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Financial services integration in East Asia: Lessons from the European Union

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Introduction

Economic integration in the European Union[1] has, arguably, been one of the most significant developments in the global economy in the last half-century. How could countries that just a few decades earlier were at war and culturally disjointed now aim at closer economic and political integration, and appear en route to forming one virtual "country" under a proposed European Constitution? The formation of the European Union, the adoption of the single currency, and many other erstwhile targets that were deemed "too difficult", but which are now realities, have proved many skeptics wrong. Other regions in the world, to a greater or lesser degree, appear to be in quest of a similar goal – the integration of their regional economies. What lessons could they learn from the European Union experience? Specifically, as closer cooperation appears a clarion call at the level of Asian politicians, can East Asia learn some lessons from the European Union?

East Asia has had several mechanisms for integrating the national economies into a regional trading area. The ASEAN+3 frameworks and dialogues, involving the 10 members of the Association of Southeast Asian Nations (ASEAN),[2] plus China, the Republic of Korea and Japan, are meant precisely to establish contacts and foster mutual trust among these economies as well as to progress, albeit incrementally, towards freer movement of goods, services and capital within the region. In the financial sphere, in addition to the overall political leaders' meeting, there are also meetings such as the Executives' Meeting in East Asia-Pacific central banks (EMEAP), which launched the Asian Bond Fund, as well as other forms of cooperation such as the ASEAN+3 Economic Review and Policy Dialogue Process for economic surveillance. The countries in the region have bilateral swap arrangements through the Chiang Mai Initiative (CMI) and have started initiatives to develop the Asian bond market. It can truly be said that the wheel of integration started for East Asia. In the same way that these types of cooperation in the European Community eventually turned out to be preludes to an eventual monetary integration for some, and tighter economic (trade) integration for all, the ongoing processes in East Asia might also turn out to be pieces of the East Asian integration puzzle.

However, at this juncture, it might be too early to tell. After about a decade since ASEAN Free Trade Agreement (AFTA) was signed and other mechanisms including the 'plus 3' economies were established, East Asia has not yet reached the level of trade integrations that the original six members of the European Union achieved at the end of the 1960s. The EU-6,[3] after 10 years since the Treaty of Rome, has accomplished a

[1] The discussion of European Union reforms in this paper mainly refers to the EU-15, which had carried out these reforms. The EU-15 countries are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.
[2] ASEAN's 10 members are: Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam,
[3] The original EU-6 economies are Belgium, France, former West Germany, Italy, Luxemburg and the Netherlands.

formation of the customs union.[4] East Asia's trade integration, in contrast, has barely begun. Many bilateral trade agreements between ASEAN and other East Asian economies have been negotiated, and some have been signed, but thus far have not yet delivered a true free trade area in the sense of zero tariffs for all products. What exist, at the moment, are a collection of preferential trade agreements rather than free trade agreements (FTAs). In the financial markets, regional integration is in an even more infantile state than in goods trade. At least, in trade in goods, multilateral and regional agreements forced tariffs and other trade barriers down and volumes of trade have shown growth. In the financial field, the region has yet to show bigger intraregional transactions, while capital markets have yet to deepen and a host of financial market barriers yet to come down. Each domestic economy remains highly protected by different regulations and restrictions on capital flows, as discussed later in this paper.

An advantage of the present East Asian situation is that being at the start of the process presents an opportunity to observe the experiences of other regional integration efforts, the European Union phenomenon in particular, and learn from both their positive achievements (and to imitate them) and negative experiences. Indeed, the European experience serves as a reference point for determining the policy requirements and operational aspects of regional integration process.

Chapter I discusses the state of play in the financial integration process in the European Union, its characteristics and noteworthy features, and the remaining tasks that are being addressed to complete the Single Market Programme. By financial integration, this paper is not referring to the monetary union leading to the single currency condition, but more to the integration of financial services sectors. Thus, it focuses more on improved facilitation of cross-border financial flows rather than discussions of optimal currency areas and other macroeconomic aspects. Chapter II tackles East Asian progress in different areas of financial integration, its current state of integration, the different regional mechanisms working towards financial integration, the existing policy landscape for cross-border regional financial flows, and steps forward. Chapter III considers some policy lessons and challenges ahead for East Asia.

[4] The establishment of a customs union for industrial goods was completed by 1 July 1968, 18 months ahead of schedule, while the final arrangements for agricultural products were completed by 1 January 1970. Later entrants into the European Union have been allowed a transitional period before the customs union applies fully in their territory.

I. European Union financial and monetary integration

This chapter discusses the experience of the European Union, the steps taken to liberalize the financial sector, the specific features of its liberalization programme, the results achieved so far from these reforms and an assessment of potential lessons for other regional trading arrangements.

A. Steps towards financial integration, and features of European Union liberalization

The present integration of financial services in the European Union, which started in the 1970s, rests on three major framework directives on banking, insurance and investments. The first banking directive (Council Directive 77/780) focused on the freedom of establishment of credit institutions within the European Community (EC) subject to national legislation.[5] This banking directive is similar to a country that liberalizes its financial services market to foreign entrants, allowing them access to the domestic market but under the laws and regulations of the domestic regulatory regime. Thus, other EC banks wanting to establish themselves in another member country had to obtain authorization from the supervisory body of each host country. National treatment, in this context, meant substituting restrictions on entry with explicit restrictions on the range of activities allowed (Bongini, 2003), akin to many the General Agreement on Trade in Services (GATS) commitments in financial services of many World Trade Organization (WTO) member countries. What is noteworthy is that this condition existed in the European Union in the 1970s, while the similar legal framework for WTO member countries took place only in the 1990s.

The second banking directive (Council Directive 89/646) amended the first banking directive and introduced the single banking licence, home country supervision for overall solvency and minimum capital requirements (minimum harmonization) across the Community. With the single passport and home country supervision, many authorization requirements and restrictions among the national authorities of member countries ceased to be imposed on banks headquartered in other EC member economies. The single banking licence is revolutionary and, so far, has no parallel in other economic integration agreements anywhere else.

In addition to the first and second banking directives, there were other directives affecting banks that were related to consolidated supervision, harmonized accounting rules, capital adequacy requirements, reporting and monitoring of large exposures, and deposit guarantee schemes. Table 1 provides a summary of the "legal itinerary" for banking services up to 1996.

[5] The directive provided national treatment to both EC and non-EC headquartered banks, under a reciprocity condition. It allowed banks to compete on a level playing field, as long as they followed the rules of the national supervisory regime.

Table 1. Single market banking services – sequence of liberalization

Directive	Issue date	Implementation date	Objective
First EC Banking Directive (77/780/EEC)	1977	1979	Establishes authorization procedures for deposit taking institutions
Consolidated Supervision Directive (86/635/EEC)	1983	1985	Brings EC supervisory arrangements in line with the revised Basel Concordat
Bank Accounts Directive (86/635/EEC	1986	1993	Harmonizes accounting rules and reporting requirements
Capital Liberalization Directive (88/361/EEC)	1988	1992	Removal of exchange controls with the aim of enabling free capital movement within EC
Own Fund Directive (89/299/EEC)	1989	1993	Provides common definition of bank capital in accordance with Basel Accord
Solvency Ratio Directive (89/647/EEC)	1989	1993	Sets common minimum risk-adjusted capital adequacy requirements in accordance with Basel Accord
Second EC Banking Directive (89/646/EEC)	1989	1993	Provides single passport and gives a broad definition of banking activities
Monitoring and Control of Large Exposures Directive (92/121/EEC)	1992	1994	Annual reporting to supervisory authorities detailing large exposures
Capital Adequacy Directive (93/6/EEC) and (93/31/EEC)	1993	1996	Extend the risk-adjusted capital requirements to investment firms and set capital requirements for market risks
Deposit Guarantee Directive (94/191/EEC)	1994	1996	Common rules for the implementation and functioning of depositor compensation schemes in all member countries.

Source: http://europa.eu.int/eur-lex/en/index.html as cited by Bongini, 2003.

The legal path of insurance and investments mirrored the liberalization steps in banking services. In particular, the first sector directives bestow national treatment on foreign banks subject to national supervisory rules, then with subsequent further relaxation of access rules as well as home country regulation while at the same time complementing these with minimum conditions for prudential rules.[6] All in all, the legal

[6] The first insurance (direct insurance except life) Council Directive 73/239 paralleled the first banking directive, establishing authorization procedures within the Community. The second insurance Council Directive (88/357) put in home country control and strengthened the power of supervisory authorities. Council Directive 92/49 established the single passport, further enhanced home country control and financial supervision, and specified certain supervisory provisions (e.g., ceilings for individual investment categories that insurance companies are allowed to hold). For life insurance, various Council Directives

itinerary of financial services liberalization provides a glimpse of some characteristics and features of European Union liberalization.

1. Pillars

The European Union approach rested on three pillars: minimum harmonization, mutual recognition and home country control. Minimum harmonization entailed a minimum level of coordination and harmonization of national standards to secure a functioning integrated internal market. This meant uniform reporting requirements, accounting treatment of income and expenses, consolidated reporting, capital requirements etc. The principle is intended to ensure that "basic public interest" is safeguarded in a single market with different national rules and standards. Harmonization facilitates free competition by stopping member States from erecting "standards barriers" against one another's products and services, but it can, likewise, hinder free competition by barring certain products or practices from the market altogether (Steil, 1999).

Mutual recognition means that once minimum agreement has been reached on essential rules, member States agree to recognize the validity of one another's laws, regulations and standards, and thereby facilitate free trade in goods and services without need for prior harmonization. The single passport concept directly derives from this condition, under which a financial service provider incorporated in any European Union member State and which thus satisfies the basic standards in one member country, may carry out a full range of "passported services" throughout the European Union.

Home country control puts the main responsibility of supervising national financial institutions on the home country supervisory authority even when doing business in territories of other member countries.

To be sure, the principles themselves have not co-existed without tension. From the beginning, prior to the formal launch of the Single Market initiative in 1985, the EC's White Paper considered mutual recognition as an inferior integration mechanism that was chosen only on pragmatic grounds because of the Council's obstructionism in the EC's pursuit of common rules. On the other hand, the political dynamics of the Council have shown that, in general, harmonization of rules and standards operates to curtail liberalization, whereas the combination of mutual recognition and home country control has proven reasonably effective in muting the influence of protectionist lobbies (Steil, 1999). Box 1 illustrates this type of tension between harmonization and mutual recognition principles in the Investment Services Directive (ISD).

(79/267, 90/619 and 92/96) again lay down the coordination of laws, regulations and administrative provisions for the establishment as well as, subsequently, the supply of services and single official authorization. They also introduce reciprocity criteria such as those established in the second banking directive.

Box 1. Investment Services Directive: harmonization versus mutual recognition[*]

The ISD has two major components. The first contains authorization provisions for recognized "investment firms", something akin to the First and Second Banking Directives; the second contains procedures defining "rights of access" to organized securities exchanges for recognized investment firms and credit institutions, and single passport rights for exchanges seeking to provide remote foreign membership or access.

The draft Directive, based on mutual recognition, was highly liberal. With respect to securities exchanges, it wanted to liberalize access to membership for all European investment firms; with respect investment firms, it wanted to liberalize cross-border provision of investment advice, broking, dealing and portfolio management. It did not aim to regulate market structure; i.e., member countries were free to set their own national market regulations provided that they did not obstruct rights of access of foreign European Union investment firms. Implicitly, it meant that investors could bypass their home State exchanges and execute transactions in another member State exchange based on its rules.

The six southern member States rejected the draft Directive. Instead, led by the French, they wanted national authorities to have the right to require that securities transactions effected by resident investors would take place only on a recognized exchange, thus introducing minimum standards harmonization on the market structure. The harmonization approach taken by the six southern members allowed host States to block cross-border trading where home States did not adopt market structure rules that the hosts identified as essential to prudential market operation.

The debate made the concept of "recognized market" (or "regulated market") critical in the development of the harmonization-based Directive. It required the adoption of harmonized minimum standards that defined a "regulated market". In fact, the Directive did not define a regulated market but specified two essential requirements: the market must formally "list" securities and that it must be "transparent". These idiosyncratic definitions of a regulated market revealed what the northern States believed to be purely protectionist motives by the French. At the time, the London Stock Exchange's SEAQ International (SEAQ-I) dealer market neither formally listed stock nor published individual transaction details, but it was transacting volumes of French shares amounting to approximately 35 per cent of Paris volumes. It did not, therefore, qualify as "regulated" under the proposed Directive definition and thus ran the risk of its transactions being reduced if member States forbid their residents, or the residents' representatives, from transacting domestic share business through the London Stock Exchange. Thus, the directive, which was originally intended to liberalize cross-border trading, was now being crafted to curtail it by using harmonization of minimum standards as its vehicle.

