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**NEW REGIONALISM IN GLOBAL ORDER: REGIONAL TRADE INTEGRATION
AND LINKS WITH FINANCIAL SECTOR**

by

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A Dissertation Submitted to the Faculty of
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ABSTRACT

NEW REGIONALISM IN GLOBAL ORDER: REGIONAL TRADE INTEGRATION AND LINKS WITH FINANCIAL SECTOR

Tulu Balkir
Old Dominion University, July 2017
Director: Dr. David Earnest

This dissertation evaluates the linkages of regional trade integration with regional financial integration and financial development in the EU and the ASEAN. The research utilizes quantitative and qualitative data to analyze development of banking sector and capital markets in these two regions, to review integration initiatives in these major parts of financial sectors and their possible links to regional trade. The results mainly indicate that banking sector and capital markets perform important functions to provide financing to firms and infrastructure projects, to hedge trade and project risks and to support macro-financial stability, all of which can support regional trade. However, there are significant differences in the EU and ASEAN both in trade and financial sectors and being a member in a region with developed institutional structures and large trade networks is the biggest advantage to intra-regional trade.

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CHAPTER I

INTRODUCTION

This dissertation aims to research the trade integration in the EU and ASEAN in a comparative view and analyze the effect of financial sector development and integration on trade regionalization. The literature on trade regionalization mentions many factors to have impact on regional trade; such as population growth, income growth, tariff levels, factor mobility and technology. However, the research on the links between trade integration and financial sector integration is relatively rare, where financial sector -in this sense- means the banking sector and capital markets, mainly equity and bond markets. Indeed, initiatives for financial sector development and integration and their possible consequences started to attract more attention from the scholars, after strong effects of global finance have multiplied cross border investments and trade of financial instruments and the connectivity between the financial sector and real economy have increased especially in last decade. Over time, fierce competition in global trade and finance as well as the volatility of financial and investment flows –especially in crisis times- led many countries to seek more advantageous regional arrangements to increase cross border trade and to facilitate financial sector enlargement, since both are shown to promote economic growth. In fact, increasing number, coverage and complexity of regional trade agreements and recent initiatives by more countries to link their financial markets conform to the strengthening of regionalization in the globalized world.

The dissertation aims to make an original contribution to the literature by incorporating financial sector development and regional financial integration into the analysis of regional trade

integration. It will seek to understand which links exist between trade integration, financial development and financial integration and whether those links became stronger in the EU and ASEAN over time. This research is expected to reveal linkages between financial integration, financial development and intra-regional trade, although the strength of these linkages may vary by country depending on development levels of economy, trade activity and financial sector as well as related policies and trade patterns. It should be also noted that financial integration is conditional on financial development, and the policies for financial development and integration are not exact substitutes to each other. Therefore, some countries need to focus on financial development before financial integration, which means that the linkages between financial sector and trade can be stronger for more developed countries since financial sector is more functional in these areas.

In order to provide a more complete picture of the EU and ASEAN integration, this thesis will also review the most crucial achievements of these regional agreements to remove tariff and non-tariff trade barriers as well as the main drivers and roadblocks in the trade integration. The EU and ASEAN are selected for this research since they both have ongoing initiatives on trade and financial integration -despite different levels of progress-, which makes them not only comparable but also a good fit for the main research question. While there are other regions targeting both types of integration at the same time, (such as MILA group in Pacific Alliance, East African Community, and West African Monetary Zone) the financial integration and intra-regional trade is lower among these groups. The EU and the ASEAN have higher levels of intra-regional trade, and lead ambitious initiatives for banking sector and bond market integration, with some market-led stock market convergence started to take place.

This dissertation consists of seven chapters and starts with the literature review to show how regional integration is explained by different schools of the IR and Economics and what can possibly affect the course of integration. (Chapter 1) It also focuses on how regional trade integration, financial integration and financial development are connected to economic development, which is the ultimate motivation for most states for regionalization. Chapter 2 explains the evolution of regionalization in the 21st century and the interaction between regionalism and multilateralism in a globalized world. It continues with expected benefits and costs of regional integration in trade and financial sectors (banking and capital markets) and explains the linkages between trade integration, financial integration and financial development. Chapter 3 provides an insight on the research methodology and the main variables used in the analysis of regional trade and financial integration, as well as financial development.

The next step is the detailed analysis of the EU and ASEAN regionalization: Chapter 4 evaluates trade and FDI patterns in two regions as well as formal regionalization initiatives. Chapter 5 overviews the important role of banks in the financial and economic systems and possible benefits and costs of banking integration, while providing specific details on the EU and ASEAN banking sectors. Chapter 6 analyses the stock and bond markets in the EU and ASEAN and provides chronological development of these markets as well as the evolution of their integration. The dissertation ends with concluding Chapter 7, which states that some positive relations were observed between regional trade and financial variables, while the strongest positive effect on regional trade comes from region-specific effects (such as being member of the EU), which refers to more advanced economic structure, larger financial systems and extensive trade networks.

CHAPTER II

LITERATURE REVIEW

REGION AND REGIONAL INTEGRATION

To understand the regional integration requires in the first place to clarify what the terms of region and regional integration mean. In fact, neither “region” nor “regional integration” has uniform definitions; various scholars from political science and economics defined the concept by focusing on different aspects of regional integration. As the first definitions of a region was based simply on territorial dimension, this was later disputed since it was hard to define exactly what kind of borders would constitute a region or how its optimal area would be decided. Today, the definition of region is more fluid and allows different combinations of states, even when they are not that geographically close but indicate convergence in issue areas. In terms of size, regions can be macro (supranational – group of states) or micro (subnational) as well as cross border regions (territories with subnational areas of at least two countries).¹ Macro regions are still the major units of regional international analysis, while micro regions are mostly considered the realm of economics and domestic politics. In terms of criteria, the definition of region or its integration is not only limited to territorial dimension after the distinction between international and domestic realms become blurred with globalization.² Actually, the scholars mention many factors such as geographic proximity, economic (trade and investment) flows, and coordination of foreign policy, as well as shared institutions, common ties (cultural, economic, linguistic, or

¹ Philippe De Lombaerde, Fredrik Söderbaum, Luk Van Langenhove and Francis Baert. “Jean Monnet/Robert Schuman Paper Series Vol. 9 No. 7 April 2009.

² De Lombaerde, P., F.Söderbaum, L.Langenhove and F. Baert; The Problem of Comparison in Comparative Regionalism. Jean Monnet/Robert Schuman Paper Series Vol. 9 No. 7 April 2009.

political) and even mobility of people across the borders when describing the regions.³ In the literature, it wasn't exactly agreed how extensive these ties should be in order to constitute an integration or how an optimal area for a region can be determined. Another approach to regions stipulates that regions can be shaped by common goals or the need to face common problems such as in the case of security communities or regional economic communities. Indeed, regional subsystems can be characterized by clusters of states, which coexist in geographical proximity as interrelated units, and sustain significant security, economic, or political relations.⁴

In this context, regional integration can be seen as a process, which consists of different phases and policies to create closer communities.⁵ Over time, this process can reach an advanced stage to form an integrated community and integration.⁶ According to Haas (1976), “integration theorists tend to assume that the process of regional cooperation, coordination, or centralization” can be conceptualized as leading to some definable outcome or order for the region, “which takes its own institutional form”.⁷ Regional integration can be initiated in security, political and economic dimensions, as the earlier studies of integration in the post-war period concentrated on political and security dimensions of regionalism.⁸ For example scholars such as Karl Deutsch argued during the 1950's that transnational relations would lead to first peaceful relations among societies and then to security communities, in which group of people became “integrated” and solve their issues or conflicts without resorting to physical or military power. Deutsch also

³ Mansfield, Edward D. and Helen V. Milner; *The NewWave of Regionalism*. *International Organization*, Vol. 53, No. 3, Summer, 1999, pp. 589—627.

⁴Kacowicz, Arie, M. *Regionalization, Globalization and Nationalism: Convergent, Divergent, or Overlapping?* Kellogg Institute, Working Paper 262, December 1998.
<https://www3.nd.edu/~kellogg/publications/workingpapers/WPS/262.pdf>

⁵ Heinonen, Hannu; *Regional Integration of the state: The Changing Nature of Sovereignty in Southern Africa and Europe*. PhD Thesis, University of Helsinki, 2006

⁶ Amitai Etzioni; *Political Unification: A Comparative Study of Leaders and Forces*. New York : Holt, Rinehart and Winston, 1965

⁷ Haas, Ernest; *Turbulent Fields and the Theory of Regional Integration*, *International Organization*, 30(2), pp.173-212, 1976

⁸ Hannu Heinonen. *Regional Integration of the state: The Changing Nature of Sovereignty in Southern Africa and Europe*” PhD Thesis, University of Helsinki, 2006

defined integration as turning of “previously separated units into components of a coherent system.”⁹ Scholars from neofunctionalist school such as Haas (1971), Lindberg and Scheingold (1970) saw regional integration more of a political process, while intergovernmentalists such as Oppenheim (1987), Moravcsik (1993) and Rhodes and Mazey (1995) considered it as interplay of national interests between the states. Neoinstitutionalists such as March and Olsen (1984) concentrated their analysis on formation and functioning of supranational institutions in regional integration, and emphasized the role of institutionalization in furthering the regional initiatives and systems. Later on, the economic or welfare considerations started to gain importance in regional integration, drawing the scholars’ attention in trade and economic integration initiatives. Interdependence liberalists, led by Robert Keohane and Joseph Nye (1977), claim that stronger transnational relations between the countries create higher level of interdependence and can lead to closer integration, while emphasizing the important role of economic and trade interests in bringing states together around common goals. In the realm of Economics, different theories also took on this approach and focused on analyzing economic and trade integration with frameworks such as HOS model or new institutional economics, which will be mentioned in more details later. Finally, one crucial point to note is that both IR and Economics made the distinction between two types of regional integration: The first, regionalism, refers to a top-down and government induced process, which relies on formal agreements among the states. (de-jure integration) Second, regionalization refers to an increase in the cross border flow of trade, investments, monetary instruments or people: It is bottom-up process driven by the society, while the interests of economic and political non-governmental actors play a key role in the integration. (de-facto integration) Cooper also mentioned this differentiation between formal

⁹ Keohane, Robert and Joseph S. Nye; *International Interdependence and Integration*, in Fred I Greensrein and Nelson W. Polsby, Eds. *International Politics*. MA. Addison-Wesley, 1975, pp. 363-414

integration via legal and institutional framework and informal integration of markets.¹⁰ Indeed, both terms are often used interchangeably to refer the regional integration process but they represent different phenomena in the IR perspective. Although regional integration relied on mostly “regionalism” or government induced processes in the past, the importance of market integration, which refers to flow of goods and production factors in the region has also been acknowledged more recently. The two processes are considered closely related and even reinforcing each other. In the existence of institutional or legal barriers to trade flows or capital movements, markets can’t be fully integrated. Informal or market based integration among regional countries will eventually need to be supported and regulated by governmental initiatives to ensure their effectiveness and continuance. Likewise, regional treaties not supported by market actors or accompanied by increased market activity can risk failure in achieving their objectives. According to Wallace (1990), informal integration can have effective consequences without formal intervention and cooperation of nonstate actors can lead to deepening of formal integration over time. This approach also fits today’s regional integration initiatives, which incorporate legal, institutional and market stimulating elements.

This recent emphasis of integration theories on the driving role of economic interests in regional integration also fit the approach of this dissertation. Although the security concerns were influential in foundation of the regional treaties such as EU and ASEAN in the post-war era, the gradual reduction of security threats and rise of economic interests in the post-Cold War period strengthened the role of economic agenda in regional integration,¹¹ which also contributed

¹⁰ Cooper, Richard N.; *Worldwide vs Regional Integration: Is there an Optimum Size of the Integrated Area?* in Fritz Machlup (Ed); *Economic Integration: Worldwide, Sectoral, Regional*. Fourth Congress of the International Economic Association. NY, Halsted Press, 1977.

¹¹ Chen, Jie. *Factors Shaping Regional Integration in Europe, Asia and Africa*. M.A. Thesis to University of Lethbridge, 2011. <https://www.uleth.ca/dspace/bitstream/handle/10133/2637/chen,%20jie.pdf?sequence=1>
Chen, Jie. *Factors Shaping Regional Integration in Europe, Asia and Africa*. M.A. Thesis to University of Lethbridge, 2011. <https://www.uleth.ca/dspace/bitstream/handle/10133/2637/chen,%20jie.pdf?sequence=1>

to increasing regionalization trend after 1990's. As many researchers pointed out, both trade and financial integration serve economic interests, while the literature also confirms the positive relation of trade and financial integration with economic development through various channels. In the context of this dissertation, "regions" will be considered as gathering of proximate states under region-wide agreements such as the EU and the ASEAN with a common end-goal of strengthening economic development or competitiveness. The EU and the ASEAN are the subjects of this study since they incorporate the territorial and institutional dimensions of integration, given that their regional institutions extended and trade and financial linkages became strengthened in last two decades. In both regions, integration is based on formalized agreements, which already initiated both trade and financial integration policies for multiple countries, while setting even further convergence as target within a defined future period. In both regions, common goals evolved over time. Security and peace considerations were the main elements of cooperation in the ASEAN until the 1990's. After the Cold War ended, the ASEAN strategy for "collective FDI dependent and export oriented industrialization" came into effect in order to promote collective economic development, exports and regional integration.¹² Likewise, the EU was founded to promote peace and economic prosperity in the post war era: As states agreed to share sovereignty in specified areas such as coal and steel production, economics and trade, the resulting interdependence would make another war in Europe unthinkable.¹³ With the rise of economic interests and decline of security tensions in the 1990's, the European ties also extended in economic, trade and financial areas across the existing and new members more than ever before.

¹² Chen, Jie. Factors Shaping Regional Integration in Europe, Asia and Africa. M.A. Thesis to University of Lethbridge, 2011. <https://www.uleth.ca/dspace/bitstream/handle/10133/2637/chen,%20jie.pdf?sequence=1>

¹³ Kristin Archick. "The European Union: Questions and Answers" Congressional Research Service. Jan 19, 2016

IR THEORIES OF REGIONAL INTEGRATION

The next step in analysis of trade and financial integration requires an understanding of the integration theory as well as its findings on how regional trade integration can be formed and proceed. Integration theory has various permutations -rather than a single theory- and these theories differ from traditional analysis of international politics since they assign causal significance to integration dynamics and posit specific policy effects generated by integration.¹⁴ Early theories of integration were developed to explain the integration of the Europe in 1950s. Since then, neofunctionalism and liberal intergovernmentalism became two grand theories on regional integration, while new institutionalism and interdependence theory became middle-range theories to explain integration. These schools provided valuable insights on how regional integration can it be defined and explained, which expectations lead the states to share sovereignty under regional agreements, and which conditions enhance the continuation, expansion and gains of the integration process rather than its dissolve and undesired results.

Neofunctionalism

One of the most important theories that focused on international integration is neofunctionalism. Neofunctionalism has linked the formation of European Coal and Steel Community (ECSC) and its later development into European Economic Community (EEC) to three different factors; (i) behavior of political actors, whose interests are better served with the existence of supranational institutions, (ii) the need for economic cooperation between the states

¹⁴ O'Neill, Michael (Ed); *The Politics of European Integration*. Routledge, New York, NY 1996.

in order to improve their national welfare, (iii) the positive spillover effects, which is mainly a feedback mechanism of positive results that creates more demand for regional integration.¹⁵

According to Haas (1958), the acknowledged leader of neofunctionalist school, supranational institutions emerge and progress when national actors such as interests groups, organizations and elites recognize these supranational institutions as a better instrument to pursue their interests compared to national institutions and therefore shift their loyalty towards those international entities. In addition,¹⁶ the common desire of the European countries after the WW II to search for policy alternatives in order to enhance security and welfare without repeating the nationalist mistakes of earlier generation brought them together to form a supranational community. The neofunctionalism was based on functionalism, which was led by David Mitrany during the interwar period. Mitrany (1933) also believed that supranational institution building comes from the need for economic and technocratic cooperation among the states in order to improve welfare of their constituencies.¹⁷ Neofunctionalism however, differs from its predecessor since it considers integration with a dynamic nature and searches the roles of supranational, transnational and sub-national actors in its progress.¹⁸ Functionalism searches on institutions and actors' interactions in a stable environment, while focusing on maximization of human welfare.

Both neofunctionalism and its predecessor functionalism expected integration to be progressive. Scholars such as Etzioni (1965) and Deutsch (1957) defined integration as a continuous and expanding process: The problems coming with higher international activity

¹⁵ Haas, Earnest; The Uniting of the Europe and the Uniting of Latin America. *Journal of Common Market Studies*. Vol 5, No: 4, June 1, 1967, pp 315-343,

¹⁶ Haas, Earnest; The Uniting of the Europe and the Uniting of Latin America. *Journal of Common Market Studies*. Vol 5, No: 4, June 1, 1967, pp 315-343,

¹⁷ Ben Rosamond; The Uniting of Europe and the Foundation of EU Studies: Revisiting the Neofunctionalism of Ernst B. Haas. *Journal of European Public Policy*, Vol.12, No.2, 2005, pp 237-254.

¹⁸ Thomas Gehring "Integrating Integration Theory: Neo-functionalism and International Regimes." *Global Society*, Vol. 10, No. 3, 1996 225

create more demand for international problem solving, which will be again provided by more international collaboration and institutionalization. Neofunctionalists claimed that regional integration is progressive through the spillover effects. The notion of spillover remained the most relevant element of the neofunctionalist approach to the study of European integration. Spillover effects “amounts to a (positive) feedback mechanism stressing the possibility of self-supporting social processes that start modestly, gain dynamics and may over time produce dramatic outcomes.”¹⁹ In other words, the positive effects of integration would lead to increased cooperation among the states, which contribute to expansion in the number and tasks of international institutions, of which mandate and competence would grow larger compared to national governments over time. This spillover process has two key components:²⁰ The sectoral or functional spillover means the expansion of integration from one sector to others. The political spillover refers to deeper integration or a shift from coordination of national policies to a more internationally centralized or supranational governance structure. Apart from these, the geographical extension of integration can also be added to these key forms.²¹ Neofunctionalism predicted self- sustenance and development of sectoral integration in these three dimensions. Furthermore, Lindberg and Scheingold (1970) expanded their analysis on complex bargaining underlying the integration and identified four mechanisms of coalition-formation: functional spill-over, side payments and log-rolling, actor socialization, and feedback.²² Still, it was mostly the first mechanism that integration researchers have mostly focused on.

¹⁹ Gehring, Thomas. Integrating Integration Theory: Neo-functionalism and International Regimes. *Global Society*, Vol. 10, No. 3, 1996, p. 225

²⁰ Moga, Teodor Lucian; The contribution of the Neofunctionalist and Intergovernmentalist Theories to the Evolution of the European Integration Process. *Journal of Alternative Perspectives in the Social Sciences* Vol 1, No 3, 2009, pp. 796-807

²¹ Moga, Teodor Lucian; The contribution of the Neofunctionalist and Intergovernmentalist Theories to the Evolution of the European Integration Process. *Journal of Alternative Perspectives in the Social Sciences* Vol 1, No 3, 2009, pp. 796-807

²² Lindberg, L. N., and S.A. Scheingold; *Europe's would-be polity; patterns of change in the European community*. Englewood Cliffs, N.J., Prentice-Hall, 1970.

While neofunctionalism was instrumental to explain European integration in the post-war period, it was widely criticized starting from 1960's for multiple reasons: First, its emphasis on supranational institutions and non-state actors was not sufficient to explain behavior of states as macro units in regionalization. Moreover, it also fell short of addressing the recession of regional integration, not only in Europe but also the other parts of the world. In the 1960's, France vetoed the UK's application to the European Common Market and application of Ireland, Denmark and Norway were also suspended. In 1970's, disagreements related to European Common Agricultural Policy surfaced, while the oil crisis and commencement of a world-wide economic recession in 1974 led to protectionist policies and undermined regionalization around the world, especially in economics and trade areas. In this environment, neofunctionalism was criticized for having low explanatory power on regression of regional integration, putting too much significance on the supranational authorities and miscalculating the interests of nation states.²³

Intergovernmentalism

The most prominent criticism to neofunctionalism came from intergovernmentalism, which emphasized the role of state interests in the integration process. Originally presented by Stanley Hoffman²⁴, intergovernmentalism relied on realist ideas by recognizing states as the primary factors in regional integration. As the interests of states and national governments converge or diverge, the integration process can progress or regress.²⁵ This approach also

²³ Monasour, Nisreen; Neofunctionalism and European Integration: Is it Still a Case of Spillover? August 3, 2011. <http://www.e-ir.info/2011/08/03/neofunctionalism-and-european-integration-is-it-still-a-case-of-spillover/>

²⁴ Hoffmann, Stanley; *The State of War: Essays on the Theory and Practice of International Politics*, New York; Praeger, 1965.

²⁵ Hoffmann, Stanley; *The State of War: Essays on the Theory and Practice of International Politics*, New York; Praeger, 1965..

explains the volatility of the regional integration process in 1960s and 1970's. For intergovernmentalist scholars, national interest refers to goals related to national security, such as the preservation of political independence and territorial integrity.²⁶ Coming from realism, they differentiated between high and low politics and argued that integration might work in the realm of low politics, such as economic integration but not in high politics such as foreign policy, which affect key national interests. Likewise, the supranational institutions could be assigned with issues of low politics, but high politics were to be governed by states.

In terms of trade patterns, realist approach posited that large countries dominate international trade through the rules they designed themselves and force smaller countries to move along with them. (Krasner 1976). Later scholars such as Wallerstein (2004) and Irwin (2008) also pointed out that trade relations can be formed under political considerations of developed states, as they offer market access to less developed or developing states to bring them under economic and political influence. In this core-periphery setting, trade relations can exploit the less powerful states, which keep on exporting raw materials (or low value added products) and importing finished goods (or high value added products) without being able to move up in the production chain.

Hoffmann also believed that major failure of neofunctionalism was to assume regional integration as progressive: Countries are also part of the global system and integration should be viewed within the international context rather than internal dynamics.²⁷ Hansen (1969) made similar criticisms, citing that international factors may influence elite perceptions within the

²⁶ Openheim, Felix; "National Interest, Rationality, and Morality." *Political Theory*, Vol. 15, No. 3 (Aug., 1987), pp. 369-389

²⁷ Bache, Ian., George, Stephan.; *Politics in the European Union*, 2nd ed. Oxford University Press, Oxfors, UK 2006

regional union.²⁸ Moreover, since national interests decide the course of regional integration, states can actually control the degree and speed of the process, instead of being led into this process by interest groups.²⁹

These insights proved correct in 1970's when the gains from a regional union were doubtful since traditional economic policies were ineffective to treat stagflation problems and restore economic stability in the existence of global oil crisis. Hansen's criticisms was followed by interdependency theorists in the IR, who claimed that the focus of analysis should turn from integration theories to overall interdependence. Nevertheless, scholars such as Oppenheim (1987) stated that importance of states wouldn't be diminished by growth of international interdependence or significance of non-state actors (such as international institutions, transnational actors or multinational corporations) since those actors can affect international politics only by their influence on national governments.³⁰ Intergovernmentalists viewed international institutions as instruments of state power and interests, which states can use to pursue their interests by using international laws.³¹

Neofunctionalism vs Intergovernmentalism

With the fall of regionalization in 1960's and 1970's, Haas (1976) also acknowledged the shortcomings of neofunctionalism in explaining the challenges of integration. He stated that the European Community found itself in a complex economic and political context, where political

²⁸ Hansen, R. D.; Regional Integration: Reflections on a Decade of Theoretical Efforts' World Politics, 21(2), 1969 in Eilstrup Sangiovanni, Ed.; Debates on European Integration. Palgrave Macmillan: Basingstoke, 2006.

²⁹ Bache, Ian., George, Stephan.; Politics in the European Union, 2nd ed. Oxford University Press, Oxfors, UK 2006

³⁰ Openheim, Felix; "National Interest, Rationality, and Morality." Political Theory, Vol. 15, No. 3 (Aug., 1987), pp. 369-389

³¹ Beth Simmons and Losa L. Martin; International Organizations and Institutions. In Thomas Kisse, Beth Simmons (Eds) Handbook of International Relations. Sage, Thousand Oaks, CA, 2001.

actors had different incompatible objectives under imperfect information.³² In such conditions, the outcome of integration could be unpredictable. Meanwhile, some later scholars attempted to improve the argument of the neofunctionalist school by identifying other types of spillover effects such as negative ("spill back") and indifferent ("spill around") feedback.³³ In his analysis, Schmitter (1970) explained various strategic options for political actors regarding to level of decisional authority and scope (coverage of issue areas) assigned to institutions: In any given context, spillover refers to a strategy of increasing both the scope and authority level of institutions, spill-around refers to an increase only the scope of institutions while holding the level of authority constant and spill back refers to retreat on both dimensions, possibly returning to the status quo before initiation.³⁴ Schmitter (1970) also emphasized the fluidity of national actors' behavior in regionalization: During the transforming cycles of regionalization, the national actors can evolve into subnational groups with their own strategies. Nye and Lindberg suggested that this differentiation can appear even in the initial cycles.³⁵

Nonetheless, the neofunctionalist arguments started to be revitalized in 1980's, when the European integration started to progress again by the Single European Act and accession of new countries in broader and deeper perspective. Some scholars attributed this progress to two factors in the neofunctionalist context:³⁶ The first was the positive spillover effects since the removal of some cross border tariffs led to demand for more integration across other sectors. The second was the pivotal role of the supranational institutions in the EC to pursue deeper integration. Yet,

³² Haas, Ernest; Turbulent Fields and the Theory of Regional Integration. *International Organization*, Vol. 30, No. 2, Spring, 1976, pp. 173-212

³³ Thomas Gehring "Integrating Integration Theory: Neo-functionalism and International Regimes." *Global Society*, Vol. 10, No. 3, 1996 p 225

³⁴ Phillippe C. Schmitter "A Revised Theory of Regional Integration" *International Organization*, Vol. 24, No. 4, *Regional Integration: Theory and Research* (Autumn, 1970), pp. 836-868, University of Wisconsin Press

³⁵ Phillippe C. Schmitter "A Revised Theory of Regional Integration" *International Organization*, Vol. 24, No. 4, *Regional Integration: Theory and Research* (Autumn, 1970), pp. 836-868, University of Wisconsin Press

³⁶ Eilstrup-Sangiovanni, M. (2005), 'The 1992-Project, the Revival of Neofunctionalism and the Liberal Intergovernmentalist Challenge' in Eilstrup-Sangiovanni, M. (ed.) (2005), *Debates on European Integration: A Reader* (Basingstoke: Palgrave Macmillan),

intergovernmentalists argued that neofunctionalism undermined value of national sovereignty as well as importance of national interests in regional integration. Moreover, it still lacked the theoretical core to explain how governments actually make decisions.³⁷ Moravcsik build upon this approach to form his theory of liberal intergovernmentalism. He defined integration as a process in which rational governments define series of objectives and preferences, bargain their agreements to cooperate and the chose appropriate international institutions to embed these goals.³⁸ Liberal intergovernmentalists dismissed the attention placed on non-state actors in neofunctionalism³⁹ but accepted that international institutions can help states to solve their cooperation and coordination problems. They also agreed that domestic level competition among interest groups can influence formation of national preferences, which are later reflected into interstate bargains of integration. Moreover, if the states think that the other counties may cheat on international agreements, they can agree to share sovereignty with supranational institutions to ensure compliance. Rhodes and Mazey (1995) stated that by taking into account domestic interests and international institutional environment, intergovernmentalism developed better explanatory power than neofunctionalism on prominent issues of the EU, such as monetary union, enlargement, institutional reform and foreign policy.⁴⁰

Intergovernmentalism was criticized by scholars for oversimplifying regional integration by focusing too much “on the formal and final stages of decision making” and paying little attention to informal integration”.⁴¹ As a neofunctionalist, Schmitter (2005) also emphasized the role of sub-national actors and markets in European integration: He posited that when policy

³⁷ Moravcsik, A., ‘Preferences and Power in the European Community: A Liberal Intergovernmentalist Approach’, *Journal of Common Market Studies*, 31(4), p.476 1993

³⁸ Andrew Moravcsik “The Choice of the Europe” 1998

³⁹ Eilstrup-Sangiovanni, M (Ed). (2006). *Debates on European Integration*. Palgrave Macmillan: Basingstoke.

⁴⁰ *The State of the European Union, Volume 3: Building a European Polity?* Edited by Carolyn Rhodes and Sonia Mazey. Boulder, CO: Lynne Rienner, 1995. 520p

⁴¹ Neill Nugent “The Government and Politics of the European Union” 2006

expansion is coupled with a persistent increase of commercial and financial transactions among firms, individuals or sub-national groups, it becomes necessary to reach deeper or more comprehensive agreements to further benefit from the integration. This also fits the notion of complementarity of de-jure and de-facto regional integration, as mentioned before. Schmitter (2005) also stated that massive amount of intra-regional transactions triggered spillovers to capital markets and monetary policy of the EU countries and these complex interconnections can bring regional integration beyond “the threshold of irreversibility”, after which threat of defect by a member state is no longer credible. Other criticisms such as Foster (1998) pointed out that formation of government objectives and strategies can be unpredictable since politics is not always a rational process. Kassim and Menon (2003) stated that liberal intergovernmentalists underestimate the supranational institutions’ ability to “act as a policy entrepreneur” since major decisions regarding the European integration are made at the level of the European Council, rather than national governments, indicating power of supranational institutions.⁴² Scholars such as Ruggie (1998), Sandholtz (1993), Risse (1996) also claimed that only membership to a supranational institution by itself can alter the governments’ preferences.

Neoinstitutionalism

Another IR theory, neoinstitutionalism, also agreed with critics of intergovernmentalism that the EU institutions indeed constrain and shape intergovernmental politics.⁴³ Thus, institutions play crucial role in international cooperation and integration since they empower or

⁴² Hussein Kassim and Anand Menon. "The principal-agent approach and the study of the European Union: promise unfulfilled?" *Journal of European Public Policy* 10:1 February 2003: 121–139

⁴³ Mark A. Pollack “International Relations Theory and European Integration” *Journal of Common Market Studies* June 2001 Vol 39, No:2

constrain political actors, define the rules for resolving conflicts, allocate the gains and costs and help mitigate lack of trust in the anarchic international environment.⁴⁴ Neoinstitutionalists accept that institutions can constrain the behavior of political actors through “lock-in” effects, while similar arguments were also made by neofunctionalists. For example, scholars such as Panagariya (1999), Krugman (1993) pointed out that “locking in” economic reforms by member states can be a major argument for regionalization. Those two schools also agree that and international institutions can benefit from economies of scale during integration. Moreover, integration is a complex process, shaped by interaction of institutions and it doesn’t necessarily have progressive nature.

However, neoinstitutionalists don’t differentiate between high and low politics and they expand the definition of institutions to include informal rules. Their views also resemble that of intergovernmentalists by assuming that states aim to maximize their absolute gains by cooperation. This also fits the interdependence theory, in which states are less concerned on relative gains of cooperation and greatest risks to cooperation would come from non-compliance of other states.⁴⁵ Indeed, institutionalism argued for more emphasis on soft power and cooperation by international law, diplomacy and international organizations.⁴⁶

Institutionalism in its initial version focused on “describing and mapping the formal governmental institutions within specific countries on a comparative basis.⁴⁷ Starting from 1980’s the new institutionalism developed beyond this comparative method and treated institutions as political actors. According to March and Olsen (1984), institutional decisions are affected by collective interests and preferences, institutions’ own internal mechanisms and

⁴⁴ Johan P. Olsen “ Understanding Institutions and Logics of Appropriateness: Introductory Essay” Working Paper No. 13, August 2007 Center for European studies

⁴⁵ Bull, Hedley; *The Anarchical Society: a Study of order in world politics*. Macmillan, Basingstoke, 1977.

⁴⁶ Bull, Hedley; *The Anarchical Society: a Study of order in world politics*. Macmillan, Basingstoke, 1977.

⁴⁷ Bell, Stephen; *Institutionalism: Old and New*, in *Government, Politics, Policy and Power in Australia*, Dennis Woodward, Andrew Parkin & John Summers eds., 2002

distribution of power among political actors.⁴⁸ Institutions facilitate regional integration by enabling states to commit to common long-term interests rather than short-term gains. According to Keohane (1984) and Laursen (2005), regional integration can be seen as a form of international regime, which helps the participating states to solve their coordination and cooperation problems.⁴⁹ New institutionalism also developed three schools under its umbrella; historical institutionalism, rational choice institutionalism and sociological institutionalism.

Historical institutionalism focuses on developments of political institutions over time and claims that interaction of institutions shape political outcomes such as integration. Lieberman (2002), Katznelson and Weingast (2005) state that institutions create structural constraints on political actors and policy outcomes emerge as a result of the competition for limited resources and the distribution of power rather than rational choice.⁵⁰ According to Nugent (2010), these structural constraints and distribution of power produced by institutions result in “path dependence” and “unintended consequences”, which make institutional change hard to control. Similarly, national governments’ capacity to control the course of integration can be weakened by institutional effects such as “path dependence and lock –in” and institutional functions can diverge from the goals of original designers over time.⁵¹ In this context, institutions can be stable over long term or generate disturbance to status quo with discontinuances and unexpected

⁴⁸ James G. March and Johan P. Olsen “The New Institutionalism: Organizational Factors in Political Life” *The American Political Science Review*, Vol. 78, No. 3 (Sep., 1984), pp. 734-749

⁴⁹ Thomas Gehring “Integrating Integration Theory: Neo-functionalism and International Regimes.” *Global Society*, Vol. 10, No. 3, 1996 225

⁵⁰ Robert C. Lieberman “Ideas, Institutions, and Political Order: Explaining Political Change” *The American Political Science Review*, Vol. 96, No. 4 (Dec., 2002), pp. 697-712 and Sven Steinmo, Kathleen Thelen, Frank Longstreth. *Historical Institutionalism in Comparative Analysis*. 1992

⁵¹ Paul Pierson. “The Path to European Integration: A historical Institutional Analysis” in “European Integration and Supranational Governance.” Wayne Sandholtz and Alec Stone Sweet, 1998

results.⁵² If governments are not able to calculate long term results of delegating their authority to international institutions, they may choose not to so and focus on short term interests.⁵³

Rational Choice Institutionalism (RCI) takes its roots from rational choice theory and focuses on how institutional decision making and rational decisions of political actors affect integration. RCI scholars employed decision-making models such as the principal-agent model from neoclassical economics to explain cooperation under different conditions. They suggested that institutions support integration by reducing the transaction costs and influencing policy outcomes. According to Weingast (1998), this influence extends to “macroeconomic policy making, welfare, budgets, regulation and technology.”⁵⁴ However, for these effects to be durable, institutions must be durable and or “self-enforcing” themselves, meaning that only certain actors are capable of changing the institutions and they have no incentives to do so.⁵⁵ On international cooperation, Axelrod and Keohane (1985) analyzed the Prisoner’s dilemma and concluded that its non-cooperative outcome can change when the game is played iteratively, actors can better evaluate the future impacts of their joint actions and they are willing to cooperate with each other, while factors such as regularity of stakes, long time horizons, reliability of information and quick feedback about others’ actions increase the possibility of future cooperative outcomes. Gehring (1996) stated that coordination problems under regional integration can be solved either by a benevolent hegemon (and a smaller group of “privileged” states adapting the preferences of hegemon) or by establishing institutions, which can set the progressive agenda for integration and perform dispute resolution.

⁵² Ira Katznelson and Barry R. Weingast “Intersections Between Historical and Rational Choice Institutionalism” 2005

⁵³ Paul Pierson. “The Path to European Integration: A historical Institutional Analysis” in “European Integration and Supranational Governance.” Wayne Sandholtz and Alec Stone Sweet, 1998

⁵⁴ Weingast, Barry (1998) ‘Political Institutions: Rational Choice Perspectives’ in “A New Handbook of Political Science” Robert E. Goodin and Hans-Dieter Klingemann.

⁵⁵ Weingast, Barry (1998) ‘Political Institutions: Rational Choice Perspectives’ in “A New Handbook of Political Science” Robert E. Goodin and Hans-Dieter Klingemann.

Interdependence Theory

Interdependence liberals, led by Robert Keohane and Joseph Nye, claim that stronger transnational relations between the countries create higher level of mutual dependence, under which, the relations among the states and transnational actors are reciprocal, competitive and cooperative.⁵⁶ They defined the integration as “any level of association between actors, on one dimension or another.” They also linked integration with interdependence by saying that both concepts relate to interactivity or “sensitivity” of one state’s actions to another and this can influence participants asymmetrically.⁵⁷

Keohane and Nye also defined three types of interdependence and integration -social, economic and political- and made distinction among these concepts. Integration and interdependence can be interchangeable terms in cases of economic and social interdependence, except that “integration often takes place within an institutional framework.”⁵⁸ However, the political interdependence or economic vulnerability can’t be used interchangeably with integration since vulnerability signals that interdependence was not developed explicitly. Three types of interdependence and integration are defined as follows:⁵⁹ Social interdependence or integration is “sensitivity of societies to changes taking place in other societies, while economic interdependence or integration is “sensitivity of economic transactions between two or more nations to economic developments within those nations”. Political interdependence occurs when actors’ decisions in one part of a system affect other actors’ decisions elsewhere. Political

⁵⁶ Keohane, Robert O., and Joseph S. Nye. *Power and Interdependence: World Politics in Transition*. Boston: Little, Brown & Co., 1977.

⁵⁷ Keohane, Robert and Joseph S. Nye; *International Interdependence and Integration*, in Fred I Greensrein and Nelson W. Polsby, Eds. *International Politics*. MA. Addison-Wesley, 1975, pp. 363-414

⁵⁸ Keohane, Robert and Joseph S. Nye; *International Interdependence and Integration*, in Fred I Greensrein and Nelson W. Polsby, Eds. *International Politics*. MA. Addison-Wesley, 1975, pp. 363-414

⁵⁹ Keohane, Robert and Joseph S. Nye; *International Interdependence and Integration*, in Fred I Greensrein and Nelson W. Polsby, Eds. *International Politics*. MA. Addison-Wesley, 1975, pp. 363-414

integration aims to reduce adverse effects of policy interdependence by coordinating the policies.

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Interdependence liberalists claim that changing nature of states and international politics made trade and welfare objectives of states more important than military power. For example, Rosecrance (1986) stated that development of international trade system started to replace the costly territorial expansion: In this “trading world”, states are differentiated in their functions and production of different goods and services. Thus, interdependent relations and international division of labor does not only affect trade patterns under integration but also serve as an instrument for states, which seek to improve their positions in international system.⁶¹ Jackson and Sorensen (2016) also comment that economic and political modernization of states, intensified international division of labor, export oriented economic policies, developing technology and increasing significance of transnational actors strengthened the scope and level of interdependence among the states and shaped the trade patterns, while welfare become primary concern of states.⁶² The insights of interdependence theory can also be observed in foundation and development of the ECSC: Schmitter noted that the ECSC was founded to eliminate the risk of war in Europe and overcome the antagonism between France and Germany after the attempts for more direct solutions such as federalism or military union failed. The solution came through more indirect policies, namely “integration of two industrial sectors that would be necessary in the event of any future conflict, i.e. coal and steel”.⁶³

⁶⁰ Keohane, Robert and Joseph S. Nye; *International Interdependence and Integration*, in Fred I Greensrein and Nelson W. Polsby, Eds. *International Politics*. MA. Addison-Wesley, 1975, pp. 363-414

⁶¹ Richard Rosecrance, *The Rise of the Trading State: Commerce and Conquest in the Modern World*, 1986

⁶² Robert Jackson, Georg Sørensen *Introduction to International Relations: Theories and Approaches*” Sixth Edition, 2016

⁶³ Schmitter, Philippe C.; Earnest B. Haas and the legacy of neofunctionalism, *Journal of European Public Policy*, 12:2, 2005, pp. 255-272

Richard N. Cooper, another scholar of interdependence theory, approached integration on a different aspect and emphasized the role of institutional and legal framework to provide international collective goods, while making distinction between integration through legal and institutional relationships and through market relationships. According to him, institutional and legal frameworks closely relate to provision of collective goods by larger jurisdictions, which can become easier when the residents of the integrated areas have similar preferences and needs, and those needs are provided by similar regimes such as capitalism, socialism, or centralized vs decentralized governance.⁶⁴ The greater the diversity within the region, the harder it will be to meet the needs of its residents, since the integration principally targets equitable distribution of similar public goods in the area. The integration also brings the question of how much the individuals can sacrifice from their income to support the supranational institutions, which may provide the conventional public goods more or less effectively.⁶⁵

INTEGRATION THEORIES IN ECONOMICS

While the integration theories of the IR help us to understand various aspects of regional cooperation and integration, economic literature also seeks to explain and analyze this phenomenon. In fact, definition of regional integration is simpler for economics: For example; one of the most important scholars on economic integration, Balassa (1961) stated that the basic ingredient of any integration was the elimination of barriers to trade among two or more

⁶⁴ Richard N. Cooper, "Worldwide vs Regional Integration: Is there and Optimum Size of the Integrated Area?" in Fritz Machlup (Ed) "Economic Integration Worldwide"

⁶⁵ Richard N. Cooper, "Worldwide vs Regional Integration: Is there and Optimum Size of the Integrated Area?" in Fritz Machlup (Ed) "Economic Integration Worldwide"

countries.⁶⁶ Given that economic activity consists of many sub-sectors with or without comparative advantage for a specific nation, Allen (1963) stated that economic integration may mean something different to every state and also made distinction between economic cooperation and integration. Later scholars, such as Machlup (1977) or Staley (1977) defined economic integration as a process, combining separate economies into a larger economic region. Mansfield and Helen (1999) also defined regional integration in terms of region-wide trade and other economic agreements. Over time, definition of regionalism under economics became more flexible. L. A. Winters (2000) defined regionalism as “any policy designed to reduce trade barriers between a subset of countries, regardless of whether those countries are actually contiguous or even close to each other.”⁶⁷ In this respect, regional integration doesn’t have to end up in full economic union and regional integration can proceed with national differences. This latter definition also fits the more flexible nature of regional integration today and explains trade agreements between geographically distant partners such as mega-regional trade agreements.

Indeed, with the recent expansion of global trade and finance, improved sophistication of financial and product markets, more efficient technologies and better mobility of production factors, the regional economic integration can refer to different policy and market changes. According to the European Central Bank (ECB), economic integration can be considered into seven sub-categories:⁶⁸ (i) Synchronisation of the business cycle, (ii) convergence of inflation rates, (iii) exchange rate variability, (iv) trade openness and integration, (v) financial market integration, (vi) convergence of interest rates, (vii) income convergence. Out of these subcategories, inflation rates, exchange rates and interest rates are related to monetary

⁶⁶ Balassa, Bela; *The Theory of Economic Integration*. University of California, The Irwin Series in Economics, 1961

⁶⁷ Winters, Alan; *Regionalism and Multilateralism in the Twenty-First Century*. 2000

⁶⁸ Dorrucchi, E., S. Firpo, M. Fratzscher and F.P. Mongelli (2002), “European Integration: What Lessons for Other Regions? The Case of Latin America”, *European Central Bank Working Paper Series*, (185).

convergence or monetary union, while the other two categories, trade and financial integration will constitute the center of this dissertation. The ECB also distinguishes between institutional and economic integration and evaluated institutional integration also in four dimensions:⁶⁹ (i) free trade area/customs union, (ii) common market, (iii) economic union, (iv) total economic integration.

With this sophistication and expansion in the notion of economic integration, especially in last decade, the research on the economics field has evolved to include two types of analysis. On one side, a static analysis of economic integration was developed to focus on the gains from trade and integration. This traditional or static analysis of economic integration starts with Viner's (1950) customs union theory, which aimed to identify positive and negative effects of economic integration and divided its possible effects into trade creation and trade diversion effects. Trade creation refers to shift of trade from high-cost to low-cost supplier member nation, while trade diversion happens when regional imports are shifted from low-cost non-member supplier nation to a relatively higher-cost supplier member country. Viner (1950) claimed that trade creation effect would raise the welfare of home country, while trade diversion would lower it. He also identified the economies of scale effects in economic regional integration, where larger markets reduce the unit production costs and lead to more free trade agreements.

Lipsey (1960) argued that Viner's work considered production effect of the customs union, but did not take consumption effects into account, which could influence production structures and overall welfare effects. He suggested that the analysis of economic integration should make distinction between "inter-country substitution" and "inter-commodity substitution",

⁶⁹ Dorrucchi, E., S. Firpo, M. Fratzscher and F.P. Mongelli (2002), "European Integration: What Lessons for Other Regions? The Case of Latin America", European Central Bank Working Paper Series, (185).

while the former was covered by Viner's framework and the latter added by Lipsey.⁷⁰ In terms of trade gains, scholars such as Meade (1955), Hillmann (1957) and Sheer (1981) suggested that a customs union may increase the welfare of partner countries if their products are potentially complementary, initial tariff levels are high and they are primary suppliers to each other.

In economic theory, regional integration also associates with the HOS framework in neoclassical economics as well as various theories focusing on pricing of production factors under international trade (such as Factor Price Equalization theory or Samuelson-Stolper theory) in addition to New Trade Theory. To explain international trade patterns, some theories incorporated the well-known Ricardian model into their framework and searched on how countries can achieve comparative advantage. In this context, many scholars claimed that comparative advantage could be produced through various channels such as countries' endowments in factors of production, technology or reciprocal demand for each other's' commodities (neoclassical approach).⁷¹

Heckscher-Ohlin Theory predicted that international trade patterns can be determined by countries' comparative advantage in factors of production, meaning that countries would export (import) goods that intensively use abundant (scarce) production factors at home. The model was simple by assuming identical production functions for the same products across countries as well as same commodity prices, constant returns to scale, factor mobility within (but not between) countries. Coming from H-O theory, Heckscher-Ohlin-Samuelson (HOS) framework suggested that countries' competitive advantage in certain goods are determined by their relative endowments of the production factors. The factor-price equalization theorem,⁷² originating from

⁷⁰ R. G. Lipsey. The Theory of Customs Unions: A General Survey. *The Economic Journal*, Vol. 70, No. 279. (Sep., 1960), pp. 496—513

⁷¹ Andrea Maneschi Comparative Advantage in International Trade: A Historical Perspective. 1998

⁷² Samuelson, P. A. (1948). "International Trade and the Equalization of Factor Prices", *Economic Journal*, June, pp. 163-184

H-O theory, claimed that countries with different factor endowments and development levels would have the most trade with each other and prices of production factors would eventually converge between them after integration occurs. Similarly, Stolper-Samuelson Theorem⁷³ claimed a positive relationship between the relative prices of output and relative factor prices under certain assumptions such as perfect competition or constant returns to scale.

Later studies searched on the applicability of these results into international trade. Leotief (1953) put the H-O theory into test and found that the US –as a capital abundant country– exported more labor intensive commodities than capital intensive, which undermined validity of the H-O theory. Moreover, “contrary to what the H-O theory suggests, most trade flows were shown to occur between industrialized countries whose factor comparative advantage endowments are fairly similar....much of this trade is intra-industry in nature, meaning that the same types of commodity are both exported and imported.”⁷⁴ Arguments by Kravis (1963), Watkins (1963) and Sakamoto (1969) hold that comparative advantage by factor endowments may hold true for natural-resource intensive products such as agriculture but not for manufacturing products. Moreover, Linder (1961) and Kravis (1963) argued that rather than comparative advantage by supply side differences, trade patterns are formed by consumer demand and preferences, which determine especially trade of manufactured goods. In this context, trade is more likely to occur among countries with similar demand structures, while demand structure of a country can be approximated by per capita income. In addition to these discussions, Lipsey (1960) also concluded that welfare gains of a customs union would be larger for a country when its trade with regional partners is higher than rest of the world and when the

⁷³ Stolper, W. F.; Samuelson, Paul A. "Protection and real wages". *The Review of Economic Studies*. Oxford Journals. 9 (1): pp 58–73. November 1941.

⁷⁴ Maneschi, Andrea. *Comparative Advantage in International Trade: A Historical Perspective*. 1998

share of domestic trade is higher in its national GDP.⁷⁵ However, it is still under debate in the literature what kind of trade patterns (inter industry or intra-industry trade) would drive trade integration or how relative levels of per capita income –as indicator of demand structures- affect trade patterns or integration.

On the other side, a dynamic analysis of economic integration also emerged to incorporate changing trade environment and economic conditions into research of integration.⁷⁶ In the economic literature, this dynamic analysis is also referred as new integration theory or new regionalism, while the static or traditional analysis is referred as old regionalism. Dynamic analysis of economic integration came as a result of dissatisfaction with the H-O theory and related frameworks, which led to formulation of new trade theory in 1970s: Some models of new trade theory completely dispensed comparative advantage and replaced that with “increasing returns to scale, external economies, differentiated products, and the associated imperfectly competitive market structures” to explain trade patterns and integration⁷⁷.

The need for a dynamic analysis was known even during 1960’s after Viner (1950) and Cooper and Massell (1965) reached a conclusion that non-preferential trade policy (free trade) was more superior to customs union in promoting trade liberalization and better allocation of resources wouldn’t be a rationale for creation of customs union.⁷⁸ Since static analysis can’t fully access the welfare impact of integration, Balassa (1961) and Cooper and Massell (1965) became the first researchers that introduce dynamic effects of economic integration: Balassa (1961) defines the main dynamic effects of integration as “large-scale economies, technological change, as well as the impact of integration on market structure and competition, productivity growth,

⁷⁵ Lipsey, R. G. 1960. The theory of customs unions: A general survey. *The Economic Journal* 70 (279): pp. 496-513

⁷⁶ Amr Sadek Hosny. “Theories of Economic Integration: A Survey of the Economic and Political Literature.” *International Journal of Economy, Management and Social Sciences*, 2(5) May 2013, Pages: 133-155

⁷⁷ Maneschi, Andrea. *Comparative Advantage in International Trade: A Historical Perspective*. Cheltenham: Elgar. 1998

⁷⁸ Amr Sadek Hosny. “Theories of Economic Integration: A Survey of the Economic and Political Literature.” *International Journal of Economy, Management and Social Sciences*, 2(5) May 2013, Pages: 133-155

risk and uncertainty, and investment activity”⁷⁹ Those dynamic effects, in return, constitute the main drivers of integration. Schiff and Winters (1998) defined these effects as anything that affects the medium and long term economic growth of the member-states, which also can include increasing importance of private sector, services sector and FDI in member economies.⁸⁰ However, it should be noted that although expanded size of markets is expected to increase the supply and demand for products, or to reduce unit production costs, economies of scale can form by firm size rather than the size of industry for some instances. In terms of competition, some industries can have naturally monopolistic, oligopolistic or monopsonic structure. If industrial structure is naturally open to competition, regional integration would improve industrial efficiency and productivity by bringing regional competitors into national markets. Effects of increased FDI among member countries also depends on type of FDI such as short term-portfolio investments or long-term investments, the behavior of foreign firms in host country as well as whether these investments are channeled to productive sectors. The expected benefits and costs of regional integration will be mentioned more in detail later.

In addition to economic theory, the application of new institutionalism into neoclassical economic theory opened a new avenue of research “New Institutional Economics” – NIE, which placed institutions and political processes as a critical factor in explaining economic performance and divergence of economic development across countries. One of the leading NIE scholars, Ronald Coase (1960) formulated the crucial linkage between institutions, transaction costs and neo-classical economic theory. He stated that institutions are the crucial determinant of market efficiency since they reduce the transaction costs, which affect to cost of production and

⁷⁹ Eduard Marinov “Economic Integration Theories and the Developing Countries” Economic Research Institute at BAS, South-East Europe Research Centre, September 2014

⁸⁰ Eduard Marinov “Economic Integration Theories and the Developing Countries” Economic Research Institute at BAS, South-East Europe Research Centre, September 2014

productivity.⁸¹ Oliver Williamson (1985) also views transaction cost economics as a part of the NIE research, which studies economic organizations, especially firms and markets and search on how production activity is organized within the firms and markets.⁸² Another leading NIE scholar, Douglas North (1990) claimed that institutions support the economic integration since they can alter the payoff structures to induce cooperative solutions and reduce transaction costs related to economic restructuring, which can enhance productivity by worldwide division of labor and specialization: However, some scholars such as Engerman and Sokoloff also noted that to deliver these benefits, the economic and political institutions need to be flexible enough to adjust to changing conditions and allow public and private agents to take full advantage of technological and environmental changes in order to foster economic performance and growth.⁸³

The determinants of intra-regional trade and linkage to economic development

The next step of the analysis requires deeper understanding of international trade patterns, financial development and financial integration as well as how financial system affects trade. Since last two decades, the increase in both global and regional trade was remarkable: According to WTO data between 1995 and 2014, the world exports increased by more than 5% annually on average, (despite the 12% reduction in 2009), which was more than the rise of the world GDP at 3%.⁸⁴ The EU, ASEAN and NAFTA became the largest merchandise exporters of the world, with 33%, 14% and 7% of global total respectively.⁸⁵ Share of intra-regional exports in total exports were highest for the Europe, Asia and North America, with around 70% for the Europe

⁸¹ Ronald H. Coase “The Problem of Social Cost” *Journal of Law and Economics*, Vol. 3. (Oct., 1960), pp. 1-44.

