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Discussion Paper

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CAPITAL MARKET DEVELOPMENT IN ASEAN ECONOMIC COMMUNITY: ISSUES AND OPPORTUNITIES FOR OTHER SUBREGIONS OF THE ASIA-PACIFIC REGION

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Santi Chaisrisawatsuk

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Santi Chaisrisawatsuk

Assistant Professor
National Institute of Development Administration

For more information, contact:

Macroeconomic Policy and Financing for Development Division (MPFD)
Economic and Social Commission for Asia and the Pacific
United Nations Building, Rajadamnern Nok Avenue, Bangkok 10200, Thailand
Email: escap-mpdd@un.org

Dr. Aynul Hasan
Director
Macroeconomic Policy and Financing for Development Division

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Discussion Paper

Macroeconomic Policy and Financing for Development Division

Capital market development in ASEAN Economic Community: issues and opportunities for other subregions of the Asia-Pacific region

by

Santi Chaisrisawatsuk

March 2016

Abstract

It has long been argued that capital market improvement is a necessary and sufficient condition for fostering economic development. To achieve better living standards, the expected roles of the financial market include: increasing supply of capital, providing better use of (financial) resources and improving allocation of funds available. The ASEAN region is diverse in terms of economic development and the ways to narrow development gaps, particularly financial development gaps, has been among the key discussion issues in almost every regional economic integration agreements. This paper investigates the current status of the region's capital market development. After reviewing the state of financial market depth, accessibility, efficiency and stability in the ASEAN region, the paper provides an overview of the process of financial sector development and then discusses capital market integration in the region. It concludes by providing recommendations for further capital market development to help reduce financial development gaps in the region.

Authors' e-mail address: santi_nida@yahoo.com.

I. Introduction

Thailand, as a small open economy, inevitably relies so much on the external sector both in trade and finance. Generally, capital accumulation is viewed and convinced that it is the significant engine for growth and prosperity. And thus, saving is identified as the important source of domestic funding in the process of economic development. It is pointed out that if the financial sector is working appropriately, the economy will benefit a great deal from improving efficient allocation of resources and hence, lead to poverty alleviation and economic growth. As the economy grows more rapidly, the needs for capital multiply and external financing becomes a more necessary sources. Consequently, the country is forced to liberalize its financial sector more to allow for greater capital inflows in response to its raising demand. To allow for more flexible movements of capital across border, the economy that is not well prepared will run a risk of mismanagement in the financial sector and ended up with huge negative impacts to the country in form of economic crisis. Therefore, shadows of concerns are all over the appropriate approaches to develop and regulate financial sector not only in the developing but also the developed economies.

The Asian financial crisis in 1997 and the recent economic crisis in the U.S. and Europe reemphasize on how crucial development and stability of the financial sector is to the path and pace of economic development. More importantly, the consequences of financial crisis have proven to be widely spread due to economic interconnection of economies around the globe through globalization process. Developing and least developed economies are alike in terms of its inability to manage the flows of capital (especially foreign capital) in and out of the countries. Seems like capital often flow out of the economy when it is needed most. And it floods into the economy when adequate amount of capital is already existed domestically. The size and speed of capital movements internationally have identified as major risks of economic instability in developing economies in trading off for foreign financial services. Recent development trend in Thailand's financial sector focuses more on regulatory framework and increasing market competition in the financial sector, its neighboring countries (e.g. Lao PDR, Myanmar and Cambodia) still have to develop their money market (i.e., banking sector) to support further development of capital market in order to attract very much needed capital, domestically and internationally, in fostering its rapid economic growth and development. Balancing in the financial market; including money market, capital market, and long-term saving market such as insurance and pension funds, is critical for efficiency improvement in the financial sector in Thailand, its neighboring countries, and the region as a whole so that fund mismatching problems can be mitigated.

Most of the Southeast Asia members are developing economies where capital adequacy is crucial obstacle for their economic development process. More capital inflows are badly needed in many member economies to move forward with their development path not only to narrowing the development gap but also to further improving living standard in the country. Evidences are obvious as we see countries compete intensively for foreign investment especially foreign direct investment (FDI) by providing greater investment incentives. On the other hand, Southeast Asia economic stability is also jeopardized by the highly volatile capital market and speculation in the global financial market. The 1997 Asian financial crisis provides us with a good illustration that some forms of financial integration are needed in the region. With a huge gap of financial market development among East Asia economies, it is worth considering research studies on regional financial integration in such a way that a larger proportion of saving generated within the region can be utilized for the regional economic development and shelter member economies when financial storms hit.

The pros and cons of capital market establishment greatly relies on the timing, regulations, and the management (ability of regulate included) such that the market can function and perform accordingly. In this paper, the first section reviews some of the evidences in Thailand’s capital market development and its contribution s to economic performance; growth, stability (efficiency), and equity. Further improvement in the capital market and regional financial market integration will be discuss in comparison with more recently establishment of capital markets in the CLMV. The next section argues on the role of capital market in providing necessary funding to much needed infrastructure development in the region. Finally, in the last section, some policy implications and regulations as a guide to a successful financial development in supporting developing economies to narrow the development gap are discussed.

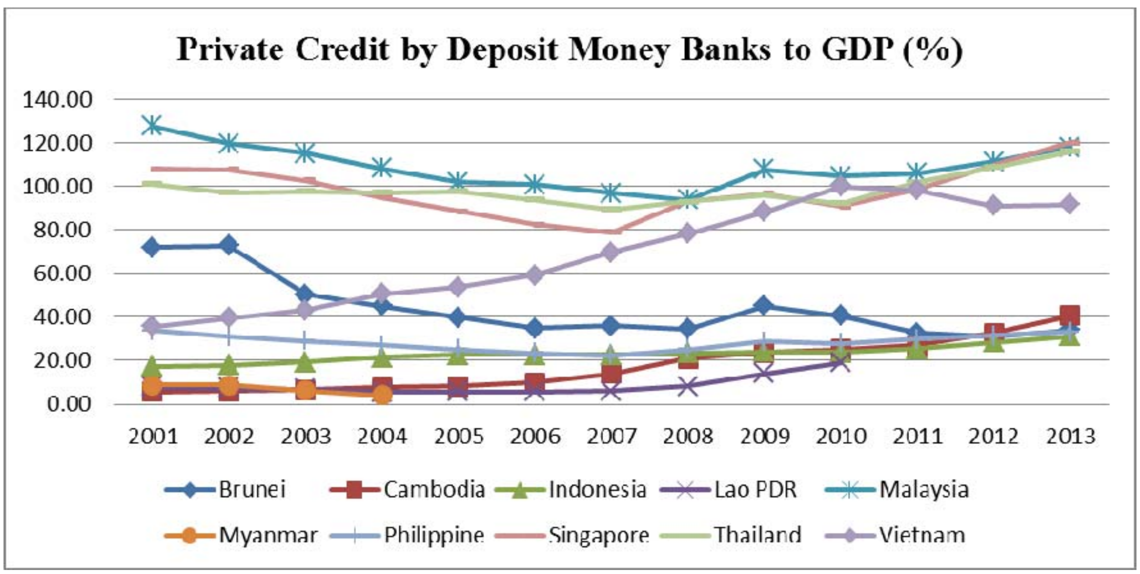
II. Capital Market Development Status in ASEAN

It has long been argued that capital market improvement is a necessary and sufficient condition fostering economic development. To achieve better living standard, the expected roles of the financial market include; increasing supply of capital, better use of (financial) resource and improve allocation of funds available, are the fundamental elements needed. Because ASEAN has been known to be a region with diversity in terms of economic development where narrowing development gaps have been the key discussion issues in almost every regional economic integration agreements, it is important, as a prior information, to investigate the current status of the region capital market development. At a difference stage of economic development, the interests and capability of carry out changes in financial market are very much diverse ranging from simply providing more access to funding necessary to focusing more in efficiency in the financial market and harmonisation of regulatory framework. In this section, development status of ASEAN financial market will be reviewed according to the “matrix of financial system characteristic” used for benchmarking of the financial system suggested in Martin, Demirguc-Kunt, Feyen and Levine (2012). The financial characteristic for the financial market covers the measurement of financial depth, access, efficiency, and stability.

