



# Voice of the **Symposium**

2013 Asia-Pacific  
Financial Market  
Development





Australian Government

Voice of the  
**Symposium**

2013 Asia-Pacific  
Financial Market  
Development

10-11 April 2013



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ISBN 978-0-642-74910-9

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# Foreword



It is with great pleasure that I introduce the *Voice of the Symposium* which explores the major themes emerging from the Asia-Pacific Financial Market Development Symposium 2013. This publication captures the discussions and key materials prepared for the event which was held in Sydney in April.

The Symposium was proudly hosted by the Australian Government and we are grateful for the assistance of the APEC Business Advisory Council (ABAC) and seven generous industry contributors, AMP, ANZ, AustralianSuper, CBA, IAG, Macquarie, and Westpac. The meeting successfully brought together senior private sector leaders, regulators and government officials from 15 economies around the region for a high quality and productive dialogue.

The Symposium explored the proposal by ABAC to establish an Asia-Pacific Financial Forum to provide a framework for the public and private sectors to work together to strengthen and promote regional financial architecture. Such a forum is a particularly worthwhile idea and I look forward to ABAC putting forward the proposal for the Forum to the APEC Finance Ministers' Meeting in September this year.

The Asia-Pacific region is recognised as the growth engine of the global economy. The region's increasing living standards and continued urbanisation are expected to contribute strongly to global growth. Our region's economic rise will transform member economies and the globe in the period to 2025 and beyond. Establishing a strong and appropriate financial architecture will ensure Asian economies are well placed to embark on this next stage of development.

I commend this publication to you as an important record of the 2013 Asia-Pacific Financial Market Development Symposium.

**WAYNE SWAN**

Deputy Prime Minister and Treasurer,  
Australia





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Image: Hamilton Lund; Destination NSW



A nighttime photograph of the Sydney Harbour Bridge and the city skyline. The bridge is illuminated with green lights, and the city buildings are lit up, with their lights reflecting in the water. The sky is a deep blue.

# Asia-Pacific Financial Market Development Symposium

Sydney, 10-11 April 2013



Hon. Bill Shorten MP

“While the focus of this forum is about financial markets, we must never forget that the function of financial markets is ultimately to support real economic activity.”


The Hon Bill Shorten MP, Minister for Financial Services and Superannuation, Minister for Employment and Workplace Relations, Australia






# Chapter I

## Voice of the Symposium



The following pages seek to capture the key themes emerging from the Symposium, including the participants' vision for the future of the region's financial markets and their understanding of the associated challenges and rewards.



# Financial markets for the Asian Century

## Asian economies want sustainable growth

Asian economies want a future of sustainable growth and their populations want prosperity and stability. The broader APEC family of economies share that goal. With Asia on track to become the centre of global economic activity, this looks achievable.

*China, India, Korea, Malaysia have already put this right in their five year national plans — prosperity, social justice, inclusiveness and growth — that's essentially what they're aiming for.* — Andrew Sheng, President, Fung Global Institute

Asia is set to overtake the combined economic output of Europe and North America within the decade to 2020 — this is why some call this the Asian Century.

*We live in possibly the only region in the world that could turn around the global economic slowdown.* — Mahendra Siregar, Vice Minister of Finance, Republic of Indonesia

Even now, Asia is the growth engine of the global economy. Asian economies are projected to grow at about seven per cent a year over the next few years while the Eurozone records negative growth and the US recovers very slowly from the Global Financial Crisis.



Mark Johnson AO

“The Asian Century is not a fact. It is just a forecast.”

Yoshihiro Watanabe, Advisor,  
Bank of Tokyo-Mitsubishi UFJ, Ltd.



Yoshihiro Watanabe



Image: Hamilton Lund, Destination NSW

## Future prosperity requires action today

Nevertheless, the Asian Century is not a certainty. An Asian Century is something that economies in the region collectively need to make happen by supporting growth and managing risk.

## Financial markets enable growth

Financial markets will play an important role in Asia's future by supporting economic growth. One of the ways economies can support growth is to establish robust and liquid financial markets.

Financial markets are not an end in themselves. Rather, their role is to support the economy by facilitating the production of goods and services — the real economy.

Financial markets can enable economic growth by:

- supporting investment in infrastructure
- making it easier for small and medium enterprises to access finance and grow
- making it easier for local businesses to access trade finance, supporting intra-regional trade
- increasing individual welfare by improving access to personal finance
- better equipping governments to manage the fiscal pressures of aging populations, and individuals to support themselves in retirement
- assisting governments to provide a stable financial and economic environment in which to foster growth.

“There needs to be a mechanism for capital markets to translate savings in the region into long term investments.”

Mark Austen, Chief Executive Officer,  
Asia Securities Industry & Financial  
Markets Association



 Mark Austen

## Supporting the real economy

Financial markets exist to support real growth by providing access to finance — for people, for businesses, for governments, for infrastructure and for trade.

It is well known that there is a significant unmet demand for infrastructure in the region. The Asian Development Bank (ADB) estimates the shortfall at \$8 trillion over the decade to 2020. Measures that increase the number of institutional investors (such as pension funds and insurers) and support the development of regional bond markets can help to fill the gap between infrastructure demand and supply by increasing access to long-term financing. In the coming decades, investment in infrastructure will be critical to the long-term productive capacity of regional economies.

Access to credit and alternative funding sources is important for the development and growth of small and medium enterprises (SMEs). SMEs are important contributors to domestic demand — they create jobs, support competition and stimulate innovation. However, the International Finance Corporation and McKinsey and Company estimate the unmet demand for credit by SMEs at \$250 – 310 billion in East Asia and \$30 – \$40 billion in South Asia. The development of sound and competitive banking systems can help close this gap between demand for credit and supply.

Financial markets do more than provide access to finance. They also allow individuals, businesses and government to manage risk by diversifying their financial holdings,



 Don Kanak

providing productive investments for retirement savings and managing risk through insurance.

The real economy is the endgame of financial markets. It is their support of the real economic activity that creates value.

## Development should be based on the needs of each economy

Economies have differing needs depending on their stage of development. For some economies, a functional and safe banking system to support basic financial intermediation will be a priority. Basic financial inclusion is still a critical issue in many parts of the region.

Other economies will ask more of their financial systems. Faced with aging populations and underinvestment in infrastructure, economies will look at how they can develop their markets to help meet these challenges. In particular, they will look at improving market depth and encouraging diversity and competition in financial product availability. Connecting markets can bring this depth and diversity.

Intra-Asia holdings of equities and bonds are generally rising, but are still at low levels. The ADB estimates that, over the period from 2001 to 2011, intra-regional bond holding of Asian countries increased from 4.1 per cent in 2001 to 9.4 per cent in 2011. Meanwhile, Asia's equity investments in other Asian economies increased from 10.5 per cent in 2001 to 22.7 per cent in 2011.

In more developed economies, deeper capital markets will provide alternatives to bank financing. Deep and efficient bond markets can provide an important recourse in the event of a banking crisis. They can also provide the sort of longer-term financing that is necessary for infrastructure investment but not readily available from the banking system. This does not diminish the critical importance of a safe and competitive banking system, critical for financial inclusion and access to finance for SMEs.

*There is a need to strengthen the financial systems so Asia's massive savings can be invested into long-term investment, including infrastructure investment but not limited to infrastructure...SMEs need significant financing and also housing markets in many countries where the middle class is rising. — Masahiro Kawai, Dean, Asian Development Bank Institute*

In North Asia and Australia, the greater availability of, and diversity in, insurance and individual retirement products will assist aging populations in their retirement. A competitive market for retirement products gives individuals the right tools to grow their wealth at low cost. Helping individuals fund their retirement will also create a large pool of assets (in pension funds, mutual funds and insurance) in the region available for long term investments.

*It's not a trade-off between [whether] we fund for retirement or we fund for growth. Funding the greying provides a pool of long term investment to fund the growing — Don Kanak, Chairman, Prudential Corporation Asia*



Andrew Sheng



**“Seventy-five per cent of the people in Pakistan own mobile phones; 12 per cent have bank accounts.”**

Andrew Sheng, President,  
Fung Global Institute



Hon Cheung

“Mutual recognition is one of those common success factors that shows up consistently across a range of market development initiatives.”

Hon Cheung, Managing Director,  
State Street Global Advisors

Stability is also an important component of sustainable growth. A key challenge for Asian economies is to develop and connect their markets while maintaining financial stability. Managing capital flows and avoiding asset bubbles have become particularly important in light of very low real interest rates in the US and Europe. The recent financial crisis and its impact on people — increased unemployment levels in the US and Eurozone and personal financial distress caused by home foreclosures — is a reminder of how critical stable financial markets are to the normal conduct of business and life.

### Different needs will require different strategies

Economies in Asia and their financial markets are at different stages of development. So achieving sustainable growth requires a two-part strategy for financial markets — developing and connecting.

Some economies may be focused on developing their markets. Others may be focused on developing particular parts of their markets while connecting other parts of their markets to the financial markets of other economies. And some may be primarily focused on connecting their markets with other economies' markets.

### Getting the fundamentals right

A strong domestic institutional framework is critically important for financial markets. This means good governance, transparency, legal frameworks and accountability mechanisms. Improvements in these areas increase trust between borrowers and savers and more broadly between market participants (investors, product issuers and intermediaries). This trust is essential to increasing depth in domestic markets, improving productivity and encouraging competition.

*Regional financial market cooperation, including public-private collaboration, should not only focus on liberalisation measures, it should also be aiming to*





Campbell's Cove — Image: Sally Mayman, Destination NSW



Mahendra Siregar

*strengthen governance and regulatory frameworks and increasing institutional capacity at both domestic and regional levels.* — Mahendra Siregar, Vice Minister of Finance, Republic of Indonesia

### Making connections between markets

Deep trade connections already exist between economies in the region. Asia is now broadly as interdependent in trade as both the EU and North America. Deeper connections between financial markets can support and expand these connections.

Improving institutional settings at a national level is a good start as it builds respect among regulators and populations. Asian investors are more likely to invest their savings in the region if they trust the business environment. As previously alluded to, improving

legal frameworks, regulation, accounting and auditing standards, transparency and corporate governance all reduce the risk, and therefore the cost, of transacting in a market for all, including for foreign participants. It follows that reduced costs encourage cross-border flows.

Governments can also work together to reduce these costs through mutual recognition and harmonisation. Mutual recognition relies on substituted compliance — that is, regulators trusting each other's rules and their enforcement of them. This can substantially reduce the legal costs associated with offering investments in multiple jurisdictions. There are many examples of this being pursued in the region. Examples are the proposed Asia Region Funds Passport under APEC, and the development of common disclosure standards for the issue of "vanilla" bonds and equities by ASEAN economies.

Not all economies will be ready, or want, to participate in such initiatives and it is important to recognise and respect these sovereign choices. The optional, "pathfinder" nature of such initiatives allows economies to choose if and when they are ready to participate.

“We’re excited about our future; excited about our integrated future... We need to be more engaged.”

Cesar V. Purisima, Secretary,  
Department of Finance, Philippines



Cesar V. Purisima

Development and connectivity are closely related in this way. While development is important for connectivity, connectivity can also stimulate development. Different economies will engage with each other at different points in time, in different ways and on different issues as they navigate this cycle of developing and connecting.

### The region is greater than the sum of its parts

While connectivity is not an end in itself, Asia’s growth path is likely to require the depth and sophistication that more connected markets will bring. Collectively, the region can achieve a degree of depth in its markets and a diversity of investment and funding options beyond that which any individual economy could achieve by acting alone.

*Despite the risks, despite the challenges, it is to our interests to have more integrated capital markets. It will allow our businesses and people, access to lower cost capital. — Cesar V. Purisima, Secretary, Department of Finance, Philippines*

“We all share a common goal, which is to support stronger, balanced growth and job creation at home and across the region. Greater integration in our financial markets is right at the centre of this.”

The Hon Wayne Swan MP, Deputy Prime Minister and Treasurer, Australia



The Hon. Wayne Swan MP

Governments should engage with each other and with the private sector to identify priorities for the development of regional markets. Greater regional cooperation may also identify other synergies between markets and market participants that can be developed. Such a process could also help Asia to develop a regional voice in global forums, ensuring that global standards facilitate Asian economies meeting their real economy goals.

In seeking ways to better connect regional markets, policymakers must be aware of and seek to manage the risks that come with greater connectivity. For example, without preventative measures connectivity can bring with it higher capital volatility and greater exposure to external shocks and contagion. Because the aim is sustainable growth, regional and domestic efforts must balance growth and stability.

