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Regional Financial Regulation in Asia

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Abstract

The Asian financial crisis (1997–1998) and the global financial crisis (2007–2009) highlighted the potential value of financial regionalism, i.e., regional-level cooperation in financial policy. This paper argues that there is a mediating role for regional-level institutions of financial regulation between national regulators in Asia and global-level institutions such as the International Monetary Fund and the Financial Stability Board. This potential role includes: (i) monitoring financial markets and capital flows to identify regional systemic risks such as capital flows; (ii) coordinating financial sector surveillance and regulation to promote regional financial stability; and (iii) cooperating with global-level institutions in rule formulation, surveillance and crisis management. This is particularly important in an environment of increasing financial integration and harmonization in the region.

The paper considers experiences of the European Union (EU) and Asia in regional financial cooperation and regulation and draws lessons for Asia. The EU represents the most advanced stage of regional financial integration and regulation in the world today, and can provide valuable lessons for Asia. Asia's greater diversity of financial development and openness requires a more nuanced approach to integration. Despite its shortcomings and slow pace, the Association of Southeast Asian Nations (ASEAN) Economic Community process probably provides the most feasible and relevant model for regulatory cooperation on a voluntary basis. It would be desirable to extend this framework further in Asia, say to the ASEAN+3 countries for a start. Asian economies can also strengthen existing surveillance processes; enhance and diversify the resources, functions and membership of the Chiang Mai Initiative Multilateralization and the Macroeconomic Research Office for surveillance and provision of a financial safety net; and create an Asian financial stability dialogue to monitor regional financial markets, facilitate policy dialogue and cooperation, and secure regional financial stability.

JEL Classification: F33, F36, G15, G18, G28

Contents

1. INTRODUCTION

This paper examines the potential roles and institutional implementation of regional financial regulation in Asia. National-level financial surveillance and regulation continue to be the workhorse and the first line of action for preserving financial stability. Under the auspices of the Group of Twenty (G20) following the global financial crisis of 2007–2009, there has been an attempt to forge a global consensus on financial reform measures based on proposals made by the Financial Stability Board (FSB), and to strengthen the role of the International Monetary Fund (IMF) both as a surveillance unit and as a global financial safety net. In this paper we argue that there is a mediating role for regional-level institutions of financial regulation in Asia. This role includes: (i) monitoring financial markets and capital flows to identify regional systemic risks such as capital flows; (ii) coordinating financial sector surveillance and regulation to promote regional financial stability; and (iii) cooperating with global-level institutions in rule formulation, surveillance, and crisis management.

The Asian financial crisis (1997–1998) highlighted the potential value of financial regionalism, i.e., regional-level cooperation in economic and financial policy. Many economies in the region found themselves subject to similar shocks and contagion, leading to volatile capital movements and the risk of "sudden stops" and reversals of capital flows. The move of the Association of Southeast Asian Nations (ASEAN) member states toward economic and financial integration, known as the ASEAN Economic Community (AEC) is one manifestation of this. [1] Another important development was the creation of the Chiang Mai Initiative (CMI) in 2000 as a regional financial safety net based on bilateral currency swap arrangements, which eventually was transformed into a multilateralized form—the Chiang Mai Initiative Multilateralization (CMIM). The Economic Review and Policy Dialogue (ERPD), established in 1999 under the auspices of the ASEAN+3 finance ministers' meeting, provided a forum for discussing regional economic and financial policy issues. [2]

The global financial crisis of 2007–2009 and the subsequent eurozone sovereign debt and banking sector crisis of 2011–2012 added to the urgency for greater financial cooperation by providing reminders of the vulnerability of Asian economies to shocks emanating from the global financial market. Moreover, one of the key lessons of the eurozone crisis is that greater financial market integration requires greater integration of financial regulation and supervision as well. These developments led to the creation of the ASEAN+3 Macroeconomic Research Office (AMRO) under the process of ASEAN+3 finance ministers and central bank governors to monitor economic and financial risks in the region.

Other factors contributed as well. First, the rising regional economic and financial interdependence in Asia, including ASEAN, the People's Republic of China (PRC), Japan, and the Republic of Korea, as a result of the establishment of supply chain networks and financial liberalization, raised correlations of economic and financial activity in the region. Second, the presence of large global or regional financial firms in the region increased the risk of spillovers and contagion, and calls for a more coordinated approach to supervision, including the establishment of supervisory

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[1] The ASEAN members are Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam.

[2] ASEAN+3 includes the 10 ASEAN member states plus the People's Republic of China (PRC), Japan, and the Republic of Korea.

colleges.[3] Third, although the global financial crisis stimulated a wave of new financial regulation under the auspices of the G20, the agenda was still very much driven by issues in developed economies. A global regulatory approach of "one size fits all" may not be appropriate for Asia, which increases the need for Asian economies to articulate their viewpoints in global forums like the FSB and the G20. Finally, a large body of literature suggests that financial development and integration can benefit economic growth,[4] and increased regional regulatory harmonization and mutual recognition can both support this process and reduce systemic risks associated with it.

Financial regulation encompasses three broad aspects: ensuring that all market participants understand the risks they face and take on only those they are capable of coping with in order to promote efficient allocation of credit; protecting consumers from unfair and fraudulent practices; and maintaining systemic stability by monitoring common risk exposures, the solvency of individual institutions, the proper functioning of markets, the operation of the payment and settlement structures, and the levels of a variety of buffers that provide comfort to participants (Fullenkamp and Sharma 2012). The experience of the global financial crisis showed that maintaining systemic stability requires both microprudential and macroprudential regulatory approaches. This paper focuses mostly on the systemic stability aspects, since this is arguably where regional cooperation probably can make the largest contribution.

Although financial integration efforts in Asia, even in ASEAN, are much more modest than those in Europe, the basic goal of increased integration has been well established, especially among ASEAN countries under the AEC. This points fundamentally to the need for greater regional regulatory cooperation between ASEAN and ASEAN+3 economies to reduce risks associated with greater integration.[5] Since regional financial integration is most advanced in Europe, its experience should provide valuable lessons (both positive and negative) for Asia. Nonetheless, the levels of economic and financial development and financial integration in Europe and Asia are much different. Asian economies encompass much greater diversity in terms of economic development, institutional capacity, and financial market depth and openness than do European economies. This suggests that the European experience represents an important reference point, but not a template or a benchmark, and that the appropriate level of financial regulatory cooperation and kinds of regional institutions will differ substantially from those that have developed in Europe.

This paper is organized as follows. Section 2 compares and contrasts economic and financial development and financial integration in Europe and Asia. Section 3 examines the experience of regional financial regulation, focusing on that of Europe, the region where economic and financial integration has progressed most. Section 4 discusses the experience of regional financial cooperation and regulation in Asia. Section 5 identifies various challenges of regional financial regulation and provides recommendations for strengthening institutions of regional financial regulation. Section 6 concludes.

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[3] The eurozone sovereign debt and banking sector crisis has led to increased calls for EU-wide supervision of major financial institutions, e.g., Barroso (2012).

[4] See, e.g., King and Levine (1993); Cecchetti and Kharroubi (2012); Levine (2005); Beck, Levine, and Loayza (2000); Rajan and Zingales (1998). Whether this effect is causal or not remains controversial, especially in light of the role of financial innovation (Rodrik 2008; Schularick and Steger 2010).

[5] Such efforts could eventually be extended to other parts of Asia as well.

2. COMPARISON OF ECONOMIC AND FINANCIAL DEVELOPMENT IN EUROPE AND ASIA

This section compares the levels of economic and financial development, financial integration, and institutional quality in Europe and Asia. The aim is to provide perspectives about the relevance of Europe's experience to that of Asia, and to identify where different approaches may be desirable. The trend to financial integration in Europe accelerated around 1990, including the deregulation of capital movements within the European Monetary System (EMS) economies in 1988 and the adoption of the Maastricht Treaty and the decision in 1992 to establish the Economic and Monetary Union (EMU). Therefore, we believe it is appropriate to compare conditions in Europe at that time with current conditions in Asia to gauge the potential for regional financial integration and regulatory cooperation.

2.1 Economic Development

Table 1 compares levels of per capita real gross domestic product (GDP) in the European Union 15 (EU15), i.e., EU member countries in 1990 plus Austria, Finland, and Sweden, versus those in the ASEAN+3 economies in 2012. The data are shown in 1990 Geary–Khamis dollars to make them comparable.[6] Clearly, economic conditions were much more uniform in Europe in 1990 than in Asia in 2012. Interestingly, the unweighted average real income levels were not that different—US$15,600 for Europe versus US$12,300 for Asia—but the population-weighted average is less than half in Asia, reflecting the large population weights of the PRC and India. Also, the dispersion in Europe was much less, with a standard deviation of US$3,400 versus US$10,000 for the Asian economies. The minimum income level in Europe was US$10,000 versus only US$2,700 for Asia.

