

Role of Finance in Regional Economic Integration: Limitations and Opportunities *

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* The views expressed here are those of the author and do not necessarily reflect the views of the Asian Development Bank (ADB) or ADB's Board of Governors or the countries they represent.

Limitations and Opportunities

1. What does the global crisis mean for Asian financial integration?
2. How are Asian financial markets integrating?
3. Where do we go from here?

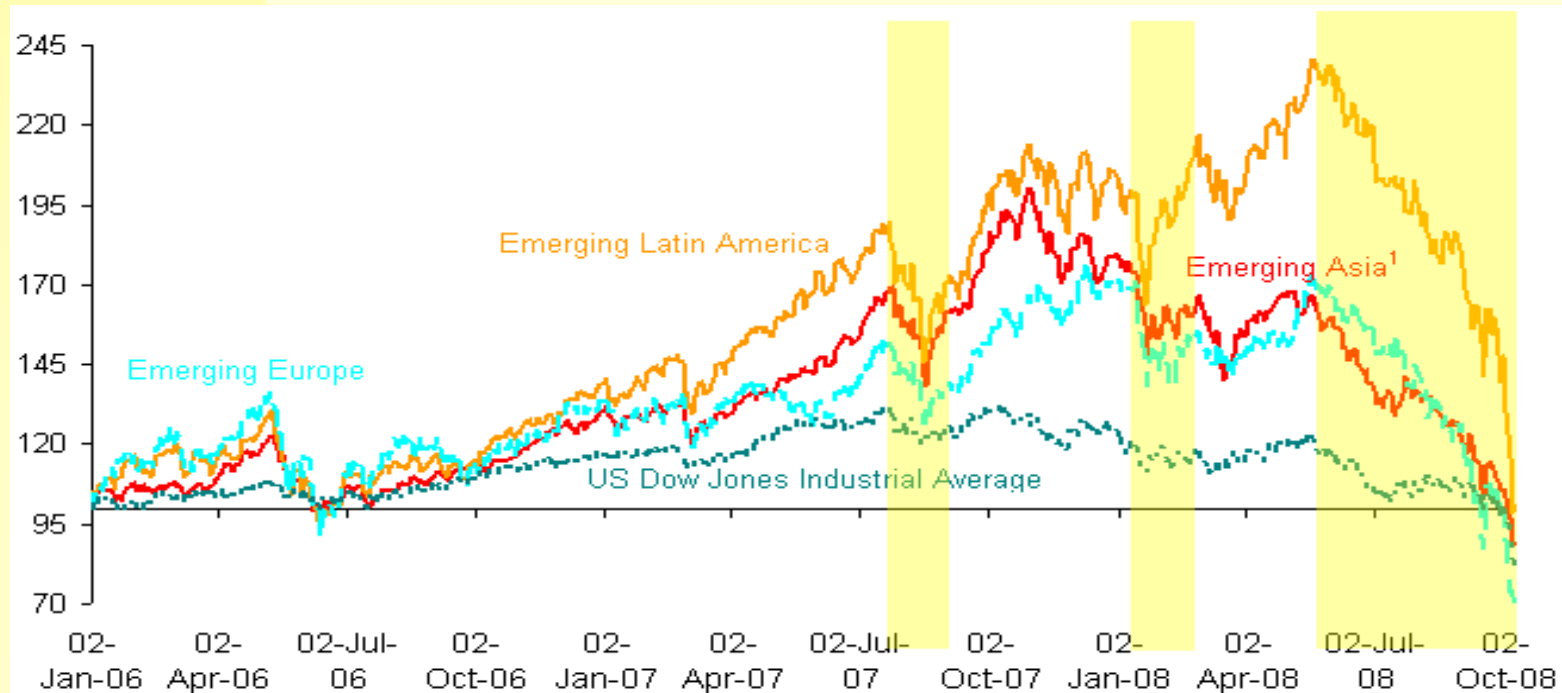
1. What does the crisis mean for Asian financial integration?