### We are ready for the next stage

Asian economies are well placed to embark on the next stage of development. The Global Financial Crisis tested the resilience of the region's financial markets

and demonstrated that the stability and macroeconomic policy measures adopted in the wake of the 1997-98 Asian financial crisis have served the region well.

The legacy of the 1997-98 crisis — well capitalised banks, established regional dialogues and a collective voice on regional crisis prevention and resolution — provides a strong basis for collective action on a broader range of issues.

Regional cooperation initiatives, such as the Chiang-Mai Initiative Multilateralisation, could pave the way for a stronger and broader regional dialogue on financial stability.

The success of programs focused on creating markets for local currency government bonds (such as the Asian Bond Markets Initiative and the Asian Bond Fund Initiatives) paves the way for efforts designed to develop corporate bond markets.

This history, together with political commitment and private sector support, can give rise to a new round of cooperation — in capital markets, insurance, pensions and lending — that will help to make the Asian Century a reality.

# A forum for financial market development



Dr Bandid Nijathaworn



**“The crucial push needs to come from Government jointly with the private sector.”**

Dr Bandid Nijathaworn, Chairman,  
Thai Bond Market Association

## We can work together to develop regional financial markets

The region’s financial markets can do more to support real economic growth. While there are challenges, the potential rewards are enormous. Fortunately, there is great willingness on the part of governments and the private sector to work together to develop the region’s financial markets.

To harness this enthusiasm, the APEC Business Advisory Council (ABAC) has proposed that an Asia Pacific Financial Forum (APFF) be established under the auspices of APEC.

ABAC sees the proposed APFF as a platform for governments, regulators and industry to work together to develop and strengthen the region’s financial markets. Its objective would be to help promote greater synergy between national financial markets and identify reforms which have the greatest potential to bring markets closer together. In doing so, it could accelerate the evolution of regional cooperation toward greater consistency and coherence.

## Finding the best fit

The success of an APFF will depend on the body finding the best place for itself in the somewhat congested landscape of regional cooperation (see Background Paper 4).

There are many bodies and initiatives currently focused on financial market development and regulation.

There is a growing volume of standard setting occurring at an international level — through the Financial Stability Board, the Basel Committee on Banking Supervision, and the International Organisation of Securities Commissions to name a few.

A range of initiatives are also being progressed regionally through a series of different economic groupings. For example, ASEAN+3 continues to progress work on the Asian Bond Market Initiative and the Chiang-Mai

Initiative Multilateralisation. A series of financial market initiatives is being progressed as part of ASEAN's Economic Blueprint, including work to link securities exchanges and establish a scheme for the cross-border offering of investment funds. APEC economies are also working to establish a passport scheme for investment funds.

This operating environment presents challenges as well as opportunities.

### Designing for success

A new body can model itself on initiatives that have been successful and avoid the pitfalls of those that have not.

As a public-private platform, an APFF would have a unique place in the landscape of regional cooperation of financial market issues. This attribute could be harnessed in the APFF's design and focus to make a significant contribution to regional financial market development.

Many point to the Asia-Pacific Infrastructure Partnership (APIP) as a model for successful public private collaboration. APIP draws on a panel of ABAC members and senior corporate executives for closed door dialogues with senior government officials and ministers from particular countries in order to identify bottlenecks and

constraints to private investment in infrastructure. A similar model could be adopted by the APFF.

In designing and establishing an APFF, ABAC could also draw on the successes of other initiatives. For example, factors cited as underpinning the success of the Asian Bond Market Initiative include the identification of objectives that members find compelling, the commitment of individual member economies from the Minister level to the working level, and the active role of key participants in leading particular work streams. These factors could be considered and built into any APFF model.

### Focusing on outcomes

In finding the best place for itself in the landscape of regional cooperation, any new body needs to be conscious of the risk it may duplicate the work of others. The proposed APFF should look to where it can contribute most effectively, being conscious of the work others are doing. If there is overlap, new work needs to fit with, and add value to, existing processes. In this sense, success will require specific objectives and a plan to work with other regional players towards a common end.

There is potential for such a body to have a real impact on developing and connecting markets. The challenge will be to translate goodwill into real outcomes.




Stephen Allen

“The APFF does need to have a number of concrete actions it is trying to achieve... but there are a lot of reasons to believe our markets can develop quite quickly.”

Stephen Allen, Chief Risk Officer,  
Macquarie Group Limited



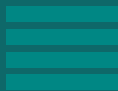


There is potential for the proposed APFF to have a real impact on developing and connecting markets. The challenge will be to translate goodwill into real outcomes.







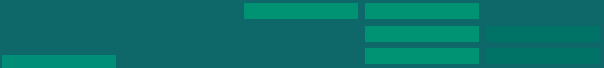





# Chapter 2

## Background Papers

The following series of background papers were published in the lead up to the Asia Pacific Financial Market Development Symposium to provide context for the agenda and to stimulate discussion at the event.





# Connecting financial markets

## Summary

- Financial market development is an important pre condition for greater financial market connectivity in the region — but regional integration efforts can also stimulate the development of national markets.
- The process of financial market integration should see domestic market participants increasingly able to access foreign markets on the same terms as foreign participants, and vice versa. The optimal degree of integration will depend on the characteristics of the countries or region seeking to integrate.
- There are many paths to greater integration. The development of national financial markets, coordinated government assistance, regulatory convergence, capital account liberalisation and financial cooperation all have the potential to reduce the costs associated with cross border transactions, supporting greater financial market connectivity.

*This paper was prepared by the Australian Treasury. It is a summary of available academic literature and does not necessarily represent the views of the Australian Treasury.*

## Why develop financial markets?

Deep and liquid financial markets play an important economic role in facilitating the efficient allocation of capital, mobilising savings and allocating them to productive investment. The development of national financial markets, with the objective of enhancing their capacity to efficiently intermediate in this way, can support economic growth.

As this paper will discuss, there is an important link between developing financial markets and connecting them. Financial market development is seen as an important precursor to greater financial market connectivity (Asian Development Bank (ADB), 2008). Strong fundamentals are important to guard against the potential risks associated with greater liberalisation. Strengthening national financial markets, infrastructure and institutions can also promote greater connectivity by reducing transaction costs for foreign investors.

Going the other way, regional initiatives aimed at greater integration can also create strong incentives for countries to improve their financial market infrastructure so that they can participate and reap the benefits of greater integration (De Brouwer and Corbett, 2005). The risks and benefits of deeper integration will be explored in the next paper in this series.

## What does financial market integration look like?

Financial market integration describes the process of two or more financial markets “joining up”. The process of financial market integration should see domestic market participants increasingly being able to access foreign markets on the same terms as foreign participants and vice-versa (Baele et al, 2004). When financial markets are fully integrated, it is said that the law of one price should hold — assets of identical risk should command the same price regardless of location or origin (Bekaert et al, 1998; Garcia-Herrero and Wooldridge, 2007). However, full integration may not be desirable. The need to manage capital flow volatility and financial system risk is likely to mean the optimal degree of integration sits somewhere on the spectrum between autarky (that is, when an economy is self sufficient and independent of international trade) and full integration. Exactly where will depend on the characteristics of the countries or region seeking to integrate.

## Initial conditions are important

The effectiveness of policies developed to promote financial market integration relies on the degree of existing integration with world markets. Countries with a low level of integration should ensure their financial sector is adequately prepared to cope with open capital markets *before* actually opening up their market. For example, if an economy’s financial sector does not manage risk properly, does not have sufficient reserves and capital, or does not have the right incentives, opening up can create severe problems. Given that the magnitude of market imperfections are different for different economies, the “integrated” approach articulated by Ishii and Harbermeier (2002) envisages a gradual and orderly sequencing of external financial liberalisation based on the initial conditions. This approach also emphasises complementary reforms in the macroeconomic framework and the domestic financial system to smooth the impact as essential to a successful liberalisation strategy.

## Paths to greater regional connectivity

The road to greater financial market connectivity is multi-faceted. A greater degree of connectivity can be achieved through efforts at domestic and regional levels. Measures taken in the areas listed below have the potential to reduce the costs associated with cross border transactions, supporting deeper integration.

Of course, greater financial market connectivity is not an end in itself. Decisions to pursue the measures described below should be supported by a strong policy case. Such a case could:

- be primarily macroeconomic (for example, the policy case for the Chiang-Mai Initiative was based on financial stability concerns stemming from the Asian Financial Crisis); or
- be primarily microeconomic (for example, the Australia-New Zealand scheme for mutual recognition of securities offerings was used over 250 times in its first year of operation, saving issuers between approximately 55 and 95 per cent in compliance and legal costs (ASIC, 2009)); or
- have both macroeconomic and microeconomic underpinnings.

## Strengthening national financial markets

The strengthening of national financial markets, infrastructure and institutions is important for the promotion of greater regional financial market connectivity. The Asian Development Bank (ADB) has described underdeveloped markets and institutions as “perhaps the biggest impediment to greater regional financial integration and intermediation” (ADB, 2008).

An inadequate legal framework, weak regulation, deficient accounting and auditing standards, poor transparency or weak corporate governance will all increase the cost of transacting in a market, creating barriers to cross border trade in financial services. These market imperfections may also exacerbate risk taking behaviour by both financial markets and governments, making it difficult to avoid and manage crises.

For this reason, existing initiatives aimed at greater financial market connectivity, such as APEC’s Asia Region Funds Passport and the Asian Bond Market Initiative (ABMI), incorporate an important capacity building component to assist less developed markets to strengthen their regulatory systems.

## Positive government intervention

Governments can also take direct action to strengthen regional financial markets through positive interventions. Examples include the credit guarantee and investment facility (CGIF) and the AsianBondsOnline website established under the ABMI.

The CGIF was established to provide credit guarantees for local currency denominated bonds issued by investment grade companies in ASEAN+3 countries. By promoting the issuance of local currency bonds, the CGIF aims to support the development of a regional bond market which, in addition to providing companies with access to external financing, also requires them to become more transparent and be subject to market discipline.

Similarly, AsianBondsOnline was also established under the ABMI to improve the information available to market participants and investors about sovereign and corporate bond markets and issuances in ASEAN+3 countries.

## Regulatory convergence

Reducing regulatory barriers to entry — through harmonisation or mutual recognition — can also assist financial market integration by reducing the compliance costs firms face associated with meeting multiple regulatory standards across different jurisdictions.

Harmonising regulations also makes it easier for countries to monitor, and in some cases regulate, transactions outside their borders.

Several initiatives are underway to reduce regulatory differences with the broader aim of promoting cross-border investment in particular sectors. For example, the APEC Asian Region Funds Passport pilot project is working to develop a multilaterally agreed framework allowing the cross-border marketing of investment funds across participating economies in the Asian region.

There are also a number of bilateral initiatives. For example, Singaporean and Thai authorities entered into a Memorandum of Understanding in 2007 which establishes a framework for the mutual recognition of the product knowledge examinations required for market professionals dealing with securities and collective investment schemes in each country.

## Capital account liberalisation

The reduction or removal of restrictions on capital account transactions and foreign entry can help to promote greater financial market integration (ADB, 2008). Comparing the volume of cross border bank claims in Asia and Europe, Eichengreen and Park (2004) suggest that controls on capital account transactions may be one contributor to the difference in financial integration between the two regions.

Nevertheless, such measures must be balanced against the needs of countries to manage the risks associated with capital flows. As the International Monetary Fund (IMF) acknowledges, “[capital flows] are volatile and can be large relative to the size of a country’s financial markets or economy. This can lead to booms and busts in credit or asset prices, and makes countries more vulnerable to contagion from global instability” (IMF, 2012).

## Financial cooperation

Measures to lower exchange rate volatility may encourage greater financial market integration. Studies have found that lower exchange rate volatility is associated with higher levels of foreign direct investment (See Wei and Choi, 2005). To this end, some authors have called for financial cooperation in East Asia to stabilise exchange rates between regional currencies (Lee, 2008; Lim and Lim 2012), and provide sufficient liquidity and monitoring/surveillance capabilities during a crisis. The Chiang Mai Initiative and the ASEAN+3 Macroeconomic Regional Office are examples of

financial cooperation in East Asia designed to build a strong regional financial architecture critical for crisis prevention, management and resolution in the region.

### Private sector partnering

Greater regional connectivity need not always require government action. There are many examples of private sector partnering in the region which have facilitated the cross border provision of financial products and services. For example, in 2012 Allianz signed a ten year deal with HSBC under which HSBC will be the exclusive distributor of Allianz life insurance products in China, Indonesia, Malaysia, Australia, Sri Lanka and Taiwan (Allianz, 2012).