[6] The Geary–Khamis dollar is a hypothetical unit of currency that has the same purchasing power parity that the United States (US) dollar has in the US at a given point in time. The data are obtained from the Conference Board Total Economy Database, January 2013, http://www.conference-board.org/data/economydatabase/.

Table 1: Real per Capita Gross Domestic Product in Europe and Asia
(1990 Geary–Khamis Dollars)

EU15 Countries, 1990		ASEAN+6, 2012	
Country	**GDP per Capita**	**Country**	**GDP per Capita**
Austria	16,895	Australia	26,356
Belgium	17,197	Brunei Darussalam	27,273
Denmark	18,452	Cambodia	2,702
Finland	16,866	PRC	8,631
France	17,647	India	3,690
Germany	16,306	Indonesia	5,207
Greece	10,015	Japan	22,002
Ireland	11,818	Rep. of Korea	22,879
Italy	16,313	Lao PDR	3,127
Luxembourg	23,028	Malaysia	10,733
Netherlands	17,262	Myanmar	4,248
Portugal	10,826	New Zealand	18,915
Spain	12,055	Philippines	3,178
Sweden	17,069	Singapore	29,851
United Kingdom	16,430	Thailand	9,677
		Viet Nam	3,504
Simple Average	15,879	**Simple Average**	12,623
Population-Weighted Average	15,850	**Population-Weighted Average**	7,131
Standard Deviation	3,377	**Standard Deviation**	10,089

ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; EU15 = The 15 Member States of the European Union (EU) as of 31 December 2003, before the new Member States joined the EU (the 15 Member States are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom); GDP = gross domestic product.

Note: Figures for Brunei Darussalam and Lao PDR are estimated using Geary–Khamis conversion factors for Singapore and Cambodia, respectively.

Sources: The Conference Board Total Economy Database, January 2013, http://www.conference-board.org/data/economydatabase/; Asian Development Bank. 2013. *Key Indicators for Asia and the Pacific 2013*. Manila: ADB.

2.2 Financial Development

Financial development is frequently measured by the ratio of total financial assets to GDP, since capital deepening generally accompanies economic development. Table 2 shows the levels and standard deviations of the ratios of private bank credit to GDP for the two regions. The average ratio for Europe in 1990 was actually lower than in Asia in 2011—69% versus 75%—and the gap in the GDP-weighted averages was even larger. However, the standard deviation was much lower—25% versus 45%—indicating a smaller diversity of development.

Table 2: Ratio of Bank Private Credit to Gross Domestic Product in Europe and Asia

EU15 Countries, 1990		ASEAN+6, 2011	
Country	**Bank Private Credit/ GDP (%)**	**Country**	**Bank Private Credit/GDP (%)**
Austria	85.7	Australia	121.2
Belgium	35.8	Brunei Darussalam	32.6
Denmark	50.2	Cambodia	26.8
Finland	82.3	PRC	121.5
France	89.6	India	47.2
Germany	88.1	Indonesia	25.4
Greece	34.1	Japan	105.7
Ireland	45.3	Rep. of Korea	98.4
Italy	52.8	Lao PDR	22.0
Luxembourg	110.4	Malaysia	106.4
Netherlands	77.2	Myanmar	8.2
Portugal	48.0	New Zealand	143.9
Spain	76.7	Philippines	29.8
Sweden	53.8	Singapore	104.2
United Kingdom	108.5	Thailand	101.9
		Viet Nam	107.7
Simple Average	69.2	**Simple Average**	75.2
GDP-Weighted Average	79.2	**GDP-Weighted Average**	102.3
Standard Deviation	25.1	**Standard Deviation**	45.3

ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; EU15 = The 15 Member States of the European Union (EU) as of 31 December 2003, before the new Member States joined the EU (the 15 Member States are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom); GDP = gross domestic product.

Sources: World Bank Global Financial Development database. http://data.worldbank.org/data-catalog/global-financial-development; for Lao PDR, CEIC Database https://ceicdata.com; for Myanmar, IMF (2013).

Table 3 shows total bond issues outstanding for the two regions, including both domestic and international issues. The simple average level was somewhat higher in Europe—69% versus 59%—but the GDP-weighted average was much lower. Again, the standard deviation was only about half of that in Asia. Viet Nam and Myanmar in particular stand out with a ratio of only 2%–3%.

Table 3: Ratio of Total Bonds Outstanding to Gross Domestic Product in Europe and Asia

EU15 Countries, 1990		ASEAN+6, 2011	
Country	**Outstanding Bonds/GDP (%)**	**Country**	**Outstanding Bonds/GDP (%)**
Austria	52.7	Australia	126.5
Belgium	141.5	Brunei Darussalam	N/A
Denmark	151.5	Cambodia	N/A
Finland	38.8	PRC	47.0
France	72.8	India	34.5
Germany	59.6	Indonesia	16.8
Greece	41.5	Japan	263.5
Ireland	54.7	Rep. of Korea	118.2
Italy	102.5	Lao PDR	N/A
Luxembourg	62.9	Malaysia	127.4
Netherlands	62.0	Myanmar	3.3
Portugal	40.6	New Zealand	36.2
Spain	39.3	Philippines	48.7
Sweden	77.9	Singapore	55.4
United Kingdom	37.5	Thailand	65.8
		Viet Nam	2.3
Simple Average	69.1	**Simple Average**	59.1
GDP-Weighted Average	68.1	**GDP-Weighted Average**	119.1
Standard Deviation	36.1	**Standard Deviation**	70.5

ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; EU15 = The 15 Member States of the European Union (EU) as of 31 December 2003, before the new Member States joined the EU (the 15 Member States are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom); GDP = gross domestic product; N/A = not available.

Note: Since values for countries with data not available are likely to be small, the averages and standard deviation were calculated assuming zero values for those countries.

Sources: World Bank Global Financial Development Data database, http://data.worldbank.org/data-catalog/global-financial-development; CEIC Database https://ceicdata.com.

Table 4 shows the ratio of stock market capitalization to GDP. The average ratio for the European countries in 1990 was only about half of the Asian level in 2011 in both unweighted and weighted terms, but the standard deviation was also much lower. Interestingly, Greece, Austria, Portugal, and Italy had lower stock market levels in 1990 than did Viet Nam in 2011.

Table 4: Ratio of Stock Market Capitalization to Gross Domestic Product in Europe and Asia

EU15 Countries, 1990		ASEAN+6, 2011; ASEAN+6, 2011	
Country	**Stock Market Capitalization/GDP (%)**	**Country**	**Stock Market Capitalization/GDP (%)**
Austria	11.6	Australia	103.5
Belgium	38.0	Brunei Darussalam	0
Denmark	31.9	Cambodia	0.3
Finland	20.9	PRC	58.8
France	30.0	India	69.7
Germany	18.7	Indonesia	45.1
Greece	11.3	Japan	68.8
Ireland	38.1	Rep. of Korea	96.2
Italy	15.2	Lao PDR	7.4
Luxembourg	89.6	Malaysia	144.1
Netherlands	51.7	Myanmar	0
Portugal	13.8	New Zealand	40.1
Spain	24.6	Philippines	73.9
Sweden	48.0	Singapore	148.1
United Kingdom	87.1	Thailand	81.7
		Viet Nam	15.4
Simple Average	35.4	**Simple Average**	59.6
GDP-Weighted Average	34.1	**GDP-Weighted Average**	69.8
Standard Deviation	25.0	**Standard Deviation**	48.3

ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; EU15 = The 15 Member States of the European Union (EU) as of 31 December 2003, before the new Member States joined the EU (the 15 Member States are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom); GDP = gross domestic product.

Note: Ireland data is for 1995, Cambodia data is for April 2012 (initial public offering), and Lao PDR data is for January 2012. Brunei Darussalam and Myanmar do not have stock markets.

Sources: World Bank Global Financial Development Data database, http://data.worldbank.org/data-catalog/global-financial-development; Lanexang Securities Public Company 2013; Cambodia Securities Exchange, http://www.csx.com.kh/main.do.

