# Asian Economic Integration Monitor (AEIM) April 2014 Launch and Seminar on Regional Cooperation and Integration, Asian Institute of Management, Makati City, 22 April 2014

I highly appreciate your invitation for me to be a panelist at this event, which launches the ADB's AEIM 2014. I note that this is the 4th publication year and that the Report evolved from the Asia Economic Monitor, which started in 2001. I find this launching especially significant as it precedes the AEC aspirational timeline of 2015.

**Focus of Comments**. The AEIM2014 is as usual most informative but I choose to limit my comments on the following points –
(1) the impact of the quantitative easing on the regional integration agenda;
(2) the debate on the AEC timeline;
(3) the current effort to integrate the regional banking system;
(4) maintaining the relevance of the CMIM as a regional financial safety net; and
(5) capacity building in the region as a critical equalizer.

**(1) Quantitative Easing**.

*AEIM Commentary*: The section on the external economic development argues that the US recovery drives the US FED's decision to taper its quantitative easing (QE) program and ultimately start its normalization of interest rates. The announcement of (QE) tapering in December 2013 caused a transition in the global economy by probably limiting financial stability risks posed by an extended period of low interest rates. The impact on EMEs will most likely include capital reversal and volatility, assets valuation, and currency adjustments.

*What is the transmission process?* We all know that risk aversion will somehow increase and this is expected to intensify volatilities in capital flows and impede the smooth functioning of financial markets. Consequently, this may put a squeeze on credit markets and liquidity, with adverse consequences on the availability and cost of funds. At the same time, interest rate hikes to help stabilize asset markets in the course of capital reversal could raise debt servicing costs and lower asset valuation, posing significant valuation losses for bond holders.

*Impact on the ASEAN*. No doubt, the ASEAN member countries have been most affected by negative market sentiment since the US QE announcement in December 2013. Movements in regional equity prices were quite erratic and capital flows have become more volatile. If combined with domestic weakness, the result could be substantial capital outflows and sharp exchange rate adjustments. In this regard, policy buffers are needed and have to be used wisely to balance financial stability and growth.

Which brings us to one important question:

*To what extent will these global economic developments affect regional integration?* More specifically how will increased risk aversion impact capital account liberalization (CAL), financial services liberalization as well as initiatives to develop the regional capital markets?

I believe domestic priorities precede the regional integration agenda. In fact, ASEAN economies implemented their own policy mix to deal with external and financial market weaknesses. These measures include fiscal consolidation, tightening monetary policy, allowing local currency adjustment, recalibrating macro-prudential or capital flow measures, and pursuing structural reforms to enhance export competitiveness. Indonesia, for one, adopted a clear strategy in the form of bold, pre-emptive decision to put priority on the stabilization of the economy over growth. It raised policy rates progressively in four months last year. Thailand did the opposite by cutting policy rates three times from 2013 to the first quarter of 2014 to address greater downside risks to growth stemming from delay in government investment and fragile private confidence. Finally, the Philippines maintained policy rates based on a manageable inflation environment that is consistent with market expectations. In particular, the BSP reduced the interest rates on the special deposit account (SDA) facility. The manageable inflation environment and robust domestic growth prospects provided scope for further enhancing the efficiency of monetary operations in absorbing liquidity through the SDA facility. The bottomline of this is that even as the ASEAN member states approached the global challenges to growth and stabiulity based on their own national perspective and priorities, the resulting strength and resiliency would actually promote the broader cause o regional integration. Stronger ASEAN member states are in a better position to look outward and pursue handholding together.

**(2) The AEC timeline.**

My second comment is on the AEC timeline. The general approach to financial integration as approved by ASEAN central bank governors involves:
(a) an agreement on the end-goal of financial integration;
(b) a recognition that each AMS has its own initial conditions; and the
(c) the necessary preconditions to build before achieving specific milestones towards financial integration.