These forms of cooperation can also assist financial market development. For example, the Commonwealth Bank of Australia's strategic partnerships with the China-based Qilu Bank and Hangzhou Bank have included capability transfer projects focusing on risk management capabilities and talent development (Oliver Wyman, 2012).

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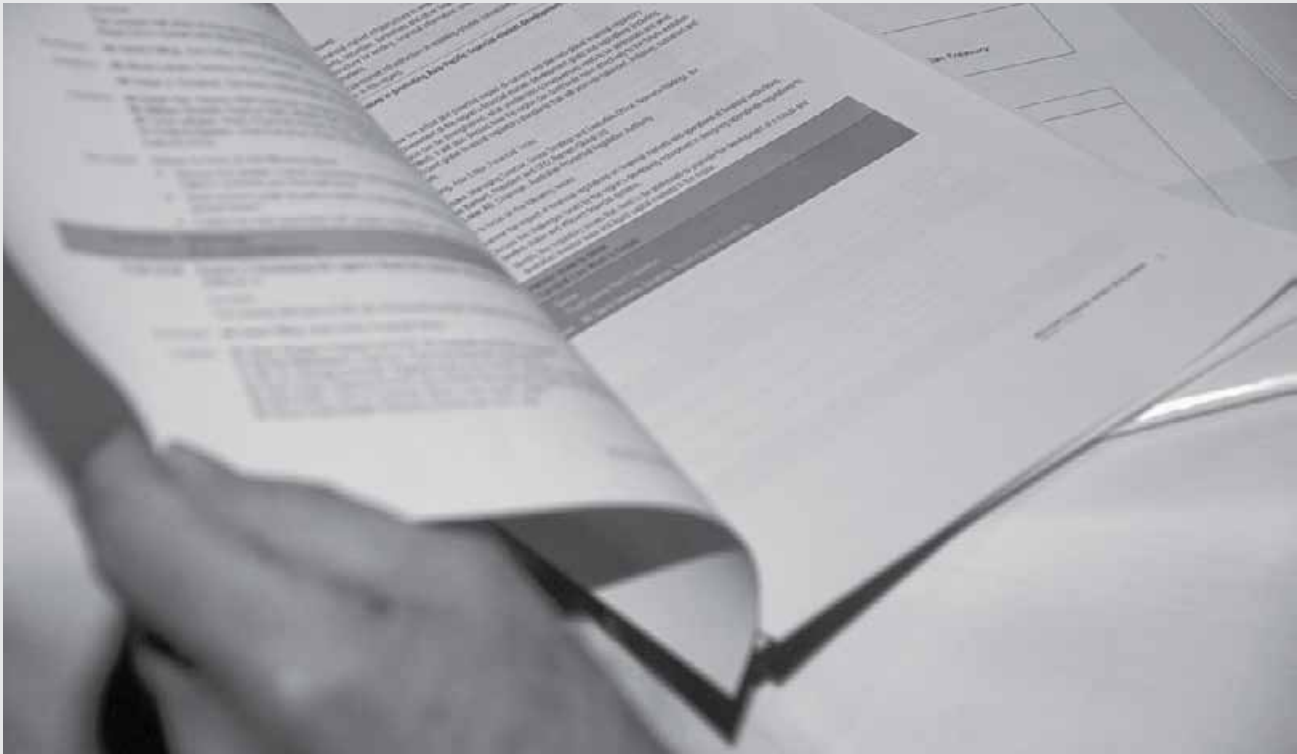


# The benefits and risks of more connected financial markets

## Summary

- Financial integration can be both “a benefactor and a menace” (Obstfeld, 1998).
- On one hand, financial integration is expected to increase the efficiency and overall welfare of economies. It can also enhance the resilience of financial systems by enabling risk diversification.
- However, financial globalisation also carries risks such as the increased likelihood of banking and sovereign crises as a result of high capital volatility. These risks are more likely to appear in the short run, when countries open up while financial institutions and markets are still developing.
- The main challenge for policymakers in the region is to manage the process so as to take advantage of the opportunities, while minimising the risks.

*This paper was prepared by the Australian Treasury. It is a summary of available academic literature and does not necessarily represent the views of the Australian Treasury.*



## Introduction

As discussed in the first background paper, “Connecting Financial Markets”, financial integration includes efforts to broaden and deepen financial links globally, whether through market driven or institutionalised processes.

This paper explores the benefits and costs of financial integration, in order to better understand the implications for the region of greater financial market connectivity, and to develop a successful agenda for regional cooperation. The next paper in this series will look at the existing degree of financial market integration in the region.

The following list has been loosely adapted from the World Bank’s assessment of the benefits and risks of financial integration as detailed in Agenor (2003).

## Benefits

Broadly speaking, financial openness can provide important benefits. Open capital markets can encourage the development of a well-functioning domestic financial sector. A well functioning domestic financial sector is critical for the efficient provision of funds to borrowers (households, firms, and governments) and savers. It allows borrowers to make use of productive investment opportunities, and savers to reduce investment risks through diversification, as well as to increase their profits through expanded investment opportunities.

Some important benefits of financial integration are set out below.

### Risk diversification/risk sharing

From an economy-wide perspective, access to world capital markets expands investors' opportunities for portfolio and cross country risk diversification (Obstfeld, 1994). This affords insurance against shocks and can provide potentially higher risk-adjusted rates of return.

### Expansion of funding and investment alternatives

Financial integration allows borrowers (as defined above) to expand their financing alternatives by raising funds directly through bonds and equity issues in international markets, reducing the cost of capital. More financing alternatives also help foreign investors to overcome direct and indirect barriers associated with investing in a domestic market, and likewise for domestic investors investing in foreign markets.

### Higher domestic investment and growth

Financial openness allows countries which have a "savings gap" due to low levels of income to close that gap. Net foreign inflows can supplement domestic saving, increase levels of physical capital per worker, and help the recipient country to improve economic growth and raise living standards. Additionally, financial integration can also assist in meeting the "skills/technological gap" by facilitating the transfer or diffusion of managerial and technological know how. This can result in more efficient financial intermediation which further reduces transaction costs.

### Consumption smoothing

Through borrowing and lending, countries can also stabilise their consumption around their long term potential growth, even in the presence of idiosyncratic shocks. This "counter-cyclical" role of integrated capital markets is particularly important if shocks are temporary in nature.

On a microeconomic level, borrowing and investing by domestic households and firms can also help to smooth their inter-temporal consumption and investment by relaxing financial constraints. Obstfeld (1994) finds that such international risk sharing can often produce large and permanent growth and welfare gains.

### Enhanced macro discipline

By increasing the rewards of good policies and the penalties for bad policies, the free flow of capital across borders may induce countries to follow more disciplined macroeconomic policies and thus reduce the frequency of policy mistakes (Obstfeld, 1998).

Additionally, greater capital account liberalisation (which generally accompanies financial integration) can act as a "signal" that a country is willing to adopt macroeconomic policies for the reduction of budget deficits and inflation (Bartolini and Drazen, 1997). This can result in a more efficient allocation of resources and more sustainable economic growth.

### Development of domestic financial systems

Finally, one of the key benefits of greater integration is that it may increase the degree of efficiency in the financial intermediation process by lowering costs and the "excessive" profits associated with monopolistic or cartelised markets (Baldwin and Forslid, 2000).

Greater participation by foreign banks may also reduce capital flight during domestic instability because depositors are able to shift funds to domestic branches of foreign banks that are perceived to be stable.

### Risks

Financial integration and financial stability do not always go hand in hand. Risks can spread from one segment of an integrated market to another, increasing the likelihood of contagion from financial fragilities and systemic crisis. Some of the key risks from greater financial integration are set out below.

### Enhances short run risks

Financial integration can result in an increase in the probability of a crisis. A high degree of financial openness in a country with weak fundamentals can result in volatile capital movements, including large reversals in speculative short-term flows. These risks are likely to be far less pronounced where there is a fundamentally robust macroeconomic policy framework.

## Increases exposure to imperfections in international capital markets

Imperfections in international capital markets can lead to crises in countries with sound fundamentals, often as a consequence of market failure of one sort or another. These imperfections in financial markets can generate bubbles, irrational behaviour, herding behaviour and speculative attacks which often translate into large movements into and out of certain types of assets. This exacerbates fluctuations in asset prices and capital movements and causes crashes (Stiglitz, 2000).

## Increases exposure to external shocks and contagion risk

Globalisation can lead to a crisis in an open economy as a result of contagion from outside events. Financial contagion may occur when a country suffers massive capital outflows triggered by a perceived increase in the vulnerability of a country's currency or, more generally, a loss of confidence in the country's economic prospects, as a result of developments elsewhere (Dornbusch, Park and Claessens, 2000; and Masson, 2000). Frankel and Rose (1996) also highlight the role that foreign interest rates play in determining the likelihood of financial crises in developing countries.

## Loss of macro stability

The large capital inflows induced by financial integration can have undesirable macroeconomic effects, including rapid monetary expansion (due to the difficulty and cost of pursuing sterilisation policies) and inflationary pressures (resulting from the effect of capital inflows on domestic spending).

In an open economy with fixed exchange rates, central bankers may also not have control over their monetary policy (the so called "impossible trinity"). They are therefore relatively helpless when capital can move freely. Even in an open economy with flexible exchange rates, real exchange rate

appreciation and widening current account deficits from large capital inflows can make maintaining macro stability difficult for central bankers.

## Domestic misallocation of capital

Although the inflows of capital associated with an open capital account may raise domestic investment, their impact on long-run growth may be limited if such inflows are used to finance speculative or low quality domestic investments. The Eurozone crisis was fuelled by greater regional integration, mispricing of risk and misallocation of capital into speculative investments in real estate in countries like Greece and Spain (Volz, 2012).

## Pro-cyclicality of short-term capital flows

Access to capital flows may be pro-cyclical because in a "boom" time it is easier for developing countries with attractive (albeit risky) returns on investment to attract short term capital flows. In a growing economy, it is also easier to roll over debt and borrow at a cheaper rate. However, in "bad" times they tend to face credit constraints because investors are more risk averse and unwilling to invest in developing countries where market information may be difficult to access.

In these conditions, the ability to smooth consumption during temporary adverse shocks is limited or virtually non-existent. In fact, the pro cyclicity of capital flows may have a perverse effect and increase macroeconomic instability (Agenor, 2003).

## Risks of entry by foreign banks

Entry by foreign banks in the domestic market can be a source of vulnerability. Foreign banks may be biased in their credit allocation, and given their limited knowledge of the domestic market, may extend credit only to the large firms. Unless domestic banks are able to continue lending to smaller firms, this may have an adverse effect on output, employment and income distribution. Moreover, foreign banks may make the domestic system

more unstable if they have the tendency to cut losses and close shop when domestic conditions deteriorate.

Large foreign banks can also create pressure on local banks to merge in order to remain competitive. The process of concentration (which could also arise as foreign banks acquire local banks) could create banks that are “too big to fail” or “too political to fail” (Agenor, 2003).

### Complexity

Greater financial market connectivity also has the potential to add to the complexity regulators face in supervising financial market participants and their behaviour. This is especially true because of the informational asymmetries that exist between individual market participants and regulators, particularly when participants are operating across borders. Greater financial market connectivity, to the extent that it is expected to make financial markets deeper and more diverse in terms of the number and nature of participants involved, amplifies those challenges even further.

### Conclusion

As seen from this short summary of the risks and benefits of financial integration, financial integration is a double-edged sword. Still, in the long run, the net effects of financial globalisation are likely to be positive. This is particularly relevant in the Asian region, where the region’s surplus savings and large foreign exchange reserves have not been utilised adequately to meet the region’s infrastructure and development needs. The main challenge for policymakers in the region is therefore to manage the process so as to take advantage of the opportunities, while minimising the risks.

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# Financial integration in Asia – developments and trends

## Summary

- Asia has witnessed a trend towards increasing capital mobility in the region since the early 1990s. As a result, we have seen stronger financial linkages between Asian markets and financial markets in advanced economies. However, financial linkages within the region have not been as well developed.
- The 1997/98 Asian financial crisis helped spur policymakers to develop new regional arrangements to help address the region's vulnerabilities to external shocks. As a result, monetary and financial cooperation in Asia has grown out of public sector initiatives, in contrast to trade integration, which has been largely market led.
- In the aftermath of the Global Financial Crisis, strong growth prospects in Asia and attractive returns in the face of weak and volatile global market conditions have helped support the rise in intraregional asset holdings. These global trends are complemented by continued national efforts to liberalise domestic capital markets and market infrastructure.
- The intraregional bond holding of Asian countries increased from 4.1 per cent in 2001 to 9.4 per cent in 2011. Meanwhile, Asia's equity investments in other Asian economies increased from 10.5 per cent in 2001 to 22.7 per cent in 2011.