As is often the case in many European Union negotiations, the compromise text has produced considerable ambiguities with correspondingly different interpretations allowed, until a possible legal dispute in the future brings about a binding decision from the European Court of Justice.

[*] Abridged from Steil, 1999.

2. Sequencing

Financial liberalization in the European Union followed the commonly agreed sequencing, even though the pace varied across member countries depending on the initial state of its financial sector and economic development. In particular, domestic real sector reform preceded financial system reform, and the two preceded capital account liberalization. Indeed, EC countries maintained capital controls even as they opened up their trade regimes in the 1970s among themselves and with the rest of the world. Germany and the United Kingdom fully liberalized capital account only in 1983; Belgium, Luxemburg and the Netherlands opened theirs only partially around the same time while the rest of the European Union put in plenty of safeguard clauses. Similarly, even as a free trade area was achieved as early as 1960s, limits to market entry were the rule in the 1970s in all European Union banking systems until the set of financial sector directives essentially forced in greater intra-Community competition.

Allowing greater competition forced the European Union to tackle the issue of explicit and implicit barriers. Explicit barriers consist of limits to cross-border movements of financial services and investment restrictions, and were usually present through capital and exchange controls as well as restrictions of foreign institutions' entry. The explicit barriers to capital movements started to be liberalized in the second half of 1980s when both world macroeconomic conditions had improved and the EC had accelerated the process of single market creation (Bongini, 2003).

At the same time, implicit barriers, comprising differences in regulatory, legal and tax systems were slowly chipped away through the Second Banking Directive. While the First Banking Directive allowed market access, allowing foreign firms to compete on a level playing field, as long as they satisfied host country national requirements, the Second Banking Directive aimed at doing away with many of the host country requirements through the application of the mutual recognition principle. The single passport from the Second Banking Directive provides member States banks with both the freedom of supply and the freedom of establishment within the European Union.

The process is far from complete, however. While the mutual recognition principle has served the European Union well, it had also caused substantial gaps between European Union-wide legislation and national laws affecting financial transactions. To address this, in 1999 the European Commission adopted the five-year Financial Sector Action Plan (FSAP) highlighting the priorities for a true single financial market as well as to ensure compatibility of its rules with global practices. It comprises 42 measures seeking to harmonize the member States' rules on securities, banking, insurance, mortgages, pensions and all other forms of financial transactions; most of the measures have been finalized while some are still awaiting transposition by member States.[7, 8]

[7] The deadline for implementation should have been in 2005 but in some cases had already been extended to 2007. As happened with many other EC proposals, many of the approved directives are diluted versions of the original drafts, with the consequent lowering of goals. For example, in the case of the prospectus document for companies, instead of the uniform European Union-wide reporting, Parliament exempted businesses with assets lower than € 350 million, which means that only about one-fourth of European businesses will need to produce prospectuses in accordance with the common format.

[8]Within FSAP, the regulatory institutions are likewise being reformulated to streamline financial sector regulation. Dubbed as the Lamfalussy approach to securities regulation, FSAP seeks a four-level approach for speeding up the adoption of new rules. The idea is to separate first principles from secondary legislation. In level 1, the framework principles are to be decided by normal European Union legislative procedures

3. Deregulation and re-regulation

The Single Market Programme (SMP) is also characterized by a simultaneous application of deregulation (of conduct and structure) and re-regulation policies (of prudential rules). Much attention has been focused on the deregulation aspect of SMP – the freedom of establishment, freedom of supply, liberalization of capital movements, removal of discriminatory rules against foreign banks, branching rules deregulation etc. But in fact SMP went in tandem with re-regulation or prudential (or supervisory) rules in key areas such as bank capital adequacy, consolidated surveillance, solvency ratios, money laundering etc. Table 2 summarizes SMP-related legislation and rules that address financial structure, conduct and prudential concerns – in fact, summarizing the sequencing aspects of European Union liberalization. It allowed domestic market reform through interest rate deregulation, and then allowed freer competition through market entry of other European Union banks as well as liberalization of capital movements. At the same time, prudential rules such as the reporting of consolidated accounts and surveillance, and capital adequacy rules were strengthened in order to reduce systemic risk potential.

Table 2. Single Market Programme-related legislation and rules

Legislation/rule	Focus		Focus
Interest rate de-regulation	Conduct	89/646 Second banking directive	Conduct
73/I 83 Freedom of establishment	Structure	89/647 +91/31 Solvency ratio directives	Prudential
77 /780 + 85/345 + 86/I 37 + 86/524 First banking directive	Structure	91/308 Money laundering directive	Conduct
83/350 Consolidated surveillance	Prudential	91/633 Modifications to 89/299 (own funds directive)	Prudential
86/635 Consolidated accounts	Prudential	92/121 Large exposures directive	Prudential
1988 - Article 76 of the EEC Treaty on Liberalization of Capital Movements	Structure	92/30 Modifications to 83/350 (consolidated survey)	Prudential
89/I 17	Structure	94/7	Prudential

(i.e., by proposals by the EC to the Council and the European Parliament for co-decision). Level 2 arranges for implementation of details following the level 1 framework through committees (in securities: the European Securities Committee and the Committee for European Securities Regulators), which will assist the EC. Level 3 is enhanced cooperation and networking among European Union securities regulators to ensure consistent and equivalent transposition of levels 1 and 2 legislation. Level 4 is strengthened enforcement, with more vigorous EC action, underpinned by enhanced cooperation between member States' regulators and the private sector.

Branch establishment and head offices outside the European Union	Modifications to 89/647 (solvency ratio)
89/299 + 92/16 Prudential Own funds directive	94/19 Prudential Deposit insurance directive

Source: European Commission, 1997 (table A.10.12) as cited by Gardener and others, 2000.

Gardener and others (2000) pointed out the strategic implications of the simultaneous deregulation and re-regulation pressures on European Union banking. It was important that the competition released through deregulation and the consequent decline in bank prices and margins led to improved cost efficiency, and that it did not degenerate into poorer quality of asset portfolio as happened in the United States in the aftermath of the liberalization of the saving and loans institutions. The requirement for capital adequacy put pressure on profits (to remain high) in order to achieve the required capital adequacy ratios.

At the same time, as erstwhile segmented financial institutions increasingly competed against each other (because of deregulation), it became more important that their supervisory regimes (especially capital adequacy ratios) were similar. Otherwise, a lax supervisory regime could provide some institutions with a competitive advantage and result in regulatory arbitrage. Without common minimum standards, national supervision can be driven down through "competition in laxity" as different jurisdictions seek to provide advantage to their own national firms through less restrictive rules. The simultaneous applications of deregulation and re-regulation, therefore, are necessary conditions for competitive equality within the European Union.

B. Current state of play

After more than three decades of financial sector reforms, what is the current state of financial sector integration in the European Union? Within the European Union, SMP succeeded in removing many barriers to cross-border supply of services and restrictions on the establishment of branches and subsidiaries of European Union financial institutions. With respect to non-European Union headquartered banks and other financial institutions, subsidiaries enjoy the same single passport privilege within the European Union, i.e., subsidiaries can establish branches anywhere in the member countries. The same privilege does not apply, however, to branches of foreign financial institutions. Branches of non-European Union banks enjoy national treatment privilege, subject to reciprocity condition, but the head offices need to negotiate with each member State for the establishment of branches in each territory. Put another way, rules of origin within the European Union are completely liberal for European Union-based financial institutions as well as third-country subsidiaries but not for foreign (third-country) branches (table 3).

While the mutual recognition principle (with home country regulation) unambiguously applies to establishment, a limited dose of national treatment principle still applies with respect to cross-border provision of financial services through the exceptions granted by the general good clause. The European Union granted exception to the mutual recognition principle in the area of information regulation, allowing the national treatment rule for regulations that attempt to protect the consumer. The general good clause exception allows the domestic authorities to control key aspects of marketing and information provided for financial products[9] and to deny foreign providers or foreign financial services access to domestic markets to when it is deemed that the general interest is at risk.

Other than the general good exception, there remain other obstacles that make a pan-European product range impractical for the moment. These include cultural preferences, divergent regulatory conditions, different corporate governance structure, and taxation. For example, a pension fund must satisfy very different sets of requirements across the European Union to qualify for special tax treatments. Another example is interest-bearing checking accounts, which are barred from some countries while allowed in others.

Has deregulation affected the European Union financial landscape? Do European institutions exhibit greater integration after almost two decades of reform? Studies analysing the effects of financial integration efforts in the European Union provide a mixed outcome, depending on the specific financial subsector. These studies focus on the evolution of price convergence, quantity indicators, such as cross-border flows or, in the case of direct investment, the market share of foreign entities. The theory is that price convergence is an outcome of an integrated market where price differentials have been eliminated or greatly reduced to the level justified by the existence of significant arbitrage or transportation cost. Growth in cross-border flows is a complementary indicator, although its absence need not be incompatible with substantial integration for as long as the market is contestable. Drawing from studies that analyse change in transactions volume and the pricing behaviour of various segments of financial services, this section presents some of these conclusions.

1. Wholesale banking[10]

In the case of wholesale banking[11] activities, there has been a significant increase in the volume of cross-border activity. Based on the European System of Central Banks (ESCB) survey, the share of transactions of intra-euro area transactions increased from 21 per cent in 1998 to 42 per cent in 2001, while the share of domestic transactions dropped from 68 per cent to 31 per cent in the unsecured money market segment. While the cross-border share of TARGET payments has reached a plateau at just above the 30 per cent level, the absolute value of cross-border transactions has nearly doubled since 1999 (table 4). Looking at the aggregated euro area balance sheet data, cross-border interbank assets

[9] For example, foreign banks perceive domestic regulations affecting UCITS (Undertakings for Collective Investments in Transferable Securities) as significantly preventing them from exploiting scale economies for this financial product.
[10] This and succeeding sections draw heavily on Cabral and others, 2002.
[11] Wholesale activities are those in which both sides of the transaction are banks or other financial institutions.

and liabilities within the euro area has also increased, even as cross-border activity with non-euro area counterparties has tended to decrease. Smaller nations such as the Benelux countries, Ireland, Portugal and Finland have cross-border activities greater than the euro area average, accounting for more than 50 per cent of interbank assets or liabilities.[12] In general, the number of cross-border interbank transfers is smaller but the value of these

transactions is much larger.

Table 3. Liberal rules of origin for European Union banks

Mode	**Financial institutions with headquarters in European Union member States**	**Financial institutions with headquarters in non-European Union member States**
Mode 1: Cross-border supply of services	In theory, no restrictions; however, "general good" exception (consumer protection issues) can curtail cross-border provision due to so-called "rules of conduct" that tend to be broadly interpreted by host countries.	No restrictions, but only for subsidiaries established in a member State. Same restrictions from "general good" exception.
Mode 2: Consumption abroad	No broad European Union legislation	National legislation applies
Mode 3: Commercial presence	No restrictions; home country supervision; single passport.	Subsidiaries established in a member State granted single passport, but not foreign branches. Home country supervision for branches of subsidiaries; host country supervision for foreign branches.
Mode 4: Movement of persons	No specific broad European Union legislation; however, Single Market Programme for free movement of labour applies.	

Source: Elaboration by author.

In terms of pricing, greater integration should lead to greater convergence of prices across Europe as the law of one price supposedly takes effect. Across the euro area, such convergence is indeed observed in very short-term interest rates. Differences in the overnight rates, based on the Euro Overnight Index Average (EONIA) across countries, fall and resemble those observed in national markets before the introduction of the euro. Similar evidence of convergence is available for longer maturities based on EURIBOR data.

[12] A similar increase in intraregional vis-à-vis domestic transactions is noted for the repo market despite divergent rules in collateral law.