⁸² Williamson, Oliver (1985) *The Economic Institutions of Capitalism*, New York, Free Press

⁸³ Stanley L. Engerman and Kenneth L. Sokoloff “Debating the Role of Institutions in Political and Economic Development: Theory, History, and Findings.” *The Annual Review of Political Science* 2008. 11:119–35

⁸⁴ https://www.wto.org/english/res_e/statis_e/its2015_e/its2015_e.pdf

⁸⁵ https://www.wto.org/english/res_e/statis_e/its2015_e/its2015_e.pdf

and around 50% for the other two regions.⁸⁶ Specifically on financial sector, world export of financial services increased from \$50 billion to \$350 billion during the same period, while the increase for Asia and Europe was almost seven times, reaching around \$90 billion and \$180 million, for these regions.⁸⁷ Moreover, trade patterns also changed as the South-South trade has increased steadily between 1995 and 2014 and the merchandise exports among developing countries reached from 38% to 52% of their total exports. World trade in intermediate goods grew with the rise of vertical specialization, which was supported by increasing FDI, lower trade costs and improved technology, creating geographically more diverse manufacturing base. In 2011, nearly half of world trade in goods and services took place within global value chains, up from 36% in 1995. According to the IMF, global value chains and vertical specialization are among the factors that promoted expansion of both regional and global trade.⁸⁸

The research on regional trade integration suggests that it affects economic growth through different channels. In fact, income convergence or economic growth constitute one of the main arguments for promotion of regional trade agreements. Krugman (1986) stated that economies of scale effects, which is an important determinant of productivity and economic growth, lead to higher trade volumes, specifically among similar countries. Krugman (1991), Huntington (1996), EichenGreen and Irwin⁸⁹ also emphasized the importance of cultural, historical and geographical proximity in fostering international trade, which is one of the main advantages of regional trade agreements. Analyses by Baldwin and Venables (1995) on the European Community and NAFTA found that regional trade agreements generate welfare gains for the participants, while small negative effects can be observed on their non-regional partners,

⁸⁶ https://www.wto.org/english/res_e/statis_e/its2015_e/its2015_e.pdf

⁸⁷ https://www.wto.org/english/res_e/statis_e/its2015_e/its2015_e.pdf

⁸⁸ Changing Patterns of Global Trade. IMF Strategy, Policy, and Review Department. June 15, 2011

⁸⁹ "The Role of History in Bilateral Trade Flows" in "The Regionalization of the World Economy". Jeffrey A. Frankel, Ed. National Bureau of Economic Research (NBER) University of Chicago Press January 1998

depending on certain conditions. They also added that regional agreements account for a large share of world trade, which is expected to grow further. Analysis by Velde (2011) on 100 developing countries over 1970-2004 revealed that regional integration tends to increase trade and FDI and hence contribute to economic growth.

The literature also differentiates between two types of income convergence through trade: Sigma convergence happens when income of countries move to closer levels, whereas beta convergence happens when less developed countries grow faster than more developed countries until they both reach similar income levels. Sala-i-Martin (1996) found evidence of beta convergence in five EU members (UK, Germany, France, Spain and Italy), although the convergence was slow with only 2% per year. Sperlich and Sperlich (2011) analyzed regional agreements in South Asia, South America, and West and Central Africa over four decades and found evidence of beta convergence. Their later paper in 2014⁹⁰ suggests that income dispersion between and within states has been reduced by South-South regional agreements, which also shows evidence of sigma convergence (ANDEAN, MERCOSUR, ASEAN, CEMAC, WAEMU, and ECOWAS). Clark (2007) argued that “dependent” integration to a trade network generate economic stagnation, while “network” integration positively affects economic growth. Dependent integration associated by exports/GDP, whereas the network integration was measured by “trade coreness”, which is a calculated score from the trade matrix⁹¹ to show how “core-like” each state is (in a continuous scale of core, semi-periphery and periphery). Countries that are closer to the core enjoy increasing trade relations both in number of partners and amount of bi-lateral trade in a regional trade network, while the periphery countries are more “dependent”

⁹⁰ Yvonne and Stephen Sperlich (2014) Income Inequality in the South–South Integration. *Journal of Economic Integration* Vol.29 No.4, December 2014, pp. 726-758.

⁹¹ In the trade network, ties are measured as the logarithm of the annual average value of bilateral imports between countries for the 1980-1990 period.

since they see their bilateral trade increase mostly with the same partners. This research⁹² claimed that developmental benefits accrue more to core/central actors relative to dependent/peripheral economies. Grasland and Beckouche (2007) took a different approach on North-South integration stating that share of developed countries in world population and GDP have been declining between 1950 and 2000, while developing countries (in the immediate periphery of advanced states) had parallel increases. They claim that North-South regional agreements are advantageous since they benefit from complementarities between capital and technology on one side and a large labor force and booming markets on the other. Moreover, introduction of public policies on regional base may be easier due to similarities between national economies, cultural values and collective preferences.⁹³

Research on trade patterns considered multiple variables in determination of international trade: Those include –but not limited to- tariff rates, FDI (FDI inward stock/GDP), domestic investment (ratio of gross capital formation over GDP, fixed assets of the economy), income growth (mostly per capita GDP), country size (population growth or GDP) and several indicators of institutional and governance quality (such as polity scores, data on business environment and legal strength etc.) Dummy variables for geographical or cultural proximity, such as common border, common language and common membership to regional trade agreements were also included in analyses. Other indicators, which affect international trade patterns, measure the placement of countries within the regional trade networks. One of these indicators is trade coreness,⁹⁴ which estimates the extent of a country's trade network in relation to other countries

⁹² Rob Clark. Integration, Mobility, and Development: International Trade and Organization Networks, 1980-2000 Submitted to the Indiana University May 2007 in the Department of Sociology

⁹³ C. Taillard “New Regional Integration in East Asia” 2004 and Grasland and Beckouche (2007)

⁹⁴ Calculation summarized in previous page. The measure of trade coreness was also mentioned in Zining Yang and Mark Abdollahian “Trade networks, regional agreements and growth” In Chapter 4 of “Handbook of International Trade” by David A. Deese (2014) and Rob Clark “Integration, Mobility, and Development: International Trade and Organization Networks, 1980-2000.” (2007)

and its closeness to “core” of the regional trade network. As mentioned before, coreness of a country increases by both number of trade partners and the bilateral trade with them. Likewise, Krugman (1980) also argued that intensive and extensive margins of trade (the number of trade partners and trade volumes) can affect trade patterns, relative factor prices and source of comparative advantage. Other similar measures include trade eigenvectors, out-closeness, in-closeness and closeness centrality:⁹⁵ Out-closeness measures the closeness of a country to any other country in the trade network, where the distance between the countries is weighted by bilateral exports. In-closeness is defined as the weighted distance based on bilateral imports, while closeness centrality is defined as a weighted distance based on total bilateral trade. The higher closeness centrality of a country indicates closer connection between that country and rest of the countries in the trade network. Like trade coreness, trade eigenvectors are largely used in literature since they affect trade patterns; eigenvector measures the proximity of a country to many other ‘central’ countries in a trade network, while the eigenvector centrality of a country depends on the centrality of the largest trading partners.

Much research is based on gravity model of trade, which states that trade flows between two countries are proportional to the product of their GDP’s and inversely related to the distance between them. In this respect, countries with similar economic power are likely to trade more. For example, Thornton and Goglio (2002) used the gravity model to confirm the importance of economic size, geographic distance and common language in intra-regional trade. They also showed that re-exports and ASEAN membership are important to promote intra-regional trade in ASEAN. Moreover, intra-regional trade bias (defined as Intra-regional trade in total trade / Total region’s trade in world trade) was stronger in ASEAN than the EU. Salim and Kabir (2010) also

⁹⁵ Carlos Aller, Lorenzo Ductor, M.J. Herrerias. “The world trade network and the environment” *Energy Economics* Volume 52, Part A, December 2015, Pages 55–68 and Zining Yang and Mark Abdollahian “Trade networks, regional agreements and growth” In Chapter 4 of “Handbook of International Trade” by David A. Deese (2014)

used gravity model with currency union dummy variable to prove that monetary union enhanced the intra-EU trade by 1.14 times for all the EU members. In terms of FDI, the analysis by Hunya and Richter (2011) on Visegrad countries (Czech Republic, Hungary, Poland and Slovakia) between 1999 and 2009, showed that revival of mutual trade among these countries after their EU accession in 2004 can be attributed to FDI from EU-15 and other advanced countries, which promoted intra-industry trade between these four EU members. Marcusen (2002) and Broadman (2005) also had findings confirming the positive link between FDI and trade, while FDI is also linked to intra-industrial trade. (Ng and Kaminski, 2001). While IMF also acknowledges the FDI and vertical intra-industry trade to have a positive effect on intra-regional trade, research by Aminian, et al (2008)⁹⁶ confirms these results for East Asia: International fragmentation of production, especially in intermediate goods, can be tied to FDI and outsourcing, while this vertical specialization seems to increase intra-East Asian imports and exports, particularly in the case of trade in components and parts, followed by trade in capital goods. It should be also noted that intra-industry trade can be formed either vertically (VIIT) or horizontally (HIIT). HIIT refers to trade in products of homogeneous quality, cost and technology, with different characteristics, whereas the HIIT increases with a higher level of country similarity in terms of capital endowments (or other attributes) and implies increasing convergence between trading partners. VIIT involves imports and exports of goods of heterogeneous quality, technology and costs. It implies division of production stages between countries and differences in factor endowments, technology and in the pattern of income distribution. In regional integration, IIT promotes positive income effects and more synchronized business cycles, improves industrial competitiveness and reduces the effects of asymmetric shocks. Research by Dautovic,

⁹⁶ Nathalie Aminian, K. C. Fung, Hitomi Iizaka and Alan Siu. Foreign direct investment, intraregional trade and production sharing in East Asia. Macao Regional Knowledge Hub Working Papers, No. 11, December 2008

Orszaghova and Schudel (2014) suggests that “Central, Eastern and South-Eastern European (CESEE) countries with “better management of monetary policy, a lower average corporate tax rate, a more flexible exchange rate regime and better political institutions tend to be more engaged in IIT with the EU15”. While FDI and lower corporate tax rates can promote VIIT for candidate CESEE countries, floating exchange rate regime and lower corporate taxes can promote the HIIT in more developed, new member countries.

Some research on trade integration also considered financial sector development as a determinant in international trade patterns. Although this type of research is more limited in numbers, it provides very useful insights on financial sector-trade linkages. Using firm level data for developing countries, Berman and Hericourt (2010) found that access of firms to external financing (such as bank loans) positively affect their export possibility. Moreover, productivity is a significant factor in export decision only if the firm has access to external finance. Muuls (2008) claims that firms that are more productive and have less credit constraints are more likely to export. On the macro level, Kletzer and Bardhan (1987) showed that that countries with more developed financial sectors achieve a comparative advantage in industries and sectors which rely on external finance. Do and Levchenko (2007) found that countries with comparative advantage in financially intensive goods will experience a higher demand for external finance, which promotes financial development (measured by private credit/GDP). By contrast, financial development is found lower in countries, which primarily export goods that do not rely on external finance. Manova (2008) found that financial frictions (low access to credit) reduce exports more than domestic production since exporters rely more on external financing due to their higher costs and risks. One third of these effects (on export sector due to financial access) is reflected on the firm entry into exporting (fixed costs) and the rest is reflected on firm

sales abroad (variable costs). Using a 30-year panel for 65 countries, Beck (2002) found that economies with better-developed financial sectors have comparative advantage in manufacturing industries. Goksel (2012) claims that financial (credit) constraints act as trade barriers, the largest amount of trade is between countries with higher access to loans. Moreover, financial constraints can cause one way or zero trade.

Financial Integration: Linkages to Financial and Economic Development

As mentioned before, fast development of global finance, increase in global financial flows, and rising investments on financial instruments, triggered by easier access to international financial markets by technology, innovation of new financial products for (non-financial consumers such as) retail customers and real sector businesses promoted stronger ties between financial and real sectors as well as between national financial systems. Especially last ten years, the literature on financial sector has been evolved to identify various connections between financial development, financial integration, international trade and economic development.

Financial regional integration means an increase in cross border connectivity of financial intermediaries and institutions, expansion of cross border provision of financial products and services and improved access to finance by population across the borders. In practice, it means increasing linkages between financial sub-sectors such as banks, stock markets or bond markets across countries either through international agreements or market-led initiatives as well as availability of financial products and services for customers from providers abroad. Just like trade integration, financial integration can take place on global or regional basis. In the literature, financial integration was often associated with law of one price. According to Garcia-Herrero

and Woodridge (2007), financial markets are integrated when law of one price holds: Assets with same returns and risks would have the same price provided that assets are perfectly mobile and the real interest rates tend to equalize across countries. While Yeyati (2005) states that law of one price can be a good measure of financial integration for capital markets, other scholars such as Baele et al (2004) suggested that the law of one price wouldn't be able to measure integration of unlisted financial instruments and even if it holds, that wouldn't mean that the countries were financially integrated.

Theoretically, under financial integration, there wouldn't be any relationship between domestic savings and investments since they would be allocated within the integrated region rather than national basis. In this context, De Nicolo and Ivaschenko (2008) mention the role of financial integration in efficient allocation of capital: Under perfect financial integration, capital can be invested where it will have highest risk adjusted expected return and cost of equity capital will be equalized while same investments will have same risk pricing across the borders. Financial integration will facilitate efficient allocation of capital in economy and increase opportunities for risk-adjusted growth. Yabara (2012) suggests that financial integration can take place while national institutional differences still exist: Under perfect financial integration, there would be no barriers to transactions across borders and comparable asset returns across economies would be equalized as long as country and exchange rate risks are not different. In this sense, markets of different countries can be operated under different legal frameworks.

However, this doesn't mean that financial integration should be to be purely market driven; Wagh and Linn (2008) state that "regional financial integration (RFI) refers a process, market driven or institutionalized, that broadens and deepens financial links within a region". Broadening financial markets implies elimination of investment barriers across countries and

equal treatment of domestic and foreign investors, while deepening financial links includes harmonization of regulations, laws, institutions and policies across countries. If financial integration progresses further, regulatory and institutional frameworks, information systems, operational structures, asset prices and risk assessments may converge among national financial markets, making the markets effectively function as one. In this respect, RFI can also open the path to economic integration. Cally and Majnoni (2002) comment on importance of regulatory base for financial integration: They state that financial integration has two aspects; one is cross border provision of financial products and services and the other is integration of regulatory frameworks. Although provision of financial products and services across the borders have disciplining effect through increased competition, regulatory improvements can't be left to market forces alone due to coordination failures, systemic externalities and high cost of public goods. Regulatory harmonization can also reduce regulatory arbitrage and eliminate inefficient laws since stronger legal standards tend to attract investors rather than repel.³⁵ Garcia Herrero and Wooldridge (2007) claim that whether it is regional or global, financial integration implies the removal of cross border barriers for capital flows and financial services, (i.e. capital controls and taxes) and the equal treatment of foreign and domestic capital, firms and institutions where investors can invest across borders without preferential treatment. If the links between financial systems get stronger, national laws and standards can be harmonized by mutually recognized minimum standards. Baele et al (2004) suggests that markets for financial services or instruments are fully integrated if "all potential market participants with same characteristics face single set of rules, have equal access to those financial instruments or services and are treated equally when they are active in the market."⁹⁷ This definition also implies that financial regionalization can

⁹⁷ Baele, L, A Ferrando, P Hördahl, E Krylova and C Monnet: "Measuring Financial Integration in the Euro Area",

accommodate institutional differences. Moreover, financial integration would be only partially achieved unless both demand and supply side are integrated.

The states may want to integrate their financial sectors regionally since regional financial integration (RFI) promotes financial development, economic growth, productivity and better income distribution.⁹⁸ Financial development can be facilitated by the RFI since it can enlarge financial systems pool national resources together, mobilize savings for more productive investments, facilitate competition and efficiency in financial sector and increase the range and availability of financial products and services with wider access to finance. Access to finance is especially important for small firms to find funding and for poorer households to increase living standards and afford education, which raises human capital. In this respect, financial regionalization can be anticipated to have positive effects on economic development and poverty in the long run.

While RFI affects financial development, the reverse connection also applies since financial development levels are decisive in the success of financial integration. If financial development levels did not pass minimal threshold levels, it will be harder to utilize the benefits from financial integration.⁹⁹ Generally, the realization of benefits under RFI takes time and they may accrue unequally, which poses one of the main political challenges to regionalization.

Still, the literature widely states that financial development and economic development are connected by multiple channels:

ECB Occasional Papers, no 14, April 2004.

⁹⁸ Kose, A. M., E. Prasad, K. Rogoff and S-J. Wei (2009), "Financial Globalization: A Reappraisal", IMF Staff Papers, 56(1), p. 8-62 and Demirguc-Kunt, Asli and Ross Levine, "Finance and Inequality: Theory and Evidence" World Bank Policy Research Working Paper 4967, June 2009.

⁹⁹ M. Ayhan Kose, Eswar S. Prasad and Ashley D. Taylor. "Thresholds In The Process Of International Financial Integration". National Bureau of Economic Research, Working Paper 14916, April 2009.

A. Productivity: Research on more than 60 countries indicate that financial development affects GDP and economic growth by increasing total factor productivity (TFP), while development of financial intermediaries is linked to private savings and physical capital growth in the long run.¹⁰⁰ Improved financial depth associates with higher productivity and income per capita.¹⁰¹ Research on 102 countries confirm the link between financial development and productivity: “Financial frictions distort the allocation of capital and entrepreneurial talent” and adversely affects output per worker and aggregate productivity.¹⁰² Increasing TFP is especially crucial for less developed countries¹⁰³

B. Macroeconomic policy and stability: Shallow financial systems limit macroeconomic policy options, impede monetary policy transmission mechanisms, limit stable funding sources of government for operation of fiscal policy, complicate liquidity and risk management, and cause volatilities in investment, output and consumption patterns.

C. Macro financial linkages; When real sector firms can receive financing (loans) from financial sector, their debt sustainability, savings and investment increase, which positively reflects on real sector development and economic growth. Availability of capital facilitate viability and expansion of small and medium enterprises (SME's), while low income households' access to financing can improve potential spending on education,

¹⁰⁰ Beck, Thorsten, Ross Levine, Norman Loayza. “Finance and the sources of growth. *Journal of Financial Economics* Volume 58, Issues 1–2, 2000, Pages 261–300

¹⁰¹ FitzGerald, Valpy. “Financial Development and Economic Growth: A Critical View.” Background paper for World Economic and Social Survey 2006.

¹⁰² Buera, Francisco J.; Kaboski, Joseph P.; and Shin, Yongseok. "Finance and Development: A Tale of Two Sectors." *The American Economic Review*, 2011, Vol. 101, No. 5, pp. 1,964-2,002.

¹⁰³ Buera, Francisco J.; Kaboski, Joseph P.; and Shin, Yongseok. "Finance and Development: A Tale of Two Sectors." *The American Economic Review*, 2011, Vol. 101, No. 5, pp. 1,964-2,002.

health and housing. Both of these development can stimulate economic activity and growth.

CHAPTER III

INTRODUCTION TO THE SUBJECT

EVOLUTION OF REGIONAL INTEGRATION

In order to develop a better understanding of regional integration in trade and financial sector, one first needs to look at the evolution of regional integration as a process. Successive regionalization waves of the 20th century can be mentioned in three chronological episodes:¹ The regionalism of 1930's was shift from open and liberal order and was characterized by "state protectionism, discriminatory and regionalist imperialisms." The second wave emerged in 1950's and 1960's under American centered system with tolerance to national and regional protectionism while setting multilateral visions at the same time. This was the phase when the example of European Community was followed by less successful examples in Latin America, Africa and Asia. Combined with isolationist and ISI policies, these regionalization efforts firstly proceeded with regional trade agreements, assuming full economic integration at the end. The failure of ISI policies, unsuccessful industrialization efforts, inefficient institutions and lack of sound macroeconomic policies slowed down the trend of regionalism until mid-1980's. Then, the third wave of regionalism started with a different structure in limited unipolar order in 1990's: The regionalism has been revived as response to globalization,² characterized by massive economic liberalization, reduction of trade barriers, technological advances, changed production

¹ Telo, Mario. Ed. "Globalization, New Regionalism and the Role of the European Union" Introduction in "European Union and New Regionalism: Regional Actors and Global Governance in a Post Hegemonic Era", Mario Telo (Ed). Second Edition 2007.

² "Globalism and Regionalism" Selected Papers Delivered at the United Nations University Global Seminar '96 Shonan Session, 2-6 September 1996, Hayama, Japan. Ed. Toshiro Tanaka and Takashi Inoguchi.

structures, amplified FDI and capital flows and increasing importance of global financial system with stronger links to real economic activity.

This new wave of regional integration differed from its previous counterparts in certain ways: First, the new regionalization can be initiated not only by governments with international treaties but also by non-state and transnational actors such as non-governmental institutions, economic and political actors and even market participants due to the need to cooperate in competitive global environment and harvest more benefits from globalization in a stronger framework. In this context, the new regionalization can start as a de-jure or de-factor process. If integration starts with markets, increased cross border activity of market participants can eventually carry their standards and practices across the countries in informal basis, which can be later incorporated into formal practices and regulations.

Second, with the break of isolationist policies, the new regionalization is based on open trade, liberalization and integration into international system, rather than protection. It aims to achieve development and competitiveness of regional firms and national economies in the international economy and markets, while seeking higher bargaining power in multilateral negotiations.³ In this respect, some scholars⁴ claim that regional integration can lead to better global integration over time.

Third, regionalism today means organized cooperation, convergence and transformation from particular heterogeneity to increased homogeneity instead of targeting full economic

³ “Globalism and Regionalism” Selected Papers Delivered at the United Nations University Global Seminar '96 Shonan Session, 2-6 September 1996, Hayama, Japan. Ed. Toshiro Tanaka and Takashi Inoguchi.

⁴ Examples can be Bhagwati, J. 1993. “Regionalism and Multilateralism: An Overview.” In *New Dimensions in Regional Integration*, edited by Jaime de Melo and Arvind Panagariya, 22– 57. Cambridge: Cambridge University Press and Robert C. Feenstra and Alan M. Taylor, Eds. “Globalization in an Age of Crisis: Multilateral Economic Cooperation in the Twenty-First Century December 2013

union.⁵ Regional initiatives can focus on select sections of financial or real sector to promote strategic financial and trade activities with only needed and partial adjustments in legal and institutional framework.

Fourth, financial development is placed into regionalization agendas. Liberalization of financial sectors across the world, expansion of new financial products and services into non-financial customers and improved access to financial markets by technology multiplied the effect of financial sector on economic stability and trade activity, making it an important element of national economic policies. Stronger links of finance to macro economy, real sector and trade as well as the connection between financial sector and economic growth led states to seek cooperation to promote financial sector development and stability, which can be achieved through integration.

Fifth, new regionalism suggests more active role for developing countries. Recent changes in production and investment structures in developing countries suggest more active role for them in the world trade, finance and regional agreements. Recent data indicates that FDI flows to developing countries exceeded to 50% of total global investments for the first time in 2013, while South to South trade rose faster than North-South trade and South to South investments are on the rise.⁶ This structure suggests stronger relations within the South and affected relations with developed partners. The literature suggests that while developed countries seek to improve their competitiveness and economic growth in regional agreements, developing countries seek regional synergies to promote development of targeted sectors, to address their developmental problems. In this context, Linder (1966) and Sakamoto (1969) suggests that trade diversion in regional integration can benefit developing countries. According to Inotai (1997)

⁵ Mashayekhi, Mina. "The Contribution of Trade in Financial Services to Economic Growth and Development. June 2012, UNCTAD.

⁶ unctad.org/en/PublicationsLibrary/wir2014_en.pdf UNCTAD 2014 trade report

and Heimenz and Langhammer (1990) industries in developing countries can improve their competitiveness gradually by relying on the regional market during the first phase of industrialization.

Sixth, the regionalization can incorporate specific development goals into regional agenda. Integration policies can be customized according to the needs of developing or less developed countries. Integration can remain limited to targeted sectors or activities, while liberalization of critical sectors can be delayed or designed in stages to be compatible with developmental objectives. Indeed, this is one of the differences between regionalism of 20th and 21st centuries: The new regionalism does not mainly focus on economic liberalization and suggest that liberalization can be delayed according to maturity of economy and development level of the sectors in question.⁷ New regionalization of the 21st century focuses more contemporary issues such as opportunities and challenges of the IT developments, increasing importance of service economy and factor mobility.⁸ In this context, the future regionalization efforts are likely to promote integration of services sectors (including financial services) more intensively: Lawrence's (1997) suggested that any sector (goods, services or investments) can be included in new integration initiatives rather than the sole focus on industrial sector. Increasing role of services sector in the world economy and inclusion of services sectors in regionalization initiatives can enhance both trade and financial integration since financial sector is mainly a services industry. Moreover, the services trade is also complementary to the intra-regional trade of goods.

⁷ 21st Century Regionalism: Filling the Gap between 21st Century Trade and 20th Century Trade Rules." CEPR Policy Insight No: 56 May 2011

⁸ 21st Century Regionalism: Filling the Gap between 21st Century Trade and 20th Century Trade Rules." CEPR Policy Insight No: 56 May 2011

REGIONALIZATION VERSUS MULTILATERALISM

Another issue related to regional integration how it is related to multilateralism. Opponents of regionalism claim that it can hinder globalization since extra-regional discrimination can harm globalization and multilateral trade system, while its proponents claim that regionalism is complementary to globalization (building block vs. stumbling blocks approach by Bhagvati),⁹ and a third groups of scholars suggest that regionalism is the middle step towards globalization. The building-stumbling block approach was developed on shallow RTA's and MTN's and a new approach was needed by 1990's due to changing facets of regionalism.¹⁰ In fact, the relation between regionalism and globalization is quite intricate since both are the part of the transformed world order: Globalization involves deepening of internationalization, which strengthens functional but weakens territorial dimensions of development.¹¹ Regionalism comes as enhancement of this territorial dimension, while world markets dominate national economies and local production and states look for the ways to strengthen their economic and financial development under pressures of global competition. In this case, the revival of regionalism in the form of new regionalism can be seen as a reaction to globalization, but not necessarily hindering globalization.

The reasons of states to choose regional integration over global one comes from the inability of multilateralism to address certain problems such as the need for better international public goods (i.e. economic and legal governance and stability) as well as the deficiencies in

⁹ "21st Century Regionalism: Filling the Gap between 21st Century Trade and 20th Century Trade Rules." CEPR Policy Insight No: 56 May 2011

¹⁰ "21st Century Regionalism: Filling the Gap between 21st Century Trade and 20th Century Trade Rules." CEPR Policy Insight No: 56 May 2011

¹¹ "Globalism and Regionalism" *Selected Papers Delivered at the United Nations University Global Seminar '96 Shonan Session, 2-6 September 1996, Hayama, Japan.* Ed. Toshiro Tanaka and Takashi Inoguchi.

speed, coverage and evolution of multilateralism. In addition, asymmetric gains and costs of globalization especially for developing and less developing countries led these states to regionalization since most were unable to achieve their economic and financial developmental targets under fiercely competitive international system despite applying similar liberalization policies. Moreover, the needs of smaller countries or region specific issues can be better addressed in regional rather than global settings, while small countries may also have better chance of grouping against the leader state. In this context, regional groups will also have more negotiation power in multilateral settings against other states. Another important reason for regionalization relates to the advantages coming with the expansion of markets: Larger regional markets for products and services (both in real and financial sector) create economies of scale and scope effects, support economic efficiency, productivity, development, which may not be realized on national basis. On the legal and institutional levels, legal cooperation or harmonization as well as operation and design of common institutions can be less complicated in regional than multilateral basis. In this respect, regional cooperation can be effective for crisis prevention since legal harmonization and regulatory cooperation enable the states to detect hazardous behavior of systematically important institutions before they cause damage. Finally, common issues will be easier to solve with smaller number of countries, while defective behavior would be easier to catch. Regionalization also helps developed countries against competitive pressures from other developed countries as well as newly emerging economies.

Regionalism and multilateralism has been coexisting the last few decades, suggesting complementary nature of two processes. Regionalism is the way to cooperate and overcome new global challenges by nation states. “Regionalism stands in the center of globalized economics and world politics and regionalization and globalization are two components of the same

historical process of global structural transformation, strengthening interdependence and weakening state barriers and the outcome of this process is dialectical rather than linear”.¹² Today, economic liberalization, multilateralism and free trade, tariff reductions, globalized finance, internationalized production structures, cross border flow of financial and non-financial products and services prove building block approach more plausible than stumble block thinking.¹³ Moreover, regionalism can be seen as the antecedent of globalization since it can be seen as necessary intermediate or preparation stage for states to deal with opportunities and risks of global markets and accept multilateral rules.¹⁴ As the anarchic international system can be partly tamed by international cooperation, institutions, agreements and regulations among the states, the countries can choose to form varying degrees of regional and/or multilateral ties depending on their interests, needs and standing in the international community.

TRADE INTEGRATION AND FINANCIAL INTEGRATION ON REGIONAL BASIS

Trade integration: Benefits, costs and potential issues

Regional trade agreements have been implemented in different parts of the world and so far produced different results across the globe. In the past, the progress was seen mostly in few agreements such as the EU and NAFTA, while the regional integration in Latin America

¹² Telo, Mario. Ed. “Globalization, New Regionalism and the Role of the European Union” Introduction in *“European Union and New Regionalism: Regional Actors and Global Governance in a Post Hegemonic Era”*, Mario Telo (Ed). Second Edition 2007 and “Globalism and Regionalism” *Selected Papers Delivered at the United Nations University Global Seminar '96 Shonan Session, 2-6 September 1996, Hayama, Japan*. Ed. Toshiro Tanaka and Takashi Inoguchi.

¹³ “21st Century Regionalism: Filling the Gap between 21st Century Trade and 20th Century Trade Rules.” CEPR Policy Insight No: 56 May 2011

¹⁴ Telo, Mario. Ed. “Globalization, New Regionalism and the Role of the European Union” Introduction in *“European Union and New Regionalism: Regional Actors and Global Governance in a Post Hegemonic Era”*, Mario Telo (Ed). Second Edition 2007.

remained limited even today. However, liberalization of trade and investment regimes after 1990's around the world promoted rise of new emerging markets, especially in Asia, making regional integration more possible than before.

In the literature, countries implement regional trade schemes for various reasons. First, trade agreements can generate a trade creating effect among members by decreasing tariff and non-tariff barriers to trade.¹⁵ Moreover, some scholars claim that trade agreements such as PTA's and RTA can also increase FDI since they lead the governments to make stronger commitments to liberalization and prevent them from arbitrary interventions on regulatory, taxation and tariff issues, which can make the business environment safer for investors.¹⁶ Second, regional integration allows the companies to benefit from increased market size, which can spread the fixed costs on a larger consumer base and facilitate economies of scale.¹⁷ Larger markets can also promote economies of scope through expansion on different product lines. Third, relative proximity of regional markets reduce transportation costs and help companies to expand internationally. This way, operations and exports can enlarge regionally to build production chains across the borders. The firms can use this capability to increase competitive advantage in global basis. Fourth, similarity in economic and business conditions, technology levels and cultural affinity gives regional companies advantage. Mergers among regional firms are encouraged to compete against global firms, if they already accessed the regional markets. Fifth, regulatory and institutional changes, increased market size and free entry of foreign firms improve competitiveness in the markets, leading domestic firms to become more efficient. Sixth,

¹⁵ Hiroyuki Hoshiro "Regionalization and Regionalism in East Asia" ISS Discussion Paper Series F-162, Institute of Social Science, The University of Tokyo

¹⁶ Tim Büthe and Helen V. Milner "The Politics of Foreign Direct Investment into Developing Countries: Increasing FDI through International Trade Agreements?" 2008

¹⁷ EBRD Transition Report 2012 "Integration Across Borders" Chapter 4-Regional Trade Integration Benefits and Challenges

regional integration can promote regulatory harmonization and reforms in related issue areas, which are hard to achieve on national basis. Finally, under regional cooperation, the developing countries may cooperate and acquire the capability to better stand against the international shocks and crises, while they deal with the risks of the global markets and adapt to multilateralism under a stronger regional framework than their national power.¹⁸ On the regional level, countries pool their resources and expertise to act on common problems.

Current concerns on trade regionalization mainly include three issues: Trade diversion, asymmetry between member states and magnification of vulnerabilities. Trade diversion occurs when changes of barriers for the regional vs. extra-regional partners divert trade from efficient external exporters to less efficient regional ones. Regional integration with unfair advantages to inefficient regional providers or excess costs to outsiders can lead to inefficient domestic industries and protectionism, which undermines openness to multilateralism and benefits of integrating into global system. Asymmetry between members in economic size and political power can affect the distribution of gains, which influence the motivation of the states to stay in regional integration. In this case, it is important to ensure that all member states will be included in decision making of supranational institutions and mechanisms for supervision and dispute resolution will operate fairly. Lastly, output contractions and crisis contagion can be amplified under trade regionalization due to increased economic connectivity across borders and a possible synchronization of business cycles.

Besides these issues, pressures from social and economic groups or other domestic lobbyist against regionalization can influence the national policy commitments for regional integration. Other problems include optimization of the number of members, geographical coverage, depth

¹⁸ Telo, Mario. Ed. "Globalization, New Regionalism and the Role of the European Union" Introduction in "European Union and New Regionalism: Regional Actors and Global Governance in a Post Hegemonic Era", Mario Telo (Ed). Second Edition 2007.

and breadth of the regionalism can be also challenging given the tradeoff between size and cohesion. Moreover, balancing the inequalities in income, wealth and employment opportunities, and dealing with asymmetrical capital mobility may be problematic. Inconsistencies between laws and regulations, defining jurisdictions of supervision and facilitating the quality of monitoring and enforcement in the co-existence of different legal structures would also be challenging. The sovereignty issues are also important since states may not want to give up their sovereignty as integration progresses. Distribution of the costs to set regional framework should also be carefully adjusted not to outweigh the benefits.

Financial integration: The motivation of states for regionalization

Financial regional integration includes cross border connectivity of financial intermediaries and institutions, expansion of cross border provision of financial products and services and improved access to finance by population across the borders. In practice, it stipulates intra-regional expansion of the domestic banking sectors, inter-operability or integration of stock or bond markets.

The states may want to integrate their financial sectors regionally since it promotes financial development, facilitates economic growth, productivity and better income distribution.¹⁹ Besides its connection to financial and economic development, some other benefits of financial integration are also similar to that of trade integration. Those can be explained as follows:

¹⁹ Kose, A. M., E. Prasad, K. Rogoff and S-J. Wei (2009), "Financial Globalization: A Reappraisal", IMF Staff Papers, 56(1), p. 8-62 and Demirguc-Kunt, Asli and Ross Levine, "Finance and Inequality: Theory and Evidence" World Bank Policy Research Working Paper 4967, June 2009.

First, capital markets and banking sector are also subject to economies of scale: The regional expansion of financial systems reduces cost of providing financial services (which increases supply) and enlarge customer base (which increases demand) across a region. Reduced capital costs -as a result of market expansion- facilitate investments, increase productivity as well as economic and financial activity. Economies of scale effects in financial sector regionalization appear on firm, institutional and systemic levels:

a) On the firm level, financial intermediaries benefit both from economies of scale with lower fixed costs per unit and economies of scope by providing cross-sectorial services under regional integration.²⁰ Moreover, foreign investors present competition to domestic providers, encourage them to operate more efficiently through spillover effects (such as technology, management, know-how, risk management techniques etc.) and market discipline/reputational effects. Cross border investments and consolidations in financial sector may allow further economies of scale on firm basis. As the number of financial intermediaries increase, the competition will draw the spreads and fees down, raise quality of financial products and services and increase financial access to under-served segments.²¹ This way, larger savings pool can be diverted into investments and facilitate better risk management, portfolio diversification and efficient capital allocation.

b) Economic scale effects also manifest in institutional and systemic levels. Institutions are subject to systemic scale effects: Merging of financial markets, infrastructure and institutions across the borders brings institutional scale economies via reduction of costs and elimination of redundancies in bureaucracy and management. Systems for regulation and supervision are expensive to design, operate and reform both on regional and national basis with high fixed and

²⁰ Kono, Masamichi and Mamiko Yokoi-Arai, "Dissecting Regional Integration in Financial Services from the Competition Policy and Trade Policy Perspectives." BIS Papers No: 42

²¹ Financial Sector Integration in Two Regions of Sub-Saharan Africa, World Bank, January 2007.

operational costs. Smaller institutions face higher information, administrative, regulatory and operating costs while information services such as credit ratings, risk management, advisory and consultancy services are also under developed.²² Regionalization can motivate states to pool their resources to perform these functions while the costs can be justified in larger regional setting. Better regulation on regional level can improve discipline of national institutions and lead to better management, regulation and operation of domestic markets.

Second, countries can utilize regional financial integration (RFI) to develop financial infrastructure including technological systems. Financial sector is becoming more technology intensive, while technological applications spread to different functions of the financial intermediaries and institutions: Payments and settlement systems, online provision of financial services, mobile services, recordkeeping, management systems and technical analyses are today all based on technology. Those tools do not only facilitate operations of financial intermediaries but also lead to strategic decisions and innovations of financial products to improve outreach in the financial sector. Infrastructure and technological base is highly sensitive to economies of scale and fixed costs can be better justified under RFI. But the reverse connection also applies; infrastructure and technology makes it easier for financial intermediaries to benefit from economies of scale and widened scope of financial services.²³ Moreover, especially small countries can benefit better from modern financial services under regional infrastructure.

Third, regional financial integration can solve the problems with the financial sector size. Despite financial globalization of last decades, most countries still experience problems with financial development due to small financial sector size, most of them being emerging or low

²² Bossone, Biagio, Patrick Honohan, and Millard Long. "Policy for Small Financial Systems." World Bank, Financial Sector Discussion Paper No. 6, 2001.

²³ 88. Croce, R. D. (2011), "Pension Funds Investment in Infrastructure: Policy Actions", OECD Working Papers on Finance, Insurance and Private Pensions, No. 13, OECD Publishing.

income countries. If M2 money and quasi money data is taken as indicator for the size of the financial sector, 22 countries had less than \$ 1 billion of M2, out of 181 countries as of 2010. 59 countries stand between \$ 1-10 billion, 54 countries between \$ 10-150 billion and only 36 countries reached M2 levels between \$ 150 billion and \$ 12 trillion.²⁴ Small financial systems suffer from limited availability of investors and investment instruments, inefficient allocation of capital, lack of liquidity, informational problems and limited financial access. Financial services in small systems tend to be more limited in scope, more expensive, and poorer quality than large systems. For most countries, financial development policies can't solve problems of small financial sector size. In this case building regional markets can be especially important to overcome the difficulties of small market size.²⁵

Fifth, macroeconomic coordination under RFI directly contributes to macroeconomic stability by different channels:¹⁴⁰ Macroeconomic policy dialogue, surveillance and consultation, liquidity support during crises, exchange rate coordination can be utilized through RFI. Regional institutions can also perform monitoring and regulation of financial systems, assess the vulnerabilities and deal with crises through regional reserve funds, swap agreements and coordinated policies, which will minimize national externalities and let the states to utilize larger macroeconomic policy autonomy on the regional basis since the policy autonomy of the states are reduced by the global liberal economy.¹⁴⁰

Sixth, financial regionalization can assist the members to address the problem of incomplete markets. Most developing countries have bank-dominated financial sectors and under-developed non-bank financial providers, which limits provision of financial services. Under RFI, development of capital markets, insurance, pension or investment industries may be directly

²⁴ Global Financial Development Report 2013, World Bank.

²⁵ Bossone, Biagio, Patrick Honohan, and Millard Long. "Policy for Small Financial Systems." World Bank, Financial Sector Discussion Paper No. 6, 2001.

targeted and promoted: In advanced economies, non-bank financial intermediaries especially insurance and pension providers play larger role in global and domestic asset allocation and sometimes in credit provision than the banking sector. In addition, capital markets provide financing to firms and governments, and instrumental in development of corporate control and risk management. In fact, Limited depth and breadth of financial sector challenges macroeconomic stability, growth and income equality.²⁶ Shallow and undiversified financial markets hamper liquidity management, undermine monetary policy transmission mechanisms, reduce stable government financing sources, increase procyclicality of fiscal policies, cause concentration of exposures and risks on balance sheets and limit crisis coping mechanisms.²⁷

The linkages between trade integration and financial integration

Financial system affects international trade through various channels such as trade finance, trade credits, leasing, insurance or any other financial services: Financial institutions provide loans to the firms to increase their trade activity, while they also mitigate and reduce the risks of trading such as currency and interest rate risks (hedging instruments), payment risks (electronic payment & clearing services), and accident or disaster protection (insurance). Moreover, financial institutions enable verification of international parties through networks of banks and other involved financial institutions. Any problems in financial sector (such as low financial sector development, small financial sector size or financial crises) that undermine these functions can also affect trade negatively. As mentioned before, financial sector is also closely related to economic outlook and allocation of resources among sectors, which can affect trade

²⁶ “Frontier and Developing Asia: Financial Sector Transformation.” IMF

²⁷ Enhancing Financial Sector Surveillance in Low Income Countries: Financial Deepening and Macrostability.” IMF April 2012.

patterns. On the other side, the finance-trade linkages are reciprocal: Expansion of intra-regional trade can also promote expansion of financial sector across the borders since financial providers/institutions tend to follow their clients to provide international financial services. The absence or low capacity of domestic or regional financial institutions to perform trade supporting functions or to provide adequate financial services can result in expansion of global (non-regional) financial firms into the region to enter and dominate these markets. These cases can be seen in some ASEAN countries. In addition, trade patterns closely relate to economic cyclicity and synchronization of business cycles among regional members. Further links between trade and financial sector will be mentioned in more details later.

CHAPTER IV

RESEARCH DESIGN, METHODOLOGY AND ECONOMETRIC ANALYSIS

RESEARCH DESIGN AND METHODOLOGY

The dissertation will widely utilize quantitative data and analysis first to compare regional trade integration, financial development and financial integration of the EU and the ASEAN countries and then to estimate relationship between these variables. In the latter statistical part, the dependent variable is regional trade integration, which can be measured by intra-regional trade. Independent variables will include two variables on financial integration, two variables on financial development and control variables. The original targeted time frame was 2006-2015 with 10 countries on ASEAN and 28 countries on the EU. However, data availability and use of first differences to eliminate autocorrelation problem shortened the time frame to 2009-2015, while reducing the number of countries to 33 with 28 EU countries and ASEAN-5. Nevertheless, the qualitative analysis for the EU and ASEAN integration still covers 2006-2015 period.

International and regional trade data are available from the UN Trade Database, while GDP and FDI inward stock exists under WB/IMF database. Due to confidentiality in intra-regional FDI data in ASEAN, this variable is calculated by using Asia values and then subtracting the other Asian regions to reach only to South East Asian data. In this context, the intra-regional FDI data for ASEAN can be considered as proxy to the original, while such problems did not exist for the EU.

Variables on financial integration originally include intra-regional bank assets and correlation between capital market returns (stock and bond markets). These variables are expected to increase over the years if financial and trade regionalization initiatives really promoted integration. According to Bank of International Settlements (BIS)¹ intra-regional bank assets (or bank claims on other regional countries) is a fundamental indicator for regional expansion of the banking system, since it shows expansion of bank credits on regional basis. However, data search on the EU and ASEAN indicated that intra-regional banking assets are unavailable for many countries, especially non-disclosed for ASEAN countries. This necessitated the use of next closest variable in banking sector integration, banking sector openness, which can be defined as; foreign assets of banking sector over total banking assets in every country. As data sources, bank international assets by country are downloadable from the BIS database, but IMF database was used since it contained data for all countries in the research period, including hard to find ASEAN countries.

In capital markets, integration can be considered as correlation of index returns, although more sophisticated techniques are also available.² Various sources referred the stock and bond market (index) return correlations as proxies of integration.³ However, capital market integration measures are of secondary importance since financial systems of the EU and the ASEAN countries are bank based, as banks constitute more than 90% of financial systems.

¹ “EME banking systems and regional financial integration.” BIS Committee on the Global Financial System, paper no 51. March 2014

² Michael Mussa and Morris Goldstein. “The Integration of World Capital Markets” US Federal Reserve-Kansas

³ Examples include Guntur Anjana Raju and Harip Rasulsab Khanapuri “Regional Integration of Emerging Stock Markets in Asia: Implications for International Investors. The journal of Investing, Fall 2009.

Also “Asian Capital Market Development and Integration: Challenges and Opportunities” Oxford University Press 2014. In addition, Horobet et al “The Impact of EU Integration on the Risk-Return Trade-Off of European Diversified Portfolios” <http://anale.feaa.uaic.ro/anale/resurse/fin3horobet.pdf>

Baele and Soriano, Global vs. Regional and Economic vs. Financial Integration in European Stock Returns http://www.uibcongres.org/imgdb/archivo_dpo3676.pdf

Burcu Erdogan, How does European Integration affect the European Stock Markets? German Institute for Economic Research April 2009

while capital market index returns and correlations can be found from Bloomberg database. Stock market return correlations have been used in the analysis, while use of bond market returns require solution of some technical issues.

Variables on financial development include domestic credit to private sector/GDP for development of banking sector and stock market capitalization/GDP for development of stock markets and bond market issuance/GDP for bond market development. The first variable, which is also called “private credit” is considered as one of the main variables in financial development by the World Bank and the IMF.⁴ It is an indicator of financial sector depth and available in the IMF database, defined officially as deposit money bank credit to the private sector as a percentage of GDP. Although used in analysis, this variable can also be replaced by “financial institutions’ assets to GDP” or M2 to GDP, which are wider. For development of capital markets, stock market capitalization and outstanding debt securities to GDP were used as main developmental variables for stock markets and bond markets.⁵ However, if data was available, the analysis could be expanded by private debt securities to GDP (size of corporate bond market), public debt securities to GDP (size of public debt markets) and international debt securities to GDP (size of international bond market) can be also considered as relevant variables for bond markets.

The control variables are chosen from the determinants of intra-regional trade, which was mentioned in literature review. These control variables include weighted average tariff rates on imports by countries, per capita GDP (representing demand structure), international trade/domestic GDP (trade openness) and FDI inward stock/ GDP (received inward FDI).

⁴ One of the most important research defining these variables is by Cihak et al. “Benchmarking Financial Systems Around the World” World Bank Policy Research Working Paper 6175, 2012

⁵ Cihak et al. “Benchmarking Financial Systems Around the World” World Bank Policy Research Working Paper 6175, 2012

Dummy variables were needed in the analysis on border-sharing or common currency between the countries and their inclusion were decided according to the course of analysis. Currently, only EU dummy has been used and turned out to be significant. Therefore, this variable can be further improved by constructing categorical variables to differentiate between EU and non-EU members and different expansion rounds of the EU; non-members of the EU (ASEAN); EU members for less than 10 years; less than 20 years; less than 30 years; and members before that (EU-15). This improvement may allow to see the influence of EU membership in more details.

Data on institutional quality or legal strength (which can be indicator of business environment) are preferable to include in the analysis, however they may not be found for all countries and targeted number of years. Therefore, their inclusion is also subject to data availability. The main source of data on business environment is currently World Bank's Doing Business database, available online. This analysis used an alternative data source, Global Competitiveness Index (GCI) by the World Economic Forum (WEF), which is composed of more trade related variables such as Goods market efficiency; Labor market efficiency; Financial market development; Technological readiness; Market size; Business sophistication; Innovation; Institutions; Infrastructure; Macroeconomic environment; Health and primary education; Higher education and training. Within this index, trade tariffs as percentage of duty was also taken as a separate variable in the analysis.

ECONOMETRIC ANALYSIS

The panel regression (OLS) of the regression mentioned above were expected to indicate problems with endogeneity, heteroscedasticity and autocorrelation. Regressing first differences of variables can help with the autocorrelation issues. Panel heteroscedasticity can also be seen due to unaccounted effects or omitted variables; which can be treated by fixed or random effects models. In random effects model, the individual-specific effect is assumed to be a random variable and uncorrelated with the explanatory variables. However, this assumption may need to be checked for robust standard errors. (Hausman Test) In the fixed effect model, random effect estimators are biased and inconsistent, since a variable is omitted and possible correlated with other regressors. Yet, the fixed effects model can cause the losses in degrees of freedom and hence explanatory power. For the problem with endogeneity, IV or 2 SLS can be applied.

The analysis in STATA suggests that random effects model fits the relation between regional trade integration and finance. (Table 1) The regression with random effects model suggests that change in intra-regional trade is positively related with banking sector development (bank private credits/GDP) and openness (bank foreign assets/GDP) with coefficients of 0.06 and 0.04, respectively. Although the effect seems low, it still indicates at least some positive relation. Given that many countries in the sample have under-developed banking sectors with low foreign assets, banks from other developed countries expand to these markets and fill the void. Therefore, countries with less developed banking sector may not indicate strong banking sector-trade relations, which can lead to low value of coefficients. The analysis can be repeated only with countries that have developed banking sectors, which can show stronger coefficients.

Table 1 Random effects model

Random-effects GLS regression		Number of obs =		194		
Group variable: countrynum		Number of groups =		33		
R-sq:		Obs per group:				
within =	0.1958	min =	4			
between =	0.3748	avg =	5.9			
overall =	0.2450	max =	6			
corr(u_i, X) = 0 (assumed)		Wald chi2(10) =		56.64		
		Prob > chi2 =		0.0000		
RegTrade	Coef.	Std. Err.	z	P> z	[95% Conf. Interval]	
BankDEV	.0648444	.0287956	2.25	0.024	.0084062	.1212826
StMktDEV	-.0170219	.0212365	-0.80	0.423	-.0586447	.0246009
BndMktDEV	-.0062688	.015668	-0.40	0.689	-.0369776	.0244399
BankOPEN	.0414783	.0147636	2.81	0.005	.012542	.0704145
StkMKTCORR	.0938594	.0223059	4.21	0.000	.0501406	.1375782
GDPperCAP	-.0995019	.0584889	-1.70	0.089	-.2141379	.0151342
FDISTKin	-.0004209	.0021259	-0.20	0.843	-.0045876	.0037457
Tariff	.0089968	.003511	2.56	0.010	.0021154	.0158783
GCI	-1.831851	4.258477	-0.43	0.667	-10.17831	6.514612
EUdummy	3.695049	.9080525	4.07	0.000	1.915299	5.474799
_cons	-1.180781	.8586681	-1.38	0.169	-2.863739	.5021777
sigma_u	.81987739					
sigma_e	3.7412123					
rho	.04582487 (fraction of variance due to u_i)					

Another significant variable in analysis is stock market correlation, which is positively related with changes in intra-regional trade by a coefficient of 0.093. This can be expected since companies raise funds from equity markets –besides investing in equities- and higher integration with other stock markets can encourage these firms to raise capital abroad from foreign investors and enable them to find foreign partners, while making cross border mergers and acquisitions easier. In addition, for smaller companies and start-ups, equity markets provide an exit mechanism for initial investors, which can increase cross-border holding of firm shares.

Among the control variables, GDP per capita is significant and its increase is negatively correlated with intra-regional trade by a coefficient of -0.099. This result may seem contrary to expectations in the beginning since GDP and trade is regarded as positively related. However, speed of economic growth can be higher in developing countries compared to developed ones once they engage in trade and liberalization. This means that the less a country is developed (with faster increase in GDP per capita), the less will be the increase in its regional trade. This result also confirms the claim that regional integration strengthens the existing economic and power structures within a region.

Tariff variable (percentage of tariff in duties) is also significant and positive. This variable was constructed to estimate the effect of non-tariff barriers in customs duties on regional trade. In other words, when share of tariffs in customs duties increases, share of non-tariff barriers decrease. Less share of non-tariff barriers is associated with increase in intra-regional trade, which is expectable. However, the coefficient is very low with 0.008, which may also be indicator of mixed effects across countries.

It is also noticeable that the most significant and strongest variable in the regression is membership to the EU. The coefficient is highest with 3.69, meaning that only being in Europe increases regional trade almost by four times. As explained in coming chapters, the EU and ASEAN regionalization in trade and finance differ by multiple ways: The EU integration is more formal and institutionalized, developmental differences across members are less substantial, both intra and extra regional trade is a lot higher than ASEAN with much more expanded trade networks. These factors, namely, institutionalization, equitable development and expansive trade networks may play great role in deciding how much membership to a regional organization will increase the regional trade. Additionally, ASEAN has dominance of extra-regional trade and

trade partners (such as EU, US, Japan, China), which also affect members' trade patterns and contribute to the fact that ASEAN membership increases regional trade less than the EU.

To check suitability of random effects model against fixed effects and OLD models, two other tests were done. The fixed effects model suggests significance of only three variables; banking development, stock market development and tariffs. (Table 2)

Table 2 Fixed effects model

note: EUdummy omitted because of collinearity

```

Fixed-effects (within) regression          Number of obs   =       194
Group variable: countrynum               Number of groups =        33

R-sq:                                     Obs per group:
  within = 0.2079                          min =           4
  between = 0.0099                          avg =          5.9
  overall = 0.1394                          max =           6

corr(u_i, Xb) = -0.0918                    F(9,152)        =        4.43
                                           Prob > F        =        0.0000

```

RegTrade	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
BankDEV	.0699404	.0309716	2.26	0.025	.00875	.1311307
StMktDEV	-.0246703	.0221364	-1.11	0.267	-.0684052	.0190645
BndMktDEV	-.0050792	.0159768	-0.32	0.751	-.0366445	.0264861
BankOPEN	.0157749	.0174325	0.90	0.367	-.0186663	.0502162
StkMKTCORR	.0956327	.0224736	4.26	0.000	.0512317	.1400337
GDPperCAP	-.1009502	.0630412	-1.60	0.111	-.2255004	.0236
FDISTKin	.0007622	.0021511	0.35	0.724	-.0034878	.0050122
Tariff	.00879	.0034907	2.52	0.013	.0018933	.0156866
GCI	-2.188784	4.471467	-0.49	0.625	-11.02303	6.645467
EUdummy	0	(omitted)				
_cons	1.826256	.3309371	5.52	0.000	1.172426	2.480087
sigma_u	2.3958408					
sigma_e	3.7412123					
rho	.29083112	(fraction of variance due to u_i)				

F test that all u_i=0: F(32, 152) = 2.24

Prob > F = 0.0006

However, Hausman test (Figure 3) results confirm the validity of random effects model over fixed effects model.

Table 3 Hausman Test

	— Coefficients —			
	(b) fixed	(B) random	(b-B) Difference	sqrt(diag(V_b-V_B)) S.E.
BankDEV	.0699404	.0648444	.005096	.0114042
BankOPEN	.0157749	.0414783	-.0257033	.0092697
StMktDEV	-.0246703	-.0170219	-.0076485	.0062476
BndMktDEV	-.0050792	-.0062688	.0011897	.003126
StkMKTCORR	.0956327	.0938594	.0017733	.0027401
GDPperCAP	-.1009502	-.0995019	-.0014483	.0235213
FDISTKin	.0007622	-.0004209	.0011831	.0003287
Tariff	.00879	.0089968	-.0002069	.
GCI	-2.188784	-1.831851	-.3569333	1.363595

b = consistent under Ho and Ha; obtained from xtreg
 B = inconsistent under Ha, efficient under Ho; obtained from xtreg

Test: Ho: difference in coefficients not systematic

chi2(9) = (b-B)'[(V_b-V_B)^(-1)](b-B)
 = 4.74
 Prob>chi2 = 0.8567
 (V_b-V_B is not positive definite)

The final step in the analysis is to check the regular OLS model and see whether it may be a better fit. Estimation of OLS model is below; (Table 4) the model suggests significance of banking development and openness, stock market correlation, tariffs and the EU dummy, which are the same with random effects model. Moreover, the value of coefficient are also close to random effects model.