*This paper was prepared by the Asian Development Bank.*

## Introduction

Asia has witnessed a trend towards increasing capital mobility in the region since the early 1990s. This reflects both the increasing importance of trade in the region's economy and a commitment to financial market liberalisation and deregulation. As a result, we have seen stronger financial linkages between Asian financial markets and financial markets in advanced economies outside the Asian region. However, financial linkages within the region have not been as well developed.

Asian investors still prefer to invest either in their home markets or in mature markets such as the US and Europe. This preference remains, despite the fact that most Asian countries have consistently run current account surpluses since the 1997/98 Asian financial crisis, implying there is a large pool of funds available in the region for investment. Despite the higher yields available in Asia, most investors still prefer to invest outside the region. In 2011, 22.1 per-cent of the region's cross-border assets were held in Asian equities, with a mere 9.4 per-cent in debt securities.

## Financial integration in context

The 1997/98 Asian financial crisis revealed major weaknesses in the financial systems of several Asian economies. The spread of the financial crisis across the region also highlighted the economic and financial interdependence of the region's economies. Following the crisis, the region's policymakers have introduced significant reforms to prevent similar crises from striking the region in the future. These reforms, mostly at the national level, have led to impressive growth in the region's capital markets — particularly local currency bond markets. They have contributed to increased stability in national financial markets by reducing dependence on foreign borrowings and excessive intermediation through local banks. The reforms have also helped to address the problem of

maturity and currency mismatches that were one of the root causes of the 1997/98 Asian financial crisis.

The crisis also brought to the fore the interlinkages and potential for spillover effects across the region. This has helped to spur policymakers to develop new regional arrangements to help address the region's vulnerabilities to external shocks. Thus, in contrast to trade integration, which has been largely market-led, monetary and financial cooperation in Asia has grown out of public sector initiatives.

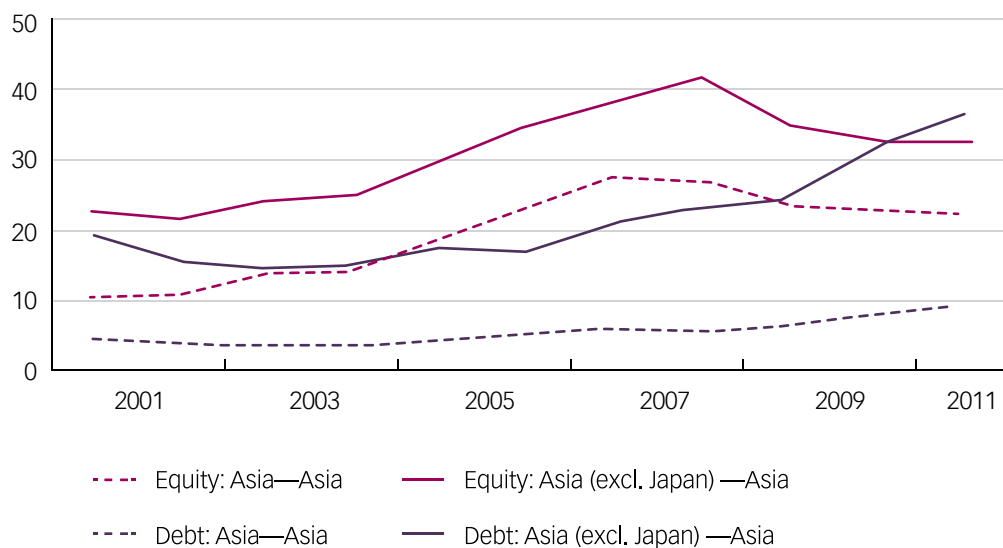
Some of the key regional initiatives that have been launched are the Asian Bond Funds (ABF), the Asian Bond Markets Initiative (ABMI) — including its associated Credit Guarantee and Investment Facility (CGIF) — and the ASEAN Infrastructure Fund (AIF). These initiatives have been developed to tap the region's massive savings, not to just deepen regional markets, but to finance widening infrastructure and social development gaps.

Furthermore, policy makers in individual countries — as well as through regional initiatives — are working to remove remaining barriers to cross-border investment, attempting to harmonise rules, mutual recognition of credit ratings and strengthening related market infrastructure to facilitate cross-border issuance and demand for local currency debt. These are key factors affecting Asian investors' decisions. The ASEAN+3 Bond Market Forum (ABMF) — comprising bond market experts from the region — was established in September 2010 to facilitate this market harmonisation process.

## Trends in financial integration

Over the past decade, increased intraregional trade and financial liberalisation have helped to contribute to increased financial integration across the region. One quantitative measure of financial integration within the region, the share of intraregional asset investments, has shown substantial growth. Furthermore, in the aftermath of the Global Financial Crisis, strong growth



**Figure 1****Intra-Asia holdings of equity and bonds (by investment source, % share)**

Notes: Asia includes East Asia, Southeast Asia, Central Asia, South Asia and the Pacific. Australia and New Zealand are excluded due to the difference in the structure of their economies with the rest of the countries in Asia. Countries included in Asia as recipient region differ from that of Asia as source region due to data unavailability. In particular, data for People's Republic of China as source is not available. Source: ADB calculations using data from *Coordinated Portfolio Investment Survey*, International Monetary Fund 2012.

prospects in Asia and attractive returns in the face of weak and volatile global market conditions have helped to support the rise in intraregional asset holdings. These global trends are complemented by continued national efforts to liberalise domestic capital markets and market infrastructure.

Over the period from 2001 to 2011, the intraregional bond holdings of Asian countries increased from 4.1 per cent in 2001 to 9.4 per cent in 2011. The intraregional bond holdings of Asia, excluding Japan, further increased from 19.1 per cent in 2001 to 36.8 per cent in 2011. One of the reasons for the rise in intraregional bond holdings is that most Asian countries decreased the share of US and Eurozone assets in their investment portfolio, reflecting very low yields and the reassessment of the riskiness of these assets.

Meanwhile, Asia's equity investments in other Asian economies increased from 10.5 per cent in 2001 to 22.7 per cent in 2011. Excluding Japan, equity investments have risen from 22.4 per cent in 2001 to 32.9 per cent in 2011. Unlike intraregional bond holdings, intraregional equity holdings declined after the Global Financial Crisis due to the relatively poor performance of Asian stock markets compared with the advanced economies.

The different trends in intraregional bond and equity holdings after 2008 were mainly due to increased risk aversion among investors. With bonds seen to be the safer investment, this has resulted in a flight from equity towards bonds. The effect

is stronger for Asian equities, as they are generally considered to be riskier than those of advanced economies. Monetary easing, by both the Federal Reserve and European Central Bank, has increased the relative attractiveness of Asian bonds to US and Eurozone bonds as investors search for higher yields.

Japan continues to receive the largest share of intraregional investments in both equities and debt securities. But a greater number of economies within Asia have also become an increasingly popular destination for Asian investments. Those showing the largest increases differ for equities and debt securities. Increasing shares of intraregional equity investments go mainly to the two giant emerging economies of the People's Republic of China (PRC) and India, while those receiving bond investments are spread wide across many different countries. The PRC and Republic of Korea in East Asia and Indonesia, Malaysia, and Singapore in Southeast Asia dominate, as well as India in South Asia.

In the past, Asian investors have generally been reluctant to invest in regional markets. However, there have been signs of a shift in attitude. While there is evidence that "home bias" deepened in some markets after the 2008/09 Global Financial Crisis, there was no statistically significant difference between regional and global markets in 2009 and 2010. This is in stark contrast to pre-2008 — when Asian investors clearly favored financial assets in advanced economies.

# Faces of the Symposium







Dr J.C. Parrenas

# Map of international and Asian financial forums

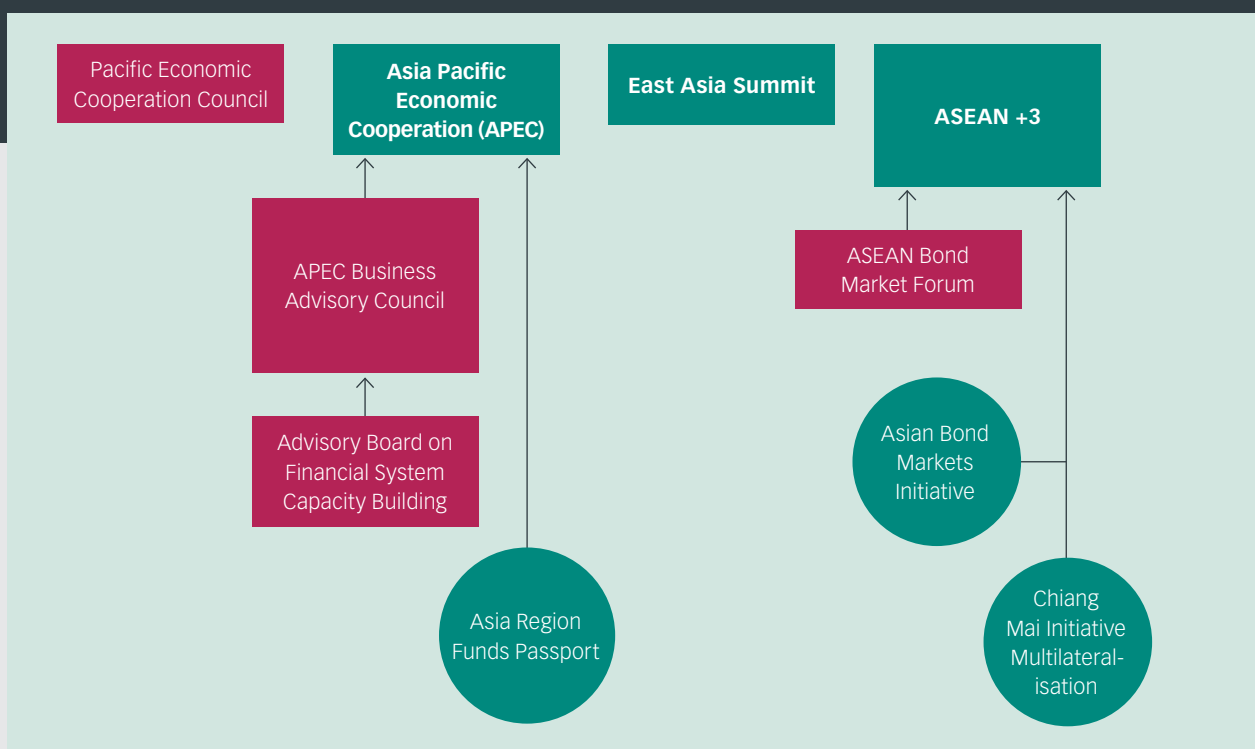
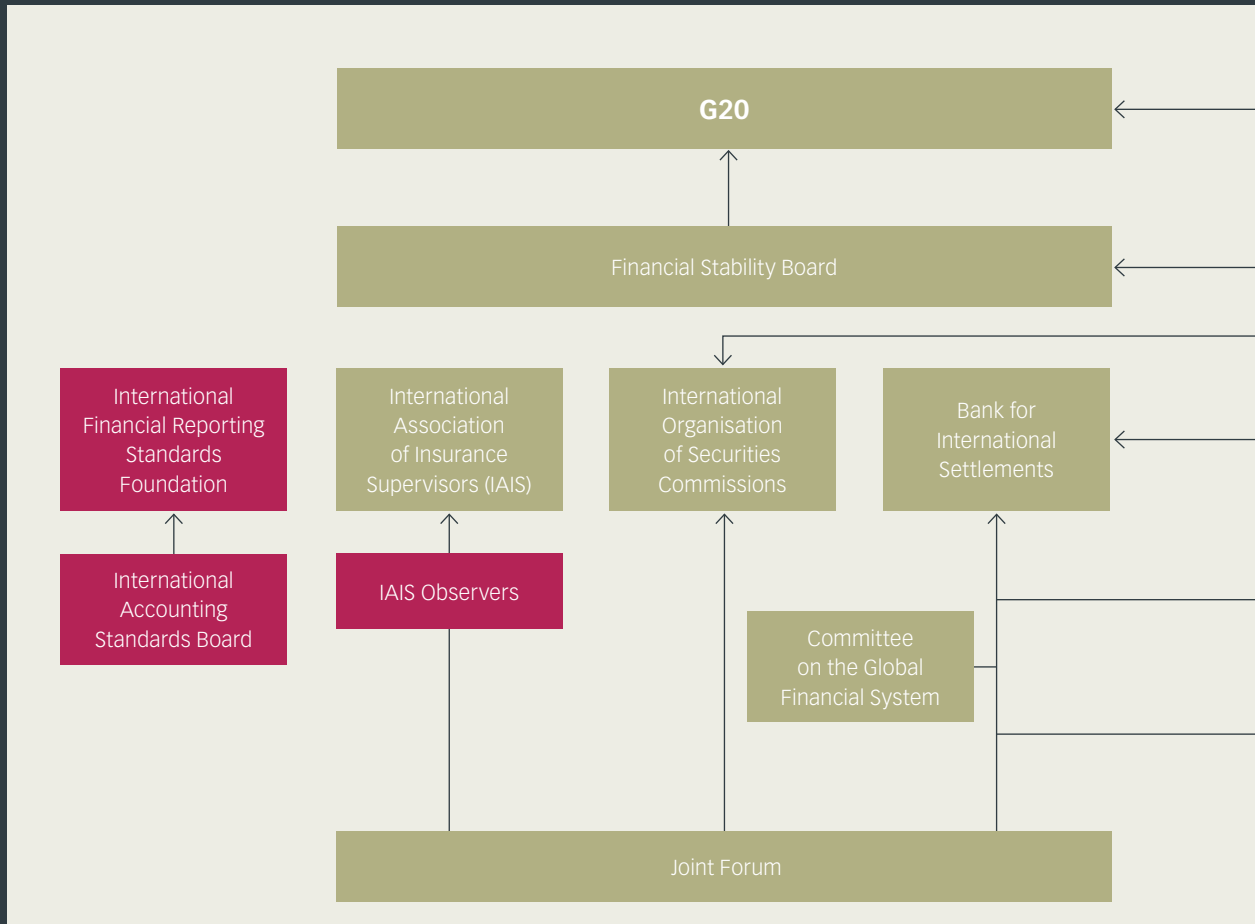
The map on the following page sets out some of the key international and regional policy-making forums and a few of the key initiatives being progressed thereunder, with the aim of providing an overview of the framework for international and Asian cooperation on financial market issues.