- Contagion leaves no-one a bystander
- Global banks scrambling—
Asia less affected
- Channel Asian savings into Asian investment

Contagion leaves no-one a bystander

Equity market correlation is greater during downturns

MSCI Indexes (2 Jan 2006=100)



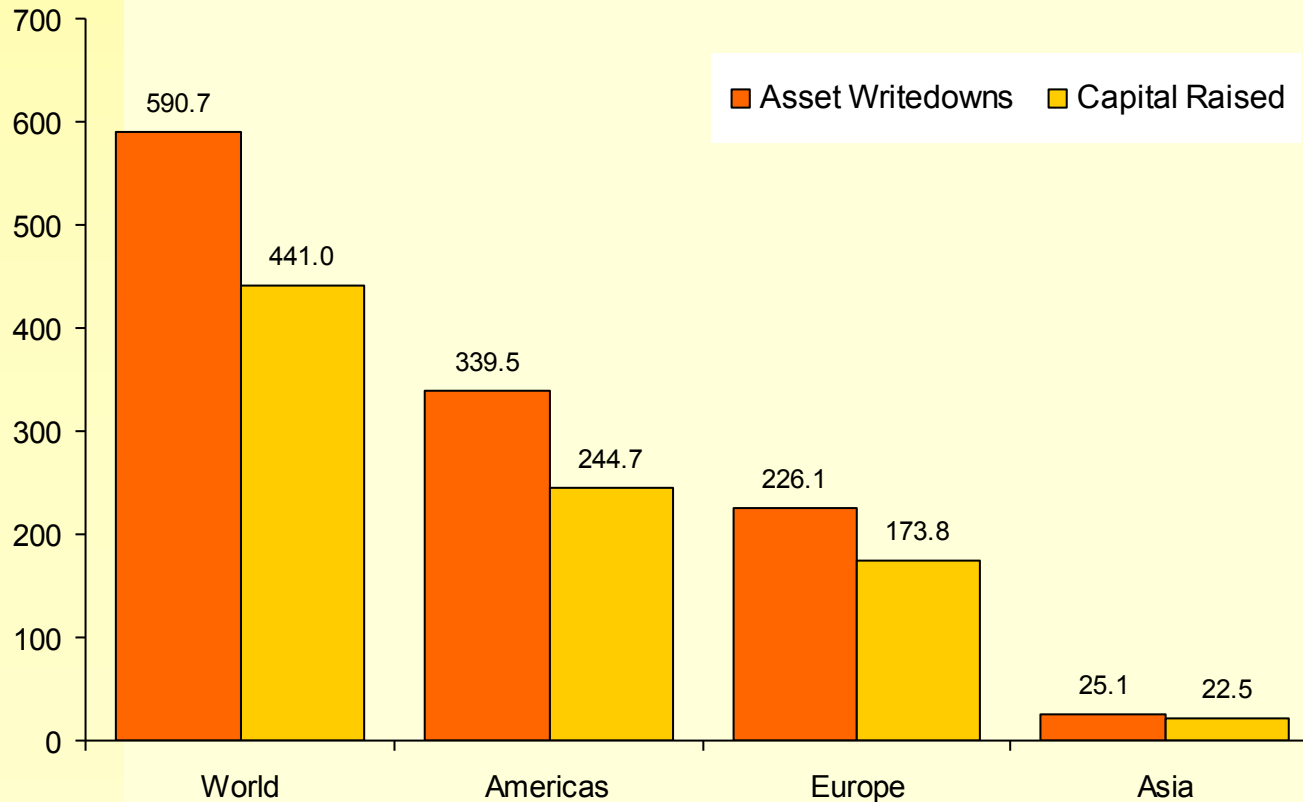
Note: The shaded areas indicate the periods 15 Jul to 20 Sep 2007; 14 Jan to 28 Feb 2008; and 22 May to 9 October 2008.

¹Includes China, People's Rep. of; India; Indonesia; the Republic of Korea; Malaysia; Pakistan; Philippines; Taipei,China; and Thailand.

Sources: Morgan Stanley Capital International (MSCI) Barra and Bloomberg.