Table 4 OLS model

Source	SS	df	MS	Number of obs	=	194
Model	918.53734	10	91.853734	F(10, 183)	=	5.95
Residual	2822.93333	183	15.4258652	Prob > F	=	0.0000
				R-squared	=	0.2455
				Adj R-squared	=	0.2043
Total	3741.47067	193	19.3858584	Root MSE	=	3.9276

RegTrade	Coef.	Std. Err.	t	P> t	[95% Conf. Interval]	
BankDEV	.0638004	.0288822	2.21	0.028	.0068155	.1207854
StMktDEV	-.0163172	.0215204	-0.76	0.449	-.0587773	.0261429
BndMktDEV	-.0061231	.0159433	-0.38	0.701	-.0375794	.0253332
BankOPEN	.04601	.014592	3.15	0.002	.0172199	.0748001
StkMKTCORR	.0925722	.0227467	4.07	0.000	.0476927	.1374517
GDPperCAP	-.096672	.0587377	-1.65	0.102	-.2125622	.0192181
FDISTKin	-.0006165	.00217	-0.28	0.777	-.004898	.0036649
Tariff	.0090816	.0035892	2.53	0.012	.002	.0161632
GCI	-1.76317	4.296301	-0.41	0.682	-10.23982	6.713484
EUdummy	3.718925	.8320724	4.47	0.000	2.077236	5.360613
_cons	-1.182617	.7916823	-1.49	0.137	-2.744616	.3793815

One way of testing suitability of OLS model in comparison to random effects and fixed effects models is Breusch and Pagan Lagrangian multiplier test. (Table 5) The test confirms that use of random effect model is more suitable for the analysis rather than OLS model.

Table 5 Breusch Pagan Test

Breusch and Pagan Lagrangian multiplier test for random effects

$$\text{RegTrade}[\text{countrynum},t] = Xb + u[\text{countrynum}] + e[\text{countrynum},t]$$

Estimated results:

	Var	sd = sqrt(Var)
RegTrade	19.38586	4.402937
e	13.99667	3.741212
u	.6721989	.8198774

Test: $\text{Var}(u) = 0$

$$\text{chibar2}(01) = 2.69$$

$$\text{Prob} > \text{chibar2} = 0.0505$$

Other tests include testing for variance inflation factor, correlation matrix of coefficients and correlation matrix of coefficients for asymptotic properties of estimators and multicollinearity. Tables 6-8 indicate that VIF values confirm the use of coefficients, while correlation and covariance between coefficients are low enough to assume non-existence of multicollinearity.

Table 6 VIF, Uncentered

Variable	VIF	1/VIF
EUdummy	1.31	0.766151
GDPperCAP	1.28	0.778662
BndMktDEV	1.27	0.789143
BankOPEN	1.16	0.865792
BankDEV	1.14	0.874890
Tariff	1.10	0.911124
GCI	1.10	0.911521
StMktDEV	1.10	0.912958
StkMKTcorr	1.09	0.916024
FDISTKin	1.03	0.973156
Mean VIF	1.16	

Table 7 Covariance matrix of coefficients in random effects model

Covariance matrix of coefficients of xtreg model

e (V)	BankDEV	StMktDEV	BndMktDEV	BankOPEN	StkMKT CORR	GDPperCAP	FDISTKin
BankDEV	.00082918						
StMktDEV	.000014	.00045099					
BndMktDEV	.00003643	-.00002947	.00024549				
BankOPEN	-.0000911	-.00002204	-.00001082	.00021797			
StkMKT CORR	-.00004816	.00006137	-.00002885	.0000204	.00049755		
GDPperCAP	.00033773	-5.236e-06	.00035562	.00003606	-.00014062	.00342095	
FDISTKin	2.027e-06	-3.348e-06	1.584e-07	-1.215e-06	-2.156e-06	.00001596	4.519e-06
Tariff	-5.426e-06	-.00001233	-1.730e-06	9.676e-07	-3.249e-06	-1.994e-06	-2.592e-08
GCI	-.00091269	.01281416	.0029005	-.00361496	-.00052262	-.02450103	-.00043778
EUdummy	.00401021	.00036366	-.00063675	.00074123	.00130527	.00364194	.00011033
_cons	-.00318251	.00015526	-.00069154	.0004607	.00054945	-.00484253	-.00014456

e (V)	Tariff	GCI	EUdummy	_cons
Tariff	.00001233			
GCI	-.00023933	18.134629		
EUdummy	.00054908	.46785859	.82455932	
_cons	-.00079644	-.74168516	-.70882225	.7373109

Table 8 Correlation matrix of coefficients in random effects model

Correlation matrix of coefficients of xtreg model

e (V)	BankDEV	StMktDEV	BndMkt~V	BankOPEN	StkMKT~R	GDPper~P	FDISTKin	Tariff	GCI
BankDEV	1.0000								
StMktDEV	0.0229	1.0000							
BndMktDEV	0.0807	-0.0886	1.0000						
BankOPEN	-0.2143	-0.0703	-0.0468	1.0000					
StkMKT CORR	-0.0750	0.1295	-0.0826	0.0619	1.0000				
GDPperCAP	0.2005	-0.0042	0.3881	0.0418	-0.1078	1.0000			
FDISTKin	0.0331	-0.0742	0.0048	-0.0387	-0.0455	0.1283	1.0000		
Tariff	-0.0537	-0.1654	-0.0314	0.0187	-0.0415	-0.0097	-0.0035	1.0000	
GCI	-0.0074	0.1417	0.0435	-0.0575	-0.0055	-0.0984	-0.0484	-0.0160	1.0000
EUdummy	0.1534	0.0189	-0.0448	0.0553	0.0644	0.0686	0.0572	0.1722	0.1210
_cons	-0.1287	0.0085	-0.0514	0.0363	0.0287	-0.0964	-0.0792	-0.2642	-0.2028

e (V)	EUdummy	_cons
EUdummy	1.0000	
_cons	-0.9091	1.0000

The next chapters analyze trade patterns and trade integration in the EU and the ASEAN (Chapter V), banking sector and development in the EU and the ASEAN (Chapter VI) and

capital market development integration in the EU and ASEAN (Chapter VII) to explain these variables in more detail and identify mechanisms how financial sector can affect regional trade integration.

CHAPTER V

TRADE INTEGRATION IN THE EU AND ASEAN

OVERVIEW OF THE EU AND ASEAN TRADE AGREEMENTS AND FDI

Development of Regional Trade

Integration in trade of goods and services around the world goes back to General Agreement on Tariffs and Trade (GATT) and its services counterpart, the General Agreement on Trade in Services (GATS). GATT negotiations included over 50 countries with the aim of liberalizing global trade by reducing tariff and non-tariff measures, addressing trade related issues (intellectual property rights, dispute resolution, and others) and by creating an international trade organization. GATS (1995) aimed liberalization of service sectors and defined four modes of trading services: The first is cross border supply as services supplied from one country to another (such as ICT). Second is consumption abroad as consumers use services in another country (such as tourism). The third is commercial presence as foreign companies set up subsidiaries or branches to provide services in another country (such as opening of bank branches in another country). Finally, GATS addresses the presence of natural persons as individuals travel from their country to supply services in another (such as consultants).

Since the foundation of World Trade Organization (1995), trade of goods and services in the EU and ASEAN increased. However, trade integration in goods proceeded faster than the

services due to level of development as well as regulatory restrictions that limit liberalization of services. Indeed, developmental differences within the regions have substantially slowed down both trade and financial integration, especially in the ASEAN. For this reason, the leading ASEAN-5 countries also initiated free trade areas (FTAs) with their more developed regional neighbors (Japan, China and South Korea) under the ASEAN+3 scheme. They also look forward to further expansion under “Regional Comprehensive Economic Partnership” (RCEP or ASEAN+6) agreement with Australia, New Zealand and India. Meanwhile, in the EU, free movement of goods is ensured by a customs union and the principle of non-discrimination. The region manages imports from non-member states, while duties between member states are prohibited and imports circulate freely. The EU has the most developed countries in its west and north, which lead the region’s trade and FDI activity, while former communist countries have formed intra-industrial trade links with developed Europe and received substantial FDI inflows from them until the global financial crisis of 2008.

Over the last two decades, trade networks of the EU and ASEAN have expanded substantially with trade agreements on goods and services. The EU places special importance on its extra-regional trade partners since around 90% of global economic growth over the next ten to 15 years is expected to be generated outside Europe.¹ In this context, EU economic recovery will need to be consolidated with stronger links with other growing regions such as Asia. Therefore, the European Commission developed a new trade policy to complement European engagement at the WTO. So far, the EU concluded or currently negotiates multiple FTAs with many partners. Ten years ago, the FTAs (in force) covered less than 25% of EU

¹ Trade for all - Towards a more responsible trade and investment policy, EU 2015
<http://ec.europa.eu/trade/policy/in-focus/new-trade-strategy/>

Table 9 EU External Trade Network

<p>1. <u>Customs Union:</u> Andorra (1991), San Marino (1992), Turkey (1995)</p> <p>2. <u>Association Agreements</u> Europe - Macedonia (2004), Albania (2006), Montenegro (2010), Serbia (2013), Ukraine (2014), Bosnia (2015), Kosovo, Moldova (2016) Middle East and North Africa - Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine, Syria, Tunisia (1997-2005) Caucuses - Georgia (2016) Central America (2012)</p> <p>3. <u>Partnership and Cooperation Agreements</u> Caucuses- Russia (1997), Armenia, Azerbaijan (1999), Kazakhstan (2016) Africa: South Africa (2000), Cameroon, Madagascar, Mauritius, Seychelles, Zimbabwe (2009), East African Countries* (2014), West Africa* (2014), South African Development Community (2016), Ghana (2016) Other Countries: Mexico (2000), Iraq (2012), Ivory Coast (2016)</p> <p>4. <u>Other Agreements:</u> South Korea, Free Trade Agreement, signed (2010) Singapore, Free Trade Agreement* (2014) Vietnam, Free Trade Agreement* (2016) Canada,* Comprehensive Economic and Trade Agreement (2016) The US – TTIP negotiations started. *Finalized but not yet applied</p>

trade, which increased to more than a third and can double to two thirds in the future if all pending agreements are realized. (Table 9)

Source: EU Trade Web site (<http://ec.europa.eu/trade>)

The ASEAN trade network is more limited than that of the EU, but the region has been receiving significant FDI inflows from the US, EU and Japan with developing vertical intra-industry trade (VIIT) and links with multinational corporations from the advanced countries. With an export oriented strategy, ASEAN firms are getting more sophisticated and internationalized as their technology, know-how and market connections develop. The extension of the extra-ASEAN trade network mostly involves other Asian countries in the region. (Table

Table 10 ASEAN RTA's

ASEAN Regional Trade Agreements*			
	Coverage	Type	Date of Entry into Force
ASEAN Free Trade Area (AFTA)	Goods	FTA	1992
ASEAN - Australia - New Zealand	Goods & Services	FTA & EIA	2010-2012
ASEAN - China	Goods & Services	FTA & EIA	2005-2008
ASEAN - India	Goods & Services	FTA & EIA	2010-2015
ASEAN - Japan	Goods	FTA	2009
ASEAN - Korea, Republic of	Goods & Services	FTA & EIA	2010
Costa Rica - Singapore	Goods & Services	FTA & EIA	2013
Panama - Singapore	Goods & Services	FTA & EIA	2007
Peru - Singapore	Goods & Services	FTA & EIA	2009
Trans-Pacific Strategic Economic Partnership	Goods & Services	FTA & EIA	2007
Turkey - Malaysia	Goods	FTA	2015
United States - Singapore	Goods & Services	FTA & EIA	2003
* Enabled by GATT Art. XXIV for goods & GATS Art. V by services			

Source: World Trade Organization web site

10) In addition, ASEAN also has strong trade and FDI relations with the EU and prospective trade agreements under negotiation.

Negotiations for an FTA between the EU and ASEAN were launched in 2007 and paused in 2009 to continue the process with bilateral FTA negotiations. Negotiations with Singapore and Malaysia were launched in 2010; with Vietnam in June 2012; with Thailand in March 2013; with the Philippines in December 2015; and with Indonesia in July 2016. The European Commission finalized negotiations of a bilateral FTA with Singapore in October 2014 and with Vietnam in December 2015.²

² The EU accounts for 13% of international trade in ASEAN, which makes it the second largest trade partner of ASEAN after China. The EU is also largest investor in ASEAN, accounting for 22% of total FDI inflows. ASEAN represents the EU's third largest trading partner after the US and China with more than €246 billion of trade in goods and services in 2014. The EU's main exports to ASEAN are chemical products, machinery and transport equipment. The main imports from ASEAN to the EU are machinery and transport equipment, agricultural products as well as textiles and clothing. (<http://ec.europa.eu/trade/policy/countries-and-regions/regions/asean/>)

Trade integration of the EC and ASEAN differs in various aspects. In the EU, trade liberalization causes more interdependence, which increases demand for regional institutions. On the other side, ASEAN integration shows how regional integration works as part of an export-based development strategy.³ In this context, regional integration reinforces the existing economic structures of a region rather than changing them. When intra-regional interdependence prevails, intra-regional trade increases; but when extra-regional interdependence prevails, regional integration can support extra-regional trade and become a part of an export-based development strategy.⁴ Moreover, power asymmetries between regional power and other countries can be enhanced.

Trade and Financial Integration

The financial system affects international trade through various channels, which relate to different parts of financial system such as banks; non-bank financial institutions (savings institutions, cooperatives, leasing services, asset management firms, and others); the insurance sector; and capital markets (equity and bond markets, derivative markets, and others). The financial sector is crucial for trade since it provides funds or loans for firms: As mentioned in the literature, developed financial systems lower the cost of capital and improve capital availability for companies to fund their growth and trade activities. Besides that, the financial sector also enables large-scale and long-term financing for infrastructure investments, which are also crucial for trade since they provide transportation, energy and communication (and

³ Different Paths of Regional Integration: Trade Networks and Regional Institution-Building in Europe, Southeast Asia and Southern Africa. SEBASTIAN KRAPOHL and SIMON FINK *Journal of Common Market Studies* 2013 Volume 51. Number 3. pp. 472–488

⁴ Different Paths of Regional Integration: Trade Networks and Regional Institution-Building in Europe, Southeast Asia and Southern Africa. SEBASTIAN KRAPOHL and SIMON FINK *Journal of Common Market Studies* 2013 Volume 51. Number 3. pp. 472–488

other) facilities. With the reduction of public sector spending on infrastructure over the last decade, syndicated loans from banks, infrastructure bonds or equity issuances can create resources for large-scale investments. These channels are explained in more detail as follows.

First, banks and financial institutions provide loans and trade credits to firms, which support their growth and increase in trade activity. Moreover, they enable verification of international parties through networks of banks and other involved financial institutions. Banks and financial institutions also perform other functions that relate to trade such as financial leasing; payment and monetary transmission services; guarantees and commitments; issuance of equity and debt securities to raise funds; money brokering; asset management and advisory services; and transfer of financial information. Regional integration of banking sectors can allow national banks to follow their clients across borders to provide the services they need abroad.

Second, safe and timely transfer of payments and funds is achieved through well developed financial infrastructure (payment and settlement systems, and trade repositories) and related service providers. For international trade, these services are crucial and many risks associated with transfers (operational, economic, and regulatory risks as well as the risk of delay or counterparty default risks) are handled through regulatory and technological safeguards embedded into these systems.

Third, the development of capital markets (equity and bond markets) provides a viable alternative to bank loans. As seen in the Asian Crisis of 1997-98, the global financial crisis of 2008 and the European sovereign debt crisis of 2011, the banking sector is vulnerable to economic disturbances and responds to stress by narrowing the provision of credit, while over-reliance on the banking sector makes all companies vulnerable to any disturbance in banking

and economic system. Capital markets allow countries to raise funds by issuing equities in stock markets (instead of seeking debt) or by issuing bonds, which enable them to borrow money outside of the banking system. This challenge to access financing is more pronounced for smaller companies, while both the EU and ASEAN have bank-based financial systems. Development of capital markets diversifies funding sources for firms, while integrated capital markets can enable them to tap into a larger regional investor base as funding sources.

Capital markets also provide alternative financing for infrastructure investments other than bank loans. These investments require large and long-term funds, the provision of which has become more challenging for banks since they are subject to higher capital and liquidity requirements after the recent global crisis. Capital markets allow issuance of bond and equity securities and their sale to a large base of investors in order to raise funds for any desired durations.

Fourth, the financial sector mitigates the currency, interest rate and maturity risks of international trade. Through derivative instruments⁵, capital markets help companies and investors to hedge their risks when their assets and liabilities have mismatches in currency and duration. Thus, risks from difference of interest and exchange rates between countries can be addressed by financial instruments.

Fifth, as a part of the financial sector, the insurance sector provides protection against accidents, disasters and other related risks of trade. Moreover, insurance of trade credits, business credits, and export credits to firms is also possible. For infrastructure investments, solid large-scale insurers and reinsurers are crucial to address many project risks. Therefore, internationalization and expansion of insurance sectors can enable them to handle larger risks across the countries.

⁵ Interest rate or exchange rate swaps, options are examples.

Finally, trade activity closely relates to economic stability, which is linked to the financial sector. Macroeconomic cooperation and surveillance under regional integration can ease detection and treatment of systemic risks. Besides, well developed financial sectors enable better monetary policy and transmission mechanisms through issuance of government bonds and improved liquidity in the banking system. By providing an alternative channel to banks to mobilize savings into investments, capital markets can also act as a shock absorber during times of economic distress. Moreover, trade patterns closely relate economic cyclicity, while synchronization of business cycles among countries affects international trade. Well developed financial sectors can ease initiation of counter-cyclical policies when economic activity and growth slows down.

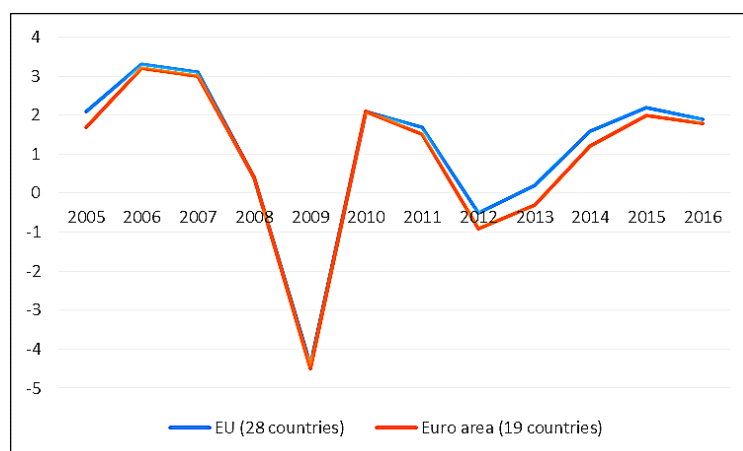
Any problems in the financial sector (such as low financial sector development, small financial sector size or financial crises) that undermine these functions can also affect trade negatively. The financial sector is also closely related to economic outlook and allocation of resources among sectors, which can affect trade patterns. On the other side, the finance-trade linkages are reciprocal. Expansion of intra-regional trade can also promote expansion of financial sector across the borders since financial providers and institutions tend to follow their clients to provide international financial services. The absence or low capacity of domestic or regional financial institutions to perform trade supporting functions or to provide adequate financial services can result in expansion of global (non-regional) financial firms into the region to dominate these markets. Further details on financial sector integration and its implications will be addressed in upcoming sections.

EU TRADE INTEGRATION

EU Trade, FDI and Business Environment

After the introduction of euro in 1999, the EU recorded positive GDP growth until the 2008 crisis, which also supported international and intra-regional trade. Before the global crisis, Europe benefited from technological spillover, increasing trade, decreasing trade barriers, strengthening FDI, technological diffusion and net inflow of capital and labor. Decreasing inflation and interest rates, more jobs and higher GDP growth were also observed.⁶ The crisis spread to Europe by its exposure to international banks and economic slowdown, and was later followed by the sovereign debt crisis. As a result, the European economy fell into a double dip recession between 2009 and 2012, with negative GDP growth and substantial problems in the financial sector. Trade integration was negatively affected by the vulnerability of the EU economy and financial sector to crises.

Figure 1- EU GDP Growth 2005-2016



Source: IMF Database

⁶ Hamilton, Daniel S. and Joseph P. Quinlan. "Globalization and Europe", Center for Transatlantic Relations, 2008.

EU intra-regional trade remained solid with around 63% of total trade in goods and 55% of total trade in services in 2014 (Table 11) despite slight decreases during the crises. However, nominal trade values indicate that EU intra-regional trade is sensitive to global and regional economic pressures. All EU sub-regions recorded decline in their exports and imports between 2007 and 2009, compared to before crisis, both in nominal values and as share in GDP. (Table 12)

Table 11 EU Merchandise and Services Trade Partners, 2014

EU-28 Merchandise Trade by partner					
Exports		Share	Imports		Share
World	6,162,240	100	World	6,132,501	100
EU28	3,900,147	63.3	EU28	3,900,120	63.6
US	413,027	6.7	China	401,894	6.6
China	218,855	3.6	US	272,904	4.5
Switzerland	186,452	3	Russia	241,027	3.9
Russia	137,264	2.2	Switzerland	128,308	2.1
EU-28 Commercial Services Trade by partner					
Exports		Share	Imports		Share
World	2,051,279	100	World	1,731,184	100
EU 28	1,120,440	54.6	EU 28	1,033,613	59.7
US	237,830	11.6	US	209,453	12.1
Switzerland	131,274	6.4	Switzerland	71,477	4.1
Russia	40,193	2	China	27,578	1.6
China	38,006	1.9	Turkey	20,271	1.2

Source: WTO International Trade Statistics 2015

As of 2015, the northern and western regions still account for majority of EU trade, although trade of the south and Central and Eastern Europe (CEE, especially exports) experienced some increases after 2010. The high share of intra-regional trade in the CEE can be attributed to increasing FDI flows from the EU-15 and the formation of intra-industry trade (IIT) between Central, Eastern and South-Eastern Europe (CESEE) countries and these developed EU-countries. In general, countries with better monetary policy, lower corporate tax rate, more

flexible exchange rate regimes and stronger political institutions tend to develop higher IIT with the EU-15.⁷

Table 12 EU Sub regions: Average Imports and Exports with the Region and the World

In nominal value – Billion USD											As percentage of GDP												
TRADE	REGION	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	TRADE	REGION	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
IMP WORLD	WEST	351	410	465	360	402	475	447	454	459	394	IMP WORLD	WEST	35%	35%	37%	31%	35%	38%	38%	37%	36%	36%
	NORTH	224	243	258	196	223	259	257	249	257	227		NORTH	25%	24%	26%	23%	26%	27%	27%	25%	25%	23%
	SOUTH	134	158	175	127	142	160	142	142	144	124		SOUTH	25%	26%	26%	20%	24%	26%	25%	24%	25%	25%
	CEE	48	63	76	53	62	76	72	75	78	69		CEE	51%	52%	52%	44%	50%	55%	55%	55%	56%	56%
IMP REGION	WEST	227	266	297	232	254	299	279	286	289	248	IMP REGION	WEST	22%	23%	23%	20%	22%	24%	24%	23%	23%	22%
	NORTH	123	141	146	108	121	140	137	141	148	133		NORTH	14%	14%	14%	13%	14%	15%	15%	14%	14%	14%
	SOUTH	82	97	102	78	83	91	78	80	84	75		SOUTH	15%	16%	15%	12%	14%	14%	14%	14%	14%	15%
	CEE	35	46	54	39	44	54	51	54	57	51		CEE	37%	39%	37%	32%	35%	39%	39%	39%	41%	41%
EXP WORLD	WEST	386	453	502	393	436	505	482	496	505	442	EXP WORLD	WEST	38%	39%	40%	34%	38%	40%	41%	40%	40%	40%
	NORTH	193	202	218	161	185	221	206	223	214	189		NORTH	21%	20%	22%	19%	21%	23%	22%	23%	20%	19%
	SOUTH	102	121	133	102	113	134	130	136	139	120		SOUTH	19%	20%	20%	16%	19%	21%	23%	23%	24%	24%
	CEE	42	54	65	51	59	73	70	75	79	70		CEE	45%	45%	45%	42%	47%	53%	54%	55%	56%	57%
EXP REGION	WEST	267	314	345	265	288	330	306	315	322	281	EXP REGION	WEST	26%	27%	27%	23%	25%	26%	26%	25%	25%	26%
	NORTH	118	119	126	91	101	117	108	108	111	95		NORTH	13%	12%	12%	11%	12%	12%	12%	11%	11%	10%
	SOUTH	67	79	85	64	70	81	74	78	81	71		SOUTH	12%	13%	12%	10%	12%	13%	13%	13%	14%	14%
	CEE	34	43	51	40	47	56	53	57	61	55		CEE	35%	36%	35%	33%	37%	41%	41%	42%	43%	45%
GDP	WEST	1010	1160	1270	1163	1150	1253	1177	1240	1270	1101	GDP	WEST	26%	27%	27%	23%	25%	26%	26%	25%	25%	26%
	NORTH	899	1031	1006	842	871	947	943	977	1048	970		NORTH	13%	12%	12%	11%	12%	12%	12%	11%	11%	10%
	SOUTH	538	619	678	622	598	628	567	580	584	499		SOUTH	12%	13%	12%	10%	12%	13%	13%	13%	14%	14%
	CEE	95	120	145	122	125	138	129	136	140	123		CEE	35%	36%	35%	33%	37%	41%	41%	42%	43%	45%

Source: IMF Direction of Trade Statistics (DOTS)

There's also differentiation between vertical and horizontal IIT (VIIT and HIIT): VIIT implies exchange of products from different production stages (different service levels and quality), driven by comparative advantage. Low quality VIIT shows that a country exports low quality and imports high quality products. HIIT implies exchange of competing or substitute products (different versions of similar products) directed by economies of scale; HIIT takes place between high income countries with similar economic patterns and allows for bigger trade benefits and lower adjustment costs. Although low quality VIIT also dominates the industrial trade of the CEE with the EU, the HIIT and high quality VIIT accelerated for these countries,

⁷ Dautovic, Orszaghova and Schudel (2014)

while the low quality VIIT decelerated.⁸ While FDI and lower corporate tax rates can promote VIIT for CESEE countries, floating exchange rate regime and lower corporate taxes can promote the HIIT in more developed, new member countries.

Nevertheless, developmental differences negatively affect the competitiveness of the EU as half of the EU lags behind China, India and even Russia in competitiveness.⁹ Northern Europe copes with globalization with export orientation; trade surpluses; high education levels; high technical products; strong innovation; and assistance to low-skilled unemployed to adjust to market conditions. Continental Europe has weaknesses in tertiary education and inflexible labor markets. South and East Europe exhibit structural deficiencies, which require reforms to keep up with the challenges. In terms of inequality, there is also more variation in GDP standards.

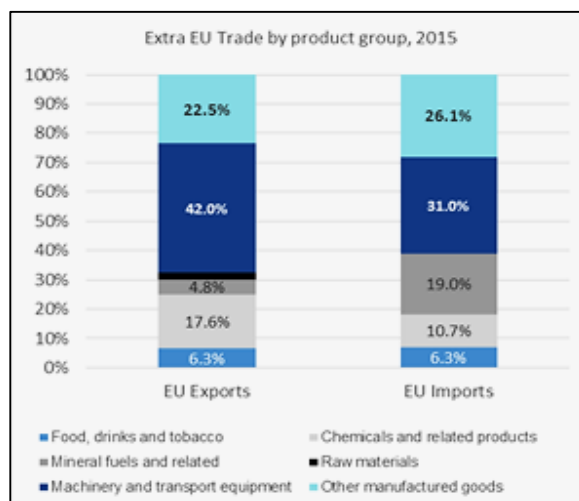
In addition, technological diffusion is very diverse in the euro area. Denmark, the Netherlands, Finland, and Sweden are quite developed in IT, while Greece, Portugal, Spain, Italy and many Eastern Europe countries lack technology and are far behind their competition in R&D innovation: Europe is a medium-to-high technology exporter (Figure 2) behind the United States, Japan and developing Asia.¹⁰ In goods trade, the main competitive sectors include machinery and equipment, other manufactured goods, and the chemical industry, while in services trade other business services, travel and transportation constitutes major share of global exports. (Figure 3) This competitiveness is mostly achieved by the developed economies of Germany, the Netherlands, France, the UK and Nordic countries. Most R&D by Europe is from affiliates of non-EU companies, mostly from United States. Technological convergence between regions has to be supported by developing telecommunications, internet, and technical training for human capital because discrepancies in technology, innovation and R&D weaken the integration.

⁸ Dautovic, Orszaghova and Schudel (2014)

⁹ Hamilton, Daniel S. and Joseph P. Quinlan. "Globalization and Europe", Center for Transatlantic Relations, 2008.

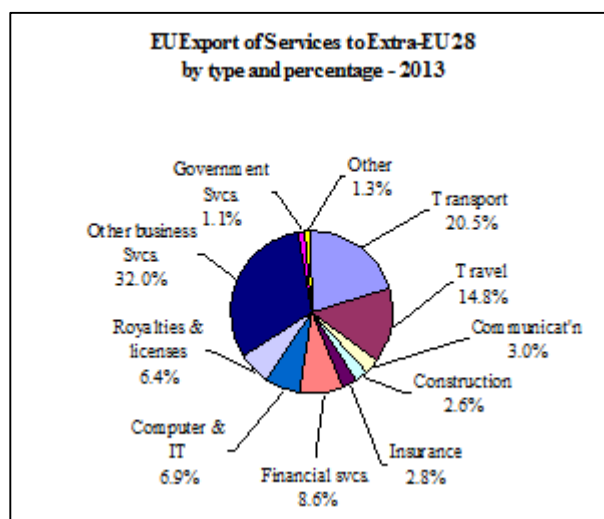
¹⁰ Hamilton, Daniel S. and Joseph P. Quinlan. "Globalization and Europe", Center for Transatlantic Relations, 2008.

Figure 2 – Extra-EU Goods Trade by Product, 2015



Source: UNCTAD Database

Figure 3- Extra EU Services Exports, 2013



Source: UNCTAD Database

Another important issue in EU trade integration is liberation of the services sector: In 2015, this sector accounted for 80% of the gross value added in the EU (71% in 2005), compared to 19% for industry.¹¹ Besides, more than 60% of EU direct investment abroad is connected to trade in services.¹² The highest value added in the EU services sector was recorded in transport, accommodation and food services, followed by public administration, education and health, and real estate. The next largest activities include business services (professional, scientific, technical, administrative and support services), financial services, and ICT (information and communication technologies).¹³ Between 2007 and 2009, both industrial and services output declined due to the global crisis.

EU efforts to liberalize the services sector started with General Agreement on Trade of Services (GATS-1995) and continued with 2006 EU Services Directive. The Directive aimed to simplify establishment of service providers in their home country and abroad and cross-border provision of services into other EU countries. It also aimed to strengthen the rights of services consumers and ensure easier access to a wider range of services. The latest efforts for liberalization include negotiations for Trade in Services Agreement (TISA), which started in 2013 and focused on financial services. However, the initiatives until TISA covered around half of the EU service sectors: According to EU Services Implementation Report, services such as Government and Public Services, health & social services, network services, transport services and other services (manufacture, agriculture and fishing), -which together represented 46% of gross value added in the EU services sector as of 2009- were not covered under the EU services

¹¹ http://ec.europa.eu/eurostat/statistics-explained/index.php/National_accounts_and_GDP

¹² Trade for all - Towards a more responsible trade and investment policy, EU 2015
<http://ec.europa.eu/trade/policy/in-focus/new-trade-strategy/>

¹³ http://ec.europa.eu/eurostat/statistics-explained/index.php/National_accounts_and_GDP. ICT is Information, Communication, Technology

Directive.¹⁴ The EU Commission focuses its efforts on sectors with economic significance and above average growth potential such as business, construction, tourism and retail services. Most of the sectors not covered by the directive are covered by sector specific legislations.

Restrictions in the services sector differed significantly across the EU countries, with a total of (around) 35,000 regulatory restrictions to competition. Germany, the Netherlands, Spain, and Austria have the most restrictions, while Cyprus, Malta, Luxembourg and Finland have relatively few. Besides regulatory preferences, the legal system also affects competitiveness of services sectors as it becomes weaker when countries have more layers of government and bureaucracy and they have sector-specific regulations prevail under umbrella laws. The reduction in regulatory barriers with the services directive varied across countries, ranging from below 10% in Austria and Malta to more than 50% in Spain and Slovakia. The most deregulated sectors were tourism, hotels and restaurants, construction and real estate.¹⁵

With the foundation of the EU and start of the monetary union, trade and FDI accelerated in the EU from 2000, reaching a peak in 2007. However, the global financial crisis and the recession during 2008-2009 strongly hit FDI inflows, causing a 50% decline from 2007 to 2008: Thus, FDI inflows to the EU dropped from \$551.4 billion in 2008 to \$246.2 billion in 2013.¹⁶ Although developed countries such as Germany, Austria, Denmark, Ireland and Luxembourg registered nominal increases in FDI flows after 2009, FDI inflows as a share of GDP have drastically decreased during 2007-2014. CEE countries indicated the same trend as investments especially from developed EU countries dropped and their economies and trade were dependent and vulnerable to advanced Europe.

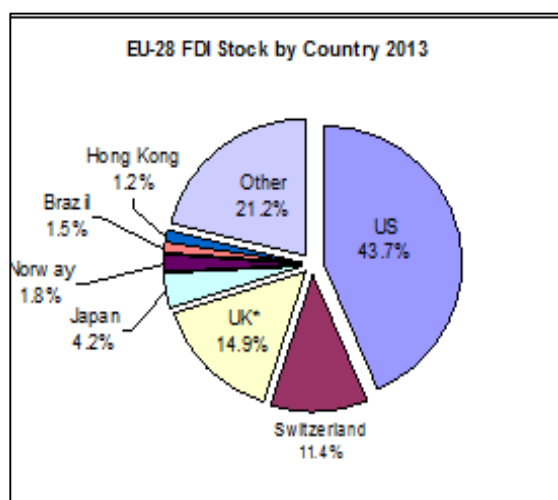
¹⁴ EU web site, available at http://ec.europa.eu/internal_market/services/docs/services-dir/implementation/report/COM_2012_261_en.pdf

¹⁵ <https://www.imf.org/external/pubs/ft/wp/2014/wp14113.pdf>

¹⁶ Calculated from Eurostat database

In terms of FDI partners, the US made the most investments in the EU, followed by the UK and Switzerland. (Figure 4) FDI mainly concentrates on technology-intensive (electronics and computers, pharmaceuticals) and capital-intensive activities (basic metals, vehicles, and other transport equipment). Services sectors are also attractive for foreign investors. In this context, the economic structure of countries also affects investors' decisions on where to invest their capital.

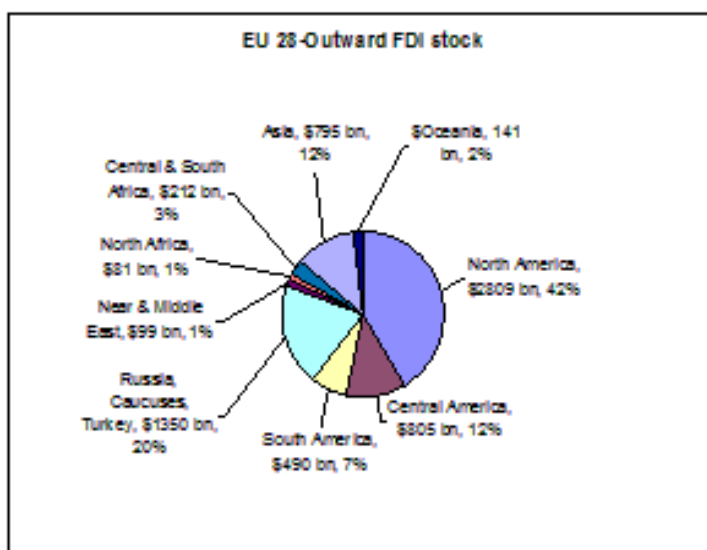
Figure 4- EU FDI Inward Stock by country, 2013



Source: Eurostat Database

FDI outflows from the EU also increased between 1990 and 2006 as the EU accounted for 64% of global FDI outflows. Since the crisis, FDI outward stock decreased nominally for the UK and the Netherlands but increased for most of the European countries (Figure 5).

Figure 5– EU FDI Outward Stock, 2013



Source: Eurostat Database

The EU has been the largest regional investor in the US, while around 60% of FDI stock in the US comes from the EU and 70% comes from the Europe as a whole: Out of the total EU FDI of \$2.8 trillion, 33.4% went to manufacturing sector, 13% to finance and insurance sector, 11.7% to wholesale trade and 5.3% went to information sectors.¹⁷ After that, other Europe (Russia, Caucasus, Turkey), Asia and Central America were the favorite FDI destinations out of the EU.¹⁸ (Figure 6)

¹⁷ Eurostat Database and “Foreign Direct Investment in the United States - 2014 Report” by Organization for International Investment.

¹⁸ Hamilton, Daniel S. and Joseph P. Quinlan. “Globalization and Europe”, Center for Transatlantic Relations, 2008.

Development of The EU Trade Integration

Development of trade patterns in the EU reflected economic interdependence that existed from the start of European integration and progressed over time. The origins of the EU come from European Coal and Steel Community (ECSC), which was established in 1953 to create a common market for coal, iron and steel industries of Germany, France, Italy, Netherland, Belgium and Luxembourg. Two years later, the Treaty of Rome was signed in 1955 which eventually established a common market as the European Economic Community (EEC) was founded. The European Court of Justice (ECJ) became the court of EEC to interpret the Treaty of Rome and solve disputes over EEC decisions. In 1958, the first European Commission took office.

In 1960, Norway, Switzerland, Austria, Denmark, Portugal, Sweden and the UK founded the European Free Trade Association (EFTA) as an alternative trading block to the EU. Thereafter, Finland (1961), Iceland (1970) and Lichtenstein (1991) joined EFTA, whereas Austria, Denmark, Portugal, Sweden and the UK joined the EU and ended their membership later.¹⁹ EFTA aimed to improve trade liberalization among its members as well as with the rest of the world, instead of establishing a customs union, common external tariffs or common trade policy. As a result, EFTA countries improved their trade relations with the EEC (at the time) with bilateral and multilateral agreements over the next three decades.

In 1965, the European Community (EC) was founded by the Brussels Treaty, which entered into force in 1967. The treaty combined the European Coal and Steel Community (ECSC), the European Atomic Energy Community (EAEC), and the European Economic

¹⁹ Iceland, Norway, Switzerland and Liechtenstein) are still members of EFTA

Community (EEC) under one institutional structure and envisaged the Commission and Council of the EEC to replace the Commission and Council of Euratom and Council of the ECSC.

In 1968, six founding Member States of the EC (Belgium, France, Germany, Italy, Luxembourg and the Netherlands) agreed on a customs union as planned by the Treaty of Rome. The customs union envisaged: “(i) no customs duties at internal borders between the EU Member States; (ii) Common customs duties on imports from outside the EU; (iii) Common rules of origin for products from outside the EU; (iv) A common definition of customs value.”²⁰ Following that, the EC agreed to expand regional integration and the single market; it accepted Denmark (1973), Ireland and UK (both in 1977) for membership. In 1977, customs duties between nine EC members were completely abolished.

During the 1960s and 1970s, a viable regional market already existed in the EC as intra-regional networks (with nine members) dominated trade, while external trade partners had peripheral positions in trade networks. In this context, core member states were mutually important trade partners. Although Germany was the most important trader in the EC, it did not dominate the economy of Europe. Instead, the axis of Germany, France and (later) the UK dominated the trade network of the Europe.²¹ Over the next decade, expansion of the EC continued. Between 1981 and 1986, the EC enlarged to the less developed south to include Greece, Portugal and Spain. By that time, the industrialized economies of the EC were able benefit from cost advantages and economies of scale by regional expansion²² as economic interdependence led to more trade liberalization and regional institution-building later on.

²⁰ http://ec.europa.eu/taxation_customs/40customs/customs_general_info/about/index_en.htm

²¹ Different Paths of Regional Integration: Trade Networks and Regional Institution-Building in Europe, Southeast Asia and Southern Africa. SEBASTIAN KRAPOHL and SIMON FINK *Journal of Common Market Studies* 2013 Volume 51. Number 3. pp. 472–488

²² Different Paths of Regional Integration: Trade Networks and Regional Institution-Building in Europe, Southeast Asia and Southern Africa. SEBASTIAN KRAPOHL and SIMON FINK *Journal of Common Market Studies* 2013 Volume 51. Number 3. pp. 472–488

By the late 1980s, the EC still had difficulties enforcing a single market due to the lack of strong decision-making structures, while intangible barriers to trade remained due to protectionism and undermined competitiveness of the EC economies. Therefore, the Single European Act (SEA) came into force in 1987 to address the obstacles to free trade among the EC members, mainly by harmonizing (or at least approximating) laws and resolving policy discrepancies within the region. The SEA was based on the White Paper of 1985, which set out a comprehensive program and identified about 300 measures to complete the single market by December 31, 1992. Among these, a new approach for liberalization of financial services rested on (i) a minimum level of coordination and harmonization among national standards, instead of harmonizing of all national regulations restraining trade; (ii) mutual recognition—once agreement was reached on essential rules, each member recognizes validity of the rules applied in other countries such that products or services satisfying basic standards in one country can be sold anywhere within the EU; and (iii) home country control, that is, the supervisory authority in each member assumes responsibility for national financial institutions.

Following the White Paper, the Single European Act set a deadline December 31, 1992 to achieve the single market and complete related legislative reforms. The SEA reformed the EC legislative process by giving the European Parliament a greater role in the decision-making process (the introduction of the cooperation procedure) and facilitating the European Council's adoption of certain decisions (via Qualified Majority Voting). Other measures were also introduced to shorten the legislative process. According to the SEA, Council decisions regarding changes to the common customs tariff; free movement of capital; freedom to provide services; common air and sea transportation policies; internal market; economic and social cohesion; R&D;

technological development; and environment could be taken by a qualified majority.²³ Moreover, the Commission would address the issues with arbitrary discrimination or disguised restriction of trade between member states.²⁴ The SEA also assigned a co-legislative role to the European Parliament along with the Council by a new mechanism called the “cooperation procedure”, applicable in ten decision-making areas. Among these, the Parliament’s approval was required to conclude enlargement and association agreements.²⁵ Moreover, member states were obligated to recognize goods that were legally produced in another member state, unless the member state could justify the restriction. Harmonization would only be used to overcome justified trade restrictions, while ensuring essential standards to prevent a race to the bottom.

Most of these trade-related issues were solved until the Maastricht Treaty, (or Treaty on European Union) which entered into force in 1993. By that time, the Community Customs Code had already been adopted in 1992 as a single piece of legislation to ensure that (i) the common tariff is applied equally along the EU’s external borders; (ii) a common approach on warehousing procedures was introduced; (iii) movements of goods were facilitated in customs transit; and (iv) a wide variety of customs documents were replaced with a single administrative document.²⁶ Thereafter, the Maastricht Treaty initiated the next stage of integration by leading the region to European Economic and Monetary Union. One of the important achievements was that the Maastricht Treaty of the new EU obliged members to comply with “convergence criteria”, which required them to maintain fiscal stability by limiting their public debt to 60% of GDP and annual deficits to less than 3% of GDP. It also imposed control over inflation, exchange rate stability and the convergence of interest rates. The nominal long-term interest rates would be no higher

²³ http://www.cvce.eu/obj/the_single_european_act-en-abd540f4-e8e6-4d11-8b67-f551892e2f1b.html

²⁴ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:11986U/TXT&from=EN>

²⁵ http://www.cvce.eu/obj/the_single_european_act-en-abd540f4-e8e6-4d11-8b67-f551892e2f1b.html

²⁶ http://ec.europa.eu/taxation_customs/40customs/customs_general_info/about/index_en.htm

than two basis points (0.02%) of the average inflation of three lowest inflation member states. The members and applicants should also have joined the exchange-rate mechanism (ERM II) under the European Monetary System (EMS) for two consecutive years and not devaluated their currency during this period. This monetary step—as discussed before—complements trade regionalization because at least monetary cooperation is needed among countries once their intra-regional trade reaches the crucial 50% level of total trade such as in Europe in the 1970s.²⁷

With the fall of the Eastern Block, plans started in the 1990s to expand the EU into Central and Eastern Europe. To prepare these countries for a future membership in the EU, two free trade areas were created; CEFTA (the Central Europe Free Trade Agreement) and BAFTA (the Baltic Free Trade Area). Once the members of these organizations are accepted to the EU, their membership with CEFTA or BAFTA ends. CEFTA was originally formed among Poland, Hungary and Czechoslovakia in 1992, while Slovenia, Romania and Bulgaria joined during the 1990s. Until 2007, Croatia, Macedonia, Albania, Bosnia and Herzegovina, Moldova, Montenegro, Serbia and Kosovo joined the CEFTA.²⁸ Although the members signed for free trade among themselves, a majority of their trade remained with the EU countries. BAFTA was created between Estonia, Lithuania and Latvia as a free trade and common visa area in 1994 and ceased to exist with acceptance of these countries into the EU ten years later.

In 1994, the Agreement on European Economic Area (EEA) went into force and provided free movement of persons, goods, services and capital within the European Single Market. The EEA has been open to the EU member states and European Free Trade Association (EFTA) members. On one side, EFTA states can access the EU's internal market without being within the

²⁷ Trade, Investment and Financial Integration in East Asia. Submitted to the ASEAN Secretariat; Daiwa Institute of Research. May 2005

²⁸ Montenegro and Serbia have started EU accession talks since 2012 and 2013, whereas Albania and Macedonia are official candidate countries of the EU.

EU. They also adopted most of the EU legislation related to single market, but with exclusions such as agriculture and fisheries, left out of free trade with the EU. On the other side, the EFTA members (non-EU members of EEA) are not represented in institutions of the EU such as the European Parliament or European Commission, while the EEA only allows input from the EFTA countries before legislation is adopted. In 1995, three main markets of EFTA (Austria, Finland and Sweden) acceded to the European Union. Switzerland is linked to the EU by a series of bilateral agreements after its voters rejected ratification of the EEA in a referendum.

In 1995, the General Agreement on Trade and Services (GATS) came into force to set multilateral rules covering international trade in services and to remove cross-border barriers in services trade. It promoted transparency and non-discrimination between suppliers of services. The EU adopted GATS and played a relevant and leading role during GATS negotiations in promoting the liberalization program. The GATS covered all internationally traded services with two exceptions: services provided to the public by exercising governmental authority, and in the air transport sector and traffic rights. Participation in GATS was voluntary and member governments could choose the service sectors or subsectors to liberalize. However, GATS was criticized because national governments could be pressured by international business interests not to exclude any service “provided on a commercial basis” from liberalization despite having the option to do so.

In 1997, the Amsterdam Treaty was signed to prepare the EU for eastward expansion. With this agreement, member states agreed to delegate powers of national governments to the European Parliament in certain issue areas such as adoption of civil and criminal laws, foreign policy and implementation of institutional changes for the EU expansion. In addition, the Amsterdam Treaty removed physical barriers across the single market by implementing

the Schengen Area for the EU and four remaining EFTA countries. The agreement eliminated border controls between most member states and initiated common rules on visas, which are very crucial for the transportation industry and regional trade. In 1998, the ECB was founded before the monetary union was introduced in 1999. In terms of trade structure and networks during 1980s and 1990s, research with the gravity model indicates the “core” status of certain countries²⁹ in the Europe, including Germany, UK, France, Italy, Netherlands, Belgium, Sweden, Austria, Denmark and Switzerland. These core states are centrally integrated with many ties, state strength and ability to organize interstate relations, while peripheral states are more isolated with fewer ties and dependent on core powers.

In 2001, the Treaty of Nice amended the Maastricht Treaty and focused on institutional changes in the upcoming enlargement round. It set out principles to change the number of seats in the European Parliament for the new Member States, the number of votes allocated to them within the Council, and the qualified majority threshold applicable in the future. The treaty also stated that commercial policy would be based on uniform principles, “particularly in regard to changes in tariff rates, conclusion of tariff and trade agreements, the achievement of uniformity in measures of liberalization, export policy and measures to protect trade such as in case of dumping or subsidies.”³⁰ Consequently, the EU expanded to the south and east in 2004 with ten new members.³¹

In 2006, another important step in trade liberalization was taken with the adoption of the EU Services Directive. The directive aimed to liberalize and foster competition in services sectors across Europe. It had broad coverage; as much as 65% of service activities or 45% of EU

²⁹ Integration, mobility, and development: International trade and organization networks, 1980-2000 Rob Clark Phd Dissertation in the Department of Sociology, Indiana University May 2007

³⁰ https://www.ecb.europa.eu/ecb/legal/pdf/en_nice.pdf

³¹ Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland and Slovenia.

GDP.³² The implementation of the Directive was spread between 2006 and 2009 and required members to review their regulatory framework for services in order to promote transparency and good regulatory practices. The efforts mostly focused on multiple sectors such as retail trade; tax and accounting services; legal services; architectural and construction services; tourism; and real estate. However, the implementation proved challenging since it allowed governments to maintain pre-existing restrictions if deemed necessary to protect the public interest.

In 2007, the enlargement of the EU continued with the accession of Bulgaria and Romania into the Union. The same year, another primary treaty of the EU integration was signed: the Treaty on the Functioning of the European Union (TFEU) formed the basis of the EU law by setting the scope of the EU's legislative authority. The TFEU covered a wide range of issues including internal markets the free movement of goods, workers, services and capital; competition rules; taxation; employment; social and consumer policy; and institutional policies. TFEU prohibited member states from levying any duties on goods when they are produced within the EU. If goods are imported to the EU from a third country by paying appropriate customs duties, then they can circulate freely between member states. Besides eliminating customs duties within the EU, TFEU also prohibited other charges that have equivalent effects. A charge is not considered a customs duty if same criteria is applied to domestic and imported products alike, the charge is a service payment related to the product, or the good is subject to certain conditions such as inspection. Internal discriminatory taxation and all forms of protection also were eliminated to ensure the free movement of goods between the states. However, some indirect measures can still be justified when they are related to consumer protection, labor standards, protecting the environment, and fairness in commerce. Like the Maastricht Treaty, the TFEU also removed all restrictions on the movement of capital among member states (such as

³² <https://www.imf.org/external/pubs/ft/wp/2014/wp14113.pdf>

currency transactions, transactions of other financial assets, company shares as well as foreign investments) as well as between the EU and third countries. However, TFEU does not prevent national taxation, the distinguishing of taxpayers based on their residence or the investment location, or the measures against tax evasion. Taxation of capital, including taxes on corporate, capital gains and financial transactions are not affected. Moreover, all intra-EU payment transfers in the euro are considered as domestic payments and charged domestic transfer costs, even for non-Eurozone EU members, while these improvements were supported with updates and integration of payment and settlement systems. Finally, TFEU also set the core principles governing single market for services as³³ (i) the freedom to establish a company in another EU country; and (ii) the freedom to provide or receive services in an EU country other than the one where the company or consumer is established. This way, restrictions on freedom to provide services within the Union were prohibited for nationals of member states. Priority in these areas would be given to the services which directly affect production costs or the liberalization of which helps to promote trade in goods.³⁴

The Treaty of Lisbon was signed in 2007 by EU members and entered into force in 2009, which amended Treaty of Rome and Maastricht Treaty. Under the Lisbon Treaty, the European Council (EC) gained the status of an EU institution and became separated from the Council of Ministers. The EC acquired key role in appointments to crucial institutions such as the European Commission or European Central Bank (ECB) as the latter also acquired status of an EU institution. The Lisbon Treaty also tasked the EC with setting the strategic priorities of the EU, while the legislative power of the European Parliament (EP) increased and the co-decision procedure between the EC and Parliament was extended to almost all areas of policy. The Treaty

³³ https://ec.europa.eu/growth/single-market/services_en

³⁴ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:12012E/TXT&from=EN>

also introduced an exit clause from the EU and formalized the exit procedures by requiring negotiation on a withdrawal agreement between the exiting member state and the EU. According to the Lisbon Treaty, the EU has exclusive competence (not shared with member states) to make directives on customs union; establishment of competition rules for the internal market; common commercial policy; monetary policy in the Eurozone; and conclusion of certain international agreements. The EC has shared competence with member states in other issues such as consumer protection; economic, social and territorial cohesion; research and technical development; transportation; coordination of economic, employment and social policies; and common foreign and security policies. In 2011, 2013 and 2015, Estonia, Croatia and Lithuania joined the union. In terms of trade patterns, the dominance of Germany, France and the UK remained relatively stable over time as the other original members became closely integrated in the European trade network. The smaller new members formed a new periphery around the old core. Enlargement rounds expanded trade integration in the EU.

In 2013, talks for the multilateral Trade in Services Agreement (TISA) started among the EU, Switzerland and 21 other participating countries (twelve members from G-20), representing 70% of world services exports. TISA is amongst the largest and most significant free trade agreements after failure of the services negotiations in the WTO's Doha Round. TISA aims to boost liberalization of the global services sector beyond the current levels of GATS. Since 2013, there were 19 rounds of negotiations in two years. Participants of TISA are also the world's largest exporters and importers of financial services: The negotiations focus on financial sector liberalization in many sectors and sub-sectors including insurance (life accident and health insurance; non-life insurance; reinsurance and retrocession; and services auxiliary to insurance) and banking and other financial services (asset management, taking deposits, lending, financial

leasing, trading, participation in securities, provision and transfer of financial information, and advisory services). However, liberalization of financial services is more challenging than trade: Trade agreements are not used to develop international standards, or impose substantive regulatory requirements as a basis for regulatory harmonization. In financial services, integration and harmonization between cross-border banking sectors, financial services and eventually capital markets by cooperation with Basel Committee for Banking Supervision (BASEL), the International Organization of Securities Commissions (IOSCO) and International Organization of Pensions Supervisors (IOPS), and International Association of Insurance Supervisors (IAIS).