A. ASEAN financial depth

The depth of the financial sector is first investigated as a factor to determine its contributions on the region economic development process. Financial depth is basically a measure of the availability of financial infrastructure including necessary financial institutions, financial products, and financial regulatory framework to deliver financial services demand in the economy. It has been pointed out in numbers of studies that providing greater access to financial services is a key factor for developing economy to promote growth and reduce poverty. Bird (2015), Martin, Demirguc-Kunt, Feyen and Levine (2012), Beck, Demirguc-Kunt and Levine (2009) are some of the examples in recent studies to show such a positive relationship between economic growth and financial depth. At the initial stage of financial development, it is very common to see most of the financial services to support economic activities are provided by the banking system. A bank-base measure of financial depth is employed first because of the different stages of financial development of ASEAN members. Less developed economies has a tendency to rely more on the banking sector than financial market (which includes bond and equity market as they are making progress) for financial services compared to more advance economy. As the economies grow, more and various types of financial services are demanded. Creation of financial products, more sophisticated financial institutes or more specialized unit will be needed to effectively handle those raising demands. The private credit providing by the banking sector as a percentage of GDP is used as countries, at the relatively early stage of economic development, rely more on commercial bank to provide most of the necessary funding. As indicated in figure 1, ASEAN, as a region, has been experiencing an increasing trend of financial depth. Malaysia, Singapore, and Thailand have led the group on this aspect and Vietnam has been catching up at a greater pace. This is consistent with the economic performance of the respective economies. Greater economic growth requires more capital and financial services and hence, a rising number of financial depth. The figure also suggests an upward trend for the CLM countries (Cambodia, Lao PDR and Myanmar). Funding of the capital needed and financial services to facilitate economic growth (the countries are growing at a greater rate than the ASEAN5) in those countries were not only coming from capital inflows but also from the improvement of the financial environment (mainly banking system) domestically.

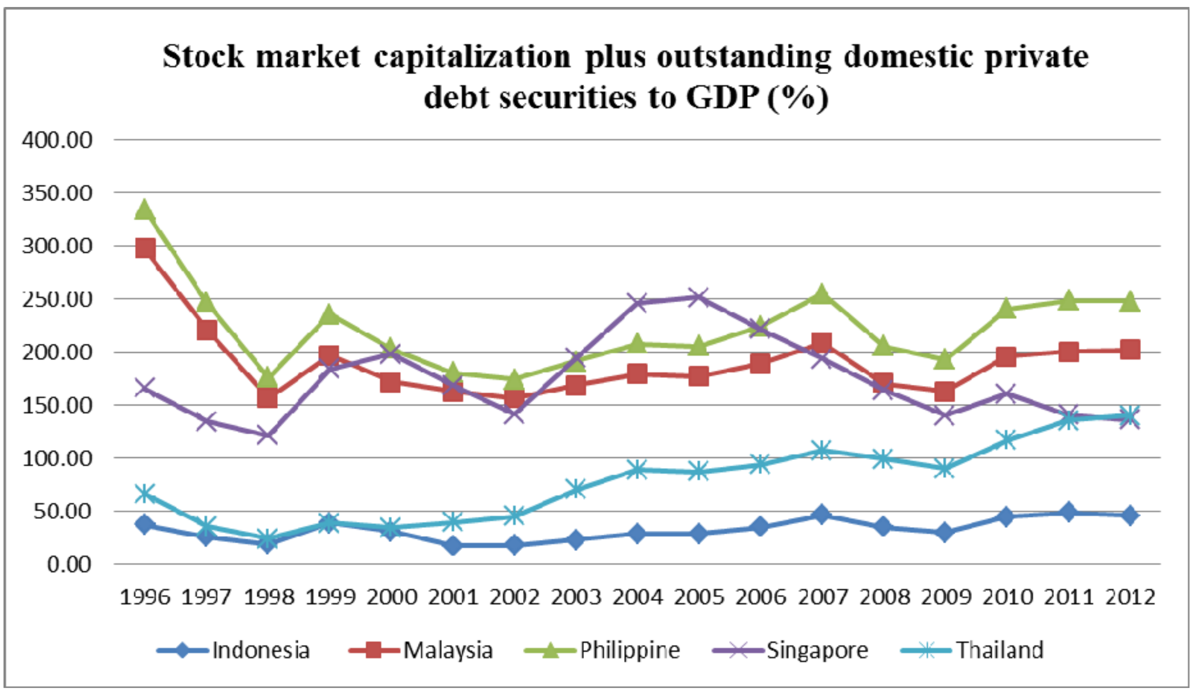
Figure 1. ASEAN financial depth (bank-base measure)



Source: Global Financial Development Database (GFDD).

For a more advance economies, especially in the financial sector, financial services are not supplied only through the banking system. Bond, equity, and derivative markets are introduced as alternatives to offer wider range of financial products in response to the needs in the private and public sector. Infrastructure investment projects funding can be viewed as an example for such demand. A well-established and functioning liability and equity markets an example that the availability of capital markets allow for more involvement of private sector in larger investment projects which deem to be more efficient than being handled by the public sector. The economy as a whole benefits from improving utilization of capital and more efficiently operation in the financial sector through gains from economies of scale. Hence, the development of those infrastructure institutions helps facilitate liquidity and risk management in the economy. Figure 2 shows the ASESN5 members have been increasingly developing the depth in its capital market. Thailand has been one good candidate illustrating a clear trend of financial market depth after 2000. This is consistent with the financial development plan in the country to promote more activities in the bond market for the private sector. The issuance of corporate bond by state owned enterprise and some of the relatively larger firms has been highlight as another step forward in the financial development process. Long-term capital needs are not merely rely on the banking sector but there are alternatives which make possible by the bond and equity market providing liquidity for the corresponding financial instruments. Furthermore, it is also argued that the mechanism helps reduce financial mismatching practices which identified as one of the key reasons blamed for the 1997 financial crisis.

Figure 2. ASEAN5 financial market depth (market-based measure)



Source: Global Financial Development Database (GFDD).

During the period from 2000, Thailand has seen as the most improved in financial depth as shown by the market-based measure. As percentages of GDP, financial depth in Thailand is under 50% in 2000 and it reached almost 150% in 2012. This is consistent with the period in which Thailand's Financial Sector Master Plan (Phase I and II) was proposed and implemented. The main objective of the plan is to create a more sufficient resilience financial system for the country after the devastating impacts of the 1997 financial crisis. In one aspect, it had been highlighted that prior to the crisis, Thailand's economy relied solely on the banking sector for financial services. The collapsed of some of misbehaved banks as well as inefficiency in the banking process brought down the financial system and the economy. According to the measure, the Philippine and Malaysia has been ranked in the top two in financial depth respectively with Singapore showing greater financial depth at some time periods (from 2003-2006). Thailand has been gaining ground as the bond and equity market conditions improved over time. The private sector is encouraged to draw its long-term investment fund from the bond and equity market. For example, some of the tax incentive schemes are offered for companies listed in the stock market and also an establishment of equity market for small and medium enterprises (SME).

B. Accessibility to financial market in ASEAN

Providing access to capital in an economy has always been an issue of discussion in ASEAN economic development. There are also concerns about equal access to the financial market as the regional financial sector becomes more liberalized. Because of lacking in access for some of the economic agents such as lower income individuals, individuals in the rural area with not enough financial infrastructure, and SME, some special financial institutions (SFI) was created to tackle the problems. Microfinance scheme was also introduced as a potential tool to serve those specific needs that are perceived as an effect of the financial market failure in the country. Numbers of SFI have been created in Thailand and it posted some other obstacle as the region moving toward more liberalized and integrated financial market. Table 1 reveals that the majority of ASEAN member has improved its financial accessibility as domestic credit by banking sector to GDP increase from 1995 to 2014. Malaysia, Singapore, and Thailand has experienced a clear improve in financial access in the last 15 years. Thailand's domestic credit by banking sector to GDP increased from 141.3% in 1995 to 182.5% in 2014. Similar pattern is observed in Malaysia and Singapore where financial access improved from 126.7% and 59.1% to 145.3% and 126.3% respectively. For CLMV countries, Vietnam stood out as the most improved in the financial access as the domestic credit by banking sector to GDP rose from 20.1% to 113.8% in 2014. Greater financial access is also evidenced in Cambodia and Lao PDR. Myanmar on the contrary experience a drop in the domestic credit provided by banking sector to GDP as the country is in the transition period in opening up more to foreign investment capital.

