, 2011).

Despite its potential benefits, financial integration also carries potential risks. The current global financial crisis bring to the fore the risks of financial sector development without sufficient regulatory structure in place. While developing countries like Indonesia want to develop its financial market, it would want to do it in parallel with the development of credible market supervision. Financial integration would, therefore, need to be coupled with financial regulatory harmonization and this is where Basel 3 plays a key role.

As shown by the lessons from Europe, financial integration is not to be blamed, but the industry needs better regulations, supervision, transparency, and a less risky business model. In a banking crisis, the reserve and equity capital of the banking sector may not be enough. Meanwhile, government rescue would put the state budget in jeopardy. How can we ensure a better lifeline? International banks could strengthen the domestic banking sector, as we saw after the Asian financial crisis. But, we also need to have a coordinated, cross-border supervision and surveillance. ASEAN+3 Macroeconomic Research Office can be a platform for not only regional monitoring and surveillance but also policy coordination and cooperation. There is a need to strengthen our regional financial safety net, including through the Chiang Mai Initiative Multilateralization (CMIM). Currently, the size of the CMIM has been doubled from USD 120 billion to USD 240 billion and members can borrow up to USD 30 billion. In addition, to provide increased flexibility, the IMF de-linked portion has been raised from 20% to 30%, with a goal of reaching 40% in 2014.

In regards to regional banking supervision, Siregar (2013) wrote: "The banking sector are not only deeply interconnected regionally, but also globally. ... the local and regional banks have not only borrowed heavily from, but also extended loans to global banking system. The traditional global banks, such as the HSBC and the Standard Chartered bank, have increasingly become regional banks. At the same time, many of the ASEAN banks, such as the DBS, OCBC, UOB, MayBank and the CIMB, have become regional and global banks. The need to integrated financial market supervisory agencies is no longer a domestic issue. Given the cross-border nature of these banks' operations, the regular supervision on domestic activities of these banks will not be sufficient to assess the overall risk exposures. There are a number of lessons from the recent global financial crisis that underscore the importance of establishing a close coordination among banking supervisors across the borders." (Siregar, 2013).

In ASEAN, banking integration is proceeding slowly but surely. ASEAN Central Bank Governors have endorsed the ASEAN Banking Integration Framework (ABIF) in April 2011. It aims to provide financial stability in the region, as well as achieving multilateral liberalization in the banking sector by 2020 for ASEAN commercial banks. A study by Park, *et. al*. (2011) became the foundation of the ASEAN Banking Integration Framework (ABIF), in which a set of pre-conditions are introduced, namely: harmonization of principles of prudential regulations, financial stability infrastructure, capacity building, and lastly setting up a set of criteria for Qualified ASEAN Banks (QAB) (Park, *et al.*, 2011). In their study, they highlight the following points:

- ASEAN-X approach has been suggested to allow countries who are not ready to sequence market opening according to the progress these countries make in capacity building.
- The size of banking (relative to GDP) in ASEAN is much less than that of the EU.
- Based on Cambodia, Thailand and Indonesia's cases, these countries have low shares of foreign banks, and moreover, among these foreign banks, the majority is non-ASEAN. This suggests that given the relatively low barriers to entry, foreign banks are not actively penetrating the ASEAN banking market. Moreover, non-ASEAN banks are more interested in entering the ASEAN banking market than ASEAN-based foreign banks are.
- ASEAN banking market is integrated in the context of very diverse banking regulations. Integration will be difficult if regulatory environment between the home and host countries are not compatible. Full integration cannot be expected out of ASEAN.
- Individual countries may first focus on capacity building while allowing only a limited number of foreign banks. Countries that are more developed can remove barriers to entry fast, but those that are less developed in their financial sector may initially place priority on improving the financial infrastructure and regulatory environment to increase competitiveness.
- Integration to a single ASEAN banking market is seen through three dimensions. Access: the end goal is to eliminate all restrictions on cross-border access to domestic financial market. Equal treatment: the end goal is

to eliminate any discrimination against foreign institutions operating in the host country's domestic market. Environment: (full or partial) harmonization of financial integration and market infrastructure to boost banks' competitiveness.

- Unlike the EU, ASEAN does not have a system of reaching agreement with such supra-national legal power as an EU directive. In the case of EU, because of its supranationality, it could regulate all banks from its member states to meet the specified minimum qualifications for a bank under an EU directive, with the provision that an individual country could still impose higher standards on domestic banks but they might not reject market access by banks from other countries that satisfied the minimum qualification specified in the EU directive. In the case of ASEAN, it must set criteria for QABs, but it will not be for all banks, so integration will be more limited in the case of ASEAN.
- The process of integration should follow the following steps: Firstly, liberalize market access for QAB in the form of a subsidiary, then a branch, then for all ASEAN-based banks in either subsidiary or branch. Why subsidiary first? First, it is because host country has full supervisory authority over a subsidiary that is under stress. Second, it allows a separation of the qualifications of the parent company from the requirements of the subsidiary.
- There are five regulatory areas to harmonize: 1. bank accounting standards and disclosure requirements, 2. minimum capital requirements, 3. Prompt Corrective Action (PCA) and methodologies for the resolution of failed banks, 4. restrictions on large exposure, 5. anti-money laundering and consumer protection regulations.
- Regional institutions through joint efforts that would help supplement the lack of critical infrastructure in some of ASEAN5 and BCLMV countries, which might still need to improve their financial infrastructure and competitiveness, are suggested to be established.
- There are five key areas of concern for capacity building: (1) the competitiveness of domestic banking institutions (2) the penetration of the ASEAN banking market by domestic institutions (3) the coverage and efficiency of domestic credit rating agencies (4) the quality of human resources (5) other financial infrastructure
- These are the possible criteria for QAB: (1) the definition of a bank and the scope of banking activities (2) capital adequacy requirements (3) consolidation requirements and authority for consolidated supervision (4) restrictions on large exposure (5) accounting and transparency requirements.
- Conditions on establishing QAB: (1) the list of qualifications for QABs should be agreed upon by all countries and clearly stated in a legal binding

document. (2) Since a host country may not have access to all relevant information on the parent bank, the home country has the obligation to provide information to the host country. Establishing a college supervisor would help resolve the conflicts. (3) Transparency of information and disclosure requirements for banking institutions should be consistent between home and host countries. (4) An ASEAN-wide deposit insurance scheme must eventually be developed. (5) Regulatory convergence to guarantee an equal level playing ground and align domestic regulations with the qualifications of QAB.