Since the global economic and financial crisis, the EU has been suffering from a slowdown of economic growth, weaknesses in financial sector (declining profits and capital inadequacy of banks, as well as volatility of capital markets) and low levels of investment. In 2014, the EU started the Investment Plan to reverse this downward trend and support economic recovery. Investments in the EU declined from €3 trillion in 2007 to €2.6 trillion in 2013, with only a slight rise to €2.7 trillion in 2014.³⁵ The European Investment Plan aims to use public funds as a catalyst for private investments to boost economic growth and job creation. The focus of the program involves transport and energy sectors, R&D, SMEs education, research and innovation. To mobilize investments, the European Fund for Strategic Investments (EFSD) was created in 2014 with around €21 billion of capital to raise €315 billion in the markets, which will be used to fund €240 billion of long term investments and €75 billion of support to SMEs.³⁶ These investments are expected to contribute €410 billion to the EU GDP and 2.1 million jobs.³⁷

Investments and firm financing are among the major channels that connect trade and financial integration in the EU. It is estimated that the EU national and regional infrastructure

³⁵ https://ec.europa.eu/commission/sites/beta-political/files/investment-plan-1-year_en.pdf

³⁶ https://ec.europa.eu/commission/sites/beta-political/files/investment-plan-1-year_en.pdf

³⁷ https://ec.europa.eu/commission/sites/beta-political/files/investment-plan-1-year_en.pdf

will need €2 trillion of investments until 2020, mostly for transport, energy and communication.³⁸ In contrast, Europe's public infrastructure investment as a share of GDP halved from 5% to 2.5% between the 1970s and 2000s. Nevertheless, one third of infrastructure investments in the EU is made through public sector financing.³⁹ Bank lending has provided the main source of funds for infrastructure; however, some major banks retreated from this line due to decline of monoline insurers (credit insurers), which could enhance the credit quality of infrastructure projects. In addition, the project bond market in the EU is small and underdeveloped, even as its share in infrastructure has been increasing. One way to fill funding gaps caused by the retreat of banks can be promoting investments by institutional investors. However, fragmentation of capital markets (as explained in capital market section) as well as insurance and pension sectors and the investment fund industry reduce this potential (due to low liquidity, regulations, tax treatments and charges, and information dissemination). Insurance and pension funds have total assets of €7 and €2.5 trillion respectively but their cross-border expansion is limited by market fragmentation as well as investment mandates and regulatory requirements.

The EU also faces investment gap in firm financing due to over-reliance on banking sector, which strongly relates to trade. The financial and sovereign debt crises substantially reduced economic growth, while the investment gap opened; gross fixed capital formation decreased 10% between 2007 and 2015, and made the EU also less attractive for financial investments.⁴⁰

³⁸ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

³⁹ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

⁴⁰ EU -28 total capital inflows declined from 15% of GDP during 2004-2007 to 5% on average during 2009-2014 more due to decline in portfolio flows than FDI flows, especially financial flows between banks.

Table 13 Use of financing instruments by EU non-financial corporations
(Percentage averages out of total sample over 2009-2014)

	Micro	Small	Medium	Large
Retained earnings	24	30	38	46
Grants/subsidised loans	12	16	20	22
Bank overdrafts	38	43	40	42
Bank loans	28	39	43	48
Trade credit	26	30	35	38
Other loans	9	12	19	28
Leasing	19	40	50	56
Debt securities	1	1	1	4
Mezzanine	1	2	4	6
Equity	4	6	8	9

Sources: ECB and EC Survey on the access to finance of enterprises.

The EC's new Investment Plan was adopted in 2015 with €375 billion⁴¹ to promote investment and provide EU investors and investment with legal certainty and market access. The European Fund for Strategic Investment (EFSI) was founded in 2015, and mobilized €116 billion⁴² of investments mainly on R&D (22% of total); energy (22%); transportation (6%); and digital (11%) industries in addition to providing funds to small firms (30%) in one year.⁴³ The EFSI also will provide at least €500 billion by 2020, and €630 billion by 2022⁴⁴

Meanwhile, financial assets of the EU non-financial companies reached €15 trillion or 106% of GDP in 2013, which are mostly held in non-listed equity (40% of GDP), loans (13% of GDP) and deposits (19% of GDP).⁴⁵ As seen in Table 3, the use of debt and equity instruments to raise funds has been very low among firms, especially for small and medium companies. Given the higher capital and liquidity requirements for banks (introduced after the global and sovereign debt crises), solid improvement and integration in capital markets is especially crucial to create

⁴¹ https://ec.europa.eu/commission/sites/beta-political/files/2-years-on-investment-plan_en_2.pdf

⁴² http://europa.eu/rapid/press-release_MEMO-16-2983_en.htm

⁴³ https://ec.europa.eu/commission/sites/beta-political/files/2-years-on-investment-plan_en_2.pdf

⁴⁴ https://ec.europa.eu/commission/sites/beta-political/files/2-years-on-investment-plan_en_2.pdf

⁴⁵ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

new financing resources for firms and to mobilize funds from institutional investors. That way, economic growth and trade integration can utilize more resources by supporting investments on firms and infrastructure.

ASEAN TRADE INTEGRATION

ASEAN Trade, FDI and Business Environment

ASEAN has very promising growth potential in the fast developing Asian region, as its economic growth exceeded major developed regions. From 2013 to 2015, ASEAN growth changed between 4.4% and 5%, which was higher than the US (ranging between 1.7% and 2.6%), the EU (-0.2% and 1.9%) and Japan (-0.1% and 1.4%) and lower than East Asia (6.1% and 6.8%).⁴⁶ Table 14 shows that ASEAN GDP growth from 2006 to 2015 doubled for ASEAN-5 and tripled for other ASEAN countries, despite the global crisis, reaching \$500 billion in 2015.

Although growth slowed down after 2012, especially in ASEAN-5, ASEAN had growth better than global average. The slowdown of regional growth reflects lower growth in Indonesia, Philippines, Singapore and Thailand. Growth is based on diversification of economic activities, new cross border markets and high value added activities while the solid performance of trade contributed to regional output.

⁴⁶ ASEAN Integration Report 2015

Table 14 ASEAN - Average Imports and Exports with the Region and World

In nominal value – Billion USD												As percentage of GDP											
		2006	2007	2008	2009	2010	2011	2012	2013	2014	2015			2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
IMP WORLD	ASEAN-5	122	136	169	129	171	205	217	217	210	178	IMP WORLD	ASEAN-5	60%	56%	60%	47%	48%	50%	50%	49%	47%	42%
	ASEAN (other)	11	15	20	17	21	27	30	35	40	54	IMP WORLD	ASEAN (other)	54%	62%	61%	51%	53%	58%	58%	63%	68%	91%
IMP REGION	ASEAN-5	29	33	40	31	41	47	49	49	48	41	IMP REGION	ASEAN-5	14%	13%	14%	11%	12%	11%	11%	11%	11%	10%
	ASEAN (other)	4	5	6	4	5	7	7	8	10	12	IMP REGION	ASEAN (other)	17%	18%	18%	13%	14%	15%	14%	15%	17%	21%
EXP WORLD	ASEAN-5	142	159	180	147	191	222	221	220	222	194	EXP WORLD	ASEAN-5	70%	65%	64%	53%	53%	54%	51%	49%	50%	45%
	ASEAN (other)	11	13	17	15	18	25	28	32	38	40	EXP WORLD	ASEAN (other)	55%	53%	53%	45%	47%	52%	55%	58%	64%	66%
EXP REGION	ASEAN-5	36	41	47	37	49	58	60	60	60	52	EXP REGION	ASEAN-5	18%	17%	17%	13%	14%	14%	14%	14%	14%	12%
	ASEAN (other)	2	3	3	3	3	4	5	6	6	6	EXP REGION	ASEAN (other)	11%	11%	11%	8%	8%	9%	10%	10%	10%	9%
GDP	ASEAN-5	204	244	280	277	357	412	434	446	445	428												
	ASEAN (other)	21	25	32	34	40	47	52	55	59	60												

Source: IMF Direction of Trade Statistics and Balance of Payment Statistics

Between 2008 and 2014, the share of industry in the ASEAN GDP remained stable around 38% to 39%, agriculture decreased from 12.7% to 11%, and services increased from 47% to 50%, which makes the free flow of services important.⁴⁷ The share of services in FDI increased from 48% to 72% between 2008 and 2014.⁴⁸ Growth in services output was driven by increasing FDI flows to the services sector, which became the largest recipient of FDI inflows. However, the contribution of services exports to GDP did not increase strongly between 1996 and 2010, except in Cambodia and Singapore. The development of services is also heterogeneous as exports of Indonesia and Thailand increased for traditional service sectors such as transport and construction, with some rise in professional services in recent years. Malaysia performs well in computers, ICT and financial services. The Philippines experienced a rise in

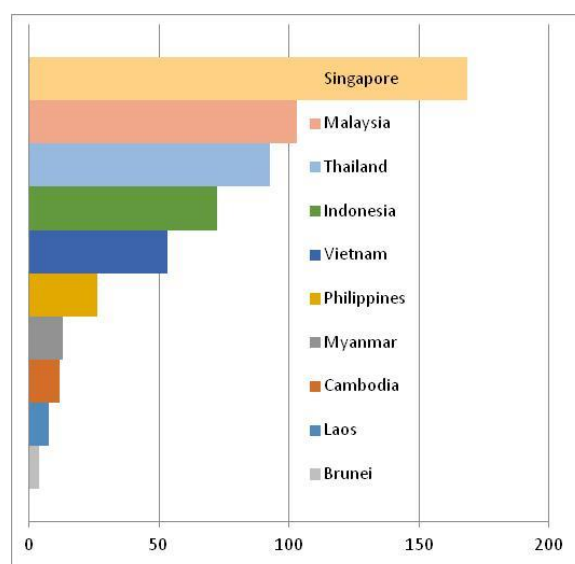
⁴⁷ ASEAN Integration Report 2015

⁴⁸ ASEAN Integration Report 2015

other professional services and insurance. Singapore has strong financial services and the most diversified growth in the services industry.

ASEAN's trade openness has been maintained despite the global financial crisis. Total trade was 118% of GDP in 2007, declining to 99% in 2009 and rising again to 127% in 2014.⁴⁹ In nominal values, total trade increased from \$1.6 trillion in 2007 to \$2.4 trillion in 2014, while intra-regional trade rose from around \$400 billion to \$610 billion.⁵⁰

Figure 6 – ASEAN Countries: Regional Trade as percentage of GDP, 2015



Source: IMF Direction of Trade Statistics and Balance of Payment Statistics

As of 2014, Singapore had the highest share in intra-regional trade (33%), followed by Malaysia (20%), Thailand (17%), Indonesia (15%), and Vietnam (6.7%). For total trade, these countries had shares of 30%, 17%, 18%, 14% and 13% respectively.⁵¹ As for the trade balance, the surplus in merchandise trade is offset by deficits in service trade, keeping current account

⁴⁹ Asian Development Bank (ADB) Database

⁵⁰ ASEAN Integration Report 2015

⁵¹ IMF DOTS Trade Data

budget in surplus. The trade surplus is narrowing due to weaker trade in goods, shrinking from 8.4% to 2.1% of GDP between 2007 and 2013.⁵²

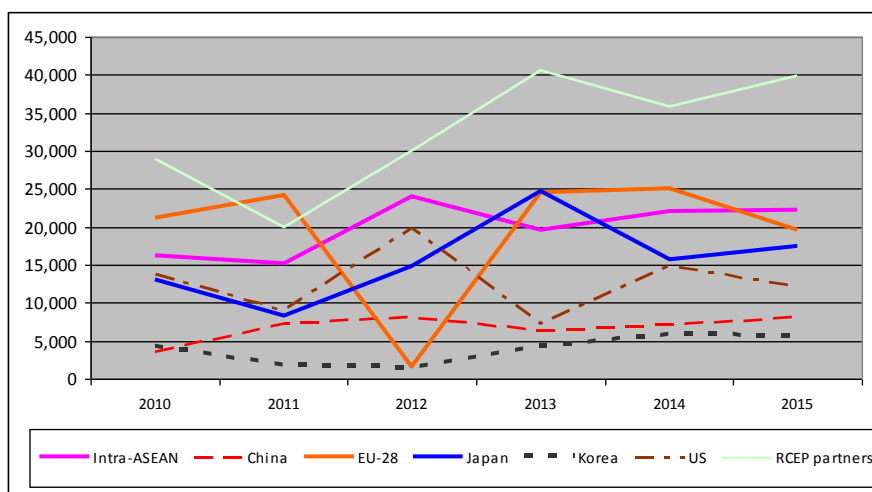
In the first years after AFTA (ASEAN Free Trade Agreement-1992), regional trade was low and concentrated on Singapore, Malaysia and Thailand. Extra-regional trade was dominant in the ASEAN trade network, while member states mostly remained at the periphery. Since AFTA permitted many exemptions for trade of sensitive goods, implementation was limited as most non-tariff trade barriers stayed during the 1990s. One institutional aspect, the lack of a leading regional power, contributed to a subtler integration, while ASEAN integration relied more on consensus and common norms and less on formal rules and institutions, which are weakly enforced on a regional basis.

During the last ten years, developmental differences remained in the region. (Figure 8) Most of the imports and exports have taken place outside the region, rather than within the region or by ASEAN-5. However, exports and imports of other ASEAN countries, especially to the world, have been increasing fast, along with the GDP. The importance of external partners on ASEAN trade persisted over time, as the ratio of intra-regional trade remained stable around 25% over the last ten years. Likewise, the recovery from the Asian Crisis of 1997-98 and later the global crisis of 2008 was supported by external trade, mainly with Japan and later with China. According to research on Asian trade networks,⁵³ the East Asian region is unique in being more “core-like” and industrially advanced than other “non-core” regions such as Latin America, Africa, and the Middle East as well as being more mobile upwards compared to traditional core regions. During the 1980s and 1990s, ASEAN-5 countries were semi-periphery in the world system.

⁵² ADB Database

⁵³ REF

Figure-7 ASEAN FDI Inflows



Source: Calculated from IMF Trade Data

Among ASEAN+3, the strongest upward move to “core” status was in China. This growing interdependence with East Asia led ASEAN to form an extra-regional cooperation with China, Japan and S. Korea, which became formal with ASEAN+3 initiative. This cooperation led to a regional liquidity fund and three ASEAN+1 trade agreements. The ASEAN Charter and other initiatives can also be seen as a step to increase formalization. Although ASEAN member states integrated their economies, their major economic partners are still outside the regional organization. As a result, intraregional trade grew only modestly from 1992 to 2010, while major impulses for integration came from external partners.

Over the last decade, investments to ASEAN were strengthened by sound macroeconomic fundamentals, economic resilience, increasingly affluent consumers and regional integration. ASEAN pursues a free and open investment regime in the region, through the specific actions listed in the AEC Blueprint. Cost competitiveness of the region and strong cash holdings of ASEAN companies also led to expansion in intra-regional investments. Given ASEAN’s advantages (cost, natural resources, growing regional markets and middle-income

consumers, and economic growth), ASEAN FDI inflows rose from \$40 to \$119 billion between 2005 and 2015 with a decline from around \$80 to \$50 billion between 2007 and 2009.⁵⁴ FDI flows to ASEAN declined from \$130 billion in 2014 to \$120 billion in 2015, mainly caused by falling FDI in services, cross-border M&As (mergers and acquisitions) and lower intra-company loans. FDI in manufacturing as well as equity capital financing of FDI increased and regional investment expansion by MNCs (multi-national corporations) remained strong. (Figure 7)

In terms of extra-regional partners, the largest investments to ASEAN came from Japan (\$17 trillion), the US (\$12 trillion), China (\$8 trillion), followed by the Netherlands (\$8 billion) and the UK (\$7 billion) in 2015.⁵⁵ In regional groups, the EU and Regional Comprehensive Economic Partnership (RCEP) are the largest investment partners. Investment from six partners in the RCEP increased by 11% to \$40 billion in 2015.⁵⁶ FDI from different economies dominated in different industries in ASEAN. As with 2014, three industries accounted for the lion's share of FDI: finance (33%), manufacturing (24%) and wholesale and retail (9%). Within ASEAN, most FDI flows came to manufacturing; agriculture; financial and insurance services; real estate; ICT; wholesale and retail trade; and mining sectors in 2015. Flows from the US, EU and Japan focused on manufacturing, financial services and wholesale and retail sectors. The EU and China also had substantial investments in mining. Chinese FDI mostly focused on real estate, financial services and manufacturing. ASEAN is both a major recipient and a source of FDI. The region is an important source of and partner in South–South cooperation. Outward FDI flows from the region to the world rose by 19% in 2014, to \$80 billion.⁵⁷ Companies from the region are

⁵⁴ ASEAN Investment Report 2016

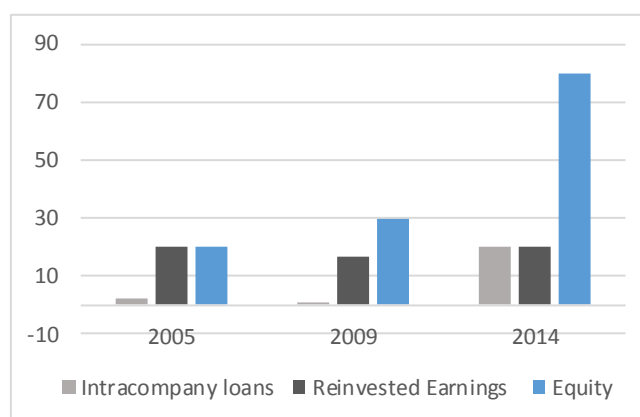
⁵⁵ ASEAN Investment Report 2016

⁵⁶ ASEAN Investment Report 2016

⁵⁷ ASEAN Investment Report 2015

expected to increase their internationalization in 2015 and beyond, including using more M&A strategies, hence strengthening further South-South partnerships.

Figure-8 Sources of FDI finance in ASEAN, 2005–2014 (Billion USD)



Source: Data from ASEAN Investment Report 2016

In terms of intra-regional FDI, those investments exceeded any external trade partner in 2015. Intra-ASEAN FDI rose from around \$5 billion in 2005 to \$22 billion in 2015, with a less sharp decline than total FDI flows during crisis years.⁵⁸ Malaysia, the Philippines, Thailand and CLMV countries received higher intraregional investment, suggesting stronger regional connectivity. FDI inflows to manufacturing rose significantly by 61% from \$18 billion in 2014 to \$29 billion in 2015. Flows to the services industries declined by 21% to \$79 billion, driven by a fall in FDI in finance.

ASEAN companies also continued to expand and made new investments in the region, raising both intraregional investments and the region's share of FDI. Intra-ASEAN M&A sales rose to \$7.3 billion in 2015, which accounted for 39% of cross-border M&A sales in the region.

⁵⁸ AASEAN Investment Report 2015

Companies from at least six ASEAN Member States—Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam—announced plans for intraregional investments in 2015-16.

It should be also noted that direct investors became more active in using equity capital to finance investment projects in ASEAN in 2015. (Figure 8) Equity capital financing increased especially in Singapore and Vietnam, reaching almost 90% of total FDI flows to these countries. The share of intra-company loans in FDI flows to ASEAN declined from 14% to 1% during 2015, mostly due to repayment of loans in Singapore and Thailand (not because obligations are due but enough profits are generated for repayment), or provision of loans to newly founded subsidiaries in other ASEAN member states.

The first and main factor affecting the region's future investments and supply chains is ASEAN's higher economic growth relative to world and its growing middle-income customer base. Secondly, regional integration promotes expansion of ASEAN firms, especially after AEC 2015, which will increase competitiveness and connectivity between ASEAN states, and reduce costs of transactions, investments and doing business in the region. Third, large infrastructure plans of ASEAN member states and commitment to attract private investors into infrastructure will contribute to the rise in investment. Fourth, the investment environment is developing with efforts to address issues in international investments and trade.

In connection, the business and investment environment in the region continues to improve with reforms and favorable investment measures announced or introduced by ASEAN member states as well as interest in addressing international investment governance issues. Overall, the investment environment improved with launch of the ASEAN Economic Community in December 2015. World Bank doing business indicators show efficiency gains in timing and procedural costs of trade since 2007, with greatest improvements in CMLV

(Cambodia, Myanmar, Laos, Vietnam) countries. Between 2009 and 2016, ASEAN also recorded improvements in the minimum capital required to open a business, protection of minority investors, and taxation. On the average, the ASEAN-5 countries ranked 52nd out of 190 countries in business environment, while other ASEAN countries ranked 77th as of 2016 data.

These improvements reflect the business and trade profile of the ASEAN firms as well as foreign multinational corporations (MNC). During last decade, foreign MNCs have been strengthening their presence in ASEAN especially in manufacturing, finance, infrastructure and other services. Those MNCs mostly come from the US, EU and Japan, followed by China, Canada, the Republic of Korea, Hong Kong (China), Taiwan and RCEP partner countries. Both ASEAN and foreign multinational corporations use location advantages to build an effective supply chain, by geographically diversifying investment and production based on cost structures as well as by availability of production factors, natural resources and skills in different countries. This way, the MNCs connect member states by production, investment and intra-firm links, helping the region to attract FDI. As ASEAN integration gets stronger, some MNCs have already adopted a regional business strategy, while others plan to do so.

ASEAN companies are expected to continue to internationalize beyond 2015 with more M&A to access new markets and stronger South-South partnerships. The increasing financial strength of ASEAN MNCs—their strong profitability and cash holdings—is encouraging both regionalization and internationalization. As of 2014, the top 100 ASEAN companies (by market capitalization) had total cash holdings of \$228 billion and assets of nearly \$3 trillion, with most of them also operate in other ASEAN member states.⁵⁹ In general, ASEAN firms internationalize for various reasons, such as to seek markets, cost reduction, efficiency, resources or strategic

⁵⁹ ASEAN Investment Report 2015

assets. Market-seeking internationalization is most common for MSMEs.(Micro, small and Medium Enterprises) Firms internationalize by exporting, or engaging in franchising or licensing or becoming contractors to foreign firms or through FDI.

Development of ASEAN Trade Integration

ASEAN integration constitutes a key part of its export-promotion development strategy. ASEAN was founded in 1967 by Indonesia, Malaysia, the Philippines, Singapore and Thailand. The major step in economic integration was the foundation of the Asian Free Trade Area (AFTA), signed in 1992 as a common preferential tariff scheme. Thereafter, the ASEAN has expanded to include Brunei, Myanmar, Cambodia, Laos and Vietnam. Since the establishment of AFTA in 1992, tariff liberalization progressed gradually. With the following initiatives such as Agreement on Common Effective Preferential Tariff Scheme (CEPT) in 1993, the protocol to amend on AFTA-CEPT for elimination of import duties in 2003, and ASEAN Trade in Goods Agreement (ATIGA) in 2010, tariff rates have been reduced substantially. ATIGA enhanced AFTA-CEPT as more comprehensive legal document and provided a schedule for full tariff reductions in member states until 2015.

According to the 2003 amendment to the AFTA-CEPT, tariffs in the Inclusion List (IL) were to be eliminated in ASEAN-5 and Brunei by 2010 and in CMLV by 2015 with flexibility for sensitive products by 2018. These requirements did not apply to sensitive list (SL) and Highly Sensitive List (HSL), which would be liberalized according to “Arrangement for Sensitive and Highly Sensitive Products” (signed in 1999) to be gradually transformed to the Inclusion List. Import duties for Priority Integration Sectors (PIS) were to be eliminated for

ASEAN-6 in 2007 and for CLMV in 2012 as envisaged in the ASEAN Framework Agreement for Integration of Priority Sectors. In 2015, the ASEAN Economic Community (AEC) defined four pillars of economic integration, in which trade integration occupies a major part.

A single market and production_base is the first pillar of the AEC and a key element is free flow of goods. This pillar focuses on removal of trade barriers, non-tariff barriers, customs integration and harmonization of regulations and standards. The second pillar is to build a competitive economic region, with large-scale infrastructure investments. The third pillar is equitable economic development, which aims to facilitate inclusive economic growth with more equitable distribution of income and address developmental differences across the region. The fourth pillar concerns integration into the global economy as regional development and integration are seen as complementary to global integration.

As a result of these initiatives, the average ATIGA rate in ASEAN was reduced from 2.58% in 2007 to 0.54% in 2014, compared to average Most Favored Nation (MFN) rates declining from 8.15% to 6.90% respectively. The ATIGA tariff rate is targeted to reach zero in 2018. Eligibility to benefit from tariff reductions is determined by origin status of goods since they should first meet Rules of Origin (ROO) requirements. Hence, some ASEAN originating goods may not be traded under ATIGA tariffs. The AEC Blueprint seeks reform and enhancement of ROO by simplification of operational procedures and alignment of national procedures. Some products may be subject to Product Specific Rules (PSR) in terms of rule of origin, which can be customized by industry or sector. ATIGA sets list of applicable PSR's.

Meanwhile, ASEAN services integration has been pursued under ASEAN Framework Agreement on Services (AFAS), signed in 1995. Since then, nine packages have been completed with increasing depth of commitments and number of subsectors. There is also the ASEAN

Trade in Services Agreement (ATISA). AFAS also promotes mobility of skilled labor through Mutual Recognition Agreements (MRA), completed for eight sectors including engineering, architectural, medical, accounting and tourism services.

On non-tariff trade barriers (NTBs), the ASEAN Framework Agreement entered into force in 2002, setting general principles for sectoral MRAs and elimination of Technical Barriers to Trade (TBT) within ASEAN. Thereafter, elimination of NTBs has progressed with implementation of multiple initiatives such as trade facilitation work programs; reforms in ATIGA rules of origin; development of the ASEAN Trade Repository; the ASEAN Agreement on Customs (2012); and harmonization of standards as well as Mutual Recognition Agreements (MRA) and ASEAN Single Window. The WTO classifies NTBs (Non-tariff barriers) under six categories: Antidumping (ADP), Countervailing (CV), Quantitative Restrictions (QR), Safeguards (SG), Sanitary and Phytosanitary (SPS), Special Safeguards (SGS), and Technical Barriers to Trade (TBT). The largest ASEAN NTMs exist in TBT's and SPS, as the latter mostly associate with natural resource-based products. QR is the third most prevalent restriction.

The AEC blueprint envisaged removal of NT's in three stages; by 2010, Brunei and ASEAN-5 except Philippines (by 2012); and by 2015 CMLV with flexibilities until 2018. ATIGA also plans for development of the NTB database applied in member states, yet to be established and currently upgraded by member states. All ASEAN members also established interagency bodies to strengthen coordination in addressing NTBs and NTMs. ASEAN established a Work Program on Streamlining ASEAN NT's 2013-2014 under which member states are to establish a revised NTM directory using WTO consistent UNCTAD classifications, while agreed NTM streamlining was envisaged to be monitored and enforced at the national and

regional levels. ATIGA also includes provisions on non-tariff measures, rules of origin, trade facilitation, customs and standards.

On customs integration, the AEC Blueprint implemented the ASEAN Trade Facilitation Work Program (ATFWP), adopted in 2008, to standardize and harmonize trade and customs processes. The ASEAN Agreement on Customs was signed in 2012 and entered into force two years later, implementing ATIGA's related sections on customs integration. ASEAN states also adopted the ASEAN Harmonized Tariff Nomenclature at least for intra-regional trade for classifying trade transactions, calculation of tariffs, and collection of trade statistics. Moreover, ATIGA promotes customs integration as a key element in the free flow of goods and aims to ensure consistency and transparency in member states' customs laws, efficient administration of customs procedures, and expedited clearance of goods as well as simplification and harmonization of customs procedures and cooperation of national customs authorities. ATIGA also deals with issues such as customs documentation, risk management, IT applications, customs valuation, authorized economic operators, post clearance audits and advanced rulings. Meanwhile, harmonization of standards and technical regulations are governed by ASEAN Guidelines on STRACAP by specific guidelines. The ASEAN (ACCSQ) covers legal issues on common procedures such as verification procedures or inter-laboratory comparison programs.

Other measures have also been introduced to strengthen regional trade integration, in addition to the initiatives above to reduce tariffs and NTBs as well as facilitate customs integration and harmonization of standards. In 2009, the ASEAN Trade Facilitation Framework was adopted and ASEAN Trade Facilitation Indicators were endorsed. Thereafter, ATIGA authorized the establishment of the ASEAN Trade Repository (ATR), which documents trade and customs laws, and procedures in a public domain and releases trade related information such

as tariffs, ROO, NTMs, national trade and customs laws, documentation requirements, administrative rulings, and best practices as well as authorized dealers. So far, Indonesia, Laos, Malaysia and Thailand completed their national trade repository portals. The ASEAN Single Window (ASW) is the center of AEC to facilitate intra-regional trade through an integrated platform by partnerships among government agencies and end-users (such as transport and logistics operators) and by enabling electronic data exchange for cargo clearance and release. Once operational, ASW will integrate National Single Windows (NSW) of ten member states, which enable single submission, synchronized data processing, and single approval for expedited customs clearance and reduce transaction costs. ASW will ensure compatibility of national single windows and exchange of data between member states and trade partners in international standards. The AEC blueprint targeted the NSWs to become operational in ASEAN-6 by 2008 and CMLV by 2012. A more comprehensive legal framework on ASW implementation was signed in 2015 and currently pilot versions of ASW are being probed.

In 2015, ASEAN Economic Ministers (AEM) reactivated ASEAN Trade Facilitation Joint Consultative Committee (ATF-JCC) to address issues with NTBs with participation from the private sector, reviewing the ease of doing business in member states by using OECD trade facilitation indicators as a benchmark. AEM also agreed on to address complaints by ASEAN enterprises with the ASEAN Solutions for Investments, Services and Trade (ASSIST) system. ASEAN also takes initiatives to develop regulations across the region, which relate to competition policy, consumer protection, intellectual property rights, and business enabling regulations. Out of ten ASEAN members, eight states have competition laws, but those are most comprehensive in Indonesia, Malaysia, Singapore and Thailand. Nine members have consumer

protection laws. The ASEAN Action Plan on consumer protection was developed to be implemented across the region in the coming years.

The second pillar of AEC concentrated on building a competitive economic region. Regional integration also requires infrastructure, especially in transportation, energy and telecommunications. Recent estimations indicate that ASEAN will need \$2.2 billion of investments before 2030 to facilitate regional competitiveness. MNCs from developed countries have invested in ASEAN infrastructure development for a long time. Chinese companies have recently become active in ASEAN infrastructure, while they invest, own and operate infrastructure. ASEAN companies are also increasingly getting involved in infrastructure development as companies from ASEAN-5 and Vietnam founded subsidiaries in other member states.

To finance infrastructure needs, the ASEAN Comprehensive Investment Agreement was signed in 2012 and transformed the regional investment environment to be more liberal, competitive and transparent. Thereafter, the ASEAN Collective Investment Scheme (CIS) and the ASEAN Infrastructure Fund (AIF) have been established. Since then, ASEAN–China Infrastructure Funds and the ASEAN Infrastructure Fund have financed various projects in ASEAN member states. Significant sources to finance infrastructure also come from ODA (Official Development Assistance) donors, Multilateral Development Banks (MDB), specialized infrastructure funds, private equity investors, commercial banks and sovereign wealth funds. In this context, financing for infrastructure is mostly done by using debt and equity markets (as financiers issue bonds and equities in international markets to raise money) or syndicated bank loans. Therefore, development of capital markets and the banking system is crucial to gather large and long-term resources needed to build infrastructure. The Asian Infrastructure

Investment Bank started operations in 2015 with a capital base of \$100 billion to provide infrastructure financing.

ASEAN initiatives have promoted substantial development in land and maritime transportation. Roads were constructed and upgraded under the ASEAN Highway Network, while development of regionally integrated ports and shipment sectors was promoted under the Roadmap towards an Integrated and Competitive Maritime Transport. In aviation, the ASEAN open skies policy was implemented as part of the ASEAN Single Aviation Market. Regulations on transport facilitation aimed improvement and harmonization of customs and international transport procedures and included the ASEAN Framework Agreement on the ASEAN Facilitation of Goods in Transit (AFAFGIT), on the Facilitation of Inter-State Transport (AFAFIST), and on Multimodal Transport (AFAMT). Energy cooperation is also crucial to support regional production and growth, guided by the ASEAN Plan on Action for Energy Cooperation, which will have completed twelve out of 16 power interconnection projects for the ASEAN power grid by end 2017 along with targets on renewable energy and R&D. The ASEAN telecommunication service market is characterized by a high level of privatization (almost 60%) and foreign involvement as all ASEAN members (except Brunei) have at least one foreign strategic investor in their telecommunication. Besides production and trade, ICT is highly related to e-commerce, which is not well developed in ASEAN. In 2013, the UNCTAD recommended ASEAN develop regulatory systems related to ICT and e-commerce, strengthen information sharing, and promote cross border harmonization, conflict resolution and cooperation.

Equitable economic development constitutes the third pillar of AEC focusing on addressing large developmental differences across ASEAN. In this respect, the Initiative for ASEAN Integration (IAI) was introduced in 2001, focusing on SMEs. The second phase of AIA

assisted 285 projects worth \$20 million to help CLMV countries. In 2011, the ASEAN Framework for Equitable Economic Development (AFEED) was endorsed by member states for inclusive and sustainable growth. SME development has been supported by implementation of ASEAN Benchmark for SME Credit Rating Methodology, SME Service Center, ASEAN SME Policy Index, and ASEAN Common Curriculum for Entrepreneurship. Supporting micro, small, and medium enterprises (MSME) is also crucial in ASEAN economic development and integration since these companies also internationalize. ASEAN MSMEs and multinational corporations (MNCs) have also been expanding with more sophisticated production technologies thanks to their business links with developed country MNCs.

MSMEs have played a role in ASEAN economic growth since they constitute a major share of businesses, contribute significantly to employment and GDP, and strengthen industrial linkages with increased supply. ASEAN members implemented specific measures to promote an entrepreneurial environment and support the development and internationalization of MSMEs. Indeed, the ASEAN MSMEs Blueprint and the ASEAN Strategic Action Plan for MSME Development, 2016–2025 support further development and internationalization of MSMEs through regional cooperation. Development and internationalization of MSMEs depend on access to finance; the ability to venture abroad; industry- and technology-specific factors; and the home and host country environment. MSMEs in more mature, smaller and high-cost markets (Malaysia and Singapore) tend to invest abroad more, while those from Indonesia, Philippines, Thailand and Vietnam invest less in other ASEAN states since they have lower costs and bigger home markets. FDI by internationalizing MSMEs expanded in many industries, from low- to high-technology manufacturing to various services.

ASEAN MSME contractors have extensive business linkages with foreign MNCs through contracts in professional services, research, engineering or infrastructure development and operation management. FDI by MNCs is made with three main goals: to use the region as a production base; serve regional market with local production of goods and services; or access raw materials. MNCs have substantial sourcing operations with ASEAN firms, which help MSMEs to upgrade their product quality and build skills and to participate in MNCs' regional and global supply chains.

Integration into the global economy is the fourth pillar of ASEAN Economic Community and closely relate to extra-regional trade. As mentioned before, the main links of ASEAN to the global economy include trade and FDI flows with major economic powers such as the EU, US and China, as well as links of the ASEAN companies with MNCs of developed partners. Within Asia, ASEAN signed FTAs with China, Korea, India, Japan, Australia and New Zealand. It is also negotiating a CEPA (Cooperation Economic Partnership Agreement) with these six partners with broader scale and more commitments. As mentioned before, this group, ASEAN+6 (RCEP) constitutes one of the mega-regional groups of the world.

In summary, the analysis of the EU and ASEAN trade patterns show that EU trade network is much larger than the ASEAN with more than 40 countries around the world. Likewise, EU intra-regional trade is much more developed than the ASEAN; 60-70% of the EU's total trade takes place within the region. EU trade integration is also more institutionalized as tariffs were eliminated within the region, customs procedures were aligned and non-tariff barriers reduced substantially.

Meanwhile, ASEAN's trade network concentrates on other Asian countries or its developed trade partners such as the US, EU, Japan and China. That structure also led to

ASEAN+3 FTA and ASEAN+6 initiatives in the region. ASEAN's intra-regional trade is only 25% of its total trade, but this ratio is stable. ASEAN integration still needs to improve on legal and institutional basis as tariffs are expected to be eliminated by 2018 but reduction of NTB's are limited.

Developmental differences both in the EU and ASEAN lead to dominance of more developed members in trade and FDI flows. However, trade integration is expected to improve in the EU with recovery from economic recession. For ASEAN, export oriented strategy led ASEAN firms to become more competitive and sophisticated over time, which will support regional integration in the future.

Recent financial integration initiatives in banking, stock markets and bond markets are also expected to support regional trade integration, since financial integration can allow cross-border provision of capital and other financing to firms and infrastructure projects, while making better risk management possible for international trade. Therefore, the next chapters will review the regionalization of financial sectors.

CHAPTER VI

BANKING SECTOR DEVELOPMENT AND INTEGRATION IN THE EU AND ASEAN

As mentioned earlier, financial sector is crucial for economic development and real sector since it selectively allocates capital among companies, provides credits to firms and individuals and promotes investments, entrepreneurship, and innovation. In literature, development of financial sector refers to development of its main segments; namely banks, capital markets and non-bank financial institutions (NBFI), which includes different financial players such as asset and wealth management companies or institutional investors such as pension or insurance funds. Meanwhile, the initiatives for regional financial integration (including the EU, ASEAN, MILA, East and West Africa) have been focusing on banking sector, capital markets or both.

Development of financial sector largely depends on framework of regulations, institutions and supervisory practices. These structures impact the “operating environment” of financial institutions which affects their business opportunities and risk behavior, the efficiency and profitability of their activities and their ability to reach unserved clients as well as the competitive structure of the industry. These structures also play a key role in risk management practices and minimization of losses as well as dispute resolution mechanisms and safety nets for financial institutions. Therefore, quality of regulatory, supervisory and institutional structures closely relates to how financial development can contribute to economic growth in longer term. When financial markets don't function well, governments attempt to pick the winner firms/sectors to provide efficient allocation of capital. These selections, however, could lead to

inefficient allocation of resources over time as those advantages would be harder to take back in the longer run.

ROLE OF BANKS IN FINANCIAL DEVELOPMENT AND REGIONALIZATION

Function of Banks in Economic and Financial Development

Banking sector is a crucial part of financial integration since most countries have bank-based financial systems, including the EU and ASEAN. Although the large functional scale of banking sector may differ by country, the WTO sectoral classification list for services trade states 12 activities of the banking sector: (a) acceptance of deposits, (b) lending, (c) financial leasing, (d) payment and monetary transmission services, (e) guarantees and commitments, (f) trading for own account or for account of customers, (g) participation in issues of all kinds of securities, (h) money broking, (i) asset management, (j) settlement and clearing services, (k) advisory services and (l) provision and transfer of financial information. With this large extent of services, the banking sector has far reaching effects on economic activity and financial sector.

The stability and efficient operation of banks are crucial for financial and economic development for various reasons: (i) Banks allocate resources; they intermediate on credit provision between savers and investors, transform short term savings into longer term investment funds. (ii) Banks are integral part of the payment and settlement systems, enabling flow of money. (iii) Banks provide critical financial services to individuals, firms and governments including trade credits, guarantees, commitments, leasing etc. -important for real sector activity. (iv) Banks can perform asset management, brokerage, advisory and underwriting functions

related to capital markets activities. (v) When capital markets and institutional investors are not sufficiently developed, banks can expand to provide non-traditional banking services. Besides, banks affect development of capital markets, institutional investors and vice versa. (vi) Banks play crucial role in transmission of monetary policy, macroeconomic stability and liquidity. Effects of monetary policy can change through monetary channel (interest rates), bank lending channel (loans to borrowers) and balance sheet channel (availability of credit based on collateral valuation).¹ Efficient functioning of interbank markets are crucial to prevent quantity rationing in loan markets and to support illiquid banks.²

Role of Banks and Non-Bank Financial Sector in Development

Banks and capital markets are two major components of financial system as both impact economic and financial development. Economic research on 125 countries suggests that sound and efficient financial systems—banks, equity markets, and bond markets— positively relate to economic growth, especially in developed countries.³ Moreover, overall financial development is robustly linked with economic growth, whether the financial system is bank based or market based.⁴ However, impact of banking sector and capital markets on financial and economic development can change according to stage of development: Research on 72 countries between 1980 and 2008 showed⁵ that development of banking sector promotes economic growth in earlier stages of financial development, while market based financial development becomes more

¹ BIS Report, Group of Ten: “Report on Consolidation in Financial Sector” January 2001.

² Freixas, Xavier and José Jorge. “The Role of Interbank Markets in Monetary Policy: A Model with Rationing.” www.econ.upf.edu/~freixas/more/FreixasJorgeTheRole.pdf

³ <https://www.adb.org/sites/default/files/publication/28277/economics-wp233.pdf>

⁴ Ross Levine, “Bank-Based or Market-Based Financial Systems: Which is Better? University of Minnesota, October 2001

⁵ Demirguc-Kunt, Asli and Erik Feyen, and Ross Levine. “Optimal Financial Structures and Development: The evolving importance of banks and markets.” Policy Research Working Paper 5805, World Bank, September 2011.

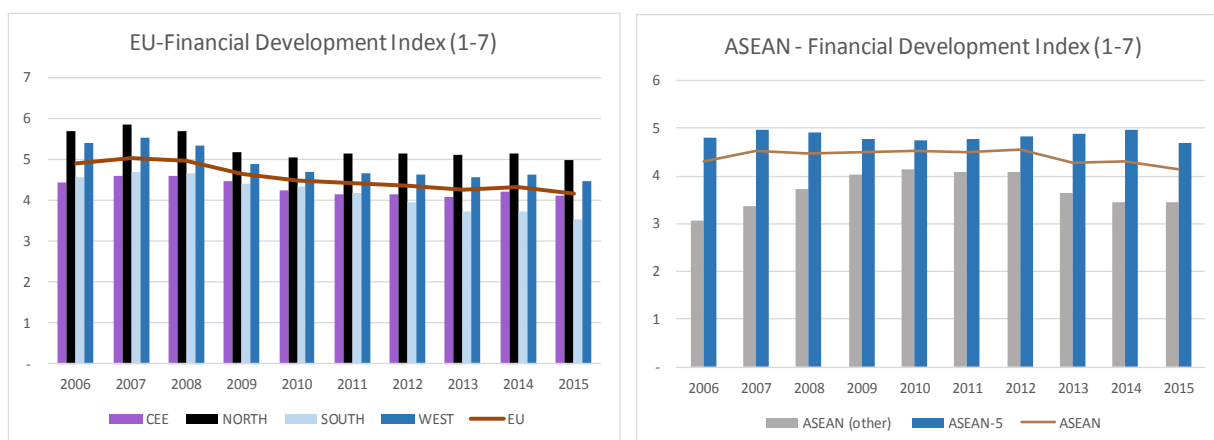
important for economic growth in later stages. Moreover, income per capita actually associates with more advanced financial structure and “move from banks towards non-bank financial intermediaries, and from both of these towards stock markets”. While most economic systems in the world are bank dominated, capital markets are developed mainly in advanced countries and a few emerging markets and under-developed in developing or less-developed countries.

In regional integration, importance of the banks is strengthened by their relations to capital markets and non-bank financial institutions (NBFI). These relations can be competing, complementary or co-evolving depending on level of financial sector development: On one side, banks can enlist in local stock exchanges or issue debt securities in local markets, which directly contribute to transaction volume and capitalization in local capital markets. In addition, banks can issue debt securities based on returns of their certain assets such as credits or mortgages (Securitization -Asset Based Securities or ABS), which also contribute to capital markets by additional investment instruments.⁶ Moreover, in many financial systems, banks hold capital market instruments under their assets or capital portfolio, which expand volume in capital markets. More stable and deeper capital markets help to lower cost of capital for banks and make the holdings of the banks less risky. Stronger capital and asset valuations can lead the banks to expand their credit provision to especially to private sector, which is the main measure of financial sector depth. Finally, banks have strong role in bond market development and government borrowing as they are purchasers of the bonds. However, the strength of these linkages are conditional on development level of financial markets, behavior of banks and operating environment, which includes economic, technological, regulatory and institutional environment.

⁶ Provided that they are well regulated with adequate valuation and risk management practices. Otherwise, Mortgage Based Securities (MBS) are known to have triggered the 2008 crisis, started in the USA.

On the other side, relation between banks and capital markets can be competitive in terms of lending: As capital markets get deeper and liquid, the firms use capital markets more for financing than traditional banking or insurance products. Besides, financial products by non-bank financial institutions (NBFI) may compete with bank deposits since deregulation and technology already blurred distinction between bank and non-bank activities.

Figure-9 Financial Sector Development Indices, the EU and the ASEAN



Source: Calculated from WEF Data

Improving Stability and Resilience of Banking Systems

Although banks are indispensable parts of financial system and contribute greatly to financial development, excessive reliance on banks can be problematic in the long run as in the Asian Crisis. It should be noted that as financial development and integration policies target a more efficient and competitive banking sector with extended outreach, some issues with banking domination may need to be addressed. In some cases, banks may dominate financial sector and

control majority of NBFIs, which will undermine competitiveness in the financial sector and block profitability and development of other NBFIs. Bank dominance also has potential to promote spread of relationship banking and limit availability of credits, which reduces financial access and outreach as well as efficiency of capital allocation. Moreover, under-development of capital markets and other NBFIs such as insurance and pension funds will limit availability of financial instruments for investments, reduce portfolio diversification and hence, increase counter-party and concentration risks. In payment and settlement systems, bank domination can increase prices and decrease competition in financial transactions. In addition, moral hazard problems can arise due to government safety nets and liquidity provision by central banks –rather than markets–, reducing the motivation for appropriate risk management. Finally, when banks dominate economy, their financial problems can undermine overall macroeconomic and financial stability.

In order to support stability and efficiency of banking system and prevent its destabilizing effects to financial and macroeconomic stability, BASEL regulations set a benchmark for international best practices in banking regulation and supervision. BASEL principles also constitute the basis for the regulatory and supervisory frameworks under financial regionalization of banking systems both in the EU and the ASEAN. The BASEL framework has been evolving to cover larger spectrum of risks to banks as well as to cover various types of economic crises; with BASEL-I in 1988, BASEL-II in 1999 and the most updated BASEL-III in 2009. BASEL frameworks vary in terms of complexity and operating requirements on banking sector. Each can be adapted by different countries according to their development levels; for example, BASEL III is mostly adopted by developed countries and some emerging markets. Therefore, different countries within the same region can observe different versions of BASEL.

According to BASEL regulations, banks should be sound in six areas to avoid risks to financial sector and economic stability;⁷ (i) capital adequacy; to absorb losses (ii) asset quality; to minimize risks from loans and loan concentrations as well as risks to solvency (iii) management soundness; to ensure efficiency and stability (iv) earnings and profitability; to absorb losses without use of capital, to ensure durability within the industry and to avoid excessive risk taking (v) liquidity; to counter cash flow shocks (vi) internal risk management; to manage changes in market or equity prices, interest and exchange rates.⁸ Banking sector concentration and composition are other important elements of banking development. These figures for banking sector resiliency will be separately provided for the EU and the ASEAN in order to evaluate the strength of their banking sectors.

REGIONAL INTEGRATION OF BANKING SECTORS

Benefits and Issues in Banking Sector Regionalization

Regional integration can expand the size and outreach of banking sector and promote its development through various channels:

(i) *Economies of scale* effects in financial infrastructure reflect into bank costs in two ways: Banks operating in larger systems indicate lower average cost of production and benefit from technological developments more rapidly.⁹ Moreover, small banks in large systems are more cost efficient than their peers in smaller systems. (ii) Larger financial systems associate

⁷ BASEL web site

⁸ Financial Sector Assessment: A Handbook. IMF and World Bank, 2005. 47. The Financial Sector Assessment Program Fact Sheet. IMF, September 30, 2012. The Financial Sector Assessment Program FAQ. IMF, October 30, 2012.

⁹ Bossone Biagio and Jong-Kun Lee. "Bank Efficiency and Financial System Size" Chapter 3 in Hanson James A. Partick Honohan, Giovanni Majnoni Eds. "Globalization and National Financial Systems" 2003

with *lower banking sector concentration*, more efficiency and competitiveness. (iii) Banks can be strengthened by *consolidation accross borders* by M&As and partnerships. Small banks benefit more from business with groups from larger countries than smaller ones.¹⁰ (iv) Banks in larger systems have *lower costs of risk absorption and reputation signaling*¹¹: Financial sector size promotes banks for better risk management and reputation signaling since investors are more sensitive to risk in more developed and competitive financial environments. (iv) *Regionalization can improve information availability* since expanded branch networks ease collection of information on clients and risk management.¹² Banks in larger systems face *lower uncertainty* in servicing loans, while non-performing loans can be diversified accross borders.¹³ (v) Banks in small systems may be required to maintain higher capital ratios and *small banks need less capital to survive* in larger systems.¹⁴ (vi) *Reginalization can utilize increasing sophistication and expansion of South to South banking*. Recent trends indicate that quality of banking and financial services have been improving in developing countries, while South to South financial integration is faster than North and South.¹⁵ ¹⁵³ (vii) Physical presence still matters in the banking industry; *geographic proximity, less informational asymmetry, similar business culture and practices* can be distinctive advantages to regional banks. (viii) *Regionalization can prepare the banks for competition from global banks*. Regional banks can expand across borders, improve their operational and management strategies and technical

¹⁰ “Welfare effects of financial integration” Falko Fecht, Hans Peter Grüner, Philipp Hartmann. Deutsche Bundesbank.

Discussion Paper Series 2: Banking and Financial Studies No 11/2007

¹¹ Bossone Biagio and Jong-Kun Lee. “Bank Efficiency and Financial System Size” Chapter 3 in Hanson James A.,Partick Honohan, Giovanni Majnoni Eds. “Globalization and National Financial Systems” 2003. Research on 875 banks from 75 countries (1995–1997)

¹² Bossone, Biagio, Patrick Honohan, and Millard Long. “Policy for Small Financial Systems.” World Bank, Financial Sector Discussion Paper No. 6, 2001

¹³ “Welfare effects of financial integration” Falko Fecht, Hans Peter Grüner, Philipp Hartmann. Deutsche Bundesbank. Discussion Paper Series 2: Banking and Financial Studies No 11/2007

¹⁴ Bossone, Biagio, Patrick Honohan, and Millard Long. “Policy for Small Financial Systems.” World Bank, Financial Sector Discussion Paper No. 6, 2001

¹⁵ Financial Integration among Developing Countries.” Chapter 4 in “Global Development Finance 2006”, World Bank.

knowledge to serve foreign markets. (viii) *Better institutional, regulatory and supervisory frameworks* under regional system can improve operating environment of banks and promote their development through better reporting, disclosure and risk management standards, investor and creditor rights, transparency, dispute resolution and regulatory enforcement. This can reduce moral hazard, rent seeking, information problems.

Regionalization, however, may not be correct strategy for all banking systems since it requires large resources, international capabilities and long term commitment. Main difficulties include: (i) Some banks may evolve to systematically important financial institutions (SIFI), while high scale mergers can lead to *concentration problems* in the banking sector. In this context, trade-off between efficiency and concentration should be noted. (ii) *Cross border synergies are harder to achieve when differences among markets are substantial*; synergies are easier when products and services are uniform, client base are similar and regulations or standards are more harmonious across the borders. (iii) *Building reputation among cross border markets require long years and investments* especially when large global competitors already exist in the markets. (iv) *Banking is a risk intensive industry*; governance and risk management can become more complicated under regionalization due to local laws, listing requirements, financial supervision and central bank requirements. In this context, adoption of international standards would be useful. Currently, the BASEL framework is applied among ASEAN countries, while the new EU laws for banking sector union also reflect the main guidelines of the BASEL. (v) Foreign banks are more likely to leave or reduce operations in the host country in case of economic and financial crises, which can trigger more instability. (vi) As a process, integration of financial services (including banking), is more complicated than trade integration with slower pace. Financial liberalization requires harmonization of regulatory

standards, market practices, licensing and disclosure requirements. Moreover, it requires a threshold level of convergence in development of financial markets and economies. Financial liberalization and integration must be designed around maintaining systemic stability. Premature opening of financial markets without strengthening domestic financial systems and credible safety nets can lead to instability and crises.¹⁶

In this context, banks can share risks under regional integration under four different frameworks:¹⁷ *National or regional segmentation, integration through secured interbank market, integration through unsecured interbank market and integration of retail markets.* Secured interbank lending prevents financial contagion since it includes collateral and it is mostly recommended for small integrated financial areas. This system is open to moral hazard problems since it can lead to free-riding on other banks' liquidity and insufficient reserves, which become more acute in larger integrated financial systems. *Unsecured* interbank lending is mostly recommended for intermediate-size integrated financial areas, which have enough aggregate liquidity. Banks with excess liquidity can lend to others with shortage and fear of contagion can discipline banks to not to free-ride on liquidity of other banks. But the disciplinary effects weaken as the system gets larger. Cross border penetration of retail markets is the most advisable strategy to large, integrated and more diverse financial systems since interbank markets can provide limited risk sharing, leading to contagion in large systems. Retail markets integration can create significant welfare gains by cross-border lending, especially in case of monetary unions with large and integrated wholesale interbank markets.

¹⁶ Ravi Menon: ASEAN financial integration – where are we, where next? Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the ASEAN Banking Council Meeting, Singapore, 12 June 2015.

¹⁷ “Welfare effects of financial integration” Falko Fecht, Hans Peter Grüner, Philipp Hartmann. Deutsche Bundesbank. Discussion Paper Series 2: Banking and Financial Studies No 11/2007

Entry of Foreign Banks: Potential Implications

Foreign entrance to banking sector is considered increasing efficiency and competitiveness of the banking sector, especially in developing and less developed countries. However, overall effect of foreign banks on local banking industry depends on various factors. Host countries want foreign banks for different reasons such as attraction of foreign investors, high costs of resolving state banks (Central Europe or Latin America) or developmental effects of banking liberalization (Africa). Stronger financials and stability of foreign banks or possible transfer of operational and technical knowledge through spillover effects can be the other reasons. Various literature also confirms these effects: Foreign banks can operate more efficiently than domestic banks due to better management, risk assessment and more experience in competitive environments with variable costs.¹⁸ They can also improve scale and variety of services and products¹⁹ and import technology, know-how, better regulatory standards and risk management into host countries.²⁰ Foreign banks can also mitigate market concentration in host countries.²¹ Overall, they can improve competition and efficiency, foster stability and reduce financial intermediation costs.²²

Foreign banks come to developing or less developed countries either for profits or to follow their clients to other countries.²³ Various research indicates that foreign banks mostly enter into countries with less efficient banking sectors and into segments where they have more

¹⁸ Yannick Vennes and Marion Jansen, "Liberalizing Financial Services Trade in Africa" Staff Working Paper ERSD-2006-03. World Trade Organization Economic Research and Statistics Division, March 2006

¹⁹ Cárdenas, Juan, Juan Pablo Graf and Pascual O'Dogherty. "Foreign banks entry in emerging market economies: a host country perspective. BIS papers.

