

The Prospects and Challenges of Southeast Asian Financial Integration

Through the Association of Southeast Asian Nations (ASEAN), many countries in the region are working to liberalize their financial markets and integrate with one another, with the goal of gaining efficiencies for their individual markets and better positioning themselves to compete for international capital. While they are making progress, many challenges still lie ahead. To achieve their objectives, ASEAN's member countries will need to work hard over the next few years to reach and implement agreements, develop investment opportunities for the global community, and leverage integration initiatives in other regional organizations. This paper highlights the opportunities that ASEAN presents, outlines the most recent financial initiatives in the region and presents some of the challenges that lie ahead for that integration to succeed. Ultimately, despite these challenges, the opportunities that an integrated ASEAN presents are too great to be overlooked.

Created in 1967, ASEAN currently comprises 10 diverse Southeast Asian nations — Brunei, Cambodia, Indonesia, Laos, Malaysia, Myanmar, the Philippines, Singapore, Thailand and Vietnam — and encompasses nearly 600 million people. East Timor may soon join as the eleventh member. Although all part of the same region, ASEAN's members differ greatly, particularly in their levels of development. For example, the GDP per capita of Singapore, the richest country, is more than 60 times that of Myanmar, the poorest, as shown in Figure 1. Political systems also vary greatly, ranging from democratic Indonesia to socialist Vietnam. Similarly, tax rates and capital controls diverge from country to country.

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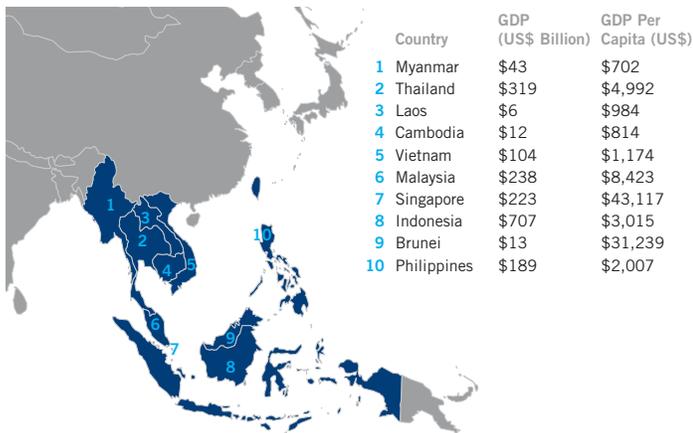
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Figure 1: A Diverse Region



All data as of year-end 2010.

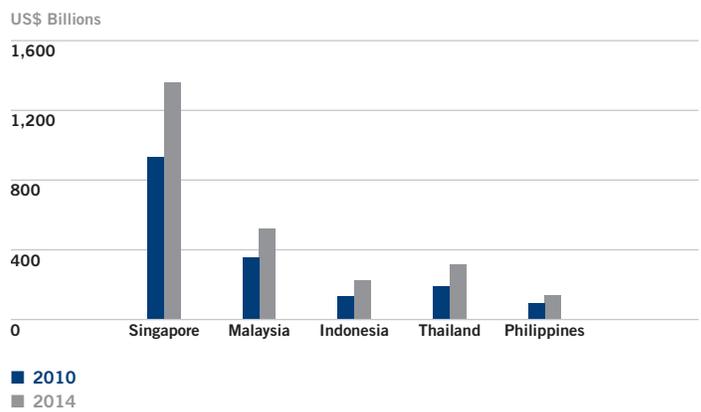
Source: IMF World Economic Outlook Database, April 2011

Despite their differences, there are compelling arguments for the ASEAN countries to work together to create a more integrated market. Together, the ASEAN economies are large, representing approximately \$2 trillion, the equivalent of the fifth largest market in the world in terms of purchasing power parity. The cumulative trade volume of the ASEAN-5 economies (Indonesia, Malaysia, Thailand, the Philippines and Singapore) is more than triple that of India and about 60 percent that of China.¹

Economic growth in the region and changes in government policy have also led to the rapid development of assets. Pension schemes in Southeast Asia's five largest economies totaled \$377 billion in mid-2010, a 70 percent increase from just five years earlier. Collectives-related assets in those countries totaled \$185.7 billion at the end of 2010 and are forecasted to surpass \$320 billion by 2014.² Overall, institutional investable assets in the ASEAN-5 market are projected to grow substantially, approaching \$2.5 trillion by 2014, as illustrated in Figure 2.³

Regional assets will likely continue to show good growth as economies benefit from the resource boom and increased trade linkages with major economies such as China and India. The integration and liberalization of regional financial markets will also contribute to further economic growth as a result of the increased efficiencies that will accompany these changes.