Table 1. Domestic credit provided by banking sector and bank non-performing loans for ASEAN members

Countries	Domestic credit provided by banking sector[a] (% of GDP)					Bank non-performing Loans (% of total gross loans)			
	1995	2000	2005	2010	2014	2000	2005	2010	2014
Brunei Darussalam	...	38.6	10.4	25.1	25.3	...	...	6.9	3.7
Cambodia	5.3	6.4	7.2	22.7	47.4	...	...	...	...
Indonesia	51.8	60.7	46.2	34.2	48.4	34.4	7.3	2.5	2.1
Lao PDR	9.9	9.0	8.1	26.5	...	...	...	...	...
Malaysia[f]	126.7	138.4	117.7	127.0	145.3	15.4	9.4	3.4	1.6
Myanmar	32.5	31.2	24.6	24.8	28.3	...	...	...	...
Philippines[g, h]	55.7	58.3	47.2	49.2	55.9	24.0	10.0	3.4	2.0
Singapore[i]	59.1	76.7	61.2	80.8	126.3	3.4	3.8	1.4	0.8
Thailand	141.3	138.3	119.2	142.7	182.5	17.7	9.1	3.9	2.5
Viet Nam	20.1	32.6	65.4	124.7	113.8	...	...	2.1	...

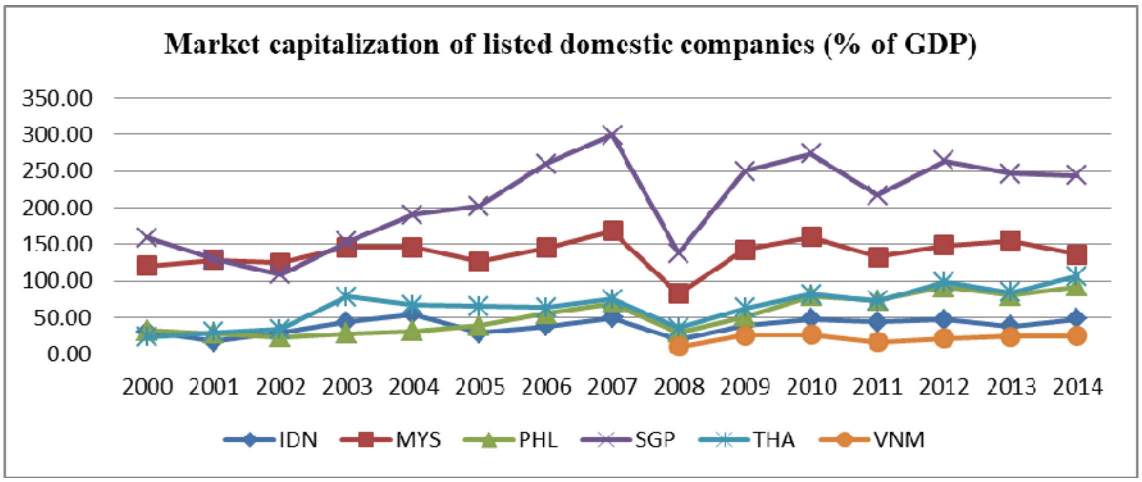
Source: World Bank. World Development Indicators Online. http://data.worldbank.org/ (accessed 20 July 2015); economy sources.

Notes: = data not available at cutoff date, 0.0 = magnitude is less than half of unit employed, GDP = gross domestic product, Lao PDR = Lao People's Democratic

[a] Domestic credit provided by the banking sector as a share of GDP is a measure of banking sector depth and finance sector development in terms of size. Since the claims on the central government are a net item (claims on the central government minus central government deposits), this net figure may be negative, resulting in a negative figure of domestic credit provided by the banking sector.
[b] Loans classified as loss, which are fully provisioned against, are held off-balance sheet.
[c] Includes loans that are overdue less than 90 days.
[d] Loans classified as substandard, doubtful, loss, and not necessarily linked to a 90-day criterion.
[e] Unless otherwise indicated, data refer to the end of the fiscal year, i.e., March of the indicated calendar year.
[f] Loans with principal and/or interest over 180 days; credit card debt and bankers' acceptances over 90 days; and loans secured by cash and cash substitutes past 365 days.
[g] Thirty days for loans payable in lump sum or payable in quarterly, semi-annual, or annual installments; 90 days for loans payable in monthly installments; as soon as they are past due for loans payable in daily, weekly, or semi-monthly installments.
[h] Interbank loans are excluded.
[i] Nonbank nonperforming loans to total nonbank loans. Other characteristics may be considered beyond the 90-day past-due criterion to classify a loan as non-performing.
[j] Includes both impaired and past due items.
[k] For nine major banks only. Unless otherwise indicated, data refer to the end of the fiscal year, i.e., March of the next calendar year.

As an illustration of ASEAN capital market development from the accessibility perspective, the size of capital market has gradually increased overtime from 2000 with more advance financial sector having larger share of market capitalization as a percentage of GDP. Singapore, as a relatively more advance financial sector in the region, leads the pack with market capitalization up to 250% of GDP. Malaysia and Thailand are next in line with market capitalization over 100% of GDP. Indonesia, Philippine, and Vietnam are also showing greater market capitalization. This suggests that ASEAN as a region has been generating more financial access in the equity market and it has played an important role in economic development. With greater financial access shown by market capitalization to GDP ratio, through an increasing of the amount of equity issued in the primary market and economic values created by the existing equity in the secondary market, the region shows good progress in the financial market development. Private firms have been gaining access to additional investment funding from the equity market as an alternative to those provided by the banking sector. In Thailand particularly, stock market helps private sector to raise much needed investment equity and allow private participation in larger investment projects by providing liquidity and information for investors. Greater financial accessibility also fosters competition in the financial market and hence, implies financial market efficiency improvement.

Figure 3. Capital market accessibility for ASEAN5 and Vietnam



Source: Global Financial Development Database (GFDD).

In addition to the domestic bond market, ASEAN5 and Vietnam have been opened to the international pool of saving. Table 2 reveals financial accessibility of the ASEAN5 and Vietnam to the international bond market. Significant jumps of international bonds and notes outstanding for ASEAN5 and Vietnam are observed from 1998 to Jun-2015. Thailand has its foreign bonds and notes outstanding at 20.28 bn. USD in Jun-2015 while Indonesia and Singapore are the top two countries at 83.13 and 78 bn. USD respectively. In tapping for cheaper international funding, Malaysia has its international bonds and notes outstanding worth 60.08 bn. USD in Jun-2015.

Table 2. International bonds and notes outstanding for the ASEAN 5 and Vietnam

End of Year (Dec)	BIS: International Bonds and Notes Outstanding (bn USD)					
	IDN	MYS	PHL	SGP	THA	VNM
1998	16.13	12.02	14.63	7.24	15.12	0.54
1999	12.27	14.62	18.04	10.05	13.98	0.54
2000	10.46	15.57	18.69	14.41	12.63	0.54
2001	8.6	17.18	18.66	20.85	9.82	0.54
2002	8.38	22.84	22.6	19.93	8.96	1.04
2003	8.84	22.9	26.68	26.61	8.16	1.04
2004	9.51	28.39	28.06	33.85	8.49	1.04
2005	13.09	28.47	29.53	36.68	10.19	1.77
2006	16.94	31.44	32.07	42.17	10.91	1.74
2007	18.78	31.82	32.44	47.02	9.15	1.9
2008	21.9	32.33	31.78	48.73	8.88	1.87
2009	32.26	32.75	36.18	48.63	7.84	2.03
2010	36.84	39.46	39.92	53.01	9.26	2.9
2011	41.25	40.96	41.65	53.06	10.19	2.9
2012	51.71	49.94	45.15	72.25	16.45	2.91
2013	61.22	53.68	46.2	75.08	18.41	3.11
2014	69.65	55.14	46.04	76.68	20.93	4.12
Jun-15	83.13	60.08	48.66	78	20.28	4.12

Source: CEIC database.

C. Efficiency of financial market in ASEAN

Efficiency in financial market measured in two folds. One is to look at how cost effective the market delivers funding services to those who needed and the other is to consider the efficiency of the financial institution involved. A relatively narrow lending-deposit spread at the same level of risk indicates a more efficient banking system. Average bank lending-deposit spreads for ASEAN5 and Vietnam show in Table 3 suggest that Malaysia has been relatively more efficient in the banking sector. Malaysia has gone through a major overhaul of the banking system with changing in banking landscape by merger and acquisition (M&A) process which lead to the lowest interest rate spread in the region. Increasing in size and cut down on the numbers of bank together with changing regulatory framework to promote competition in the market has been indicated as the key success. Thailand, according to the Financial Sector Master Plan (FSMP), follows with similar direction by limiting the numbers of commercial bank existed. The central bank is not looking to issue any more licenses for the banking industry. In addition, more competition from foreign banks is welcome as more of the commercial banks in Thailand have been taken by foreign banks. Allowing for more foreign ownerships in the banking sector is one of the key aspects taken by the authority not only for the creation of more competition but also viewed as another step toward financial service liberalization.