It is not intended to be comprehensive and does not list forums/bodies whose primary function is training and capacity building. It also does not list many of the initiatives being undertaken by the forums/bodies shown.

The forums/bodies marked **red** are those in which the private sector has a key role – either as the primary driver of the forum or where the forum is a joint public-private initiative.

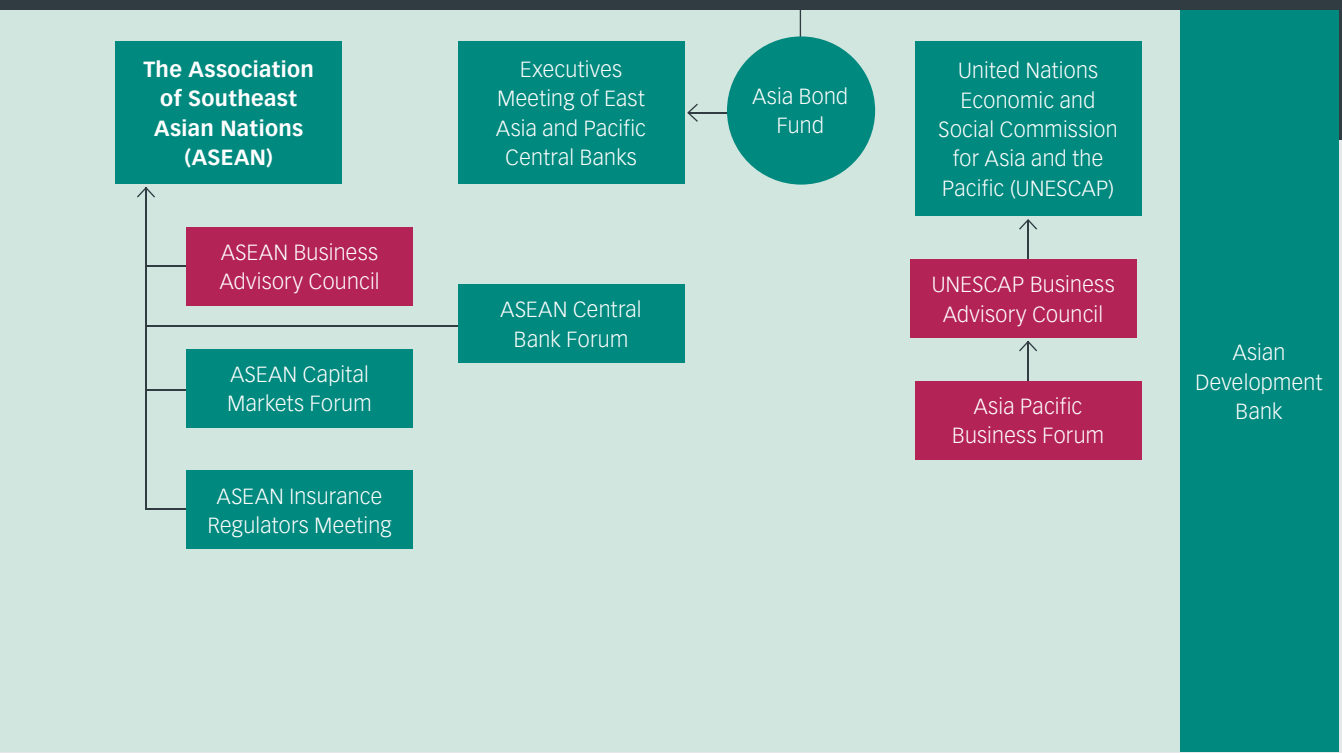
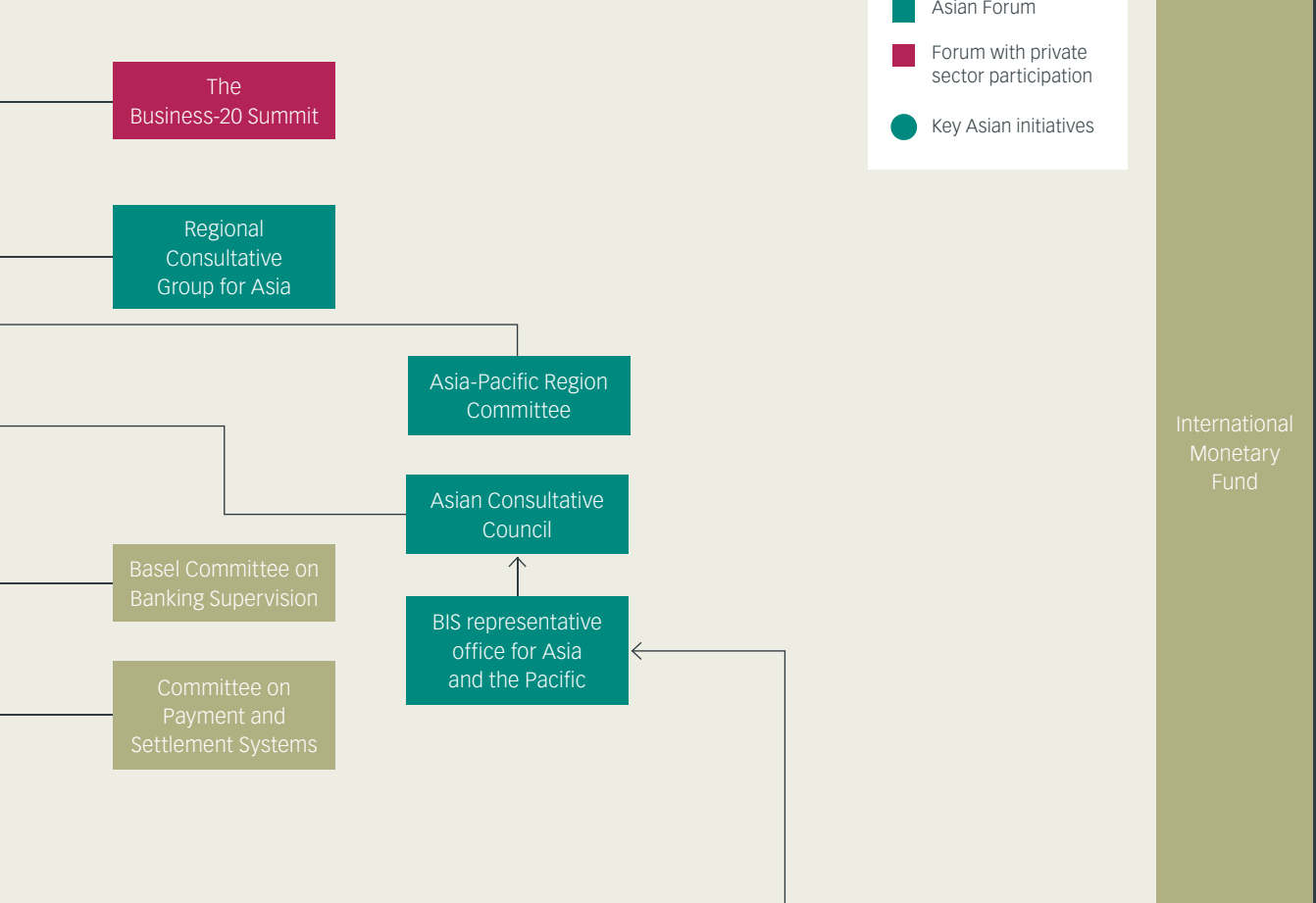
*This paper was prepared by the Australian Treasury.*

## International and regional financial market forums and initiatives



**LEGEND**

- International Forum
- Asian Forum
- Forum with private sector participation
- Key Asian initiatives



# Asian Bond Markets Initiative and the New Roadmap

## Summary

- The Asian Bond Markets Initiative (ABMI) was launched in December 2002 by ASEAN+3. Its aim is to foster the development of local currency bond markets as an alternative source of funding to short-term foreign currency loans to reduce the region's vulnerability to the sudden reversal of capital inflows.
- Highlights of the program include:
  - the issuance of local currency denominated bonds by the Asian Development Bank under the Asian Currency Note Program;
  - the establishment of the Credit Guarantee and Investment Facility (CGIF) to facilitate local currency bond issuance by providing guarantees;
  - the establishment of the Asian Bond Market Forum (ABMF) as a public-private platform to foster standardisation of market practices and harmonisation of regulations relating to cross-border bond transactions in the region;
  - the launch of the AsiaBondsOnline website which provides centralised access to information about the region's developing bond markets; and
  - research on the options and models for establishing a regional settlement intermediary, including a legal and business feasibility study.
- Key success factors have included: identification of appropriate objectives that members find compelling; commitment of individual member economies from the Minister level to the working level; continued communication with stakeholders on long-term perspectives; and the active role of core groups to lead and develop the discussion on specific topics.

*This paper was prepared by the Asian Development Bank.*



## Background on ABMI

ABMI was launched in December 2002 by ASEAN+3. Its aim is to foster the development of local currency bond markets as an alternative source of funding to short-term foreign currency loans in order to reduce the region's vulnerability to the sudden reversal of capital inflows, thereby helping to strengthen regional financial resilience.

Since its launch, ABMI has been discussing various issues on developing bond markets. Every three years, ASEAN+3 policy makers have developed a medium-term roadmap to accelerate the development of bond markets in the region. The roadmaps have been consistent with the Group of 8 (G8) action plan to support the development of local currency bond markets and each has been built on the progress made under ABMI and reforms undertaken by member countries.

Since 2008, the roadmap has focused on four key areas including: promoting issuance of local currency-denominated bonds; facilitating the demand for local currency-denominated bonds; improving the regulatory framework; and improving related infrastructure for the bond markets. To address specific topics and policy measures in the four key areas, four Task Forces were established (TF1 to TF4). The policy measures supported under each key area are adjusted every three years to address the immediate challenges relating to bond markets faced by ASEAN+3 policy makers.

