10. Capital Market Deepening, Financial Integration, and Macroeconomic Policy Management

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Capital Market Deepening, Financial Integration, and Macroeconomic Policy Management

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Background

Since the Asian financial crisis (AFC), member economies in the Association of Southeast Asian Nations (ASEAN) have taken large strides towards enhancing regional integration and cooperation. Policymakers, who took the lessons of the AFC to heart, have rebuilt the foundations for economic growth while remaining open to trade, foreign direct investment (FDI), and capital flows. This has enabled developing ASEAN economies to reap the benefits of regional integration. As the global environment becomes less supportive of trade, the case for further integrating the ASEAN region as a key means of boosting ASEAN's growth potential is becoming more compelling. The prospects for financial integration look particularly promising. Financial integration allows the region's economies to benefit from a more effective and efficient allocation of resources and risk diversification. By allowing the region's financial resources to move more freely across borders, financial

integration will open up new opportunities for businesses and trade, enhancing further financial linkages within the region.

The ASEAN vision of 'one region, of one identity' is rising in importance as building pressures threaten to splinter the world into 19th-century spheres of influence. Crucial to ASEAN's vision is a robust financial system that efficiently provides a wide range of savings and investment products tailored to the risk and return preferences of its firms and households.

Embedded in the concept of an effective, efficient, and stable financial system are two related concepts: (i) that of 'complete markets', meaning the provision of financial contracts that allow holders to hedge risks across a variety of possible futures;[1] and (ii) that of 'efficient' intermediation of savings and investments, where efficiency is measured in terms of both cost (i.e. bank margins) and allocation (funding projects with ex-ante expected returns higher than the cost of capital).

The first concept implies a variety of products, including debt and equity (and gradations in between), and the pooling and diversification of assets and hedging instruments. The second concept raises questions of competition, regulatory oversight, and the role of the state. The state's role is especially important because the presence of a monetary payment system within a broader financial system has important collective benefits, eliminating the need for a double coincidence of wants to effect exchange. When that system is intertwined with the savings and investment function of a financial system, risks can be misaligned in ways that prejudice the system's stability and put taxpayers at risk, necessitating government oversight.

In this chapter we argue that complete, efficient, and stable financial development can be fostered by promoting greater autonomy, accountability, and access across financial firms and their users. We begin by assessing the challenges across these three broad rubrics

[1] Economists usually refer to hedging consumption risk, rather than investment or income risk, on the assumption that smoothing consumption over one's lifetime is a person's main goal.

evident in the progress to date on financial integration in ASEAN. We then elucidate a series of goals that, if achieved, would foster the desired financial development. We also explore what macroeconomic or financial measures would complement our vision of a healthy, integrated ASEAN financial system.

Progress of Financial Integration

The vision of the ASEAN Economic Community is envisaged to be a multi-year process, with individual countries choosing to move at their own pace. The 'ASEAN Way' means that each economy can take further steps to improve financial services liberalisation and capital account liberalisation as and when they are ready. A country's readiness depends on a number of factors, such as favourable economic and financial conditions and, more importantly, having adequate policy frameworks, safeguards, and institutions in place.

The ASEAN region still has a long way to go in terms of achieving a fully integrated financial market. According to Rillo (2018), ASEAN countries have made some 583 separate commitments to liberalise the financial sector (categorised as banking, capital markets, insurance, and other), and completed 56% of those commitments. However, the vast bulk of these commitments have been concentrated in insurance, and few focus on banking outside of Viet Nam, Cambodia, and Myanmar.

The relative paucity of liberalisation in banking is important because banks have traditionally dominated the ASEAN financial landscape. Commercial banks account for a majority of all financial assets in ASEAN, although domestic capital markets have developed quite rapidly in some of the larger economies since the AFC. Despite a large presence of international banks within the region, the presence of ASEAN-based international banks has expanded significantly, especially within the region. Large international banks are naturally preferable because they have more advanced banking technology and a global network. The ASEAN Banking Framework was established with this in mind, but is only expected to be implemented in 2020 due to differing levels of banking sector development in the region. The ASEAN Banking Framework is

designed to allow ASEAN banks to enter and operate freely in other ASEAN countries, creating a single market for banking services. The framework rests on three pillars: (i) the elimination of entry barriers for 'equal access', (ii) the elimination of discrimination against regional banks (providing 'equal treatment'), and (iii) ensuring an 'equal environment' through harmonisation and capacity building.