Table 3. Money market efficiency for ASEAN5 and Vietnam

	Bank Lending-deposit Spread					
	Indonesia	**Malaysia**	**Philippine**	**Singapore**	**Thailand**	**Vietnam**
Average from 2000-2013	5.44	2.94	4.11	4.84	4.41	3.39
SD	1.17	0.74	0.89	0.37	0.53	1.18
Max	7.68	4.31	5.82	5.24	4.92	6.90
Min	3.07	1.64	2.52	4.12	2.92	1.94

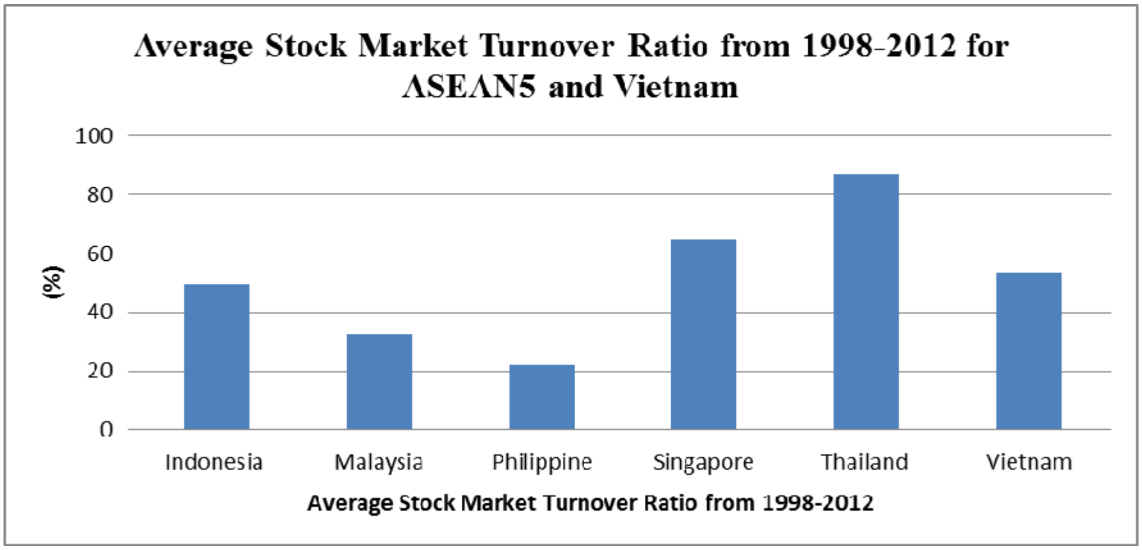
Source: Author's Calculation using Global Financial Development Database (GFDD).

Efficiency in terms of providing a lower cost of funds to finance economic activities especially investment spending is another major contribution of an improvement in the financial system. In supporting an increasing numbers of economic activities as the economy grows, the big challenge is also to supply those financial services in a more effective way. Economies of scale and efficiency improvements are the two profound sources to tap in as ASEAN move along its development path. Furthermore, there are also risk and diversification aspects reflected in the banking sector through lending-deposit spread. At one end, the spread is expected to be narrowing down to the real cost of borrowing. Meanwhile, there are systematic and unsystematic risk (country risk, for example) to be considered in comparison of spread across countries. Thus, variations of the interest rate spread are observed as a supporting measure. Table 3 suggests that a more advance financial system trends to have less fluctuation, i.e. Singapore, Malaysia, and Thailand. The rest of ASEAN5 and Vietnam exhibits higher standard deviations of lending-deposit spread.

A common benchmarking of financial market efficiency is to consider the stock market turnover ratio as it is argued that an efficient financial market is expected to provide, or at least sending signal by digesting available information rationally, a priori information necessary for the players (investors, speculators, and regulators) to make appropriate decisions. Greater market turnover suggests more exchange of information and reactions in the market and hence, greater degree of market efficiency. The data on stock market turnover ratio for ASEAN5 and Vietnam illustrate an increase investment in the respective equity markets. The trend has been picking up after 1997 financial crisis and the turnover has risen consistently with greater degree of financial liberalization policy which allows for freer international capital flows. Figure 4 shows an average of stock market turnover ratio from 1998 to 2012 for ASEAN5 and Vietnam[1]. The turnover ratios have been high (greater than 40%) in Thailand, Singapore, Indonesia, and Vietnam. Malaysia and Philippine market appear to have relatively less turnover in the stock market.

[1] The average for Vietnam is from 2001-2012 due to the availability of data.

Figure 4. ASEAN5 and Vietnam financial market efficiency



Source: Author's Calculation using Global Financial Development Database (GFDD).
Note: The average for Vietnam is from 2001-2012 as for the availability of data.

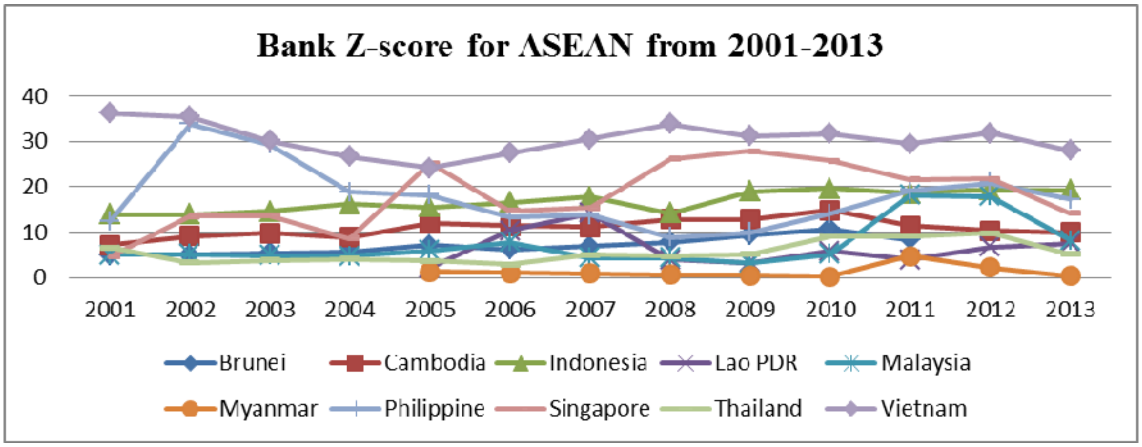
D. Financial market stability in ASEAN

One of the key features ASEAN looking forward to as reasons for financial market development and integration is to create an economic stability environment both domestically and for the region as a whole. Allowing for freer flows of capital across countries, on one hand, is a necessary mechanism to ensure all the benefits we hope to gain from the financial liberalization and development process. One the other hand, it creates more volatility in the market and can lead to some crucial negative consequences when the market is overwhelm with inappropriate activities such as to much speculation, funds mismatching, and excessive risk taking. Fluctuation in the foreign exchange market is just one major example as the movements of capital from one currency denominated asset to another resulted in changes on demand and supply of the foreign exchange and thus, appreciation or depreciation of one currency against the other.

Stability benchmarking index used for the banking sector proposed by Martin, Demirguc-Kunt, Feyen and Levine (2012) is the Z-score or the "distance to default" which defined as the average annual return on asset (ROA) plus the ratio of equity to total asset per unit of ROA variation measured by the standard deviation[2]. The small number of Z-score indicates a higher probability that the value of the money market's (or the financial institution's) assets becomes lower than the value of its liability, i.e., larger Z-score suggests more stability.

[2] Z-score = [average annual ROA + (equity/total asset)]/SD(ROA).

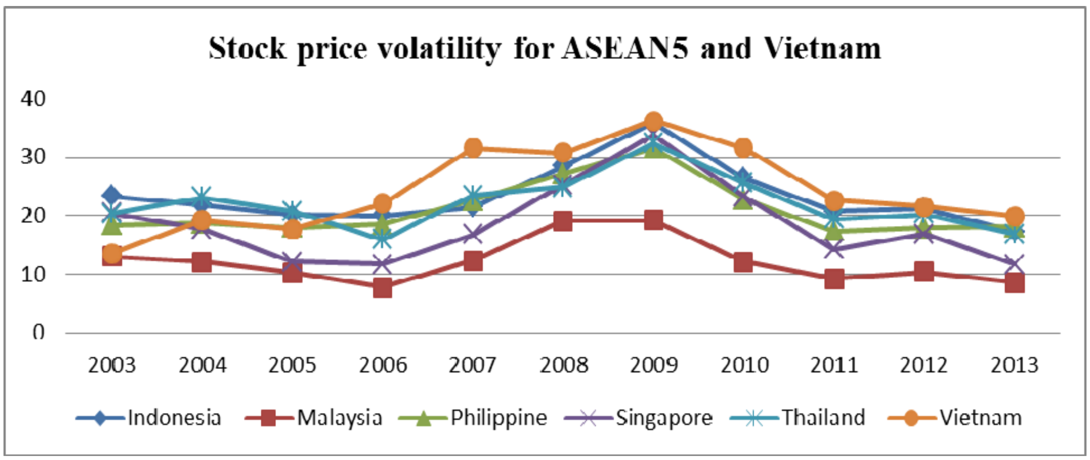
Figure 5. ASEAN money market stability



Source: Global Financial Development Database (GFDD).