Figure 2: Projected Institutional Investable Assets, 2010 vs 2014



Source: Cerulli Quantitative Update: Institutional Asset Management in Asia, 2010

Integration Initiatives Progress

ASEAN is in the process of creating an ASEAN Economic Community (AEC) to facilitate the “free movement of goods, services, investment [and] skilled labor and [the] freer flow of capital.”⁴ The intention is to create a network of mutual recognition agreements and harmonized regulations, rather than a European Union-like structure of political and economic unity. An Implementation Plan seeks to achieve meaningful capital market integration by 2015, and is broadly structured around three themes: (1) regional integration through harmonization, (2) development of market infrastructure and regionally focused products and intermediaries, and (3) strengthening of the implementation process through a greater role for the ASEAN Secretariat.

ASEAN is making progress toward these goals. At the fifteenth ASEAN Finance Ministers’ Meeting in Indonesia in April 2011, summit participants announced several new initiatives relating to equity exchanges, monitoring and surveillance, and mutual recognition of market professionals, that build on those announced over the last few years, relating to bonds, currency swaps and cross-border offerings of equity and debt securities as outlined in Figure 3.⁵

Challenges to Integration

Despite the progress achieved so far and the promise of the newly announced initiatives, several challenges still remain to achieving regional financial integration and liberalization. One recurring stum-

¹ Opening address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the Merrill Lynch Asian Stars Conference 2011, Singapore, May 18, 2011.

² Cerulli Associates, Institutional Asset Management in Southeast Asia, May 2011.

³ Cerulli Associates, Institutional Asset Management in Asia, December 2010.

⁴ Association of Southeast Asian Nations.

⁵ To view the Finance Ministers’ full announcement, see www.asean.org/26157.htm.

Figure 3: ASEAN Initiatives

Initiative	Brief Overview
Equity Exchanges	A collaboration of seven stock exchanges (from the six countries of Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam) to create an integrated, ASEAN-branded market where ASEAN products are viewed as an asset class that investors can trade freely on any ASEAN exchange. The ASEAN Stars Initiative is a first step and lists 30 stocks from each exchange, ranked in terms of market capitalization and liquidity.
Monitoring Financial Integration	Establishes a Macroeconomic and Finance Surveillance Office (MFSO) at the ASEAN Secretariat that will be responsible for implementing macroeconomic surveillance in ASEAN and monitoring regional economic integration.
Chiang Mai Currency Swap Initiative	Establishes the ASEAN +3* Macroeconomic Research Office (AMRO), an independent regional monitoring and surveillance unit in Singapore, as part of the Chiang Mai Initiative Multilateralisation (CMIM). The newly created AMRO will monitor developments in the region such as the need for swap lines to be activated.
The ASEAN Bond Markets Initiative (ABMI)	In progress for some time, the ABMI creates local currency-denominated bond markets in the region. Efforts are also under way with the Asian Development Bank, under the sponsorship of the Japanese government, to catalogue and improve post-trade and settlement practices.
ASEAN and Plus Standards Scheme	Facilitates cross-border offerings of plain equity and debt securities within ASEAN and is available to ASEAN and non-ASEAN issuers making offerings within ASEAN. Standards based on international securities; accounting and auditing standards; and additional standards required by some ASEAN jurisdictions due to individual market practices, laws or regulations.
Collective Investment Schemes (CIS)	Discussions are under way to permit the sale of Collective Investment Schemes (CIS) across ASEAN by 2015. It is unclear if the initiative will only apply to schemes created, domiciled and managed within the region or if it will extend to products outside of the region such as European UCITS. This initiative appears to overlap with the creation of an Asian regional funds passport, and effort being pursued within the broader Asia Pacific Economic Cooperation (APEC) group.**
Market Professionals	Promotes the harmonization of accounting and auditing standards and mutual recognition of certification and qualification of market professionals. If an agreement could be reached about allowing sales and marketing activities across ASEAN countries, the distribution of products and services would become much easier, to the benefit of consumers and companies.

* ASEAN +3 includes China, Japan and Korea.