Table 4. Quantity indicators of integration

Indicator	1999	2000	2001	2002	2003	2004	2005
A. Cross-border TARGET payments[a]							
Daily average total value (€ billion)	349.0	413.0	518.0	479.0	537.0	564.0	641.0
Percentage of all TARGET payments	36.2	41.2	41.9	31.1	32.5	32.9	33.7
Daily average volume (‘000)	25	37	44	51	60	65	69
Percentage of all TARGET payments	16.0	20.8	22.1	20.8	22.9	24.3	23.2
Average daily payment (€ million) [b]	14.1	11.1	11.8	9.3	9.0	8.7	9.4
B. Interbank assets and liabilities[c]							
Assets							
Domestic	62	61	59	59			
Euro area	18	18	18	19			
Rest of the world	20	21	23	22			
Liabilities							
Domestic	57	55	53	53			
Euro area	16	16	16	16			
Rest of the world	27	29	31	31			

Sources: Cabral and others, 2002; and *TARGET Annual Reports*, 2003 and 2005, European Central Bank.
[a] 1999-2002 are first quarter figures, 2003-2005 are end of period.
[b] Average value for the year, 2003-2005; value is 9.6, 8.7 and 9.4 in first quarter of 2003, 2004 and 2005, respectively (*TARGET Annual Reports*, 2003 and 2005, European Central Bank).
[c] Percentage of total euro area banks’ interbank assets and liabilities, end of period except 2002, which is for first quarter (Cabral and others, 2002).
Note: TARGET system is a clearing and settling mechanism for cross-border transactions. It connects credit institutions in the European Union in an interbank network.

High integration in the wholesale unsecured money market is influenced by the existence of financial centres in Europe, where large banks act as money centre banks for the euro market as a whole and redistribute liquidity across borders. Financial centres such as Frankfurt, London and Paris, trade among themselves and with all other countries, while bilateral cross-border flows are much more limited.

The wholesale repo market, in contrast, exhibits wider price differentials, hence, weaker integration. Factors that influence this outcome include remaining segmentation of the national markets due to: (a) legal and fiscal obstacles in collateralized cross-border transactions; and (b) poorer market infrastructure. While the TARGET system, the clearing and settlement mechanism for unsecured cross-border transactions, has greatly facilitated integration in the unsecured money segment, the same infrastructure does not yet exist for repo transactions. Prior to the TARGET interbank network, cross-border interbank operations made use of correspondent banking channels.

In summary, the wholesale unsecured money market has unambiguously shown improved financial integration in terms of both the volume and price convergence across the European Union. For the repo market, the volume increase manifests greater integration, but price differentials remain large due to infrastructure and legal bottlenecks.

2. Capital market-related banking activities

Capital market-related activities include corporate finance services such as underwriting and other investment banking services, syndicated lending, corporate restructuring and investment, corporate advice etc. They also include the part of asset management and trading related to large-scale portfolios and institutional investors (Cabral and others, 2002).

Price indicators to assess integration in capital market-related activities are difficult to compare because "price or fees" in this market depend on the service content. In addition, since the services are often differentiated, price comparisons and the law of one price are difficult to apply. However, from a broad point of view, intermediaries' fee levels have converged, although the exact content of the services provided is not determined. Gross fees on issues of securities by euro area firms have declined, pointing to greater competition in a more integrated market. This is most pronounced in bonds issues, but less so in equity issuance, which indicates weaker integration and greater importance of local factors in the equity markets. Commitment fees in large syndicated loans have also declined, although some years point to an increase due to the financing of riskier than average telecom, media and technology sectors.

Compared with prices of capital market activities, quantity indicators provide a more unambiguous evidence of integration. In the bond market, higher volumes of bond issues have been noted compared with pre-EMU (the volume was 16 times higher in 2001 than in 1995), owing to greater liquidity and depth of the euro-denominated market as well as the possibility for firms to go beyond their domestic markets under the single currency conditions. Indeed, as the bond issues rose, the euro emerged as the second most important currency for international bond issuance after the United States dollar. Similarly, syndicated loans[13] and equity issues also grew, and the share of private sector debt securities also sharply rose relative to sovereign issuance.

Another way to determine greater integration, besides increase in volume, is whether the nationality of both intermediary and the firm being financed remain important. If the nationality link declines, it can imply an integrating market, because nationality has become less relevant. Cabral and others (2002) found that the number of bond issuances in which the intermediary (or bookrunner[14]) and the issuing firm's nationality were the same followed a decreasing trend between 1995 and 2000. Over the same period, foreign firms (mostly United States companies) also made large inroads in the bond market, from a zero presence in 1995 to intermediating 80 per cent of large transactions.

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[13] Syndicated loans are bank loans with several credit providers and which can be resold in the capital market.

However, no such clearly declining trend in intermediary-user nationality link for equity issuance exists. The shares of domestic and United States bookrunners in total equity issuance remained approximately the same from 1995 to 2000, perhaps reflecting the localized nature of equities. In the secondary market, major problems in cross-border clearing and settlement infrastructure remain. Nationally-based structures, which offer very limited scope for cross-border trading, remain a viable alternative to the cross-border payments system, highlighting fragmentation in the European Union market. Thus, despite the consolidation of stock exchanges, e.g., OMX (integration of Nordics and Baltic stock exchanges) and Euronext (Amsterdam, Brussels, Paris and Lisbon exchanges), the cost of issuing equity securities in the European Union remains larger than in the United States where the clearing and settlement system is more efficient.

An indication of increased cross-border bank lending is the extent of involvement of non-domestic loan arrangers.[15] In 1995, 15 per cent of large syndicated loans involved at least one non-domestic euro area arranger, but in 2000 this figure was more than three times higher (Cabral and others, 2002). Domestic bank arrangers, however, retained their share of about 80 per cent of the transactions. Thus, while there appears greater integration in syndicated loans market – as indicated by the increased number of non-domestic euro area syndicated bank loan participants for large syndication – the need for local information and risk assessment has not erased the large role of domestic banks, especially in small-sized transactions where strong credit relationship remains important.

The capital market component in asset management is that intermediaries trade assets in order to offer diversified products for final retail investors. Large financial groups, involving banks and securities firms (and, at times, insurance companies), have become involved in the management of mutual funds in the euro area. With the introduction of the euro, the supply of portfolio diversification services (the capital market part of the business) has increased following the lessening of cost and risks as well as the removal of regulatory restrictions. In the case of equity mutual funds, the share of domestic equities declined from 49 per cent in 1997 to 28 per cent in March 2002, while European shares rose from 10 per cent to 26 per cent. Funds are now managed by asset type and industry, rather than on a country basis. However, the retail interface with investors still remains largely local.

3. Retail banking

Unlike wholesale banking, retail banks' counterparties are mainly households and small firms. Retail business requires the proximity of banks to customers, hence distribution networks are crucial. Market participants are also widely diverse, ranging from small banks and securities firms to large financial holding companies.

[14] Bookrunners initiate the transaction with the borrower, and organize the underwriting and placing of the issue in the primary capital market.
[15] Arrangers are banks responsible for originating, structuring and syndicating loan transactions.

Of the different financial sector segments, the retail sector remains the most fragmented. For one, cross-border flows are still negligible in retail loans and deposits, and, in 2002, 89 per cent of the loans by banks in the euro area were to non-banks with domestic customers. In contrast, only 60 per cent of loans to financial institutions (the wholesale banking component) are domestic (table 5). One important reason for this is the required closeness of banks to its customers. Domestic banks enjoy competitive advantage because of their widespread branch distribution networks.

Table 5. Domestic and cross-border on-balance sheet activities of euro area banks

	December 1997	March 2002		December 1997	March 2002
Wholesale banking					
Loans to MFIs[a]	3 859	4 835	Interbank deposits	4 057	5 534
Domestic business (%)	60.1	59.2	Domestic business (%)	59.5	52.6
Business with other euro area countries (%)	15.3	18.6	Business with other euro area countries (%)	14.6	16.4
Business with the rest of the world (%)	24.6	22.2	Business with the rest of the world (%)	25.9	31.0
Retail banking					
Loans to non-banks[b]	5 905	8 046	Deposits from non-banks	5 104	6 586
Domestic business (%)	91.6	88.7	Domestic business (%)	88.0	83.7
Business with other euro area countries (%)	2.2	3.6	Business with other euro area countries (%)	5.4	5.2
Business with the rest of the world (%)	6.2	7.7	Business with the rest of the world (%)	6.6	11.1

Source: Cabral and others, 2002.
[a] Data refer to monetary financial institutions (MFIs), excluding the Eurosystem.
[b] Including general government.

To tap into domestic markets, European banks are establishing branches in other member States; in this regard, a clearly increasing trend of establishing branches of European banks within the euro area has been noted. Alternatively, a fast way to gain access to the retail sector is to merge with or acquire an existing local bank. Thus, cross-border bank mergers and acquisitions (M&As) are relevant information to check for better integration. As with branch establishments, an increasing trend in euro area bank merging with another euro area or European Union banks can be noted.

Interestingly, majority of the total number of M&As in the European Union are domestic bank mergers that have caused higher market concentration in the national markets (table 6). These domestic M&As have been motivated by the desire to be able to compete more effectively in the area-wide dimension. These are frequently accompanied by a restructuring process and a reorientation of activities from traditional bank lending towards investment banking-style activities, evident in the shift in banks' revenue flows from interest income to non-interest income (fees and commissions), and reduced reliance on deposits in favour of securities issuance. Some of the reasons for the dominance of domestic bank M&As over cross-border ones is that differences in national legal and regulatory environments make a pan-European product range impractical at the moment, thus lessening economies of scale benefit from cross-border M&As. Cultural factors, and differences in corporate governance and taxation also tend to discourage cross-border consolidation (Carre, 2006).

Table 6. Mergers and acquisitions in the European Union geographical breakdown

	1995	1996	1997	1998	1999	2000*
Number of mergers and acquisitions						
Domestic	275	293	270	383	414	172
Intra-European Union	20	7	12	18	27	23
Extra-European Union	31	43	37	33	56	39
Total	326	343	319	434	497	234
Breakdown by size of domestic transactions						
Large (%)	18	10	13	13	12	22
Small (%)	82	90	87	87	88	78

Source: European Central Bank, 2000, as cited by Gual, 2003.
Large: Mergers and acquisitions involving at least one firm with assets of € 1 billion or more.
*Up until to June.

There is also a notable regional clustering of these M&As, where the Benelux banks, Nordic/Baltic, and Southern, Central and Eastern European banks are merging among themselves. Such regional clustering is motivated by the search for a larger market but with only a minimum cultural adjustment, thus more or less being considered their “home markets”. Banks in Nordic countries tend to define their home banking market as comprising Denmark, Sweden, Norway and Finland. In continental Europe, banks in Belgium, the Netherlands, Luxembourg and, to some extent, France have become closely interlinked.

C. Assessment

In summary, while milestones have been achieved in integrating the European Union financial market, particularly in the wholesale and capital market-related activities, the objective of a single financial market has yet to be achieved. Divergences in many national laws (e.g., in consumer protection rules, private law, differing consumer habits across the European Union, taxation regimes favouring specific domestic products) make selling the same financial product from one country/area to another difficult. Consequently, the economic incentive from economies of scale for cross-border M&As is lessened.

In addition, supervisory arrangements, with multiple reporting requirements, make it difficult for a cross-border company to unify some of its back office operations. Different taxation schemes for dividends or exit taxes on capital gains may, likewise, hamper an efficient reorganization of head office functions.

In terms of infrastructure, while a few European Union exchanges have been consolidated, the post-trading activities remain inefficient. The development of a European Union-wide clearing and settlement system, especially for securities, is on the drawing board but, so far, has not yet delivered significant cost reduction results. The European Union settlement infrastructure is divided into two kinds of institutions – a national market settlement system (currently, 17 central securities depositories [CSDs]), and two international depositories (ICSDs), Euroclear and Clearstream – that act as custodians of debt instruments from several countries and provide settlement to a more global market across their books. A concentrated clearing and settlement system as in the United States allows greater "netting" possibilities,[16] thus reducing the cost of financial transactions.

The Centre for European Policy Studies published a report on the costs of cross-border securities settlement, which found that customers in the European Union paid around four times as much for domestic settlement than in the United States, while the average cost for domestic and cross-border settlement together in the European Union is also four times higher. This higher cost is attributed to lower netting opportunities, partly due to smaller and fragmented markets with smaller issues and thus fewer netting opportunities, and partly due to restrictions and other barriers to netting (from differences in regulation, taxation and law).