- ASEAN and EU banking integration models are different in three ways: (1) EU adopts a single passport principles for all EU banks, while only those ASEAN banks that meet the QABs criteria could operate within ASEAN. (2) QAB approach will screen out weaker financial institutions mostly from less developed banking markets, while the EU model removes the right of the host country to limit the access of incompetent foreign banks. (3) Subsidiaries are subject to full host country supervision giving some comforts to the regulators while branches are subject to home country supervision (although not true for all countries).
- Individual countries should be given flexibilities to choose the timing, but it is critical that some member countries agreed to open their market at the earlier stage. ASEAN5 are expected to open their domestic markets under the framework then eliminate within-market discriminatory practices and to harmonize regulations.
- Specific recommendation for Indonesia include:

  1. Relax local talent requirements for the management of foreign banks.
  2. The requirement of global ranking should not be applied to QABs.
  3. Give more freedom to foreign banks with respect to the introduction of products and services.
  4. In terms of capacity building: first, it is important to harmonize Prompt Corrective Action (PCA) rules with those of other countries by adopting clear and simple PCA triggers. Second, Indonesia should maintain high standards for the quality control of internal models adopted by banks employing the advanced methodologies of Basel II. Third, enhance transparency by strengthening accounting and audit practices.
- Lastly, in order for Indonesia to enjoy the full benefits of integration, penetration of the regional market by domestic banks should precede the opening of the domestic market.

Although Park, *et al.* study is very comprehensive, some of the recommendation seem to be conflicting with the other arguments made in the paper. For example, the authors suggest that riskier than conventional lending operations may threaten the safety of domestic financial system. But, in their country-specific recommendation to Indonesia, the authors suggest that Indonesia should open up the market to derivative lending and more banking products and services, without suggesting the necessary additional precautions to be taken given the escalated risks. There are also some inconsistencies and there are issues unanswered. For example, authors are aware of protectionist "infant industry" argument, but does not address whether it is legitimate and if it is not, how to address it so it will not become a barrier to integration. It partially suggests that countries with infant industry should accelerate capacity building to increase competitiveness of domestic banks, but whether this means that protectionist measures against foreign bank entries can be implemented simultaneously is unclear, and if it can, for how long? Moreover, while they suggest that integration will be difficult if regulatory environment between the home and host countries are not compatible and full integration cannot be expected out of ASEAN, they also suggest that even before the banking regulations are fully harmonized, promotion of cross-border banking activity by easing the entry of foreign institutions into the domestic market should start.

3. About ABIF

ASEAN envisages integrated financial and capital markets under the ASEAN Economic Community (AEC) Blueprint. ASEAN foresees that an integrated regional financial system with more liberalized financial services, capital account regimes and interlinked capital markets will facilitate greater trade and investment flows in the region.

In the midst of global financial crisis especially with the increasing downside pressures from the continuing European sovereign debt and banking crisis, ASEAN envisions financial integration as mandated by ASEAN leaders. As a part of the AEC Blueprint, ASEAN Central Bank Governors endorsed the ASEAN Banking Integration Framework (ABIF) on April 7, 2011. Against that background, as

ASEAN financial sector is generally bank-dominated, the banking sector is a key driver in the financial integration process.

The initiative for ASEAN financial integration could be traced back to the Roadmap for Monetary and Financial of ASEAN (RIA-Fin) established in 2003. As stated in RIA-Fin, financial integration in ASEAN is facilitated through the following initiatives:

- Financial Services Liberalization (FSB), i.e. progressive liberalization on financial services;
- Capital Account Liberalization (CAL), i.e. removal of capital controls and restrictions to facilitate freer flow of capital;
- Capital Market Development (CMD), i.e. building capacity and laying the long-term infrastructure for development of ASEAN capital markets.

In April 2011, ASEAN Central Bank Governors accepted the results of the commissioned study by the team of consultants led by Professor Yung Chul Park as a reference for the ASEAN financial integration process. Central Bank Governors also endorsed the ASEAN Financial Integration Framework (AFIF) which is based on the agreed Broad Thrusts (i.e. three dimensions of FSL namely equal treatment, access and environment, milestones for ASEAN5 and BCLMV, clear set of preconditions and safeguards, financial stability, capital account liberalization, capacity building and shared responsibility, and integrated payments and settlements).

Given the diversity of financial market development, economic structure, and priorities among ASEAN members, the implementation process of ABIF is undoubtedly very challenging, particularly in establishing necessary preconditions. Each ASEAN member state would like to have as many flexibilities as it can to determine the timelines and preconditions in regards to the preparedness of its economy to implement AFIF.

In this regard, the Central Bank Governors have agreed to establish a high level committee, namely the ASEAN Senior Level Committee on Financial Integration (SLC) to supervise the financial integration implementation plan and the implementation process itself. The SLC had its first meeting in Manila in June 2011. Formulating the implementation plan of AFIF will require specific and highly technical activities, such as setting priority actions, negotiating standard criteria for

Qualified ASEAN Banks, harmonizing rules and regulations, determining strategies, approaches and activities to keep the region abreast with international best practices, aligning processes and works between AFIF and AFAS, as well as ensuring that financial stability is in place during and after the integration process.

With these in mind, the SLC is able to reach an agreement on several important issues, including the need to form a group of banking experts, comprising the ASEAN Banking/Prudential Directors. This banking expert group serves as a Task Force, which will prepare the same end-goal of financial integration built upon the agreement, and undertake the aforementioned technical works based on the appropriate technical capacity.[4]

Currently, ABIF is based on four guiding principles: bringing economic benefits and financial stability for individual countries and the region, allowing flexibilities by adopting a double-track implementation for ASEAN5 - Singapore, Malaysia, Thailand, Philippines, and Indonesia - and BCLMV - Brunei Darussalam, Cambodia, Laos, Myanmar, and Vietnam, and achieving multilateral liberalization by 2020 (e.g. measured by the number of ASEAN commercial banks presence in ASEAN).

To ensure a successful implementation of ABIF, four pre-conditions have been agreed upon. The first is harmonization of principles of prudential regulations. The second is building financial stability infrastructure. The third is providing capacity building for BCLMV. The fourth is setting up agreed criteria for ASEAN Qualified Banks (QAB) to operate in any ASEAN country with a single 'passport'. There is a Working Group set up for each of the four pillars above. For the 2011-2013 period, ABIF is co-chaired by Malaysia and Indonesia. The Working Group in harmonization of principles of prudential regulations is co-chaired by Singapore and Indonesia; financial stability infrastructure by Thailand and Indonesia; capacity building by Malaysia and Philippines; QAB by Indonesia and Malaysia.

In its early stage, ABIF invites a lot of crucial debates. The first is about the definition of integration and its benchmark indicators. Is commercial banks presence a measure of banking integration that indicates how much ABIF brings about economic benefits and financial stability? Second is about the pre-conditions in ABIF. Can ABIF be seen as 'AFAS+'? Third is about the benefits, opportunities, costs and risks of ABIF. A comprehensive study to assess the trade-off between the benefits/opportunities and the costs/risks is urgently needed. Fourth is about the strategies to maximize the benefits/opportunities and minimize the costs/risks. How could ASEAN accelerate the operation of regional financial safety net? How could ASEAN minimize the differentiated and adverse impacts of ABIF on BCLMV? How could ASEAN learn from the success stories and failures of other ASEAN countries as a part of the integration process? Another important point is the fact that there is a wide spectrum in regards to political commitments on ABIF. On the one end of the spectrum, in countries like Malaysia, ABIF has been integrated as a national blueprint. On the other end of the spectrum, in countries like Indonesia, it is still an internal debate among the central bank officials whether the benefits of ABIF overweigh the costs. It is not surprising that each country has a different political commitment since each country will undergo a different impact. For example, Indonesia with such a big market and unsaturated demand for banking services will take a more cautiously protectionist approach for banking liberalization while Malaysia with a saturated market will take a more aggressive approach to enter Indonesia.