## Progress under ABMI

Although it is difficult to measure the direct influence of ABMI on bond market development in the region, it is generally perceived that ABMI has contributed to the market by enhancing policy dialogues and information sharing on best practices, together with the policy measures taken by each national economy. Since the launch of ABMI, there has been a rapid growth in bond markets. The larger ASEAN+3 economies including the People's Republic of China (PRC), Indonesia, the Republic of Korea (Korea), Malaysia, Thailand, and the Philippines have issued bonds to finance their funding needs and have gradually lengthened the maturity of their bonds to provide a benchmark yield curve for corporate bonds. Local currency bond markets have now become an alternative source of funding for both the government and corporate sector in the region. They have helped to finance fiscal stimulus programs and meet the financing needs of governments and corporates, as witnessed during the recent financial market turmoil. Corporate bond markets in the PRC, Korea, and Malaysia have exceeded US\$100 billion, the estimated threshold set by the Bank for International Settlements (BIS) as the size required for a deep and liquid market.

As a result of continued policy dialogue since 2003 and especially in response to the Global Financial Crisis, ABMI has made significant progress in some areas. Highlights of progress are summarised below.

- **Asian Currency Note Program (ACNP):** Under its Medium-Term Note (MTN) Program, the Asian Development Bank (ADB) has issued local currency denominated bonds in a few ASEAN+3 countries. These issuances have used common disclosure standards and terms and conditions governed by a common law as steps towards the harmonisation of these standards for bond issuance among participating countries.
- **Credit Guarantee and Investment Facility (CGIF):** CGIF was established in 2010 to facilitate local currency bond issuance by providing guarantees. It has received 100 per cent of its paid-in capital in the amount of US\$700 million from ASEAN+3 economies and ADB. The business plan and risk management framework for CGIF have been approved by its Board of Directors. CGIF has been assigned a AA rating and could be upgraded to AAA with more experience. It is expected to issue its first guarantee in 2013.
- **ASEAN+3 Bond Market Forum (ABMF):** ASEAN+3 Finance Ministers endorsed the establishment of the Asian Bond Market Forum (ABMF) in May 2010 as a common platform to foster standardisation of market practices and harmonisation of regulations relating to cross-border bond transactions in the region. It is a public-private joint forum where most of the exchanges, depository bodies, market associations, and some of the capital market regulators of ASEAN+3 are gathering together with global and regional private market participants. ABMF is envisaged, not only to lead the region toward more harmonised and integrated markets, but also to act as the link between ASEAN+3 and the rest of the world in international standard-setting and rule-making.
- As a key output of the first (Phase 1) activity, ABMF published a comprehensive ASEAN+3 Bond Market Guide in April 2012, containing detailed information on market regulations and practices in 11 ASEAN+3 economies. ABMF is currently conducting Phase 2 activity, aiming to develop a regionally standardised bond issuance program named "ASEAN+3 Multi-currency Bond Issuance Framework (AMBIF)", and policy recommendations to streamline bond transaction flows. Key findings will be reported to the ASEAN+3 Finance Ministers and Central Bank Governors' meeting in May 2013.
- **AsianBondsOnline (ABO):** As an information hub, the ABO website has been online since May 2004. It

provides centralised access to information about the region's developing bond markets including data on current market activities and performance, legal and regulatory frameworks, and government policies and initiatives in ASEAN+3 economies. ABO has played an active role in reporting on local currency bond markets trends and developments, to help disseminate information about the region's bond markets to foreign investors. The information, data and analysis on the ABO website are also utilised to produce a quarterly publication, the Asia Bond Monitor (ABM).

- A Regional Settlement Intermediary (RSI): An in-depth study on the options and models for establishing an RSI has been conducted, including a legal and business feasibility study. Although it is expected to take some time to establish an RSI, discussions will continue.

## New Roadmap+ for ABMI

ASEAN+3 Finance Ministers tasked the Deputies to discuss how to further enhance the ABMI focusing on its objective, scope (including capital markets), and framework during their meeting in May 2011. Following the instruction given by the Ministers, ABMI members have reviewed the ABMI, including broadening the scope beyond bond markets.

Based on ABMI members' discussions, the Ministers approved a new roadmap for ABMI on 3 May 2012. Referred to as the "New Roadmap+", it aims to produce tangible and concrete outcomes and reinvigorate ABMI discussion. The New Roadmap+ reviewed the issues under ABMI with three basic directions: to produce tangible outcomes, current and critical ongoing issues were further developed; to strengthen the momentum for ABMI discussions, important but un-discussed issues relating to bond markets were to be added; and to meet and accommodate the changing global financial needs, including mitigation of volatility in capital flows, relevant issues were addressed. As a result, the New Roadmap+ identified the following nine priorities:

- launching the guarantee programs of CGIF;
- developing infrastructure-financing schemes (including the Lao-Thai project);
- fostering an investment-friendly environment for institutional investors and transmitting the ABMI knowledge to them;
- enhancing ABMF activities (including the Common Bond Issuance Program);
- facilitating the establishment of an RSI;
- further developing the government bond markets;
- enhancing financial access to consumers and small and medium enterprises (through securitisation);

- strengthening the foundation for a regional credit rating system; and
- raising financial awareness.

ABMI members are currently discussing a detailed work plan to implement the nine priority areas in the New Roadmap+. ADB will continue to work closely with ASEAN+3 to implement the New Roadmap+.

## Cooperation with other MDBs in support of bond market development

In light of the global economic slowdown which has significantly shrunk external sources of funding available for Africa, combined with the lack of fiscal space resulting from the financial crisis, the African Development Bank (AfDB), launched the African Financial Markets Initiative (AFMI) in 2008. The initiative is designed to develop the bond markets to meet the funding needs of AfDB member countries. AFMI was based on the lessons learned from ABMI. In November 2012, AfDB representatives asked ADB staff to share the lessons learned from ABMI with member countries of AfDB to assist them in designing their approach to implementing AFMI. The lessons include: how policy makers in emerging Asia have so rapidly and successfully developed the region's local currency bond markets; how ASEAN+3 policy makers decided on the structure of ABMI; how they have changed it over time to make it relevant; and what brings policy makers together to work on this regional initiative. Key success factors have included: the identification of appropriate objectives that members find compelling; commitment of individual member economies from the Minister level to the working level; continued communication with stakeholders on long-term perspectives; and the active role of core groups to lead and develop the discussion on specific topics.

At the 4th International Workshop on Developing Local Currency Bond Markets in Emerging Market Economies and Developing Countries, hosted by the Bundesbank, on 6-7 December 2012, representatives of the Inter-American Development Bank expressed strong interest in learning more about ABMI for knowledge sharing with their member countries in Latin America. Representatives from the Ministry of Finance of Turkey have also indicated that they would like to learn more about ABMI for further developing their local currency bond market.

For more information, please see A. Noy Siackhachanh, 2012, "Strengthening the financial system and mobilizing savings to support more balanced growth in ASEAN+3" *ADB Working Paper Series on Regional Economic Integration No 94*, March.

# The Asia Region Funds Passport

## Summary

- Establishment of an Asia Region Funds Passport was first recommended by the Australian Financial Centre Forum in its 2009 report to the Australian Government, *Australia as a Financial Centre: building on our strengths*. The concept was then put forward at an APEC Policy Dialogue in October 2010.
- The Passport will be designed specifically to benefit the region, including by providing cost effective funds intermediation, linking the growing pool of investors in the region to investment opportunities and unlocking savings and re-cycling Asian savings efficiently within Asia.
- The technical model for a pilot Passport is to be presented to APEC Finance Ministers at their September 2013 meeting. Industry will be consulted on the model in the first half of 2014.

*This paper was prepared by the Australian Treasury. It does not necessarily reflect the views of the Australian Treasury.*

## Background

The concept of the Asia Region Funds Passport was first put forward at an APEC Policy Dialogue in October 2010. The Passport will allow cross border marketing of funds between countries that agree to a common framework. In time, this will lead to greater integration of capital markets in the region.

The exploration of the concept began in November 2010 under the auspices of the APEC Finance Ministers Process (FMP). Since then, the progress made by this group has been acknowledged by Finance Ministers twice — at FMP meetings in 2011 and 2012. In the most recent Finance Ministers Communique from the Moscow meeting last year, Finance Ministers called on officials to further develop the pilot model and the governing arrangements.

## Benefits of a passport

The underlying concept of the Passport is similar to that of the European UCITS model, which is popular in several Asian economies. The development of a somewhat similar ASEAN scheme is additional evidence that the idea of a well-regulated cross-border funds trading regime is fundamentally sound. The Passport, and the ASEAN scheme, will be different to UCITS in that the regulatory framework will be designed in Asia.

The Passport will be designed specifically to benefit the region:

- to provide cost-effective funds intermediation, linking the growing pool of investors in the region to investment opportunities, which are also increasing in the region;
- to help develop capital markets by unlocking savings and re-cycling Asian savings efficiently within Asia;
- to help fund infrastructure investment in the region;
- to strengthen the capacity and expertise of the local funds management industry; and
- to boost local Asian employment in the industry.

The Passport is a real opportunity for economies in the Asian region to further develop the funds management industry in the region, providing greater choice and diversity for Asian investors.

## Progress to date

Since 2010 a high level technical model for the Passport has been developed through a series of six policy and technical workshops attended by representatives of 13 economies. The last workshop in Hanoi in December 2012 agreed to the overarching technical framework, but it became clear that more detailed work was needed to advance the model to a point where a pilot of the initiative could be implemented. Specifically, a number of

special rules need to be drafted for Passport funds. Work has also been undertaken on a governance framework for the Passport, to set out the underlying rules that govern conduct of the participating economies.

In December 2012 the Australian Treasury invited economies to join a Working Group on the Passport to further develop the technical rules. It was envisaged that the Working Group would comprise representatives from economies that in the short term were able to become participants in the Passport pilot when the model is put to APEC Finance Ministers in September 2013.

A Working Group was considered an efficient way of progressing the technical model, as it gives those participating economies the opportunity to shape the design. The task of the Working Group will be to refine and expand on the Passport model and its governance arrangements. It will also accelerate the development of the model and governance arrangements. Australia, New Zealand, Korea and Singapore are members of the Working Group.

The Working Group's output will be presented at the next policy and technical workshop on the Passport, to be held in June this year. This allows the broader group of economies to have input into the model before it is finalised.

After September, a consultation paper will be developed and jointly issued by the Working Group. It is expected that each participating economy will then engage with fund management industry representatives in their respective economies to obtain feedback about the workability of the proposed model. It is envisaged that consultation will occur throughout the first half of 2014 and be undertaken on an economy-specific basis.

The Working Group will then use feedback from the consultation to further refine the model before the Pilot is launched.

In the second half of 2014, regulators will work on implementing the Passport in their jurisdictions.

The Passport pilot is expected to commence in 2015, with membership comprised of a limited group of economies that possess a relatively high standard of financial regulation and oversight. Robust regulatory standards are a necessary prerequisite for Passport membership, given that its model is based fundamentally upon mutual recognition.

The pilot will provide operational experience with the Passport model, and may identify the need for minor refinements. Following implementation, the pilot phase will end and membership will be open to other qualifying economies.

In order to ensure that as wide a range of regional economies as possible are able to qualify for membership, Australia has been providing capacity building training to a number of targeted economies since 2010. It is intended that this continue throughout the Passport's pilot phase, greatly assisting those economies to qualify for Passport membership following completion of the pilot.

# The Asian Bond Fund Initiative

## Summary

- The Asian Bond Fund (ABF) Initiative was established in 2003 and was the result of cooperation among the 11 central banks and monetary authorities that take part in the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP). The Initiative set out to broaden and deepen Asian bond markets, for the purpose of enhancing financial stability and integration.
- The ABF Initiative has involved two broad phases: ABF1 and ABF2.
  - ABF1 was launched in June 2003 and involved the EMEAP members pooling together around US\$1 billion to invest in US dollar denominated bonds of Asian sovereign and quasi-sovereign issuers in EMEAP economies (except in the developed markets of Australia, Japan and New Zealand).
  - ABF2, which was launched in December 2004, involves the same types of issuers as ABF1, but the investments are in local currency denominated bonds. Investment in ABF2 is also open to private sector investors.
- To help gauge the effectiveness of the ABF Initiative in promoting the development of bond markets in the Asian region, EMEAP members commissioned the Bank for International Settlements (BIS) to carry out a third-party assessment.
- The BIS sees the ABF2 project as playing an important catalytic role in the development of bond markets in the region, although it noted that the significance of this role is hard to quantify. Some of the specific factors that BIS highlights are the role of the ABF2 project in accelerating tax reforms to exempt withholding tax of non-resident investors; enhancing the regulatory framework for exchange traded funds (ETFs); and further liberalisation of foreign exchange administration rules.
- The BIS also notes that further development in repo markets could assist in enhancing bond market liquidity.