Even in banking, transferring money from one country/area to another is much more expensive than transferring money within a country/area due to the lack of an integrated pan-European retail payment system as well as the fact that parts of these payments have to be processed manually. The banking sector argues that the cross-border payments volume is too low to justify investments in costly automation and inter-operability, yet the low volume may itself be due to current high cost.[17]

The to-do list goes on, but at least the major roadblocks have been overcome in internationalizing financial services and liberalizing capital flows through the strengthening of the regulatory and supervisory regimes and the market liberalization of the domestic real sector. Pre-SMP, the banking environment was not only fragmented but was often also anti-competitive, with major restrictions on foreign entry and capital flows. Banks were often stimulated more towards regulatory capture and collusion rather than free and open competition (Gardner and others, 2000). Today, many major restrictions, especially on foreign entry, have disappeared. There is increased focus on capital adequacy requirements and risk management, demarcation lines between particular business lines and across geographical markets have significantly declined, and competition has increased.

[16] Netting reduces the total value of financial obligations and the number of transactions by its focus on daily net positions of each of its members rather than on actual transactions.

[17] The European Commission passed a regulation equalizing cross-border and national charges in the euro area in order to improve cross-border volume and to force banks to establish efficient structures for retail credit transfers.

There are important lessons here for Asia and other regions. On the sequencing of financial reforms, i.e., the removal of capital controls after domestic financial reforms and strengthening of supervisory capacities, the almost simultaneous application of deregulation (for structure and conduct) and re-regulation (for prudential rules), the principle of "mutual recognition" of financial sector licences, and "home country control" that effectively facilitate full market access. Over and above these general experiences, the European Union is also teaching another lesson from its experiences on building new market infrastructure, such as cross-border settlement and payments, adapted to the modern global financial system. However, to date, this remains as work-in-progress.

II. East Asian financial integration

In the East Asia Vision 20/20, in political summits and at other regional gatherings of political pundits, economic thinkers and decision makers, the aspiration of building an East Asian Community is ubiquitous. The exact form it would take and how long it would take to achieve has not yet been spelled out; the roadmap to integration is lacking, but an East Asian Community is present in the regional leaders' rhetoric. Undoubtedly, the European Community experience, with its positive results of stable growth and larger markets, looms large among its inspirations.

Yet, based on the preliminary first steps in East Asia, its itinerary does not appear to be exactly headed to a straightforward copying of the European Union itinerary. Some of these differences are worthwhile highlighting here. First, there is a big chasm between the institutional arrangements followed in Europe and the existing arrangement in East Asia. Europe followed a supranational government structure, empowering the European Commission and the European Court of Justice to enforce treaty provisions. These institutions, along with the European Parliament, have been pivotal in bringing the Single Market Programme into reality.[18]

In contrast, no similar institution exists within South-East and East Asia. ASEAN comes close to having a central body through the ASEAN Secretariat, but not East Asia at large; even then, unlike the European Commission, the ASEAN Secretariat has no enforcement power. The intergovernmental structure within ASEAN is well-known to be ineffective and lacking the political muscle that the European Commission wields in the European Union.

Second, the European integration idea started and proceeded through the leadership of Germany and France, while East Asia is still in search for one. While Japan, the largest economy in Asia, is expected to play a crucial role, the historical legacies of conflicts with the rest of the region form an important obstacle to a common understanding. Asia and Japan have not yet reached a détente in understanding; until then, Japan will be hampered in taking a role similar to that played by Germany in Europe.

[18] On the financial front, the European Central Bank (ECB) is another supranational European institution that followed the introduction of the euro. The ECB takes care of monetary policy for the euro area.

China, to date, remains saddled with its own economic growth and adjustments, thus precluding any move to take the reins of Asian integration. The ASEAN bloc is important glue for integration, yet the disparate levels of its economy and its propensity to "speak big about integration but act slow" makes it doubtful whether it can lead an East Asian Community to safe anchor.

Third, unlike the relatively homogeneous level of economic development of the European Union member States, the initial conditions of countries within Asia are greatly disparate. On one side of the spectrum, Japan, the Republic of Korea, Singapore, Hong Kong, China and Taiwan Province of China have OECD-level incomes per capita and sophistication. On the other side are the underdeveloped economies of Cambodia, the Lao People's Democratic Republic, Myanmar and Viet Nam.

While it is true that when the European Union started thinking of financial market integration in the 1970s, income per capita of Portugal or Spain was much lower than that of the United Kingdom, Germany or France. The disparity in income levels, arguably, acted as a boost to generating efficiency-seeking restructuring across the region rather than a hindrance. Yet, the base comparison between the European Union and East Asia should take into account the fact that Portugal and Spain were already fairly developed at the time they considered European Community accession. The same cannot be said of the poorest countries in East Asia where, often, the most basic infrastructure – especially financial infrastructure – remains to be constructed.

Perhaps a more acceptable comparison with Portugal and Spain vis-à-vis the richer European Union member States in the 1970s would be the ASEAN 6 (ASEAN minus CLMV) vis-à-vis East Asian economies. To the extent that an important issue in financial services liberalization is the sequencing concern, and because the costs and benefits of financial liberalization vary depending on the initial level of financial development, the dire lack of homogeneity among East Asian economies creates a big challenge as to appropriate regional policies that the region should be aiming for.

Based on these differences, to what extent can the European Union be a model for Asia? In particular, can its experience of financial integration be replicated in the region without a supranational institution to enforce any integration agreement? The experience of the European Union shows that its trajectory towards SMP imposes stringent demands on policy coordination and institution building, which would not have been possible without a strong "centre". Might Asia be better off being resigned to the fact that whatever integration it achieves, it would not be the same watertight integration that the European Union now has and which it still continues to improve? Perhaps this is the case.

On the other hand, East Asia has managed to establish various financial arrangements like CMI, a regional swapping facility that could help provide liquidity in times of financial stress, the Asian Bond Fund 1 and 2, preliminary first steps towards regional bonds markets, the surveillance process and others. Thus, arguably, some actions can be undertaken without need for a supranational institution, whose formation may perhaps wait a long time before the region, including Japan and China, would be ready for it, if it comes at all. Put differently, East Asia has to craft a financial programme that is accommodated within an institutional structure that is dominated by national governments rather than by a strong supranational "centre".

Therefore, given the present intergovernmental institutional framework, what lessons remain applicable for East Asia from the European Union? Which policies can be replicated to facilitate intraregional cross-border financial transactions? This section first discusses the different efforts at regional financial liberalization and integration, and then tackles the existing pattern of cross-border flows and policy landscape. The steps forward, drawing lessons from the European Union, are discussed last.

A. Regional mechanisms and initiatives

1. ASEAN Framework Agreement on Services and bilateral trade agreements

Except for the Lao People's Democratic Republic, all ASEAN+3 countries are members of the World Trade Organization and have made commitments in financial services under GATS. Like many other WTO members, most of their schedules of commitments are conservative. For example, foreign equity limits in banks, the number of branches allowed and restrictions on employment of expatriates are usually more stringent than the actual regime.[19] Significantly, the framework agreement on services in ASEAN as well as the bilateral trade agreements in the region have commitments in financial services that are either bound at the actual regime or much closer to it than these countries' bindings in WTO. Specifically, in the ASEAN Framework Agreement on Services (AFAS),[20] ASEAN made the most improvement in its commitments in mode 3 (commercial presence) (table 7).

How much financial liberalization has been achieved within ASEAN through AFAS? Quite marginal is the answer. At least, in terms of commitments, there is an apparent GATS-plus feature in AFAS. In terms of actual and real liberalization, however, AFAS has achieved nothing because, following the GATS/WTO negotiations process, what negotiators usually tend to commit are less than or equal to what, in fact, are already the applied regulations.

Moreover, the current approach in AFAS, i.e., the positive list approach, does not promote any consideration of the value of opening up financial services either within ASEAN countries or to the rest of the world. The bargaining nature of the negotiations gives incentive for countries to defer opening up sectors, even if it is in their own best interest, in the hope that it might gain greater access to another country's market later.

[19] Annexes 1 and 2 provide a snapshot view of financial services commitment in WTO by ASEAN countries.

[20] AFAS aims for free trade in services within the ASEAN region by 2020. It follows the positive listing and request/offer approach in GATS and, so far, has concluded five schedule of commitments packages including financial services. Through AFAS, mutual recognition agreements on mobility of engineers and nurses have been signed, while those for architecture, accountancy, surveying and tourism are under discussion.

Because of its voluntary nature, AFAS did not force any market opening in any ASEAN financial market, unlike what was achieved by the First and Second Banking Directives in the European Union.

Table 7. GATS plus components of commitment for WTO member States

Country	Commitment
Singapore	• Offshore banks can lend up to S$300m to residents instead of S$ 200 million.
Indonesia	• To eliminate all market access and national treatment limitations on the banking subsector by 2010 rather than 2020. • ASEAN foreign banks and joint venture banks can open branches in three additional locations.
Malaysia	• Some commitments in the presence of natural persons – up to three foreign nationals, in a range of advisory, intermediation and auxiliary financial services permitted to set up a representative office
Philippines	• Commitments in commercial banking services only, maximum of six branches, half locations designated by the Monetary Board and in mode 4.
Brunei Darussalam	• Commitments under mode 4 to allow temporary presence of up to two intra-corporate transferees.
Thailand	• Limit on foreign equity shareholding of up to 100 per cent paid-up capital compared to 49 per cent in areas of securities brokerage, securities dealing and underwriting schemes, and collective investment involving asset management corporations.

Source: Rajan and Sen, 2002.

AFAS has not put on pressure for changes in national legislation, if necessary, to accommodate greater integration in the region, unlike in the case of the European Union where a certain degree of top-to-bottom approach takes place, and where countries are required to change their domestic laws, if need be, to meet the European Union-wide integration programme. In ASEAN, the process is bottom up, where the individual member countries often find no compelling incentive to change their regulations for the sake of the top. It must, however, be said that there are ongoing work programmes to harmonize regulations and supervision within ASEAN. There are in-principle agreements to international accounting standards (IAS), a subset of IOSCO standards, development of corporate governance as well as cooperation among financial supervisors to monitor their firms' activities in other countries and to share information with the host country (Gordon and Chapman, 2003).

As intraregional trade in goods increases, it is expected that the need for an integrated regional financial market will grow. So far, no major infrastructure initiative, such as a regional payment and settlement mechanism, to improve regional financial services trade is on the agenda. ASEAN banks usually make use of correspondent banks