²⁰ Claessens and Lee. "Foreign Banks in Low Income Countries" GNS 2003.

²¹ Cárdenas, Juan, Juan Pablo Graf and Pascual O'Dogherty. "Foreign banks entry in emerging market economies: a host country perspective. BIS papers.

²² Yannick Vennes and Marion Jansen, "Liberalizing Financial Services Trade in Africa" Staff Working Paper ERSD-2006-03. World Trade Organization Economic Research and Statistics Division, March 2006, Claessens and Lee. "Foreign Banks in Low Income Countries" GNS 2003 and Claessens, ADK and Huizinga 2000.

²³ Claessens and Lee. "Foreign Banks in Low Income Countries" GNS 2003

expertise³⁸, Foreign banks tend to get into wholesale business and lend to manufacture sector and large enterprises, while domestic banks concentrate into retail markets.²⁴ However, adverse effects also exist in entry of foreign banks: Excess competitive pressure on domestic banks may lead to foreign dominance in host country banking sector, while weakness or failure of domestic banks may create systemic vulnerabilities. Instead of efficiency, low cost and high quality services, dominant foreign banks can implement harmful profit maximization strategies such as limited provision of financial services, high pricing, and other rent seeking activities, especially in a weak regulatory environment. They may also fail to expand financial access to unbanked segments by focusing on already served client segments. Finally, foreign banks can amplify credit cycles and magnify the shocks to host country by reducing their operations faster than domestic banks.²⁵ In this context, advantages of domestic banks shouldn't be underestimated: Domestic banks are less likely to favor foreign investors over domestic investors to provide funds. They are more likely also build stronger relationships with local industries and population. They can't exit from the markets in the same ways as foreign banks, which strengthen reputation effects.²⁶

Lessons from foreign entry for regional banks

The analysis on foreign banks yields important results applicable to regional banks. Foreign entrance into financial sector is beneficial as long as the entrants increase efficiency and competition, lower costs of financial products and services and create positive spillover effects

²⁴ Yannick Vennes and Marion Jansen, "Liberalizing Financial Services Trade in Africa" Staff Working Paper ERSD-2006-03. World Trade Organization Economic Research and Statistics Division, March 2006

²⁵ Financial Integration and Foreign Banks in Latin America: How Do They Impact the transmission of External Financial Shocks? Arturo J. Galindo, Alejandro Izquierdo, Liliana Rojas-Suárez

²⁶ Andrews, Michael A. "State-Owned Banks, Stability, Privatization, and Growth: Practical Policy Decisions in a World without Empirical Proof." IMF Working Paper, 2005, WP/05/10.

on local banks and NBFIs to improve their cost structure, operations, management and outreach. Foreign entrance is more preferable in sectors with no or inefficient domestic providers. Regionalism already imposes higher costs on global financial banks and institutions, which may be more efficient than their regional counterparts. However, regional integration can come with extra costs if regional banks are inefficient, granted unfair advantages and capture high market power. Governments need to facilitate efficient competition in banking sectors and minimize domination and rent seeking by regional players.

Therefore, strong regional banks (or RSIBs - regional systematically important banks), which can be formed through regional expansion or mergers of banks, need to be properly regulated against moral hazard, rent seeking and excessive concentration so that their operations will serve development of banking sector. Similarly, financial conglomerates, which conduct financial activities at least in two of the banking, insurance or securities sectors, should be regulated on group basis. These entities should be evaluated with their subsidiaries, parent companies, direct or indirect links in terms of their intra-group transactions, market power and risk exposure.²⁷ The same considerations also apply to domestic systematically important banks (DSIBs): Although most DSIBs are not important in global scale (GSIBs), they can affect domestic financial and economic systems. Therefore, the Basel Committee required national authorities to make periodical assessments of DSIBs and comply with the requirements for systematically important banks by 2016.²⁸ These measures impose various requirements on banks' capital and liquidity levels as well as their asset quality.

It should be noted that implications of foreign entry also depend on the entry mode. Strategic partnerships or joint ventures with domestic banks are preferable to many countries

²⁷ Principles for the supervision of financial conglomerates". Basel Committee on Banking Supervision Joint Forum, Sep 2012

²⁸ A framework for dealing with domestic systemically important banks." Basel Committee on Banking Supervision, Oct 2012

since it allows domestic actors to retain control of local banks. Besides, better investment and employment opportunities can be created this way, while transfer of technical and operational knowledge is more likely.²⁹ Additionally, the advantages of domestic, regional and global banks in a host country highly depend on context: For example, informational advantages of domestic banks can be undermined by non-transparent governance and outdated accounting practices of its client firms.³⁰ Risk perception and crisis behavior of foreign banks depend on availability of resources from the parent, location/type of crisis (home or host country) and degree of financial and operational autonomy (decentralized organizational structure) from the parent.³¹ Also, foreign banks may not enter some host country segments due to remaining capital controls, economic and political instability, entry barriers, lack of demand, cost structures, information disadvantages and insufficient regulatory protection.

REGIONAL INTEGRATION OF THE ASEAN BANKING SECTOR

Initiatives for ASEAN Banking Integration

Financial integration of ASEAN proceeded slower than trade integration as financial sector initiatives started after the Asian Crisis of 1997-1998. The crisis resulted from large capital inflows into underdeveloped financial systems, which could not efficiently channel these

²⁹ <https://www.inkling.com/read/international-financial-management/chapter-16/cross-border-mergers-and>

³⁰ IMF Working Paper WP/11/4 Research Department. "Asian Financial Integration: Trends and Interruptions" Eduardo Borensztein and Prakash Loungani, January 2011.

³¹ "Basel III and regional financial integration in emerging Europe: An overview of key issues." Alexander Lehmann, Micol Levi and Peter Tabak, EBRD

into productive investments.³² Excess credits to investments with limited productive capacity (such as real estate), currency mismatches and reduced debt payment capacity led the banking sector into crisis. After this crisis, reforms in the economic and financial system contributed to restructuring of banking sector by reducing dependence on foreign borrowing, rebuilding foreign exchange reserves, recapitalizing the banks as well as by introducing tighter prudential regulation and supervision and reducing non-performing loans and corporate leverage.

In 1999, the ASP (ASEAN Surveillance Process) started as a mechanism for review and exchange of views on economic development and policy issues, among senior officials of Central Banks and Finance Ministers. Since then, the key changes in Asian banking sectors include consolidation, greater transparency and disclosure, increase in foreign ownership and decline in state ownership.³³ Asian banks built stronger balance sheets and capital cushions with new capital injections. They also widened their products and services and expanded their business into new areas, including investment banking, consumer lending, and real estate. This development was accompanied by development of equity and bond markets, which further diversified the financial systems.

In 2003, ASEAN Finance Ministers agreed on “the Roadmap for Monetary and Financial Integration in ASEAN” (RIA-FIN), in order to facilitate the integration of the ASEAN financial markets by promoting development of capital markets, liberalization of financial services and liberalization of capital accounts.³⁴ In 2007, the ASEAN leaders declare their intention to establish an Economic Community (AEC) by 2015 to facilitate greater trade and investment flows in the region. The so-called AEC blueprint envisaged plans for regional liberalization of

³² Gemma Estrada, Donghyun Park, and Arief Ramayandi. Financial Development and Economic Growth in Developing Asia. ADB Economics Working Paper Series No. 233, November 2010

³³ Adams, C. 2008. Emerging East Asian Banking Systems. Ten Years after the 1997/1998 Crisis. Working Paper Series on Regional Economic Integration No. 16, Asian Development Bank, Manila.

³⁴ The RIA_FIN was agreed on 2003 but implemented in 2009.

trade and services (including the financial services) as well as regional liberalization of capital account regimes by integrating the members' financial systems. Specific goals under the AEC blueprint included: (i) Progressive removal of restrictions on regional provision of financial services (ii) Dismantling capital account restrictions (iii) Harmonization of regional capital market standards (iv) Promoting capital market development in ASEAN, by regional capacity building and infrastructure (v) Harmonization of payments and settlements systems (vi) Mutual recognition of qualification of financial sector professionals.

Banking liberalization has been a part of the AEC Blueprint by the financial services commitment, which originated from the ASEAN Framework Agreement on Services (AFAS) in 1995. It involved removing barriers in cross-border bank flows (Mode 1 of AFAS), consumption abroad (Mode 2 of AFAS), commercial banks presence (Mode 3 of AFAS), and movement of natural persons (Mode 4 of AFAS).³⁵ The AEC blueprint also recognized the developmental differences between ASEAN-5 and other ASEAN countries (also referred as BLCMV for Brunei, Laos, Cambodia, Myanmar and Vietnam). The plan proposed common objectives and a single goal for all ASEAN member states; but with different timelines and milestones for each country.³⁶

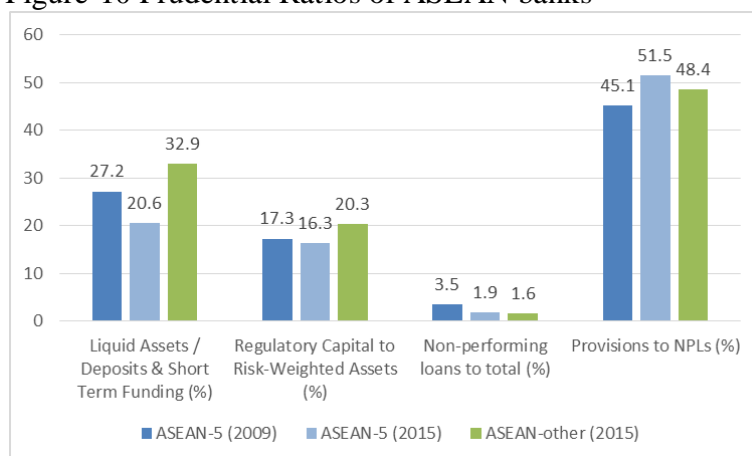
With the global crisis of 2008, the output (GDP growth) and exports of Asian countries were hit hard in general but their monetary and financial systems were largely resilient. The financial shocks from developed Western economies caused decline of trade credits and cross-border capital flows, while the global banks reduced their presence in ASEAN markets due to

³⁵ Maria Monica Wihardja. "Financial Integration Challenges in ASEAN beyond 2015." ERIA Discussion Paper Series November 2013

³⁶ The Road to ASEAN Financial Integration: A Combined Study on Assessing the Financial Landscape and Formulating Milestones for Monetary and Financial Integration in ASEAN. Asian Development Bank, 2013

higher risk aversion and fall in asset values.³⁷ However, there were no serious financial instability as interest rates and exchange rates remained stable in most countries. Most problems during the Asian crisis of 1997-1998 were absent in 2008 due to previous substantial reforms. Households and corporations entered this crisis with stronger balance sheets, which helped to increase economic confidence. As it can be seen in Figures 11 and 12, that the growth in deposits and credits continued in ASEAN overall, however, the liquidity was decreased and provision for non-performing loans increased in ASEAN-5 countries since 2009.

Figure-10 Prudential Ratios of ASEAN banks



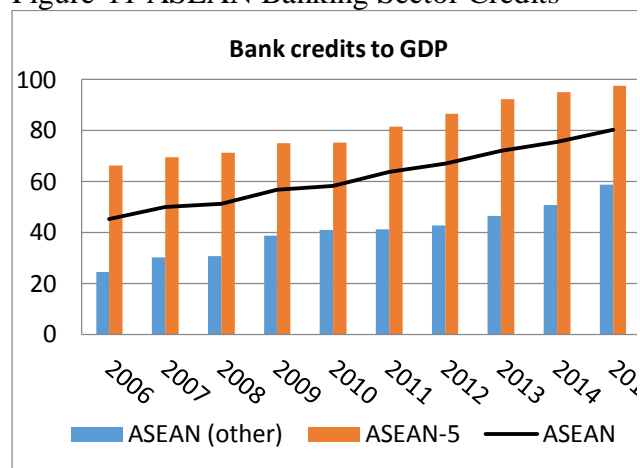
Source: IMF FinStats Database, 2017

In 2011, the ASEAN Central Bank Governors endorsed the ASEAN Financial Integration Framework (AFIF) and the ASEAN Banking Integration Framework (ABIF) as a part of the AEC blueprint, before the AEC was officially launched at the end of 2015. The AFIF envisaged a more integrated financial region by 2020. It aimed to remove restrictions to the intra-ASEAN

³⁷ Heng Swee Keat. "The Global Financial Crisis: Impact on Asia and Policy Challenges Ahead" Asia Economic Policy Conference, 2014

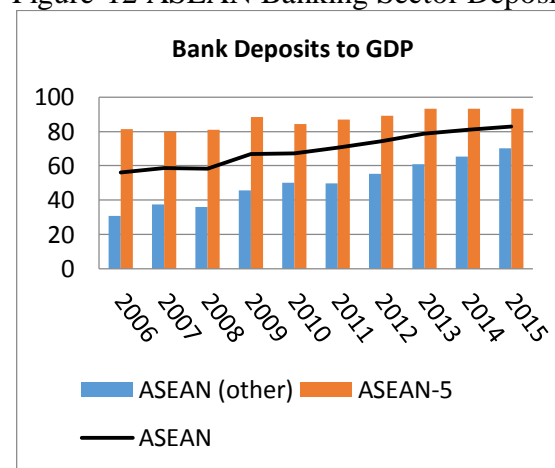
provision of financial services by ASEAN financial institutions; to build financial infrastructure to develop and integrate the ASEAN capital markets; to liberalize capital flows across the region; to harmonize payments and settlements systems and to strengthen regional financing and regional surveillance. The ABIF aimed to provide financial stability in the region and achieve multilateral liberalization in the banking sector by 2020 for ASEAN commercial banks. Under the ABIG Guidelines, there are four main elements in banking sector integration: (i) harmonizing prudential regulations (ii) building up of a financial stability infrastructure (iii) setting the criteria for Qualified ASEAN Banks (iv) capacity building, mostly for BCLMV countries to reduce gaps in banking sector development.

Figure-11 ASEAN Banking Sector Credits



Source: IMF database, average for country groups

Figure-12 ASEAN Banking Sector Deposits



For the first element, regulations, the ASEAN countries try to transpose Basel Core Principles for Effective Banking Supervision into their laws to promote safe and sound banking system. Indonesia, Malaysia, Philippines, Thailand, Singapore are already compliant with Basel II and in the process of adopting Basel III. From the other ASEAN countries, only Brunei is

partially compliant with Basel II, while Vietnam is working towards Basel III implementation. The second element includes bilateral supervision of banks by the home and host countries, consistent with international principles and commensurate with size and complexity of QABs. The third element include the main characteristics of the QABs, which should be well managed with proper business plan, risk assessments, strong capital, governance & ownership. These banks should be local ASEAN banks supported by their home country, and meet host country's prudential requirements. The capacity building includes the ABIF Learning Program, which was established to reduce banking sector capacity gaps and improve human resources and know-how in the under-developed banking industries and enhance readiness of all ASEAN members to participate in ABIF Framework.

The ABIF Guidelines were signed by ASEAN Central Banks' Governors in 2014 and set basis for ASEAN countries to enter into reciprocal bilateral arrangements to provide Qualified ASEAN Banks (QABs) with greater market access and operational flexibilities:¹ Under the ABIF, the QABs be treated similarly to indigenous banks in the host country, while operational flexibility can include flexibilities in scope of activities, supply of products and services or others that are mutually agreed between host and home countries. Despite the single goal of banking sector integration, the ABIF allows double-track implementation of these measures in the ASEAN-5 and BCLMV countries. In this context, the ABIF employs the principles of both reciprocity and voluntary Most Favored Nation (MFN). In the former, the arrangements and level of concessions between two or more countries should be reciprocal, mutually beneficial and acceptable for all the countries involved. In the latter, adoption of the voluntary MFN allows each country to give special concessions only to a certain country. Under the ABIF, banking liberalization can be done on bilateral basis and customized; two ASEAN countries can agree on

¹ Yati Kurniati. "Advances and Challenges in Regional Integration" Bank Indonesia, March 2016

specific areas to be liberalized based on the QAB's commercial interests. The ABIF is expected to help creation and growth of strong pan-ASEAN banks with the capability to compete with global banks.

Economic Outlook and Potential of the ASEAN Banking:

Last two decades, the ASEAN regional economy has been evolving to an important economic force with a GDP of \$2.6 trillion, higher than India, UK and France as of 2017.² The GDP of the region is expected to increase to \$6.4 trillion by 2027, surpassing Japan. The momentum of growth is expected to remain strong both in ASEAN-5 and other frontier economies. (BCLMV) The region have from various trade agreements with the EU and USA, increasing the export capacity, while it will also benefit from China's 'One Belt, One Road' initiative over the medium term, which will accelerate infrastructure development and regional transport connectivity. Economic growth, rising incomes, urbanization and expanding middle class will increase demand for goods and services, especially financial products and services. Indeed, middle class population is estimated to increase from around 150 million (or 25% of total population of 600 million) to 467 million (66% of total population of 700 million) in 2030.³ As income and wealth increases, demand for financial services⁴ (such as consumer credits, wealth management or insurance) will rise more than proportionately due to high income elasticity of

² IHS Global Insight world economic forecast

³ Ravi Menon: ASEAN financial integration – where are we, where next? Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the ASEAN Banking Council Meeting, Singapore, 12 June 2015.

⁴ Other services with high income elasticity of demand include education, health and telecommunications.

demand.⁵ The growing economic and trade activity will also provide new businesses for the ASEAN banks since they can follow their clients, needing regional services.

The near term outlook of the ASEAN will be affected by ongoing recovery in the EU, US and Japan as well as slowdown in the Chinese economy. Anticipated rise of the US interest rates, quantitative easing in the EU and Japan could increase volatility in foreign exchange and bond markets with large capital outflows from ASEAN economies, while banks may face higher non-performing loans and reduced dollar liquidity. However, as mentioned before, the banks have strong capital and liquidity structure with stable growth in loans and deposits, which support financial system stability. (Figures 3.2 and 3.3) In this context, The ABIF will eventually allow the ASEAN banks to operate freely in the region with equal access and treatment. By 2018, each ASEAN-5 country should have a bilateral deal and at least one Qualified ASEAN Bank (QAB) announced per country. The banking sector liberalization is to be completed by 2020.

Issues with the ASEAN banking integration

Developmental differences in financial sector between the ASEAN-5 and BCLMV countries constitute one of the main issues in the ASEAN banking integration. These two groups differ in bank assets, credits, loans and prudential ratios as well as international or regional reach. As it can be seen by Figures 11 and 12, bank credits and deposits in ASEAN-5 reached almost 98% and 93% in 2015, while these figures were 59% and 70% for BCLMV. Out of total credits, 11% in BCLMV and 15% ASEAN-5 was directed to state economic enterprises rather than private firms. In addition, physical reach of the banking sector is more limited in frontier

⁵ Ravi Menon: ASEAN financial integration – where are we, where next? Keynote address by Mr Ravi Menon, Managing Director of the Monetary Authority of Singapore, at the ASEAN Banking Council Meeting, Singapore, 12 June 2015.

countries: As of 2015, there were 12 bank branches for 100,000 adults in ASEAN-5 and 7 bank branches for BCLMV.⁶ Within the ASEAN, the most developed Singapore, Malaysia and Thailand had highest reach in banking as 78% and 96% of the surveyed population reported to have an account at a financial institution, while the same figures ranged between 12% to 36% for the rest of ASEAN. Developmental differences raise questions on how to create benchmark indicators of integration, how to minimize adverse impact of the ABIF, especially on BCLMV and how to accelerate the operation of regional safety nets.

Differences in market structure also affect the commitment to regionalization. For example, large markets with unsaturated demand for banking services (such as Indonesia) can be expected to take a more cautious or protectionist approach toward liberalization of the sector, while countries with saturated markets (such as Malaysia) would be more aggressive to enter new markets. In this case, the decision to allow entrance of foreign banks and treat them as nationals would depend on whether costs of the ABIF outweighs its benefits.

Regional expansion of banking sector remained limited, despite steps taken towards liberalization. (Table 15) So far, no ASEAN banks have expanded their branch or subsidiary network to all ASEAN members. 18 banks from Singapore, Malaysia and Thailand have widened their network throughout the ASEAN the most, while Thai banks have geographical advantage to expand in Cambodia, Laos, Myanmar, and Vietnam. Singapore and Malaysia have the largest economies of the ASEAN as their banks are largest in size and scale. Indonesian and Philippine banks are building scale but still domestic-driven, which could make them targets for regional M&A deals.⁷ Meanwhile banks in the ASEAN-5 countries expressed intentions to strengthen their balance sheets to prepare for the ABIF. The expansion of the ASEAN banks in

⁶ IMF Finstats 2017

⁷ Lim Sue Lin, Lynette Cheng, Benedictus Agung Swandono, Thaninee Satrareungchai, "ASEAN Banks and Financial Opportunities in ASEAN Integration." DBS Asian Insights Sector Briefing, 29 October 2016

the region has been mostly done by M&As, which could increase over the coming years due to increasing competition in banking sectors. Especially Indonesia and Philippines would benefit from the M&A's since they have large number of small banks and out of 121 and 220 total banks, the top 10 hold 70% to 80% share of these markets.⁸ However, the M&A's can be difficult to implement due to various reasons such as capital requirements, valuation issues and disagreements on controlling stakes. Until 2012, cross border M&A's underperformed against the M&As between Asian and non-Asian banks.⁹ Cross border bank M&A's need to be supported with strong business models, risk management practices and regional regulations and incentives.

Among the BCLMV countries, Brunei and Myanmar have no regional banks.¹⁰ Commercial banks are most important financial institutions across the region as they accounted for 82% of total assets in ASEAN-5 and 96% in BCLMV.¹¹ However, assets and liabilities of these banks are regulated by governments and foreign competition is limited.¹² Limitations on the number of branches for both domestic and foreign banks or on foreign ownership differ in each country.¹³ Currently, only Philippines allow for 100% bank foreign ownership.

⁸ Lim Sue Lin, Lynette Cheng, Benedictus Agung Swandono, Thaninee Satirareungchai, "ASEAN Banks and Financial Opportunities in ASEAN Integration." DBS Asian Insights Sector Briefing, 29 October 2016

⁹ The future of ASIAN banking – vol 2. Marsh and McLennan Companies, Oliver Wyman 2012

¹⁰ Yati Kurniati. "Advances and Challenges in Regional Integration" Bank Indonesia, March 2016

¹¹ The road to ASEAN financial integration, ADB 2013. Data from 2009.

¹² The road to ASEAN financial integration, ADB 2013.

¹³ DBS Asian Insights Sector Briefing 29, 2016

Table 15 Regional Expansion of the ASEAN banks

Country	Number of banks regionally expanded	Number of countries expanded in ASEAN	Number of branches and subsidiaries in ASEAN
IND	4	2	4
PHL	2	1	1
MAL	6	8	23
SGP	5	6	14
THL	7	8	18
BRU	1		
CAM	1	2	2
LAO	2	1	1
MYN			
VTN	4	2	3

Source: Yati Kurniati. "Advances and Challenges in Regional Integration" Bank Indonesia, March 2016

On international basis, the ASEAN bank openness is generally low. (Figure 3.5) The ratio of credits to foreigners¹⁴ to GDP are highest for Singapore in the ASEAN-5 and Brunei in the BCLMV countries. However, international expansion of Singaporean banks have focused on China rather than the ASEAN, while Malaysian banks have been oriented towards regional expansion. In Cambodia, Thailand and Indonesia, majority of the foreign banks is non-ASEAN¹⁵, suggesting that despite relatively low barriers to entry, non-ASEAN banks were more interested in the ASEAN banking markets than ASEAN banks.¹⁶ Yet, this structure may change: The ASEAN members hold discussions on further liberalization, including raising foreign ownership limits for the financial sector. They pursue reciprocal bilateral agreements, that will facilitate better market access and operational flexibilities for QABs. In Dec 2014, Malaysia and Indonesia signed an agreement to expand the business and operations of their banks in

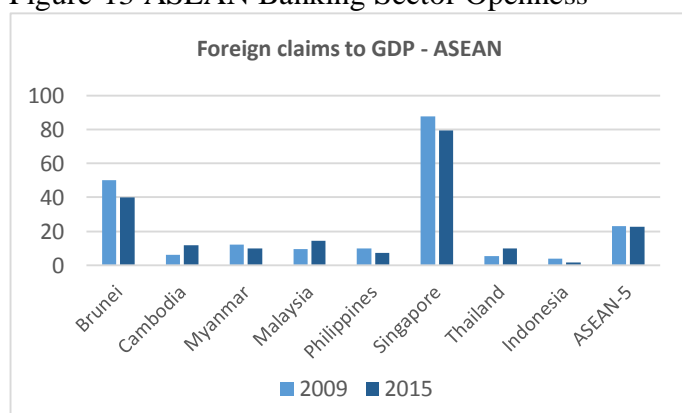
¹⁴ In IMF IFS Database, this would be net foreign assets, claims on non-residents

¹⁵ According to the data from the Asian Development Bank (The road to ASEAN financial integration, ADB 2013), average size of assets for ASEAN banks were \$4.8 billion in 2009, compared to \$14 billion of 500 largest global banks. In Malaysia, Philippines and Thailand, foreign banks had only 18% of total commercial bank assets.

¹⁶ Maria Monica Wihardja. "Financial Integration Challenges in ASEAN beyond 2015." ERIA Discussion Paper Series, November 2013

each other's markets. Agreements between other Central Banks continued such as Singapore-Myanmar agreement in February 2015 as well as the Malaysia-Philippines, Malaysia-Thailand and Indonesia-Thailand deals in March 2016. These agreements are expected to increase in coming years. As regional integration of the ASEAN banking sectors strengthened, not only global banks, but also North Asian Banks will be competing with regional banks for market share.

Figure-13 ASEAN Banking Sector Openness*



*Foreign claims are net foreign assets, claims on non-residents over GDP

Source: IMF Database and calculations.

Regulatory and supervisory issues also complicate the ASEAN banking integration, while these differences make integration harder. As mentioned before, some ASEAN countries (ASEAN-5, Vietnam and Brunei) are in different stages to adopt to Basel international standards, while others operate under national rules. Moreover, implementing uniform banking standards such as capital and liquidity requirements will be more complicated since banking systems have developmental differences. In addition, the ASEAN banking integration was founded on reciprocal agreements between two or more countries and

it doesn't have a supra-national entity and rules such as in the EU. The EU can regulate all banks and require them to meet minimum standards under the EU directive. The EU countries also can't reject market access of regional banks. The ASEAN can set criteria for all QAB's but not all banks, which means that the ASEAN banking integration will be more limited than the EU.¹⁷

Strengthening the ASEAN Banking Integration

Integration of the ASEAN banking sector is supported by multiple region-specific factors such as growth of intra-regional trade, international expansion of companies, ongoing liberalization of financial markets, increasing use of Asian currencies and developing capital markets since they create new business opportunities for the ASEAN banks. Regionalization will expand the market size and customer base in the banking sectors, which can lead to emergence of large competitive banks and M&A's to benefit from economies of scale and increase efficiency.¹⁸

The ASEAN banking integration should go through a series of processes including cooperation, coordination and liberalization. Cooperation refers to information exchange, consultation, mutual adoption of certain policies and strategies, whereas coordination refers to cross-border crisis management and stronger policy coordination such as interest rate, exchange rate and fiscal policy coordination, which is less practiced in the ASEAN.¹⁹ In terms of liberalization, the AEC Blueprint stipulates "ASEAN-X" approach, in which countries ready for

¹⁷ Maria Monica Wihardja. "Financial Integration Challenges in ASEAN beyond 2015." ERIA Discussion Paper Series November 2013

¹⁸ "The road to ASEAN financial integration", Asian Development Bank, 2013

¹⁹ Maria Monica Wihardja. "Financial Integration Challenges in ASEAN beyond 2015." ERIA Discussion Paper Series November 2013

liberalization can proceed first and be joined by others later. It also allows "pre-agreed flexibilities"²⁰ by which a country can maintain certain restrictions on the sub-sectors pledged to liberalization. Although multi-pace liberalization is useful to avoid harmful effects of liberalization, especially in under-developed financial and banking systems, exclusions and exceptions should be adjusted not to prevent full implementation of the liberalization process. Another approach on this issue can be to start phasing out restrictions in wholesale banking but delay liberalization of cross border retail banking with multi-stage integration. Nature of two businesses differs and members can grant specific licenses for different types of cross border banking.²¹ On the other side, liberalization of banking sector wouldn't be enough for banking integration: Capital account liberalization is among key conditions for the ASEAN integration since it facilitates free flow of capital, including cross border lending and borrowing. Some restrictions on capital flows may still remain for macro-prudential purposes, while most controls will be applied to outflows.²²

For banking integration, the local banks need to become stronger especially against non-regional competitors; they should improve on management capacity, business models, risk management and international standards for regional penetration. In this respect, strengthening of local banks through reforms (rehabilitation of state banks, consolidation in the banking sector, stronger regulation and supervision, adaptation of international standards) with adequate capital buffers and asset quality is crucial. The ASEAN members that fell behind development of domestic banking and financial infrastructure, especially BCLMV countries, can integrate faster with assistance and cooperation from other member states.

²⁰ Maria Monica Wihardja. "Financial Integration Challenges in ASEAN beyond 2015." ERIA Discussion Paper Series November 2013

²¹ The road to ASEAN financial integration, ADB 2013

²² The road to ASEAN financial integration, ADB 2013

International competitiveness of the ASEAN banks need to be improved. In the past, financial businesses, especially cash management, trade finance, wealth management services have been ceded to international banks or carried out by partnerships or correspondent banking. With the recede of some global competitors due to financial crisis of 2008, the ASEAN banks may find better opportunities to expand their business. For this purpose, banks should develop international strategies for cross-border provision of financial services (retail market), improve wholesale market capabilities and interest rate swap capabilities in debt markets, especially to appeal to mid-size corporates.²³ As the firms become more sophisticated with more complex needs, the ASEAN banks will need to invest more on technology, innovation, research and diversification of their services. Other potential expansion areas can also include investment banking, securities trading, infrastructure finance, asset and wealth management. Moreover, development of regional wholesale banking facilitates transfer of liquidity from markets with excess liquidity (deposits exceed loan demand) to the ones with shortage of liquidity (loan demand exceeds savings or deposits). This would promote efficient capital allocation since the fast-growing businesses and industries that need financing could access funds in any ASEAN states. This “transferred liquidity” among the ASEAN can be directed into productive investments, while especially infrastructure investments can be opportunity for the ASEAN wholesale banking.

Harmonization of regulation and supervision are crucial for inter-operability and safety of banking sector and the whole financial system. Specifically, the harmonization areas include; entry and licensing, reporting and disclosure requirements, accounting standards, risk management and restriction of large exposures, customer protection, anti-money laundering measures, operational and prudential requirements (on assets, capital, liquidity, or liabilities) as well as rules on resolution of failed banks, periodical supervision of banking system and

²³ The future of ASIAN banking – Vol 2. Marsh and McLennan Companies, Oliver Wyman 2012

enforcement mechanisms to take corrective actions. Other important elements of banking integration include regional safety nets for liquidity support, a region-wide deposit insurance scheme, cooperation among regional supervisors and consolidated supervision of SIB's both in home and host countries.

REGIONAL INTEGRATION OF THE EU BANKING SECTOR

Initiatives for The EU Banking Sector Integration

The initiatives leading to financial integration of the Europe goes back as far as 1970's. In 1972, the European Community (EC) made its first attempt to harmonize exchange rates: The members were required to limit the fluctuations of their currencies within a band of +/- 2.25% against each other. In 1979, the European Monetary System (EMS) was launched as a step towards the European Monetary Union (EMU). The EMS encouraged the EU countries to coordinate a central exchange rate under the Exchange Rate Mechanism (ERM). This provided the basis to create a single currency for the EU as all members joined the ERM.²⁴ In 1980, economic policy coordination and the removal of obstacles to financial integration were declared as initial stages toward the EMU. In 1992, the EC was transformed into the EU through the Maastricht Treaty. Two years later, The European Monetary Institute (EMI) was established to oversee coordination of the monetary policies of national central banks and to work towards the creation of the European Central Bank. (ECB). In 1998, The ECB was founded in Germany with responsibilities to set monetary policy for the EU countries and manage foreign reserves. The European Council and European Parliament agreed that 11 of the 15 member states meet the

²⁴ The UK joined to the ERM one year later, in 1980.

criteria to adopt a single currency. The Euro was launched in 1999 as the official currency in 11 out of 15 member states (Austria, Belgium, Finland, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal and Spain), which constituted a major milestone in banking integration. The Euro existed only as a virtual currency until 2002, when 12 states started to phase out their national currencies. Latvia and Lithuania became the latest states adopting the Euro in 2014 and 2015). Also in 2002, the balance of payments (BOP) assistance became available to non-euro EU members, experiencing financial problems. The outstanding loans granted under this facility were limited to €12 billion per country as it usually provided medium-term financial assistance, typically in cooperation with the IMF.

In 2004, the Committee of European Banking Supervisors (CEBS) was founded as an advisory group on banking supervision, consisting of senior representatives from the EU states' Central Banks and national supervisory authorities. The CEBS aimed to develop high quality and common supervisory standards as well as to assess the members' supervisory practices and their convergence. It provided consultation to supervisory authorities, mediated between them, and facilitated information exchange and delegation of tasks among these supervisory authorities. The CEBS also reviewed the practical results of suggested applications and monitor potential risks and vulnerabilities in the banking sector. The CEBS worked in cooperation with other agencies to assess cross-sectoral risks, such as Committee of European Securities Regulators, Committee of European Insurance and Occupational Pensions Supervisors and Basel Banking Supervision Committee.

Two years after the 2008 crisis, the EU states set up a temporary stabilization mechanism against the sovereign debt crises to preserve financial stability of the region. In 2010, two loan

programs²⁵ -The European Financial Stabilization Mechanism (EFSM) and The European Financial Stability Facility (EFSF)- started for this purpose. The EFSM allowed the EC to borrow up to €60 billion from the financial markets on behalf of the EU under an implicit EU budget guarantee. The EFSF has a total lending capacity of €440 billion and these loans are financed by the EFSF's bond and other debt instruments on capital markets and guaranteed by the EU states. The funds from both mechanisms have been used for Ireland, Portugal and Greece.

Also in 2010, the European System of Financial Supervision was introduced to ensure supervision of the EU financial system. The ESFS was comprised of; the European Securities and Market Authority (ESMA), the European Insurance and Occupational Pensions Authority (EIOPA), the European Banking Authority (EBA) and the European Systemic Risk Board (ESRB), which was established the same year. The ESRB has been responsible for monitoring and assessing systemic risks, mitigating exposure of the economic and financial system to the risk of failure of systemic institutions and enhancing the financial system's resilience to shocks. The ESRB also monitors compliance to its warnings and recommendations and implements recommendations from the IMF and the FSB (Financial Stability Board). In 2011, the European Banking Authority took over the tasks and responsibilities of the CEBS. It became the regulatory agency of the EU with a power to overrule national regulators if they don't regulate their banks properly. The EBA aims to remove the regulatory arbitrage throughout the EU by developing uniform requirements for banks and ensure fair competition in the sector. The EBA also performs stress tests on the European banks to identify their weaknesses, increase transparency in the financial system and provide protection to consumers, depositors and investors. Finally, it issues a common and standardized reporting framework, which was adopted by European countries.

²⁵ http://www.europarl.europa.eu/atyourservice/en/displayFtu.html?ftuId=FTU_4.2.3.html

Another major milestone in banking integration came in 2012, when the ECB was assigned supervisory tasks within the Single Supervisory Mechanism (SSM) to ensure that the large EU banks are supervised properly on regional basis and bailout of failed banks by public funds are prevented. The SSM constituted the one of the three pillars of banking integration with the Single Resolution Mechanism (SRM) and the European Stability Mechanism (ESM). Under the SSM, the ECB directly supervises 129 Significantly Important Financial Institutions (SIFIs), which hold more than 80% of total banking assets in the Eurozone. Banks are classified as SIFI²⁶ if; their assets exceed €30 billion or exceed €5 billion and 20% of the GDP of the member state of residence; they are among the top 3 banks in that member state; they have large cross border activity; and they received or applied for state assistance from Eurozone bailout funds (the ESM or EFSF).²⁷ Around 6000 smaller banks are monitored by national banking authorities in line with the ECB guidelines. The ECB is the final supervisory authority in supervision and can take over direct supervision of any bank regardless of size.

Also in 2012, the European Stability Mechanism (ESM) has been introduced as a permanent instrument for financial assistance to Euro Area Member States. With a total lending capacity of €500 billion, the ESM finances its loans by borrowing from financial markets, which are guaranteed by the Euro Area Member States. After the introduction of the ESM, the EFSM remained in place to address exceptional situations, along the ESM. The EFSF does not anymore provide financial assistance. The ESM is so far used for Spain, Cyprus and Greece.

With two additional regulations in 2013, the EC have been granted with the authority to subject any member State to enhanced surveillance if financial difficulties of the state carry the risk of regional contagion. Member state requesting financial assistance has to follow a

²⁶ SIFI's also include global European banking groups.

²⁷ Legislative package for banking supervision in the Eurozone – frequently asked questions". European Commission. 2013-09-12.

macroeconomic adjustment program in agreement with the EC, acting in liaison with the ECB and, when appropriate, the IMF. This ensures that the receivers of financial assistance will implement necessary economic, fiscal, structural and supervisory reforms on schedule as the loan assistance is disbursed in tranches conditional on improvement. Also in 2013, the European Parliament adopted two legal acts to transpose the BASEL III prudential capital requirements into the European Law.

In 2014, the Single Resolution Mechanism (SRM) was introduced as the second pillar of the EU banking integration. In the SRM, the Single Resolution Board (SRB) decides to initiate the resolution of a bank, and carry it out with cooperation of national resolution authorities. The SRB aims to manage potential bank failures without resorting to public funds in order to minimize the effects to taxpayers and real economy. Resolution of any bank is first financed by its shareholders, and then partly by its creditors (such as bond holders). If these funds are not enough, the SRB can administer the Single Resolution Fund (SRF) to cover the gap. The SRF will be funded by contributions from the banks and investment firms, which will be paid out over eight years. By 2017, total funds of the SRF was about €10 billion. By 2023, it is expected to reach to €55 billion, or 1% of covered deposits in the Euro Area.

In 2015, the EC Commission presented a legislative proposal to add the third pillar of the EU banking Union, namely the European Deposit Insurance Scheme (EDIS). The EDIS will be introduced gradually and built on existing national deposit guarantee schemes, which are not backed by a common European scheme. It will guarantee deposits of up to €100,000 in any Eurozone bank with funds from national schemes. The EC intends the EDIS to evolve into a fully mutualized co-insurance scheme over the next years.²⁸ However, the EDIS was not supported by Germany and the other Northern EU states, which may disproportionately pay for

²⁸ <http://www.reuters.com/article/eu-banks-deposits-guarantees-idUSL8N1D25O7>

the rescue of depositors in other countries. In this context, another alternative plan, envisaging mandatory lending among national deposit insurance schemes can replace the establishment of a single deposit guarantee fund.²⁹ If realized, the mandatory lending would be conditional on specific requirements.

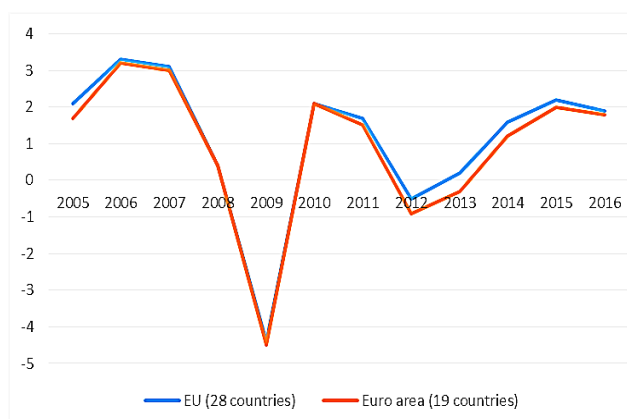
Progress of the Banking Sector Development and Integration

Since 2000, the EU financial and banking regionalization have been improving amid stronger integration measures especially in banking and money markets. From the introduction of common currency in 1999, the total bank assets of EU-27 expanded from 250% to 350% of the GDP till 2008 global crisis.³⁰ The crisis spread to the Europe through exposure to international banks and economic slowdown and was followed by sovereign debt crisis later on. As a result, the European economy fell into a double dip recession around 2009 and 2012, with negative GDP growth and substantial problems in banking sector. (Figure 14) The slowing economy also led to a deflation problem as the inflation rate dropped from around 3% in 2007 to 1.5% in 2009 and then saw negative values in 2014. (Figure 15) Financial integration has been negatively affected by the vulnerability of the EU economy and financial sector to crises.

²⁹ <http://uk.reuters.com/article/uk-eu-banks-regulations-idUKKCN0YI1DI>

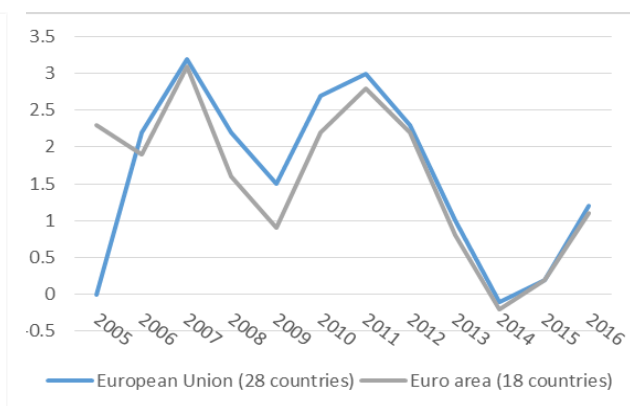
³⁰ “Bank performance in the US and Europe” Deutsche Bank Research, Sep 26 2013.

Figure-14 GDP Growth in the EU



Source: Eurostat Database.

Figure-15 Inflation in the EU



Source: Eurostat Database.

In the EU banking sector, the crisis led to weak loan growth, low profitability, stronger deleveraging and shrinking, especially in international and regional markets. The banks also needed to raise capital to comply with new capital requirements and cover their losses. Indeed, European financial institutions suffered from writedowns of more than \$0.5 trillion between 2007 and 2009.¹ These problems were aggravated by doubts on the survival of the EU monetary union and weak domestic governments, especially in the Southern Europe.

In late 2009, the European economy started to suffer from a sovereign debt crisis and a second recession around 2012-13. (Figure 6) The sovereign debt crisis started as these debts of some Eurozone members (Greece, Cyprus, Ireland and Portugal) and non-Eurozone members (such as Hungary and Romania) increased sharply due to bank bailouts, while rising debt and deficit levels created a crisis of confidence in the EU economic and financial system. According to the EC, member states pumped more than €1.6 trillion into their troubled banks between October 2008 and December 2012, which amounted to 13% of the regional GDP.²

¹ Bank performance in the US and Europe” Deutsche Bank Research, Sep 26 2013.

² <http://www.telegraph.co.uk/finance/economics/12076186/Europes-trillion-euro-bank-bail-outs-are-over.html>

In fact, recovery of the Europe from the crisis has been much slower than the US: Although both economies are comparable in terms of size, the EU financial sector is still bank dominated. Total bank assets in the EU is four times that of the US, while much more US firms raise capital from bond and securities markets rather than using bank loans. As a result, health and stability of the banks as well as their capacity provide credit to public and private sectors have reflected more intensely on the economic performance of the EU. Moreover, the interdependencies between banks and governments (such as banks' holding of government debt) amplified strongly till the second half of 2012, increasing the systemic risk in the Europe.³ Therefore creditworthiness of the Euro Area increasingly influenced overall financial market as troubled European banks and countries had their credit ratings downgraded.

To facilitate recovery, the European Finance Ministers approved creation of the European Financial Stability Facility (EFSF) in 2010 to address the European sovereign-debt crisis. As a special purpose vehicle, the EFSF can raise funds by issuing debt instruments (such as bonds), which are backed by guarantees of the Eurozone members. The funds can be used to provide loans to troubled Eurozone countries to help them recapitalize their banks or to buy their sovereign debt. The EFSF's €440 lending capacity may be supported with up to €60 billion of loans from the European Financial Stabilisation Mechanism and up to €250 billion from the IMF, all of which can create up to €750 billion of financial stability funds. In 2010, the €110 billion of Greek bailout was followed by a €85 billion rescue package for Ireland and a €78 billion bail-out for Portugal in 2011 by the combination of funds from the EU, WB and the IMF in return for austerity measures and banking sector reforms.⁴ Out of the EU, Hungary, Latvia and Romania

³ Adrian Alter and Andreas Beyer. "The Dynamics of Spillover Effects during the European Sovereign Debt Turmoil." The ECB Working Paper Series No 1558, June 2013

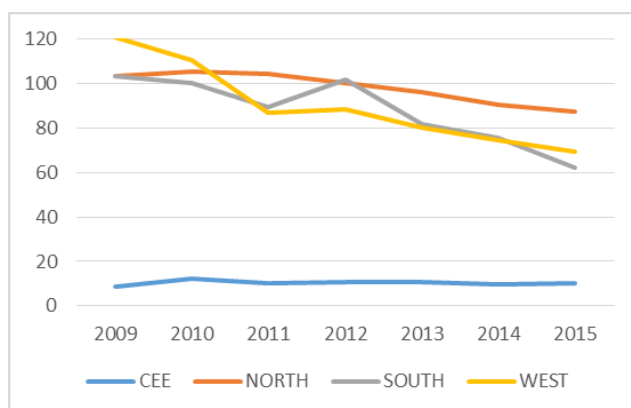
⁴ Zestos, George K. "The Global Financial Crisis: From US Subprime Mortgages to European Sovereign Debt". 2015

also benefited from smaller amounts of assistance (up to \$30 billion in total) from the World Bank, IMF or the EU's BOP facilities but these countries recovered faster than expected. Cyprus and Spain started to receive financial assistance in 2011 and 2012, while Italy had difficulties to recapitalize its failing banks since 2010 without receiving financial aid from the EU. The total cost of all the EU bailouts is estimated to reach close to €544 billion in 2018.

The double crisis also negatively affected international standing of the European banking sector: Before the start of the financial crisis, European banks accounted for nearly half of the 25 largest institutions worldwide.⁵ This share has fallen to currently only 17.5%. According to the IMF data, openness of the EU banking sector (Banks' foreign claims to GDP) decreased for all sub-regions except a slight rise in the CEE since 2009. (Figure 16) Not only international but also regional openness of the banks have been influenced from crises: The share of the EU banks' regional assets within their total assets went continuously down after 2008, remaining much below pre-crisis levels in 2014. (Figure 17)

⁵ "Bank performance in the US and Europe" Deutsche Bank Research, Sep 26 2013.

Figure-16 Openness of the EU banking sectors*



*Average for the sub-regions
Source: IMF IFS Database

The pathway of the regional financial and banking integration also resembles that of the economy since integration is also affected by crisis. Starting from the introduction of Euro in 1999, both price and quantity based financial integration indicators (including money, equity, bond and banking markets) of the ECB –FINTEC- steadily went up until the 2008 crisis.⁶ After a three-year decline, the increase resumed in 2013 but still below the pre-crisis levels.

The banking integration also shows similar trends (Figure 17); the assets of foreign branches and subsidiaries of Eurozone banks within Euro area (other than the home country) as a share of the total assets of the Eurozone banking sector sustained steady increases till 2008 crisis, along with convergence of interest rates for new loans between Group B (distressed) and Group A (non-distressed) countries till 2009.⁷ After the 2008 crisis, the share of regional foreign assets

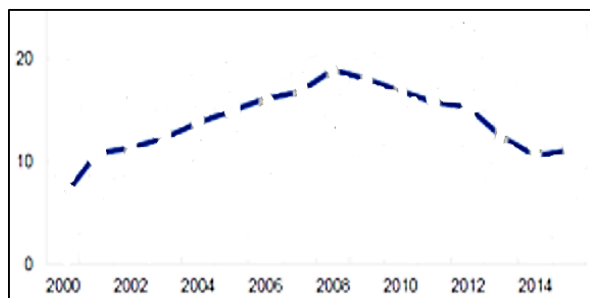
⁶ Financial Integration in Europe, the ECB, April 2016. The price-based FINTEC aggregates ten indicators covering the period from the first quarter of 1995 to the fourth quarter of 2014, and the quantity-based FINTEC aggregates five indicators available from the first quarter of 1999 to the third quarter of 2014. The FINTEC is bounded between zero (full fragmentation) and one (full integration).

⁷ Financial Integration in Europe, the ECB, April 2016

within total assets for Eurozone banks steadily decreased to levels about a decade ago, while interest rates decreased but diverged between distressed and non-distressed countries.

Figure-17 Euro Area Banking Sector Integration

Eurozone Banks - Share of regional foreign assets within total assets*



*Median values

Source: Financial Integration in Europe, the ECB, April 2016

It should be noted that the EU's institutional mechanisms have been supporting the recovery of its economy, financial sector as well as its financial integration by strengthening regulations and supervision and by introducing measures towards the banking union and sustainable economic policies. In 2009, the ECB started the Covered Bond Purchase Program (CBPP), under which it purchased covered bonds, both in primary and secondary markets, to provide liquidity to the financial sector. In 2010, the EFSF was set up to provide loans to states to bailout their banks and to support their budgets, while fiscal measures to cut spending and increase tax revenues have been applied across the troubled European countries in the coming years.⁸ Also in 2010, the European Central Bank (SCB) started the Securities Market Program (SMP) to address liquidity shortages in the interbank market and its negative impact on the

⁸ These fiscal measures were not applied only by countries under bailout programs but also by developed EU members such Belgium and France.

transmission of monetary policy. Under the SMP, the ECB purchased government bonds of depressed countries in the secondary markets in order to alleviate sovereign debt risk in banks' balance sheets and provide liquidity for them. In 2012, the SMP was discontinued and replaced by the Outright Monetary Transactions Program (OMT), under which the ECB could buy bonds, which matured between 1 and 3 years and were issued by governments already received financial support from ESM/EFSF. Although never used, the existence of the program contributed to more fairly priced interest rates for bonds of states under EFSF/ESM.⁹ In 2011, the ECB started Long Term Refinancing Operation (LTRO), a cheap loan program for the European banks. LTRO-1 was carried out in December 2011, as banks received €489 billion of loans from the ECB at 1% to be repaid in three years, while the loans were backed up by collateral from the banks' own national central bank. In early 2012, LTRO-2 was introduced to provide the banks with liquidity, avoid credit crunch and restore stability of the banking system. The main beneficiaries of the program were banks from Italy, Spain, France, Greece and Ireland.

To stimulate economic growth, which also fell into negative territory, the ECB cut its rate for main refinancing operations (fixed rate) from 2% in 2009 to 0.05% in 2015, and rate for deposit facility from 1% to -0.40%¹⁰. To address the deflation, the ECB announced a new expanded asset purchase program (Quantitative Easing or QE), in which €60 billion of Eurozone bonds from central governments, agencies and European institutions would be bought per month. The stimulus was worth at least €1.1 trillion from March 2016 to September 2016. On March 2016, the ECB increased its monthly bond purchases to €80 billion and started to include corporate bonds under the asset purchasing program and announced new cheap four-year loans to banks.

⁹ "Outright Monetary Transactions, one year on" Speech by Benoît Cœuré, ECB. Sep, 2 2013.

¹⁰ http://www.ecb.europa.eu/stats/policy_and_exchange_rates/key_ecb_interest_rates/html/index.en.html

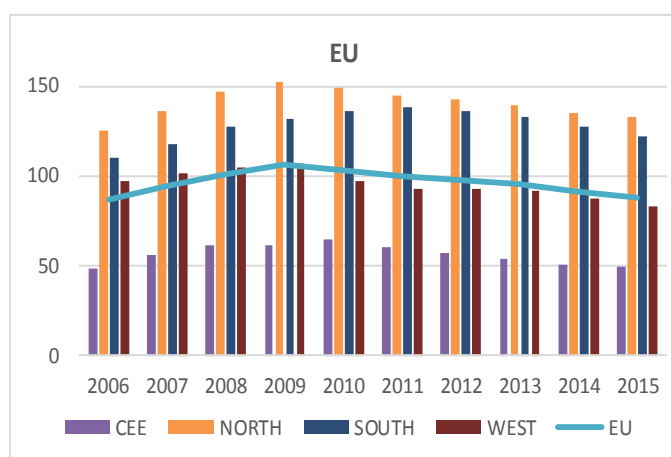
Looking forward, many experts expect the financial integration to continue in coming years due to two main factors: First, the ECB's actions to restore stability in monetary and banking system as well as the economic programs for fiscal stability have supported the overall European economy and addressed banking sector problems. The ECB's programs mentioned above have been instrumental to provide liquidity to most failing banks and mitigate the effects of their toxic assets, whereas economic recovery is expected to enhance the operating environment of the banks in medium to long term. Secondly, despite the double crisis, the institutional and regulatory steps for effective implementation of the banking union have continued. The regulatory and supervisory improvements were influential to restore confidence in the banking system as they defined new asset and capital structures for the banks to minimize possibility of default and enabled resolution of banks without relying on public funds. From now on, banks would need to adjust their business models to these new regulations to be competitive internationally. Introducing critical institutions such as Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM), the European Stability Mechanism (ESM) as well as applications such as unified banking standards (under Basel), supervision of SIFI's by the ECB and periodical stress testing of banks have paved the way for continuing banking integration, even during the crisis years.