*General idea of ASEAN integration*. It is a highly phased approach in which some members may be able to achieve the end goal earlier, while some may follow later. The idea is to reach the same goals at different speed, with different milestones.

Financial integration is not imposed and mandatory but follows a multi-track approach through various sector-specific initiatives. While there are major deliverables for 2015, ASEAN is only aiming for a semi-integrated market and not full liberalization in all dimensions. ASEAN has achieved significant progress in all areas of financial integration and continues to work towards instituting the necessary reforms and measures to meet the liberalization targets under the AEC.

*Progress so far*. In fact, as of end-2013, ASEAN has implemented 72.2 percent of all AEC measures targeted for the monitoring period of January 2008-December 2013. Notwithstanding significant achievements in several areas, more effort is needed especially in the areas of trade facilitation, services, investment, and transport.

*Looking ahead.* While the AEC envisions regional integration to be achieved by 2015, this to me is an aspirational target. Given the varying levels of development and preparedness of the ASEAN members states, the effort to integrate the region may be more realistic if one were tro talk about achieving it by 2020, the original timetable.

It is good to target 2015, but we should not be hard on ourselves if we breach our timelines. The point is not to waste any more time, the point is to do things today as much as we can, as early as we can.

**(3) The current effort to integrate the regional banking system**

My third point is on the progress of initiatives on banking integration. I focus on this issue because the outlook on trade and investment is critically linked to an integrated system of financial intermediation.

ASEAN has achieved significant progress in establishing a guiding framework for the integration of the ASEAN banking sector to promote deeper regional financial integration through more meaningful participation of Qualified ASEAN Banks (QABs), and in turn, promote regional growth and financial stability. The task, however, is difficult and complex. Economic conditions as well as legal and structural limitations vary across member states.

*Benefits and risks of banking integration*. Banking integration can provide banks the opportunity for capturing larger markets, lowering banking costs, and increasing efficiency as well as mobility of services. But we also know that increased integration may also potentially increase risks attendant to cross-border transactions, capital flows volatility, and risks of contagion. The recognition of the benefits, risks, and the diversity of ASEAN is, therefore, a key element in forming the appropriate parameters in implementing banking integration in ASEAN. The challenge is to build a framework that takes into consideration domestic conditions and encourages efforts towards reducing existing restrictions. In this context, ASEAN member states continue their work in drafting the Guidelines for the ASEAN Banking Integration Framework, with focus on strengthening the following principles and elements: readiness, reciprocity, bilateral negotiations, capacity-building and financial stability infrastructure. Let me just say a few words on reciprocity and bilateralism.

*Reciprocity*. Reciprocity is defined as the set of market access and flexibilities to be granted to QABs based on reciprocal arrangements between home and host countries. It bears emphasis that the rules for the entry of QABs will also respect domestic laws and licensing requirements of the host countries.

*Bilateralism.* On the other hand, bilateral negotiations allow countries to agree on arrangements that are mutually acceptable to both parties. But countries are committed based on the principle of national treatment to treat enterprises operating in its territory, but controlled by the nationals of another country, no less favorably than domestic enterprises in like situations. In short, no one size fits all; domestic conditions will continue to drive the extent and the progress of regional banking integration.

Given this set of principles enshrined in the Guidelines, there are recent concerns for making the ABIF Guidelines more meaningful and beneficial

across ASEAN and not to favor only the bigger banking players. Cross border banking integration does not exclude the possibility that domestic banking markets will eventually be dominated by foreign banks.

*Current situation in regional banking*. The overseas expansion of ASEAN commercial banks into other ASEAN countries is very limited. In fact, there is no ASEAN commercial bank that has either a branch or a subsidiary in all ASEAN countries. The three most internationally active banks in ASEAN (i.e., Maybank of Malaysia; Bangkok Bank of Thailand; and UOB of Singapore) have subsidiaries in six out of the 10 countries of ASEAN and a branch in one country. For example, Maybank has either a branch or a subsidiary in Indonesia, Malaysia, the Philippines, Brunei Darussalam, Cambodia and Viet Nam, as well as a representative office in Myanmar.