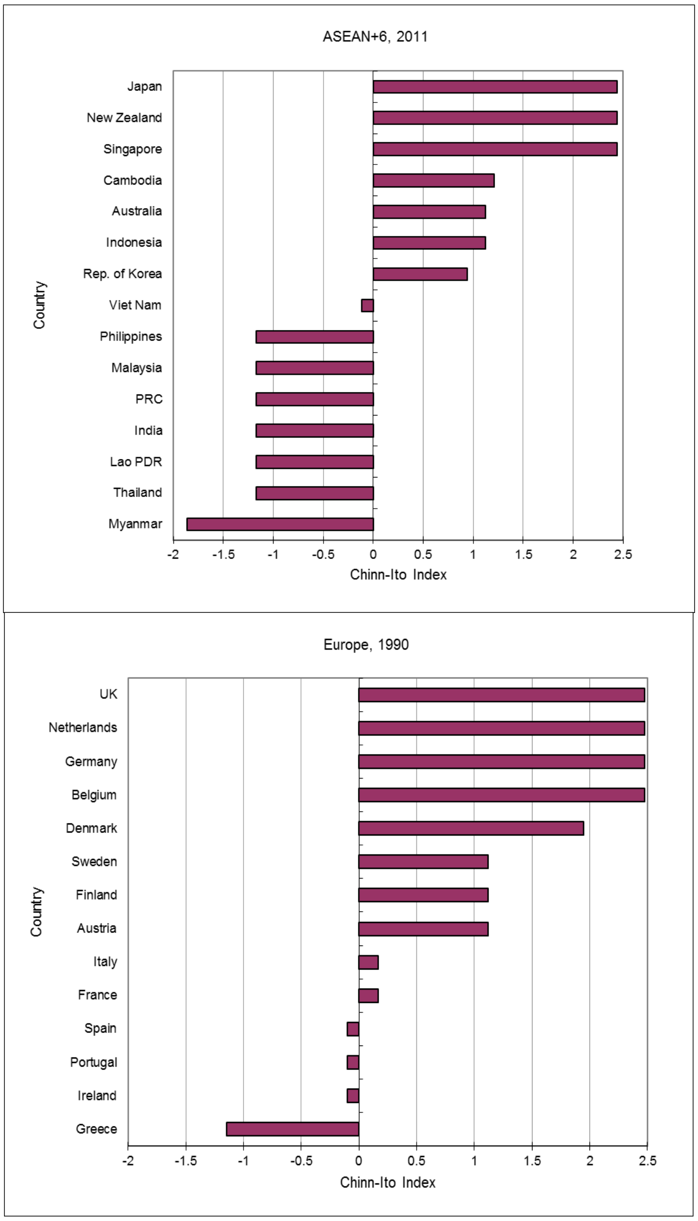
Overall, the average level of financial development of Asia currently compares favorably with that of Europe in 1990. Nonetheless, the much higher variance of financial development in Asia does indicate obstacles to financial integration, although they do not appear to be as great as those for income levels.

2.3 Financial Integration

Financial openness and financial integration are not quite the same thing, but clearly an economy must be financially open to make integration possible, especially on the capital account. Capital account openness has been measured empirically both in *de jure* (based on laws and regulations) and *de facto* terms. *De jure* openness is perhaps more important for financial integration. One popular measure of *de jure* openness is the Chinn–Ito Index (Chinn and Ito 2006), which is an index compiled based on the IMF's annual report on exchange rate arrangements and regulations (IMF 2012). The index values range between 2.5 (fully open) and –1.8 (fully closed).

Figure 1 shows the comparative values for European countries in 1990 and Asian countries in 2011 (the latest year available). Interestingly, both regions showed a considerable divergence of capital market openness with the standard deviations being very similar, but the average index value of openness in Europe in 1990 was much higher—1.01 versus 0.18 for Asia in 2011. In Europe, only Greece was relatively closed, while seven countries in Asia have high negative scores against only three being completely open. Moreover, as a result of the Maastricht Treaty of 1992, Denmark, France, Ireland, and Italy had moved to complete financial market openness by 1996.

Figure 1: *De Jure* Capital Market Openness in Europe and Asia



ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; UK = United Kingdom.

Note: Index values are not available for Luxembourg or Brunei Darussalam.

Source: Chinn and Ito. 2006. The latest data can be found at http://web.pdx.edu/~ito/Chinn-Ito_website.htm.

Other data also suggest that financial integration in Asia is much less advanced than in the EU. For example, Table 5 shows the share of intra-regional cross-border portfolio investment in total cross-border investment for a number of regions for the year 2001 (the earliest year data are available) and 2012. Cross-border portfolio investment in Asia represents a much smaller share of total cross-border investment in Asia than in Europe, although it has increased over the past decade, especially in the ASEAN+3 and ASEAN+6 countries.[7] Foreign entry into banking is still heavily restricted in many Asian economies as well.

Table 5: Intraregional Portfolio Investment in Asia Rising but Still Lags Behind Europe

Share of Total Portfolio Investments, %				
	2001		2012	
Region	**Assets**	**Liabilities**	**Assets**	**Liabilities**
ASEAN	10.5	11.9	10.2	13.4
ASEAN+3	5.3	9.1	13.2	12.4
ASEAN+6	8.6	13.2	18.2	17.2
EU15	60.0	57.1	60.4	60.4
EU27	60.0	57.2	60.5	60.5

ASEAN = Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam; ASEAN+3 = ASEAN plus the People's Republic of China, Japan, and Republic of Korea; ASEAN+6 = ASEAN+3 plus Australia, India, and New Zealand; EU15 = Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom. EU27 = EU15 plus Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Romania, Slovak Republic, and Slovenia.

Source: IMF Coordinated Portfolio Investment Survey database. http://cpis.imf.org/ (accessed 26 November 2013).

2.4 Institutional Quality

Finally, there are considerable differences between the EU in 1996 (the earliest year data are available) and Asia in 2012 in terms of institutional quality. Table 6 focuses on regulatory quality, based on the World Bank World Governance Indicators database. Not only is the average percentile ranking in Asia considerably lower than in the EU, but the variance is also greater. Greece had the lowest ranking in the EU (71%) while Asia has seven countries below the 50th percentile, including an astonishingly low level for Myanmar at 1.9%. This suggests the presence of a relatively greater potential for systemic risks in Asia, and hence a preference for less integrated financial markets.

[7] ASEAN+6 = ASEAN+3 plus Australia, India, and New Zealand.

Table 6: Regulatory Quality Considerably Lower in Asia than in the European Union

EU15 Countries, 1996		ASEAN+6, 2012	
Country	**Percentile Ranking**	**Country**	**Percentile Ranking**
Austria	95.1	Australia	97.1
Belgium	86.3	Brunei Darussalam	84.7
Denmark	98.5	Cambodia	39.2
Finland	93.1	PRC	43.5
France	78.9	India	34.0
Germany	91.2	Indonesia	43.1
Greece	71.1	Japan	83.7
Ireland	96.6	Rep. of Korea	77.0
Italy	76.0	Lao PDR	22.0
Luxembourg	97.1	Malaysia	69.9
Netherlands	98.0	Myanmar	1.9
Portugal	89.7	New Zealand	96.2
Spain	84.8	Philippines	51.7
Sweden	90.2	Singapore	100.0
United Kingdom	99.5	Thailand	57.9
		Viet Nam	27.3
Simple Average	89.7	**Simple Average**	58.1
GDP-Weighted Average	87.4	**GDP-Weighted Average**	62.0
Standard Deviation	8.8	**Standard Deviation**	29.9

ASEAN+6 = Association of Southeast Asian Nations (ASEAN—Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Viet Nam) plus PRC, Japan, Republic of Korea, Australia, India, and New Zealand; PRC = People's Republic of China; EU15 = The 15 Member States of the European Union (EU) as of 31 December 2003, before the new Member States joined the EU (the 15 Member States are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, and the United Kingdom); GDP = gross domestic product.

Source: World Bank Governance Indicators database. http://info.worldbank.org/governance/wgi/index.aspx#home.

2.5 Summary

Surprisingly, average measures of economic and financial development for the EU in 1990 (or the earliest year when data are available) versus the ASEAN+6 economies in recent years are similar. However, this masks a much greater degree of diversity in the latter group, both in terms of income levels and financial development. Moreover, capital markets in Asia are still relatively closed compared with the level that prevailed in the EU in 1990, not to mention the fully open capital markets there today. This may partly reflect the substantially lower level of regulatory quality in Asia today than in Europe in the mid-1990s. Thus Asia needs a more modest and measured approach to financial surveillance and regulation compared with what has been seen in the EU over the past two decades.

Although the EU experience provides many valuable lessons for Asian financial integration, it should only be regarded as a comparison point, not a benchmark or a template. Nonetheless, Asia will inevitably experience progressive, but most likely gradual, capital account liberalization and consequent financial integration. Greater financial integration entails risks as well as benefits, particularly the easier transmission of financial shocks. This highlights the need over time for regional regulatory cooperation to help reduce such risks in Asia.