To promote regional financial integration by allowing ASEAN-based banks to operate in other countries within the region, a specific list of criteria for the qualified ASEAN bank (QAB) is proposed. These criteria are based on common principles but negotiated bilaterally between the host and parent countries on the principle of reciprocity. The QAB idea is similar to that of the European Union's 'single bank passports', which allows banks to operate in all EU member states. As of 2017, only four such bilateral QAB agreements have been signed, with Indonesia showing the most interest. QABs are intended to become pan-ASEAN banks that can compete with global banks and drive regional financial sector development. Several ASEAN economies have signed reciprocal bilateral arrangements regarding QABs, such as between Bank of Thailand and Bank Negara Malaysia. Bank of Thailand is also in the process of negotiating the establishment of QABs in Indonesia with that country's Financial Services Authority, and in Myanmar with the Central Bank of Myanmar. This progress is encouraging.

The liberalisation of capital markets is an important component of financial integration and the creation of a single ASEAN market. Free capital mobility allows excess savings within the region to be recycled and efficiently allocated towards productive investments, thereby promoting economic growth and welfare. The relationship between capital mobility and regional trade integration is mutually reinforcing. Capital mobility promotes further trade integration by facilitating payments for transaction through cross-border lending and borrowing. At the same time, increased trade openness helps to mitigate the risk of default because countries that are more open to trade are in better positions to service external obligations through export revenues, are less likely to default, and, hence, are less vulnerable to sudden reversals of capital flows. However, according to Vinokurov (2017), ASEAN capital markets are still burdened by the following restrictions:

(i) most countries limit the use of their currencies overseas;
(ii) there are restrictions on overseas borrowing and lending denominated in local currencies;
(iii) most countries restrict foreign exchange risk hedging by investors; and
(iv) some countries still use a withholding tax on securities investment.

As in the banking sector, steps have been taken to encourage capital market liberalisation. The Implementation Plan for ASEAN Capital Markets Integration established in 2009 covers the creation of regulatory environment and market infrastructure, the development of new products, and the expansion of domestic capital markets (Shimizu, 2014). Capital market integration in the region is also rendered more challenging by the varying exchange rate regimes—from Brunei Darussalam adopting a fixed exchange rate system (on par with the Singapore dollar), to Thailand and the Philippines using a managed float exchange rate regime.

Policy Implications

Kose, Prasad, and Taylor (2009) discussed the national economic development benefits of financial integration in terms of the development of the financial sector and key institutions, better governance, and informed macroeconomic policy. However, due to the varying depth of financial markets and sophistication of market institutions across the region, more developed economies benefit from financial integration to a greater extent than do emerging economies.

To achieve the best results, it is important to plan and coordinate the execution of the financial integration process carefully. The economic diversity in the ASEAN region in terms of the countries' development, regulatory infrastructure, and human capital is a risk on its own. To achieve full integration, it is important for the region to invest in capacity building to level the playing field. The region needs to be equipped with the right infrastructure such as legal, tax, and regulatory systems, as well as having adequate human resources and management skills to operate effectively under the new integrated financial market. Liberalising

financial services and allowing for the freer flow of capital is just one step to increase the breadth of financial integration across the region. However, with the right tools, the ASEAN region will be able to achieve greater depth in integration as well.

Jang (2011) raised the possibility of larger countries in the region, such as China, Japan, and the Republic of Korea, playing a more active role in furthering intra-regional integration to realise its benefits. The ASEAN Way provides more developed economies the opportunity to start the integration process before less developed economies. Despite concerns that the gaps between ASEAN countries could potentially widen due to differing speeds of financial innovation and development, it is also imperative that the less developed economies do not jeopardise their own financial stability for the sake of catching up.

The AFC served as a very good lesson as to how critical vulnerabilities in the banking and capital markets can emerge when there is rapid growth and inadequate supervision and regulation. Following the global financial crisis, the Group of 20 also addressed the need to enhance financial stability, promote financial sector development, and reform the international financial architecture.