ASEAN money markets have been relatively stable from 2001 to 2013 as indicated by the bank Z-score in figure 5. A slight improvement in most of the ASEAN banking system can also be observed. It appears that the CLM banking systems are relatively less stable than the rest of ASEAN members. Fluctuation of money market stability also suggested during 2005-2009 when the hamburger crisis struck.

Figure 6. ASEAN5 and Vietnam capital market stability



Source: Global Financial Development Database (GFDD).

Stability in the capital market particularly equity market for ASEAN5 and Vietnam measured by the stock price volatility is investigated next. Variations of stock prices in ASEAN equity market have been in a similar pattern over the last decade. When the volatility is high, it is high in very markets and vice versa. Malaysian stock market appears to be relatively more stable than others with the lowest stock price volatility.

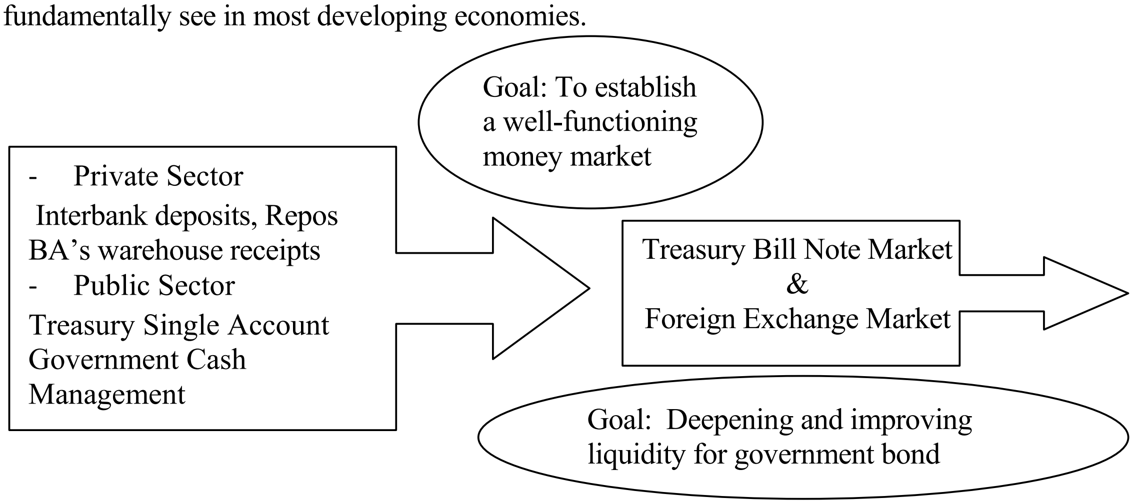
III. ASEAN Financial Sector Development Process

Obviously there are doubts surrounding the regional financial development and its contributions versus the possibilities of harmful consequences in the regions because of the differences in level of economic and financial market development. It is argued that ASEAN members, because of its economic development level, demand different type of financial services. In less developed economies, the priority for financial needs are placed on accessibility to funding needed for economic expansion while more advance economies are more interested in diversification and risk management. Generally, capital market development can help support narrowing financial gaps by bridging economic development activities in areas such as infrastructure financing, greater access to financial needs (for households, private sector, and public sector), and better options for financial diversification. Contributions of capital market on economic development can be briefly summarized as to improve financial market conditions in gearing up for economic prosperity which implies creation of the following;

1. Financial accessibility (easy to access and available of adequate funding) to individuals, private sector (corporate sector) and government (public sector)
2. Financial efficiency - providing lower cost of capital and better use of capital resources
3. Financial stability and equality (getting access to financial resources with comparable condition, i.e., allocation of capital that fit risk and return profile which requires the works of market mechanism.

Stage I of the financial sector development: Emphasis more on money market development

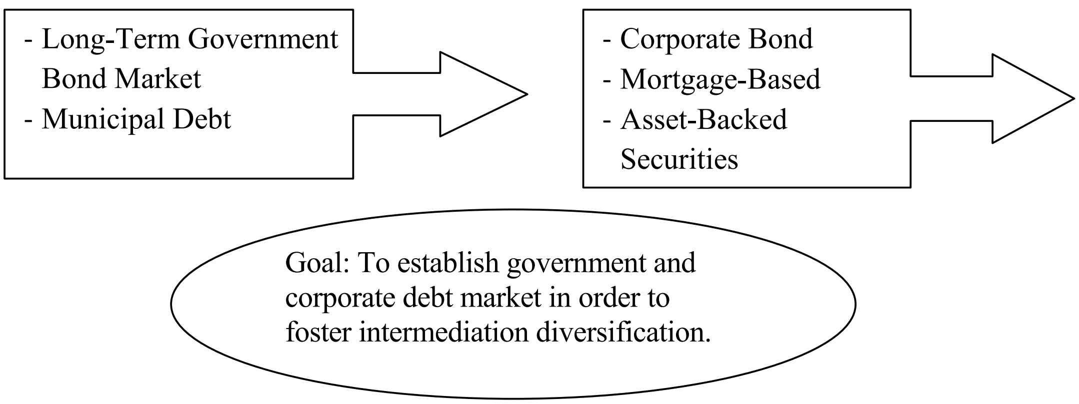
The initial stage of financial development emphasis on improving money market conditions, i.e. efficiency in the bank industry, guarantee adequate competition in the money market, and sufficient accesses to the financial services. Banking system as a primary institution to handle financial intermediary processes is the focal point to allocate domestic pool of savings to meet with investment demand. Promoting competition in the banking sector is suggested for this stage of development as it is fundamentally see in most developing economies.



Source: Adopted from World Federation of Exchanges, and KPMG Report 2013.

The aftermath of the 1997 financial crisis resulted in a trimming down of unnecessary financial institutions in Thailand. Number of bank and financial institutions was reduced by those failure financial institutions created before the crisis and not many has re-established even though after the economy has recovered. In addition, greater emphasis has been placed on improving efficiency of the financial system to cut down costs of funds and the ability of the financial mechanism to deliver better allocation of capital resource. In the process, it was recognized that there are needs for a system to cope with financial mismatching and risk management. Different types of financial instruments and the creation of market for long-term funds such as the bond market not only for the government but also the corporate are the badly missing pieces as the economy moving forward along its development path.

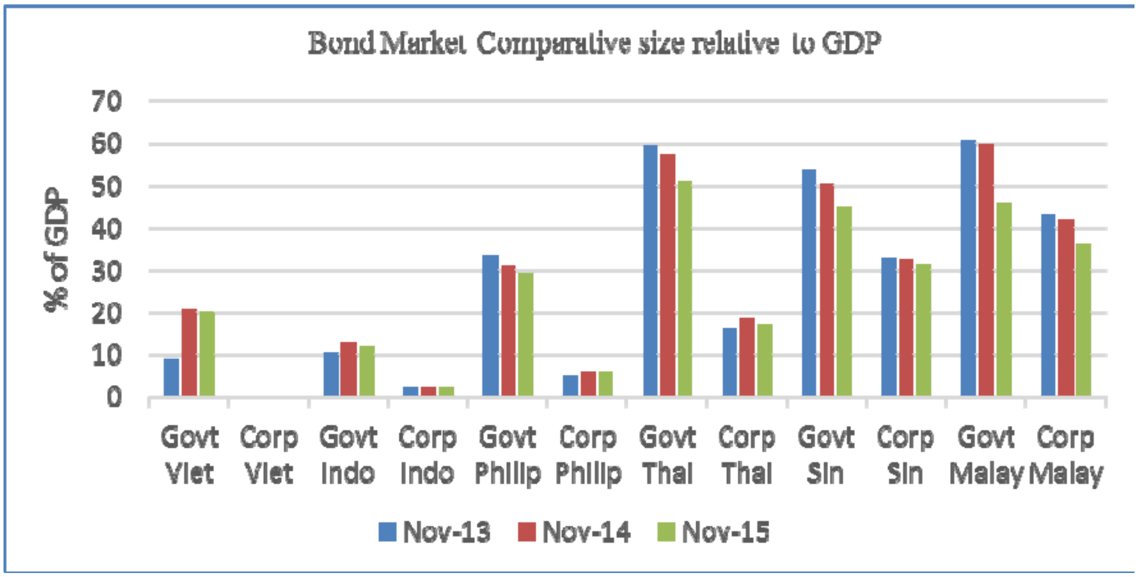
Stage II of the financial sector development: Related to the development of long-term bond market both domestically and internationally



Source: Adopted from World Federation of Exchanges, and KPMG Report 2013.

