

## **Bandid Nijathaworn: Regional financial integration and development of local markets**

Speech by Mr Bandid Nijathaworn, Deputy Governor of the Bank of Thailand, at the JP Morgan Investor Seminar during the IMF/WB Annual Meetings, Singapore, 17 September 2006.

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First, let me start by thanking JP Morgan for inviting me to speak this morning. The topic today is “Regional Financial Integration and Development of Local Markets”. Given the limitations of time, I want to focus my talk this morning on just two issues. The first is on what has been achieved so far in East Asia in regional financial integration. And the second is the prospect for regional financial integration as we move forward, and what role should policy play.

To begin, I think one important defining phenomenon that has been a key driver of East Asia's recent rapid growth is the increased interdependency amongst economies in the region, especially in trade, and especially in the trade between China and the rest of the region. Intra-regional trade is now the largest component of total trade in most East Asian economies. For example, total trade share of Asia-10 with Asia-10 has risen to 41 percent this year, compared to a share of about 21 percent fifteen years ago. And Asia-10 now trade among themselves more than with the G3 economies.

This growth in intra-regional trade has been spurred, in part, by the integration of production network and supply chain in the region, especially the emergence of China and its integration into the regional economy. Also, government policies to support freer trade through bilateral and multilateral trade agreements have also had a strong supporting influence.

Accompanying the growth in intra-regional trade is a deepening process of financial integration in the region, defined as cross-border investment flows within East Asia. Evidence of this can be seen from the data on cross-border flows in FDI, portfolio investment, and bank lending that point to a rising trend. Also, financial prices in the region's financial markets show greater tendency to converge. For example, cross-border interest rate and bond yield differentials have narrowed while the volatility in money market interest rates across the region has declined.

To me, a key stimulus to the current process of financial integration has to be East Asia's rapid economic growth and the accompanying growths in intra-regional trade and cross-border investment. Government policies to develop financial markets in the region have also been important in so far as helping to provide a clear direction of policy preference towards greater regional integration. As a result, cooperative government efforts to develop regional financial markets, especially the bond and equity markets, are being carried out in many regional fora. The important ones have been the Asian Bond Market Initiatives under ASEAN+3, the launching of the Asia Bond Funds I and II under EMEAP, and the Roadmap for Monetary and Financial Integration undertaken by ASEAN.

The key rationale underlining this cooperation is the desire to develop resilient and robust regional financial markets, especially the capital markets. Such markets will allow the private sector in East Asia to better manage risk, as well as to reduce the dependency of the region on its banking sector. Moreover, better financial integration means saving surpluses of Asia will be better mobilized to support investment activities in Asia, thereby increasing the efficiency of resource use. And more importantly, greater cross-border financial flows will help sustain and expand intra-regional trade and investment onto the next higher levels.

But despite the recent progress, many observers have noted that, while the progress is well and good, financial integration in East Asia seems to lag behind that of trade integration. As a result, East Asia as a region continues to be more integrated financially with markets outside the region than within the region.

I think this is a valid and fair observation, but such observation needs not mean that financial integration in East Asia, going forward, will continue to be a slow process. In my view, specific factors have come into play in limiting the pace of integration in its initial stage, but as these factors become less binding, one will begin to see a more solid and faster pace of financial integration.

The slow pace of financial integration relative to trade, in my view, is a reflection of three specific factors.

First, trade integration has a much longer history in East Asia, of which the key turning point was the introduction of the ASEAN Free Trade Area in 1992. Therefore, trade integration benefits from an established policy structure and a more simplified policy framework of tariff reductions, compared to that of financial integration. Second, financial integration has essentially been a market-driven process, with the policy supports focusing on removing market impediments and developing financial infrastructure. Therefore, there has been less of a deliberate policy push while the different levels of financial market developments in the region also act as a constraint to rapid integration.

And the third factor is that, compared to trade integration, financial integration is complicated by a wider set of rules and regulatory framework, especially on cross-border capital flows, that tends to be more difficult to dismantle quickly. At the same time, the policy approach on capital flows liberalization in East Asia has been more cautious following the Asian financial crisis because of the risk of capital outflows and the weakened external financial positions. This, in my view, is one reason that led to a more cautious approach in liberalizing cross-border capital outflows.

Let me now come to the second part of my talk, that is, the prospect for financial integration in the region going forward, and what should be the role of policy.

On this, I see substantial scope for the pace of financial integration in East Asia to be gaining more momentum going forward as the constraints that used to limit the pace of integration begin to unwind. First, the external positions of the economies in East Asia have now become much stronger, with current account surpluses, substantially lower external debt, and larger international reserves. Second, Asian savers themselves increasingly want to diversify their savings abroad in search for better yields while Asian firms also look for better opportunities to lower their costs of fund by tapping funds from external sources. Reflecting these two factors, we are seeing a reorientation of policy in the region to make cross-border capital outflows more liberal without compromising the risk on macroeconomic stability.

And the third factor is that Asian financial institutions are now back in good health after a period of restructuring and consolidation. So, we are likely to see Asian financial institutions becoming more active in intermediating cross-border capital flows within the region, as they explore new business opportunities based on their expertise and knowledge of the region.

All these factors, I think, will set in train a stronger momentum of cross-border capital flows within the region in the period ahead. And under such circumstances, what then should be the role of policy?

Government policies, in my view, have played an important role in the development of East Asian financial markets. The key policy has been the implementation of financial sector reform which has resulted in a much improved financial system, especially the banking sector. Policies have also been directed at developing the region's capital markets, especially the bond market. And as I noted, policy cooperation has also been strengthened to support regional financial integration.

But while policies have been important, financial integration in East Asia has essentially been left to the market, in the sense that the process is basically a market-driven one. My view is that, going forward, the process of integration should continue to be market-driven and not policy-driven. But policy can do more by focusing on developing robust, efficient, and resilient local markets. This is because well-developed local markets will make the process of regional financial integration much easier.

As for policy cooperation, there are definitely areas that government policies can do more collectively, especially on issues that involve efforts on a region-wide basis. In this context, future efforts at policy cooperation should focus on few but concrete and specific issues to be addressed or projects to be executed. A case in point is the development of a shared regional financial infrastructure such as linking the clearing and settlement systems, harmonizing regulations on cross-border investment flows, and developing a shared facility to promote greater flows of investment information. This type of specific efforts and projects would be easier to win region-wide commitment and support.

Another suggestion I want to make is that, for the market-based approach to work efficiently, we should also engage more formally the cooperation of the private sector. On this, I think East Asia can learn a lot from the experience of the EU in engaging the private sector in planning and reviewing major financial initiatives. Specifically here, I am thinking of the Giovannini Group of private experts, established in 1996, which has done at least four useful reports for the EU Commission. Their inputs have helped the EU in introducing the necessary directives.

I think I have taken up a lot of time already and hope my remarks have been useful. Again, I want to thank JP Morgan for the invitation. Thank you.