Global banks scrambling— Asia less affected

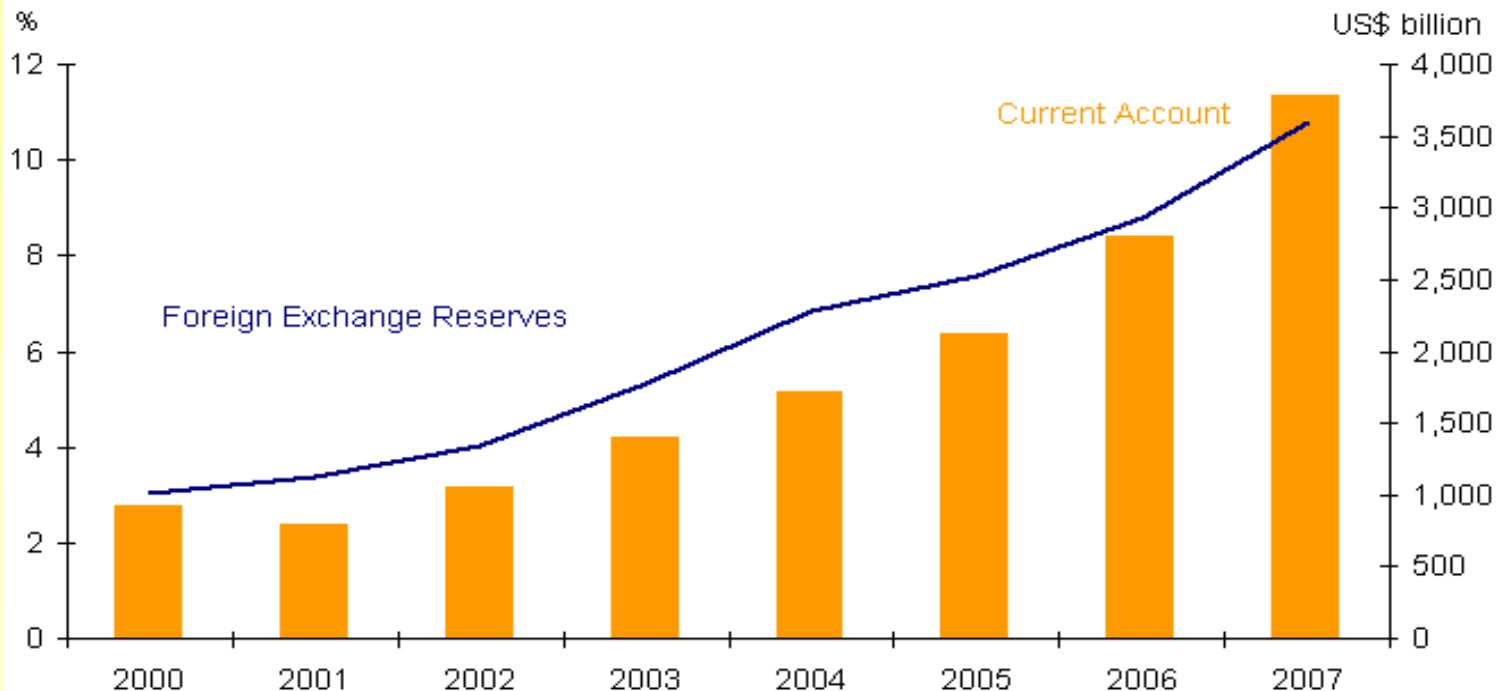
Writedowns and capital raised by major banks since the third quarter of 2007
(US dollar billions)



Source: Bloomberg.

Channeling Asian savings into Asian investment

Current Account (as % of GDP) and Foreign Exchange Reserves (US\$ billion)
—Emerging Asia¹ + Japan



¹ Includes China, People's Rep of; Hong Kong, China; Indonesia; Korea, Rep of; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.

Sources: *Asia Economic Monitor* July 2008, and CEIC.

Inadequate financial development drive Asia to export capital to the U.S.



Notes: Based on USG data released on 4/30/2008. Includes official and non-official sector holdings.
 * Bahrain, Iran, Iraq, Kuwait, Oman Qatar, Saudi Arabia & United Arab Emirates.

Source: Forbes, Kristin J. "Why do foreigners invest in the United States?" (NBER Working Paper, April 2008).

Need to focus on developing internally well-integrated and vibrant Asian financial markets