Issues and improvements in the EU Banking Integration

One of the main issues in the EU banking integration is the developmental differences of banking sector within the Europe itself. However, these differences are less than the ASEAN countries. Total assets and depth of banking sector (bank Credits to GDP) differ among the four

sub-regions of the EU, which becomes more pronounced when outliers such as Cyprus and Spain are taken out. The lending activity is most developed in the North region and least in the CEE. After the 2008 crisis, the bank subsidiaries from the developed EU countries started to reduce lending in developing Europe, due to economic slowdown, increasing non-performing loans (NPL) and higher risks in either home or host countries. The problem of non-performing loans have been especially aggravated in the South, where the NPLs peaked especially in Greece (36%), Cyprus (48%), Italy (18%) and Portugal (12%), far above the European average of 6%.

Figure 18- Depth of the EU banking markets: Bank Credits to GDP

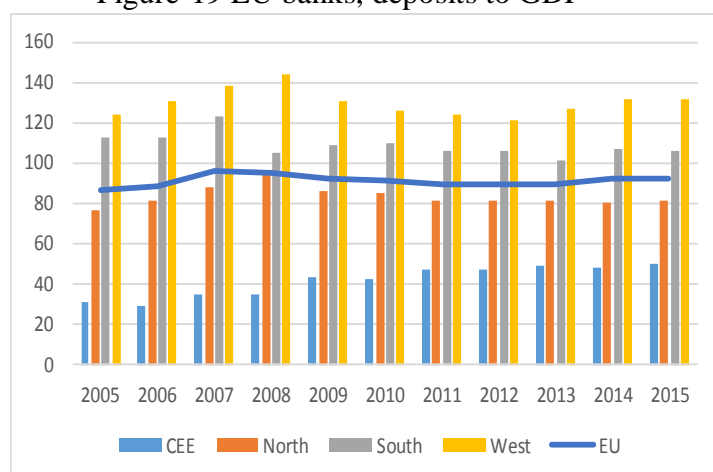


Source: IMF IFS Database

Deposits in the EU banks remained more stable compared to lending, with discrepancies between the sub-regions. Deposits to GDP have been lowest for the CEE countries and highest for

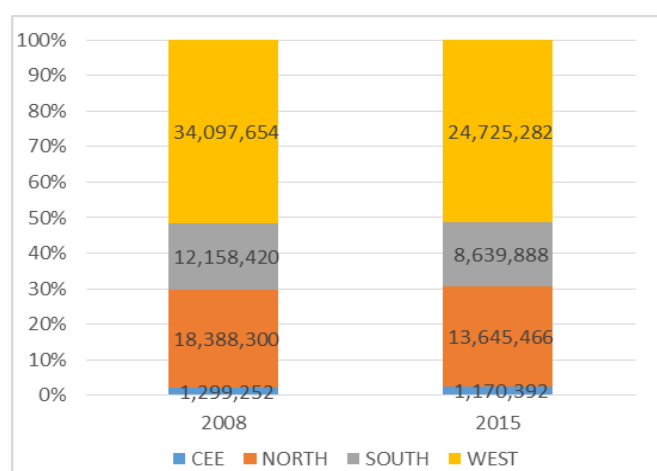
the North. Low lending and deposits in the CEE can be explained by unfulfilled potential of these countries as well as under-development of their banking industry with dominance of Northern and Western European banks. These banks are highly responsive to crises and decrease their activities in host countries before home, despite equal treatment of regional banks.

Figure-19 EU banks, deposits to GDP



Source: IMF IFS Database

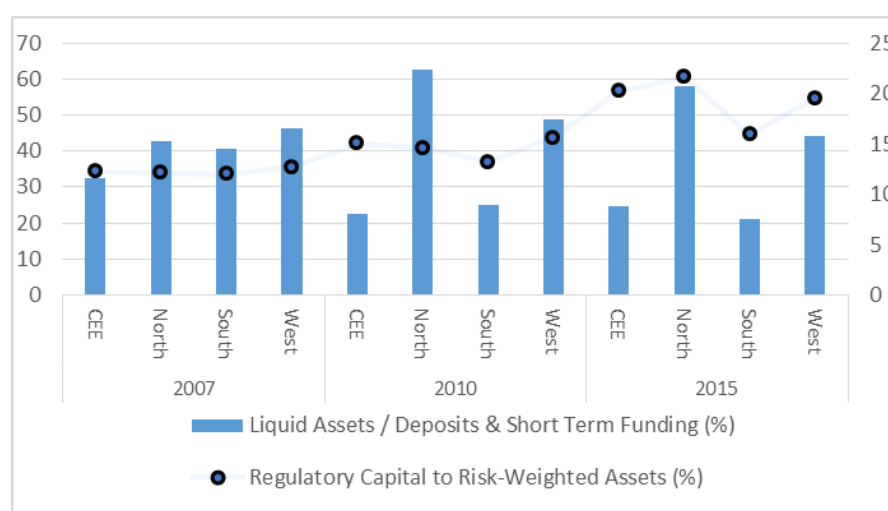
Figure-20 Distribution of bank assets among the EU sub-regions



Source: IMF IFS Database

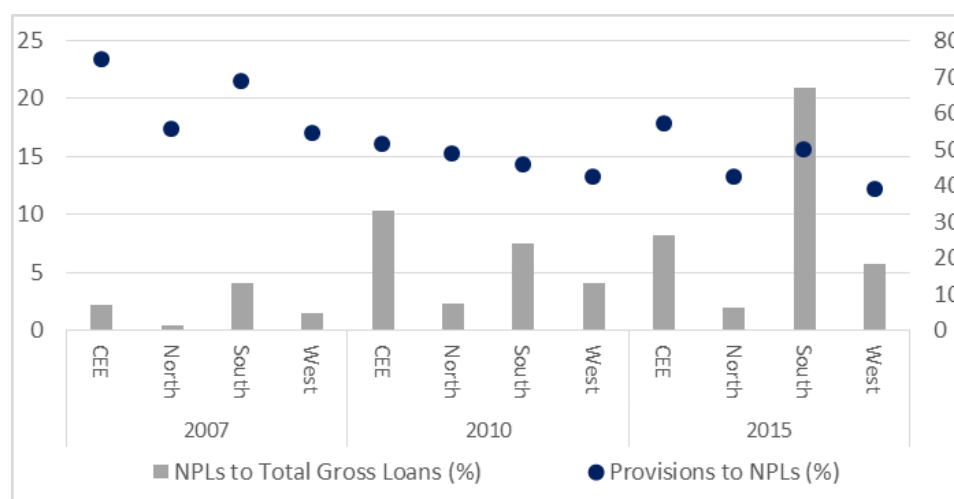
Banks in the Southern countries were caught up in 2008 crisis with lower capital and liquidity, which made them highly vulnerable to their governments' sovereign crises. (Figures 21 and 22) The discrepancy in terms of capital adequacy, liquidity, non-performing loans, and provision for these bad loans between the underdeveloped South & CEE and developed West & North regions worsened after the 2008 crisis as the same discrepancy peaked in 2015. With economic slowdown, increasing unpaid loans, high amount of purchased government debt (bonds) in portfolios fastened the fall of the banks especially in Greece, Cyprus, Italy and Portugal, while Spanish markets are under pressure of high holdings of real estate loans and a shrinking real estate market. The regional mechanisms to bail out problematic banks stipulated macroeconomic austerity programs for these countries as well as the use of banks' shareholders' and bondholders' assets to cover the capital shortfalls, which have been identified in the stress tests.

Figure-21 Liquidity (left axis) and Capital Adequacy (right axis) in the EU sub-regions



Source: IMF Finstats Database, 2017

Figure-22 Non-performing loans (left axis) and provisions for NPLs (right axis) in the EU sub-regions



Source: IMF Finstats Database, 2017

Another challenge for banking union after the crisis is the fact that low growth, subdued profitability and regulatory changes undermine the sustainability of banks' business models: Income and profitability of the EU banks are still far from rising trend, profitability concerns kept risk premium on the EU relatively high and low interest environment pressurize bank net interest margins. Supervisors need to evaluate sustainability in business models in terms of profitability and funding models, management strategy, business mix and relationships between banks and customers since bad business practices has very negative effects on confidence to banking sector.¹ Bank business models have to be adjusted for new capital and liquidity requirements and better risk management to improve confidence to sector, reduce the link to sovereigns and move along with cross border integration objectives. Confidence is slowly returning into EU banking system with implementation of measures to resolve banking problems; but weaknesses in economy and monetary dynamics and well as in global markets still impede the reversal of market sentiments.

¹ Risk Assessment of the European Banking System. EDB, December 2013.

For the sustained banking sector integration, the issues with the dominance of the EU banks from developed Europe within the emerging European banking markets should be addressed, especially in terms of credit provision. Emerging countries are highly vulnerable to deterioration of bank lending standards during boom years, while high private sector debts especially in foreign currency created liquidity risks. Although foreign bank subsidiaries can also have stabilizing effects on credit supply, the problems of recent crisis originating from international inter-bank markets, combination of high loan to deposit ratios and ongoing funding needs from parent banks or other banks caused shrinking credit supply from domestic and foreign banks, the only exceptions being the banks participating to Vienna Initiative.²

The banking sector integration also remained partial; The Eurozone interbank markets rapidly integrated by the introduction of Euro but retail banking remained highly fragmented as the financial crises undid the integration in interbank market. Before the crisis, wholesale banking became highly integrated through debt based wholesale banking, which created vulnerabilities due to high exposure to risk in the absence of a European system for financial stability. Dysfunctional wholesale banking market and absence of cross border retail banking caused differences in price and availability of credit especially for non-financial firms, significant variety of interest rates across countries and differences in quantity restrictions and likelihood of getting credit.³ This fragmentation disadvantaged the firms in distressed countries and affected economic growth potentials. As a reaction, ECB directed liquidity to crisis countries along with bank support programs, however fragmentation and divergence of rates still continued.

The launch of a European Deposit Insurance Scheme (EDIS) should continue as it can contribute to lower cross-country dispersion and promote depositor confidence independently of the location of a bank and will thus bring more competition in the European retail banking

² Lehmann, Alexander, Micol Levi and Peter Tabak; Basel III and regional financial integration in emerging Europe EBRD, 2011.

³ Note presented at the informal ECOFIN 14 September 2013. "The neglected side of banking union: reshaping Europe's financial system" André Sapir, Guntram B. Wolff.

market. EDIS contains a number of measures aiming to further reduce risks in the banking sector and it would be an effective tool to promote a uniform level of depositor confidence and to protect against adverse consequences of individual bank failures. The credibility of a national deposit guarantee schemes (DGS) is highly influenced by the fiscal strength of the respective sovereign, while uneven levels of confidence in national DGSs play a relevant role in driving deposit inflows and outflows, which are highly related to stability of the banking sector.

In summary, banking sector performs crucial functions for trade such as providing capital, financing and trade credits for firms as well as financing for large infrastructure process, which supports trade activity. Expansion of these functions through regional integration can support intra-regional trade. Dominance of banking sectors both in the EU and ASEAN makes role of banks in trade even more important due to relatively lower use of non-bank institutions and capital markets. However, the EU banking sector is more integrated than the ASEAN, which still needs to build capability for regional expansion of its banks. Next chapter will focus on development and integration of stock and bond markets and their possible contribution to EU and ASEAN trade.

CHAPTER VII

CAPITAL MARKETS DEVELOPMENT AND INTEGRATION IN THE EU AND ASEAN

After reviewing banking sector, this chapter will analyze how capital markets relate to economic and financial development and international trade. Capital markets provide capital to firms and enable risk diversification in investments. Regional integration of capital markets promotes lower cost of capital across borders and diversify investment opportunities, which closely relate to intra-regional trade. Capital markets also offer firms an alternative to bank lending, which reduce their lending activity during times of economic distress. Finally, capital markets have an increasing role to finance infrastructure investments such as roads, energy, etc., closely affecting international trade.

Regionalization of capital markets can be reviewed in two dimensions: First, analysis of financial infrastructure integration is necessary for remote connectivity across markets. The second dimension is capital market development and integration and how they relate to the larger economy and real sector firms. The chapter will end with evaluation of the EU and the ASEAN capital markets and integration efforts.

FINANCIAL INFRASTRUCTURE AND REGIONAL CONNECTIVITY

Financial infrastructure is the foundation for the financial system and regional financial integration. It includes a technological framework and related institutions and regulations. Functions of financial infrastructure enable operation of financial intermediaries such as banks, other depository and financial corporations as well as institutions in securities markets. Financial infrastructure mainly includes payment systems (PS), security settlement systems

(SSS) and trade repository systems (TR) as well as credit bureaus, collateral registries and other financial systems. Financial infrastructure can be owned or operated by central banks or the private sector and be organized in different institutional forms such as profit or non-profit.

Payment systems include large value payment systems, retail payment systems and foreign exchange settlement systems. Under-developed payment systems can result in the inefficient distribution of financial resources, inadequate risk distribution among participants and loss of confidence in financial system and economic instability. The most technically efficient system for large value payments is Real Time Gross Settlement Systems (RTGS) in which settlement (completion of transaction) is done on a continuous basis without a waiting period. Retail payment systems focus on smaller fund transfers, including use of credit and debit cards. Important elements of payment systems include clearing (exchange of payment information among payment service providers and confirmation on the availability of funds/credit lines) and settlement (completion of transaction and discharging obligations with respect to fund transfers between two or more parties). In 2007, emerging markets payments infrastructure supported flows of more than \$64 trillion annually—nearly six times combined GDP in these markets.¹ In the EU, an average 100 or more cashless transactions per person/per year were performed, compared to thirteen for EAP (East Asia and Pacific), while the most restrictions on FX transactions exist in the EAP and the least in the EU and developed countries.² In addition, half of the countries in South and East Asia and Pacific also report one foreign currency (USD) accounting for more than 90% of total FX transactions.³

Securities settlement systems enable transfer and settlement of securities by predetermined multilateral rules and deliver their ownership upon payment. Specific systems are used to settle products in the equity markets, bond markets, currency markets, futures markets, derivatives markets, options markets and to transfer funds between financial institutions. Security Settlement Systems generally include central securities depositories (CSD)

¹ Financial Infrastructure- Building Access Through Transparent and Stable Financial Systems 2009 WB.

² Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

³ Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

and central counterparties (CCP). These systems are becoming more complex with the changing behavior of financial markets, and operational conditions and they reflect extend of capital market development. CCPs place themselves between counterparties (buyers and sellers) as a guarantor of open contracts by typically requiring collateral from participants to cover potential exposures and reduce systemic risks against the default of either party. CSDs provide securities accounts, safekeeping facilities and administrative asset services and keep securities either in immobilized (physical) forms or dematerialized (electronic record) forms. They conduct the securities settlement, transfer the securities from the seller to the buyer by debiting and crediting their respective electronic accounts.

Systemic Effects of Financial Infrastructure

Financial infrastructure is positively correlated to deeper financial markets; modern infrastructure for payments and security settlements mobilize savings and investments better and promote confidence in financial and economic system. It also enables flow of liquidity among banks and financial institutions, affecting monetary policy. Timely delivery of payments and collateral, safety of clearing and settlement, and the protection of client assets against insolvency and bankruptcy of custodians promote confidence in markets.

Financial infrastructure is subject to significant economies of scale; reduction of unit transaction costs can promote expansion of financial services both nationally and regionally.⁴ The World Bank estimates indicate that efficient financial infrastructure can potentially reduce transaction costs by nearly 80% (compared to highest cost margins) for credit evaluations, collateralizing loans, payments and remittances.⁵ It is also estimated that payment system reforms between 1987 and 1999 reduced global bank operating costs by 24 percent.⁶

⁴ Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

⁵ Financial Infrastructure- Building Access Through Transparent and Stable Financial Systems 2009 WB.

⁶ Humphrey, David, Magnus Willeson, Ted Lindblom, Goran Bergendahl; What does it cost to make a payment? Review of Network Economics, Vol 2 Issue 2, June 2003.

Positive effects of financial infrastructure is maximized when financial markets have adequate scale and scope, competitive structure, and legal and institutional framework.⁷ Institutional and regulatory frameworks should provide incentives for safe and efficient operation of the financial system, strong protection of participant and investor assets and open access to markets. However, excessive competition in the market should not lead to reduction in risk standards (race to the bottom) or distortions in financial system.⁸

Interdependency between payments and securities settlement systems increase over time as well as their links with monetary policy and financial stability.⁹ Payment and settlement systems affect the monetary system and liquidity through links to central bank, interbank markets and the flow of funds to the financial sector and real economy. Sound payment and settlement systems promote financial stability by reducing credit, operational and liquidity risks and promote better risk management. Likewise, Security Settlement Systems are linked to the clearing of securities and cash.¹⁰ The SSS affect monetary policy and liquidity of securities markets since government securities are used to conduct monetary policy operations.¹¹

Risks of Financial Infrastructure

The operation of the financial infrastructure requires high legal certainty, procedures and contracts, enforceable across jurisdictions. To reduce systemic risks, compatibility (or inter-operability) of technological systems, legal harmonization and cooperation in risk management and operational issues are especially important. The following risks are typical in financial infrastructure:

⁷ CPSS-IOSCO report Principles for financial market infrastructures (PFMI), April 2012 and CPSS-IOSCO – Disclosure framework and assessment methodology, December 2012

⁸ CPSS-IOSCO – Disclosure framework and assessment methodology December 2012

⁹ Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

¹⁰ David F. Muñoz, Arturo Palacios b, Miguel de Lascurainb “Modeling, simulation and analysis of a securities settlement system: The case of Central Securities Depository of Mexico.” *Journal of Economics, Finance and Administrative Science* 17(33), 2012, 48-59.

¹¹ Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

- Legal risk stems from different application of regulations across jurisdictions, leading to freeze, loss or delayed recovery of financial assets and payments.
- Credit risk comes from the inability of counterparties to meet fully their financial obligations on time due to failure of custodians, settlement banks, and other linked parties and financial institutions.
- Liquidity risk arises when a counterparty does not have currently sufficient funds to meet obligations but may have in the future. Payments not received can lead to excessive borrowing or untimely liquidation of transaction collaterals and create systemic risks especially in closed or illiquid markets with volatile asset prices.
- Custody and investment risk relate to loss of assets under custody, the custodian's insolvency, poor administration or fraudulent removal of assets. Investment risks come when financial infrastructure institutions invest participants' collateral in markets.
- Operational risk includes deficiencies in internal processes or IT systems or disruptions due to external events, human errors, or management failures.
- General business risks relate to administration and operation of financial infrastructure such as low profitability, poor management, adverse reputation, and inadequate risk management.
- Systemic risk comes from transfer of all these adverse effects and resulting illiquidity across participants and jurisdictions.

In terms of payments and security settlement system functionality and oversight, central banks and securities regulators are the most relevant authorities. Recent trends indicate that oversight of these systems shifted from narrow goals (efficiency and safety) to broader targets (promotion of competition, consumer protection, etc.). Other key priorities in oversight include adaptation of CCPs into international standards and strengthening organized markets and central bank facilities for liquidity provision.¹² More improved legal framework for

¹² "Payments and Infrastructure", CGAP web site <http://cgap.org/topics/payments-and-infrastructure>)

payment and security settlement systems should also include civil and commercial codes, consumer protection laws and competition laws. In terms of oversight for all payment and security settlement systems, the EU has applied broader perspective but security and FX settlement still need to improve in East Asia and Pacific along with other regions.¹³

Financial Infrastructure and Regionalization

Regional integration can improve both economies of scale and scope in financial infrastructure through expansion of markets. Depending on industry and market structure, financial institutions can also operate multiple payment and settlement systems, which improves economies of scope.¹⁴ Design of financial infrastructure under a regionalization framework should achieve (i) inter-operability and compatibility of financial infrastructure across the region and within the national borders; (ii) common or harmonized legal, regulatory and supervisory standards to improve safety and efficiency of financial systems; (iii) regional coordination in oversight and information sharing to minimize systemic risks as well as strategies for potential recovery or resolution; (iv) a multi-paced approach according to resources and developmental level of members and support for less developed regional states for financial infrastructure projects;¹⁵ and (v) market-specific requirements related to customer preferences and type of financial products.¹⁶

A regional framework should address extensive linkages among banking sector, capital markets and financial infrastructure systems. Banks are highly involved with payment systems and exposed to capital markets through their asset holdings for investment purposes and their issuance of capital market instruments such as shares and bonds. The functional and regulatory links of banks with financial systems and markets create systemic risks and contagion risk

¹³ Payment Systems Worldwide: A Snapshot. Outcomes of Global PS Survey 2010, WB

¹⁴ Financial Infrastructure- Building Access Through Transparent and Stable Financial Systems 2009 WB.

¹⁵ The road to ASEAN financial integration, ADB 2013

¹⁶ CPSS-IOSCO – Disclosure framework and assessment methodology December 2012

across sectors and countries. Currently, the Basel Committee on Banking Supervision (BCBS) and International Organization of Securities Commissions (IOSCO) work together to oversee risky bank exposures in equity portfolios, commodity markets and products with option-like characteristics. Moreover, the Committee on Payment and Settlement Systems (CPSS) and IOSCO have agreement on “Core Principles for Systematically Important Payment Systems,” CPSS-IOSCO recommendations for Securities Settlement Systems, which provide basis for international best standards.

Brief Review of Financial Infrastructure in The EU

The integration of payment systems in the EU started with the Payment Services Directive (PSD) in 2007¹⁷, which aimed to regulate payment services and providers throughout the EU, increase competition in the payments industry, and facilitate participation of non-bank institutions. The directive also envisaged harmonization of consumer protection as well as the rights and obligations for payment providers and users. In 2008, it became operational and transposed into national laws by the next year. The PSD was amended in 2015 to enhance consumer protection, promote innovation and improve security of payment services. In the EU, large banks dominate and control access to payment systems.¹⁸ Therefore, some national central banks started to develop platforms for smaller banks to access domestic payment systems, while some countries made specific arrangements with commercial banks to access to national payment systems.¹⁹

The integrated EU system for large value payments was founded in 1999 with the start of the monetary union. The “Trans-European Automated Real-time Gross settlement Express Transfer” (TARGET) system was set up to process both interbank and customer payments in the euro between and within the member countries. The system facilitated the conduct of the

¹⁷ European Commission Directive 2007/64/EC

¹⁸ “Payments and Infrastructure”, CGAP web site <http://cgap.org/topics/payments-and-infrastructure>)

¹⁹ “Payments and Infrastructure”, CGAP web site <http://cgap.org/topics/payments-and-infrastructure>)

single monetary policy and the creation of a unified money market in the Eurozone.²⁰ TARGET2 started to replace TARGET in 2007, which is also an interbank RTGS payment system for the clearing of cross-border transfers in the Eurozone. It supports the European monetary policy and the functioning of the euro money market. TARGET2 is mandatory within the Eurosystem (The ECB and Eurozone national central banks) for the settlement of any euro operations. TARGET2 is also available to non-Eurozone members to facilitate settlement in euro transactions.

In 2008, the Single Euro Payments Area (SEPA) became operational to integrate Euro dominated retail payments across the region. SEPA aimed to enable cashless euro payments from a single bank account or payment instrument to any party located in the EU. Since then, SEPA introduced common instruments, practices and standards, and inter-operability of retail payment infrastructures. In 2011, SEPA payments replaced national payments in the Eurozone. In 2013, the ECB announced the launch of the Euro Retail Payments Board (ERPB) to replace the SEPA Council, to foster development of an integrated, innovative and competitive market for retail payments in euro in the EU. The SEPA has been recently extended to payment service users and providers in non-Eurozone members for euro transactions.²¹

TARGET to Securities (T2S) by Eurosystem aims to provide a single European platform to settle securities both in Euro and other currencies. The system harmonized services and prices of all participating CSD's and removed barriers to cross-border clearing and settlement with harmonization of common processes in these post-trade services. By 2018, 23 European CSDs, covering 21 EU markets are expected to have connected to the T2S platform, for both securities and euro cash settlement. In capital markets, T2S will improve economies of scale and liquidity and reduce settlement risks as it will use central bank money. T2S initiatives are led by the European Commission, the European Securities and Markets Authority (ESMA), and the Association for Financial Markets in Europe (AFME) and

²⁰ <https://www.ecb.europa.eu/pub/pdf/other/target2005en.pdf?3201cff4f28bcfbdf32f3c1904c874c>

²¹ <https://www.ecb.europa.eu/pub/pdf/other/financialintegrationineurope201604.en.pdf>

complements other measures and regulations that are designed to remove the national, legal and regulatory barriers for the integration of the EU post-trade industry. Among such measures, the Central Securities Depository Regulation (CSDR) entered into force in 2015 and established a common regulatory and supervisory framework for the CSD's in the EU. Its update, level II CSDR was completed in 2016, to improve cross border CSD services. The European Commission is developing legislations to improve recovery and resolution of Central Counterparties (CCP) as well as other financial infrastructure.

The Exchanges and other trading platforms are the most visible part of Europe's market infrastructure even though some securities (such as bonds) are traded in over-the-counter (OTC) markets. Almost all EU capital markets use an electronic platform, so the number of intermediaries operating across borders increased after the monetary union, while several central counterparty clearing houses already plan mergers and alliances to realize economies of scale and network externalities. Most regulated retail markets are multi-product ones, in the sense that bonds, equities and other securities are listed on the same market. For the (OTC) markets, the European Market Infrastructure Regulation, or EMIR entered into force in 2013 and defined regulatory technical standards for over-the-counter (OTC) derivatives, central counterparties and trade repositories. In 2015, the European Commission reviewed the EMIR framework and ESMA announced new standards on clearing obligations of certain OTC derivatives.

Today, The European Securities and Market Authority (ESMA) lists 104 regulated markets, 153 multilateral trading facilities, 16 authorized counterparties, six trade repositories and 30 CSDs in the EU. Despite new systems, cross border trade is more expensive than domestic trade since the cost of the latter fell more than the former. Using brokers or custodians—located other than the place securities are issued—is more expensive, while trade costs are even higher in smaller markets. Listings tend to shift to more developed larger

markets due to economies of scale, lower costs and stronger supporting institutional and regulatory frameworks.

Financial infrastructure is still fragmented across the EU markets. The inefficiencies in the clearing and settlement systems are the most important barriers to financial infrastructure integration. The EU states have to address divergent technical requirements, market practices, national tax procedures and other regulations. The European market infrastructure is also not well adapted to collateral management and transfer across borders, while considerable legal and operational problems remain. Much government bond trading and most corporate bond trading takes place on a bilateral basis, rather than on multilateral electronic platforms, but automated trading is becoming more widespread. The European Commission is called to accelerate its proposal on the Securities Law Directive, perform a cost-benefit analysis on the effectiveness of the adopted legislation since the 2008 and make an impact assessment of all the EU financial market legislation.²²

Brief Review of Financial Infrastructure in the ASEAN

Financial Infrastructure development varies widely across the ASEAN; some countries have modern FI systems while others lack even domestic payment or settlement systems, which are required to establish regional cross-border links.²³ Therefore, regional payment and settlement systems does not exist in the ASEAN as they do in the EU. However, the ASEAN countries accepted that development of financial infrastructure is critical to support integration objectives in the banking sector and capital markets as well as in larger financial and trade sectors.

In 2008, ASEAN approved the AEC Blueprint of 2015, which aimed to promote development and liberalization of national financial infrastructure and improve safety of

²² <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:52013IP0276&from=EN>

²³ Asian Economic Integration Report 2016, Asian Development Bank

electronic transactions, payments and settlement systems by 2015. However, a report by Asian Development Bank (2013) stated that developing ASEAN countries lack sufficient resources to build their infrastructure and the supporting regulatory systems. These countries need developmental assistance, which could come from more developed members such as Indonesia, Malaysia, Singapore, and Thailand, or ASEAN +3 countries such as China, Japan and S. Korea as well as international organizations such as the Asian Development Bank (ADB) and the World Bank. Moreover, ASEAN ranks lower than other neighboring regions (South and Central Asia) in consumer protection and related legal and institutional framework and dispute resolution mechanisms.²⁴ On liberalization, the AEC Blueprint (2015) envisaged liberalization of all payment services in banking systems of Cambodia, Laos and Vietnam and of asset management services in Indonesia, Philippines, Singapore and Thailand as well as of security issuances in Indonesia and Philippines by 2015.²⁵

In payment and settlement systems, the initial efforts focused on improving the legal, regulatory and institutional framework and infrastructure base. After members' payments and settlement systems are developed enough, ASEAN countries can regionally link these systems. In this context, five enhancement areas were identified in 2013:²⁶ (i) cross-border trade settlement, where the banking system could meet demand adequately but efficiency had to be improved by reducing the FX spreads and bank charges; (ii) cross-border money remittance, where non-standardized and informal channels still exist; (iii) cross-border retail payment systems, where some countries still have fragmented and non-interoperable payment systems while inefficiency and opaque pricing make these services costly; (iv) cross-border capital market settlement, which were hindered by different national market regulations and practices and require introduction of international standards and risk mitigating measures; and (v) standardization, since various national standards make payment systems interoperable and

²⁴ <https://www.adb.org/sites/default/files/publication/30202/road-asean-financial-integration.pdf>

²⁵ ASEAN Economic Community Blueprint, 2015.

²⁶ <https://www.adb.org/sites/default/files/publication/30202/road-asean-financial-integration.pdf>

regional linkage more costly. Central banks need to promote standardization to enable interoperability and cross border linkage.

In 2010, the ASEAN Governors endorsed the establishment of the Working Committee on Payment and Settlement Systems (WC-PSS) to foster an integrated, safe and efficient payments system for cross-border transactions. ASEAN targets to improve and harmonize the PSS firstly in ASEAN-5 in five key areas; trade settlement, remittances, retail payments, capital markets and standardization. In 2015, the WC-PSS adopted the Principles for Product Transparency and Disclosure on Cross-Border Trade Settlement to improve transparency on charges and services by ASEAN institutions for cross-border settlement. Malaysia, the Philippines, Singapore, and Thailand implemented the principles. After 2015, the WC-PSS aims to facilitate regional linkages in retail payment, large-value payment and settlement systems and to establish co-operative oversight national regulators.

CAPITAL MARKETS DEVELOPMENT AND INTEGRATION

Capital Markets and Economic Development

According to the literature, capital markets development relates to economic growth through multiple channels. Development of domestic equity and bond markets affects financial and economic development positively.²⁷ Market-based financial systems can promote economic growth better than bank-based systems after early stages of financial and institutional development.²⁸ Through the productivity channel, capital markets can influence

²⁷ Yartey, Charles Amo. “The Determinants of Stock Market Development in Emerging Economies: Is South Africa Different?” IMF Working Paper WP/08/32, February 2008 and Mohtadi, Hamid and Sumitr Agarwal. “Stock Market Development and Economic Growth: Evidence from Developing Countries” and Schmukler, Sergio et al “Developments in Capital Markets”, Chapter 2 in “Emerging Capital Markets and Globalization” and Adelegan, Janet O. and Bozena Radzewicz-Bak. “What Determines Bond Market development in Sub-Saharan Africa?” IMF Working Paper Wp/09/213, September 2009.

²⁸ (Beck & Levine 2002, Kpodar and Singh)

unemployment and wage levels, at least in developed countries.²⁹ In addition, developed capital markets allocate capital more efficiently and increase productivity and economic growth.³⁸ Research on 65 countries indicated that developed financial markets allocate capital better, increase investments in growing industries and decrease them in declining industries.³⁰ Large capital markets and protection of minority rights are also positively related to capital allocation.³¹ Moreover, capital markets facilitate trade, business and investments by mobilizing savings and providing long-term capital to productive firms, while ownership of productive investments and technology became diffused.³² Capital markets provide better risk diversification by diversifying investment opportunities and supporting development of alternative markets such as derivatives or structured finance. Therefore, they help absorb economic shocks from fluctuations in foreign capital flows. Finally, governments utilize capital markets to privatize state enterprises, issue debt for fiscal management, and finance long term infrastructure projects.

Economic development level also affects capital markets. Countries with greater income levels, growth opportunities and financial openness tend to have more active capital markets, while higher inflation and government deficits have opposite effects.³³ Larger economies can support larger financial systems and capital markets better. Higher economic activity promotes expansion of demand and supply side in capital markets, leading to cheaper provision of financial products and lower cost of capital for the issuers. Moreover, use of certain currencies in capital markets can also prompt more of their future use.³⁴ This way, path dependency in capital markets can be formed when firms prefer to list where others list and financial intermediaries want to trade where markets are deeper and broader. Additionally, capital market development also relates to international factors such as global economic

²⁹ Benjamin Taghavi-Awal and Johan Fredholm. "Capital markets in developing countries." School of Business, Stockholm University

³⁰ Journal of Financial Economics 58 (2000) 187-214 Financial markets and the allocation of capital." Jeffrey Wurgler

³¹ Journal of Financial Economics 58 (2000) 187-214 Financial markets and the allocation of capital." Jeffrey Wurgler

³² The Role Of Banks, Equity Markets and Institutional Investors In Long-Term Financing For Growth and Development, February 2013 OECD

³³ Schmukler, Sergio et al "Developments in Capital Markets", Chapter 2 in "Emerging Capital Markets and Globalization"

³⁴ M. Ayhan Kose, Eswar S. Prasad and Ashley D. Taylor. "Thresholds In The Process Of International Financial Integration". National Bureau of Economic Research, Working Paper 14916, April 2009.

conditions and correlation between local and international markets. Global conditions change investors' risk perception, expected returns and investment strategies. Global economic and financial instability can lead to volatility of international investments, shorter-term investment strategies, along with herd behavior, momentum trade or even fire sale of assets.

Developing Capital Markets

Institutional and regulatory system plays crucial role in development of capital markets.³⁵ Development of financial markets should be supported by macroprudential supervision and cooperation of national regulators to improve systemic risk management, investor protection, resolution of cross border investments and corporate governance. The strength of institutions and securities regulations have positive relationship with securities market development while their weaknesses reduce trust in capital markets and create disincentives for investors.³⁶ Weak regulations and enforcement also direct savings to banks rather than capital markets.³⁷ Some research also indicates that democratic institutions associate with credibility and better decision-making of government and better investor confidence: For example, countries with more democratic institutions have larger domestic and foreign currency bond markets relative to their GDP.³⁸ According to the EBRD,³⁹ harmonization of regulations under regional integration need to capture key elements to ease cross-regional transactions of investors and issuers rather than applying single uniform laws across nationals. In this context, customization to international standards and best practices can provide optimal integration framework.

³⁵ Adelegan, Janet O. and Bozena Radzewicz-Bak. "What Determines Bond Market development in Sub-Saharan Africa?" IMF Working Paper Wp/09/213, September 2009.

³⁶ Schmukler, Sergio et al "Developments in Capital Markets", Chapter 2 in "Emerging Capital Markets and Globalization

³⁷ Adelegan, Janet O. and Bozena Radzewicz-Bak. "What Determines Bond Market development in Sub-Saharan Africa?" IMF Working Paper Wp/09/213, September 2009.

³⁸ Schmukler, Sergio et al "Developments in Capital Markets", Chapter 2 in "Emerging Capital Markets and Globalization

³⁹ "Developing capital markets" Law in transition 2012. EBRD Legal Transition Programme <http://www.ebrd.com/downloads/research/law/lit12ee.pdf>

Sustainability of capital market development depends on multiple factors: First, capital markets need to grow by new issuances from productive firms, rather than by asset valuation or pricing effects. For example, between 1995 and 2007, 25% of enlargement in financial assets was due to equity market valuations, 49% was due to financial sector enlargement and 10% was due to increase in government debts.⁴⁰ In emerging markets, a high portion of increases (67%) in financial assets was due to equity valuations, while real financial sector enlargement only constituted 13% of financial asset growth, right before the global crisis.⁴¹ Growth mainly based on asset prices led the markets down when asset prices burst. Secondly, capital market development is enhanced when non-financial firms increase their issuance to find financing (equities or bonds rather than bank lending) or invest in existing securities as part of their asset portfolio. Participation of firms from the real economy is crucial to create a stable investor base. Thirdly, capital market development is sustainable when domestic investor base is built and diversified: Capital flows from domestic investors have a counter-cyclical nature as stated by the literature. A larger local investor base has “stabilizing effect on asset returns including stocks, foreign and local currency sovereign debt returns and currency returns”.⁴² A larger local investor base can offset undesired impacts of volatility increases.⁴³ Moreover, developing countries that invest more but rely less on foreign capital grow faster than the ones that invest more and rely more on foreign capital to fund investments.⁴⁴

Cross border financial firms can also play important role in capital market development and integration. Financial intermediaries and brokerages support investors in markets both on the buy and sell side. They reduce the cost of collecting and processing information, identify and analyze investment options, and guide their clients in transactions. Financial firms also help with risk assessment and investment management and contribute to technological innovation by identifying the firms with potentially profitable projects. With these functions,

⁴⁰ “Financial Globalization: Retreat or Reset?” McKinsey Global Institute, March 2013.

⁴¹ calculated from “Financial Globalization: Retreat or Reset?” McKinsey Global Institute, March 2013.

⁴² (Data 2001-2013, 38 less-developed and developing countries)” IMF Global Financial Stability Report, Chapter 2, 2014

⁴³ IMF Global Financial Stability Report, Chapter 2. 2014

⁴⁴ Prasad, Rajan, and Subramanian (2007)

financial intermediary development is positively related to economic growth.⁴⁵ In addition, international financial institutions can move across borders to connect investors and capital-seeking issuers across the markets. Issuers recommended by brokerages can reach international investors and capital without having to list abroad. Analyst coverage is especially important in developing and under-developed markets due to these reputational effects.

Issues with Capital Market Development

Over the last decade, competition among capital markets has intensified due to globalization, technology and liberalization of financial sectors. Despite domestic reforms, some capital markets still suffer from illiquidity, low market capitalization or migration of investors and issues abroad. Other problems hindering capital market development can include small economic and financial sector size (which prevents the benefits from economies of scale and scope); low income levels and poverty; unproductive financial sector structure (bank domination, lack of institutional investors, captive investors and protection of vested interests in financial sector by political power); insufficient legal, institutional and technical systems; and the inability to commit to long term policies. In the competitive global environment, some financial markets seem to be weaker to expand supply and demand and to turn themselves into well-functioning systems.

For developing or under-developed countries, migration of listings and investors abroad constitutes a major problem. These markets are especially challenged in building a domestic investor base; providing regulatory, institutional and technological infrastructure; and attracting longer-term capital flows with limited national means. Alliances, cooperation and mergers among these markets can provide solutions to deal with developmental problems and increase market size and liquidity. On internationalization, some scholars claim that it does not

⁴⁵ Torre, Augusto and Sergio Schmukler; Developments in Capital Markets, in Chapter 2 of Emerging Capital Markets and Globalization. The World Bank, 2007.

matter where financial services are provided as long as domestic investors can reach them. By this approach, domestic investors and issuers mostly participate in international markets to seek investment opportunities or capital, if they have resources to access it.⁴⁶ The risks with this approach may be further migration of market activity; less demand for local services; and lower motivation to develop local financial markets for remaining market participants with less financial power. This can also lead to path dependence in financial market development.

Development of capital markets is a long process. Despite implementation of reforms, the anticipated results—to improve market liquidity, infrastructure, regulations and supervision, as well as economic and financial stability—will take time. Gaining investor confidence, building reputation and attracting market participants will also be achieved over time. Paradoxically, during this developmental phase, capital markets may face migration of some domestic trade and issuance abroad.⁴⁷ Besides economic and market conditions, this phenomenon can be understood by analyzing preferences of firms, investors and financial intermediaries on trade location. Firms may prefer to list (equities) or borrow (by bonds) in more developed, liquid and reputable foreign markets, if it is easier to raise capital at lower costs than local markets. In some cases, the sector in which the firm operates can be more developed in another country and those capital markets can generate fairer share values than local markets. In some other cases, firm management can be controlled by foreigners who lead listing decisions or the firms themselves might be seeking new foreign partnerships. Firms may also feel safer in better economic and financial market conditions abroad and have more trust in foreign contracts, regulations and enforcement. Meanwhile, financial firms, (brokerages, intermediaries etc.) providing services to capital markets, are interested in generating enough business to cover their costs and investments and to realize profits. The viability of these firms

⁴⁶ Torre, Augusto and Sergio Schmukler; Developments in Capital Markets, in Chapter 2 of Emerging Capital Markets and Globalization. The World Bank, 2007.

⁴⁷ Research on 78 countries between 1984 and 2000 in Torre, Augusto and Sergio Schmukler; Developments in Capital Markets, in Chapter 2 of Emerging Capital Markets and Globalization. The World Bank, 2007.

depends on activity of markets; therefore, their operations are located where trade volume and liquidity is high, unless they plan to invest in markets with future potential.

The behavior of investors and traders also affects the liquidity and trade volume of the markets. Some investors rely on macro/micro economic fundamentals to determine their investment strategy and duration to realize stable returns and reduce risks in the longer term. Other investors or traders may engage in short term portfolio flows, momentum trading⁴⁸ or herding behavior and decide their asset position according to market moves. In this context, some participants prefer opaque transactions and reporting requirements, while others require highly regulated markets. Short termism in capital markets can especially pick up with anticipation of economic distress. Investors can leave the markets even when fundamentals are good but return expectations are low. Market development and policies need to be geared towards creating the desired investor base within local markets in the longer term. Overall, financial markets with economic stability, strong institutional, regulatory, supervisory frameworks and investor protection attract the long-term investors and capital seekers the most.

Exchange structure also play role in capital market development. Today, exchanges need to be well financed to invest in technology and human capital and to compete globally.⁴⁹ Many exchanges have been questioning effectiveness of their membership, ownership and governance structure since they need flexible and fast decision-making and to adjust to changing business environment. For this purpose, developed country exchanges are mostly demutualized by privatization and public offerings and transformed from non-profit and member-owned mutual organizations into profit-seeking shareholder corporations. When exchanges are non-profit, specialists and market makers can affect prices, range and quality of products and services. When demutualized, the exchanges have simpler governance; new shareholders and profitability standards and services may have to be justified on cost and profit basis. Demutualization of the stock exchanges also need to come with regulatory reforms in

⁴⁸ Momentum traders increase trade when markets move into one direction (buy or sell) in high volumes.

⁴⁹ "Integrating Emerging Market Countries into the Global Financial System: Regulatory Infrastructure Covering Financial Markets" Reena Aggarwal, Brookings-Wharton Papers on Financial Services: 4th Annual Conference, January 11-12, 2001.

securities markets and they are likely to make mergers, acquisitions and financial innovations more common in capital markets.⁵⁰ In this context, more efficient changes in market structures can include cross-listing agreements, and alliance and affiliations among exchanges, which can be considered as implicit mergers and the most likely scenario in the future:⁵¹ Capital markets form affiliations and alliances in order to (a) facilitate operational efficiency through lower costs and simpler clearance and settlement systems; (b) reduce market segmentation and promote higher market capitalization; (c) enable cross-listings by avoiding costly regulatory, technological, bureaucratic barriers; (d) develop reputational capital to attract issuers and investors; and (e) build competitive network against rival markets and share costs of maintaining infrastructure.

Regionalization of Capital Markets

States can choose integrate their capital markets regionally for various reasons. First, regionalization can address issues with small market size by linking markets and extending supply and demand. Larger markets can reduce costs by economies of scale and scope⁵² and lower the cost of capital, which attract issuers, investors and financial firms and contribute to liquidity. Economies of scale and scope also apply to regulatory and institutional frameworks.⁵³ Second, larger regional markets can offer more diversified investment options and keep regional savings within the regional financial system.⁵⁴ Especially in developing countries, higher economic growth creates the need for more capital and more savings

⁵⁰ Coffee, John J. Jr. "Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

⁵¹ Coffee, John J. Jr. "Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

⁵² Merger of exchanges can multiply the volume at the same overhead cost, especially fixed overhead costs of market oversight, trading, clearing and settlement systems. Shamshad Akhtar, Ed. "Demutualization of Stock Exchanges: Problems, Solutions and Case Studies." Asian Development Bank 2002 and Shamshad Akhtar, Ed. "Demutualization of Stock Exchanges: Problems, Solutions and Case Studies." Asian Development Bank 2002

⁵³ Bossone, Biagio, Patrick Honohan, and Millard Long. "Policy for Small Financial Systems." World Bank, Financial Sector Discussion Paper No. 6, 2001.

⁵⁴ This issue became prominent in Asian financial sectors as large amount of savings have been directed abroad, especially to developed countries.

instruments, which can be provided by regional capital markets. The literature also confirms that regionally integrated markets can create a bigger savings pool and reduce the costs of saving mobilization, while domestic investments are no longer limited by domestic savings due to capital mobility.⁵⁵ Third, regional capital markets can also mobilize foreign investments and remittances, reverse capital outflows and increase market liquidity.⁵⁶ Fourth, larger markets can generate more business and income for financial firms and lead them to provide better brokerage, infrastructure and other financial services. Integration can help these intermediaries to reach critical scale and threshold of business levels to become financially viable or grow.⁵⁷ Fifth, large markets have more informative prices and less price synchronicity and facilitate indicate better allocation of capital.⁵⁸ Sixth, the use of compatible technologies and shared platforms allow division of costs between regional members to set up and maintain expensive systems. Seventh, harmonization of regulations and reporting, region wide investor protection and dispute resolution mechanisms, and converging standards for financial products raise investor confidence and trade across capital markets, while creation of uniform products, regional brands and (bond or equity) indexes becomes also possible. Eighth, macroeconomic cooperation among states can enhance financial and economic stability needed for capital market development, while supervisory cooperation can detect early systemic risks. Ninth, regional exchanges can form an alternative to international markets: As mentioned before, issuers and investors may prefer to list and invest in developed markets abroad for various reasons. Strong regional markets can offer advantages over global centers such as less information barriers, lower costs of listing, trading and compliance and familiarity with

⁵⁵ Ross Levine and Sara Zervos. "Stock Market Development and Long-Run Growth" *The WB Economic Review* Vol 10 No: 2 and Masafumi Yabara "Capital Market Integration: Progress Ahead of the East African Community Monetary Union." IMF Working Paper, January 2012 and Cyn-Young Park. "Asian Capital Market Integration: Theory and Evidence" ADB Economics Working Paper Series, No. 351 June 2013 and Central Bank of Nigeria Economic and Financial Review March 2010, Greenwood and Smith (1997)

⁵⁶ Farid, Sally. "Financial Integration in African Emerging Markets." African Economic Conference 2013.

⁵⁷ Bossone, Biagio, Patrick Honohan, and Millard Long. "Policy for Small Financial Systems." World Bank, Financial Sector Discussion Paper No. 6, 2001.

⁵⁸ "The (mis)allocation of capital" Abhijit V. Banerjee, Esther Duflo† Kaivan Munshi. September, 2002 Massachusetts Institute of Technology and *Journal of Financial Economics* 58 (2000) 187-214 Financial markets and the allocation of capital." Jeffrey Wurgler

financial and economic systems, as participants can form vested interests in domestic markets. After taking advantage of valuation and reputation effects abroad, issuers can de-list and go back to local markets or make dual listings at home and abroad. Between 2002 and 2012, 40% of the firms, which listed in major international stock exchanges de-listed later.⁵⁹ Finally, development of capital markets through regional integration may have positive spillover effects on the real sector. As cross-border production and trade lead to international mergers, acquisitions and partnerships among firms, acquisitions may be easier with equity securities rather than cash.

Regional integration of capital markets also challenges states due to slow returns to costly investments: Markets need time to improve functionality and credibility, become self-sustainable and generate enough income to cover their expenses. Especially less developed regional members are afraid of losing national exchanges, domination by stronger markets and outflow of capital to regional markets. More developed markets may be less willing to share their issuers, investors and income with less developed regional partners. National markets with similar products, services, and client profiles can also be “natural competitors”⁶⁰ to each other within the regional settings. Integration policies need to address interests of many states and may need to allow multi-pace integration. Especially for less developed and developing countries, regional integration needs to progress in parallel with other economic and financial development policies. Differences in legal systems, administrative capacity and bureaucratic efficiency make harmonization harder, reduce applicability of common policies, and discourage cross border transactions among markets. Regulatory harmonization also creates new compliance costs for market participants. High correlation among national capital markets indicates less country-based diversification for regional investment portfolios. Other types of diversification (such as sectoral, niche, share or firm type diversification) may be needed.

⁵⁹ The Role of Banks, Equity Markets and Institutional Investors In Long-Term Financing For Growth And Development, February 2013 OECD

⁶⁰ Coffee, John J. Jr. “Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

Capital market development is closely related to economic expectations and controlling economic volatility and government debt (sovereign issuance) among unstable countries can be problematic. Increased contagion risks due to cross border holding of securities also need to be addressed by coordination and prudential regulations.

It should be also noted that regional integration may not be optimal policy choice for all small or underdeveloped capital markets. Some capital markets are small and less developed because economic potential of that country is not fully realized yet: As the economy grows, capital markets are likely to grow without regionalization. Some other countries may have small capital markets in comparison to large size of their economy. In these situations, capital market development policies—rather than regionalism—can produce positive results to increase its share relative to GDP. Finally, for others, the potential for economic and capital market growth are quite limited and regionalization can be a viable option. Capital market development requires a threshold in minimum market size: Around \$15-20 billion is needed support viable stock markets⁶¹ and \$100-200 billion for bond markets.⁶² “The positive relationship between size and capital market development raises the question whether many emerging economies are large enough to sustain fully fledged exchanges.”⁶³ When they are not, scale and scope effects can be achieved by alliances, mergers and regional integration of capital markets.

Regional integration of capital markets utilize different models:⁶⁴ (i) continued use of separate electronic platforms, with harmonization of trade rules and listing standards, while setting central clearing and settlement facility for all platforms; (ii) merger by single electronic platform and common clearing and settlement system while specialist portals are placed in

⁶¹ Coffee, John J. Jr. “Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002 and Ajay Shah, Susan Thomas. “Securities market infrastructure for small countries” The World Bank and Oxford University Press, 2003

⁶² Ajay Shah, Susan Thomas. “Securities market infrastructure for small countries” The World Bank and Oxford University Press, 2003, and Torre, Augusto and Sergio Schmukler; Developments in Capital Markets, in Chapter 2 of Emerging Capital Markets and Globalization. The World Bank, 2007.

⁶³ Bossone, Biagio, Patrick Honohan, and Millard Long. “Policy for Small Financial Systems.” World Bank, Financial Sector Discussion Paper No. 6, 2001.

⁶⁴ Addo, Elsie. “Policies and Strategies for Enhancing the Regional Integration of Capital Markets in Africa”. UNECA Meeting on Capital Flows and development of African Economies: Towards an Action Plan for Financing Investment in Africa. Zanzibar, Tanzania, 2007.

participant countries; and (iii) establishment of a regional exchange under common electronic trade platform, clearing and settlement system to serve all regional members and merger of other national exchanges with that regional exchange, while listings are transferred to regional exchange and all members are given the right to trade in regional exchange. New national markets without infrastructure can utilize neighboring market infrastructure without investment in expensive technology, while countries without exchanges can also consider setting up well-regulated OTC markets.⁶⁵

Equity Markets Outlook

Equity market capitalization accounted for a quarter of global financial assets in 2014, but the rise of equity markets over the last decade has been interrupted by crises. (Figure 1) Stock market capitalization declined almost by half, from \$65 to \$34 trillion during 2008, with a slight reduction again in 2011. In parallel, the total number of Initial Public Offerings (IPOs) decreased from an annual average of 1,909 during (1993-2000) to 1,094 during (2001-2011), while their value went down from an annual average of \$164 billion from \$129 billion.⁶⁶ After the crisis, concerns on slowing economic growth, low interest rates, market performance, pricing conditions, valuation and execution risks discouraged companies from listings. The recovery of stock markets continued after the global crisis as world stock market capitalization doubled from \$34 trillion in 2008 to \$69 trillion in 2014, but 73% of newly raised money went to fund already-listed companies.⁶⁷ On a closer look, total stock market capitalization still

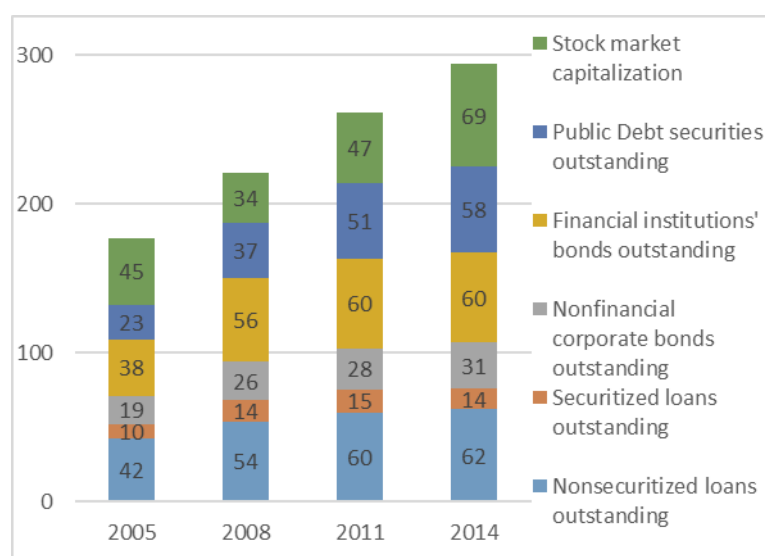
⁶⁵ Addo, Elsie. "Policies and Strategies for Enhancing the Regional Integration of Capital Markets in Africa". UNECA Meeting on Capital Flows and development of African Economies: Towards an Action Plan for Financing Investment in Africa. Zanzibar, 2007.

⁶⁶ The Role of Banks, Equity Markets and Institutional Investors In Long-Term Financing For Growth And Development, February 2013 OECD

⁶⁷ Valiante, Diego. Europe's Untapped Capital Market. Centre for European Policy Studies, 2016. https://www.ceps.eu/system/files/Capital%20Markets%20Union_1.pdf

didn't reach pre-crisis levels since it decreased from 98% to 89% of the world's GDP from 2005 to 2014.⁶⁸

Figure 23 – Stock of Global Financial Assets (USD Trillion) *



*2014 data is expected figure

Source: Data from McKinsey Global Institute

Various research indicates that stock market development, capitalization and liquidity are positively related to economic growth,⁶⁹ while stock market liquidity significantly and positively correlated with current and future economic growth.⁷⁰ Large and liquid stock markets mitigate the sensitivity of equity returns to global financial conditions,⁷¹ as equity returns also positively relate to economic performance.⁷² Indeed, equity markets can alter patterns of money demand, facilitate liquidity and economic growth.⁷³ Stock markets also improve investment diversification and risk management in financial systems and enable better

⁶⁸ Dobbs, Richard, Susan Lund, and Andreas Schreiner; How the growth of emerging markets will strain global finance. McKinsey & Co.

http://www.mckinsey.com/insights/winning_in_emerging_markets/how_the_growth_of_emerging_markets_will_strain_global_finance

⁶⁹ Rousseau, P. L., and P. Wachtel, Equity Markets and Growth: Cross-Country Evidence on Timing and Outcomes, 1980-1995. *Journal of Banking and Finance*, 24, 2000, pp. 1933-57

⁷⁰ Levine, Ross and Sara Zervos, Stock Markets, Banks, and Economic Growth. *The American Economic Review*, Vol. 88, No. 3, June 1998, pp. 537-558

⁷¹ IMF Global Financial Stability Report, Chapter 2. 2014

⁷² "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape." McKinsey Global Institute, December 2011.