4. Theoretical Foundation of ABIF

Dobson (2011) cites:

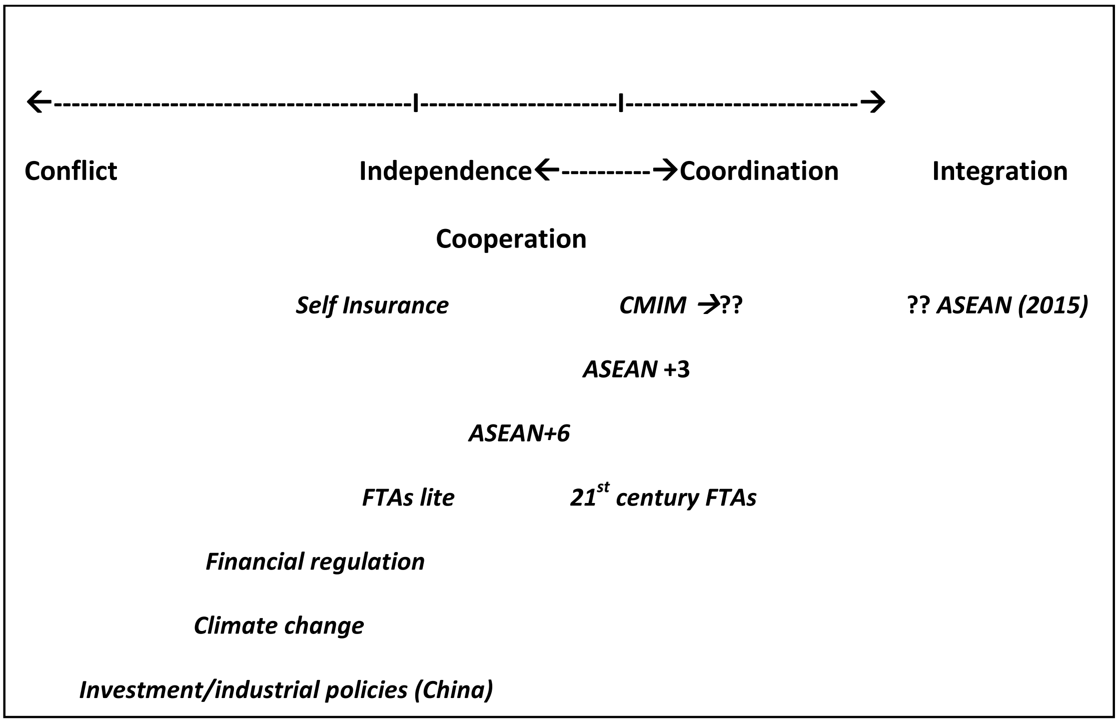
> Inter-governmental relations can be seen as ranging along a spectrum (Figure 1). At one end is conflict in which national interests are advanced by the exercise of power over others. At the other end is deep integration where governments pool sovereignty in a supranational forum to which they have ceded significant authority such as the European Central Bank and European Commission. At the midpoint lies policy independence in which governments pursue their own objectives, taking the policies of other governments as given, attempting neither to influence nor be influenced by them. In between integration and independence lie cooperation and coordination. Cooperation can take such forms as information exchange, consultation and mutual encouragement to adopt certain policies or strategies. Coordination is a more disciplined form of cooperation involving joint problem identification and pursuit of

> mutually beneficial ways of tackling shared objectives. It can involve bargaining and tradeoffs among the policies of one government for changes in policies of another. In effect, coordination allows governments some access to the 'policy levers' of others, thereby expanding policy choice. An implicit parameter of cooperation and coordination, however, is the recognition that governments do not give precedence to international over domestic concerns (Dobson 1991).

Where is ABIF situated on this spectrum?

First, by its name (ASEAN Banking Integration Framework), ABIF is situated at the extreme end of the integration spectrum. However, there are multiple ways in which one could define integration. In terms of ASEAN integration, ASEAN can strive for an ASEAN Custom Union, Common Market, Single Market (synonymous to the current ASEAN Economic Community), ASEAN Union, or any other form of integration. In terms of banking integration, it can be measured by price-based measures using the law-of-one-price hypothesis (e.g. convergence of retails interest rates) or quantity-based measures (e.g. commercial presence, cross-border bank flows, foreign bank asset to GDP ratio, and market share of foreign banks in domestic markets). In the language of ASEAN Framework Agreement on Services (AFAS), banking integration can be measured by cross-border bank flows (Mode 1 of AFAS), consumption abroad (Mode 2 of AFAS), commercial banks presence (Mode 3 of AFAS), and movement of natural persons (Mode 4 of AFAS). ABIF concept of integration is commercial presence of QAB and it has been adopted as the benchmark for ASEAN Banking Integration by 2020. However, this is highly debatable. Even though ABIF strives for an integration, the single concept that is currently used to define integration is still open to a lot of debates.

Figure 1: Integration Spectrum (Dobson, 2011)



Second, if ABIF really strives for an integration, according to Dobson's theory, it has to go through a series of processes, including cooperation - where ASEAN countries would go through "a process of information exchange, consultation, mutual encouragement to adopt certain policies and strategies" - and coordination - where ASEAN countries "adopt a more disciplined form of cooperation involving bargaining and tradeoffs among the policies of one government for changes in policies of another". As Dobson's integration spectrum shows, liberalization (either FTAs lite, or 21st Century FTAs) is situated before integration. Putting it in the perspectives of ABIF, ASEAN countries must realize that banking liberalization is one of the processes towards banking integration. Therefore, protectionist measures (besides those that are imposed for prudential reasons) may be seen as an impediment to the process towards integration. More importantly, countries that are backtracking from its liberalization commitment can be expected to be more likely to fail the integration process because integration is a much stronger inter-governmental relation than liberalization is. Integration may only give a "feeling-good effect" and it is often mere political and diplomatic language. Moreover, among ASEAN negotiators, there are always concerns that integration should not be too fast. So, the question now is whether integration is really what we want, despite the fact that ABIF has been rubber-stamped by the authorities. Maybe, we want a lesser degree of inter-governmental relation -somewhere along the cooperation and coordination spectrum but not the extreme end. In the section on the political challenges to ABIF, we will see how domestic political interests have dominated and slowed down the negotiation.

Third, if we do want integration, what should constitute the liberalization, cooperation and coordination processes. Do we have these processes? Banking liberalization is a part of the AEC Blueprint via the financial services commitment. It involves removing barriers in cross-border bank flows (Mode 1 of AFAS), consumption abroad (Mode 2 of AFAS), commercial banks presence (Mode 3 of AFAS), and movement of natural persons (Mode 4 of AFAS). In regards to service liberalization, the AEC Blueprint adopts liberalization through the "ASEAN-X" formula - where countries that are ready to liberalize can proceed first and be joined by others later - and the "pre-agreed flexibilities" (the Safeguard Framework) approach - where a particular country maintains a list of restrictions based on the pledged sub-sectors identified for liberalization in the following years - to accommodate the interests of all ASEAN countries. However, exclusion and exception as a result of pre-agreed flexibilities, albeit crucial, should not drag the full implementation of the liberalization process by countries outside the exception and exclusion lists. ERIA Midterm Review Report in February 2012 shows that there are various degrees of commitment on banking liberalization among ASEAN member states. So, we do have the liberalization process but it is not yet completed and there are always tendencies of some countries backtracking from their commitments.