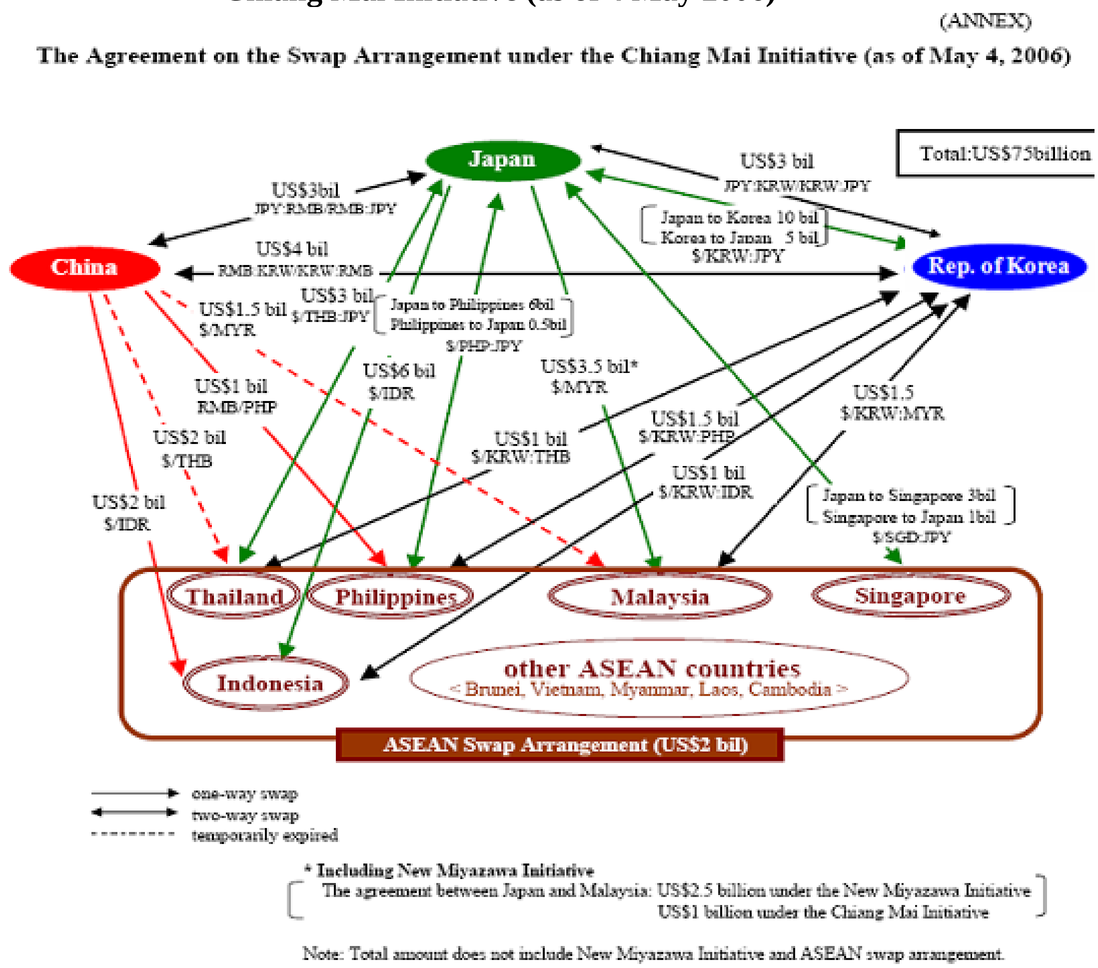
– mostly based in the United States or the European Union – to clear regional payments. In addition, the financial sector is not pursuing cross-border consolidation. Most ASEAN banks, except those in Singapore, have been preoccupied more with consolidating their position in the domestic markets and less with establishing presence in other countries in the region – a trend akin to that which took place in the European Union – to protect their domestic interests as the financial sector opens up. This lack of aggressive interest in cross-border activities and establishment gives very little scope for trade diversion, i.e., for other financial service providers outside the region being crowded out by regional agreements affecting financial services.

However, the dynamics may change and the potential for trade diversion and trade creation would rise to the fore if AFAS were extended to ASEAN + 3. To date, no meaningful services trade agreement had been signed by ASEAN as a whole vis-à-vis the 'plus 3' economies, although Singapore, Malaysia, Thailand, and the Philippines have separate bilateral trade agreement with Japan covering many sectors in services. ASEAN had also signed a services agreement with China but the level of financial liberalization is much less than that in AFAS. Its negotiations with South Korea on services are also expected to finish within the year.

2. Chiang Mai Initiative

The Chiang Mai Initiative (CMI) per se is not about financial integration. It is about creating a regional fund that can help countries in the region overcome extreme volatility in currency values through swap arrangements. As of May 2006, US$ 75 billion had been committed by the ASEAN5 + 3 for 16 bilateral swap arrangements. To the extent that, through CMI, monetary and fiscal authorities in the region are coordinating and agreeing to a regional surveillance, and gaining each other's trust, CMI can be considered a precursor to further financial integration.

Figure 1. Agreement on the swap arrangement under the Chiang Mai Initiative (as of 4 May 2006)



3. Asian Bond Markets Initiative

The Asian Bond Markets Initiative aims to develop a liquid and efficient bond market in the region to better utilize huge Asian surpluses for investments in Asia. By 2004, Asia had a net foreign asset position of 30 per cent of GDP (US$ 2.7 trillion), whereas Europe had a net foreign liability of 9.3 per cent of GDP (US$ 1.2 trillion, and NAFTA had a much larger net liability of 22.9 per cent of GDP (US$ 3.1 trillion) (Lane and Milesi-Ferretti, 2006). This is largely because a major portion of gross savings in Asia finds its way into debt instruments of governmental and quasi-governmental issuers in industrialized economies, thanks to the intermediation efforts of the United States and European investment banks, hedge funds and private equity funds. Meanwhile, Asian investments are financed, to a significant degree, by capital from those same countries, making countries in the region vulnerable to the "sudden stop" phenomenon, as the Asian economic crisis in 1997 showed.

The development of the Asian bond market, therefore, aims to provide an avenue for recycling huge Asian savings. The Asian financial system has been largely bank-dominated. The bonds and equity markets have grown since the 1990s, but are still nowhere close to the size of non-bank markets in developed economies (table 8). For example, bond market capitalization as a percentage of GDP in ASEAN averages less than 50 per cent while developed economies such as the United States and Japan greatly exceed the 100 per cent mark. The development of the bond markets in Asia has become a priority, especially after the Asian economic crisis, which highlighted the need for diversity in financial intermediation and, in particular, for developing a deep, liquid and mature market in the region.

Table 8. Financial structure in selected countries, in percentage of GDP, 2004

Country/area	Bank deposits[a]	Equity[b]	Bonds[c]	Insurance premiums[d]
ASEAN				
Indonesia	38.9	24.9	24.1	1.3
Malaysia	88.7	152.6	89.3	5.5
Philippines	48.4	30.6	28.7	1.5
Singapore	104.4	149.0	58.6	9.1
Thailand	79.7	72.3	38.9	3.5
Viet Nam	48.1	n.a.	n.a.	2.0
Asia – others				
China	177.8	40.3	29.4	3.2
Hong Kong, China	299.3	486.3	28.3	9.4
India	51.1	48.4	31.7	3.1
Japan	120.5	73.2	181.6	10.7
Republic of Korea	68.8	56.1	74.9	10.1
Taiwan Province of China	n.a.	135.3	58.3	14.2
Selected OECD economies				
Australia	73.0	108.4	52.9	7.8
Canada	62.9	106.4	75.5	7.1
Germany	96.7	42.2	80.3	7.0
Switzerland	133.8	217.6	67.6	11.7
United Kingdom	115.0	123.0	43.9	13.8
United States	58.8	131.6	157.2	9.4

Sources: CEIC data; and World Bank, Financial Structure Dataset, February 2006 as cited by Sheng, 2006.
[a] Bank Deposits/GDP.
[b] Stock market capitalization/GDP.
[c] Public and private bond market capitalization/GDP.
[d] Life and non-life insurance premium volume/GDP.
Note: n.a. = not available.

In this context, the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP)[21] launched the United States dollar-denominated Asian Bond Fund (ABF1) in

[21] The 11 members of EMEAP include the Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore and Bank of Thailand.

2003, and ABF2 in 2005. ABF1, a close-ended fund with an initial size of US$ 1 billion, is confined to the investment of EMEAP central banks only (except Japan, Australia and New Zealand). ABF2, on the other hand, will invest US$ 2 billion in domestic currency bonds issued by sovereign and quasi-sovereign issuers in China, Hong Kong, China, Indonesia, the Republic of Korea, Malaysia, Philippines, Singapore and Thailand. Half of the investments have been allocated to the ABF Pan Asia Bond Index Fund (PAIF), an open-ended bond fund investing across the region and listed on the Hong Kong Stock Exchange. Additional listings on other EMEAP stock markets will come at a later stage.

The ABFs, especially ABF2, provide private investors with the flexibility to invest in the Asian bond markets of their choice as well as a diversified exposure to bond markets in Asia in one instrument. It is expected to lower the cost of bond issues, which, until recently, had a "carry advantage" of an average of 2 per cent to 3 per cent over cash, compared with less than 50bps over cash for comparable duration United States Treasury bonds.[22] PAIF can provide the private sector fund managers with a benchmark index for fixed income products, and derivative products can be structured around it, thus adding to market liquidity. More importantly, ABF2 acts as a platform for addressing regulatory and other hurdles in bond market development. In a "learning-by-doing" fashion, regulatory authorities in the region are led to remove many non-supervisory restrictions, accelerating market and regulatory reforms to meet the demands of both potential issuers and investors, at the regional and domestic levels.

B. Cross-border flows, state of regional integration and policy landscape

While the various regional mechanisms discussed above are aimed at integrating financial systems in Asia and reducing restrictions on cross-border flows, some experts are sceptical of such schemes. Eichengreen (2004), for example, argued that current efforts were essentially opening up the capital accounts of countries in the region in the sense that it would encourage more cross-border flows. He questioned the timing of capital account liberalization prior to the development of strong, diversified and well-developed domestic financial markets. This is standard sequencing dilemma.

Other sceptics point to the lack of commercial usefulness of liberalizing measures, especially financial liberalization through services trade agreements, because the region's financing needs are anyway met by the global market. Intra-Asian financial flow data are not available, but from data on foreign claims on ASEAN banks, it be inferred that most of ASEAN's bank liabilities are with banks in the United States and European Union (table 9). What is not detectable from the Bank of International Settlements (BIS) data are liabilities of ASEAN from other Asian banks other than Japan, because most of the reporting banks are from non-Asian developed markets. For ASEAN economies, which do not seem to tap each other's financial system resources for their funding needs, regional financial liberalization may appear of marginal importance. Yet, based on other

[22] One obstacle to ABF liquidity is that the bonds are largely purchased by banks with a "buy and hold" strategy, i.e., holding bonds to maturity to meet regulatory requirements.

studies that use survey data, there appears to be a growing cross-holding of Asian debts and securities within the region.

Table 9. Consolidated foreign claims on ASEAN countries, end March 2006 (US$ million)

Claims vis-à-vis:	Total foreign claims	Japan	United States	European banks
Indonesia	49 298	6 773	4 592	25 115
Malaysia	84 287	5 949	12 084	37 572
Philippines	28 503	2 558	4 908	17 291
Singapore	166 269	20 306	23 851	99 518
Thailand	49 446	13 437	8 248	17 087

Source: BIS, based on data provided by reporting banks.

1. Asian holdings of Asian securities

Since the Asian economic crisis, countries in the region have accumulated foreign reserves as a safe cushion for any future exchange rate crisis. However, as discussed above, these surpluses are usually intermediated through non-Asian intermediaries. McCauley and others (2002) described a typical hub-and-spoke funding scenario in Asia whereby an Asian issuer chooses an affiliate of a North American or European firm as bookrunner, who takes the issuer on a roadshow and assembles a syndicate of underwriters; the underwriters then sell about half of the paper back to Asian accounts. Funds typically clear through New York or Europe, but the funds go full circle back to Asian portfolios. Thus, Asian holdings of Asian bond issues are, in fact, significant. For example, McCauley and others (2002) reported that Asian investors grabbed 78 per cent of Indonesian issues from April 1999 to August 2002, as well as 36 per cent of the Republic of Korea and Singapore. Asian holdings of issues by other Asian countries lie somewhere between those for Indonesia and the Republic of Korea/Singapore.

For syndicated loans, approximately 40 per cent to 80 per cent of funds in internationally syndicated loans to borrowers in East Asia[23] are provided by banks in the East Asia-Pacific region. This is highly comparable with United States' banks funding of United States issuers (55 per cent) and euro-area bank funding to euro-area borrowers (64 per cent). This type of information is not captured in the BIS data reported in table 9. On average, banks with the same nationality as borrowers typically provide around 20 per cent of the facility nominal amounts while Japanese involvement in East Asian syndicated loans is roughly 13 per cent (McCaulay and others, 2002).[24]

[23] In the McCaulay and others (2002) study, East Asia includes not only the ASEAN +3 economies, but also the economies of Hong Kong, China and Taiwan Province of China.

[24] While these data are available for the East Asia region, what is not clear is the degree of integration (proxied by the holdings of regional securities/loans) within ASEAN alone. Cross-border fund flow data within ASEAN are not, at present, available because reporting banks to the Bank for International Settlements (BIS) do not come from developing countries. While the BIS reports foreign claims on

Apart from data showing increased funding by Asians of Asian borrowings, how involved are Asian-based banks in intermediating Asian issuers needs? The lead roles (or bookrunners) for Asian bond issues have mostly gone to United States intermediaries (54 per cent of Asian issues have American financial institutions as bookrunners). However, for syndicated loans, East Asian and Japanese banks have grabbed a larger share (63 per cent of total value) as the arranger (table 10). This, perhaps, reflects the greater development of bond markets outside Asia as well as the relative sophistication of United States and European investment banks with their network of global investors. The larger role of Asian banks in syndicated loans, on the other hand, points to the predominance of banks in Asia's financial system (McCaulay and others, 2002).