3. EXPERIENCE OF REGIONAL FINANCIAL SECTOR POLICY IN THE EUROPEAN UNION

This section describes and analyzes lessons from existing experiences of regional financial sector policy, focusing on the EU.

The EU provides by far the richest source of information and experience about regional financial sector policy. The EU has the tightest regional political, economic, and financial structure with the longest history, and also has faced some of the most difficult challenges as a result of the eurozone sovereign debt and banking sector crisis in recent years. Although financial integration in Asia is far less advanced than in Europe, Asian economies can still learn valuable lessons from the European experience. This section examines four aspects of European financial regulation: microprudential supervision; macroprudential supervision; resolution capacity and deposit insurance; and financial safety net for liquidity support.

Legislation in the EU has substantially evolved since the creation of the three European Supervisory Agencies (ESAs)—the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA). Since then, the main divide has been between EU legislation and delegated acts. Most delegated acts are adopted by the European Commission on the basis of proposals by the ESAs, though this is still largely a work in progress. Not surprisingly, it has been found difficult in practice to implement such a complex and cumbersome process.

The main challenge seems to be substance, because there is no agreed benchmark to guide regulatory and supervisory convergence (Winkler 2012). These difficulties are compounded by two asymmetries within the EU: the presence of some countries (such as Ireland, Luxembourg, and the United Kingdom) operating international financial centers that often have a vested interest in light regulation; and the integration process between home and host country member states, as regards regulation and supervision of cross-border financial institutions. Finally, even if principles are the same, actual implementation may still vary by country depending on local laws, institutions, practices, and specific exceptions, so inconsistencies are bound to occur. Wymeersch (2010: 205) concluded that "…the European financial regulatory system is far from effectively harmonized and not fully conducive to the creation of an internal financial market." For example, implicit and explicit national guarantees were a major distorting factor of the single market, as widely evidenced in the crisis.

Recent reforms strengthened the abilities of the EU institutions to adopt legislation that is binding for member countries, a shift generally signaled by reference to a "single rulebook" (De Larosière Report, European Commission 2009). However, member nations can introduce their own legislation as well, sometimes before relevant EU directives emerge. A notable example is financial regulation in the United Kingdom, which follows recommendations made by the Vickers Report (ICB 2011). As will be discussed below, special resolution regimes have been developed in an uncoordinated manner at the national level, e.g., Germany, the United Kingdom, Ireland, Belgium, and Sweden, although the resolution issue is now being addressed in a coordinated way.

3.1 Microprudential Supervision

The area of microprudential supervision—the monitoring of individual financial institutions—has seen (and continues to see) major changes in response to the eurozone sovereign debt and banking sector crisis, which has highlighted the weaknesses of the previous system of essentially national-level supervision of cross-regional banks. First, in January 2011, legislative changes created the three ESAs and granted them a coordinating role over microprudential supervision. Increased powers of the ESAs related to microprudential supervision included: (i) resolving cases of disagreement between national supervisors, where legislation requires them to cooperate or to agree; (ii) promoting coherent functioning of supervisory colleges;[8] and (iii) coordinating policies in emergency situations (EU 2011). Nevertheless, the extent and effectiveness of these new powers is still unclear. Supervision is still primarily at the national level.

As a result, the EU has committed itself to creating a banking union—comprising EU-wide bank supervision, resolution, and deposit insurance—under the supervision of the European Central Bank (ECB). This was crystallized by the decision taken at the European Summit in June 2012 to create a Single Supervisory Mechanism (SSM). In addition to the single rulebook, an integrated financial framework for the EU is seen to require three central elements: single European banking supervision; a common deposit insurance; and a common resolution framework (van Rompuy 2012). Also, introducing the SSM is directly related to the decision to allow the possibility of direct recapitalization of banks by the European Stability Mechanism (ESM). To this end, the summit leaders called for the Council to develop proposals for the SSM by the end of 2012, and the European Council meeting later in the year called for the "legislative framework" to be completed by that time (European Council 2012b). The leaders specifically referred to the need to "…break the vicious circle between banks and sovereigns" (European Council 2012a: 1).

The European Commission's draft proposal of September 2012 calls for the ECB to take responsibility for supervision of all credit institutions in the euro member countries, "…with the objective to promote the safety and soundness of credit institutions and the stability of the financial system" (European Commission 2012a: 3). The ECB is charged to carry out its tasks within the framework of the European System of Financial Supervision (ESFS) and to cooperate closely with national supervisors and the EBA.[9] Specific proposed supervisory tasks for the ECB include: "…authority for licensing and authorizing credit institutions, assessing qualifying holdings, ensuring compliance with the minimum capital requirements, ensuring the adequacy of internal capital in relation to the risk profile of a credit institution (Pillar 2 measures), conducting supervision on a consolidated basis, and supervisory tasks in relation to financial conglomerates. Furthermore, the ECB will also ensure compliance with provisions on leverage and liquidity, apply capital buffers and carry out, in coordination with resolution authorities, early intervention measures when a bank is in breach of, or is about to breach, regulatory capital requirements" (European Commission 2012a: 4). Also, the ECB will have all necessary investigatory powers to be able to carry out its tasks. However, it is expected that most day-to-day verifications and other supervisory activities would be

[8] Supervisory colleges are multilateral working groups of relevant supervisors that are formed for the purpose of enhancing effective coordinated supervision of an international banking group on an ongoing basis. EU authorities have developed a framework of cooperation which is legally binding for all supervisory authorities from the European Economic Area (in particular the Capital Requirement Directive-CRD n° 2006/48/EC7) (BCBS 2010).

[9] The ESFS includes the three ESAs and national financial supervisors in the EU.

exercised by national supervisors operating as an integral part of the SSM. The precise allocation of responsibilities between the ECB and national supervisors remains a controversial issue.

An innovation of this magnitude has major implications for the regulatory structure in the EU, including the relationships of the ECB with the EBA and non-euro-member states, but these have not yet been resolved. The proposal states that "…the ECB should therefore be required to cooperate closely with the EBA, the [ESMA] and the [EIOPA], within the framework of the EFSF" (European Commission 2012a: 13). Regarding the EBA, the Commission proposal notes that "…the EBA will keep its powers and tasks to further develop the single rulebook and ensure convergence and consistency of supervisory practice" (European Commission 2012a: 4). Most of the ECB's increased responsibilities will be shifted from national supervisors, not the EBA. However, it seems likely that the EBA's role will need to be modified gradually over time (Véron 2012a).

Regarding the non-euro-member states wishing to enter the banking union, the Commission proposal notes that they "…will be able to enter into a close supervisory cooperation with the ECB subject to meeting specific conditions" (European Commission 2012a: 6). One of these conditions is that those member states abide by and implement relevant ECB acts. This area also remains controversial.

The proposal notes that the new ECB role does not affect in any way the position of non-euro-member states in existing colleges of supervisors for EU financial institutions. Until now, the primary vehicles for cross-border supervisory cooperation are memoranda of understanding (MOUs) among national supervisors. However, these are not legally binding and can be fragile. As noted above, the ESAs supposedly have powers to resolve disputes within colleges of supervisors, but these have not been tested much yet. Moreover, the proliferation of MOUs creates a complex environment in which to operate. Finally, such MOUs have tended to be supplanted in times of crisis by ad hoc measures, e.g., the case of the Fortis financial group in 2008 (Véron 2012b). However, this issue should be largely resolved, at least for institutions within the region, with the transfer of supervisory authority to the ECB.

3.2 Macroprudential Supervision

As mentioned above, EU-wide macroprudential regulation was introduced in 2011 with the creation of the European Systemic Risk Board (ESRB). The ESRB has a mandate to study macroprudential, or system wide, risks to stability. It is chaired by the President of the ECB, and members include the ECB, national central banks, the three ESAs, one high-level representative per member state of the competent national supervisory authorities, the European Council, and the Economic and Financial Committee (EFC)—61 members in all (ESRB 2012b). Notably, however, the national supervisory authorities do not have voting rights, which leaves the voting membership very much dominated by the ECB and national central banks. It does not appear that the change in the ECB's supervisory role described in the previous section will affect its role in macroprudential supervision, since that role is already quite large.

The ESRB has a surveillance function but no binding powers. It can issue risk warnings that should prompt early responses to avoid a buildup of systemic problems and the risk of a future crisis, and it may also recommend specific actions to address any identified risks. The ESRB cannot impose measures on member states or national authorities, but can expect replies to its assessments. It also has the ability, along with the ESAs, to identify emergency situations, and has responsibility for coordinating its actions with those of international financial organizations, particularly the IMF and the

FSB, as well as the relevant bodies in third countries on matters related to macroprudential oversight (ESRB 2012a).