Cooperation in the context of ABIF may include: information sharing, consultation, technological transfers, learning from each other's success and failures, and surveillance. Rathus (2012) argues that surveillance procedure within AMRO remains underdeveloped facing the same problem as experienced by IMF, namely that members are not providing more or better quality data. The Economic Review and Policy Dialogue is also based on the voluntary requests, and "AMRO has yet to establish the authority to extract and analyze details from key sectors in member economies, especially the banking and housing markets." Hence, there are more cooperation needed towards ABIF.

Coordination in the context of ABIF may include cross-border crisis management protocol and even stronger policy coordination such as interest rate, exchange rate and fiscal policy coordination. There is even less of this coordination process.

5. Legal Foundations of ABIF

Where is ABIF in regards to the legal framework of ASEAN?

If we can agree that ABIF is extended from AFAS (e.g. "AFAS+"), then the 2004 amendment to Article IV of AFAS may provide a legal framework for ABIF. It states: "Two or more Member States may conduct negotiations and agree to liberalize trade in services for specific sectors and sub-sectors." ABIF may start from a bilateral commitment between countries that are ready to implement ABIF (given the ABIF Framework has been completed) and any country that is ready to join may join. This "ASEAN2+X" approach is actually synonymous to AEC services liberalization formula of "ASEAN-X". The "ASEAN2+X" formulation is in fact "older" than the "ASEAN-X" formulation and was the rationale behind the adoption of the "ASEAN-X" formula. While the "ASEAN-X" formula was adopted for AEC 2015, the "ASEAN2+X" formula was already adopted in the Framework Agreement on Enhancing ASEAN Economic Cooperation (signed on January 28, 1992) and in the ASEAN Framework Agreement on Services (signed on 15 December 1995). Hence, the legal foundation of ABIF through AFAS is legitimate given that ABIF sticks to the elements and principles of AFAS.

Having said this, there may be some elements of ABIF that may seem to be contradicting with the AFAS principles, for example, by increasing prudential measures. This may not be surprising since the ultimate goal of AFAS is service liberalization while the ultimate goal of ABIF is integration, which has already been mentioned earlier, includes not only liberalization but also cooperation and coordination processes. Hence, in theory, despite legitimacy of ABIF under AFAS, ABIF still needs to get a legal endorsement from ASEAN in regards to the adoption of measures that are necessary for integration and that may not only be measures to serve the purpose of liberalization but integration. These may include legal endorsement in regards to harmonization of prudential regulations and establishment of financial stability infrastructure, etc.. Such an endorsement is not new. For financial services, GATS allows member countries to take measures for prudential reasons, "including for the protection of investors, depositors, policy holders or persons to whom a fiduciary duty is owed by a financial services supplier, or to ensure the integrity and stability of the financial system" (GATS, Annex on Financial Services, 2a).

The first question to answer is therefore whether we can agree that ABIF should be based on AFAS (and hence adopt the principles of AFAS) with some extensions in regards to harmonization of regulations and establishment of financial stability infrastructure. The main issue in regards to ABIF legal framework relies more on the extension part of AFAS (building necessary financial stability infrastructures and harmonized prudential regulations), i.e. "AFAS+", rather than the formulation of ABIF, i.e. whether it should be an ASEAN2+X or ASEAN-X, because the latter has already been agreed for both in AEC 2015 and earlier ASEAN cooperation agreements.

6. Technical Challenges to Achieve ABIF[5]

Gaps were identified among ASEAN countries in all areas of ABIF, including domestic banking regulations and financial stability infrastructure. We find that harmonizing principles of prudential regulations remains a big challenge. There are identified gaps in many areas of prudential regulations, especially between ASEAN5 and BCLMV. Difficulties also arise since ASEAN countries are diverse in regards to their financial sector depths and systemic risks. Double-track approach may be unavoidable. The biggest gaps between ASEAN5 and BCLMV in the financial stability infrastructure area are identified in macro-prudential policies and crisis management protocol, and to a lesser extent, deposit insurance.

7. Harmonization of Principles of Prudential Regulations

Harmonization of principles of prudential regulations is needed to create a level playing field.

From the summary table of ABIF stock-take, harmonizing principles of prudential regulations remains a big challenge. Singapore, adopting the relatively highest prudential regulations, including the adoption of Basel II.5 and highest paid-up capital for conventional foreign bank branches, is far ahead from some of its BCLMV counterparts. Difficulties also arise since ASEAN countries are diverse in regards to their financial sector depths and systemic risks, and therefore need different levels of austerity in regards to prudential regulations. All ASEAN5 countries, except Singapore, for example, still find Basel II.5 irrelevant.

The question remains how to harmonize the principles of prudential regulations without lowering the prudential standards that may put a threat to the regional financial stability, but at the same, without putting the prudential standards too high that may be irrelevant and even adverse to other countries previously adopting lower prudential standards. Double-track implementation may be unavoidable.

8. Financial Stability Infrastructure

Building financial stability infrastructure as a pre-condition to ABIF is a necessary crisis-preventive measure.

From the stock-take, it seems that macroprudential policy has not been comprehensive, fully integrated or even adopted in most of BCLMV countries. For example, unlike their ASEAN5 counterparts, BCLMV countries have not yet integrated crisis management in the definition of macroprudential policy. Moreover, none of BCMLV countries indicated that they have conducted macroprudential stress tests. None of BCLMV countries have extraordinary policy for a crisis scenario and only some have special resolution regimes for crisis and post-crisis scenarios. In regards to deposit insurance, only Brunei among BCLMV covers foreign currencies while none of BCLMV countries adopt risk-based premium rates.

What needs to be emphasized is here that financial stability infrastructure may start from the establishment of such infrastructure in each of individual countries, but eventually there have to be some regional financial stability infrastructure, such as regional macro-prudential monitoring and surveillance (should be under AMRO now), regional crisis management protocol, regional payment and settlement system, and regional financial safety net (should be under CMIM now).

It is beyond the scope of this paper to discuss what the best banking prudential regulations and financial stability architectures are, especially since ASEAN countries are diverse in regards to their financial sector depths and systemic risks, and therefore need different levels of austerity in regards to prudential regulations. Future standard prudential regulations and financial stability architectures for ASEAN as a whole (which will adopt a double-track approach for ASEAN5 vs. BCLMV) will be reflected in the Qualified ASEAN Banks criteria and these will be subject to hard bargaining by individual ASEAN countries.

The impacts of ABIF on ASEAN5 and BCLMV will be differentiated. BCLMV countries with poorer institutional qualities than some of their ASEAN5 counterparts may attract less bank lending, despite integration. However, looking in a more optimistic view, integration will give countries with poor institutional qualities more pressures to reform.