Table 10. Asian participation in Asian funding needs, April 1999-August 2002

Type of fund	**Percentage share of total Asian issues by bookrunners/loan arrangers headquartered in:**		
	North America	Europe	Asia
Bonds	54	29	17
Syndicated loans	12	23	63

Source: Based on McCauley, Fund and Gadanecz, 2002.

The large holdings of Asian bonds and loans by Asian investors as well as the increasingly significant lead roles of Asian banks in intermediating Asian needs for funds reflect an already considerable degree of integration in the private financial markets. Indeed, it cannot really be said that there is little commercial interest to be derived from liberalizing interregional cross-border capital flows. Perhaps, all the regional efforts, especially ABFs, to learn the appropriate cross-border policies and infrastructures, and to foster greater financial cooperation, are merely ways of catching up with already growing developments in the private markets that are unknown among non-capital market players.

2. Other quantity-based measures of financial integration[25]

The above discussion reveals a growing integration in Asian markets, in terms of significant Asian holdings of Asian securities due to surplus funds as well as more active involvement of Asian-based intermediaries in financial intermediation. However, relative to other regions and in terms of aggregate data, East Asia does not exhibit significant financial integration.

For one thing, because of significant barriers to foreign bank participation in domestic markets, the share claimed by foreign banks (including Asian banks) in total credit is below 10 per cent, compared with 20 per cent in Latin America. Of the countries in emerging Asia, China stands out with exceptionally low foreign bank penetration of less than 2 per cent of the total credit to non-banks, not surprisingly because of its closed-

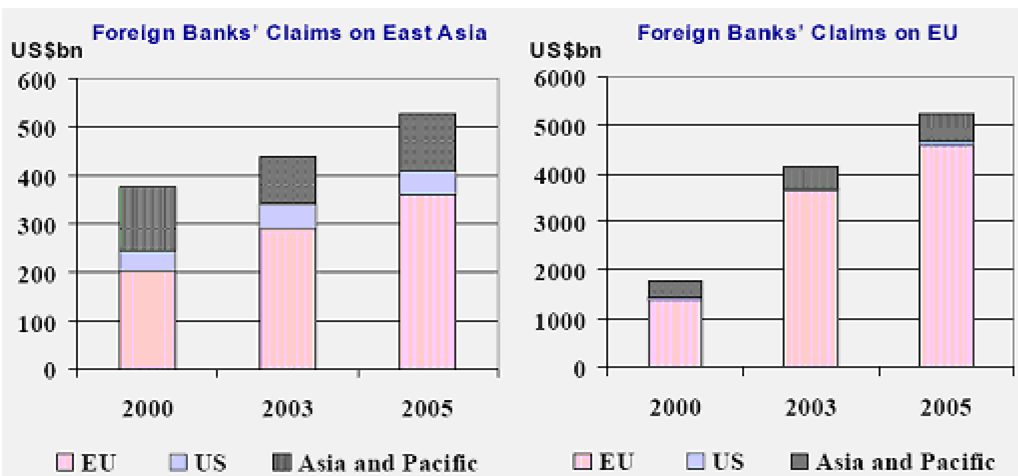
ASEAN countries, such claims typically come from European or United States banks, not from other ASEAN-based banks (see table 9).

[25] This subsection and the next draw heavily on Medalla, Pasadilla and Lacson, 2007.

door policies. Malaysia (36 per cent) and the Philippines (26 per cent) are on a par with emerging markets in other regions, as far as foreign bank penetration is concerned.

However, it is significant that although the ratio of foreign bank claims in total non-bank credits remains low, the amount of local currency claims by foreign banks as well as their share in domestic banking assets have been increasing. Figure II shows the increasing amount of foreign claims on East Asia. Yet, unlike the European Union where majority of the foreign claims are intraregional, East Asia's foreign liabilities are mostly with non-Asian banks, primarily European.[26] Figure II shows, for example, that only about 20 per cent of foreign claims on East Asia in 2005 were from other Asian and Pacific region banks, while in Europe about 90 per cent of foreign claims were from other European banks. Thus, rather than being regionally integrated, East Asia appears to have stronger links with developed markets outside Asia.

Figure II. East Asia – more integrated with developed markets



Source: Bank for International Settlements, cited in Poonpatpibul and others, 2006.
Note: East Asia in the study includes ASEAN5 plus China, Japan, Republic of Korea and Hong Kong, China.

In cross-border portfolio investment, East Asian intraregional portfolio flows in 2003, for example, were recorded as totalling US$ 110 billion, which was about 9 per cent and 5 per cent of total portfolio inflows and outflows, respectively. In contrast, for the European Union, intraregional portfolio flows reached US$ 6.058 trillion, amounting to 61 per cent and 64 per cent of total portfolio inflows and outflows, respectively. Most of East Asia's portfolio investments came from North America (US$ 476 billion) and

[26] A caveat is in order in interpreting the BIS data. It is quite difficult to ascertain the extent of integration of banking markets based on cross-border claims submitted by foreign banks because not all banks in the region submit information to the BIS. It could appear, for instance, that ASEAN banks may not have any foreign claims against each other based on BIS data, yet based on information on syndicated loans from the primary market which McCaulay and others (2002) based their study on, there is already some degree of intra-regional financial interactions, particularly in intra-Asian bank loans.

Europe (US$ 415 billion), amounting to approximately four times the investment that came from within the region itself.

Table 11. Inter- and intraregional portfolio investments in 2003 (US$ billon)

	Investment from				
	NAFTA	**EU15**	**East Asia**	**Rest of the World**	**Total**
Investment to					
NAFTA	545	1,776	747	1,620	4,688
EU15	1,614	6,058	804	1,455	9,931
East Asia	476	415	110	165	1,166
Rest of the World	823	1,292	566	492	3,173
Total	3,458	9,541	2,227	3,732	18,958

Source: Asia Bond Monitor, cited in Cowen and others, 2006.

3. Price measures of integration

Another way of measures integration is to use price measures. The law of one price states that assets with identical risks and returns should have the same price regardless of its location. This occurs because integration allows for arbitrage where arbitrators sell the asset to the location where it is priced highest, thereby increasing the supply of the asset in that location and eventually equalizing the prices between the two areas. Interbank rates in the European Union, where standard deviation of money market interest rates converges toward zero basis point (Beale and others, 2004), is a good example. In the same vein, the extent of ASEAN or East Asian integration could be measured by the degree of variation of prices.

Many studies that base their analysis on the law of one price find that there is little financial integration in East Asia, especially ASEAN5 (Park and Bae, 2002). A host of other studies have found that these countries are more integrated with developed markets than they are with the region, mirroring the flows of portfolio investments and cross-border bank loans discussed earlier.

Using data from stock markets and stock prices, and focusing on Indonesia, Japan, the Republic of Korea, Malaysia and Thailand before the Asian economic crisis (i.e., between January 1994 and April 1997) and after the crisis (i.e., June 2002), Park and Bae (2002) applied the co-integration test pairwise to check for any long-term relationships in stock prices between two of the five countries studied. Their results showed that only one relationship was significant, that of Thailand and the Republic of Korea before the crisis. No relationship was found between pairs among the five countries after the crisis, implying that, at least during the time frame of the study (i.e., up to 2002), no regional integration actually occurred.

Interestingly, Indonesia, Malaysia, the Philippines and Thailand appear to have stronger correlations with each other than with either the United States or Japan, suggesting a measure of integration between the four countries (table 12). Between the United States and Japan, however, the United States appears to have stronger correlations with all six countries, suggesting that the Japanese stock market is not as integrated with Asian markets compared to the United States (Park and Bae, 2002).

Table 12. Stock prices correlation

	US	Japan	Indonesia	Malaysia	Philippines	Korea	Taiwan	Thailand
US	1.00							
Japan	0.37	1.00						
Indonesia	0.15	0.17	1.00					
Malaysia	0.27	0.20	0.37	1.00				
Philippines	0.23	0.16	0.37	0.38	1.00			
Korea	0.28	0.27	0.18	0.24	0.19	1.00		
Taiwan	0.22	0.21	0.17	0.28	0.25	0.27	1.00	
Thailand	0.29	0.18	0.39	0.47	0.40	0.36	0.22	1.00

Source: Park and Bae, 2002.

Using a later data set, however, Poonpatpibul and others (2006) found that East Asian countries were becoming more integrated. In particular, they found that linkages between the Republic of Korea, the Philippines, Singapore and Thailand had become tighter. China was the exception (i.e., mostly negative correlations). Ties with the United States remained strong – even when the degree of co-movement had decreased, it was still above 0.70. Thus, they argued, linkages among East Asian countries were improving, although links with the United States remained quite significant.[27]

Interest rates could also be used to measure integration, based on the law of one price. The Daiwa Research Institute uses a real interest parity test based on the assumption that interest rates converge in integrated financial markets. Differentials would, therefore, be small and decreasing over time. The Daiwa Research Institute (2005) analysis of interest rates and inflation rates runs from 1991 to 2004, but excludes the economic crisis period of 1997-1998. The institute found that real interest rate differentials between six Asian countries/areas (i.e., China, the Republic of Korea, Malaysia, Singapore, Taiwan Province of China and Hong Kong, China) and the United States had declined, and that they are even lower when compared with the differentials

[27] The Daiwa Institute of Research (2005) also used stock market index correlations to judge the degree of integration between ASEAN5, China, Japan, the Republic Korea, Taiwan Province of China, Hong Kong, China and the United States. The results showed two trends. First, the Asian countries, except for Indonesia and the Philippines, appeared to be more integrated with the United States after the Asian economic crisis while Asian stock markets also appeared to be integrating more. China had the lowest average correlation with other stock markets and the lowest correlation with the United States. Second, however, correlation with Japan, the Republic of Korea and Taiwan Province of China increased after the economic crisis. The results on stock market correlations led the institute to the same conclusions as Poonpatpibul and others (2006) – that although Asian markets were integrating, that they were also still strongly integrated with the United States market.

between the same set of Asian countries and Japanese interest rates. This implies that Asian countries are more integrated with the United States than with Japan, and again coincides with findings by other researchers. China and the Republic of Korea also showed convergence with other Asian countries in the study, with the latter showing the greatest rate convergence (Daiwa Research Institute, 2005).

4. Cross-border mergers and acquisitions

Compared with other emerging markets, the number and value of cross-border M&As in East Asia's financial sector is still relatively small. During the past decade, 20 per cent of all M&As in the region were cross-border, worth around US$ 6.5 billion. In South America and Eastern Europe, 50 per cent were cross-border M&As, worth US$ 18 and US$ 12 billion, respectively (Coppel and Davies, 2003). However, following the Asian economic crisis, East Asia (especially Indonesia, the Republic of Korea and Thailand) became one of the fastest growing target regions for M&As (table 13). Most of these M&As have been underpinned by the process of financial restructuring after the Asian economic crisis, which has forced the lifting of foreign ownership limits, albeit only temporary in some countries. However, few of the cross-border M&As are actually intraregional, perhaps owing to the fact that the Asian economic crisis affected all the countries in the region. Thus, few if any East Asian banks were in a position to help restructure other banks through M&As.

Table 13. Finance sector mergers and acquisitions, 1990-2002

	Number of transactions		Value of transactions	
Country	**Total (US$ billion)**	**Cross-border (%)**	**Total (US$ billion)**	**Cross-border (%)**
Republic of Korea	85	27.1	7.1	29.8
Thailand	124	35.5	3.9	64.9
Malaysia	727	7.3	12.0	8.4
Indonesia	99	39.4	1.2	29.9
Philippines	89	41.6	4.2	10.8
Memo items:				
Rest of Asia	778	33.4	37.1	48.7
South America	394	55.3	29.5	51.7
Eastern Europe	586	52.6	13.6	85.9
Africa/Mid-East	373	30.0	27.8	20.6
All emerging markets	3 436	34.7	180.3	41.8

Source: As cited by Coppel and Davies, 2003, Thompson Financial DataStream.

In summary, although the volume of cross-border intraregional financial flows relative to other regions is still small, there are indications of increasing financial sector integration in East Asia. Different price measures of integration show increased convergence in interest rates, exchange rates and stock prices. Similarly, in terms of increasing holdings of Asian securities by Asian investors, and greater engagement of financial intermediaries in the region in cross-border funding needs, the private financial market actually appears more interlinked than previously thought.