*This paper was prepared by the Reserve Bank of Australia.*

## Introduction

The ABF Initiative was established in 2003 and was the result of cooperation among the 11 central banks and monetary authorities that take part in the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP).<sup>1</sup> The Initiative set out to broaden and deepen Asian bond markets, for the purposes of enhancing financial stability and integration.

Establishing the ABF required, not only investments by EMEAP central banks, but also regulatory and tax reforms in some member jurisdictions. It was also anticipated that individual EMEAP members would gain further insight from the process of establishing and monitoring the ABF, which could be used in determining additional measures for the development of local currency bond markets in the region. Specifically, it was noted that members could "work with the relevant authorities in their economies to improve market infrastructure by identifying and minimising the legal, regulatory and tax hurdles in their markets, thereby facilitating the creation of fixed income products in the region" (EMEAP, 2004).

Given that many factors contribute to market development, and that other regional initiatives were also in motion, it is difficult to accurately assess the contribution of the ABF Initiative. Nevertheless, an external assessment, carried out by the Bank for International Settlements (BIS), concluded that the ABF Initiative has played a catalytic role in the development of Asia's local currency bond markets through a number of channels (BIS, 2011). That being said, it was also noted that further work needs to be done, and that active secondary trading is yet to develop in some market segments, particularly for corporate bonds.

## Fund structure

The ABF Initiative has involved two broad phases: ABF1 and ABF2.

The first phase of the initiative, ABF1, was launched in June 2003 and involved the EMEAP members pooling together around US\$1 billion to invest in US dollar denominated bonds of Asian sovereign and quasi-sovereign issuers in EMEAP economies (except in the developed markets of Australia, Japan and New Zealand). Investment in ABF1 remains confined to EMEAP central banks.

From the inception of the ABF, the intention was always to have a second phase, ABF2, involving the same types of issuers as for ABF1 but with investments in local currency denominated bonds. Soon after the launch of ABF1, work began on establishing ABF2. The eventual launch of ABF2 took place in December 2004, with a total of US\$2 billion of investment by EMEAP central banks at that time.<sup>2</sup>

Importantly, unlike ABF1, investment in ABF2 is open to private sector investors. There are two components to

ABF2 — the Pan Asia Bond Index Fund (PAIF) and eight single-market funds — which were structured in order to cater for different types of investors, although both are passive, index-driven funds.<sup>3</sup> The PAIF invests in bonds across all eight East Asian markets, catering to investors who wish to have a well-diversified exposure to sovereign and quasi-sovereign bond markets across the region in a single, low cost investment. The single-market funds, in aggregate, hold a very similar bond portfolio to the PAIF. However, as individual funds they allow investors to tailor the composition of their investments across the region, and for smaller investors (such as retail investors) to invest in a portfolio of local bonds.

In order to encourage private sector participation in ABF2, a number of specific features were chosen for the funds:

- To lower transaction costs and management fees, and to facilitate ease of access, the funds were set up as passive, index-driven funds and were listed on stock exchanges where possible.
- To encourage retail investment, EMEAP members structured the funds in such a way as to help minimise the difference between the listed price of fund units and their net asset value (NAV). It was decided that, where possible, setting up the funds as open-ended bond exchange traded funds (ETFs) would help to facilitate this.
- Market makers were designated to support secondary market liquidity of the bond fund units.
- It was decided that the funds should be mandated to track transparent, representative and replicable benchmark bond indices. This involved the EMEAP Working Group on Financial Markets working with an independent index provider to construct such indices. An additional potential benefit of producing such indices was that private sector funds could also be set up to track these indices.
- To provide greater assurance to unit holders that good governance arrangements were in place, supervisory committees were set up where possible to oversee fund managers and trustees.

1 The EMEAP central banks include Australia, China, Hong Kong, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore and Thailand.

2 In order to ensure that EMEAP's holdings in the ABF qualify as foreign reserves, EMEAP's investments in the ABF are held through the BIS Investment Pool (BISIP) — a US-dollar denominated BIS investment vehicle that meets the key IMF criteria for reserve asset status of residence (by being a claim on the BIS and not a resident) and liquidity (by being able to make redemptions on demand in US dollars).

3 In terms of structure, EMEAP members' investment in the single-market funds is done via a parent fund (or Fund of Bond Funds).

## Assessment

To help gauge the effectiveness of the ABF Initiative in promoting the development of bond markets in the Asian region, EMEAP members commissioned the BIS to carry out a third-party assessment. Given the variety of factors that contribute to market development, and with other market development initiatives also at work, it is difficult to reach a definitive assessment of the contribution that the ABF Initiative has made to bond market development in the Asian region.

The BIS assessment, which was published in July 2011, considered key factors such as private sector participation in ABF2 and the contribution of ABF2 in enhancing bond market liquidity.

### Private sector (or non-EMEAP) investment in ABF2

The BIS considered that, although the ABF2 funds represented the successful introduction of a passively managed bond ETF — a relatively new asset class in Asia that also laid the foundation for broader investor participation in bond markets — the success of the ABF2 in getting non-EMEAP investment in the funds has been mixed. While non-EMEAP investment in the PAIF has steadily risen since inception, the single-market funds have not enjoyed quite the same success in attracting funds from private investors. This could reflect the relative preferences of the investors that the PAIF and single-market funds were targeted to.

### Bond market liquidity

The assessment of the BIS is that there has been a considerable improvement in Asian bond market liquidity since inception of ABF2, which it attributes to a number of factors, including: general growth of bond issuance and more concentrated issuance at a few benchmark maturities; the increase in market making activity; and reduced barriers to entry of non-resident investors.

The BIS argues that “in each of these factors, the ABF2 project seemed to play an important catalytic role, although the significance of this role is hard to quantify”. Some of the specific factors that they highlight are the

role of the ABF2 project in accelerating tax reforms to exempt withholding tax of non-resident investors; enhancing the regulatory framework for exchange traded funds (ETFs); further liberalisation of foreign exchange administration rules; improving regional market infrastructure and reducing cross-border settlement risk; promoting the use of international best practice for documentation; and introducing a set of credible, representative and transparent bond indices (although use of these has not become as well-established as for some other private sector indices).

Notwithstanding the observed improvement in bond market liquidity, the BIS sees further room for development. In particular, it argues that government bond markets would benefit from further openness to non-resident investors and that, despite the recent pickup in issuance, corporate bond markets remain relatively illiquid.

The BIS also notes that further development in repo markets could assist in enhancing bond market liquidity, as they allow market participants to take short positions and provide a market to fund bond positions. One of the issues highlighted is the lack of appropriate legal apparatus (master agreements and legal frameworks) to ensure that the cash lender would be able to take possession of the collateral in the event of default. Indeed, the development of the repo market was also highlighted as a goal by the EMEAP Working Group on Financial Markets in 2006. At that time, it was noted that “[t]he ‘buy-and-hold’ preference of Asian investors is identified as one of the main reasons behind the low level of liquidity of Asian bonds. EMEAP may assist member economies in developing repo and securities lending markets so as to make available the bond holdings of the ‘buy-and-hold’ investors for borrowing by other market participants” (EMEAP, 2006). This issue is currently on the agenda of the EMEAP Working Group on Financial Markets.



Session 8



# The Chiang Mai Initiative Multilateralisation

## Summary

- In the wake of the Asian financial crisis in the late 1990s, countries in the region saw the need for stronger regional financial cooperation to ensure speedy recovery and to prevent the crisis from recurring.
- Against this backdrop, the ASEAN+3 finance ministers and central governors adopted the Chiang Mai Initiative (CMI) in May 2000. The key feature of the CMI was bilateral currency swap arrangements between the central banks of the +3 countries and those of the ASEAN+3 members. Under the mechanism, a country in need of liquidity support is provided with the needed amount of money in US dollars or the currency of the other contracting country in exchange for its currency in the equivalent amount. The recipient country pays back the money at maturity and retrieves its currency. During the period 2001-09, a total of 16 such agreements (amounting to US\$87 billion) were made among the +3 countries, or between the ASEAN members and the +3 countries.
- Since then, subsequent ASEAN+3 Finance Ministers and Central Bank Governors' Meetings have extended the CMI to the CMI Multilateralisation (CMIM) and bolstered it progressively in various ways: by improving its crisis response capability; engaging more countries; introducing a joint decision-making system suited to the single contract; expanding the size of the swap arrangement and establishing an independent regional surveillance unit to ensure seamless operation of the regional financing arrangement. The unit, called the ASEAN+3 Macroeconomic Research Office (AMRO), was established in April 2011 and is headquartered in Singapore.
- In May 2012, amid increased uncertainties in the global economy, members committed to further strengthening the CMIM including by: increasing the size of the facility (from US\$120 to US\$240 billion) and the maturity period; introducing a crisis prevention function; and increasing the portion that is de-linked from the IMF.

*This paper was prepared by the Ministry of Strategy and Finance, Republic of Korea.*

## Background: The launch of the CMI

In the wake of the Asian financial crisis in the late 1990s, countries in the region saw the need for stronger regional financial cooperation to ensure speedy recovery and to prevent the crisis from recurring. They also shared the view that assistance from the advanced countries and international organisations such as the IMF was not sufficient to tackle the financial crisis, and that having a regional financing arrangement in place should be the top priority of the ASEAN+3 cooperation.

Against this backdrop, the heads of the ASEAN+3 gathered in Manila, the Philippines, in November 1999 and put forward “monetary and financial cooperation” as one of the most important tasks of ASEAN+3 financial cooperation. Under the initiative, they agreed to reinforce the self-help and support mechanism, and to set up a regional financing arrangement. Following the agreement, the finance ministers and central governors adopted, in May 2000, the Chiang Mai Initiative (CMI) under which the establishment of the regional financing arrangement was pursued.

The key feature of the CMI was bilateral currency swap arrangements between the central banks of the +3 countries and those of the ASEAN+3 members<sup>4</sup>. Under the mechanism, a country in need of liquidity

support is provided with the needed amount of money in USD or the currency of the other contracting country in exchange for its currency in the equivalent amount. The recipient country pays back the money at maturity and retrieves its currency. During the period 2001-09, a total of 16 such agreements (amounting to US\$87 billion<sup>5</sup>) were made among the +3 countries, or between the ASEAN members and the +3 countries.

## The launch of the CMIM

The ASEAN+3 Finance Ministers and Central Bank Governors’ Meeting in May 2009 agreed on the key elements of the CMIM, with the aim of addressing the weakness of the CMI and bolstering the crisis response capability. The CMIM was launched in March 2010, with the effectuation of the CMIM Agreement. The initiative was designed to increase the effectiveness of the existing CMI by: engaging more countries; introducing a joint decision-making system suited to the single contract; and expanding the size of the swap arrangement.

4 Already having the ASA(ASEAN Swap Arrangement) which amounted to \$2 billion, no bilateral arrangement was made separately among the 10 ASEAN members.

5 Masahiro Kawai, 2010, ‘From the Chiang Mai Initiative to an Asian Monetary Fund’, ADB Institute.

## Key Points of CMIM Agreement<sup>6</sup>

**Basic Objective:** The basic objectives of CMIM Agreement are to address short-term liquidity difficulties in the region; and to supplement the existing international financial arrangements.

**CMIM Contract Parties:** The CMI had Korea, China, Japan and the five ASEAN countries (Thailand, Malaysia, Indonesia, Singapore and the Philippines) as its members but was expanded to include all the ASEAN+3 countries, plus the Hong Kong Special Administrative Region (Hong Kong SAR), China. The contract parties of the CMIM are finance ministries and central banks of the ASEAN+3 countries and the Hong Kong Monetary Authority.

**Total Size:** US\$120 billion

**Drawing:** Each drawing of liquidity support is made in the form of the bilateral swap arrangement. The central banks of ASEAN+3 countries as well as Monetary Authority of Hong Kong, China are to swap their local currencies with US dollars for an amount up to their contribution multiplied by their respective purchasing multiples.

**Decision Making:** Fundamental issues (total size of CMIM, contribution of each CMIM party etc) for the CMIM are to be determined by a consensus approval at the Ministerial Level Decision Making Body (MLDMB),

which consists of ASEAN+3 Finance Ministers. Executive level issues (initial execution of drawing, renewal of drawing, events of default) are to be determined by a two-thirds majority at the Executive Level Decision Making Body (ELDMB), which comprises the deputy-level representatives of ASEAN+3 Finance Ministries and Central Banks and Monetary Authority of Hong Kong, China. Two coordinating countries will be appointed to coordinate the swap activation process when a request for drawing is made. They shall be the two co-chairs of the ASEAN+3 Finance Minister Process, one from ASEAN member countries and the other from China, Japan and Korea.