There are some pros and cons in having this double-track approach, which is in the same spirit as that of AEC. Firstly, BCLMV may have significantly different financial sector depths and systemic risks and even banking regimes relative to their ASEAN5 counterparts. Therefore, it will be inappropriate to impose same standards in banking prudential regulation and financial stability measures. Secondly, ASEAN5 and BCLMV may also have different economic, political and institutional capacity as well as technology to adopt high banking regulatory standards and set-up sophisticated financial stability mechanisms. Capacity building is still very much needed by BCLMV and even by some of ASEAN5 countries. Thirdly, banks from ASEAN5 with QAB criteria can start to penetrate other ASEAN countries, without having to wait for the ASEAN countries to meet the QAB criteria. On the contrary, having a double-track approach may drag the full implementation of ABIF by ASEAN5 countries. Moreover, differentiated standards will affect how funds flow.

This may create a prudential regulatory gap where funds may flow to countries will more lax standards. Also, if some ASEAN countries are more fragile to crisis, for example by having more lax prudential regulatory standards and no crisis-management protocol, then a more integrated banking sector within ASEAN means that the other ASEAN countries will also be exposed to the same risks. This is similar to a prisoners' dilemma game where a country would like the other neighboring countries to also adopt high prudential regulatory standards.

9. The Impact of Banking Integration on Monetary and Fiscal Policies

There are a few channels of how an integrated banking system can become a transmission of monetary policy. Firstly, an integrated banking system could become a transmission channel of monetary policy through policy rate adjustments. A case in point is interest rate policy adjustment in Japan that has affected mortgage rates in various states in the U.S. in the 1980s at the peak of the global activities of the US banks.

Secondly, an integrated banking system could become a transmission channel of monetary policy through capital flows and exchange rate adjustments. We can draw lessons from the recent quantitative easing by the US. During the US Federal Reserve quantitative easing measures (QE1 and QE2), which resulted in higher-than-average US$236 billion and US$278 billion of total private capital outflow per quarter respectively, a slightly above 20 per cent of these capital outflows were absorbed by the Asia-Pacific economies (Siregar, 2013). Many central banks, including those in ASEAN region, had to intervene and manage the appreciation pressures and volatilities of the local currencies. Weak global demands and appreciation of local currencies had made these central banks take precautionary actions against their translations to trade.

Moreover, a series of monetary easing measures in major advanced economies, including by the Federal Reserve, European Central Bank, the Bank of Japan, and the Bank of England were anticipated to increase commodity prices. Some co-movements (not a significant regression result) between commodity prices and quantitative easing activities were observed during QE1 and QE2. "The world commodity price index rose as much as 29.4 per cent and 31.7 per cent at the peak reached in October 2009 for the QE-1 and April 2011 for the QE-2, respectively, from the levels one month prior to the implementation of those policies. The price was particularly felt in the energy sector with the commodity fuel price index rose well above 40 percent during each of the two QE episodes... The combination of surges in the asset and commodity prices contributed to the unanchored inflation expectation and thus complicated further the management of price stability in many economies across the global, particularly those experiencing massive inflows o f the private capitals." (Siregar, 2013). An increase in fuel prices would also affect the management of fiscal policy in many countries that subsidize fuels, including Indonesia.

Thirdly, an integrated banking system could become a transmission channel of monetary policy through increased cross-border lending activities of foreign banks that could stimulate credit expansion in the domestic economy. Managing asset bubbles and headline inflation can become more complex in a more integrated banking system. Siregar (2013) shows that international bank lending has fuelled a rise in the residential property prices.

Meanwhile, on the fiscal side, interconnected banks increase the channel for external fiscal financing. They also facilitate foreign investors' holding of local sovereign bonds. Cases in point include Indonesia, Malaysia, and South Korea. In Indonesia, foreign holding of sovereign bonds reaches 30 per cent. Moreover, flows of capital through interconnected banks could affect the yield of sovereign bonds.

These are some of the lessons that ASEAN member countries could learn from the European Union, in particularly in light of the recent European sovereign and banking crisis. Although the level of cross-border banking in Asia is stable and comparable to other emerging markets, but it is three times lower than in the Euro area, according to Pongsaparn and Unteroberdoerster (2011). And although ABIF is far from a single-currency union like in Europe, there is still some relevance to draw lessons from. Firstly, the key lesson drawn from the crisis is the importance of preventing sovereign problems from spreading to banks (e.g. Greece) and preventing banking problems from spreading to sovereigns (e.g. Ireland, Cyprus). Bank bail-outs by national governments increase the cost of borrowings for sovereigns, while driving up banks' funding costs further. This creates a "doom loop" that will undermine fiscal sustainability.[6]

As a response to this malaise, a banking union has been proposed by the European Council supported by the European Central Bank. The establishment of a banking union is supposed to help break this “doom loop”. Banking union will include key proposals such as single rulebook, banking resolution, more integrated banking supervision and common deposit guarantee scheme. Firstly, a single banking supervision could rebuild depositor and investor confidence. Secondly, a single banking supervision would not be suspected of allowing banks to hide bad asset in some countries. Thirdly, a single banking supervision should also eliminate national bias, free it from local pressures and interests, and it should be able to assess independently the situation of individual banks in a systemic context. In short, banking integration will necessitate a central, integrated, single banking supervision, and a central or federal deposit insurance mechanism.

Similarly, for a regional ASEAN banking system, banking resolution, cross-border banking supervision and deposit guarantee system are needed. As a case in point, in Singapore, international reserve available is about US$ 250 billion but the value of the banking system is about US$500 billion. Who will pay if there is a crisis there? Singapore alone will not be able to pay. Another example would be CIMB-Niaga, a Malaysian foreign bank subsidiary in Indonesia, whose 30-40 per cent of profit comes from Indonesia. So, who will pay if CIMB-Negara collapses? Similarly, what happens if Maybank, or DBS in Singapore, or any other regional banks in ASEAN collapses? No single country will be able to pay.

However, EU proposal went further than banking union. It realizes that the absence of a banking union is not all that is missing from the picture. At the June 2012, European Council, Heads of States and Governments and the European Commission proposed EU's response to the crisis and for future growth, including proposals on consolidating the Economic and Monetary Union via not only banking union, but also fiscal union and political union.[7] One of the culprits of the European crisis is fiscal irresponsibility where the government deficit limit of three per cent of GDP and debt limit of 60 per cent of GDP, constituted in the EU’s Stability and

Growth Pact, were violated almost uniformly across the EU countries, except for a couple of countries.

One of the key proposals under the fiscal union agenda is to refine the financial backstops - the European Financial Stabilization Mechanism (EFSM) and its successor, the European Stability Mechanism (ESM). Banking integration will need funds in case of a bank restructuring, which must otherwise be paid by national governments and tax-payers' money. Under ABIF, ASEAN countries must decide whether it would be the host or home country that will pay for a bank restructuring and for what types of banks (branches, subsidiaries, etc.). This will impact fiscal policies in either the home and host countries. During the Asian Financial Crisis 1997-1998, for example, Indonesia issued state bonds (*Surat Utang Negara*) for the first time to top up bankrupt national banks' depleting capitals.