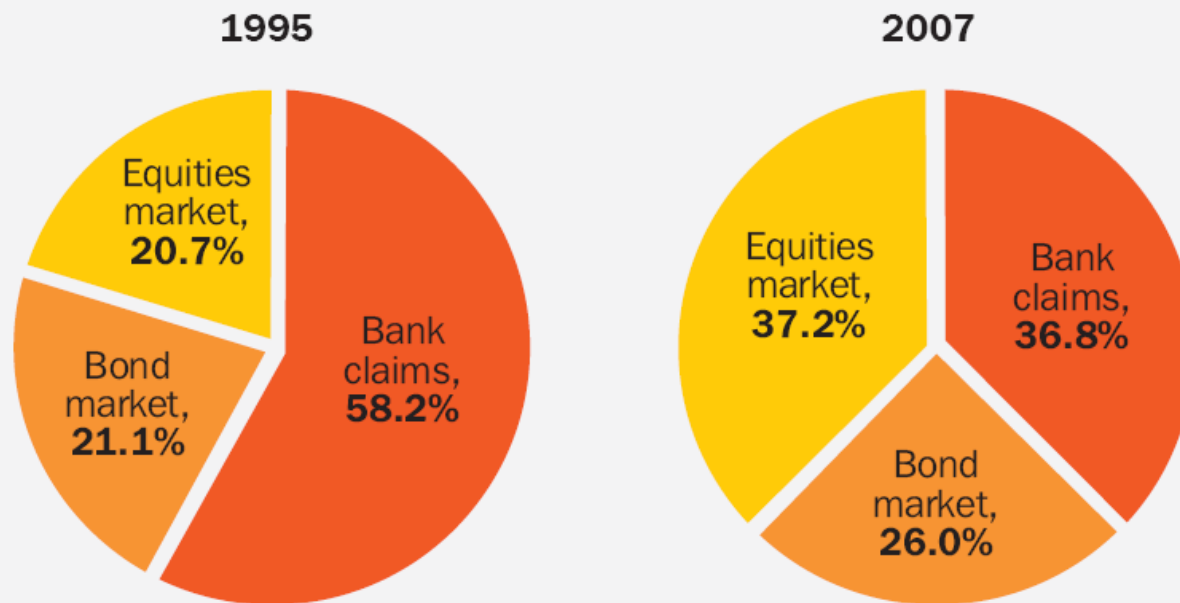
- Global payments imbalance coming home to roost
- Not only is it shiploads of goods to US markets, but today it is transfers of capital
- Asia invests in US because its own financial markets are less developed
- Need deep and liquid markets to intermediate Asian savings into Asian investments
- That's why financial integration so crucial

2. How are Asian financial markets integrating?

- Financial systems starting to diversify
- Debt markets taking their place
- Price indicators converging
- Stock price correlations are increasing
- Asia needs to invest in Asia!
- Develop Asia's financial centers
- Building an architecture for Asian integration

Financial systems starting to diversify

Increasing share of capital markets
(share of total Asian financial assets)



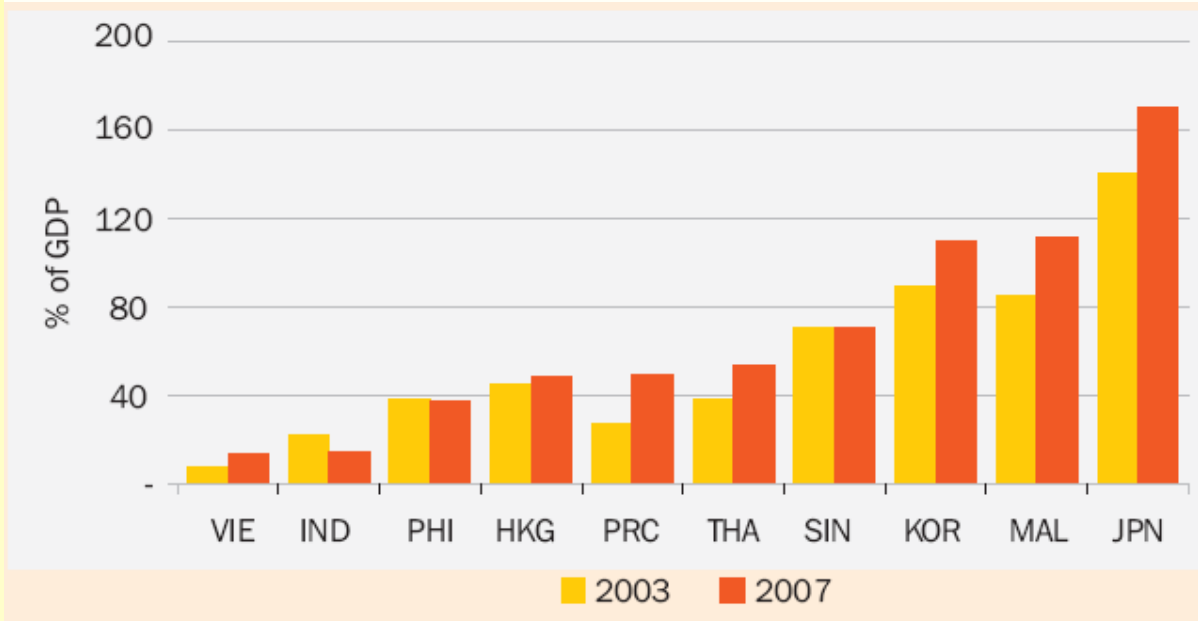
Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