**Conditions, Precedent and Covenants:** A CMIM party which makes a request for drawing has to meet conditions (such as the completion of a review of its economic and financial situation and no events of default) before the voting for a swap request. As well, each CMIM party is requested to comply with covenants such as submission of the periodic surveillance report and participation in the ASEAN+3 Economic Review and Policy Dialogue.

6 Summarised from the Joint Ministerial Statement of the 13th ASEAN+3 Finance Ministers’ Meeting (May 2010).

## The establishment of AMRO

As the CMI expanded to the CMIM, members of ASEAN+3 agreed on the need to set up an independent regional surveillance unit that would ensure seamless operation of the regional financing arrangement. Under the agreement, the members established the ASEAN+3 Macroeconomic Research Office (AMRO), headquartered in Singapore, in April 2011.

The work of AMRO is undertaken largely on two fronts. In normal times, it conducts surveillance of the macroeconomic condition of the regional economies through consultation visits, the results of which are reported to the ASEAN+3 Deputies' Meeting. In the event that a country requests liquidity support, it analyses the macroeconomic conditions of the requesting country to assist the CMIM decision-making body. It also makes sure that the requesting country complies with the terms of the drawing and supports them in implementing appropriate macroeconomic policies — reducing the potential moral hazard created by the existence of the facility.

## The expansion of the CMIM

Amid increased uncertainties in the global economy, ASEAN+3 countries agreed that the region needs a stronger regional financial safety net. It was with this background that the finance ministers and central bank governors of the ASEAN+3 committed to strengthening the CMIM at the Manila meeting in May 2012.

As the financial crisis spread globally at a faster pace than ever, countries began to put more emphasis on

measures to prevent the crisis in advance. Under that shared recognition, members of the ASEAN+3 countries decided to introduce a crisis prevention program that provides liquidity before the crisis eventuated to the existing CMIM, which previously focused only on providing liquidity support after the crisis hit. In order to protect countries that resort to the prevention program from being unduly stigmatised, members came up with the “five qualification criteria”<sup>7</sup> which can be applied flexibly by the decision of the Executive-level Decision Making Body (ELDMB), in a way that accommodates the specific conditions of each individual country.

Members also agreed to double the size of the CMIM from US\$120 billion to US\$240 billion, taking into account the volume of the regional trade and GDP. They also agreed to extend the maturity of the liquidity support and the maximum supporting period.

Meanwhile, under the CMIM, drawing of the fund is linked to that of the IMF<sup>8</sup> as a measure to prevent a moral hazard in relation to the liquidity-requesting country and to enhance the ability to detect crises. As the region's capacity to monitor the regional macroeconomic conditions strengthens, in particular with the establishment of AMRO, members consented to increase the IMF de-linked portion from 20 to 30 per cent, with a view to increasing it to 40 per cent in 2014.

7 Five qualification criteria: (i) external position and market access; (ii) fiscal policy; (iii) monetary policy; (iv) financial sector soundness and supervision; and (v) data adequacy.

8 To a certain amount (the set IMF de-linked portion), the CMIM swap requesting country is allowed to receive liquidity support without linking to the IMF's liquidity supporting program. However, if the country is to receive above that amount, it should be linked to the IMF's program.

## Key Points for Strengthening the CMIM<sup>9</sup>

**Size:** The total size of the CMIM has doubled from US\$120 billion to US\$240 billion, while keeping the existing shares of contributions and voting power among the member countries the same.

### Crisis Prevention Function (CPF)

**Name:** “CMIM Precautionary Line (CMIM-PL)” has been adopted for the newly introduced crisis prevention facility; and “CMIM Stability Facility (CMIM-SF)” has been adopted as the name for the existing Crisis Resolution Mechanism.

**Qualifications and Conditionality:** Executive Level Decision Making Body (Deputies' Level) can flexibly apply the five qualification criteria, which are stipulated below, as ex-ante qualifications and ex-post conditionality, after considering the economic reports by the requesting country and analyses by AMRO/ADB/IMF as the basis for the decision.

**IMF De-linked Portion:** The IMF de-linked portion has increased to 30 per cent in 2012, with a view to increasing it to 40 per cent in 2014 subject to review should conditions warrant.

**Maturity, supporting period:** Regarding the IMF-linked portion, the maturity period has been lengthened from 90 days to one year with two renewals, totalling up to three years in the supporting period. In relation to the IMF de-linked portion, the maturity period has been extended from 90 days to six months with three renewals, totalling up to two years in the supporting period.

9 Summarised from the Joint Ministerial Statement of the 15th ASEAN+3 Finance Ministers' Meeting (May 2012).

## Future plans

Members of the ASEAN+3 countries are committed to further developing the CMIM and AMRO. Members of the CMIM are working on an operational guideline to ensure timely support in case of crises, while seeking to strengthen cooperation with such international financial organisations as the IMF and the World Bank. In relation to AMRO, efforts are being made to expand its organisational capacity and upgrade its legal status as an international organisation to boost its surveillance capacity.



"I welcome ABAC and the business community's willingness to assist the development of markets in the Asia-Pacific region."

Dr Martin Parkinson PSM, Secretary,  
Australian Treasury.

# The Asia Pacific Financial Forum

*This paper was prepared by the APEC Business Advisory Council prior to the Symposium.*

## A regional platform for enhanced public-private collaboration in developing the region's financial markets

The current global economic situation underscores the compelling rationale for the development of sound and integrated financial markets in the region. Given the present situation in North America and Europe, global economic recovery and the resumption of previous levels of growth will hinge on the continued rapid development of emerging markets in coming years, particularly in Asia, where savings are abundant. However, the underdevelopment of the region's financial markets, unless addressed, is bound to pose a serious constraint to the future growth of Asia and, consequently, to regional and global economic growth as well.

In most of Asia, financial market infrastructure remains inadequate to effectively support the region's next stage of growth and in particular, to meet the enormous challenges of financing the region's growing urban infrastructure and the needs created by demographic pressures on health, education, ageing and retirement. Emerging Asian financial systems are also much less integrated with each other than with existing

global financial centres, particularly those of North America and Western Europe, as evidenced by the fact that industrialised markets account for roughly three quarters of Asia's total holdings of equity securities and over 90 per cent of debt securities.

In the context of Asia's rapidly growing share of global economic activity, this overwhelming preference for Western assets reflects the underdevelopment of the region's financial markets.<sup>10</sup> It also reflects the opportunities that the region's economies are missing in not developing these markets more effectively.

Regional financial integration is important for the development of the region's emerging financial markets, to allow them to fully support the financing of the region's economic and social needs. As long as these markets are fragmented, it will remain difficult to attract market players to participate in a more meaningful way. Building regionally integrated financial markets would involve three important undertakings.

First, the development of most of the region's financial markets needs to be accelerated.

Second, operating simultaneously in multiple markets should be made easier and less costly for market players through convergence and/or greater mutual recognition of standards, regulations and practices.

<sup>10</sup> This reality is most evident when emerging Asia (Asia ex-Japan) as a group is compared with the US and the EU. While accounting for roughly a quarter of the world's GDP (comparable to the US and the EU) and more than half of the world's total population, emerging Asia lags far behind the US and the EU in terms of their shares in global financial markets — only about 10 per cent of funds under management and less than 10 per cent of the markets for debt securities and interest rate derivatives.

Third, regulations and market infrastructure to facilitate cross-border transactions need to be developed.

Key to developing the region's financial markets is the emergence of integrated and diverse funding markets, particularly the debt securities and derivatives markets, which are needed to address the region's continuing over reliance on bank funding. This will require the further development of market infrastructure and regulatory frameworks, including those related to credit ratings, as well as the pension funds and insurance industries that are vital for the recycling of savings and the sustained growth of markets for long-term securities and infrastructure finance.

The development, evolution and integration of markets should also go hand-in-hand with efforts to ensure the continued soundness of financial systems. The recent crises in the US and Europe underscore the importance of regulation and supervision keeping pace with rapidly-changing markets. This is expected to be a major challenge for the region's regulators, which must avoid the temptation to agree on the lowest common denominator for the sake of facilitating integration and ensure that regulatory convergence leads to stronger financial systems.

This has significant implications for the region's participation in global financial regulatory reform and standard-setting processes. As the financial systems and markets of the region evolve to meet the rapidly-changing needs of its economies and peoples, it is important to ensure that regulatory frameworks and market infrastructure are, and will be, supportive of dynamically evolving structures and needs in the Asia-Pacific region as well.

These require closer regional collaboration among public and private sectors to develop a deeper understanding of the region's evolving financial systems and the standards, regulations and practices needed to support sound and efficient markets. This is crucial in facilitating the continued growth of the region's economies. Such collaboration should aim to facilitate integration among markets in the region, the convergence of standards and practices, and common approaches in shaping global financial regulatory reforms, in partnership with the G20, and in collaboration with international financial institutions and key organisations such as the Basel Committee on Banking Supervision, IOSCO, the OECD and the Financial Stability Board.

In November 2011, APEC Finance Ministers in Honolulu pledged to take coordinated action to strengthen global recovery, reinforce financial stability, maintain open markets and build a foundation for strong, sustainable and balanced growth. Ministers welcomed ABAC's recommendation on improving collaboration among financial regulators to help promote regional financial market integration and enhanced efficiency in capital markets.

Taking up that challenge, ABAC and partner institutions convened a forum in March 2012 in Melbourne, Australia, attended by senior representatives from financial authorities, the region's financial industry and key international bodies. The issues identified in the Forum suggested that the region would greatly benefit from an overarching framework for enhanced regional public-private collaboration that can effectively complement various ongoing regional initiatives to help the region develop sound, efficient and integrated financial markets.

This collaborative framework, named the Asia-Pacific Financial Forum (APFF) is envisioned to be a platform for public private sector collaboration in:

- the development of robust financial markets across the region; the convergence of financial standards, regulations and practices; and connectivity for facilitating cross-border financial flows, to create dynamic and integrated financial markets that will support the region's sustained rapid growth; and
- shaping global financial regulatory reforms in support of the region's financial development goals, through coordination of views on agreed areas of common regional concern and ensuring that these concerns are adequately reflected in global financial standards and regulations.

It is proposed that the APFF be open to participation from interested relevant bodies, including finance ministries, central banks and financial regulators from APEC economies, multilateral and international institutions and standard setters, regional and international financial industry groups, major financial institutions and leading academic experts. It would utilise the strengths of APEC, particularly the strong engagement of the private sector, to identify measures that support and complement ongoing efforts, fill in gaps and help overcome the fragmentation of the region's markets. It would be a multi-year informal pathfinder initiative to be coordinated in partnership among ABAC and interested relevant multilateral organizations and private and public sector bodies, including the APEC Finance Ministers process or individual finance ministries.

Through the APFF, ABAC will seek to expand constructive private sector engagement with the public sector. ABAC believes that such a structure will facilitate more active and regular collaboration of experts representing investors in long-term debt instruments such as major insurance companies and pension funds, in addition to banks and other financial intermediaries from throughout the region.

The APFF is envisioned as a framework for enhanced regional public private collaboration to promote the development, convergence and connectivity of markets in the region, as well as to help develop global financial regulatory standards that are compatible with the region's needs. The APFF is intended to support, enhance and assist in the development of the region's financial markets, without unnecessarily duplicating the work of other institutions and organisations, including ongoing regional collaboration to develop bond markets.

Welcoming intensive public-private collaboration in developing the region's financial systems, the APEC Finance Ministers in their 2012 Joint Statement expressed support for holding a symposium in early 2013 to explore the creation of the APFF. The Australian Government committed to host the symposium. The symposium will seek to develop concrete ideas on the structure, participation and future activities of the Forum, and how these activities can be coordinated with other ongoing regional initiatives. The outcomes of the symposium will serve as the basis for the way forward to be discussed with ABAC at the next Finance Ministers' Meeting in Bali in September 2013.

# Acknowledgements

Thank you to the following for their generous contributions towards the Sydney Symposium and this publication:





## The Symposium Event Team:



Jim Murphy, Executive Director; Irene Sim, General Manager;  
Project Leader, Sue Bonnett; Team Members: Philippa Henty, Simon Milnes, Tim Andri,  
Ashley George, Judy Poon, Cate Le Mesurier, Jarek Kowcza, Tim Watson, Diana Zeleny, Brendan Reilly.

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The design of this publication uses the vibrant colours from the Symposium to form a graphic that reflects the stockmarkets, technology and ideas. Throughout this publication individual colours transform and come together to depict connectivity.