Moreover, the debate over "austerity vs. growth and employment" has been politically sensitive, and for those countries that still have some fiscal spaces but not so much of monetary policies or ineffective monetary policies would choose fiscal stimulus to stimulate growth and employment. This will have a positive impact on investors' confidence but at the expense of a widening fiscal deficit.

Lastly, greater political union has also been discussed by the EU. It has been debated that as the Greek crisis worsens, so voices are being raised demanding new and more radical approaches. It was also argued that the sticking plaster bail-outs and slice-by-slice austerity packages could not solve the real problem, and the ultimate solution to the Eurozone debt crisis should be more 'political union'.[8] Banking integration will necessitate independent central banks that could enforce prudential financial regulations. Member countries must be prepared to give up some degree of sovereignty and to converge politically to avoid collapse. This is a lesson that ASEAN countries must also learn from the EU banking integration in regards to ABIF.

Another lesson to learn from the EU banking integration is that different structural policies and hence, different competitiveness will result in some countries accumulating current deficit and some other countries accumulating current surplus. In Europe, these current-deficit countries mostly are in the periphery (border areas). Some of them end up with twin deficits, in which borrowing is needed. Because countries in the Euro zone have their currency fixed, they are unable to make their tradable areas more competitive by depreciating their currency. Hence, less-competitive countries will accumulate trade deficits. Other domestic issues, such as unreformed labor markets and corruption in the southern fringe of Europe would also pose structural issues that are not always and easily reformed. This poses another structural issue that undermines competitiveness. Moreover, banking integration will also likely result in greater cross-country lending, which will make debtor countries more easily borrow from creditor countries. Easy lending combined with unimproved structural issues in less-competitive countries increase the cost of borrowing that will eventually be unsustainable. Hence, banking integration will require member countries to implement necessary structural reforms, and without which, banking integration will not be sustainable.

Related to structural reform issues, public sector failures must be eradicated to make State Owned Enterprises including state banks and regional development banks able to compete with private banks and foreign branches/subsidiaries. Special access for state banks and regional development banks to manage public sector's deposits must be eradicated. These are some of the issues that have caused the lack of competition in the banking sector in Indonesia. Reform in this area is needed to make local banks more competitive. Increasing competitiveness is the best strategy to avoid countries becoming more protectionists.

Tackling institutional issues is also important to improve competitiveness in the banking sector. Firstly, under ABIF, ASEAN countries could harmonize legal system to protect property rights. In many ASEAN countries, where the legal system is still poor and cannot be relied upon to recover collaterals, debt collectors are used to recover collateral. This usually increases transaction costs. Moreover, enforcements of prudential rules and regulations must be ensured to avoid market failures, such as in the case of Bank Bali and Bank Century in Indonesia.

Gonzales-Paramo[9] warned that "while banking integration benefits efficient firms through lower cost of external finance, very rapid integration induce firms to take on excessive leverage, exacerbating the effect of financial crises on the corporate sector." Moreover, he warned that "cross-border banking integration has been associated with the transmission of financial distress from banks' balance sheets to the corporate sector of countries which were not the origins of the shock." The main challenge is to strengthen financial stability without hurting growth. He proposed that financial stability arrangement must keep pace with the degree of financial integration by: "(1) shortening securitization chains and making them more transparent; (2) promoting greater standardization of the various credit risk transfer instruments; (3) moving over-the-counter derivative trading - in particular that of credit default swap markets - to central clearing counterparties; (4) demanding greater transparency of the assets, liquidity and leverage of non-bank financial intermediaries; (5) improving frameworks for the resolution and re-capitalization of large cross-border financial groups." He added that "financial integration (in Europe) is not to blame per se but lack of transparency, wrong incentives, sub-optimal regulation, and certain flawed banking business models."

Transparency is also crucial. Regional banking cooperation also needs to include relaxation of banking secrecy to fight tax avoidance and tax evasion. This can be done via automatic exchanges of tax information among the ASEAN member states. In this case, any bank account held by ASEAN citizens will be reported to the tax authority of its country of origin. Through the US Foreign Account Tax Compliance Act (FATCA), the U.S. forces the foreign financial institutions to give those information. If violated, they cannot operate in the U.S.. Right now, the U.S. has already signed an agreement with Mexico, the U.K., Ireland, Denmark and Swiss. Negotiations with Singapore and Hong Kong are currently in-progress. After the confession by the France's Ministry of Treasury about his secret account in Singapore and Swiss, EU is moving in the same direction. The same scandals happen in Greece, Cyprus and Germany. ASEAN countries are not insulated from money laundering and tax avoidance/evasion cases.

Another lesson to learn from the Euro crisis is that lending to states within the EU should have been risk-differentiated. The profligacy in Greece can be partly linked to the poor or lack of risk adjustment in lending to states. It may be important for ABIF to take appropriate pricing of various risks, which means that there is a need for information from those that can help determine better risk profiles.

10. Political Challenges to Achieve ABIF

Economic integration without some degree of political integration is questionable. Hence, there should be a regional institution built up within ABIF to make integration process somewhat more independent from domestic politics. At the same time, authorities should be protected against the decisions that they make.

The ABIF process seems to have been dominated by domestic political backlashes. These have slowed down the ABIF process and risked it ending in a deadlock. ABIF was supposed to be preceded by some necessary pre-conditions, namely harmonization of prudential regulations to create a level playing field and building financial stability infrastructure to ensure sufficient crisis-prevention and crisis-management measures to mitigate and minimize risks and other unintended consequences associated with a more integrated banking system. However, progresses on these two pre-conditions have somehow been slow. Currently, the working group on harmonization of prudential regulations is co-chaired by Singapore and Indonesia. It is not surprising that Singapore is co-chairing this working group because Singapore, as the ASEAN country with the highest prudential measures, has a domestic interest to keep prudential regulations high and there is no compromise, so that once ABIF is fully in operation, incoming ASEAN banks will not undermine the stability of Singapore's banking sector.

What have been relatively more active and progressing are the working groups on capacity building and Qualified ASEAN Banks (QAB). These two working groups are co-chaired by Malaysia. It is not surprising that these working groups have been progressing better than other working groups because Malaysia has put ABIF in its national blueprint agenda. Hence, Malaysia has given full supports and has been pursuing ABIF in a very comprehensive manner. Other countries seemingly have given their "true colors" during the process of negotiations. Even though ABIF has been signed by the ASEAN central bank governors, as ABIF negotiation progresses, some countries have shown some signs of slowing down in their reforms towards banking integration.

The process of QAB has been somewhat in a deadlock as of the time this report is written with countries agreeing on bilateral negotiations but not on multilateral negotiations to achieve an integrated banking sector. This is the kind of bilateral negotiations that could have been achieved without ABIF, some officials argue. Under the previously multilateral negotiation framework, only banks with QAB criteria can enter all ASEAN countries, however, under bilateral negotiation framework, through bargaining between two countries, non-QAB banks can also penetrate other countries. Moreover, while some countries are pursuing reciprocal treatments (e.g. Indonesia), other countries are increasing barriers for foreign banks to enter (e.g. Singapore's recent Qualifying Full Bank requirements). This has resulted in a slow-down of ABIF.