5. Policy landscape

Arguably, one of the reasons for the relatively low cross-border financial sector investments in East Asia is still the nascent commercial interest in establishing strong commercial presence regionwide. This, however, can change once intraregional trade grows further due to the bilateral trade agreements between ASEAN and the ‘plus 3’ economies. Yet another reason for the low level of cross-border investments might well be the existing investment and financial flow barriers in all Asian economies.

In the above discussion, there is a notable heterogeneity among Asian countries in terms of participation by foreign banks in domestic credit. This heterogeneity in foreign bank participation may well reflect the relative openness and policy differences not only with regard to foreign bank participation in the local credit market, but also in capital controls and restrictions on foreign lending. Within the Asia-Pacific region, there are varying degrees of controls on foreign direct as well as portfolio investments, with Singapore and Hong Kong, China – the regional financial centres – being the most liberal. Restrictions on FDI across the region usually take the form of equity limits or approval requirements

More detailed studies on restrictions show that in cross-border investments, various East Asian countries limit the number of domestic branches for foreign banks (Malaysia, the Philippines and Thailand) and limit the deposit-taking activities of foreign bank branches to wholesale activities. At the same time, they allow a limited choice of legal entity (whether a branch or subsidiary), and have established requirements that must be met before allowing profits to be repatriated (see annex 3).

Investments in specific financial market instruments likewise contain various restrictions (table 14). There are reporting or registration requirements for either outflows (Indonesia, Japan, Malaysia and Thailand) or for both inflows and outflows (China and the Philippines). Equity purchases by non-residents are likewise limited to a specific percentage of investment fund or total equity. For outflows, Indonesia prohibits insurance and mutual funds from investing abroad. Malaysia and Singapore require repatriated amounts to be in foreign currencies only, while China, Malaysia, the Philippines and Thailand have various limitations either on repatriated amounts or on investments beyond certain thresholds.

These various existing restrictions among East Asian countries help to explain why penetration by foreign banks in the domestic financial markets likewise differs. They also help to explain the relatively low intraregional, cross-border financial investments.

In cross-border fund flows, portfolio and securities are, generally, not as tightly regulated. Most restrictions involve having to secure approval from the concerned government agency, e.g., from the central bank. Aside from this, the most common prohibition involves either restrictions on the use of domestic currencies for equity portfolios (Indonesia and Singapore) or limitations on investments denominated in the domestic currency (e.g., Malaysia and Thailand).

For private sector foreign borrowing and lending, caps are usually placed on the amount lent or borrowed. For Malaysia the maximum is M$ 50 million while for Thailand it is B 50 million. For Singapore it is S$ 5 million for corporate entities while a lower limit is designed for individual borrowings. In other countries, government approval needs to be sought or payment of loans needs to be converted into foreign currency.

Asian regulatory authorities have also built up barriers to cross-regional trading of financial products. In the mutual funds and bond markets, for example, it is easier to get approval for a bond listed on the Irish Exchange to trade in Asia than to get approval for an Asian-issued bond. It is also easier for a mutual fund registered in Luxemburg to be marketed throughout Asia than for a mutual fund issued in Hong Kong, China to be traded in Singapore and vice versa (Sheng, 2006).

Table 14. Existing regulation of cross-border investment in East Asia

	Capital Inflow			Capital Outflow	
	Money Market Instrument	**Bond Market Instruments**	**Equity Instruments**	**Resident Investors**	**Nonresident Inventors**
PRC	Non-residents (NR)not allowed	Subject to quota, only qualified investors (QFII) allowed	Only QFII < 10% of listed company, with quotas	Only for qualified domestic investors (QDII)	QFIIs must retain investments in PRC bet. 1-3 yrs. principal
Indonesia	Foreign investor may purchase locally	Nonresidents can purchase debt securities	Nonresidents <10% of investment fund	Mutual funds and insurance companies not allowed to invest abroad	Reporting requirements, generally no restrictions
Japan	NR free to purchase	NR free to purchase	NR free to purchase	Requires ex post facto report of investments	No restrictions
Malaysia	No restrictions	NR free to purchase	Bank investment by NR<30% of equity in a bank	MYR 50,000. Requires approval, investment abroad allowed with certain limits	Remittances must be in unrestricted foreign currency
Philippines	Registration required if foreign exchange used is from local banks	Registration required if foreign exchange used is from local bank	Registration required if foreign exchange used is from local banks	Registration of investments, approval of investments>6USD million/yr	Registration required if foreign exchange used is from local banks, no approval needed
Thailand	No restrictions	No restrictions in thai debt securities	Foreign investors subject to various limits	Requires regulatory approval, commercial banks can hold<20% of capital fund	Require documentation for repatriation of portfolio investments
Singapore	No restrictions	No restrictions	No restrictions	No restrictions	SGD proceeds must be converted to foreign currency

Sources: International Monetary Fund, *Annual Report on Exchange Arrangements and Exchange Restrictions, 2004*; Economist Intelligence Unit, Country Reports; and information from various links, compiled by AsianBondsOnline (asianbondsonline.adb.org), Asian Development Bank.

C. Steps forward

In summary, despite various regional mechanisms aimed at closer financial integration, many roadblocks remain in the East Asian process. These include large national differences in market practices, institutional and infrastructure development, and regulatory standards, laws and processes that lead to high transaction costs. While closer cooperation is a clarion call at the level of political leaders, these efforts become seriously constrained when it comes to specifics. In particular, various barriers to foreign entry as well as regulatory conservatism towards financial innovation remain considerable, while supporting institutions, laws, regulations, supervision, oversight, standardization etc. are still lacking.

On the one hand, no one is surprised. It took more than 50 years for the European Union to iron out many national differences, and even now the process still contains many loopholes. On the other hand, if policy makers in the region believe that financial integration is beneficial with regard to achieving more efficient allocation of resources, and can contribute to faster economic growth as well as help financial stability, then there is no reason to delay action. The steps to be taken, which have already been exhaustively researched, can be summarized as follows:

(a) Infrastructure development. Establishing linkages between jurisdictions across the whole spectrum of financial infrastructure – trading, payment, clearing, settlement and custodian systems for money and for financial instruments – is necessary in order to make cross-border transactions more efficient (Yam, 2006). It is encouraging that even the European Union does not have such efficient regional facility, although each national clearing and settlement system is individually efficient. In Asia, not all nations have even an efficient clearing and settlement mechanism, especially for newer financial instruments like bonds;

(b) Strengthening and harmonizing prudential regulations within the region. Countries/areas in East Asia have signed on to Basel 2 standards, even though the pace of implementation varies according to the regulatory capacity of each country/area and the conditions of its domestic market, with Singapore and Hong Kong, China being among the more advanced, the Republic of Korea and Taiwan Province of China in the middle, and the four ASEAN emerging economies being relatively slower. A degree of harmonization, at least in the adoption of minimum acceptable international standards, is essential not only to establishing mutual confidence among the regulators in the region, but also to improving investor confidence as a whole. These minimum standards not only pertain to risk management and capital adequacy but also to accounting rules and consolidated reporting, among others;

(c) Harmonization, mutual recognition, and home country control entail the need for supervisory competence and efficiency, and a considerable degree of trust and confidence among the authorities in the region. Since these aspects require training and experience, and to a certain extent, significant changes in cultural and managerial practices, East Asia must invest a great deal in regular and quality training of financial sector supervisors as well as in facilitating regular formal and informal contacts and collaboration. Necessarily, competence and efficiency will not be achieved overnight, which is even more of a reason to make regular dialogue as well as exchanges of experience and information among supervisors in the region a regular activity;

(d) Moreover, in addition to supervisory rules, there is a wide scope for work on an inventory of national laws that raise obstacles to a seamless financial market. For example, in the area of mergers and acquisitions, what are the laws that can make a possible future wave of intraregional M&A difficult? What about laws on bankruptcy, collateral arrangements and competition policy?

(e) With regard to capital flow barriers that have already been identified, their relaxation should be a matter for constant policy review. This is unlikely to be easy, partly because the state of the economies is different across Asia and their capacity to cope with the accompanying liberalization risks thus varies. Another reason is the huge vested interests that always come into play in any liberalization programme, which makes it a thoroughly challenging venture;

(f) Emergence of an integrated market is possible when there is good quality of cross-border information and trust in the quality of counterparts located in other countries. Otherwise, even in a monetary union, market segmentation may occur if cross-border information on the soundness of banks is of low quality (and banks suspect that cross-border borrowing is triggered by an inability to borrow at the domestic level). Thus, surveillance work, not only at the macro level but also the micro financial level, should be strengthened. Independent efforts by regional rating agencies can partly fill the need for information, but work on accreditation of such agencies is needed.

III. Lessons and challenges

First, a particularly noteworthy experience from the European Union is that it achieved the SMP without a major regional financial crisis or large bank bankruptcies. For East Asia, the important lesson for preserving banking resilience and reducing systemic risk is that strong liberalization and bank deregulation must be accompanied by an equally strong re-regulation of bank prudential supervision. However, an excessive re-regulation of supervision can reduce the economic benefits from contemporaneous deregulation of banking structure and conduct rules. The European Union, as discussed above, carefully balanced de- and re-regulation.[28]

This balance was achieved through harmonization of minimum regulatory standards while adopting the principles of “mutual recognition” and “home country control”. Minimum harmonized standards were important in engendering mutual trust in each other’s supervisory quality and in preventing regulatory arbitrage, or competition in laxity, as each jurisdiction’s supervisory authorities wanted to gain advantage for their own regulatees. A harmonized regulatory framework was established prior to effecting the large-scale liberalization and deregulation associated with the SMP. Mutual recognition and home country control, on the other hand, were helpful in preventing protectionist tendencies lurking in the guise of “national rules and standards”.

In addition, the consolidation trends that result from the perceived greater competition were tempered by a clear competition policy. The concern for providing a competitive, level playing field was even more important as traditional boundaries between banks and other financial institutions were removed. This implies that regulated financial institutions must have the same competitive freedoms as the growing array of non-bank competitors. This almost always implies, in practice, a convergence in regulatory regimes, in order that market players in one jurisdiction are not significantly disadvantaged by the regulations in other places. Harmonization has to be clearly embedded in global standards and practices.

Another important experience from the SMP of the European Union is its emphasis on public persuasion regarding the benefits of liberalization and integration. The European Commission embarked on a strenuous public programme aimed at stressing the timetable and the inevitability of the liberalization events, providing significant lead time for expectation build-up. At this point, East Asia is not prepared to embark on any specified timetable and financial liberalization build-up because no one has yet clearly articulated the broad vision or the financial market roadmap. What is more important at this juncture is involving the private sector, policy makers, academia and regulators in working together in the search process. When, eventually, the path becomes clearer, the public programme to embed a single East Asian financial market in the strategic radar of financial institutions would have to be implemented.

The challenges to be faced on the road to financial integration in East Asia are undoubtedly daunting. First, the European Union implemented the integration of financial systems with the strong guidance and supervision of a supranational authority, which East Asia does not have. As discussed above, the existence of the European Commission, Parliament, and Court of Justice have been decisive in integrating the European Union market thus far. East Asia, in contrast, remains in search of an adequate institutional

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[28] For more than two decades, even though the balancing of de- and re-regulation involved change in national legislation in European Union member States, these did not entail introducing entirely new structures but involved improvements of existing ones. In some of the new proposals, especially those related to the Lamfalussy procedures and supervision, the same cannot be said since new regional institutions and mechanisms are being considered.

structure that can help accelerate Asian integration. In addition, the “carrot and stick” system worked to enforce the necessary liberalization in the European Union, with the “stick” being all the pains of adjustment in a domestic market transitioning to a more competitive financial market and the “carrot” pertaining to all the benefits of being an “in-country” (i.e., belonging to the European Union). In the European Union’s case, the benefits were strong enough to help accept the dismantling of protectionist barriers. In East Asia, these benefits are presumed to be present but their magnitude is yet unclear. It remains to be seen if they are going to be sufficient to excite the region’s financial sector.

Second, while European Union bureaucracy is not immune to the influence of interest groups, public policies are not completely determined by them. In Asian countries, the linkages between politicians, influential families and economic interests are more stringent, and tough measures in support of regional financial market integration might receive little support if the elite find that it works against them. To the extent that international commitments tend to weaken the power of entrenched interests, they can attempt to withhold support for the process right from the start. The challenge is for them to accept that the transition to global markets is inevitable, and that it is only a question of time and pace of change.