Hence, while individual economies can work bilaterally or multilaterally to open up to each other and advance in terms of financial integration, a regional approach should be taken to ensure financial stability. There is a particular need to establish a regional oversight framework with a strong resolution management system in this single market. An ASEAN-wide oversight framework might also be necessary in the future given the diversity of financial systems across the economies. During a crisis, national-level decisions can have region-wide repercussions on financial stability. A key challenge for policymakers in the region would be to design and implement policies that support an integrated financial system that is both dynamic and resilient. For instance, a single regional supervisor could be established with responsibility for the oversight of large, systemic banks in the region. Harmonising regulations and supervisory frameworks can accelerate the pace and effectiveness of financial integration. Next, we look in greater detail at how greater

autonomy coupled with greater accountability and accessibility can provide the balance needed for ASEAN to reap the benefits of financial integration.

Improving Autonomy and Accountability

Autonomy – the scope to make independent decisions – is crucial in any environment in which actors are to be held accountable for their decisions. Financial decisions must, by their very nature, entail assessments of future uncertain outcomes. If a lack of autonomy distorts risk and return, it is unlikely that such decisions will be made prudently. Autonomy is also critical for holding actors accountable for their actions. Autonomy can be conceived of along three dimensions, that is degrees of autonomy between financial institutions; between financial institutions and the state; and between financial institutions and their customers.

Borrowers' autonomy is hindered by a structure that is highly concentrated amongst financial institutions, since market leading lenders can price in a manner that can be detrimental to customers. High concentration can diminish price competition, lessening the cost efficiency of the system, although not necessarily its profits (Berger and Hannan, 1998). Higher concentration can also foster less innovation since market power can provide excess profits.

One counter argument about bank size and concentration revolves around a purported connection between bank size and the acquisition of client information that helps overcome the problems of asymmetric information between lenders and borrowers. With the explosion of online information on retail customers and a reduction in its cost of acquisition, the extent of asymmetric information is likely eroding.

Owen and Pereira (2018) argued that, at least for financial inclusion, bank size does not adversely affect access, so long as the contestability of the market, measured by the price of a service and its marginal cost persists. Contestability is enhanced by the openness of a banking system to foreign competition, as has been demonstrated in papers by DeYoung

and Nolle (1996); Berger, Hasan, and Klapper (2004); and Claessens, Dornbusch, and Park (2001). In the ASEAN context, by increasing the passporting of ASEAN banks, member states would tend to lower net interest margins and increase the range of products provided.

Contestability is also likely to rise with the surge in the digitalisation of finance, reductions in the cost of communication, and the application of machine learning to the vast quantities of data now being produced. Generally falling under the rubric of fintech, the potential of new entrants to reshape existing financial hierarchies is already on display in the burgeoning of payments services offered by non-banks.

The labourious pace of advance on the QAB initiative reflects concerns amongst member states over the adequacy of each other's regulatory frameworks, as well as the potential for contagion and instability that greater integration can entail. Both of these issues relate to financial institutions' autonomy from the state. Regulatory or supervisory oversight of financial intermediaries is necessary because the failure of systemically important institutions is likely to necessitate capital injections from fiscal authorities to prevent broad macroeconomic distress. Such a role is clearly consistent with the ASEAN goal of financial stability, where regulation is focused on financial stability and on limiting the cost to taxpayers in the event of widespread financial distress.

In the context of the QAB programme, though, the entrance of other member state banks seems very unlikely to engender risks that would threaten overall financial sector stability in the recipient country if those banks meet local regulatory standards. Such concern might be warranted if, in the case of financial distress in the entrant's home country, the presence of the new entrant would lead to stronger contagion effects in the receiving country than would otherwise occur. Nonetheless, the solution is not to preclude QAB agreements, but rather to harmonise regulatory and supervisory standards concerning financial stability across ASEAN. A bigger issue than passporting ASEAN banks will likely be creating a proportional regulatory system focused on activities, rather than institutions, that can better manage the systemic risks that will arise as non-bank intermediaries take on larger roles in financial systems.

To achieve financial stability, rising market shares for those adopting fintech must be based on true improvements in cost and efficiency, not regulatory arbitrage that leaves the taxpayer at risk. In the context of the QAB programme, it might be prudent to license particular activities by fellow ASEAN banks, rather than the banks as institutions. While this would likely present a lower hurdle to entrance, it would be better aligned with the nature of the supervisory and regulatory environment that technological change is compelling states to adopt.