On a positive note, some countries, including Indonesia, has learned from experiences of other countries throughout the process. By conducting stock-take of ASEAN economies' prudential regulations and financial stability infrastructure, Indonesia learns what is being implemented in other countries and adopt the same rules/regulations/strategies at home if found beneficial.

What has to be emphasized here is that the ABIF process is as important as the achievement of the end goal of ABIF. It is important that ASEAN countries do not push too fast nor too far if individual countries do not yet have strong commitments for integration, because banking integration carries risks that require strong political commitments to minimize them.

11. ASEAN Banking Integration Framework: Beyond 2015

In its early stage, ABIF invites a lot of crucial debates. The first is about the definition of integration and its benchmark indicators. Essentially, banking integration can be measured by price-based measures using the law-of-one-price hypothesis (e.g. convergence of retails interest rates) or quantity-based measures (e.g. commercial presence, cross-border bank flows, foreign bank asset to GDP ratio, and market share of foreign banks in domestic markets). In the language of ASEAN Framework Agreement on Services (AFAS), banking integration can be measured by cross-border bank flows (Mode 1 of AFAS), consumption abroad (Mode 2 of

AFAS), commercial banks presence (Mode 3 of AFAS), and movement of natural persons (Mode 4 of AFAS).

Currently, ABIF concept of integration is commercial presence of QAB and it becomes the benchmark for ASEAN banking integration by 2020. This is highly debatable. Is commercial banks presence a measure of banking integration that indicates how much ABIF brings about economic benefits and financial stability?

Moreover, if the process to integration has to face a lot of political challenges, as we argue in the earlier section, and if there is still a huge diversity in financial market development among ASEAN member states, so that a significant degree of banking integration does not seem to be a realistic goal in the near future, then the question now is whether integration is really achievable, despite the fact that ABIF has been rubber-stamped by the authorities. Maybe, ASEAN wants a lesser degree of inter-governmental relation -somewhere along the cooperation and coordination spectrum but not the extreme end. Regardless, capacity building will be an important part and foundation of the process.

Second is about the pre-conditions in ABIF. The aforementioned four pre-conditions may look contradictory to AFAS that promotes services liberalization from the perspectives of the abovementioned four modes. It may look contradictory since ABIF may increase regulatory and prudential barriers instead of promoting banking liberalization. But, ABIF can be seen as 'AFAS+'. While AFAS promotes banking liberalization via the four modes, ABIF provides the "soft infrastructure" (harmonized regulation) and "hard infrastructure" (financial stability infrastructure).

Harmonization of prudential regulations among ASEAN countries is needed to create a level playing field. Siregar (2013) warns against regulatory gaps: "The recent global events also demonstrate that the economic cost of gaps in regulation across banking supervisors across economies will likely be amplified. A tougher set of regulation by the Financial Service Authority in UK introduced in the past two years, including on mode of entry (branch or subsidiary) and more rigorous liquidity rules, has resulted in international banks pulling out big shares of their activities away from London to other European economies with less-regulated financial markets. Expansion of global banks has increasingly been influenced by the rules and regulations of domestic supervisors relative to their foreign counterparts." (Siregar, 2013).

It cannot be emphasized more the need to build financial stability infrastructure to contain systemic risk and contagion effect after integration, but as Azis[10] said wisely: "the word preconditions is very easy, but we know a lot of preconditions are missing. So, do not base goals and targets on an ideal world, but the world as it is." Financial stability infrastructure may start from the establishment of such infrastructure in each of individual countries, but eventually there have to be some regional financial stability infrastructure, such as regional macro-prudential monitoring and surveillance (should be under AMRO now), regional crisis management protocol, regional payment and settlement system, regional financial safety net (should be under CMIM now), legal system to protect property rights and possible automatic exchanges of tax information among the ASEAN member states.

Siregar (2013) suggested that the establishment of a closer coordination among banking supervisors across the borders needs to be preceded by a much more in-depth research to map the networks and degree of integration of the regional banking systems. "The lack of timely and publically available data on the bilateral breakdowns of foreign bank lending directed for trade and project financing inhibits efforts in conducting more in-depth analyses on the lending activities of the foreign banks. Furthermore, data on the lending activities of the regional banks are not publicly available. While the frequently visited BIS database reports bilateral lending from the advanced economies' banks to most individual ASEAN+3 economies, no disaggregated level of lending data to various destinations, particularly to the ASEAN+3 economies, is reported for Singaporean, Malaysian, Korean and Indonesian banks. Without these valuable information and data, potential contagion or spill-over within the banking sector of the region and the world will likely be underestimated." (Siregar, 2013).

Third is about the benefits, opportunities, costs and risks of ABIF. It is *passé* to think that financial integration is always good. To think this way only brings a 'feeling-good' effect. ASEAN banks have learned a lot from the European banking crisis and the same should apply in regards to banking integration. In a short term, theoretically, ABIF should bring the promised benefits and the costs of 'tied hands' or inflexibilities to respond to domestic issues.[11] In a long term, theoretically, ABIF should bring the opportunities to achieve a stronger regional growth and accelerate poverty reduction, and the risks of systemic risks, contagion effects, and financial instability. A comprehensive study to assess the trade-off between the benefits/opportunities and the costs/risks is urgently needed.

Fourth is about the strategies to maximize the benefits/opportunities and minimize the costs/risks. Firstly, ASEAN should accelerate the operation of regional financial safety net. The current ASEAN+3 (ASENA+China, South Korea, and Japan) Chiang Mai Initiative Multilateralization (CMIM) have uncertainties over procedures and is untested. It also possesses a lot of inconsistencies. For example, the likely donor countries (the +3 countries) are still reluctant to de-link CMIM with the IMF because otherwise, they would carry a bigger burden to bail out troubled countries. Besides, CMIM only deals with crisis prevention and resolution, but not crisis management protocol. CMIM now has two instruments: a Short-Term liquidity facility - CMIM Precautionary Line - as a crisis prevention mechanism and a Medium-term crisis resolution facility - the CMIM stability Fund. However, whether or not CMIM will work in times of crisis is inconclusive.[12] Clearly, the size of the reserve pooling fund is too small for the Plus Three and the ASEAN5 countries (even for the smaller BCLMV countries in crisis). Hence, CMIM cannot be a substitute to the IMF but maybe a complement. Moreover, decisions lie with a high-level, non-resident body, and it is not a fund but a reserve pooling system. So, CMIM still appears unusable if crisis strikes tomorrow, although progresses are being made.[13]

Secondly, ASEAN should be re-thinking about the differentiated impacts of ABIF on ASEAN5 and BCLMV. ABIF Stock-take above has shown that there are wide gaps in some areas of regulations and financial stability infrastructure. Some studies have also shown that cross-border bank lending flows to countries with better political stability, less corruption, more efficient government policies, and high-quality law. Moreover, less (financially) developed countries may not be able to bail out large international banks, deterring international banks to enter these countries. Hence, integration may not result in capital flowing to less developed countries with generally poorer institutional qualities. On the other hand, double-track approach that ABIF will adopt may result in more funds flowing to BCLMV countries with probably more lax prudential standards. Thirdly, ASEAN should learn from the success stories and failures of other ASEAN countries. The last crucial debate is how each ASEAN country should position itself. Political challenges at home are not always easy to handle.