The Commission report on the proposed expansion of the ECB's supervisory role calls for strict separation from the ECB's monetary policy tasks to eliminate potential conflicts of interest between the objectives of monetary policy and prudential supervision. However, it remains to be seen whether or not such a strict separation is practical. Experience suggests that its monetary and macroprudential policy tools cannot be operated totally independently. For example, if monetary conditions are easy, borrowers will find ways to evade various macroprudential restrictions on lending.

3.3 Resolution Capacity and Deposit Insurance

A weak link in the EU's region-wide financial regulatory capacity is the lack of an EU-wide framework for resolution of cross-border banks and other financial institutions and for deposit insurance. The approach to cross-border bank resolution is still based on MOUs—which may prove fragile—and insolvency laws are not harmonized. Moreover, national fiscal authorities are not included in such MOUs, even though they must make the critical decision of whether or not to inject public funds into an institution. To be sure, the EU has also created crisis resolution groups, in which treasuries are members, precisely to address this weakness.

Deposit insurance in the EU is currently implemented only at the national level. While there have been waves of harmonization—for instance in 2009, a uniform minimum coverage of €100,000 was introduced—they still display significant national differences across the EU. As such, they are not well equipped to deal with the failure of cross-border banks within the EU. Moreover, deposit guarantee schemes are unfunded in many countries, which means that their fiscal position could be affected significantly by the failure of a large institution. Although they have been recently strengthened by various measures, they do not substitute for an EU-wide scheme.

This situation will change dramatically following the commitment to create a banking union, including EU-wide supervision, resolution arrangements and a deposit insurance scheme. The latter two are needed together, and van Rompuy (2012: 5) has noted that "…the deposit insurance scheme and the resolution fund could be set up under the control of a common resolution authority." Constancio (2012) has suggested that the US Federal Deposit Insurance Corporation could be a model. The European Commission was charged with developing such a resolution and deposit insurance framework.

Progress is being made on the establishment of a European-wide resolution mechanism. European Commission (2013b) proposed a legislative framework for a new Single Resolution Mechanism (SRM). The SRM will apply a single rulebook on bank resolution for ailing banks from the participating member states in this mechanism. The SRM will consist of uniform rules and procedures to be applied by the Single Resolution Board (SRB), together with the Commission and the resolution authorities of the participating member states. The SRB, made up of representatives from the ECB, the European Commission, and the relevant national authorities, would prepare the resolution of a bank. It would have broad powers to analyze and define the approach for resolving a bank: which tools to use, and how the European Resolution Fund should be involved. A Single Bank Resolution Fund would be set up under the control of the SRB to ensure the availability of medium-term funding support during the restructuring process. It would be funded by contributions from the banking sector, replacing the national resolution funds of the euro area member states and those non-euro states participating in the banking union. It is expected that the law will be approved by the European Parliament in 2014.

However, not much progress has been observed on the deposit insurance scheme even in 2013. If this is implemented successfully, it will represent a marked improvement over the current system, which is carried out mostly at the national level, and augmented only by relatively weak MOUs and ad hoc responses. Van Rompuy (2012) has argued that a European deposit insurance scheme would strengthen the credibility of the existing arrangements and serve as an important assurance that eligible deposits of all credit institutions are sufficiently insured.

3.4 Financial Safety Net

The European financial safety net also evolved over time in response to the sovereign debt and banking crisis. In June 2010, the European Council created the European Financial Stability Facility (EFSF) by which euro member states provided a mainly credit-funded facility to lend to small countries that had lost access to capital markets. However, when the financial crisis contagion spilled over into large member states, especially Italy, the original EFSF bailout fund was insufficient and the European Council increased the fund's resources from the initial amount of €440 billion to €780 billion in July 2011. However, when Italy had to refinance approximately €350 billion in 2012 and there were large liquidity risks for lenders, the European Council in October 2011 agreed to leverage the EFSF up to €1 trillion, but even this measure failed again to calm the markets. In October 2012, this temporary facility was transformed into a permanent ESM.

A more lasting solution to the crisis was found through the development of the "troika" financial safety net, comprising the EFSF (afterward the ESM), the ECB, and the IMF. The troika's first project was the bailout for Ireland in November 2011, followed by that for Portugal in May 2012, and the second Greek bailout in September 2012 (European Commission 2013a). These measures finally stabilized markets and allowed sovereign bond yields to decline substantially in the crisis countries. Nevertheless, the earlier lack of a regional financial safety net led to a virtual shutoff of intraregional capital flows, which in turn hampered the transmission of monetary policy throughout the region.

3.5 Summary

The EU has created by far the most highly developed regional institutions for financial supervision, regulation, and resolution, and achieved by far the highest regional financial integration and harmonization of rules, standards, procedures, etc. Nonetheless, it is still very much a work in progress. Significant differences in national practices and institutions remain, and have proven a substantial barrier to fully harmonizing financial regulations, tax systems, corporate law, and other systemic aspects. The role of regional supervisory agencies has been strengthened, but microprudential supervision is still carried out mainly at the national level, while regional macroprudential institutions appear cumbersome and lack enforcement powers. Information sharing by national supervisors remains inadequate, and MOUs underlying supervisory colleges and deposit insurance schemes are still fragile.

The eurozone crisis has revealed a number of shortcomings in the previous architecture, as essentially national-level regulation could not cope with the high degree of financial integration in the region, and the "doom loop" mechanism could not be avoided. The decision to create a full-fledged banking union in coming years will dramatically alter this situation, and should mark a major improvement. The imminent establishment of the SSM marks the first step in this process, and the agreement on an EU-wide resolution mechanism is another step forward, but a full union will also require establishing a unified deposit insurance scheme with EU-wide fiscal backing.

4. EXPERIENCE FROM REGIONAL FINANCIAL COOPERATION AND REGULATION IN ASIA

Regional financial cooperation and regulation in Asia is much less developed than in the EU, but some significant developments have emerged, including economic and financial surveillance; financial regulatory harmonization; a regional financial safety net; and measures to support financial market development, mainly for local-currency bonds. This section describes these developments.

4.1 Economic and Financial Surveillance

A number of regional forums have emerged for the purposes of information exchange, economic monitoring, policy dialogue, and peer pressure for better policies. The ASEAN finance ministers established the ASEAN Surveillance Process in 1998. Its objective is to strengthen cooperation by (i) exchanging information and discussing economic and financial development of member states in the region, (ii) providing an early warning system and a peer review process to enhance macroeconomic and financial stability in the region, (iii) highlighting possible policy options and encouraging early unilateral or collective actions to prevent a crisis, and (iv) monitoring and discussing global economic and financial developments which could have implications for the region and propose possible regional and national level actions. The ASEAN Surveillance Process includes the ASEAN Finance Ministers Meeting and the ASEAN Select Committee, comprising the members of the ASEAN Senior Finance Officials Meeting and the ASEAN Central Bank Forum (IIMA 2005).

The ASEAN+3 Finance Ministers Meeting process has the Economic Review and Policy Dialogue (ERPD), which meets once a year mainly to discuss macroeconomic and financial issues in East Asia. Starting in 2012, the members' central bank governors joined this forum, which consequently has been renamed the ASEAN+3 Finance Ministers and Central Bank Governors' Meeting. The ERPD receives inputs from the Asian Development Bank (ADB). In addition, the ASEAN+3 finance deputies meet twice a year. Other meetings of Asian finance ministers include the Asia-Pacific Economic Cooperation (APEC) and the Asia-Europe Meeting (ASEM). The policy dialogue and surveillance process among ASEAN+3 members is in transition from the "information sharing" stage to the "peer review and peer pressure" stage, while the "due diligence" process has yet to start in a serious manner (Kawai and Houser 2008).

Another key forum is the Executives' Meeting of East Asia-Pacific Central Banks (EMEAP), a cooperative group of central banks and monetary authorities in the East Asia and Pacific region.[10] Its primary objective is to strengthen the cooperative relationship among its members. The EMEAP has activities at three levels: Governors' Meetings, Deputies' Meetings, and working groups. Another organization is the South East Asian Central Banks (SEACEN) Research and Training Centre in Kuala Lumpur,

[10] It comprises the central banks of 11 economies: Reserve Bank of Australia, People's Bank of China, Hong Kong Monetary Authority, Bank Indonesia, Bank of Japan, Bank of Korea, Bank Negara Malaysia, Reserve Bank of New Zealand, Bangko Sentral ng Pilipinas, Monetary Authority of Singapore, and Bank of Thailand (IIMA 2005).