Some of the difficulty in reaching QAB agreements could reflect a link to the state that is less justifiable on the basis of financial stability than on regulatory oversight: the ownership/influence link between the state and financial institutions. The government ownership share in ASEAN banks is relatively high. Higher rates of state ownership are associated with poorer allocative and cost efficiency (Clark et al., 2005). These inefficiencies undermine financial stability. Aligning risk and return – crucial to the allocative efficiency of a financial system – hinges on eliminating implicit guarantees that arise more naturally when direct state ownership of financial institutions is prominent. In this light, protecting state banks from further competition by limiting QAB entry is counterproductive.

Besides helping to improve overall efficiency, efforts to lower the role of state-owned firms can lessen the incentive for the state to intervene. The playing field would also be more level, because the implicit guarantee on deposits in state-owned banks that accrues to them because of their state ownership would disappear. This, in turn, would create a greater incentive for large depositors to monitor the bank's credit portfolio and lessen the likelihood of poor credit decisions.

The reticence to enter into QAB agreements may also reflect regulators' concern that the QAB may not be as susceptible to moral suasion from the receiving country's regulators. Yet, if a regulatory system relies on moral suasion or unwritten rules for stability, resiliency will depend on how deeply those rules are held and how adroitly moral suasion is applied. Although social conventions are important constraints on behaviour, they do not move easily from one society to another. Thus, in targeting integration, ASEAN will need to codify social conventions

as principles by which outsiders can abide. The system of adhering to principles rather than to specific, detailed regulations has the advantage of adapting more easily to a shifting environment and being less susceptible to gaming.

The third dimension of autonomy is that which exists between financial institutions and their customers. When customers become captive to particular institutions, either because there are few institutions or because the cost of switching service providers is high, customers' leverage over pricing and their range of choices can erode. Maintaining a dynamic, competitive market will require regulatory efforts to avoid artificial barriers to customers who wish to change providers. Transparency in costs and the promotion of financial literacy, already elements of the AEC blueprint, will need to continue to form a part of the strategy for achieving financial development.

While autonomy can create a better decision-making environment and one in which accountability is easier to maintain, the irreducible element of uncertainty in any financial contract means that defaults and losses will occur. Thus, to maintain accountability, it is crucial to have a legal framework for contract resolution that combines fairness with speed and low cost, especially when hedging is limited as is the case across much of ASEAN.

Improving Accessibility

Accessibility to finance has been an objective of ASEAN ever since 1995 when members committed to push for greater integration of services. In that sense, the milestones and objectives already in place to widen both the scope of financial products on offer and the take-up of those products by a wider swathe of persons and firms remain relevant.

Going forward, accessibility can be massively expanded by the prudent adoption of the technologies embodied in fintech. To date, much of the attention has focussed on reducing the cost of payments and broadening access created by settling payments through cellular telephones. Simply

lowering costs increases access by raising the number of people who can afford to use the service. Meta-search aggregators enhance competition by making pricing more transparent. However, to the extent that banking involves intermediating saving and investment, not simply processing payments, there is still a wide scope for improving accessibility.

Retail credit extension currently relies heavily on the borrower's financial capital, which is not evenly distributed. Yet, non-banks are now extending credit not simply on the basis of financial capital, but on the basis of the nature of the social capital a borrower exhibits through activity on social media. Such social capital is inherently more evenly distributed as it requires only a cellular telephone.

To capture the benefits of greater financial inclusion through fintech, governments must take several enabling steps. Most fundamentally, they should invest in a high-speed 5G cellular network. 5G, which will form the backbone of the next stage of cellular technology, will offers download speeds 1,000 times faster than today's 4G, and its cell stations will be a small fraction of the cost of current 4G stations (although at least four times as many will need to be deployed given the smaller effective radius covered by the high-frequency spectrum used by 5G).

Beyond investing in telecommunications networks, governments will need to think through the trade-offs between data security and data availability. If future credit decisions hinge on social media and cellular telephone usage, it must be determined where that data will reside and under whose control. Decisions on the boundaries between personal privacy, business interest, and national security will profoundly affect who has access to the data needed to propagate the machine learning for building effective algorithms. This gives rise to practical questions as to the quantum of data needed to produce accurate algorithms, and how varied the criteria will be by region. Here, harmonising legal and regulatory regimes will likely increase the accuracy of lending algorithms developed based on data from other areas.