There are a few foregone conclusions. Firstly, soundness and credibility of domestic policies are no substitutes to any regional commitments although at times when domestic policies are 'stuck', regional commitments can help to 'tie hands' and put external pressures. Secondly, authorities should not rubber-stamp how integration works since it will not be sustainable. Instead, they should facilitate it, but still let the market work without imposing a strict benchmark. Thirdly, regardless of whether or not ABIF will be successful, ASEAN banking sector will be more integrated, especially since they have to reduce dependence on the European and American market. Hence, there is no excuse of ASEAN countries not to prepare for this.

ASEAN countries can draw lessons from the EU, especially in light of the current European sovereign and banking crisis, and its proposal on greater banking, fiscal and political union. Firstly, for a regional ASEAN banking system, banking resolution, cross-border banking supervision and deposit guarantee system are needed. ASEAN countries must decide whether it would be the host or home country that will pay for a bank restructuring and for what types of banks (branches, subsidiaries, etc.). This will impact fiscal policies in either the home and host countries. Banking integration will necessitate independent central banks that could enforce prudential financial regulations. Member countries must be prepared to give up some degree of sovereignty and to converge politically to avoid collapse. This is another lesson that ASEAN countries must also learn from the EU banking integration in regards to ABIF.

As correctly put by Siregar (2013): "Another concrete lesson from the recent sovereign debt crisis in the Eurozone area is on the design of legal framework to inject emergency funds required to bail-out trouble banks. Given the cross-border networks of the banks, any bail-out program must be coordinated across the border. An important hurdle of the bail-out program in the European economies is with the lack of cross-border integrated supervisory capacity to fully assess the extensiveness of the bail-outs needed. The failure to mitigate the impacts of the Lehman- Brothers' debacle in 2008 for instance could arguably be attributed to the lack of cooperation between the supervisors in the US and the UK. Hence, building trust through deepening cooperation among supervisors across the borders is greatly vital to manage this increasingly interconnected banking system."

ASEAN should also learn an important lesson from the Asian Financial Crisis - not only in terms of what causes a crisis and structural reforms that need to be made but also in terms of why such a crisis had come so unprecedented. A lesson to learn here is that when market sentiment is high on the region, the gap between the fundamental and the asset price can become very wide that a selling by an investor who may have come to realize about this gap will all of a sudden trigger a herding behavior and massive selling by other investors. There are also political economic issues in relation to the IMF, Central Banks, domestic financial institutions, credit rating agencies, the governments, and other stakeholders in the banking and financial market. For example, some observers contend that IMF reports are not free from political interventions. Blustein (2013) has shown this in the case of IMF report on China's currency misalignment.[14]

Having AMRO, a regional surveillance institution, on board, may increase a sense of ownership and as a result, political backing from the member states. However, it is clearly a challenge for AMRO, together with the IMF, to learn from the previous Asian Financial Crisis in terms of managing asset pricing and the political economy among stakeholders. Like the operation of CMIM, this is clearly a challenge for AMRO that has so far gone untested.

In regards to global banking standards, such as those that are set by the Basel Committee on Banking Supervision (BCBS), there is no need for ABIF to re-invent regional banking standards. Financial regulatory reforms such as those of the Financial Stability Board and Basel reforms, which are driven as a reaction to the European and the US financial and banking crises, apply to all countries including ASEAN countries.

Having said this, Asian financial system, including those of ASEAN, is somewhat different from those of Europe and the US:

- Asian countries learned from the Asian Financial crisis in 1997-1998 and some countries went through painful structural reforms.

Park (2013) argues:[15]

- Asian financial system was relatively unscathed from the recent crisis.
- Large foreign exchange reserves provided a cushion against volatile capital flows in most cases.
- Asian regulatory frameworks were more "conservative" with less regulatory capture and less ideology about virtues of free financial markets.
- Asian regulators already had some macroprudential policies (administrative guidance to limit bank-credit growth, real estate loan caps, prohibition to high derivative financial products, etc.)
- Asian financial system is still relatively bank-dominant, with smaller bond markets and role model for securitization, derivative products, etc.
- Asian financial system has limited regulatory capacity to address procyclicality, exposure to activities of large global financial firms, growing non-bank financial activities, and rising financial complexity over time.
- It is vulnerable to volatile capital flows.
- Many Asian countries still have stigma over the IMF.

Moreover, many Asian countries also still need to balance between financial regulation with development: (Park, 2013)

- Asian financial system was resilient to the recent crisis partly because of immature financial systems.
- Much of the G20 debate on financial regulation reflects viewpoints and problems of the US and Europe, not necessarily so relevant for emerging countries.
- Developing Asian countries still need to promote financial inclusion, long-term financing on infrastructures, etc.

The impact of current financial regulatory reforms on long-term financing is still too early to understand:

- According to the FSB's report submitted to the G20 Finance Ministers in February, there is little tangible evidence to suggest that the reforms have significantly contributed to current long-term financing concerns. However, it is still too early to really understand the actual impact of the reforms on the availability of long-term financing.

It is likely that financial regulatory reforms have different (adverse) effects on Asian countries than those of the US and Europe.

- Reforms will depend on different characteristics of countries, distinguishing emerging and developing markets from those of advanced markets, not only because of their level of economic development, but also their developing domestic financial markets and regulatory capacity to comply with the new global standards.
- Problems could also arise from the manner in which banks achieve their new capital adequacy ratios (deleveraging vs. raising capital).
- Because of these reasons, Asian countries, in particular those emerging and developing countries with the abovementioned concerns, need to collect their voice and action, without paralyzing the global financial regulatory standard and reforms. The establishment of regional financial and banking architecture is necessary to support the current financial regulatory reforms by making those reforms more fitting and relevant to the Asian financial system.

In short, although there is no need to re-invent regional banking standards to be adopted at ABIF, since banking standards are regulated globally, ABIF could make sure that given the ASEAN more conservative and traditional banking sector than those of the US and Europe, global banking standards remain relevant to the different banking sector development and do not impede development and growth that are still very much needed by most of ASEAN countries. ABIF will not be like that of the EU banking integration initiative, especially since ASEAN is not and does not need to have a supranational body like that of the EU. ABIF will continue to progress in the "ASEAN way" marked by small incremental changes, pragmatism and countries retaining much of their sovereignty.

China's recent moves to strengthen market discipline through deleveraging and reducing future financial risks are seen as a preparatory step toward interest rate and capital account liberalization.[16] Current policy discussion in China points to reforms in some areas including financial liberalization in which greater flexibilities on deposit and lending rates, and in the deposit insurance system, are expected in the coming months. Some experts have also envisioned the internationalization of RMB. All these may change how ASEAN countries will behave in regards to ABIF.

For future research, strategic behaviors of ASEAN member states towards cooperation and coordination in ABIF can be illustrated with some game-theoretical model, although there will be some limits as to how much such a model can realistically portray the situation because of the complexities of economic and political interests of each individual country.

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