⁷³ Central Bank of Nigeria Economic and Financial Review March 2010

absorption of shocks.⁷⁴ They supply capital into the financial system and provide investment vehicles for savings. Besides, equity markets facilitate entrepreneurship, innovation and foreign capital inflows.⁷⁵ These markets also reduce information asymmetries, provide mechanisms for asset valuation and pricing and support privatization of state enterprises. Equity markets facilitate corporate restructuring and promote better corporate governance⁷⁶ and monitoring of firms and investors,⁷⁷ while providing exit mechanisms especially for private equity investments.

The small size or under-development of equity markets lead to an equity and savings gap; it is estimated that share of equities in global financial assets will decline from 28% to 22% between 2010 and 2020, leaving a gap of \$12.3 trillion between the capital needed by firms and the demand from investors to buy equities.⁷⁸ This can raise the cost of equity, push the companies to have more debt, and make them vulnerable to economic distress. Meanwhile, banks may find it harder to increase lending under new capital requirements to cover the demand for debt.⁷⁹ A similar situation is likely to arise between investments and savings in the future.⁸⁰ Total investment demand is projected to increase from \$11 to \$24 trillion between 2008 and 2030,⁸¹ as savings will fall short of covering investments by \$0.8 to \$2.4 trillion.⁸²

⁷⁴ “The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.” McKinsey Global Institute, December 2011.

⁷⁵ Samy Ben Naceur, Samir Ghazouani, Mohamed Omran. “The determinants of stock market development in the Middle-Eastern and North African region”. *Managerial Finance*, Vol. 33 No. 7, 2007, and Lin (2009), and Valeriano F. Garcia And Liu, Lin and Valeriano F. Garcia; *Macroeconomic Determinants Of Stock Market Development*. *Journal of Applied Economics*, Vol. II, No. 1, May 1999, pp 29-59

⁷⁶ *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing For Growth And Development*, February 2013 OECD

⁷⁷ “The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.” McKinsey Global Institute, December 2011 and *The Role of Banks, Equity Markets and Institutional Investors in Long-Term Financing For Growth And Development*, February 2013 OECD, and Demircuc-Kunt Asli and Vojislav Maksimovic. “Stock Market Development and Financing Choices of Firms.” *The World Bank Economic Review*, Vol. 10 No 2, pp. 341-369, 1996.

⁷⁸ “The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.” McKinsey Global Institute, December 2011.

⁷⁹ “The Emerging Equity Gap: Growth and Stability in the New Investor Landscape.” McKinsey Global Institute, December 2011.

⁸⁰ Dobbs, Richard, Susan Lund, and Andreas Schreiner; *How the growth of emerging markets will strain global finance*. McKinsey &Co. http://www.mckinsey.com/insights/winning_in_emerging_markets/how_the_growth_of_emerging_markets_will_strain_global_finance

⁸¹ 15% of these investments will be for infrastructure, 62% for productive investments (such as factories, commercial facilities, machinery, equipment etc.) and 23% will be for residential real estate

⁸² Dobbs, Richard, Susan Lund, and Andreas Schreiner; *How the growth of emerging markets will strain global finance*. McKinsey &Co. http://www.mckinsey.com/insights/winning_in_emerging_markets/how_the_growth_of_emerging_markets_will_strain_global_finance

This may lead investors to fixed income instruments and deposits especially if long-term interest rates rise.⁸³

Multiple reasons cause the equity gap such as levels of economic and financial growth as well as demographics.⁸⁴ Most of the equity gap is expected in emerging markets since savings are mainly kept in bank deposits because of lower incomes, a cautious view of the economic situation and the possibility of unexpected future expenses due to deficiencies in public services such as health or retirement systems. For higher income groups, mobilizing savings into equity markets is hard when markets are under-developed, equity investments are risky and regulations and investor protection are insufficient.⁸⁵ In developed countries, home bias in investments still continue, while pension funds reduce demand for equities due to the aging population. Moreover, savings by younger populations are less directed into equity investments, especially in the US and Europe. Besides, the increase in alternative investments of institutional investors also reduce demand for equities. After the 2008 crisis, the crush of the banking sector and reduction of bank shares triggered a decline of stock markets especially in developed countries.

Equity Market Development

Further development of equity markets can be promoted by various policies. First, new incentives and customized products can be designed to increase savings and direct them to equity markets.⁸⁶ Firms can be encouraged to pay dividends to raise demand for equities. Second, household access to equity markets can be improved through stronger retail

⁸³Dobbs, Richard, Susan Lund, and Andreas Schreiner; How the growth of emerging markets will strain global finance. McKinsey & Co. http://www.mckinsey.com/insights/winning_in_emerging_markets/how_the_growth_of_emerging_markets_will_strain_global_finance

⁸⁴ Eswar S. Prasad. "Saving in Developing Countries" NBER Reporter, Number 1: Research Summary 2013

⁸⁵ "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape." McKinsey Global Institute, December 2011.

⁸⁶ Charles Roxburgh and Susan Lund, "Beware the Global 'Equity Gap'" December 20, 2011. <http://online.wsj.com/news/articles/SB10001424052970204879004577108431415621446>

channels.⁸⁷ Growth of institutional investors (such as investment funds, insurance firms and pension funds) is critical to increase equity market liquidity and provision of long-term capital. However, banking, insurance and pension regulations should be reviewed to avoid the risk of cross holdings and other negative effects on equity markets.⁸⁸ Third, tax policies should encourage investment into equity markets with reduced compliance costs. Fourth, home bias in investments, especially in developed countries can be reduced by fewer limits on institutional investors to buy foreign assets. For this purpose, instruments to hedge foreign currency risks are crucial for cross border transactions. In general, policies to improve macroeconomic stability and financial markets, strengthen regulatory and supervisory frameworks, promote investor protection and dispute resolution mechanisms also contribute to equity market development. It is also important to avoid large capital controls but also to manage the risks of short term capital flows.

Finally, privatizations can accelerate stock market development but its ultimate effects depend on the privatization strategy, an ability to promote investor confidence and the perceived political/economic risks. A comparison between developing Central and Eastern Europe (CEE) and large emerging Asian markets suggests that large-scale privatizations in small and immature markets with weak regulatory structure, investor protection and enforcement of laws do not generate stock market development.⁸⁹ These deficiencies undermine investor confidence and participation into initial listings. Besides, concerns about the financial performance of state-owned enterprises, the possible need for large restructuring, and the lasting political influence in these entities after privatization reduce demand for their shares. Moreover, small and illiquid markets prevent investors from selling their shares back to the markets. This suggests that when privatizations are gradually made and supported by sound markets, they are more likely to contribute to stock market development.

⁸⁷ "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape." McKinsey Global Institute, December 2011.

⁸⁸ Charles Roxburgh and Susan Lund, "Beware the Global 'Equity Gap'" December 20, 2011. <http://online.wsj.com/news/articles/SB10001424052970204879004577108431415621446>

⁸⁹ Ajay Shah, Susan Thomas. "Securities market infrastructure for small countries" The World Bank and Oxford University Press, 2003

It should be noted that stock markets are subject to lower economic thresholds compared to bond markets, and setting up national stock markets is relatively easier. This contributed the existence of many small and illiquid markets around, while most of these exchanges cannot self-sustain their operations: Despite reform efforts, these markets become cumbersome on public finances, some under risk of closing. In this case, regional integration can transform these markets to be more efficient parts of a larger market.⁹⁰ Even developed markets can expand their reach by cooperating with smaller exchanges. Developed markets can also merge among themselves to improve competitiveness, reduce costs, attain larger market share, expand to new asset classes, form niche markets, and extend geographical reach—even in multiple time zones.

Corporate Governance and Equity Markets

Corporate governance is also closely related to business environment, economic growth and international trade as well as equity market development. Econometric evidence suggests that sound corporate governance, transparency and investor protection can foster development of stock and bond markets and resilience to external shocks.⁹¹ Capital market development mainly relate to two types of corporate governance. In concentrated ownership (insider system), ownership and voting power are concentrated, while businesses are owned by holdings, families, or cross shareholdings among multiple companies. In this system, close relations with banks or bank ownership of corporate shares are common. Capital markets in insider systems are less developed due to bank domination and confidentiality of relations between banks and firms, which contradicts with transparent markets.⁹² Mostly used in Europe and Asia, insider systems benefit from stronger control and monitoring and solve principal-

⁹⁰ Charles Amo Yartey and Charles Komla Adjasi “Stock Market Development in Sub-Saharan Africa: Critical Issues and Challenges”. August 2007

⁹¹ IMF global stability report 2016

⁹² Maria Maher and Thomas Andersson, “Corporate Governance: Effects On Firm Performance and Economic Growth” OECD 1999

agent problems better by separating ownership and control. Concentrated ownership increases their ability to make longer commitment in investments but reduces their potential to diversify firm risk among diverse investors and to receive a lower cost of capital.⁹³ Disciplinary effects of markets by the possibility of takeover are likely to be less effective under concentrated ownership.

Dispersed ownership (outsider system) spreads corporate ownership to a wider investor base and improve liquidity of the firms, which is crucial for development and innovation.⁹⁴ Dispersed system is practiced in the US and UK, as it benefits from diluted ownership and lower cost of equity capital. Dispersed systems can suffer more from principal-agent problems, especially when the interests of many investors and management diverge. This situation may lead to prioritization of short-term benefits over long-term productive investments. These firms need to improve monitoring and firm performance.⁹⁵ Under outsider systems, capital markets place disciplinary effects on owners and managers more easily since takeovers and removal of inefficient management are more likely.⁹⁶

It should be noted that globalization, liberalization of capital flows and international trade transform the business environment for firms and lead to some convergence between two systems. As the risks of over-reliance on bank lending becomes more apparent, more firms consider raising equity capital, whether they have concentrated or dispersed governance. To comply with improving laws and benefit from reputational effects, firms started to focus more on quality reporting and disclosure standards, transparency, investor protection, monitoring and cross-border partnerships regardless of their corporate governance. These trends reduced the difference between insider and outsider systems as concentrated ownerships recognize the

⁹³ Karen H. Wruck. "Private Equity, Corporate Governance, and the Reinvention of the Market for Corporate Control." American Enterprise Institute, Conference on The History, Impact and Future of Private Equity: Ownership, Governance and Firm Performance, November 27, 2007, Washington D.C.

⁹⁴ Maria Maher and Thomas Andersson, "Corporate Governance: Effects On Firm Performance and Economic Growth" OECD 1999

⁹⁵ Maria Maher and Thomas Andersson, "Corporate Governance: Effects On Firm Performance and Economic Growth" OECD 1999

⁹⁶ Xavier Vives, "Corporate Governance: Theoretical and Empirical Perspectives." Chapter 1, Corporate Governance: Does it Matter? 2000 Cambridge University Press.

importance of shareholder rights and transparency, and dispersed systems put greater focus on powerful monitoring and recognizing the value of long-term investments.⁹⁷

Bond Market Development

Well-developed bond markets provide alternative financing to governments and firms, reduce currency and maturity mismatches between assets and liabilities, and enhance fiscal and monetary policy management. For investors, they can provide stable income, guaranteed returns at the maturity and serve as collateral. For these reasons, bond markets developed substantially during last decade (Figure 1): Global outstanding public debt securities increased from \$23 to \$58 trillion, private debt securities from \$19 to \$31 trillion and financial institutions' debt securities from \$38 to \$60 trillion between 2005 and 2014. In 2014, bond issuance exceeded \$69 trillion of equity market capitalization and \$76 trillion of outstanding loans.⁹⁸ Since the 2008 crisis, low interest rates, quantitative easing, and reducing returns lead investors to high returns to emerging bond markets with strong economic fundamentals.

However, bond market development is more complicated than stock markets, as the minimum threshold size for viable bond markets (\$100-200 billion) is an order of magnitude greater than stock markets (\$15-20 billion). Moreover, bond markets are harder to set up and operate for multiple reasons. First, bond markets are less transparent than stock markets: Secondary bond markets are mostly OTC markets, in which bids are not centrally posted and same bonds can be sold with different prices to different customers by dealers. On the contrary, stock markets have prices posted electronically, visible to all buyers and sellers. Second, bond markets are less liquid than stock markets: Bonds are more diverse than stocks as they are issued and traded in much higher amounts, with varying prices, yields, maturities, and currency denominations. Therefore, they are traded less frequently, while trade of bonds generally

⁹⁷ Xavier Vives, "Corporate Governance: Theoretical and Empirical Perspectives." Chapter 1, *Corporate Governance: Does it Matter?* 2000 Cambridge University Press.

⁹⁸ Projections for 2014, McKinsey Global Institute

declines significantly days after issuance. Unlike stock markets, liquidity is a bigger problem in bond markets without steady buyers and sellers every day for many type of bonds. Third, financial intermediaries play bigger role in bond markets: Due to their large variety in type, price, yield, amount and currency denomination, bonds are mostly traded in over-the-counter (OTC) markets, where dealers perform crucial roles. They act as market makers, find counterparty for buyers and sellers and set prices, while making income from bid-ask spreads. In various countries, efforts have been made to move secondary market activity to electronic platforms; however, the wide variety of bonds would require more sophisticated and expensive systems than stock markets. Therefore, this improvement has been gradual while its future is unknown. Fourth, bond markets rely more on institutional investors: Sale in primary and secondary markets are mostly done to large financial corporations or institutional investors (such as pension, insurance and investment funds) while retail investors have very limited access.

In general, economic development and size of the economy have a positive relation with bond market development,⁹⁹ which is strongly linked to macroeconomic fundamentals. In this context, inflation, interest rate, and exchange rate stability is crucial to minimize volatility in bond market returns and improve liquidity. Interest rates directly affect bond prices and cost of capital for governments and firms, while inflation affects real interest rates and return structure of bonds. Exchange rate stability is crucial for bond markets since they impact relative return of local currency bonds compared to FX-based investment instruments. Moreover, depreciations can create macroeconomic imbalances, impact business environment, increase solvency risks of governments and firms, trigger outflow of capital and increase cost of borrowing from bond markets. However, fixed exchange regimes can also reduce investor confidence if macroeconomic fundamentals are not strong enough to maintain the rate in the long term. Indeed, countries with a more fixed exchange regime tend to have smaller domestic

⁹⁹ Adelegan, Janet O. and Bozena Radzewicz-Bak. "What Determines Bond Market development in Sub-Saharan Africa?" IMF Working Paper Wp/09/213, September 2009.

currency bond markets and larger foreign currency markets.¹⁰⁰ As a result, most research indicates that greater exchange rate flexibility and deeper derivatives markets for hedging currency risk are essential to boost domestic bond markets and reduce vulnerability to global financial conditions.

On a macroeconomic basis, monetary and fiscal policies affect bond markets—especially local currency bond and government bond markets. Improving bond markets can be challenging for developing and less developed countries since it requires coordination between monetary policy, fiscal policy and public debt management as well as government cash management and central bank liquidity.¹⁵⁵ Fiscal policy is endogenous to development of government bond markets, since governments can issue debt to create resources for public spending or to finance fiscal deficits, with implications for inflation, investments and liquidity. Fiscal policy also affects corporate bond market development more indirectly through inflation and macroeconomic stability. In monetary policy, government securities are important for indirect monetary operations and they facilitate monetary policy transmission by providing a risk-free yield curve and integrating various segments of the financial market. States can offer government bonds in primary markets to raise funds, while these bonds can be traded in secondary markets by central banks as a part of open market operations. That way, central banks need less direct controls to conduct monetary policy (such as reserve/liquidity requirements, interest rate controls or credit ceilings that can cause financial disintermediation, reduced private savings and investments). In addition, government bonds are important for interbank collateralized lending, which eases liquidity management for banks and reduces the need for central bank interventions.

In addition, bond markets require well-functioning money markets, derivative markets and repo (repurchase) markets. Deeper derivative markets for hedging currency, interest rate and credit risks are essential to boost domestic bond markets, and reduce expected borrowing costs

¹⁰⁰ Torre, Augusto and Sergio Schmukler; *Developments in Capital Markets*, in Chapter 2 of *Emerging Capital Markets and Globalization*. The World Bank, 2007.

and risks. Dealers also use repo to fund their bond inventory. Bond markets are also affected by technology and links to payment and settlement systems, financial reporting standards and the investor base. A diverse investor base such as banks and institutional investors (such as pension, insurance and investment funds) is crucial to promote demand for different types of bonds. Business cycle and recessions also lead to higher credit risks in bond markets. On the other side, well developed bond markets are also crucial for economic and financial stability since they reduce currency and maturity mismatches between assets and liabilities of governments and firms, provide them with market-based borrowing options to finance expenses, and reduce risk of economic distress.

Bond Markets and Regionalization

Larger and deeper bond markets reduce cost of domestic capital and dependency on banking sector for loans. Meanwhile, small markets suffer from illiquidity and shallowness, which cause price volatility, and the exit of buyers and sellers. Amounts raised in these markets can be too small to attract issuers and investors. If the size of economy and financial sector are insufficient to develop bond markets, regional integration can be a solution to reach the threshold market size. Regional markets can accommodate more sectors and firms, gather a larger savings pool to borrow from and promote lower cost of capital and more capital accumulation. Sharing costs of trade platforms reduces unit costs in larger scale markets. Expansion of scale and scope promotes diversification of issuances across different maturities and types. Liquidity of local bonds can also improve when they are placed into regional bond indices. Macroeconomic coordination and oversight can lead to more sustainable and transparent debt management and issuance strategies across the region with supporting institutional and regulatory development.

THE EU CAPITAL MARKETS

Initiatives on the EU capital markets integration

Integration of the EU capital markets started with adoption of the White Paper on completion of the internal market in the mid-1980s. In 1993, the EU adopted the Investment Services Directive (ISD) and allowed the access of investment firms to stock exchange membership and financial markets in host countries across the EU if they are authorized to provide services in their home member state and meet certain other criteria. In 1997, the Directive on Investor Compensation Schemes was adopted, which protects investors by providing compensation if an investment firm fails to return the investor's assets. The directive did not cover investment risk (such as loss of stock values) but did cover administrative malpractice, fraud or operational errors. The launch of the euro and Financial Services Action Plan (FSAP) became other milestone of integration. FSAP aimed to reduce regulatory obstacles to cross border investments with adaptation of 42 regulatory measures between 1999 and 2004.¹⁰¹ It focused on promoting a single market for wholesale financial services, open and secure retail markets and providing necessary prudential regulations and supervision. After the FSAP, mergers and acquisitions accelerated among domestic financial institutions and across borders. Banks from West Europe expanded to Central and East Europe (CEE) and became more internationalized than US banks.¹⁰² FSAP was followed by the EC White Paper on Financial Services Policy between 2005 and 2010, which focused on regulatory and supervisory framework as well as enforcement of existing regulations.

In 2001, the Committee of European Securities Regulators (CESR) was established as an independent organization, with high-level representatives from the national public authorities. Its goal was to improve coordination among securities regulators, prepare a draft

¹⁰¹ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

¹⁰² European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

plan related to operation of securities markets and provide recommendations to the EC. In the European Parliament resolution of 2002, the CESR was also described as institutionalization of the regular dialogue between European supervisors in the securities supervision.¹⁰³ Moreover, this approach was also recommended for insurance and pension funds sectors to guarantee a proper institutional balance in supervision of multiple financial sub-sectors. The CESR, with participation of the European Central Bank (ECB) and European System of Central Banks (ESCB) would also monitor systemic risks, while the new framework would permit establishment of links between banking, insurance and securities supervision.¹⁰⁴ In 2003, Market Abuse Regulations (MAR) were adopted to reinforce market integrity, harmonize market abuse rules and ensure transparency and equal treatment of market participants. The MAR prohibited market manipulation and insider dealing and facilitated stronger exchange of information between national authorities.

Other regulatory improvements in integration of the EU financial markets include the Markets in Financial Instruments Directive (MiFID) and the EU Securities Law. In 2007, MiFID replaced the EU Investment Services Directive (ISD), which granted passport for EU securities firms, with licenses issued by their home states, (brokers, asset management, investment funds etc.) to conduct cross-border operations anywhere in the EU. MiFID retained the EU passport of the ISD and focused on supervision of investment firms by their home states as well as increasing competition and customer protection in investment services. Other supportive EU directives on prospectus and transparency requirements and market abuse have also been introduced, to complement the MiFID. In 2009, the Recommendation on Simplified Withholding Tax Relief Procedures was issued, which allowed investors residing on one EU state to claim relief from withholding tax on securities income received from another Member State.

¹⁰³ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P5-TA-2002-0568+0+DOC+XML+V0//EN>

¹⁰⁴ <http://www.europarl.europa.eu/sides/getDoc.do?pubRef=-//EP//TEXT+TA+P5-TA-2002-0568+0+DOC+XML+V0//EN>

In 2011, the European Securities and Markets Authority (ESMA) replaced the CESR. Under the European System of Financial Supervisors, ESMA has been working on securities legislation to improve the functioning of the EU financial markets and cooperation between national authorities. Strengthening investor protection and regulation of credit agencies to address problems in credit assessments were among other tasks of ESMA. In addition, the EU Alternative Investment Fund Managers' Directive was introduced in 2011 to set the regulatory framework for alternative investment funds, including hedge funds and private equity.

In 2014, the EU has adopted a regulation on PRIIPs, (Packaged retail investment and insurance products) which obliged seller of these products to provide investors key information documents to investors. This regulation was especially important since it covered retail investors (individuals and households) who save for a specific objective such as education of housing.

Again in 2014, the European Parliament approved the updated version MiFID II, and accompanying MiFIR (Regulation on markets in financial instruments) to be implemented by the EU member states by January 2018. MiFID II aims to address weaknesses in governance and risk management of financial firms to reduce systemic risks as well as stronger investor protection.¹⁰⁵ MiFIR established comprehensive rules for a broad range of financial instruments and introduced uniform requirements on transparency of orders and transactions. Trading of financial instruments are to be carried out on organized and appropriately regulated venues as far as possible.¹⁰⁶ The legal environment in T2S will also benefit from the harmonization of the rules applicable to the transfers of securities that the future EU securities law legislation is expected to bring about. The same year, Markets in Financial Instruments Directive (MiFID II) and some other regulations gave more powers to the European Securities

¹⁰⁵ <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014L0065&from=EN>

¹⁰⁶ <http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32014R0600&from=EN>

and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA) on investor protection.¹⁰⁷

In 2015, the Securities Financing Transaction Regulation was adopted to address risks in securities lending and repurchase agreements as these should be reported to trade repositories and investors in collective investment schemes. The EC and European Systemic Risk Board also assess issues with market liquidity, interconnectedness and intermediation activities. Efforts continue to improve micro prudential (capital/liquidity requirements on financial institutions) and macro prudential (cyclical dynamics, sector/systemic risks, linkages among different parts of financial system) oversight. In September 2015, the European Commission adopted the “Action Plan on Building a Capital Markets Union” (CMU) to establish the main elements of an integrated capital market in the EU by 2019. CMU complements the banking union as well as other regulatory and financial reforms and its action plan contains more than 30 actions and related measures, which focus on:¹⁰⁸ (i) providing more funding choices for businesses and SMEs; (ii) improving regulations to promote long-term and sustainable infrastructure investments; (iii) diversifying investment choices for retail and institutional investors; (iv) enhancing banks’ capacity to lend¹⁰⁹ as banks are important investors and intermediaries in capital markets; (v) evaluate the possibility for member states to benefit from local credit unions, which are not subject to EU's capital requirements for banks; (vi) establish a pan-European covered bond market; (vii) promote development of capital markets in all member states; (viii) work with the European Supervisory Authorities to strengthen supervisory convergence; and (ix) address obstacles to CMU from divergent national laws such as tax and securities laws, insolvency and other issues.

¹⁰⁷ European Commission, “Acting Plan on Building a Capital Markets Union” Sep 30, 2015

¹⁰⁸ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0468&from=EN>

¹⁰⁹ The EU action Plan for CMU envisages to revitalize simple, transparent and standardized European securitizations to free up capacity on banks' balance sheets.

Equity Markets in the EU

According to the CMU Action Plan, EU capital markets still have much room to develop. Despite the size of the Europe's economy is as large as the US, its equity markets are less than half the size, and its debt markets less than a third. The gap between member states are even bigger than the EU and the US. Despite strong growth, EU equity markets are almost half as large as of the US as a percentage of GDP, while private equity markets also indicate the same situation. Between 2010 and 2014, the EU stock markets represented 64% of the GDP on the average, which was 127% for the US, 84% and 76% for Japan.¹¹⁰ Still, EU stock markets have been growing since the 1990s with vulnerability to crises as total EU stock market capitalization grew from €1.3 trillion (22% of GDP in 1992) to €8.4 trillion (64% of GDP in 2014).¹¹¹ Total size of EU equity markets is also smaller than bank loans and bond markets as a share of GDP: According to the averages between 2010 and 2014, bank assets reached 316% of the GDP, while this was only 11% for the US, 256% for China and 187% for Japan.¹¹² In connection, the same averages for the EU government and corporate bond markets (together) was 81% of the GDP, which was 114% for the US, 25% for China and 198% for Japan.¹¹³

Low stock market capitalization in the EU compared to its peers such as the US, Japan or China reflect the fact that EU capital markets remained fragmented in terms of development level, and with different platforms and systems and limited interconnectivity. As can be seen in Figures 24 and 25, this fragmentation is visible as capital markets grew in mainly larger and developed states, attracting listings from firms in countries with less developed financial systems. Developmental differences between European stock markets are substantial: In 2015,

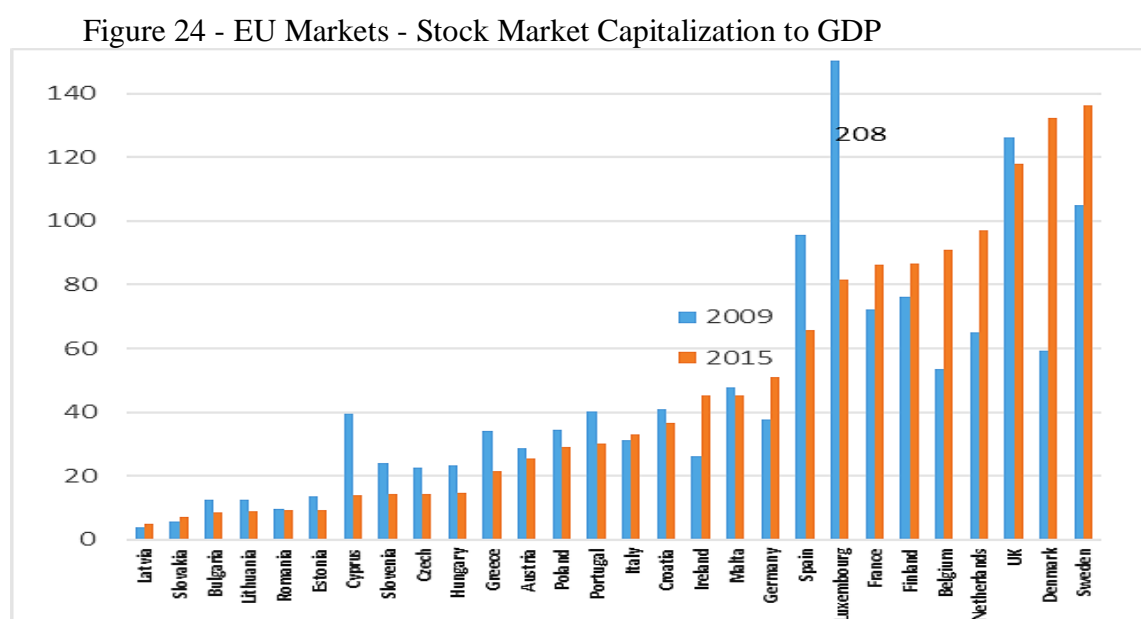
¹¹⁰ Diego Valiante; "Europe's Untapped Capital Market: Rethinking financial integration after the crisis"., European Capital Markets Institute, 2016.

¹¹¹ <http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52015DC0063&from=EN>

¹¹² Europe's Untapped Capital Market: Rethinking financial integration after the crisis. Diego Valiante, European Capital Markets Institute, 2016.

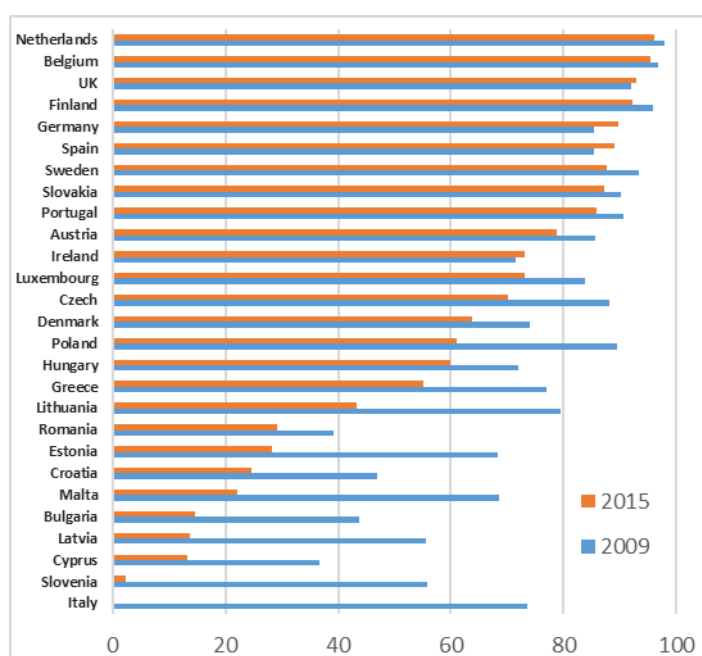
¹¹³ Europe's Untapped Capital Market: Rethinking financial integration after the crisis. Diego Valiante, European Capital Markets Institute, 2016.

stock market capitalization to GDP for member states ranged between 132% (Denmark) to 5% (Latvia) according to the World Bank GFDD (Global Financial Development Database) data. Expectedly, the most capitalization was observed in developed countries such as the UK, Belgium and Netherlands, but market capitalization in some other developed countries like Germany, Italy or Austria did not exceed 50% of GDP. In addition, stock market capitalization of developed countries generally improved only slightly since the 2009 crisis, while countries with smaller markets (Greece, Cyprus, Croatia, Central & Eastern Europe) still remain below 2009 levels.



Source: IMF and World Bank databases

Figure 25 - EU stock markets' correlation with Regional Stock Index



Source: IMF and World Bank databases

Besides vulnerability of stock markets and IPOs to crisis, this decline is also caused by the high cost of listings, especially related to compliance costs, disclosure requirements and audit fees. These inefficiencies raise the cost of capital and make equity markets less reachable to smaller companies. Indeed, listing costs account for 10-15% of proceedings in IPO's below €6 million and for 3-8% for IPO's above €50 million.¹¹⁴ Indeed, the cost structure in financial markets of the EU generally favors use of bank loans over equity markets. However, the initiatives are taken to expand equity markets: Markets in Financial Instruments Directive (MifID II) access of small and medium firms to the equity market is encouraged under specific "SME Growth Markets" under regular exchanges. The CMU action plan also focuses on easing costs and regulatory and administrative requirements for businesses and investors across the region to promote the use of stock markets.

On the demand side, European investors are more risk averse and less willing to invest directly in financial markets. In the Eurozone, institutional investors are the main holders of equity as of 2014; banks hold only 5% of their assets in equity and investment fund shares,

¹¹⁴ EU IPO Task Force 2015

while insurance firms hold 10%, pension funds hold 11% and investment funds hold 15% of their assets in equity.¹¹⁵ Household entrance in stock markets declined from 25% to 23% of their total assets between 2004 and 2014,¹¹⁶ as most of their assets are allocated to non-risky investments such as pension and insurance products or currency and deposits. Entering equity markets is expensive not only for listing firms but also for investors since accessing information on the creditworthiness of especially smaller firms is costly. Finally, securitization, which can utilize securities and improve demand for these products, is also costly and regulations prevent this market from further growth. Lack of transparency and weak enforcement deter investors from securitized products.

Other factors that can help EU stock markets' development can be summarized as follows: reduction of transaction costs; adjustment in relative tax treatment of financial assets; promoting entrepreneurial culture; stronger enforcement; and insolvency frameworks. Spillover effects across sectors, such as the effect of bank capital requirements on capital markets, should also be considered.

In addition, EU stock market development showed vulnerability to crisis: Between June 2007 and March 2009, Eurostoxx 600 index lost 60% its value and did not recover to the 2007 level until 2015 due to economic recession and banking sector problems. Recession in Europe triggered a large decline of economic activity, which reduced profitability and growth potential for both financial and real sector companies. By 2015, the Eurozone GDP growth would rise to only 1.6%, while such a low rate was not sufficient to trigger larger inflation. The consumer price inflation (HICP) rose only by 0.2%, lower than 2% target of the ECB. Therefore, the number of firms that could enlist and generate sufficient demand in stock markets declined strongly. After 2007, delayed economic recovery and ongoing low inflation in the Eurozone undermined investor confidence in the future potential of the markets since the economic outlook is linked to performance of listed firms and investor sentiment. Since then, European

¹¹⁵ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

¹¹⁶ <https://www.pwc.com/gx/en/banking-capital-markets/pdf/cmu-report-sept-2015.pdf>

stock markets were hit hard by the ongoing banking sector crisis and expedited restructuring of weak banks by introduction of higher capital and liquidity requirements and initiation of resolutions. The banking sector represented a significant amount of EU stock market capitalization and failure of many banks to pass stress tests, the resulting need to raise liquidity and capital, and resolution of some other banks triggered decline in banking sector shares. Between July 2007 and March 2009, the EuroStoxx 600 Bank Index declined by 80% and could recover to only 40% of the July 2007 value by 2015. The decline was mainly due to fall in the stock markets in Greece, Italy and Spain,¹¹⁷ which had among the most problematic banks. In this context, the development of stock markets is strongly connected to structural issues mentioned above as well as strong recovery of the banking sector and economic activity after the crisis.

In terms of integration, the integration among the EU stock markets is improving but they still remain fragmented. As can be seen from Figure 6, the most correlated markets to a Pan-European stock market index are the most developed ones. The recent crisis in economic and banking sectors also played a role in the slowdown of integration as stock market capitalization remained limited in many countries. Moreover, small markets have lost listings to developed markets due to their under-developed regulatory and institutional frameworks and lack of liquidity. In terms of infrastructure, cross-border integration among trading venues progresses very slowly, and markets still remain fragmented along national borders. The low level of participation in equity markets of household and some institutional investors, such as insurance and pension funds also weighs heavily on the integration process.¹¹⁸ Cross-border issuance of and investment in equities are still costly, while regulations, tax treatment, listing and compliance costs, investor protection, insolvency and enforcement rules still vary across countries.

¹¹⁷ MSCI share Price Indices, graphs from Morgan Stanley Capital International

¹¹⁸ https://www.ceps.eu/system/files/Capital%20Markets%20Union_1.pdf

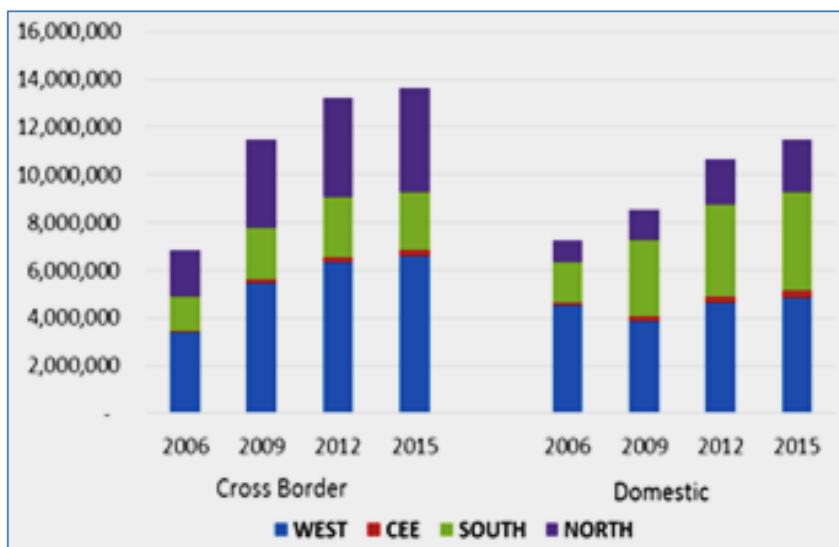
Equity markets need to address certain other issues to expedite regional integration. Tax treatment of equity and debt financing also indicate a bias toward debt. In most EU countries, corporate tax systems favor debt over equity, while the cost of equity capital was 45% higher than cost of debt due to taxation differences. However, higher leverage made European firms more susceptible to crises. There has been also a strong home market bias in equity and bond markets; as of 2014, 64% EU equity holdings were of domestic origin. The lack of harmonization of company law, insolvency law and comparable information on firms reduce cross border access to equity markets. In general, corporate governance in the EU is mainly concentrated, so managers and owners may be more unwilling to share control across borders.

EU Bond Markets

Like stock markets, bond markets across the EU also indicate developmental problems. At a first glance, total size of the EU bond markets is larger than the stock markets with a total of 163% of GDP,¹¹⁹ while most of the issuance is made by financial institutions (82% of GDP), followed by government bonds (69%) and corporate bond markets (12%). Issuance of bonds of all types (public, private, local or foreign currency, domestic or cross border) increased over last decade, between 2006 and 2015. (Figures 26-28) However, development of EU bond markets still remains below peers such as US and Japan, due to high fragmentation across national bond markets and insufficient development of regulatory, institutional and technological infrastructure.

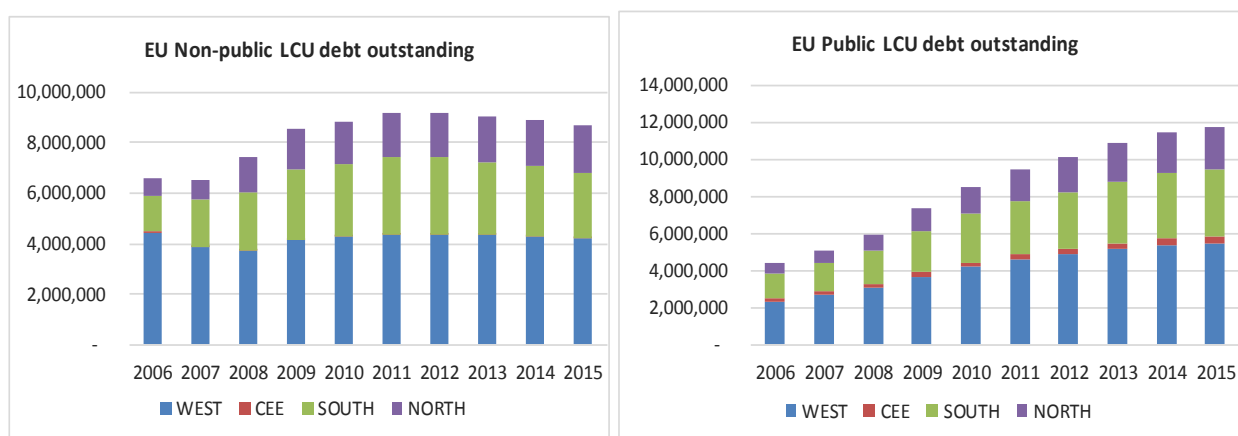
¹¹⁹ 2010-2014 average, Diego Valiante; "Europe's Untapped Capital Market: Rethinking financial integration after the crisis", European Capital Markets Institute, 2016.

Figure 26 - EU outstanding cross border and domestic bonds (USD Mil)



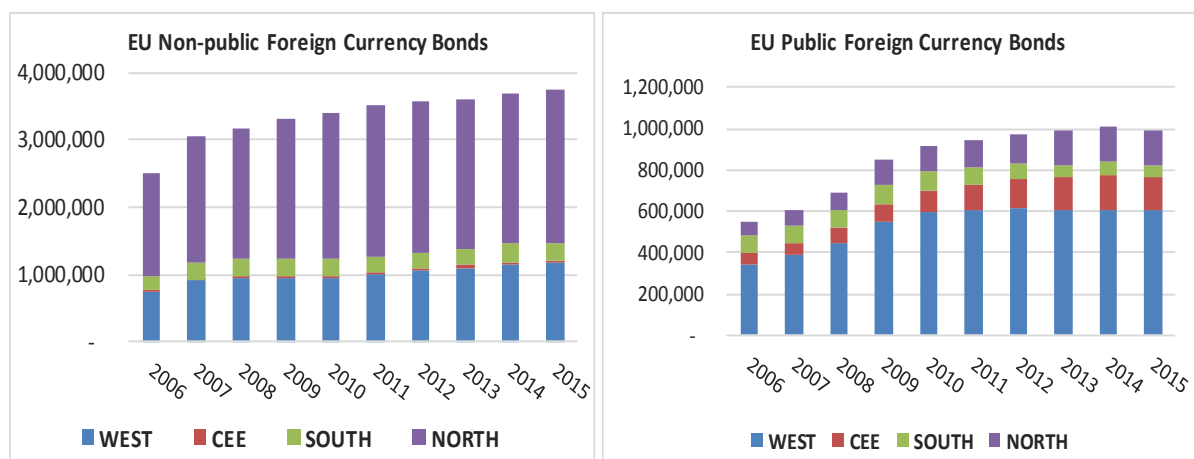
Source: IMF Data

Figure 27 - EU outstanding public and private local currency bonds (USD Mil)



Source: IMF Database

Figure 28 - EU outstanding public and private foreign currency bonds (USD Mil)



Source: IMF Database

Developmental differences among European bond markets are also remarkable across the sub- regions. West Europe is the strongest bond issuer of all types, and Northern Europe has highest outstanding cross-border bonds, mostly issued by the private sector and the UK.

In Southern Europe, both public and private local currency outstanding debt increased since the crisis, consistent with their governments and firms' needs to raise funds under global and banking sector crises. The debt issuance in CEE (Central and Eastern Europe) is minimal

compared to other sub-regions. As of Q1 2016, 54% of issuance in Eurozone is made by governments 40% by financial institutions and only 6% by non-financial corporations.¹²⁰

Both public and private bond issuance concentrated on local currency bonds in the EU, since other markets for high yield bonds, levered loans, securitization or private equity are underdeveloped in EU member states.¹²¹ Outstanding public local currency bonds almost tripled between 2006 and 2015 with governments' increasing funding needs to bail out banks and to stimulate the economy in the face of deepening recession. After Western Europe, bonds were mostly used in Southern Europe, which suffered both from banking and sovereign debt crises deeply after 2008. The banking crisis also affected sovereign debt markets since banks were also issuers of debt and government-bank relations have been very close in the EU. As the yields of the bank bonds rose (and prices fall) due to crisis and investor confidence, sovereign bonds were affected and followed the pattern. The ECB's quantitative easing and reduction of interest rates to the negative zone (to stimulate the economy) also hit the bond markets. By the last quarter of 2015, the gap between the two-year US and German bonds reached to 135 basis points, the highest in nine years. Before that, the total amount of negative yielding bonds had already increased from €1.4 trillion to €2 trillion during Q3 2015 in the Eurozone. Yields of German sovereign bonds, which are the benchmark for the EU, also were pushed to the negative zone as Germany's bonds with maturities up to 2020 had lower yields than the deposit rate of -0.2% at the time. EU bond markets remained fragmented and underdevelop for various reasons: On the supply side, firms mostly prefer financing by bank loans with relation-based services (as stated in concentrated corporate governance-sub section VIII).¹²² This led to the EU's CMU initiatives to promote issuance in debt markets. As of 2015, EU monetary and financial corporations had the largest amount of outstanding bonds, followed

¹²⁰ <https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-addressing-market-liquidity-euro-corporate-bond-market-2016.pdf>

¹²¹ European Commission, "Acting Plan on Building a Capital Markets Union" Sep 30, 2015

¹²² Since the crisis, reliance on dominant **banking sector** lending negatively affected the EU's growth and recovery; banks couldn't provide stable funding to economy when economic activity weakened and credit risks increased. EU banks reduced cross border activities since their asset quality eroded with non-performing loans and heavy exposure to sovereign debt, which led to decreased lending. Cross border lending in the EU declined in absolute and relative terms as banking sector activity migrated back home jurisdictions as they increasingly invested in home country sovereign bonds. (Battisini et al (2013) Schoenmaker et al (2013)) This led to the EU's CMU initiatives to promote issuance in debt markets

by governments (€10.8 and €6.9 trillion respectively).¹²³ The crisis also played a large role to increase issuance in financial corporations, as they turned to bond markets for their increasing funding needs. Raising government debt (86% of GDP in 2014)¹²⁴ mostly resulted from fiscal stimulus to counterbalance the downward effect of the subprime crisis. Corporate bonds stand very low compared to these two groups, only €1.8 trillion. Among the firms, only 4% of large companies and 1% for medium- and small-sized firms issue bonds in the EU.¹²⁵

On the demand side, financial institutions, insurance companies and pension funds are the strongest investors for bond markets: As of 2014, non-financial corporations had only 4.7% of their assets in debt securities. Monetary and other financial institutions (including banks) invested about 15% of their assets into bonds, while insurance and pension firms invested 25% and 11% of their assets into debt securities.¹²⁶ In 2014, total assets of pensions and insurance funds were €15 trillion, banks €48.5 trillion and other financial institutions €31 trillion. But the high number of funds and small average size keep investment fund markets fragmented and costly across member states.¹²⁷

Other institutional investors, such as investment funds, have been important holders of bonds over the last years but this market is also fragmented. Transaction costs and charges to hold fund shares are lower in member states with large capital markets and higher in small ones. Besides, differing standards in regulation, documentation, marketing, tax treatment and fees for cross-border notifications divide the markets more as the obligation to appoint a local agent makes the expansion across borders harder. In terms of pension funds, private pension industry development diverges as it is least in CEE and highest in developed countries such as Denmark, Netherlands, and France. Governance by national rules also led to fragmentation and prevented economies of scale and risk diversification. To address these issues, EIOPA is working on potential regionally standardized pension products.

¹²³ Diego Valiante; “Europe’s Untapped Capital Market: Rethinking financial integration after the crisis”., European Capital Markets Institute, 2016.

¹²⁴ <https://www.pwc.com/gx/en/banking-capital-markets/pdf/cmu-report-sept-2015.pdf>

¹²⁵ According to ECB and EC Survey “on the access to finance of enterprises.”

¹²⁶ <https://www.pwc.com/gx/en/banking-capital-markets/pdf/cmu-report-sept-2015.pdf>

¹²⁷ https://www.ceps.eu/system/files/Capital%20Markets%20Union_1.pdf

Corporate bond issuance in Europe is mostly used by large firms, which have the financial strength to issue bonds in large denominations and credit ratings, which are mainly bought by financial institutions.¹²⁸ Still, only 10% of large companies issued bonds (4% debt, 6% mezzanine) as issuance by medium companies (1% debt, 4% mezzanine) and small companies remained very limited (less than 0.05%) as of 2015.¹²⁹ While there are national initiatives to promote mid- and small-cap bonds such as securitization or pooling them into investment vehicles, the impact was limited. Meanwhile, private placements¹³⁰ (bonds, loans, equity and hybrid products, issued directly to qualified market participants) can cost less than public offerings with flexibility of financing. This market had about €17 billion of deals in 2014 and also remained fragmented due to the lack of a single legal framework and documentation standards with high compliance costs.¹³¹ Electronic trade is also widespread in corporate bonds as 50% of corporate bonds are traded that way by large retail and private banking clients trade; this led to numerous alternative electronic trade venues entering in the EU markets.¹³²

Still, EU corporate bonds are very disparate and issued and traded in in varying prices, yield, maturity, and currency denomination across members, which makes liquidity harder. Corporate bonds represent only 4% of corporate liabilities, while bank loans represent 14%,¹³³ compared to 11% and 3% in the US. Investors are mostly financial institutions (36%), investment, pension and insurance funds (34%). However, issuance of corporate bonds increased partly to compensate the decline in bank lending, due to ongoing sectorial problems. But these markets are still undermined by low standardization and price transparency.

During the financial crisis, cross-border corporate bond holdings decreased substantially. Thereafter, low interest rates, expansionary monetary policy and asset buying

¹²⁸ European Commission, “Acting Plan on Building a Capital Markets Union” Sep 30, 2015

¹²⁹ European Commission, “Acting Plan on Building a Capital Markets Union” Sep 30, 2015.

Mezzanine is hybrid of debt and equity financing.

¹³⁰ Participants arrange transaction between themselves, negotiate terms and design investment proposals, relying on private contract law.

¹³¹ European Commission, “Acting Plan on Building a Capital Markets Union” Sep 30, 2015.

¹³² <https://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-addressing-market-liquidity-euro-corporate-bond-market-2016.pdf>

¹³³ European Commission, “Acting Plan on Building a Capital Markets Union” Sep 30, 2015

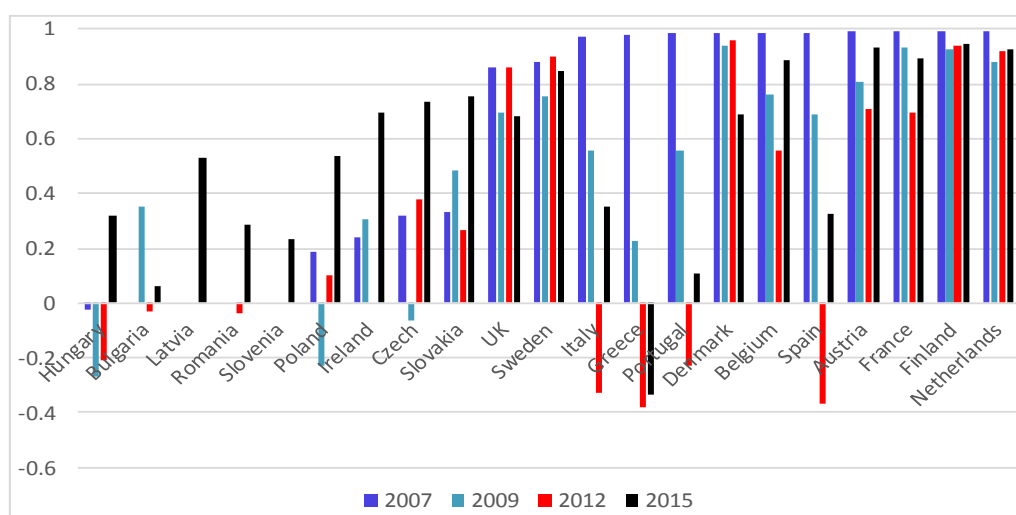
programs generated demand for these bonds as total issuance of Eurozone corporate bonds doubled to €340 billion between 2008 and 2014. Despite issuances by multinationals in the primary market, secondary market liquidity still dropped in 2015 due to limited standardization and large diversity of issues as well as withdrawal of some market makers and reduction of dealers' inventories after the crisis. (The European Commission has an important role to play to coordinate development and widespread adoption of new and existing products to stimulate demand.) In this context, the prudential requirements on capital, liquidity and risky assets of banks caused increases in dealers' cost and activity as liquidity providers.¹³⁴ Fragmented liquidity in secondary markets harms issuers and investor confidence, and it also reflects on primary markets. Liquidity of Euro corporate bonds are fragmented across thousands of bonds of varying features.

In terms of regionalization, the EU debt securities markets have shown greater integration over the years, driven by wholesale dealer banks after the monetary union and EU financial reforms, such as FSAP. This especially applies to bonds issued by governments and financial institutions. However, the impact of the financial crisis on wholesale banks produced a reversal of capital flows and the integration process. Today, the EU markets remain fragmented with typically bilateral trading, low integration and efficiency. Regulatory and tax treatment, cost of issuance, and compliance costs also differ among members. The secondary markets for European credit bonds have become critically impaired due to unintended consequences of banking regulation and extraordinary monetary policy.¹³⁵ Bank broker-dealers are responding to the impacts of regulation by changing their business models. As a result of more strict capital allocation within the banks, intermediaries shift to smaller inventories, but increasing turnover. Technology should also be improved in markets to enhance data management to identify potential holders or buyers of bonds, as well as improve connectivity across the markets.

¹³⁴ ECB 2014

¹³⁵ The current state and future evolution of the European investment grade corporate bond secondary market: perspectives from the market. ICMA Nov 2014

Figure 29- Correlation of EU countries' 10- year bond yields to German 10-year bond yields*



Correlations reflect Bloomberg's generic tickers for ten-year bonds.

Source: Bloomberg

Cross-border holdings of debt securities remain lower due to other reasons.¹³⁶ Regulatory differences such as company law, insolvency law and difficulty of exercising shareholder rights across borders fragment corporate bond markets across the EU. Inconsistencies in disclosure regimes across national regulations and diversity in application of withholding taxes impede development of regional bond markets. National accounting and reporting requirements vary across the EU as many countries provide incentives for domestic investments by taxation and prudential rules.

THE ASEAN CAPITAL MARKETS

Initiatives on ASEAN Capital Market Integration

The start of ASEAN financial integration is more recent than the EU, as ASEAN countries recognized that strengthening regional integration in trade and FDI made financial markets very important to transfer increasing regional savings to capital-seeking firms, projects

¹³⁶ Cross-border holdings of debt securities also remain lower than would be expected in a fully integrated market

and public institutions and mobilize funds across the borders. In 2003, ASEAN implemented the “Roadmap for Monetary and Financial Integration of ASEAN” (Ria-Fin), which envisaged integration of ASEAN financial markets in capital market development, financial services liberalization and capital account liberalization. For capital account liberalization, the goal is the gradual removal of restrictions in current account, FDI, portfolio investments and other flows.