The question of who controls data developed through the use of social media will also be a crucial factor in understanding the stresses faced by incumbent financial intermediaries. If the large platform companies that house social media applications hold the data to assess 'social capital', incumbent financial intermediaries will need to focus on intermediation that is less dependent on 'social capital', such as merchant or investment banking.

The underlying turmoil in the provision of retail banking will challenge the regulatory and supervisory structure for financial stability, in dealing with both the 'stock' of existing institutions facing disruption and the 'flow' of new services. This could be especially problematic for large institutions with low-cost, sticky retail deposits but high legacy overhead costs if those deposits are lost to new entrants. Fintech will also heighten the need to calibrate regulations based on activities rather than on institutions to ensure that the flow of new services is subject to regulations that will shield taxpayers from bailout costs created by inefficient regulatory arbitrage.

Regional Financing Arrangements and the Global Financial Safety Net

As regional financial markets become more integrated and financial systems continue to expand and become more complex, not only within the region but also globally, this could lead to financial instability. The experience of the AFC 20 years ago and more recent crises in other regions have shown that volatility shocks from global financial markets are becoming more frequent. Banking crises have been a major source of macro instability since the 1980s, rising in tandem with intensifying financial deepening and interlinkages. While rapid credit growth marks desirable financial deepening and market developments, it may also increase economies' vulnerability to financial stress if loans are not subject to prudent credit standards and overall portfolios subject to periodic stress testing.

The first line of defence for countries to weather crises and external shocks are their own regulatory frameworks. The Basel Committee

on Banking Supervision has provided recommendations on banking regulations with regard to capital risk, market risk, and operational risk as standards to enhance global financial stability. However, the level of adoption and implementation of these standards within the region varies across countries, depending on their level of development and market sophistication. Larger economies such as China and Japan, and financial centres such as Hong Kong and Singapore are working towards implementing the Basel III standards, while smaller economies such as Brunei Darussalam, Cambodia, the Lao People's Democratic Republic, Myanmar, and Viet Nam have either just adopted or are in the process of fully adopting the Basel II standards.

In terms of external safeguards, past crises have shown that International Monetary Fund (IMF) resources alone are insufficient for crisis financing. In addition, borrowing from the IMF continues to be seen as carrying a stigma. This motivated the ASEAN+3[2] economies in 2000 to set up a network of bilateral swaps between central banks known as the Chiang Mai Initiative, which was multilateralised into the Chiang Mai Initiative Multilateralisation (CMIM) in 2011. As a regional self-help mechanism, the CMIM aims to address short-term United States dollar liquidity or balance-of-payment difficulties, and complements IMF financing together with bilateral swap arrangements. The CMIM and other regional financing arrangements, (RFAs)[3] form an integral part of the global financial safety net, together with other layers such as an economy's own foreign exchange reserves, bilateral swap arrangements, and IMF resources.[4] The CMIM, which currently has an endowment of $240 billion, stands at the centre of the ASEAN+3 regional financial safety net, complemented

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[2] Brunei Darussalam, Indonesia, Malaysia, the Philippines, Singapore, Thailand, Myanmar, Cambodia, the Lao People's Democratic Republic, Viet Nam, China, Japan, and the Republic of Korea.

[3] RFAs have proliferated since the 2008 global financial crisis. In addition to the CMIM, these include the Arab Monetary Fund, BRICS (Brazil, Russian Federation, India, China, and South Africa) Contingent Reserve Arrangement, the European Stability Mechanism, and the Latin American Reserve Fund (Fondo Latinoamericano de Reservas).

[4] Policymakers are currently working towards strengthening the collaboration between the existing RFA and the IMF. A joint RFA staff paper (2018) discussed the importance of fostering the RFA–IMF collaboration through capacity building, information sharing and communication, and crisis prevention and resolution. It is necessary to explore these synergies due to the heterogeneity of RFAs and their respective mandates, expertise, operational modalities, and geographical coverage.

by an expanded network of bilateral swap agreements amounting to approximately $260 billion. Given the external risks now facing the region, firm policy commitment from ASEAN+3 to enhance the CMIM with support from AMRO is essential to strengthen the region's buffers and resilience. AMRO's macroeconomic surveillance process and its role as trusted policy advisor through frequent dialogue and engagement with the ASEAN+3 economies are key to identifying the risks and vulnerabilities facing the region. Enhancing the role of AMRO is therefore crucial to safeguard the region's economic and financial stability.

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