The European Union experience also sheds light on the reality that, even as regional agreements enumerating legal rights to cross-border access should, in theory, facilitate market integration by reducing regulatory entry barriers and legal uncertainties, the agreements that emerge from the political process – in which domestic producer interests usually have considerable influence – contain rights that are severely circumscribed and liable to be subject to new restrictions. The box article (section I above), on the dynamics of this process in the crafting of the Investment Services Directive in the European Union, illustrates how a supposedly liberalizing change ended up creating more barriers. Thus, in Europe as in Asia, effective liberalization of regional markets relies very much on the cultivation of an enlightened self-interest among the participating States (Steil, 1999).

Annexes

Annex table 1. GATS commitments in banking (acceptance of deposits and lending), 1997

Member	Cross-border supply		Consumption abroad		Commercial presence				
	Deposits	Lending	Deposits	Lending	Legal form	No. of suppliers	Equity	No. of operations	Value of transactions
Indonesia	N	N	N	N	LL	U	LO1	LN	
Republic of Korea	U	U	U	U		DL	LO1		LV
Malaysia	U	LC	N			U	LO1	U	
Philippines	U	U	N	N	DL	DL	LO2	LN	LV
Singapore	U	U	N	N		U	LO1	LN	DL
Thailand	U	U	U	U	LL	DL	LO1	LN	
Developed members									
Japan	LC	LC	N	N	LC	N	N	N	N
European Union	LC	LC	N	N	LL	N	N	LN	
United States	LC	LC	N	LC	LL	N	N	N	N

Source: Qian, 2003.

Notes:

Code – Type of commitment.

U – Unbound against relevant mode.

DL – Discretionary licensing or Economic Needs Test.

LC – Limited commitments.

LO1 – Limits on ownership less than 50 per cent (minority).

LO2 – Limits on ownership more than 50 per cent (majority).

LL – Limits on legal form.

LN – Limits on number of operations (branches).

LV – Limits on value of transactions or assets.

N – Full bindings or "none"; limitations again relevant mode.

Annex table 2. GATS commitments in insurance, life and non-life, 1997

Member	Cross-border supply		Consumption abroad		Commercial presence			
	Life	Non-life	Life	Non-life	Legal form	No. of sup	Equity	Other
Indonesia	U	U	DL	DL			LO2	
Republic of Korea	U	U	U	U	LL		LO	
Malaysia	U	DL	U	DL	LL	U	LO2	
Philippines	U	U	U	U		DL	LO2	
Singapore	U	U	N	N		U	LO1	
Thailand	U	U	N	N		DL	LO1	
Developed members								
Japan	U	LC	U	LC	N	N	N	N
European Union	LC	LC	LC	LC	LL	N	N	LN
United States	LC	LC	N	N	LL	N	LT	LN

Source: Qian, 2003.

Notes:

Code – Type of commitment.

U – Unbound against relevant mode.

DL – Discretionary licensing or Economic Needs Test

LC – Limited commitments.

LO1 – Limits on ownership Less than 50 per cent (minority).

LO2 – Limits on ownership More than 50 per cent (majority).

LL – Limits on Legal Form.

LN – Limits on number of operations (branches).

LT – Limits on type of operations (branches vs. subsidiaries).

LV – Limits on value of transactions or assets.

N – Full bindings or "none"; limitations again relevant mode.

Annex table 3. Domestic and foreign banking regulations in selected countries/areas

Country/area	Domestic versus foreign banks	Foreign subsidiaries versus foreign banks	Capital requirements for domestic banks, foreign subsidiaries, and foreign branches
Australia	Domestic banks and foreign banks can engage in the same types of activities; however, foreign bank branches are required to confine their deposit-taking activities to wholesale markets. Foreign bank branches also are not subject to depositor protection arrangements in Australia and must disclose this.	Except for deposit-taking, both can engage in the same types of activities. A foreign bank can also operate both as a branch and a subsidiary.[1]	Only locally-incorporated banks are required to maintain minimum capital requirements. Foreign bank branches are not required to maintain endowed capital. As such, only locally-incorporated banks are subject to the minimum risk-based capital adequacy ratio. Foreign branches are expected to meet comparable capital adequacy standards, which must be consistent in all substantial respects with the Basel Capital Adequacy Framework, as required by their home country supervisor.
China	Different set of rules govern domestic and foreign banks. However, it is CBRC's intention to develop a uniform set of rules. CBRC find this imperative because by 2006 all geographic and customer restrictions on foreign banks were to be removed.	At present, foreign banks largely operate in the form of branches rather than subsidiaries. Again, separate rules govern the two.	Capital rules cover all banks. However, foreign bank branches are subject to a working fund requirement, which is a variant of capital rules in light of convertibility constraints for capital account transactions.
Hong Kong, China	HKMA's regulations for foreign bank subsidiaries are the same as those for domestic banks. As for foreign bank branches, the supervisory approach is broadly in line with that applied to locally-incorporated banks, except that capital-based supervisory requirements such as capital-based limits on large exposures are not applied to such branches.[2] In practice, foreign banks seeking a	No difference except in capital-based supervisory requirements.	Minimum capital requirements of locally-incorporated authorized institutions vary according to classification (bank, RLB, DTC). However, foreign bank branches are not required to hold any capital, but they are subject to a minimum asset requirement. As such, only locally-incorporated authorized institutions are subject to the minimum risk-based capital adequacy ratio. Branches of foreign banks are not subject to this ratio, since the primary responsibility of supervising capital

	banking licence in Hong, China can only operate as a branch. RLB presence may be in the form of a subsidiary or a branch, while DTC Presence may only be in the form of a subsidiary.[3]		adequacy of foreign bank branches rests with the home supervisor.[4]
Indonesia	Regulations for domestic and foreign banks are the same.	Regulations for foreign bank subsidiaries and foreign bank branches are the same.	Minimum capital requirements of locally-incorporated banks are the same. Foreign branches, on the other hand, should maintain their capital in the form of net inter-office funds (NIOF) as much as their declared nominal. However, all banks are required to satisfy the minimum risk-based capital adequacy ratio.
India	Regulations for domestic and foreign banks are generally the same, except for some minor differences. For example, priority sector lending target for foreign banks is 32 per cent compared with 40 per cent for Indian banks. Also, export credit is taken as a priority sector lending for foreign banks but not for Indian banks.	As of now, only foreign bank branches are operating in India. RBI's roadmap, however, permits foreign banks in India to convert their existing branches to wholly-owned subsidiaries from now until 2009.	Minimum capital requirements are different for locally-incorporated banks and foreign bank branches.
Japan	See BCBS timetable.	See BCBS timetable.	See BCBS timetable.
Republic of Korea	Domestic and foreign banks are subject to the same regulations. However, foreign bank branches should meet a minimum requirement of operational funds (instead of capital), and they should get approval of their annual financial statements from the FSS before they send profits to their headquarters. In addition, the FSS imposes an "asset pledge" on foreign bank branches. There are also specific regulations regarding the	Apart from "capital" structure and establishment and closure regulations, the same regulations apply to foreign subsidiaries and branches.	Minimum capital requirements are different for locally-incorporated banks and foreign bank branches. For foreign bank branches, capital is in the form of operational funds. However, all banks are required to satisfy the minimum risk-based capital adequacy ratio.

	establishment and closure of foreign bank branches.		
Malaysia	Regulations are broadly the same except that foreign banks are not allowed to open new branches or new ATM machines. Currently, BNM is not issuing new licences for "conventional" banks. However, they have recently issued new licences to foreign Islamic banks. Based on BNM's Master Plan, new "conventional" banks would only likely be allowed after 2010.	All foreign banks are required to be locally-incorporated. So there are no foreign bank branches, only subsidiaries.	Minimum capital requirements are the same for all banks. All banks are also required to satisfy the minimum risk-based capital adequacy ratio.
New Zealand	The same regulations apply to both domestic and foreign banks.	The same regulations apply to both foreign bank subsidiaries and foreign bank branches.	Only locally-incorporated banks are subject to minimum capital requirements. Branches of foreign banks are not subject to such minimum requirements. However, RBNZ will wish to satisfy itself that the global bank has a level of capital which exceeds NZ$ 15 million. As such, only locally-incorporated banks are subject to a minimum risk-based capital adequacy ratio. Foreign bank branches are not subject to the same requirements, subject to the global bank satisfying the minimum capital adequacy requirements developed by the BCBS, as administered by the home supervisor.
Philippines	Foreign banks are subject to the same regulations as domestic banks in the same category (e.g., universal bank, commercial bank), thus they can engage in the same type of activities.	Foreign banks are subject to the same regulations as domestic banks in the same category (e.g., universal bank, commercial bank), thus they can engage in the same type of activities. Foreign bank subsidiaries can enter either by purchasing an existing domestic bank or by incorporation. However, due to the moratorium on the establishment of new	Minimum capital requirements for locally-incorporated banks vary according to classification (e.g., universal bank, commercial bank). Capital for foreign bank branches refer to the permanently assigned capital[5] plus net due to head office. However, all banks are required to satisfy the minimum risk-based capital adequacy ratio.

		banks, only the former option is left. Foreign bank subsidiaries are also subject to the same branching policies as domestic banks. Up to 10 banks incorporated outside of the Philippines can open branches in the country (currently, all 10 licences have been issued). Each foreign-incorporated bank can open three branches in any location of its choice. In addition, each bank can open three additional branches in locations designated by the Monetary Board, subject to additional permanent assigned capital of P 35 million for each branch.	
Singapore	The regulations governing local and foreign banks are generally similar, except in some aspects such as minimum capital requirements (different for domestic banks, foreign subsidiaries and foreign branches) and the capital structure of foreign bank branches.	Foreign banks are generally set up as branches in Singapore, except for merchant banks, which are generally incorporated as legal entities. Other than minimum capital requirements and capital structure, however, regulations are broadly the same for both foreign subsidiaries and foreign branches.	All locally-incorporated banks are subject to the same minimum capital requirements. Foreign bank branches are subject to a minimum head office capital funds and minimum net head office funds. All locally-incorporated banks are required to satisfy the minimum risk-based capital adequacy ratio. Foreign branches are not subject to the same requirement.
Thailand	Foreign banks have been under the same regulatory treatment as domestic commercial banks, and thus can engage in the same scope of business.	Subsidiaries of foreign banks are allowed to open one branch inside Bangkok and its metropolitan areas, and three branches outside. Branches of foreign banks, on the other hand, are not allowed to open any branch.	Minimum capital requirements of domestic banks, foreign bank subsidiaries, and foreign bank branches are different6. In terms of risk-based capital adequacy ratio, foreign bank branches have a slightly lower capital ratio of 7.5 per cent. Locally-incorporated banks' required capital ratio is 8.5 per cent.
Taiwan Province of China	The same regulations apply to both domestic and foreign banks.	Only foreign bank branches are operating in Taiwan Province of China.	Only domestic banks are subject to risk-based capital adequacy requirements.

Source: Hohl and others, 2006.

[1] See APRA's Guidelines on the Authorization of ADIs on the website at www.apra.gov.au/ADI/loader.cfm?url=/commonspot/security/getfile.cfm&PageID= 1265.

[2] See Prudential supervision in Hong Kong, China [chapter 5, section (b)].

[3] Banks are the only institutions that can receive money from the general public (retail deposits). RLBs (restricted licence banks) may take

call, notice or time deposits from the public in amounts of HK$ 500,000 or above without restriction on maturity. DTCs (deposit-taking companies are restricted to taking deposits of HK$ 100,000 or above with an original term to maturity, or call or notice period of at least three months.

[4] See HKMA's Guide to Authorization (paragraph 4.47).

[5] Minimum permanently assigned capital should not be less than P 210 million (United States dollar equivalent at P 26.979 = US$ 1).

[6] Minimum capital requirement for domestic commercial banks is Baht 5 billion of Tier 1 capital. For foreign bank subsidiaries, registered and paid-up capital must be maintained at the minimum of Baht 4 billion. Last, for foreign bank branches, the minimum capital requirement is Baht 3 billion. Capital for foreign bank branches refer to the assets maintained under Section 6 of the Commercial Banking Act (comprising deposits with the BOT, Thai Government securities or a debt instrument guaranteed by the Ministry of Finance etc.), which have to be financed with funds brought in from the head office, reserves and net profits.

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