**To learn more about the Asian regional funds passport initiative, read State Street's Vision Focus Paper "Asian Funds Passport to Growth," available at www.statestreet.com/vision.

bling block is that finance ministers of member nations do not have control over some of the key issues that will determine whether integration succeeds, including tax, customs, legal reform and currency controls. However, the development of several channels within ASEAN to promote dialogue on these issues has been helping in this regard. At the April 2011 ASEAN Finance Ministers' Meeting, for example, a forum on taxation was endorsed to support dialogue on tax issues related to regional integration, particularly with regard to withholding tax and double taxation.

Achieving outcomes is also challenging because ASEAN takes an opt-in approach where member countries can choose to join an initiative or sit out. Even if countries opt in to an integration initiative, it can still take some time for any meaningful action to occur. Singapore, Thailand and Malaysia, for example, signed up for the ASEAN and Plus Standards Scheme, but the initiative has not been widely used.

Greater regulatory complexity and fragmentation across the broader region is also a risk because of the lack of coordination between ASEAN and other regional organizations. While ASEAN is developing its Collective Investment Schemes (CIS) initiative, for example, APEC

is working on a parallel initiative. A partnership would allow ASEAN to leverage progress in APEC and reduce the chance of conflicting regulations arising, while pursuing separate initiatives risks greater regulatory complexity and/or the failure of both initiatives. There is also room for cooperation in areas such as financing for small and medium enterprises (SMEs), infrastructure development and insurance regulation. ASEAN and APEC plan to enhance consultation, which will hopefully address some of these types of issues.

As it strives toward integration, ASEAN faces the external challenge of persuading international investors that progress is being made and that ASEAN countries present a worthy investment opportunity, particularly when measured against India and China. While perceived as more difficult markets to enter, China and India nevertheless offer great potential due to their large populations, growing economies and relatively unified financial regulations. ASEAN ministers have launched road shows in the United States and investment seminars open to global investors to raise the profile of the region, but more could be done to access a broader number of markets and investors, including locations outside of the United States, such as Japan, China, Europe and Australia.

As ASEAN builds its community, investors outside of the association have some concern that they will encounter limited, or be excluded from, market access to the region. For ASEAN to be internationally competitive, it will be important to remain open to those inside and outside of the region to draw on the expertise of industry leaders. Competition also helps ensure efficiencies and innovation in domestic markets. For the most part, these concerns seem unwarranted. ASEAN and non-ASEAN issuers are, for example, able to utilize the ASEAN and Plus Standards Scheme detailed above. But there is some concern about an ASEAN payments system that is under development. As new initiatives emerge, it will be important that ASEAN markets remain open.

How Integration Will Take Shape

International financial institutions should monitor ASEAN's integration efforts closely. If successful, Southeast Asia has the potential to provide asset managers and investors with a meaningful complement to the depth and strength of financial markets in China and/or India. If the right opportunity is identified, countries in Southeast Asia might be more receptive to foreign investment and more willing to negotiate concessions than other larger, single markets in the region given ASEAN's interest in attracting foreign investment and its openness to engaging on issues of concern.

For their part, ASEAN member governments need to continue to move toward greater liberalization to make markets more open to domestic and foreign competition. Further harmonization and integration for ASEAN countries is also important,

given the need to get different systems to work together to achieve economies of scale. Implementing and utilizing agreements made among members will also be essential if real change is to occur.

ASEAN's achievements also need to be more effectively communicated to international investors. Additional road shows and conferences in Europe, the US, Australia, Japan and China would help, along with easily accessible information on ASEAN websites and greater coverage in the international media. ASEAN should also work closely with regional groups such as APEC, particularly on overlapping initiatives, to ensure broader regional cohesion. There is room for greater cooperation on funds passporting, SME financing, infrastructure and insurance to achieve synergies in the broader Asian region rather than a more complex web of regulations.

Certainly the challenges outlined above cannot be underestimated and may mean that the process will be slower than many would hope. Greater regulatory cohesion to facilitate the more efficient sale of products and services within ASEAN, combined with a continuing growth in assets, will make Southeast Asia immediately more attractive to international investors. Local and regional investors will also profit from the opportunities that will emerge. Governments in Southeast Asia appear to remain committed to taking steps toward achieving a more integrated and open market by 2015, as set forth in the ASEAN Implementation Plan. However, substantial progress will need to be made between now and then across the spectrum of financial services if these goals are to be met.



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