Malaysia, which now has 19 member central banks.[11] As part of it, the SEACEN Expert Group (SEG) on Capital Flows was established by the SEACEN Centre in May 2000, in response to the need to manage capital flows to ensure stability in regional financial markets. In addition to the 19 SEACEN central bank members, it includes as observers the Reserve Bank of Australia, Hong Kong Monetary Authority, and Bank of Japan (IIMA 2005).

Finally, the ASEAN+3 Macroeconomic Research Office (AMRO) was established in 2011 in Singapore as the surveillance arm of the Chiang Mai Initiative Multilateralization (CMIM). Its staff resources are still quite small—about twenty economists currently—but it has been tasked with conducting full-fledged surveillance of the ASEAN+3 member countries. This distinguishes it from the other forums described above, which do not have their own full-time staff. It is expected that the AMRO will grow over time in terms of staff number and will become an international organization, although it will be a long time before it can achieve a size and depth commensurate with that of the IMF.

4.2 Financial Regulatory Harmonization

The ASEAN Economic Community (AEC) is the most advanced regional framework for financial regulatory harmonization in Asia. The AEC project is summarized in the AEC blueprint, ratified by ASEAN leaders in 2007 (ASEAN Secretariat 2007). The ambitious target of the AEC is to create its Economic Community by 2015 as a region with free movement of goods, services, investment, skilled labor, and “freer” flow of capital. The broad aims of the project are both to enjoy the scale economies of a unified market and to reduce the development gap among its member countries. To be sure, the blueprint recognizes in practice that some countries will progress faster than others, and liberalization will be done on a voluntary basis, which it characterizes as the “ASEAN minus X” formula. This is a necessary aspect of the voluntary nature of ASEAN cooperation. Regarding the financial services sector, the blueprint aims for a first round of liberalization by 2015, with other subsectors or modes being liberalized by 2020 (ASEAN Secretariat 2007).

Important components of the AEC include the ASEAN Framework Agreement on Services (AFAS) and ASEAN capital market integration. The aims of the AFAS are to: (i) enhance cooperation in services amongst member states in order to improve the efficiency and competitiveness, and to diversify production capacity and services supply and distribution by their services providers within and outside ASEAN; (ii) eliminate substantially restrictions to trade in services amongst member states; and (iii) liberalize trade in services by expanding the depth and scope of liberalization beyond those undertaken by member states under the GATS with the aim of realizing a free trade area in services (ASEAN Secretariat 1995: 1).

The ASEAN capital market integration program aims at developing a unified pan-ASEAN market for financial services and capital flows under the ASEAN Capital Markets Forum (ACMF).[12] In order to strengthen ASEAN capital market development

[11] These include: Autoriti Monetari Brunei Darussalam; National Bank of Cambodia; People’s Bank of China; Reserve Bank of Fiji; Reserve Bank of India; Bank Indonesia; Bank of Korea; Bank of the Lao PDR; Bank Negara Malaysia; Bank of Mongolia; Central Bank of Myanmar; Nepal Rastra Bank; Bank of Papua New Guinea; Bangko Sentral ng Pilipinas; Monetary Authority of Singapore; Central Bank of Sri Lanka; central bank of Taipei,China; Bank of Thailand; and State Bank of Viet Nam.

[12] Established in 2004 under the auspices of the ASEAN Finance Ministers, the ACMF focuses on strategic issues to achieve greater integration of the region’s capital markets under the AEC Blueprint 2015. Members include the relevant capital market supervisory agencies in ASEAN member countries.

and integration, the blueprint calls for the following actions (ASEAN Secretariat 2007: 17):

- Achieve greater harmonization in capital market standards in ASEAN in the areas of offering rules for debt securities, disclosure requirements, and distribution rules;
- Facilitate mutual recognition arrangement or agreement for the cross recognition of qualification and education and experience of market professionals;
- Achieve greater flexibility in language and governing law requirements for securities issuance;
- Enhance withholding tax structure, where possible, to promote the broadening of the investor base in ASEAN debt issuance; and
- Facilitate market-driven efforts to establish exchange and debt market linkages, including cross-border capital raising activities.

It further notes that the liberalization of capital movements is to be guided by the following principles: (i) promoting an orderly capital account liberalization consistent with member countries' national agenda and readiness of the economy; (ii) allowing adequate safeguard against potential macroeconomic instability and systemic risk that may arise from the liberalization process, including the right to adopt necessary measures to ensure macroeconomic stability; and (iii) ensuring the benefits of liberalization to be shared by all ASEAN countries (ASEAN Secretariat 2007: 17).

An overall assessment of the achievements of the AEC is difficult to make, as many country scorecards have not yet been released publicly. Clearly, progress has been slower than desired. One recent development is that the ACMF devised the ASEAN and Plus Standards Scheme, a framework for information disclosure standards that apply to regional cross-border securities issuance (equities and bonds). ASEAN Standards are common to all ASEAN member countries and conform to International Organization of Securities Commissions international standards, and the associated accounting and auditing standards are identical with international standards. On the other hand, the Plus Standards are an additional set of standards necessitated by the accepted practices, laws, and regulations of individual countries. In June 2009, securities market regulators in Malaysia, Singapore, and Thailand announced their decision to adopt this framework. Other countries are planning to join the framework, but have not yet specified any dates (The 21st Century Public Policy Institute 2011). Harmonization in the EU was driven to a large extent by market liberalization and adoption of international standards (see, e.g., Posner and Véron 2010), but, in the current environment and taking into account the diverse levels of economic and financial development within the region, this force is weaker in ASEAN. Nonetheless, given the essentially voluntary nature of ASEAN cooperation, strong peer pressure is needed to produce more effective results.

4.3 Financial Safety Net

Following dissatisfaction with the role played by the IMF during the Asian financial crisis of 1997–1998, a regional cooperative financing arrangement to supplement IMF resources was agreed in May 2000 at the ASEAN+3 Finance Ministers' Meeting in Chiang Mai, which was referred to as the "Chiang Mai Initiative." It initially took the form of bilateral currency swap agreements, but in May 2007 the member countries agreed to convert the bilateral schemes of the CMI into a multilateralized self-managed reserve pooling scheme governed by a single contractual agreement, or the Chiang Mai Initiative Multilateralization (CMIM). The size of the agreement was set at US$120 billion, and the amount of the allocation that would be withdrawn without triggering an IMF program was raised from 10% to 20% (so-called “IMF conditionality” or “IMF linkage”) (Sussangkarn 2010). As mentioned above, the AMRO was established in May 2011 to provide surveillance capability within the region.

However, the CMI (and later CMIM) were never used, even during the global financial crisis of 2007–2009. The link to IMF conditionality was one problem, due to the “IMF stigma” in the region, but the process for releasing funds was also considered cumbersome and untested. [13] The CMI (or CMIM) needed various other improvements to make it more effective as well. First, the CMI (or CMIM) borrowing quota was not likely to be enough if more than one country got into serious problems. Second, instead of just borrowing from the CMI (or CMIM), countries could arrange bilateral currency swap facilities with CMI (or CMIM) members or other authorities—such as Australia and New Zealand. Finally, the AMRO needed to have sufficient resources and staffing to support the capabilities of an Asian monetary fund (Sussangkarn 2010).

To address these issues, the ASEAN+3 finance ministers and central bank governors announced a number of reforms in May 2012, including: doubling the CMIM resources to US$240 billion; increasing the IMF-de-linked portion to 30% with a view to increasing it to 40% in 2014; lengthening the maturity and supporting period for the IMF-linked portion from 90 days to 1 year and from 2 years to 3 years, respectively; lengthening the maturity and supporting period of the IMF-de-linked portion from 90 days to 6 months and from 1 year to 2 years, respectively; and introducing a crisis prevention facility called CMIM Precautionary Line (CMIM-PL) (ASEAN Secretariat 2012). The last would correspond to the Flexible Credit Line and Precautionary Credit Line facilities of the IMF. These improvements should enable the CMIM to move closer to becoming a full-fledged Asian monetary fund.

5. CHALLENGES FOR REGULATORY COOPERATION AND POLICY RECOMMENDATIONS

This section discusses challenges for cooperation in financial regulation in the EU and Asia, highlights the differences between regional regulatory approaches in the EU and ASEAN, and describes some of the challenges in extending the ASEAN model to the rest of Asia. It then describes policy recommendations for strengthening regional financial regulation in Asia.