Figure 6 reveals larger bond market relative to GDP in Thailand, Singapore, and Malaysia over the past 15 years after the 1997 financial crisis. This is another sign for more advance financial market in these economies. In general, public sector relies on the bond market more than the private sector for long-term financing. Thailand has seen a more involvement of corporate sector in the bond market for long-term investment fund. There are more issuance of corporate bond and greater trading frequency in the bond market (trading volume has been increasing over time). Liquidity is a key element to bond market development because it allows for more players in the market. To encourage holding and trading of long-term asset, the market needs to be able to provide enough liquidity to facilitate both the demand and supply side.

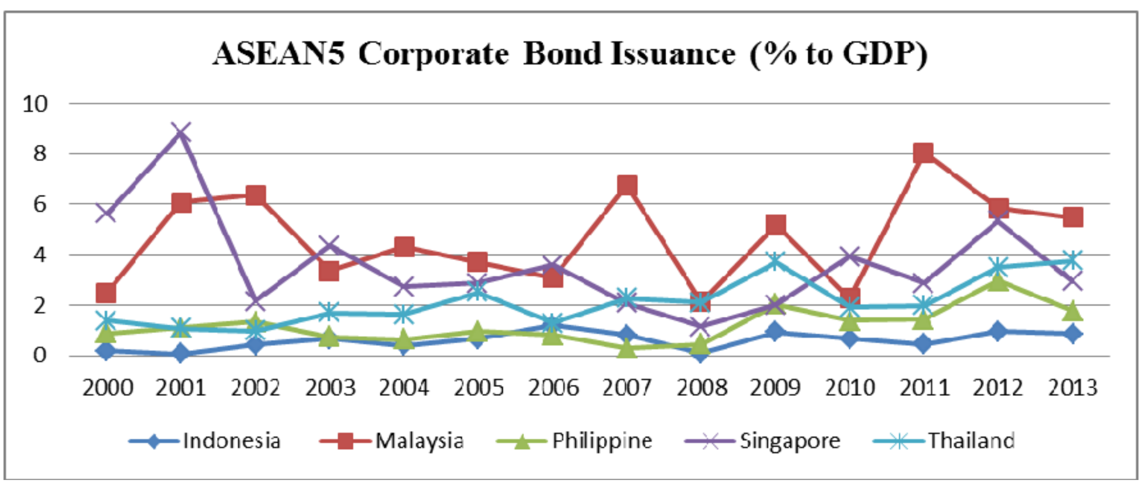
Figure 6. Bond market capitalization in ASEAN



Source: CEIC database.

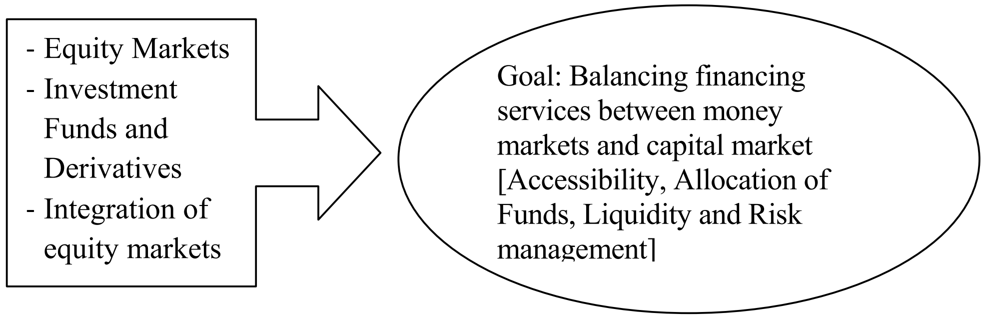
Figure 7 shows corporate bond issuance as percentage of GDP for ASEAN5. Long-term finance through corporate bond seems to be relatively small in ASEAN. Thai corporate sector has been tapping more investment funds from the bond market by issuing more bonds since 2000 and reach almost 4% of GDP in 2013. Despite relatively small individually ASEAN bond market, efforts have been put in to encourage more investors and issuers in the market especially in the corporate sector. As a result, it enhances abilities of the private sector to participate in larger investment projects and in fact realized the benefits of economies of scale in the financial market. Furthermore, it improves efficiency in the financial market by reducing costs of fund particularly for long-term financing.

Figure 7. ASEAN5 corporate bond issuance



Source: CEIC database.

Stage III of the financial sector development: Capital market development

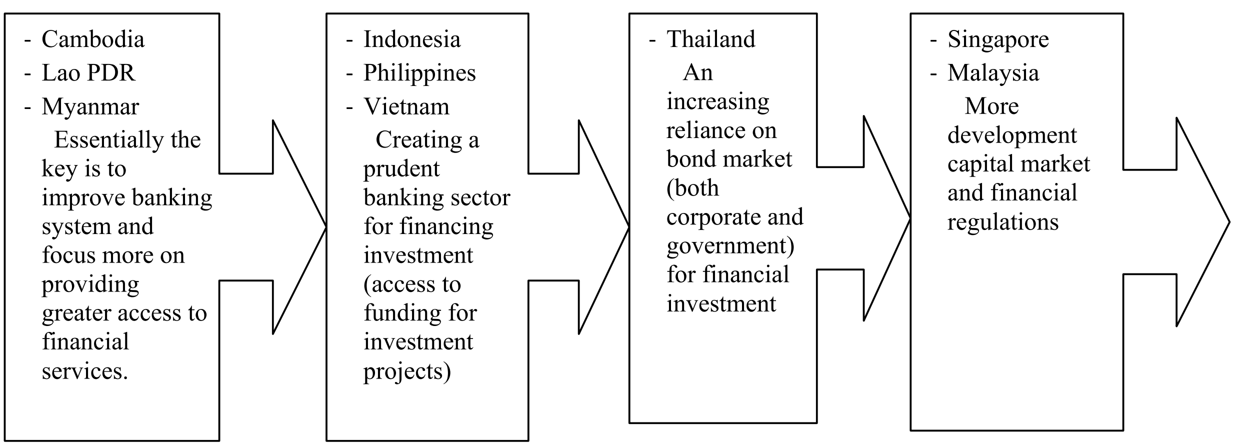


Source: Adopted from World Federation of Exchanges, and KPMG Report 2013.

Further development in the financial sector focuses more on the stability aspect. With the availability of variety of financial products and services, it runs a higher risk of financial instability especially for those with inadequate regulatory framework. The ability of the authority to regulate the financial system becomes another issue of concerns. Without those conditions, it is difficult to imagine an operation of well-functioning financial system which of course will fail to deliver what financial sector development promises.