Debt markets taking their place

(partly due to regional initiatives)

Local-currency bond markets

(share of total issuances in GDP—2003 and 2007)

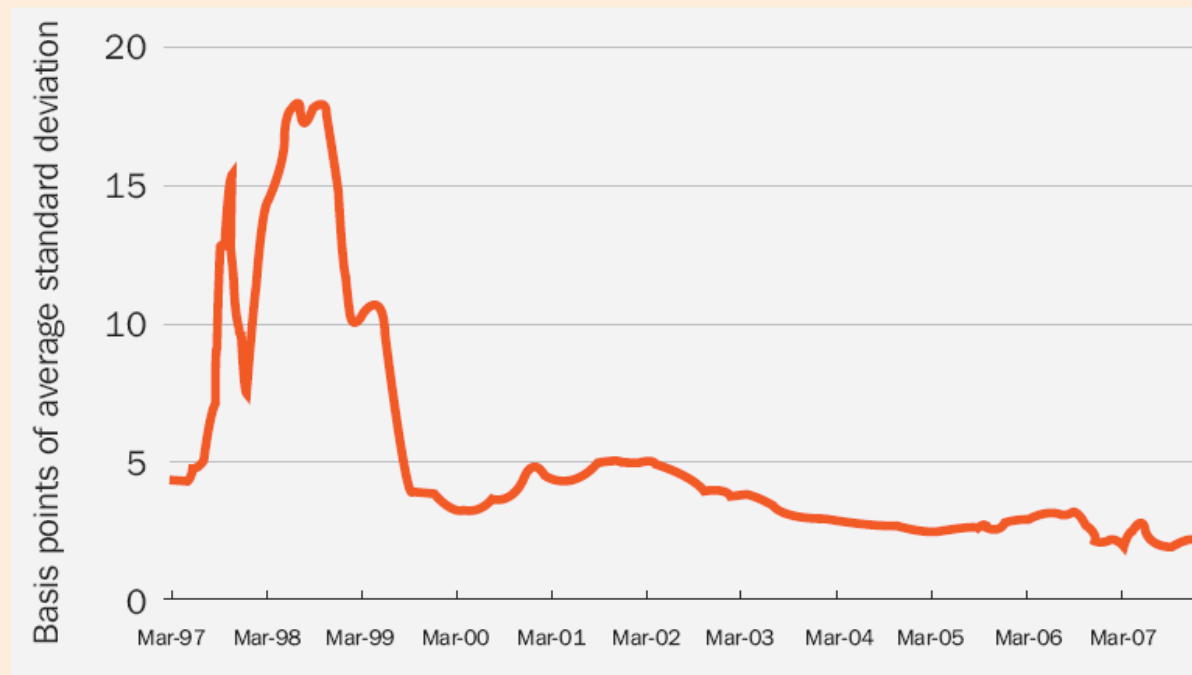


Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

Price indicators converging

Declining interbank rate differentials

(Standard deviation of cross-market overnight interbank rate differentials)