5.1 Cooperation Challenges in the European Union

As discussed in sections 2 and 3, even with elaborate regional legal and political structures and integrated economic and financial systems, the EU still faces many obstacles to effective regional regulation, including: continued diversity of financial systems, laws, and regulatory structures and practices; a complex system, with large number of players with overlapping responsibilities and potential conflicts of interest; continued evolution of EU-wide supervisory agencies with largely untested powers; large size, potential cumbersomeness, and lack of strong authority of the ESRB;

[13] Previously, members needed to have an IMF program to be able to tap more than 20% of their borrowing quota. This was raised to 30% in May 2012. In view of the negative perception of the IMF that developed during and after the Asian financial crisis, going to the IMF has become anathema in much of Asia since then.

national resistance to an expanded EU-wide authority and a tendency to protect domestic financial industries; inadequate information sharing; weak cross-border supervisory cooperation based on MOUs lacking legal force and tending to be overridden in crisis; and a lack of a legal framework for resolution and deposit insurance of cross-border financial firms.[14]

These shortcomings demonstrate that the institutional frameworks for the single financial market in the single currency area are seriously inadequate, and they indeed directly contributed to the severity of the eurozone sovereign debt and banking sector crisis. First, the lack of a regional financial safety net allowed the development of the “doom loop” between sovereigns and banks at the national and regional levels. Second, regulation at the national level substantially lagged monetary and financial integration in the region. In the presence of such a lag, the close interconnectedness of European banks led to the easy transmission of financial shocks across borders, tended to create negative externalities for other countries, and contributed to the buildup of macroeconomic imbalances within Europe. Third, the lack of a region-wide financial safety net led to a fragmentation of European financial markets via a virtual shutoff of intraregional capital flows, which in turn hampered the transmission of monetary policy easing throughout the region. These developments partly reflected the inadequacies of national-level home-host supervisor arrangements in the presence of high financial integration.

The direction of the solution is clear: financial regulatory functions—including supervision, resolution, and deposit insurance—need to be elevated to the regional level. First, regulation needs to be consistent with the cross-border activities of European financial firms, especially those within the euro member countries. Second, introducing the SSM is directly related to the decision to allow the possibility of direct recapitalization of banks by the ESM, the European financial safety net. Third, it is necessary to promote financial integration in Europe to enhance the transmission of monetary policy.

The commitment of the EU to create a banking union—including supervision, resolution, and deposit insurance—means that implementation now represents the major challenge for the EU. Issues include how to deal with the non-euro-member countries, how to enforce a sufficient degree of regulatory harmonization, and how to establish the EU-wide resolution and deposit insurance scheme. The latter also requires a commitment to a fiscal union, which in turn implies success in establishing a political union, since otherwise the fiscal union will lack political legitimacy. As noted above, the establishment of the SSM is only the first step in a lengthy process, and many difficult political decisions remain to be made.

5.2 Cooperation Challenges in Asia

Asia has no over-arching political structure comparable to the EU, and there is little willingness in the region to concede national sovereignty in these areas. The AEC provides a possible model for wider Asian cooperation, but progress even within ASEAN has been slow, and institutions weak. Barriers to stronger regionalization of political and economic institutions in Asia include: the lack of an overall agreement on the definition of “Asian” membership; great diversity in terms of economic and financial development, financial and economic systems, institutional quality, capital account openness, and regulatory regimes; weak and under-developed current regional

[14] As mentioned above, the Single Resolution Mechanism is expected to be approved in 2014.

institutions, with no legal authority; and the voluntary nature of cooperation even within ASEAN.

The weaker structure of regional institutions and greater diversity in financial development and capital market openness in ASEAN (and even more so in ASEAN+6 as a whole) require a different approach than in the EU. The EU approach in principle has been to fully harmonize laws and regulations, mainly in accordance with international standards, while only small, unharmonized parts are addressed through mutual recognition, and it has completely liberalized controls on cross-border capital transactions. In contrast, ASEAN is aiming for general harmonization, coupled with mutual recognition given for complementary purposes. It aims to attain increased levels of capital flows within the region, but stops well short of calling for complete deregulation of capital flows. This difference points to a key role for mutual recognition in the financial integration process in ASEAN, as discussed in greater detail above.

Within ASEAN, perhaps the first challenge is to promote financial development in those countries that are lagging behind, mainly the “CLMV” countries (Cambodia, Lao PDR, Myanmar, and Viet Nam). Only stronger convergence within the region can set the stage for achieving the targets of financial openness and regulatory harmonization laid out in the AEC as described in section 4. Until such convergence is achieved, ASEAN member countries will need to pursue a multi-track approach, with those countries that have achieved the relevant milestones of financial development committing to further steps of financial opening. Along with this, ASEAN economies need to strengthen institutions for regional cooperation to promote regional harmonization of regulations, taxation, etc., using the ASEAN finance ministers’ and central bank governors’ surveillance process (ERPD) as the starting point. This is particularly important in view of the great divergence of regulatory performance and capacity within the region. One beneficial step would be to include financial regulators and deposit insurance corporations in at least some deliberations so that the monitoring of regional financial stability could be strengthened.

Institutions for regulatory cooperation need to be strengthened at the level of the ASEAN+3 countries as well. One challenge is to strengthen the CMIM and the AMRO to fulfill their functions as a regional financial safety net and surveillance unit, respectively. Monitoring and exchanging information about potential economic imbalances and volatile capital flows can reduce the threat to economic and financial stability presented by them.

5.3 Recommendations for Regional Financial Regulation in Asia

Improving the ASEAN Economic Community Process

The AEC process can be improved through promoting mutual recognition, increasing regulatory harmonization, and enhancing cross-border supervisory cooperation via MOUs. Recommended steps to promote mutual recognition include:

- Ensuring conformity to International Organization of Securities Commissions principles to the extent possible, including expanding the scope of the ASEAN and Plus Standards Scheme;
- Expanding mutual recognition to the maximum extent possible by preserving domestic market soundness while securing investor protection and ensuring proper management of systemic risk; and

- Strengthening cooperation and information exchange among different regulatory authorities.

Mutual fund passporting is one example of an area that could benefit substantially from mutual recognition.

Major ways to increase regulatory harmonization include:

- Standardizing and integrating direct market infrastructures (trading platforms, clearing/settlement systems);
- Harmonizing indirect infrastructures (laws and regulations, credit rating agencies, accounting/auditing standards, tax systems); and
- Harmonizing foreign exchange regulations.

Studies have identified tax withholding rules as a major hurdle to participation in regional bond markets by international investors (The 21st Century Public Policy Institute 2011).

Enhancing cross-border supervisory cooperation via MOUs has the potential to improve the effectiveness of monitoring globally or regionally systemically important financial institutions (SIFIs), although experience shows that MOUs can be relatively weak reeds, especially in a crisis. The AMRO has already begun regional monitoring, but this effort needs to involve national supervisory bodies as well. One key problem is dealing with global SIFIs whose headquarters are outside the region. In this case, supervisory colleges with a global reach are the appropriate institution, but they could still prove problematic if home country authorities are distant from Asia—such as in the US and Europe—and not knowledgeable about conditions there. In that case, requiring Asian branches of such institutions to become subsidiaries may be a desirable option. However, the pros and cons of requiring Asian branches of such institutions to become subsidiaries would need to be carefully assessed, both in terms of financial stability and the costs and impacts such ring-fencing would entail for cross-border capital allocation.

Next Steps for ERPD, CMIM, and AMRO

The ERPD so far has been mostly a beauty contest. The policy dialogue among the finance ministers and central bank governors needs to be strengthened. The inclusion of the central bank governors in the ASEAN+3 finance ministers annual meeting in 2012 was a positive first step. Important further steps include: developing a “peer review” methodology and practice; and regularly monitoring capital flows and exchange rate movements.

As mentioned above, a number of steps were taken over the past several years to significantly strengthen the CMIM, including doubling the size of its resources, increasing the portion of the quota that can be tapped without an IMF program, and introducing precautionary lending instruments. The size of the facility that each member can borrow should be further enlarged either through an additional increase in the total resources or a change in the formula to define the maximum amount each member economy can borrow. The ASEAN+3 authorities should also consider extending CMIM membership to Australia, New Zealand, and India, and encourage the development of a financial safety net in South Asia as well. In the future, the CMIM should aim to reduce its link with the IMF over time, ultimately to zero, by providing sufficient resources for AMRO and improving its surveillance capacity. It also needs to operationalize its financial safety net functions, which have not yet been tested. At the same time, it needs to develop a framework for cooperation with the IMF in the event that a widespread systemic shock occurs involving multiple countries. With these, a *de facto* AMF will have emerged.