ASEAN financial sector development and progress

Money market development	Long-term bond market	Capital market development

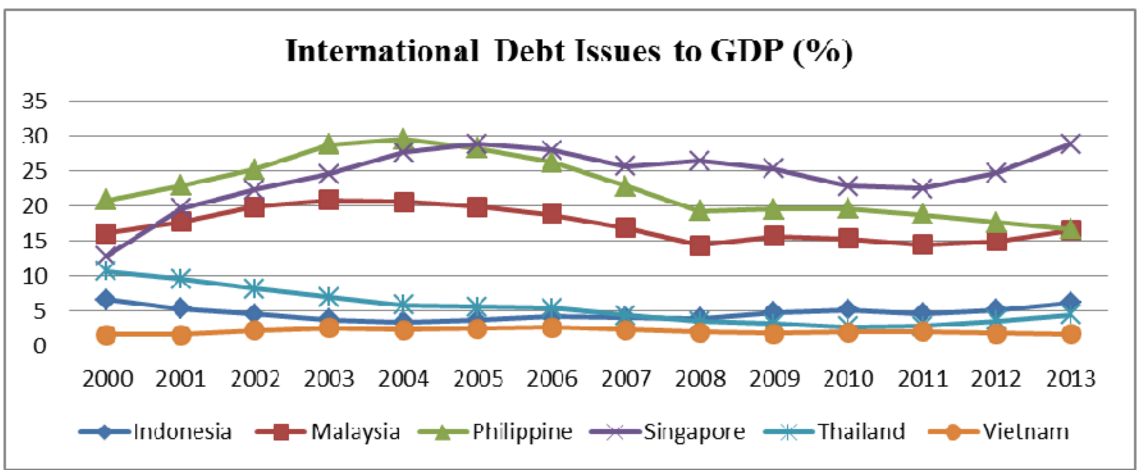


IV. ASEAN Capital Market Development and Collaboration

After the financial crisis in 1997, ASEAN as a region recognized that there are needs for ASEAN capital market integration or financial sector collaboration which leads to subsequent collaboration agreements. Chiang Mai Initiative Multilateralization (CMIM) was the first concrete evident that sees ASEAN members getting together on the necessary of a mechanism to provide "regional safety net." Financial mismatching has been pointed as one of the reasons for the economic crisis as more funds were directed to speculation activities than the activities in the real sector. A lacking of appropriate tools to control and regulate international capital flow cause economic instability and resulted in a costly consequence. In seeking for financial helps to mitigate the negative impacts of economic downturn, the hard hit economies; i.e., Thailand and Indonesia, ran into a wall. The region was given inadequate amount of financial supports and harsh conditions attached. This, later on, has been criticized as one of the reasons to prolong the recovery process. As a lesson learn, it has been evidenced that when the European Union (EU) confronted with financial difficulty caused by debt issues of the member states. Stronger cohesive among EU members, both financially and economic relations, lead to larger and more lenience financial support packages. Instead of applying some strict conditions in exchange for the financial supports, more financial liquidity was provided which is the opposite measure used under similar circumstances. More or less the same type of approach, i.e. providing more liquidity in the financial market, was used as a necessary monetary policy to guide the US economy back from the hamburger crisis. And thus, it highlights further the necessary of ASEAN to come up with a more advance and integrated capital market in the region. At least psychologically it prompts ASEANs policy authorities that some degree of financial integration and collaborations are needed to ensure regional financial stability as its members move along economic development path.

To gain access to international saving for the regional economic development, ASEAN has increasing rely more on external sources. The amount of international debt issues to GDP as indicated in the figure below shows that there is an increasing trend in most of the ASEAN5 and Vietnam except perhaps only for Philippine.

Figure 8. International debt issues for ASEAN5 and Vietnam

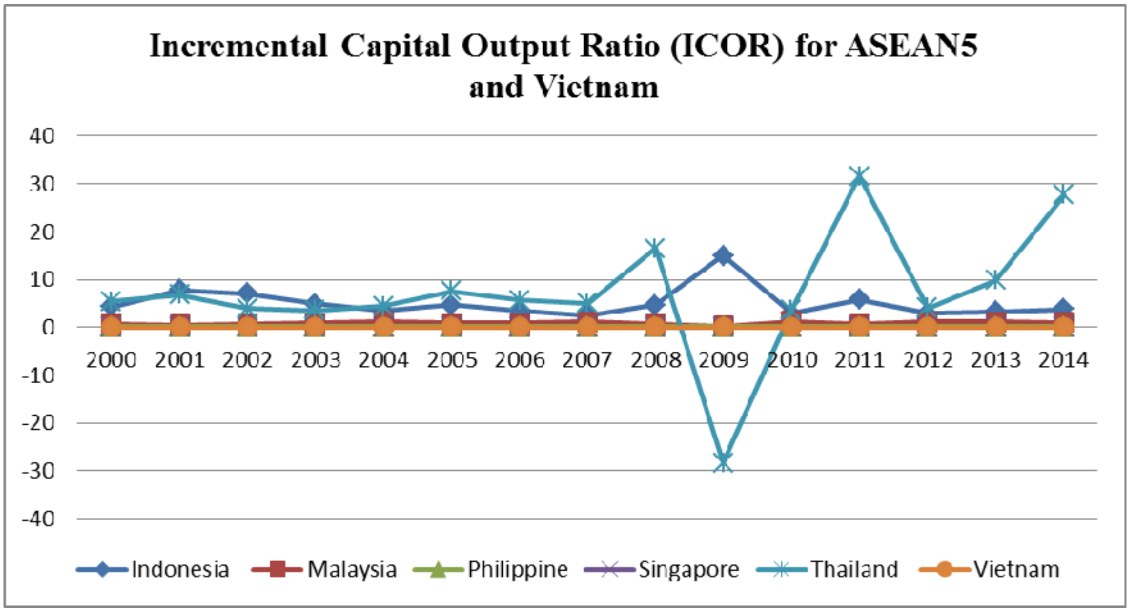


Source: CEIC database.

International debt issued as percentage of GDP is greater than 15% for Singapore, Malaysia, and Philippine in 2013. Thailand and Indonesia, the two nations hit hardest in the 1997 financial crisis, have been keeping the ratio of international debt low as it is viewed as one of the reasons creating financial risk and economic instability.

Recognizing that ASEAN capital markets are relatively small and illiquid with limited range of financial products and services, capital market integration or collaboration will enhance the possibility of access to larger and diversity pools of capital resource. By allowing for greater investors and issuers of various financial instruments opens up a wider range of financial products required for both liquidity and diversification purposes.

Figure 9. Capital productivity in ASEAN5 and Vietnam



Source: Author's Calculation using Global Financial Development Database (GFDD).