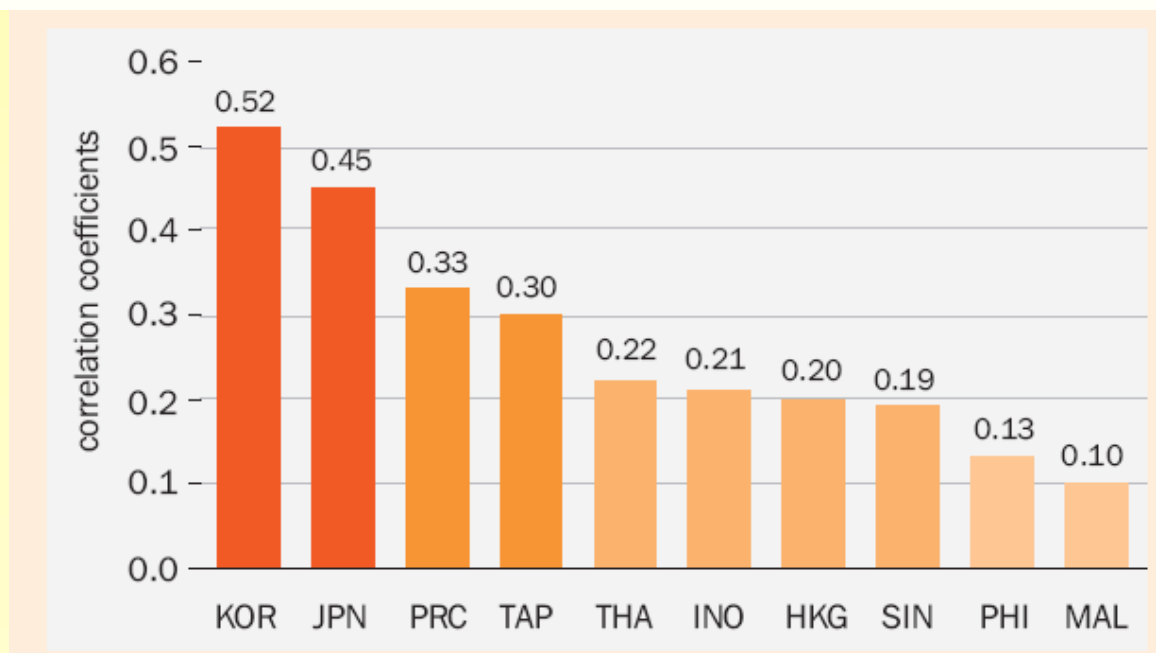


Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

Stock price correlations are increasing

Correlation of Asian stock price indexes

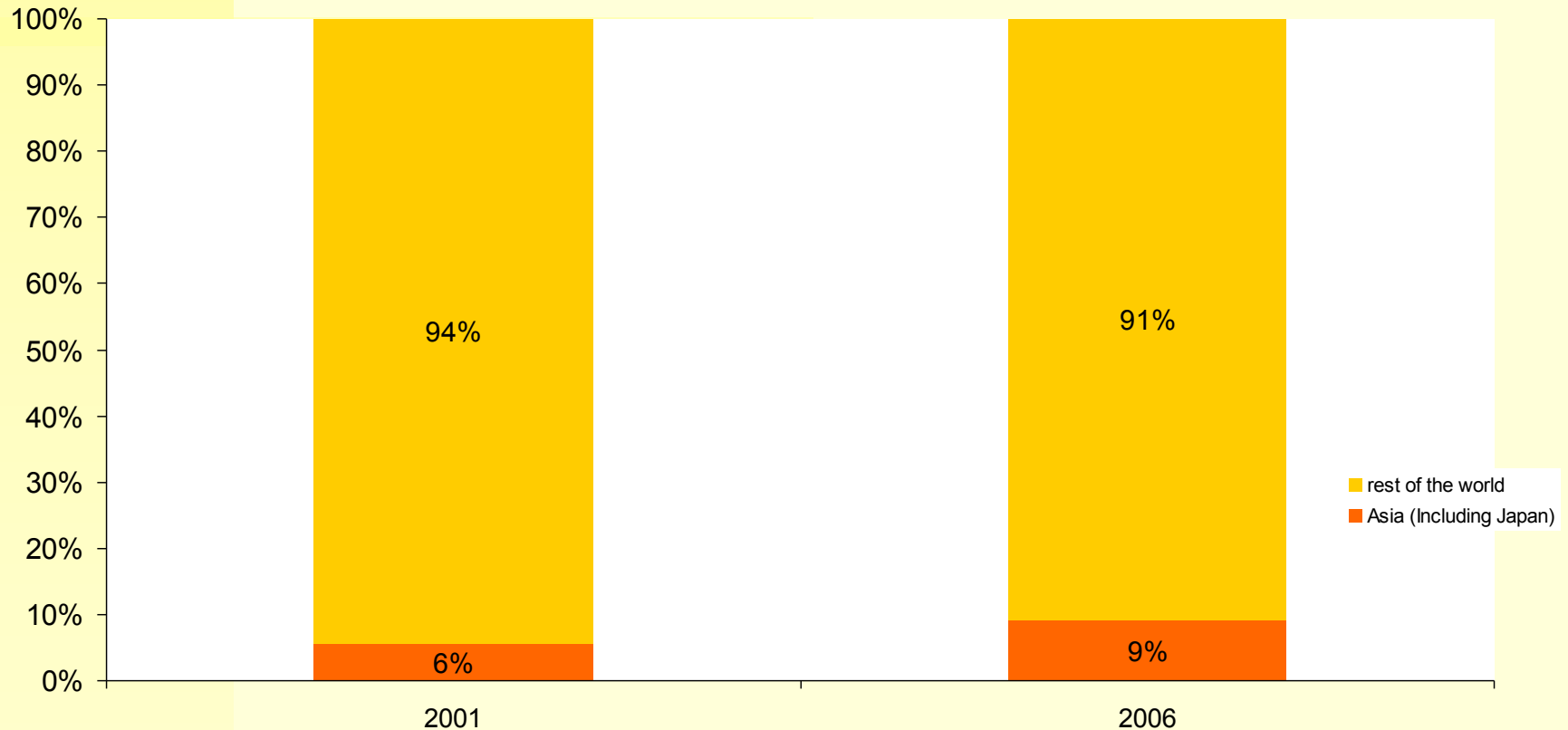
Absolute changes in the average of bilateral correlation coefficients precrisis (1990Q2–1996Q4); postcrisis (2000Q1–2006Q2)



Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

Asia needs to invest in Asia!

Invested Asian assets (% of total)



Notes: Asia includes PRC; Hong Kong, China; Indonesia; Japan; Rep of Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand.
Source: Staff calculations based on data from IMF Coordinated Portfolio Investment Survey.

Develop Asia's financial centers



Asia's Financial Centers

3 Global

5 Regional

18 National

Growing regional and global integration

Increasing competition

Developing infrastructure

Domestic financial reforms

Harmonizing regulations

Regional cooperation

Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

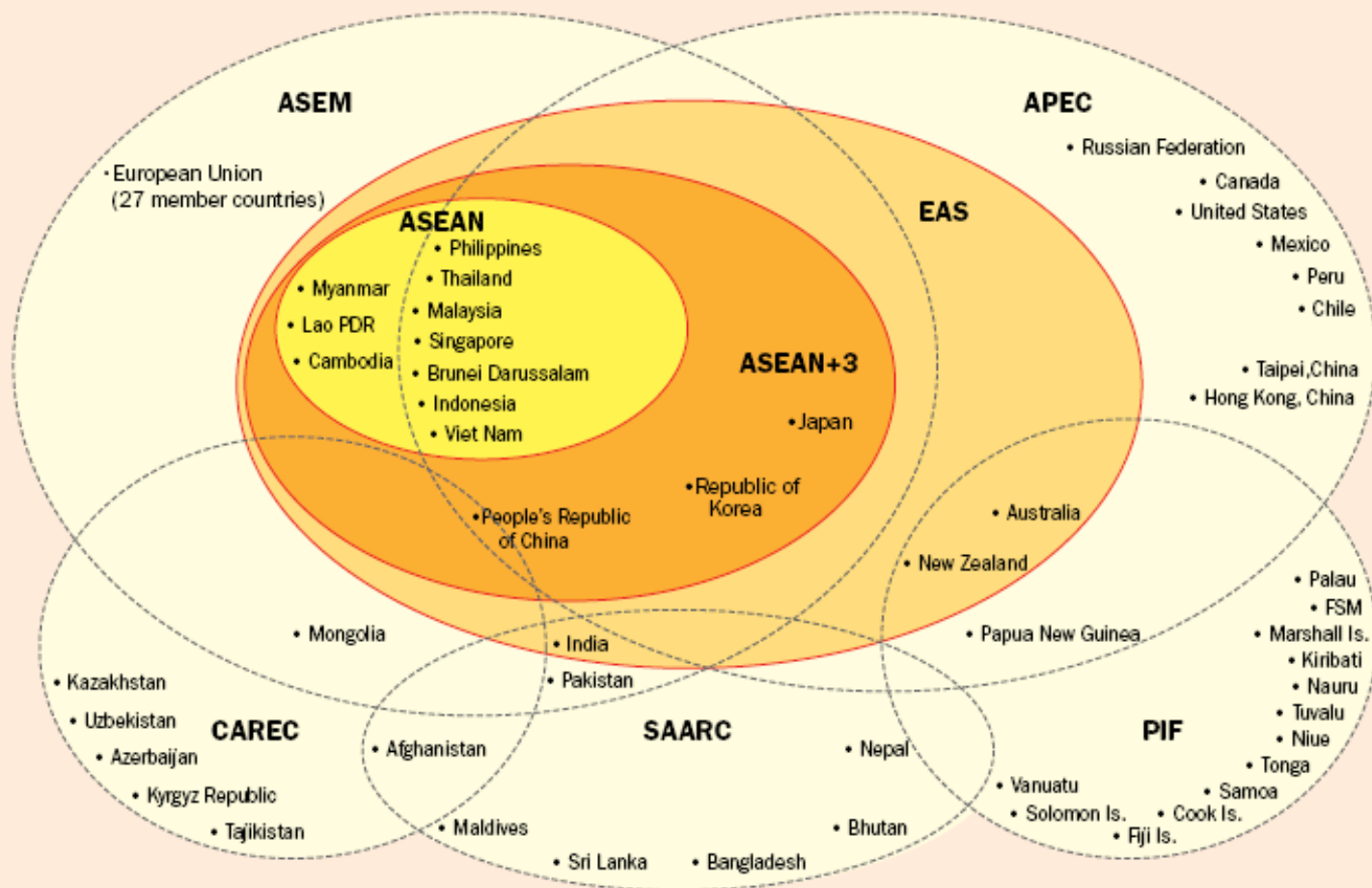
Building an architecture for Asian integration