Compare this with the Philippines - out of 676 Philippine domestic banks, only **5** universal banks, have international presence abroad. While the Philippine banks have limited presence in ASEAN countries, Philippine banks (BDO, Metrobank, Philippine National Bank, Land Bank of the Philippines) have established branches/representative offices in other parts of Asia such as Hong Kong, Japan, Korea, China and Chinese Taipei – not in ASEAN. Additionally, the Philippine banks are still relatively small compared to the top players in ASEAN. For example, the assets of DBS Singapore is bigger than the entire Philippine banking system and almost four times the combined assets of the top 3 banks in the Philippines. The biggest Malaysian bank has combined assets twice the size of the total assets of the top 3 banks in the Philippines. In terms of capitalization, the largest Malaysian and Singaporean banks have capitalizations equal to the capitalization of the entire banking system. Economies of scale will tend to dictate the rules of the game. The risk of domination suggests that the rule of integration should consider domestic preconditions – for example, allowing member states with less developed banking institutions to liberalize market access of foreign banks to their domestic market at a slower pace.

**(4) Maintaining the relevance of the CMIM as a regional financial safety net**

My fourth point is on strengthening of the Chiang Mai Initiative Multilateralization or CMIM**.** ASEAN, China, Japan and Korea are continuously putting in efforts to further strengthen the region's own financial safety net in the form of the CMIM. The CMIM, as it is today, is a US$120 billion fund pooling arrangement that aims to provide dollar liquidity in the event of a balance of payments (BOP) difficulty. It was decided that the CMIM will double its fund size from USD120 billion to USD240 billion and will have a crisis prevention feature that is expected to provide sizeable dollar liquidity

support to its members in the event of not only an actual crisis situation but also in case of even an impending liquidity difficulty. The recent amendments will also increase the CMIM portion that is not linked to any program under the International Monetary Fund (IMF) from 20 percent to 30 percent, with a view to further increasing it to 40 percent this year.

Given the present favorable conditions of ASEAN+3 countries, the next steps may include discussions on further increasing the fund size and given the much improved surveillance capability of the AMRO, its progressive de-linking from an IMF program. There is also a greater need for additional safety nets given the volatility in global conditions. Within the ASEAN, risk and crisis management protocols have been developed to speed up possible dialogue and policy exchange among the central bank governors. It is important that this is stepped up.

This is the pressing agenda for the ASEAN and its 3 partners.

**(5) Capacity building in the region as a critical equalizer**

*Requirements of financial intregration*. If financial integration is to succeed, the ASEAN financial regulatory agencies must be adequately equipped with relevant resources – human resource capacity and supportive legal, tax and regulatory systems to support financial market infrastructures. Developing countries do not have sufficient resources to build infrastructures.

In support, ASEAN established the Steering Committee on Capacity Building (SCCB) to provide necessary **capacity building** and other initiatives to narrow the development gaps among AMS to fully participate in the ongoing integration effort. In recognition of their key roles in the capacity-building initiative, the ADB and Southeast Asia Central Banks (SEACEN) Research and Training Centre were tasked to co-chair the said committee. To date, the BCMLV countries have already identified their training roadmap while the ASEAN-5, including the ADB and SEACEN (in their capacity as a technical assistance and learning providers) signified full participation to provide capacity building initiatives in the form of seminars/workshops, trainings, study visits and internship, institution building, and provisions of consultancy in the areas of monetary policy, banking supervision, payments and settlements, capital market development, capital account liberalization, exchange rate regime and policy.

**Conclusion**

There is merit in regional integration. But it is easier said than done. The difference between the two can be bridged by each country's level and depth of commitment. To me, this is the best time to talk about the region, about working and doing things together. And the best time is now rather than tomorrow.