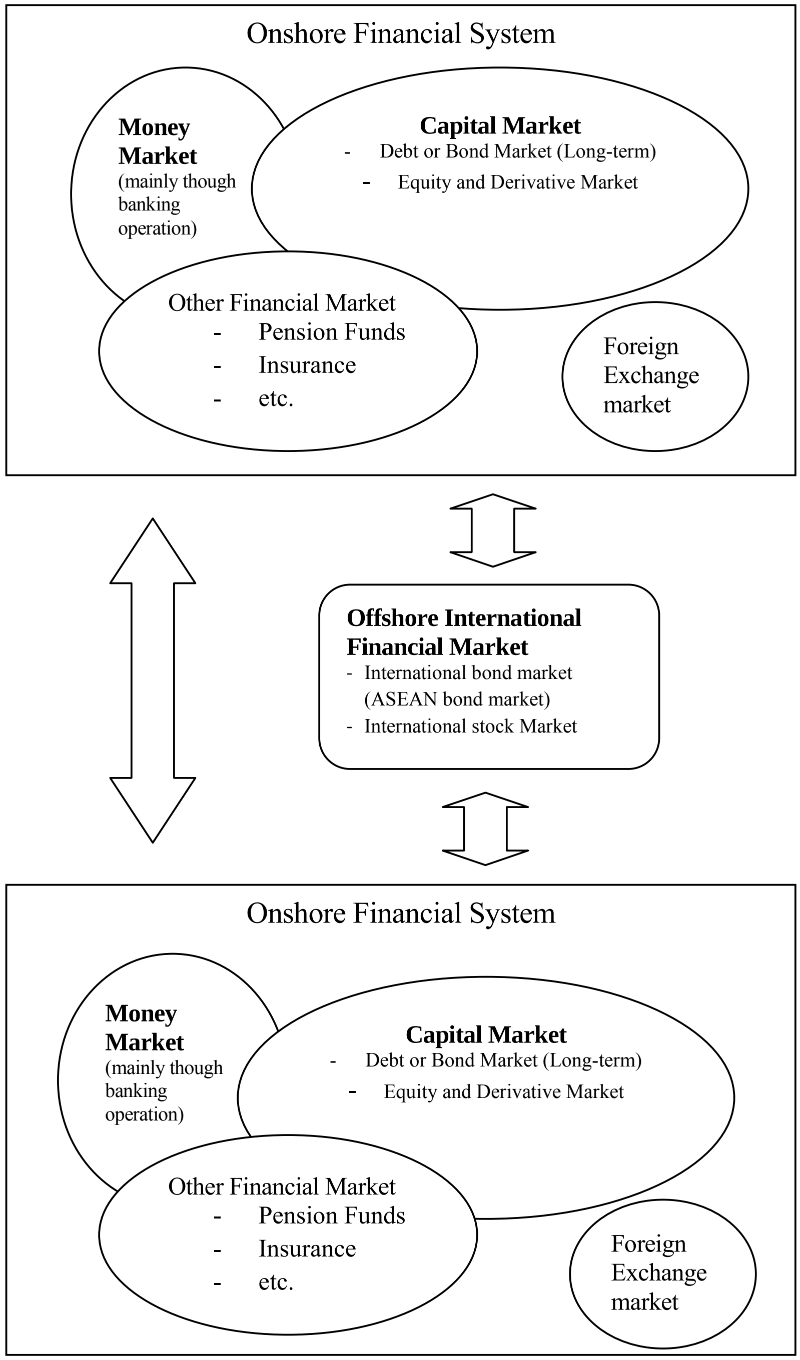
A. Capital productivity improvement

Financial liberalization and integration have long promised that the major sources of benefits stem from allocation and utilization of capital will be illustrated by better capital productivity over time. To examine how ASEAN has done over the past decade on capital utilization, a broad measurement of capital productivity, Incremental Capital Output Ratio (ICOR), is observed for ASEAN5 and Vietnam. The larger number of ICOR indicates the more inefficient use of capital, i.e. lower capital productivity. Relatively more investment is required to produce the same unit of output. General argument is that as the financial system is upgraded, the better use of capital will be delivered and hence, smaller ICOR. Figure 9 illustrates that all ASEAN5 and Vietnam have been performing well in terms of capital productivity except for Thailand from 2009 to 2014. A period of economic turbulence in 2008 leads to a disturbance of capital productivity in Indonesia and Thailand. While Indonesia had managed to move back to the same level of capital productivity before the crisis, Thailand has struggled and shown as the worst in the region. Singapore and Malaysia stand out as the more advance financial markets in the region which have minimal effects on capital utilization efficiency. This suggests that a well-functioning financial market is capable of weathering economic fluctuations through a more efficiency use of capital. In addition, there is risk of capital productivity variations (which might create some negative economic impacts) for economy in the transition period moving forward in its financial development process.

Liberalization of capital flows is perceived as necessary mechanism to facilitate a more integration financial system in the region as indicated in the AEC blueprint. Financial services liberalization and freer flows of capital across countries in the region is viewed as an important component in moving regional economy toward a single market and production base target. In addition to financial service sector liberalization agreements mentioned in the AEC Blueprint, collaboration body know as the "ASEAN Capital Market Forum" (ACMF) consists of each individual member head of securities regulators was created to pursue ASEAN capital market integration. The ADMF's implementation plan namely "Implementation Plan to promote the development of an integrated capital market to achieve the objectives of the AEC Blueprint" was proposed and approved at the 12th ASEAN Financial Ministers' Meeting in 2008. The essence of the implementation plan covers 6 principles for capital market development and integration includes;

1) International standards compliant to maximize potential benefits of regional capital market integration
2) Pushing forward financial liberalization to create greater access and cost efficiency by promoting competition
3) Recognizing the importance of sequencing in financial market integration by considering the ease of implementation, market readiness, and technical linkages
4) Seeking ASEAN Secretariat to take the role of main coordinator
5) Implementation of domestic policy and effective monitoring mechanisms to foster regional financial integration
6) Retain strong and consistent communications and consultative processes among each individual members to create sense of urgency for integration initiatives

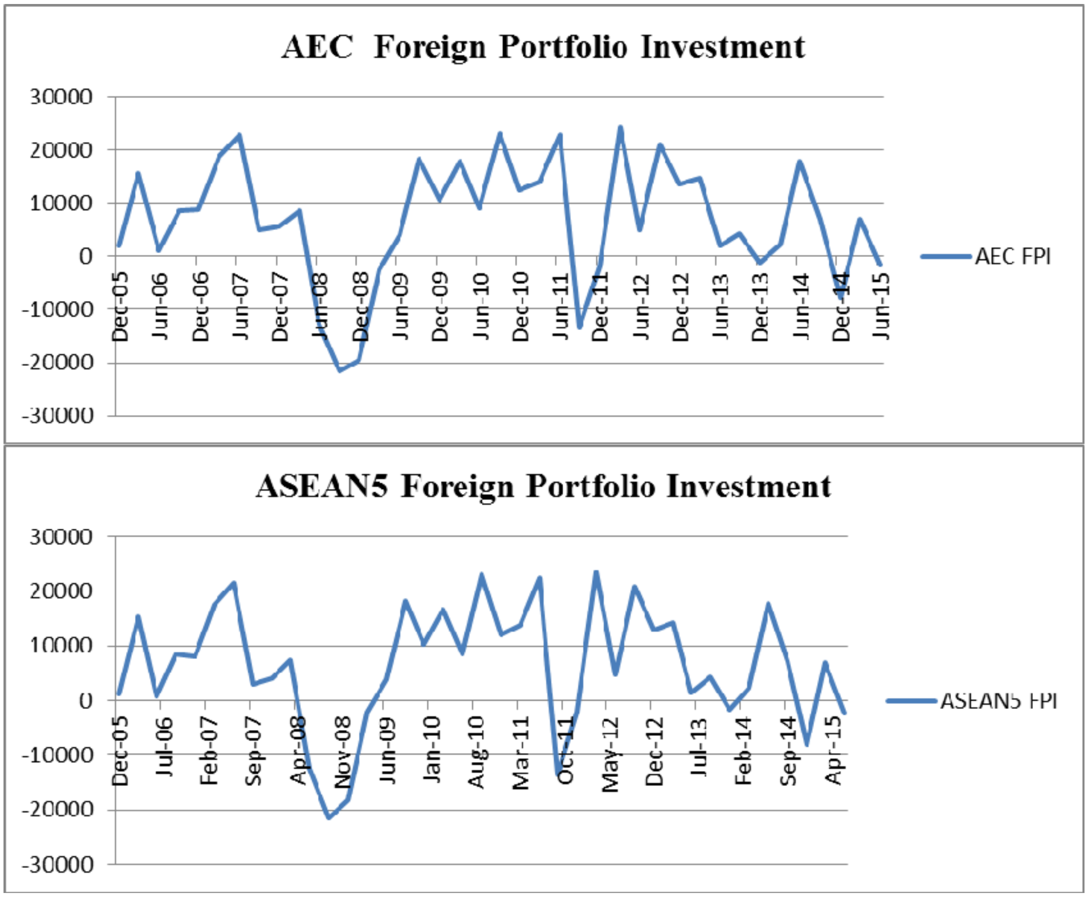
Figure 10. Financial market structure and integration



The Risks, Returns, and Needs

It seems like in the financial world, balancing between risk and return is always the issue of discussion. Market mechanism is proposed as the key element to deliver such relationship so that for those who bear greater risk receive higher return and those who choose to accept less risk end up with lower return. Flows of foreign portfolio investment generally viewed as to provide liquidity and alternative investment for the real sector for financial services. To be able to generate such a flow of fund, the financial infrastructure, which represents how advanced and integrated the financial sectors in the region are, need to be well functioning.

Figure 11. ASEAN Foreign Portfolio Investment



Source: CEIC database.
Note: AEC foreign portfolio investment excluding Brunei, Cambodia, and Myanmar.

V. Summary and Recommendations

On accessibility, it is quite obvious that the initial stage of financial markets always aim at improving market access to those who needed financial services and hence stimulate economic growth and development in the next stage. ASEAN over the last decade has improved significantly on this aspect. Greater accesses, both domestically and internationally, have been created and the region as a whole has benefited a great deal in terms of improving living standard. In addition, development of bond market in several ASEAN economies increase choices and variety of financial services allowing for more participation of private sector in projects require large capital investment which in turn help strengthen fundamental elements for further financial development. Establishment of equity (stock) market has also evidenced in less developed economies in the region with some technical guides and supports from members with more advance financial market hoping for greater access for alternative funding needed to meet greater financial demand.

Efficiency in providing financial service to reduce financial cost is the next in line for financial sector development. At this stage, a wide range of issues come into picture including financial institutions development, increasing variety of financial products and services, building financial infrastructure necessary for better risk management mechanism, providing financial literacy and knowledge to the majority of population, just to name a few. Promoting competition in the financial sector and more liberalized policy seems to be the end solution at this stage of development. Unfortunately, to achieve such goal requires some transition period in which patient and collaboration are needed as key principal for ASEAN members to consider.

Finally enhancing stability and establish a prudent financial sector to mitigate some extraordinary external shocks. Harmonization of financial regulations framework and reducing financial development gaps have been identified as key elements on this aspect. Together with policy authorities' capability to ensure fair competition in the market both domestically and internationally are the major challenges to eliminate unnecessary noises created by the financial sector and flows of capital in the region. In a sense, this stage of financial development implies an achievement of the creation of efficiency market which even some of more advanced financial sector still struggle to guarantee.

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