Emerging monetary and financial cooperation

Forum	Finance ministry-led cooperation				Central bank-led cooperation			Others	
	APEC	ASEAN	ASEAN+3	ASEM	EMEAP	SEACEN	SEANZA	ACD	EAS
Year established	1989	1967	1999	1996	1991	1966	1956	2002	2005
Number of members	21	10	13	45	11	16	20	28	16
Function	Policy dialogue/information exchange	✓	✓	✓	✓	✓	✓	✓	✓
	Surveillance/peer review		✓	✓		✓			
	Regional financing arrangements		✓	✓		✓			
	Regional capital-market development	✓	✓	✓		✓			
	Capacity building	✓	✓	✓	✓	✓	✓	✓	
	Research	✓	✓	✓	✓	✓	✓		

Source: *Emerging Asian Regionalism: A Partnership for Shared Prosperity*

Economic architecture: regional and transregional forums



APEC = Asia-Pacific Economic Cooperation; ASEAN+3 = ASEAN plus three countries, as shown; ASEAN = Association of Southeast Asian Nations; ASEM = Asia-Europe Meeting; EAS = East Asia Summit; CAREC = Central Asia Regional Economic Cooperation; FSM = Federated States of Micronesia; Lao PDR = Lao People's Democratic Republic; PIF = Pacific Islands Forum; PRC = People's Republic of China; SAARC = South Asian Association for Regional Cooperation.

Notes:

ASEM includes also the European Commission as a member.

For CAREC, the PRC's membership is focused on the Xinjiang Uygur Autonomous Region.

Source: Asian Development Bank.

3. Where do we go from here?

Lessons from the current meltdown

- Complexity is not innovation
- Leverage is not credit
- Risk dispersion is not risk reduction
- Market discipline is no substitute for regulation—“voluntary regulation does not work” (SEC Chairman Christopher Cox)
- In good times prepare for bad—case for countercyclical regulation

Financial market turmoil an impetus for accelerated Asian financial integration?

- Internally integrated yet globally connected Asian markets
- Promote “Asian Financial Stability Dialogue”
- Balance innovation with financial stability; market freedom with government regulation
- Bailout and rescue overtakes liquidation in turbulent times
- Public-Private Partnerships
 - Private sector and financial markets adhere to public regulations
 - Public sector helps markets adjust in times of distress

Fixing Asian Finance

Priorities

- Increase resilience against financial crises
- Develop larger and deeper regional financial markets
- Reduce transaction costs by strengthening the regional intermediation of savings, and by improving returns to investors and reducing firms' borrowing costs

Policy Solutions

- Improve financial market surveillance and create an "Asian Financial Stability Dialogue"
- Promote harmonization of financial regulations and mutual recognition of financial standards
- Strengthen financial markets (especially including local currency bond markets)
- Prudently liberalize capital accounts and cross-border financial services

Thank you

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