Creating an Asian Financial Stability Dialogue

To make substantial progress in improving regional financial stability, there needs to be a suitable driving force. Plummer (2010), Kawai (2011), and others support the idea of an Asian financial stability dialogue (AFSD), which was first suggested by Kuroda (2008). The AFSD would provide a forum for broader information sharing in the areas of macroeconomic and financial stability, including financial regulators and deposit insurance corporations, as well as finance ministries and central banks. The AFSD could discuss regional financial vulnerabilities, regional capital flows, common issues for financial sector supervision and regulation, and common efforts at financial integration.

There is currently an Asian regional forum led by the BIS, but such a forum should be led by Asian countries (in the form of an AFSD), and they may invite the BIS to participate. This entity could build on existing institutions in the region, including the ERPD and the EMEAP. The body should include the participation of finance ministries, central banks, financial market regulators and supervisors, and deposit insurance corporations, i.e., a wider scope than that of the ERPD, which focuses on macroeconomic policy issues. Its objective would be to monitor factors affecting regional financial stability, including national financial market conditions and capital flows, and to induce appropriate policy actions including macroprudential policy and coordination of capital flow management.

For example, policy spillovers (e.g., cross-border impacts of blanket guarantees of deposit insurance, capital control measures, or adoption of macroprudential policies) are likely to have side effects on capital flows that could be destabilizing for other economies in the region, and call for concerted action at the regional level. Table 7 shows recent capital control measures introduced in Asian economies. The AFSD could identify regional SIFIs and discuss how the national authorities in the region can improve cross-border supervision over them. It could also provide a regional counterpart to the FSB, an element of regional institutional architecture that is currently missing. In particular, the AFSD could liaise with the FSB for Asia's non-FSB member countries.[15]

[15] To be sure, the FSB established in 2011 the Regional Consultative Group for Asia (and similar groups in other regions) with the specific intention of communicating with non-FSB-member countries in Asia (FSB 2012). However, it still seems likely that an AFSD would have greater ownership by Asian members and could speak for them with more authority.

Table 7: Recent Measures Affecting Capital Inflows in Asia

Outright prohibitions on funds transfer and payments	
Taipei,China	2009: Prohibited use of time deposits by foreign funds.
	2010: One-week deadline for money to be invested or repatriated.
	2010: Measures to curb trading in foreign currency.
Explicit quantitative limits or approval procedures	
PRC	2002: QFII introduced.
	2006: QDII limits introduced.
	2011: Limits on Hong Kong, China's banks' net open positions and ability to access yuan through mainland foreign exchange market; also RQFII limits introduced.
India	2013: Cut maximum outward direct investment by companies and individuals to 100% of net worth.
Rep. of Korea	2010: Limits on FX derivative contracts on domestic banks (50% of capital) and foreign banks (250%).
	2011: Limits on FX derivative contracts on domestic banks (40% of capital) and foreign banks (200%).
	2012: Limits on FX derivative contracts on domestic banks (30% of capital) and foreign banks (150%).
Explicit taxes on cross-border flows (Tobin tax)	
Indonesia	2010: One-month holding period on SBIs (central bank notes).
Rep. of Korea	2011: Withholding tax on treasury and monetary stabilization bonds.
Thailand	2010: 15% withholding tax on capital gains and interest income on foreign bonds.
Compulsory reserve or deposit requirements (URR)	
Thailand	2006: Unremunerated reserve requirements (30%) on loans, bonds, mutual funds, swaps, and non-resident Baht accounts (abolished 2008).

PRC = People's Republic of China; QFII = qualified foreign institutional investors; QDII = qualified domestic institutional investors; RQFII = PRC renminbi QFII; FX = foreign exchange; SBI = Bank Indonesia certificate; URR = unremunerated reserve requirement.

Source: Central bank reports and other reports.

In the early stages, such an arrangement could focus on issues that would help advance the areas of common interest that have already been identified and that are largely being dealt with under separate initiatives, such as the management of volatile short-term capital flows. Plummer (2010) sees it initially focusing on improving early warning systems, being able to assist in negotiations on common exchange rate changes, and, perhaps, helping in crisis management. The principal question is how far an AFSD might proceed beyond simply monitoring, diagnosing potential threats, and suggesting remedies. One of the problems revealed in the run-up to the global financial crisis is that some organizations, particularly the Bank for International Settlements, did diagnose various sources of fragility, but they had no powers to act upon them.

To maximize its effectiveness, the AFSD should complement and coordinate with existing regional entities, including the ERPD, EMEAP, and AMRO. For example, the AMRO and ERPD could focus mainly on macroeconomic policies and surveillance, so the AFSD could focus more on financial stability issues. Since not all Asian economies are members of the FSB or the Basel Committee on Banking Supervision, the AFSD could help to consolidate the viewpoints of Asian economies so they could be delivered in global forums such as the FSB and the Bank for International Settlements. One question is whether the AFSD would have its own secretariat, or would be dependent on other institutions such as the AMRO for macroeconomic and financial sector surveillance.

6. CONCLUSIONS

An increasingly financially integrated Asia will need more intensive financial cooperation, including greater efforts to harmonize and coordinate financial supervision and regulation. In particular, greater financial openness increases the potential vulnerability of Asian economies to the vicissitudes of volatile capital flows, underlining the needs for regional efforts to improve financial stability. Increased economic integration as a result of trade liberalization and the development of supply chain networks has also increased the value of policy coordination, including stabilizing intra-regional exchange rates. Finally, a gap has opened up between national regulation efforts and global regulatory cooperation centered on the G20, the IMF, and the FSB, especially for non-G20 economies. Establishing a regional regulatory architecture can help to fill that gap.

The EU represents the most advanced stage of regional financial integration and regulation in the world today, and can provide valuable lessons for Asia, although it is by no means a benchmark or a template. The eurozone sovereign debt and banking sector crisis has highlighted many weaknesses in the EU regional architecture that need to be addressed. Fundamentally, the largely national-level regulatory structure was ill-equipped to deal with the high level of financial integration in the EU. Supervisory colleges based on voluntary MOUs have proved to be weak reeds, and tended to be supplanted by ad hoc arrangements in an emergency. EU-wide supervisory institutions have been strengthened recently, but their new powers are largely untested, and most power still rests with national-level supervisors. Regulatory harmonization has made great progress, but continued national variations make full harmonization elusive. Regimes for resolution and deposit insurance in particular remain unharmonized.

In response to these perceived inadequacies, the EU has committed itself to shifting financial regulation from the national to the regional level by establishing a banking union. This region-wide regulatory framework will include the Single Supervisory Mechanism headed by the ECB (to be launched in 2013) and region-wide resolution and deposit insurance structures. These measures will have to be supported by fiscal union and greater political union as well. This means that the implications of the single market and the single currency are at last being followed to their necessary conclusions. Without these developments, there can be no lasting solution to the current eurozone sovereign debt and banking sector crisis.

Asia has not reached the EU's stage of having regional political and legal institutions and integrated financial markets, let alone a single currency, so it is not feasible or necessary to emulate EU-wide policy arrangements at this stage. Despite rather high average levels of financial development, levels of economic and financial development, financial openness and institutional regulatory capacity vary much more widely in Asia than in the EU. Moreover, while harmonization in the EU was driven to a large extent by market liberalization and adoption of international standards, this force is weaker in ASEAN, reflecting both the current economic environment and varying levels of economic and financial development within the region.

Despite its shortcomings and slow pace, the ASEAN Economic Community process probably provides the most feasible and relevant model for regulatory cooperation on a voluntary basis. It would be desirable to extend this framework further within Asia, say to the ASEAN+3 countries for a start. This approach will require a greater tolerance for different timetables of liberalization and harmonization. Only those member countries that have achieved the requisite development milestones should move on to higher stages of integration and regulatory harmonization. The AEC can be strengthened further by taking steps to implement best practice regulation, promote mutual recognition in areas such as fund management, harmonize market infrastructure, and promote cross-border supervisory MOUs. Use and publication of country “scorecards” should be increased to incentivize harmonization efforts.

Even within this less ambitious framework, Asian economies can strengthen regional financial cooperation in various ways. They can strengthen the ERPD by giving greater teeth to the surveillance process. They can enhance and diversify the resources, functions and membership of the CMIM and AMRO for surveillance and provision of a financial safety net, which may eventually develop into an Asian monetary fund. They can create an AFSD to monitor regional financial markets, facilitate policy dialogue and cooperation, and secure regional financial stability. These regional regulatory institutions can also strengthen ties with their respective global institutions, primarily the IMF and the FSB.

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