In 2004, the ASEAN Capital Markets Forum (ACMF) was established. In 2008, the ACMF proposed a plan to promote development of an integrated capital market. The ACMF’s Implementation Plan was actually comprehensive with multiple strategic goals to enable ASEAN issuers, investors and intermediaries to access cross-border ASEAN equity and bond markets by integrating clearing, custody and settlement systems.¹³⁷ Its many provisions included progressive liberalization; regulatory harmonization and mutual recognition; adoption of international standards; and sequencing of regional integration initiatives according to ease of implementation, market preferences and technical linkages. The plan also envisaged creation of regionally focused products and intermediaries to build an “ASEAN asset class” and to strengthen bond markets.

In 2010, the Working Committee on Payment and Settlement Systems (WC-PSS) was established to foster safe, efficient and integrated payments in the region. The main goal is to improve PSS in five areas, namely retail payments, capital markets, remittances, trade settlement, and standardization. WCC adopted the Principles for Product Transparency and Disclosure on Cross Border trade settlements in 2015, which was implemented by Malaysia, the Philippines and Singapore. After 2015, WCC-PSS aims to facilitate regional linkage of retail, large value and settlement systems with cooperative oversight.

Also in 2010, seven ASEAN stock exchanges (Bursa Malaysia, Hanoi Stock Exchange and Hochiminh Stock Exchange in Vietnam, Indonesia Stock Exchange, Philippine Stock Exchange, Thailand Stock Exchange and Singapore Exchange—namely ASEAN-5 and two

¹³⁷ <http://www.sec.or.th/TH/Documents/Information/speeches/speech270452.pdf>

Vietnamese exchanges) formally introduced the ASEAN Exchanges collaboration. The initiative focuses on harmonizing regulatory frameworks, facilitating the issuance of ASEAN products, cross-exchange listing of ASEAN products, and mutual recognition of capital market professionals.¹³⁸

In order to promote visibility of an “ASEAN asset class,” three goals were achieved under ASEAN exchange alliance and governance framework, initiated by ACMF’s Implementation Plan. First, ASEAN Stars Index was created with top 180 blue chip stocks and launched in 2011 to introduce an ASEAN exchanges identity. Second, data on ASEAN Stars were made available in FTSE ASEAN analytics. Third, the ASEAN Trading Link was launched in 2012, which connected stock exchanges of Malaysia, Singapore and Thailand and enabled investors to access these markets from one single access point. These three exchanges held two thirds of ASEAN market capitalization at the time.

In 2012, the ACMF continued initiatives to facilitate multi-jurisdiction offerings of equity and plain debt securities. A Memorandum of Understanding (MoU) was signed between the exchanges of Thailand, Malaysia and Singapore for Expedited Entry of Secondary Listings, which reduced the procedural time for secondary listings from 16 weeks to 35 business days. In 2013, new disclosure standards were implemented for cross-border sale of investment instruments based on IOSCO (International Organization of Securities Commissions) standards. Additionally, International Financial Reporting Standards (IFRS) and International Standards on Auditing were fully adopted. Moreover, the progress of ASEAN bond market development, liquidity and openness is monitored by Working Committee on Capital Market Development by using the Bond Market Development Scorecard.

In order to raise corporate governance standards among publicly listed companies in ASEAN markets, the ACMF launched the ASEAN Corporate Governance Scorecard in 2011 based on corporate governance principles of the OECD. This is expected to enhance visibility of well governed ASEAN listed companies and help promotion of ASEAN as an international

¹³⁸ <http://aseanexchanges.org/mediacentre/648>

asset class. ACMF also finalized a framework for cooperation of national dispute resolution institutions to ensure that regional investors will be protected equally as domestic ones. The ASEAN Financial Integration Framework (AFIF) was adopted in 2011, to create a semi-integrated financial market by 2020, by providing guidance on liberalization and integration initiatives. By this framework, each member state defines their own milestones and timelines since they differ in development levels. ASEAN securities regulators implemented common disclosure standards in 2013, which allow issuance of debt securities across ASEAN markets with a single prospectus. The AFIF was geared to support liberalization of financial services within ASEAN, infrastructure development, liberalization of capital flows, harmonization of payment systems and stronger regional surveillance.

In collaboration with working committees on Capital Market Development and Payment and Settlement System (PSS), the ACMF also developed the blueprint to develop ASEAN Capital Market Infrastructure (ACMI) in 2014, especially to improve clearing, settlement and depository connection among ASEAN markets as well as connectivity in post-trade transactions.

On the demand side, contractual savings institutions (CSIs) such as pension funds, insurance companies or social security institutions gained importance as an investor class in the emerging Asia. Those institutional investors became a key factor supporting corporate bond market growth in Malaysia, Korea and China. This strong role of institutional investors led the ACMF to initiate the ASEAN Fund Passport (AFP) under ASEAN's Collective Investment Schemes (ASEAN CIS). The AFP became operational in 2014 including Singapore, Malaysia, and Thailand. The initiative allows fund managers operating in the three nations to distribute qualified funds across borders to retail investors, while the cross border funds should satisfy certain asset and capital requirements.¹³⁹ The signatories also signed an MOU in 2013 to provide mutual assistance for cross-border sale of ASEAN CIS to nonretail investors. In 2015,

¹³⁹ http://www.theacmf.org/ACMF/upload/standards_of_qualifying_cis.pdf

The requirements include assets under management at least \$500 million, with five years of performance record and shareholders' equity at least \$1 million. Also excludes property funds or REIT's.

Singapore pulled out of the agreement due to issues in standardization of tax treatment. As of early 2016, thirteen funds were authorized under the AFP as Qualifying CIS Securities.¹⁴⁰

Since regional institutional investors are very limited and cross-border penetration of banking is low in ASEAN, cooperation is crucial in the insurance sector. ASEAN Insurance Integration Framework (AIIF) aims progressive liberalization of the insurance sector especially in the maritime, aviation and transit sub-sectors. The principles of International Association of Insurance Supervisors (IAIS) are observed to enhance insurance regulation and supervision. Between 2007 and 2013, domestic firms accounted for more than a 50% share in ASEAN regional insurance sector, while foreign firms (including domestic partnerships) accounted for 40%.

In conclusion, the AEC blueprint 2015 aimed to achieve well integrated regional financial system with more liberalized capital account regimes, financial services and inter-operational capital markets to promote greater trade and investment flows within the region. In the future, cross-border investment and portfolio flows are expected to grow in ASEAN. Going forward, the ASEAN Secretariat, in cooperation with Ministries of Finance and Central Banks in ASEAN, plans to further liberalize capital flow restrictions and reform the tax systems. The ACMF will work on coordinated supervision and enforcement to ensure that investors are protected from cross-border fraud and misconduct, the integrity of the market is high, and systematic risks are well-managed. The ACMF will also ensure that members with less-advanced capital markets will receive technical assistance to develop capital markets and to build capacity for further integration. Cooperation also needs to be improved to facilitate technology transfer and oversight to avoid adverse economic shocks.

¹⁴⁰ Asian Economic Integration Report, Asian Development Bank (ADB) 2016.

ASEAN+3 Initiatives on Capital Markets

There's a significant economic interdependence between ASEAN as well as Plus Three (+3) countries, of which participation would increase benefits of financial integration. All these countries have export-oriented growth strategies, relatively high saving rates and therefore significant net foreign assets. Yet, development of the financial sector has not progressed as much as manufacturing, and the banking sector dominates financial sectors in almost all of them. Stock and bond markets still have substantial room to develop and expand. Capital markets are also not well integrated regionally, while there is significant integration with global markets.

The ASEAN+3 Forum was founded to facilitate co-operation between the ASEAN and three East Asian countries (China, Japan, and South Korea) after the Asian Crisis of 1997-98 led to macroeconomic deterioration, currency devaluations, and decline of stock markets and other asset prices across the Asia.¹⁴¹ In 1999, ASEAN+3 was established to restore financial stability and promote economic development by acknowledging that (i) emerging economies needed to reduce reliance on external financing by improving their financial markets, which would enable them to borrow in local currencies; and (ii) largely under-developed financial systems and the absence of a regional capital market were the main obstacles to channel substantial Asian savings into investments, which could stabilize the financial system.¹⁴²

After the Asian crisis, ASEAN+3 launched two initiatives: In 2000, the Chiang Mai Initiative (CMI) started as bilateral currency swap agreement within the group to manage regional short-term liquidity problems. By 2009, the CMI included 16 bilateral arrangements worth \$90 billion among the ASEAN+3.¹⁴³ In 2010, the bilateral swap mechanism was found ineffective and the CMI was turned into a multilateral agreement called Chiang Mai Initiative

¹⁴¹ ASEAN-5 countries had their nominal GNP declined between 1997 and 1998.

¹⁴² Since 1999, scope of ASEAN+3 expanded beyond finance to include other areas such as trade facilitation, economic development, poverty alleviation, labor movement, food and energy security, environment and sustainable development, and security cooperation etc.

¹⁴³ https://www.boj.or.jp/en/announcements/release_2009/data/un0904a.pdf

Multilateralization (CMIM). That year, the CMIM's capital was drawing from a fund (pool of foreign exchange reserves) worth \$120 billion, which was doubled two years later.¹⁴⁴ The second initiative is the Asian Bond Market Initiative (ABMI), started in 2003 to improve the resilience of the regional financial system by promoting the development of the local currency bond markets as an alternative to short-term foreign currency loans. The first phase (2003) and second phase (2005) of ABMI focused on creation of credit guarantee mechanisms, improved FX settlement, and issuance of local currency bonds by multilateral development banks, foreign government agencies and Asian multinational corporations. It also worked on setting local and regional rating agencies and creating new securitized debt instruments.¹⁴⁵ The third phase in 2008 focused on facilitating demand for local currency bonds, developing investment environment for institutional investors, regulatory harmonization, and improving infrastructure in bond markets.¹⁴⁶

In 2003, the Asian Bond Fund (ABF-1) was launched by demand from EMEAP¹⁴⁷ central banks. The ABF portfolio had an initial size of \$1 billion to be invested in liquid USD bonds of major Asian economies, namely the ASEAN-5, China, Hong Kong and Korea. In December 2004, the second stage was launched as the ABF-2 invested in domestic currency bonds of sovereign and quasi sovereigns in the participating countries with a \$2 billion portfolio. The local currency bonds in eight ABF-2 markets grew strongly as China, Korea, Malaysia and Singapore registered the highest growth between 2005 and 2009. As of 2015, total outstanding government and corporate bonds in ASEAN-5 countries came either very close to or exceeded \$100 billion, which is the threshold for deep and liquid bond markets.¹⁴⁸

In parallel, the Asian Bond Market Forum (ABMF) was founded in 2010 to foster harmonization of regulations and market practices. The ABMF introduced the ASEAN+3 bond market guide in 2012, conducted studies on bond transaction flows and infrastructures and

¹⁴⁴ http://efsd.eabr.org/e/partners_acf_e/RFAs_acf_e/CMIM_e/

¹⁴⁵ <https://www.oecd.org/finance/financial-markets/49700575.pdf>

¹⁴⁶ <https://www.oecd.org/finance/financial-markets/49700575.pdf>

¹⁴⁷ China, Hong Kong, Indonesia, Japan, Korea, ASEAN-5, Australia, New Zealand.

¹⁴⁸ Local currency bond markets and the Asian Bond Fund Initiative. Eric Chan, Michael Chui, Frank Packer, and Eli Remolona. The threshold \$100 billion mentioned in McCauley and Remolona (2000)

worked on harmonization of cross-border bond transactions under an international framework. In connection, ASEAN+3 Multi-Currency Bond Issuance Framework (AMBIF) was completed in 2014, a common regional bond issuance program for intra-regional issuance. As a result of all these initiatives, total local currency bond issuance in ASEAN-5, China and Korea rose from around \$1 trillion in 2002 to more than \$5 trillion in Q3 2011, while 60% of issuance was from China.

To support the ABMI, the Credit Guarantee Investment Fund (CGIF) was established in 2010, to promote financial stability and long-term investments in ASEAN+3 region. The CGIF provides guarantees for local currency denominated bonds of the investment-grade corporations. The guarantees help companies to issue local currency bonds on longer maturities, which provide long-term financing and reduce their dependency on short-term foreign currency borrowing. The CGIF had \$700 million of capital with contributions from ASEAN+3 countries and the Asian Development Bank (ADB).¹⁴⁹

Also in 2010, ASEAN+3 Macroeconomic Research Office (AMRO) was established as a regional macroeconomic surveillance organization of the CMIM and policy advisor to maintain macroeconomic and financial stability in the region.

In 2013, Cross-border Settlement Infrastructure Forum (CSIF) was launched to facilitate the establishment of the Regional Settlement Intermediary by networks among national CSDs and real time gross settlement (RTGS) systems. This also aimed to enable settlement of local bonds by Delivery versus Payment (DVP) via central bank money, which ensures the safety of settlement. Currently, the steps are discussed to build these linkages.¹⁵⁰

The increasing importance of institutional investors also led to the signing of Asia Region Funds Passport (ARPF) Memorandum of Cooperation (MOC) in 2016, by Australia, Japan, South Korea, and New Zealand.¹⁵¹ Thailand and the Philippines signed a Statement of

¹⁴⁹ <http://www.cgif-abmi.org/>

¹⁵⁰ Capital Market Development in ASEAN Purpose: Information Submitted by: Asian Development Bank 2015/FDM1/020

¹⁵¹ Participants need to adjust their domestic sectors for regional passport by 2018. ASEAN Banks and Financials; Opportunities in ASEAN Integration. DBS Asian Insights Sector Briefing 29 Oct 2016

Understanding to join the group, while all APEC economies (including ASEAN-5 and Vietnam) are expected to join the ARPF in the long run.¹⁵² In the longer term, the passport could also enable Asian funds to be marketed in Europe via an Asian/European mutual recognition agreement.

ASEAN Stock Markets

AEC Blueprint 2015 targets regionally integrated capital markets with the free movement of capital and equal treatment of ASEAN investors and issuers within the region. Besides technological and legal frameworks, ASEAN authorities also focus on improvements in corporate governance, disclosure standards, secondary listing applications, and integration of post trade services,¹⁵³ which strongly relate to stock markets. Currently, there are nine countries with stock markets in ASEAN. The Malaysian, Indonesian and Thai exchanges goes back to the 1960s-70s; Singaporean and Philippines exchanges were founded in the 1990s; Vietnam has two exchanges founded in 2000s; Cambodia and Lao in 2011; Myanmar in 2016; and the Brunei stock exchange is expected to open in 2017. There are still developmental differences among these markets as Singapore and Malaysia are the most developed with stock market capitalization of more than 100% of GDP. It is also worth mentioning that ASEAN countries were affected less by the global crisis and the EU debt crisis, and recovered more quickly from contagious implications. Between 2009 and 2015, market capitalization decreased slightly for the two largest markets, while it increased for Thailand, the Philippines and Indonesia.

The integration of ASEAN stock markets has progressed by the development of stock markets, market mechanisms and strengthening linkages. In general, economic growth, capital

¹⁵² <http://fundspassport.apec.org/about/>

¹⁵³ The road to ASEAN financial integration, ADB 2013

inflows and demand from global investors to Asian equities supported development and liquidity in Asian markets, while connectivity of these markets also became stronger.¹⁵⁴

On a nominal basis, intra-ASEAN equity investments dropped from around \$22 billion to \$14 billion in 2008 with the global crisis but rose to \$42 billion (i.e. by three times) in the next six years, indicating stronger linkages. However, intra-ASEAN portfolio investments did not exceed more than 10% of the total, which shows much room for further development.¹⁵⁵ Econometric analysis of ASEAN-5 markets also suggests that these stock markets became more integrated pre- and post-Asian crisis as well as after the 2008 crisis.¹⁵⁶ “The ASEAN stock markets are moving towards more integration among themselves and getting more interdependent, especially following the global financial crisis”, while both long- and short-term integration among ASEAN stock markets have significantly increased.¹⁵⁷

Despite progress, ASEAN stock and bond markets are still not well integrated and need to address fragmentation in infrastructure, regulations and supervision. It should be also noted that both global and regional integration of ASEAN-5 equity markets have been increasing during the last two decades. As can be seen in Table 16, ASEAN-5 stock markets are now almost equally correlated with the US and Asian Markets¹⁵⁸ and less correlated with Japan, China and the EU. Correlations all increased during the 1999-2007 pre-crisis period and peaked during crisis period 2007 and 2009,¹⁵⁹ which suggests easier transmission of negative shocks. After the crisis, the correlation again somehow reduced but was still higher compared to the pre-crisis period.

¹⁵⁴ Cyn-Young Park. “Asian Capital Market Integration: Theory and Evidence” ADB Economics Working Paper Series, No. 351 June 2013

¹⁵⁵ Source: Asian Development Bank, Asia Regional Integration Center (www.aric.adb.org), based on data from IMF CPIS ASEAN Integration Report 2015

¹⁵⁶ Bakri Abdul Karim and Zulkefly Abdul Karim. “Integration of Asean-5 Stock Markets: A Revisit” Asian Academy of Management, Journal of Accounting and Finance

¹⁵⁷ Bakri Abdul Karim and Zulkefly Abdul Karim. “Integration of Asean-5 Stock Markets: A Revisit” Asian Academy of Management, Journal of Accounting and Finance

¹⁵⁸ Asian Economic Integration Report 2016

¹⁵⁹ For details of data please see Table 3.7 to 3.9 in Asian Economic Integration Report 2016. Correlations were calculated over weekly returns.

Table 16 Correlation of ASEAN-5 stock markets in 2015 (top) and 2006 (bottom)

Index	JCI	FBMKLC	PCOMP	STI	SET
2015	Indonesia	Malaysia	Phillipness	Singapore	Thailand
Indonesia	1.0	0.7	0.7	0.7	0.7
Malaysia	0.7	1.0	0.6	0.8	0.6
Phillipness	0.7	0.6	1.0	0.6	0.5
Singapore	0.7	0.8	0.6	1.0	0.6
Thailand	0.7	0.6	0.5	0.6	1.0

Index	JCI	FBMKLC	PCOMP	STI	SET
2006	Indonesia	Malaysia	Phillipness	Singapore	Thailand
Indonesia	1.0	0.7	0.7	0.7	0.6
Malaysia	0.7	1.0	0.6	0.5	0.6
Phillipness	0.7	0.6	1.0	0.6	0.5
Singapore	0.7	0.5	0.6	1.0	0.6
Thailand	0.6	0.6	0.5	0.6	1.0

Source: Bloomberg

Table-17 Average correlation of Stock Price Indexes in Southeast Asia*

	Pre GFC Q1 1999-Q3 2007	GFC Q4 2007-Q2 2009	Post-GFC Q3 2009-Q3 2016
Asia	0.33	0.72	0.43
China	0.09	0.37	0.21
US	0.28	0.54	0.44
Japan	0.29	0.67	0.34
EU	0.29	0.64	0.40
World	0.34	0.64	0.48

*Correlations were calculated over weekly returns.

Source: Data from Asian Economic Integration Report 2016.

Correlation of ASEAN markets with each other remained the same or increased between 2006 and 2015 after some volatility in recent crisis years. (Figure 30) High connectivity with the US market also comes with widespread use of the US dollar in transactions within the region. (Table 17) In terms of volatility, Southeast Asia equity markets are more vulnerable to the volatility of global markets than regional markets.¹⁶⁰ However, the

¹⁶⁰ Asian Economic Integration Report 2016. Southeast Asia refers to ASEAN-5, Vietnam and Laos.

share of variance in local equity returns that can be explained by regional shocks has substantially increased from pre-GFC to the post-GFC period.

Finally, the progress with the ASEAN's only stock market integration initiative (ASEAN trading link) have been slower than anticipated, since it was initially anticipated to connect all equity markets of the ASEAN by 2015. However, the initiative remained limited to three countries and trade volume has not been strong. Moreover, brokers in Singapore, Malaysia and Thailand could already make transactions on other ASEAN exchanges before the ASEAN Trading Link. The trading link was not successful mainly due to limited capacity and speed of clearing and settlement systems. There's a need for a centralized clearing and settlement system to see the full benefits of the link. Meanwhile, other main ASEAN bourses, namely Vietnam, Indonesia and Philippines, preferred to wait to join. Moreover, differences between regulation and supervision of ASEAN markets also challenge participation, for which a supranational regulator can be appointed to manage member exchanges.

ASEAN Bond Markets

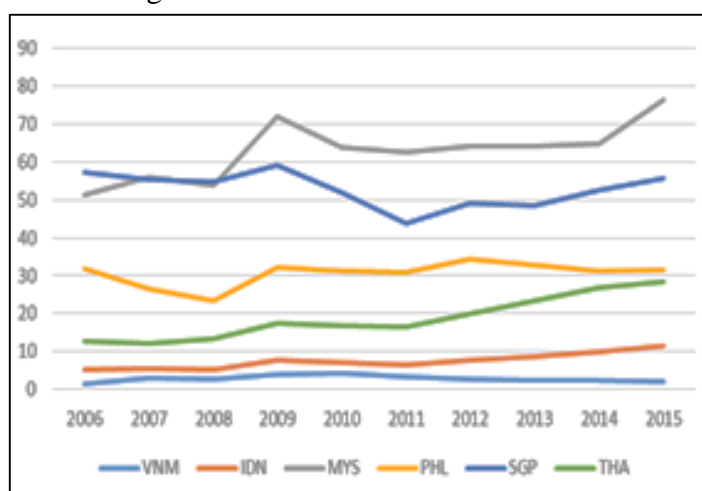
During the European sovereign crisis, foreign investors' interest in the Asian local currency government bond market remained strong, especially Korea, Malaysia, Thailand and Indonesia among ASEAN+3 countries, which positively affected development of bond markets.¹⁶¹ Prior to the global financial crisis, investors had a clear bias for investing in global markets rather than regional markets. After the crisis, they remain indifferent between global and regional markets¹⁶² However, cross-border portfolio debt holdings in Asia remain low, although they have improved in recent years. Within ASEAN-6, Malaysia and Singapore have largest bond markets, as Vietnam and Indonesia are the least developed. Issuance in other ASEAN countries is virtually minimal. The ASEAN-5 countries mostly raise funds from

¹⁶¹ Financial Integration Challenges in ASEAN beyond 2015 Maria Monica Wihardja Eria Discussion Paper Series Nov 2013

¹⁶² Financial Integration Challenges in ASEAN beyond 2015 Maria Monica WIHARDJA ERIA Discussion Paper Series Nov 2013

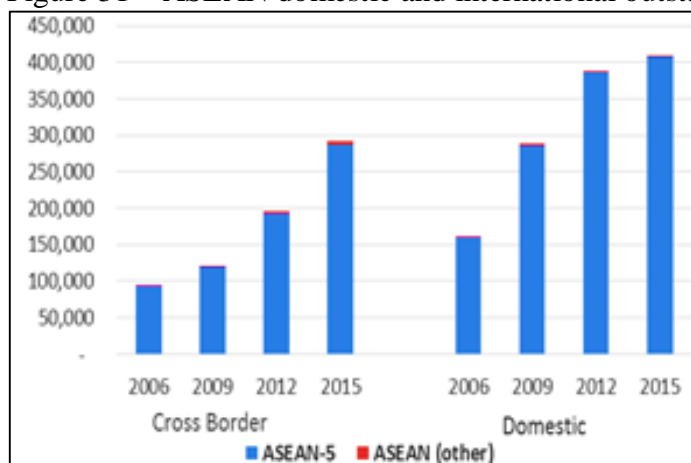
domestic markets to avoid foreign debt, while cross-border issuance almost doubled after 2009 crisis, showing global investors' demand to safer Asian bonds. (Figures 30 and 31)

Figure 30 – ASEAN Bond Market Size
Outstanding Bonds to GDP



Source: IMF Data

Figure 31 – ASEAN domestic and international outstanding bonds



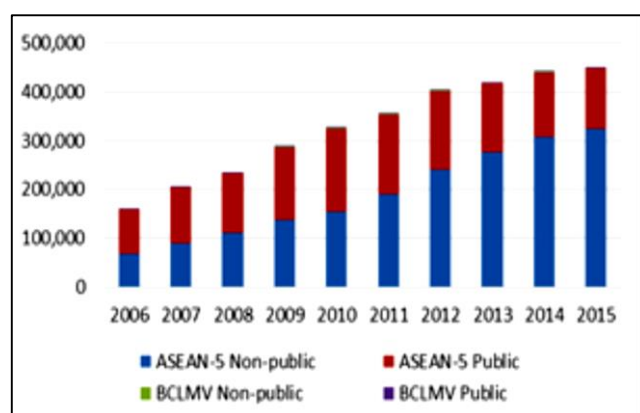
Source: IMF Data

Financial systems across ASEAN and ASEAN+3 are at very different stages of development and sophistication. Development of capital markets also differ:¹⁶³ For example,

¹⁶³ http://mddb.apec.org/Documents/2015/FMP/FDM1/15_fdm1_020.pdf

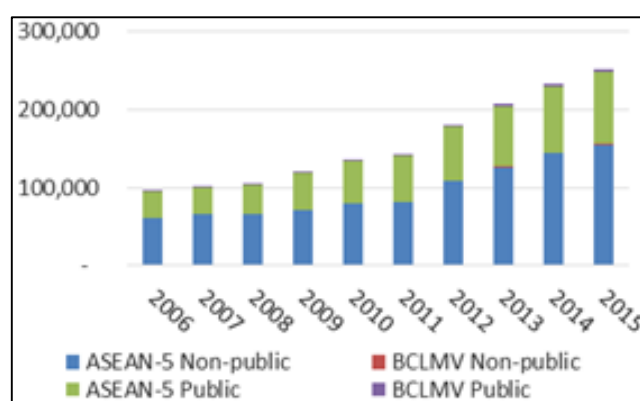
Singapore and Malaysia have more advanced capital markets and regulatory framework, while Cambodia, Laos and Myanmar have yet to introduce measures to develop sound banking systems, which are a prerequisite for capital market development. To finance investments, Indonesia, the Philippines and Vietnam heavily rely on the banking sector, and Thailand on corporate bond markets.

Figure 32- ASEAN Local currency outstanding bonds



Source: IMF Data

Figure 33- ASEAN Foreign currency outstanding bonds



Source: IMF Data

Among the ASEAN-5, government bond markets are strongest in Thailand, Malaysia, Singapore and Philippines, while corporate bond markets are best developed in Malaysia and Singapore. Government bond markets are more developed than the market for corporate

bonds,¹⁶⁴ which was also helped by regional initiatives: The ABF (by ASEAN+3 ABMI initiative) aims to address impediments to investors and improve liquidity of major government bond markets. The ABF's Pan Asian Bond Index Fund (PAIF) was offered to markets in 2010, and primarily invests in local currency government and quasi-government bonds in China, Hong Kong, Korea and ASEAN-5 with around \$3 billion of assets in total.¹⁶⁵

Corporate bond markets are also developing as outstanding bonds more than doubled since the crisis, while the increase was more in local currency bonds. This reflects the importance of local currency borrowing in ASEAN, which is the prominent strategy in the region after the Asian Crisis of 1997/98. (Figures 32 and 33) During the crisis years of 2008-2009, Asian corporations turned to local corporate bond markets to raise funds, when it became difficult in global markets. Secondary markets for corporate bonds still have room to develop as large new corporate bonds are traded a few days after the issuance and compared to government bonds, they are more heterogeneous with special covenants. Liquidity gathers around large issues, while credit ratings and standardization in bond covenants need to be improved. Post-trade transparency in price, quantity and parties should be enhanced so this information is revealed to the markets.

Developmental problems of ASEAN bond markets vary: Differences in regulatory standards, administrative processes and institutions, as well as high transaction costs, barriers of entry to foreign firms, and lack of cooperation between public and private sectors slow down bond market development. Small under-developed markets are afraid that liberalization of markets can dry liquidity, while capital restrictions, lack of clarity in ASEAN+3 monitoring and coordination and differences in tax withholding regimes increase the risks. Exchange rate risks and market fragmentation also need to be addressed. Therefore, initiatives to strengthen especially local currency bond markets continue: The ACMF's implementation plan aims to

¹⁶⁴ Implementation Plan for ASEAN Capital Markets Integration by Mr. Thirachai Phuvanatanarubala, Chairman of ASEAN Capital Market Forum At the 2nd OECD Southeast Asia Regional Forum, 27 April 2009, Bangkok

¹⁶⁵ <http://www.abf-paif.com/hk/eng/pdf/factsheet.pdf>

Table 18 Average Correlation of Weekly Bond Return Indexes before, during and after global financial crisis (GFC)

ASEAN-5	ASIA			China			Japan		
	Pre GFC Q1 1999- Q3 2007	GFC Q4 2007- Q2 2009	Post-GFC Q3 2009- Q3 2016	Pre GFC	GFC	Post-GFC	Pre GFC	GFC	Post-GFC
Indonesia	-0.15	-0.06	0.16	-0.12	0.06	0.13	-0.25	-0.06	0.11
Malaysia	0.22	0.31	0.29	0.1	0.25	0.22	0.27	0.07	0.09
Philippines		0.3	0.21		0.17	0.03		0.24	0.1
Sinapore	0.29	0.41	0.42	-0.09	0.08	0.15	0.32	0.4	0.38
Thailand	0.2	0.53	0.30	0.11	0.28	0.21	0.37	0.28	0.22

ASEAN-5	WORLD			EU			US		
	Pre GFC	GFC	Post-GFC	Pre GFC	GFC	Post-GFC	Pre GFC	GFC	Post-GFC
Indonesia	0.02	0.24	0.25	-0.23	-0.14	0.18	-0.18	0	0.09
Malaysia	0.13	0.27	0.13	0.18	0.22	0.2	0.16	0.25	0.19
Philippines		0.14	0.15		0.01	0.2		0.21	0.15
Sinapore	0.27	0.31	0.46	0.32	0.5	0.4	0.35	0.55	0.63
Thailand	0.29	0.32	0.24	0.34	0.45	0.27	0.33	0.44	0.35

Source: Data from Asian Economic Integration Report 2016.

strengthen the bond markets by accelerating reforms in issuance, listing and distribution of bonds, ratings comparability, and clearing and settlement of linkages.

Like equity markets, the share of holdings of US, EU and Japan in ASEAN+3 bond markets are also high. Holdings of the US and Europe together changed between 35% and 60% of total foreign holdings in ASEAN local currency bond markets as of 2011, with US slightly higher than the Europe.¹⁶⁶ Correlation of ASEAN+3 and ASEAN bond markets with US Treasury bonds changed between 14% and 33% during the same period.¹⁶⁷ According to correlation of weekly returns, ASEAN-5 bond markets are less integrated than equity markets both—regionally and globally—despite many initiatives.

In general, correlation of ASEAN-5 local currency government bond markets with Asia, China and the US increased last two decades, while correlation with the World and the EU increased in all ASEAN-5 markets except Thailand. Unlike equity markets, ASIANS-5 bond markets are more vulnerable to volatility in regional bond markets than the global market. Compared to the pre-crisis period, the share of variance in local currency bond returns that can

¹⁶⁶ ASEAN Banks and Financials; Opportunities in ASEAN Integration. DBS Asian Insights SECTOR BRIEFING 29 Oct 2016. Correlation of returns were measures.

¹⁶⁷ ASEAN Banks and Financials; Opportunities in ASEAN Integration. DBS Asian Insights SECTOR BRIEFING 29 Oct 2016

be explained by global and regional shocks increased, which suggests stronger regional and global integration and the rise of ASEAN local currency bonds as an emerging market asset class. However, more regional connectivity will make investors' decision more driven by regional risk factors, which strengthens this linkage further.

On the capital market integration, ten separate market systems with varying regulations and development levels complicate regional integration, while many regional reforms require domestic legislation or even constitutional changes before actions on the international level are taken. Therefore, the regional integration agenda need to be aligned with domestic capital market development plans, especially in less developed markets. From an institutional perspective, divergent national policies on current account liberalization, investor protection and withholding taxes limit growth of capital markets. Due to their small size, ASEAN markets offer limited products and services and remain illiquid, which makes them more vulnerable to crises. In terms of supervision, each ASEAN country has its own rules and policies to monitor and supervise its capital markets. There are differing guidelines for foreign investors (as well as ownership rules), qualified institutions, and retail investors. Other measures should be implemented for capital flow liberalization, regulatory harmonization, and infrastructure connectivity as well as addressing developmental differences and divergence in tax structures and entry to national markets. The ASEAN efforts need to continue on this front as the initiatives are promising. The Asian financial system is still relatively bank-dominant, with smaller bond markets and a limited role for securitization, and derivative products. Therefore, the ACMF Action Plan 2016-2020 continues to pursue an inter-connected, inclusive, and resilient ASEAN capital market, to support the ASEAN Economic Community Vision 2025, which aims to deepen economic integration over the next ten years.

In summary, EU and ASEAN equity and bond markets remain fragmented mainly due to developmental differences, insufficiency of infrastructure and diverge in national laws.

These problems are more serious in ASEAN than the EU. Indeed, many EU capital markets are more developed than ASEAN with better institutionalization, removal of intra-regional capital flows and more advanced infrastructure. In ASEAN, Malaysia and Singapore are leading markets, while some weaker countries in the region still did not set up capital markets.

In current conditions, developed EU markets are more connected with regional index than small markets, while investors and issuing firms migrate from small to advanced markets within the region. Ongoing initiative for Capital Market Union will strengthen the EU integration in the future, after economic recovery from double crises. In case of ASEAN, both stock and bond markets have been more integrated with advanced countries, which are also strong trade partners -like US or Japan-. However, the correlation within the region has been improving to close the gap. In both regions, capital markets are more accessible to large companies.

According to these findings; contribution of capital market integration to regional trade –in a near to medium term future- can be limited due to bank dominance, while capital market integration remains a long project with developmental differences and necessity of long term institutional commitments and costly infrastructure, especially in ASEAN.

CHAPTER VIII

CONCLUSIONS

This dissertation searched on how regional trade integration in the EU and the ASEAN relate to financial sector development and integration. It starts with evaluating trade and FDI patterns in two regions as well as formal regionalization initiatives. (Chapter 3) As the next step, financial sectors of the EU and ASEAN were analyzed to identify their linkages with trade. This required analysis of the EU and ASEAN banking sectors (Chapter 4) and capital markets, (Chapter 5) which are the most crucial components of the financial systems. Results indicate that trade integration is strongly linked to banking sector development and integration, while effect of capital markets is limited since both financial systems are bank dominated and capital market development and integration efforts started only recently.

The literature notes that regional integration progressed simultaneously with global trade integration, which suggests some complementarity between two processes. Rise of regionalization can be attributed to the inability of global integration to address various issues such as; disadvantageous position of developing and less developed states in trade against advanced countries, difficulty of improving national industries under liberalization and hardships to build competitiveness under fierce global competition, sudden capital outflows, crisis and contagion. Trade regionalization can support countries to gain experience and build competitiveness by expanding to closer regional markets. It can also reduce transaction costs by regional regulatory adjustments such as reduction of tariffs and non-tariff barriers, harmonization of customs procedures, mutual recognition of standards, permits and certifications. Trade

regionalization expands markets from national to regional borders, while pooled resources by the states can be used to build a more competitive regional framework in terms of regulations and infrastructure and design policies that promote economic development.

The literature also mentions that trade is connected to financial system through various channels, and therefore, trade integration is positively related to financial integration. At this point, it should be also mentioned that both trade and financial development are closely related to economic development, which explains the proliferation of policies to develop both sectors. Well-developed financial sectors can better mobilize savings into productive investments, improve capital allocation and contribute to economic stability. They also perform crucial functions for trade such as; providing capital and funds for firms (which support growth and trade activity) and for infrastructure investments (which support trade through transportation, energy and communication networks).

These functions can be summarized as follows: Firstly, banks and financial institutions provide loans and trade credits to companies, while they also perform other trade-related functions such as financial leasing, payment and monetary transmission services, guarantees and commitments, issuance of equity and debt securities to raise funds, money broking, asset management and advisory services and transfer of financial information. Regional integration of banking sectors can allow national banks to follow their clients across borders to provide services they need abroad. Second, safe and timely transfer of funds/payments is enabled by well developed financial infrastructure (payment & settlement systems and trade repositories) and related service providers. Third, development of capital markets (equity and bond markets) provides a viable alternative to bank loans. As seen in the Asian Crisis of 1997/98, global crisis of 2008 and the European sovereign debt crisis of 2011, banking sector responds to economic instabilities by narrowing their lending and over reliance on banking sector makes all companies

vulnerable to disturbances in banking and economic system. Fourth, capital markets allow companies to raise funds by issuing equities in stock markets (instead of seeking debt) or by issuing bonds, which enable them to borrow money outside of the banking system. This is very crucial for the EU and ASEAN since both have bank based financial systems. Development of capital markets diversifies funding sources for firms, while integrated capital markets can enable them to tap a larger regional investor base as funding sources. Capital markets also provide alternative financing for infrastructure investments other than bank loans. Fourth, financial sector mitigates the currency, interest rate and maturity risks of international trade through derivative instruments, especially when their assets and liabilities have mismatches in currency and duration. Fifth, as a part of financial sector, insurance sector provides protection against accidents, disasters and other related risks of trade. Moreover, insurance of trade credits, business credits, and export credits of the firms is also possible. For infrastructure investments, solid large scale insurers and reinsurers are crucial to address many project risks. Finally, macroeconomic cooperation and surveillance under regional integration can ease detection of systemic risks, help economic stability and ease initiation of counter-cyclical policies when economic activity narrows down. When national and domestic financial firms are insufficient to perform these functions, non-regional banks and financial firms can enter and dominate local markets.

Any problems in financial sector (such as low financial sector development, small financial sector size or financial crises) that undermine these functions can impact trade negatively. In fact, the literature states that larger financial systems associate with more efficiency and competitiveness as well as lower costs and better availability of financial services. Integration of financial sectors can expand markets (for financial services) from national to regional borders and distribute the operational and infrastructure expenses across broader base

(economies of scale and scope effects). This way, unit costs of financial services can be reduced and supply of financial services increased, which can support trade. Regulatory harmonization and mutual recognition agreements in financial services can facilitate product branding, standardization and easier expansion of financial firms. Adoption of regional rules enables uniform competition policies, investor protection and dispute resolution in financial sectors, which improve business environment and confidence of clients and investors. Cooperation on macroeconomic financial policies can facilitate systemic supervision of banks and markets to detect stability risks.

However, financial development is also subject to “threshold effects” meaning that countries need to pass certain levels of financial development to see noticeable benefits on economic growth. Besides, although financial integration involves developmental measures, it does not substitute for financial developmental policies. Thus, it is more appropriate to develop financial sectors (of under developed countries) before starting financial integration. In this phase, cooperation rather than integration can be more appropriate. Premature opening of financial markets without strengthening domestic financial systems and credible safety nets can lead to instability and crises. As a process, financial integration is more complicated and slower than trade integration since it requires common infrastructure, harmonization of regulatory standards and common supervision, which is more than reduction of tariff or non-tariff barriers as in the case for trade. It should be noted that financial integration is not applicable to all countries: It can address issues with small financial sector size. For example, the literature mentions minimum size for sustainable equity markets around \$15 billion and for bond markets \$100 billion, which can be achieved by merger of markets. Financial integration can also address inefficiencies (such as capital controls, market entry/exit, regulatory basis etc.). For some other

countries, (which have large economies but small financial sectors with unfulfilled potential) developmental policies may be more appropriate.

Analysis of the trade patterns in the EU and ASEAN suggest similarities based on long history of integration, ongoing negotiations for services liberalization, efforts to eliminate tariff and non-tariff barriers and sub-regional developmental differences within regions, leading to dominance of developed regions in trade and FDI. However, EU trade integration is better institutionalized than the ASEAN, with more improvements on regional free trade. European trade network is much larger, while ASEAN networks mostly rely on other Asian countries but with extended relationship with other developed countries due to an export oriented strategy, FDI and outsourcing by multinational corporations (MNC)

Indeed, both regional blocks have a long history, EU starting from late 1950's and ASEAN in late 1960's. Trade integration started to accelerate after 1980's with the start of liberalization and globalization in the world economy and financial system. In 1992, European Union was established by Maastricht Treaty and ASEAN FTA went into force. However, EU constructed a more expanded institutional structure than ASEAN: In 1990's and 2000's, the expansion of the EU continued with accession of former communist countries. During this time, European agreements and directives -such as Agreement on European Economic Area (1994), Amsterdam Treaty (1997), Treaty of Nice (2001), EU Services Directive (2006), Treaty of Lisbon and Functioning of the European Union (2007) were implemented to eliminate tariffs, reduce non-tariff trade barriers (NTBs) and to ensure free movement of goods, services, capital and persons within the European Single Market. Since 2005, the EU made substantial improvements in competition rules, consumer protection, dispute resolution, taxation and social convergence policies. Tariffs are eliminated between EU members, while imports can circulate freely within the region. Also, European institutions such as European Community, Parliament

and Central Bank have acquired the status and authority of supranational organizations, while regional laws, standards and enforcement were introduced. EU regional integration progressed in tandem with global integration as the region actively participated in WTO initiatives, GATT & GATS.

On the other side, ASEAN Free Trade Agreement (AFTA) started in 1992, when regional trade was low and concentrated on Singapore, Malaysia and Thailand. AFTA permitted many exemptions for trade of sensitive goods, as most non-tariff trade barriers stayed during the 1990s. With the following initiatives such as Common Effective Preferential Tariff Scheme (CEPT-1993), protocol to amend on AFTA-CEPT for elimination of import duties in 2003, and ASEAN Trade in Goods Agreement (ATIGA-2010), tariff rates have been reduced substantially, although not eliminated as in the EU. Between 2007 and 2014, average ATIGA rate was reduced from 2.58% to 0.54%, compared to decline of average Most Favored Nation rates from 8.15% to 6.90%. ATIGA tariff rate is to reach zero in 2018. Other initiatives include ASEAN Framework Agreement (2002- for elimination of Technical Barriers to Trade), ASEAN Agreement on Customs (2012), and ASEAN Single Window (in progress-to enable regional electronic data exchange for cargo clearance). In 2015, ASEAN Economic Community was founded; the AEC blueprint (2007) envisaged removal of NTB's in three stages between 2010 and 2018.

Both the EU and ASEAN have strong potential for economic growth and trade, while regional trade patterns reflect economic structure. ASEAN integration shows how regional integration works as a part of export-based development strategy. In the EU, trade liberalization brings more interdependence, which rises demand for regional institutions. The literature mentions that regional integration reinforces the existing economic structures of a region rather than changing. When intra-regional interdependence prevails, intra-regional trade increases; but when extra-regional interdependence prevails, regional integration can support extra-regional

trade and become a part of an export-based development strategy. Moreover, power asymmetries between regional power and other countries can be enhanced.

The EU is the second largest economy in the world with \$16 trillion of GDP (26% of global GDP), following \$18 trillion of the US in 2015. During global and sovereign debt crises (2008-2010 and 2012), the EU GDP growth shrank by 4% and around 0.4% respectively. The recession also affected trade as share of trade in GDP-both extra and intra-regional- also declined during the crisis years. Intra-regional trade has been around two-thirds of the EU total trade (\$290 billion in 2015) for the last 10 years, much higher than the ASEAN. In terms of FDI, extra-regional FDI inward stock of the EU rose from around €2.8 trillion to €5.7 trillion between 2009 and 2015, but FDI inflows to the EU dropped from \$551.4 billion in 2008 to \$246.2 billion in 2013 due to crises. Since 2000's, the US and EU are the highest FDI investors to each other. Moreover, trade network of the EU is much larger than ASEAN; EU has trade agreements with around 40 countries, while other important agreements include Canada (CETA), the US (TTIP), and Singapore. EU Trade agreements include various types such as customs unions, FTA, others (association, partnership & cooperation agreements) and mega-regional agreements.

On the other side, the ASEAN aims to form a regional block similar to the EU but without the monetary union. Between 2006 and 2015, ASEAN growth was better than global average: The GDP of ASEAN-5 doubled and of other ASEAN countries tripled in nominal values, reaching \$500 billion in 2015 -despite the global crisis and slow down after 2012. ASEAN trade openness has also been maintained despite global crisis: Total trade was 118% of GDP in 2007, down to 99% in 2009 and rising again to 127% in 2014. However, share of intra-regional trade remained stable, around 25%, much lower than the EU. As of 2014, Singapore had highest share in intra-regional trade (33%), followed by Malaysia (20%), Thailand (17%) and Indonesia (15%). ASEAN FDI inflows rose from \$40 to \$119 billion between 2005 and 2015

with a decline from around \$80 to \$50 billion between 2007 and 2009. ASEAN's strong economic growth, export oriented strategy and strong links with advanced partners such as the US, EU, Japan and China led to increasing trade and sophistication of ASEAN firms. Since the AFTA, extra-regional partners have been dominant in ASEAN trade network, while member states mostly remained at periphery. Largest investments to ASEAN came from Japan, the US and China in 2015. In regional groups, the EU and Regional Comprehensive Economic Partnership countries (RCEP or ASEAN+6) are the largest investment partners. Existence of stronger economies in Asia, growing interdependence of ASEAN with major Asian powers and the need to regionally coordinate economic and financial policies to address systemic risks led ASEAN to form FTAs with China, Korea and Japan under ASEAN+3 initiative after the Asian crisis. ASEAN also signed an FTA with Australia and New Zealand and currently works on ASEAN+6 (RCEP), which will liberalize goods and services trade in a large mega-regional agreement. ASEAN also have FTAs with a few South American countries. Compared to the EU, its trade network has less number of countries, mostly from the Asia region.

Integration of both the ASEAN and the EU need to address issues with developmental differences, services integration, regulatory differences and NTB's as well as infrastructure financing to support trade integration. In the EU, services integration developed slowly due to differences in national regulations and large restrictions on services trade and liberalization. The Services Directive (2006) could cover only half of the total services sector three years after signing. In general, the initiatives for services integration allowed members to limit liberalization on the basis of public interests. This was partly due to concerns on the investor state dispute settlements, (ISDS), which was considered to enable private companies to exercise heavy influence on state, prevent fair provision of needed services and to increase prices or reduce quality of services to maximize profits.

In addition, capital can move freely within the EU, but its taxation is made according to national rules. Developmental differences across the European sub-regions also affect integration. The most developed Western and Northern regions of the EU lead trade and FDI of the region, while Southern and Eastern regions are characterized by lower GDP's, weaker financial systems and less trade activity and mostly became FDI receivers from the rest of the union. This also made EU trade integration more vulnerable to crises since weak economic and financial systems in developing sub-regions deepened the recession and necessitated EU-wide programs to stimulate regional economy and trade activity. Moreover, the EU faces an investment gap and needs \$2 trillion of investments till 2020 (mostly transport, energy and communication) which affects its trade competitiveness, while share of public investments for infrastructure declined from 5% to 2.5% between 1970s and 2000s. For this purpose, the European Fund for Strategic Investments (EFSI) was created in 2014 to raise €315 billion in the markets, and to fund €240 billion of long term investments and €75 billion of support to SMEs.

Meanwhile, ASEAN services integration started with ASEAN Framework Agreement on Services (AFAS-1995). Since then, nine packages were completed with increasing depth of commitments and number of subsectors. Thereafter ASEAN Trade in Services Agreement was signed but so far, only limited number of services have been liberalized. In fact, elimination of tariffs and non-tariff barriers has not yet been completed even for goods. External partners such as the US, EU and Japan do not only dominate ASEAN international trade but also production networks through linkages between multinational corporations (MNCs) and ASEAN firms. Over time, ASEAN firms became more sophisticated and internationalized, which can help intra-regional regional trade to exceed current 25% in the future. However, divergence of national laws in terms of market practices; entry and exit of firms, competition policy, investor protection

and resolution of disputes have been slowing down regional trade integration, making it a long term project. Capital controls also remain, despite the initiatives.

Similar to the EU, ASEAN also has substantial developmental differences between ASEAN-5 and other ASEAN countries, while the gap between those two groups is higher than the gap between developed and developing sub-regions of the EU. Recent estimations indicate that ASEAN will need \$2.2 trillion of investments till 2030 to facilitate regional competitiveness. Therefore, initiatives such as ASEAN Comprehensive Investment Agreement (2012), ASEAN Collective Investment Scheme (CIS) and ASEAN Infrastructure Fund (AIF) have been started.

The next step in the analysis is reviewing the development and integration of banking sectors and capital markets in the EU and ASEAN. The literature suggests that sound and efficient financial systems—banks, equity markets, and bond markets— positively relate to economic growth, especially in developed countries. However, impact of banking sector and capital markets on financial and economic development can change according to stage of development: Development of banking sector promotes economic growth in earlier stages of financial development, while market based financial development becomes more important for economic growth in later stages. As mentioned before, banks mobilize savings into investments by extending loans to financial and real sector firms. They also provide financial asset management, brokerage, advisory services and are integral part of payment and settlement systems. Banking system also plays crucial role in transmission of monetary policy, macroeconomic stability and liquidity: Besides, efficient functioning of interbank markets provide liquidity to illiquid banks and support stability of financial system. Moreover, banks also participate to capital markets as issuers (of bonds, equities to raise funds) or investors.

Banking sector is crucial for economic activity and trade, but excessive reliance on banks makes the firms and the overall economy vulnerable to banking system problems, which can

shrink lending. Bank domination in financial services and payment systems can limit competition and push costs of these services up. Regionalization and expansion of financial system can reduce over reliance on banks, lower banking sector concentration and improve efficiency and competitiveness.

To promote banking system development and stability, BASEL standards set global benchmarks for banking regulation and supervision as applied in the ASEAN and the EU. Over time, BASEL evolved to cover more risks to banks and economic stability; with BASEL-I in 1988, BASEL-II in 1999 and the most updated BASEL-III in 2009. These versions vary in complexity and each version can be adapted by different countries according to their development levels. (So members of the same region can have differing BASEL versions). BASEL regulations require banks to be sound capital adequacy to absorb losses, asset quality to minimize risks from loans and liquidity to maintain sufficient cash flows as well as management soundness, internal risk management and earnings.

Regional integration positively affects banking sector development through various channels: First, it expands the size and outreach of banking sector by merging markets, which means a larger saving pool and more customers. Thus, economies of scale and scope reduce cost of banking services by spreading the expenses of financial infrastructure across regional market. The literature states that banks operating in larger systems indicate lower average cost of production and benefit from technological developments more rapidly. Third, banks in larger systems have lower costs of risk absorption and reputation signaling. Fourth, regionalization can improve information availability since expanded bank networks ease collection of information on clients and risk management. Fifth, banks in small systems may be required to maintain higher capital ratios and small banks need less capital to survive in larger systems. Sixth, physical presence still matters in the banking industry; geographic proximity, less informational

asymmetry, similar business culture and practices can be advantages to regional banks. Finally, regionalization can prepare the banks for competition from global banks. Besides, better institutional, regulatory and supervisory frameworks under regional system can improve banks by better reporting, disclosure and risk management standards.

Regionalization, however, may not be correct strategy for all banking systems since it requires large resources, international capabilities and long term commitment. Some banks may evolve to systematically important financial institutions (SIFI), while large mergers can lead to concentration problems in the banking sector. In addition, regional synergies are harder to achieve when differences in regulations, client base and products are substantial. Building reputation in regional markets require long years of investments especially when large global competitors already dominate the markets such as in ASEAN. It should be also noted that governance and risk management can become more complicated under regionalization due to local laws, listing requirements, financial supervision and central bank requirements. Therefore, adoption of BASEL standards would be useful under regionalization. Strengthening national and regional banks is important since foreign banks are more likely to leave or reduce operations in the host country in case of economic and financial crises.

Analysis of banking sector suggests that the EU banking system is more developed than ASEAN in terms of total assets, loans and deposits with much better regional expansion and institutionalization. Both EU and ASEAN banking sectors were affected by crises, as the EU proved to be more vulnerable. Both regions have developmental differences in their sub-regions, which affect pace of integration and vulnerability to systemic risks. On institutional basis, EU integration is much more advanced than ASEAN since functions like common regulation, supervision, resolution and free flow of capital are already in place. In addition, monetary union improved interbank integration (wholesale) within the EU, while retail market integration still

needs to develop. Compared to the EU, ASEAN is at the start of banking integration and common institutional structures are not yet in place. Besides, Europe has more than a hundred large banks, with power to expand across the region, while ASEAN banks do not yet have that capability. ASEAN countries try to build this capability by creating Qualified ASEAN Banks.

Major milestones in the EU banking integration include European Monetary System (1979), European Central Bank (ECB-1998), launch of euro (1999), establishment of Committee of European Banking Supervisors (2004), Single Supervisory Mechanism (2012-the first pillar of banking), Single Resolution Mechanism (2014-second pillar) and European Deposit Insurance Scheme (still negotiated-third pillar). The EU Banking Union was created as a response to global crisis of 2008, since 13% of the EU GDP was spent to bail out failing banks during 2008-2012. Since then, the European Banking Authority became the regulator of the EU banks with a power to overrule national regulators and the ECB was assigned with supervision of large EU banks under Single Supervisory Mechanism. In 2013, the EU decided to transpose the BASEL III capital requirements into the European Law.

After 2000, the EU banking regionalization improved thanks to stronger integration measures especially in banking and money markets, while total bank assets of EU-27 expanded from 250% to 350% of the GDP till 2008. Thereafter, EU banking integration proved vulnerable to double crises in 2008 (global crisis) and 2012 (sovereign debt crisis). Global crisis spread to Europe through exposure to international banks and economic slowdown. Especially Southern banks were caught up to crises with low capital and liquidity since strong regulatory requirements and supervision were not in place yet. In the EU banking sector, the crisis led to weak loan growth, low profitability, stronger deleveraging and shrinking, especially in global and regional markets. Indeed, the EU banking sector openness (foreign assets/total assets) went down after 2008, and remained below pre-crisis levels in 2014.

Developmental differences of the EU banking sectors between the underdeveloped South & CEE and developed West & North regions (in terms of capital adequacy, liquidity and non-performing loans) worsened after the 2008 and peaked in 2015. Due to crisis, under-developed regions suffered from retrieval of large EU banks to their home countries, which reduced credit provision. Another post-crisis challenge for banking union came when low growth, profitability and regulatory changes undermined the sustainability of banks' business models. For sustained integration, new business models should be developed to adjust to post-crisis environment. Also, issues with dominance of the large EU banks in emerging Europe should be addressed by strengthening national banking sectors.

Financial integration in ASEAN came into picture after the Asian Crisis of 1997-1998, when large capital inflows into underdeveloped financial sectors led to provision of excess credits, currency mismatches and banking crisis. In 2007, the ASEAN declared plans to establish an ASEAN Economic Community (AEC) by 2015, which envisaged regional liberalization of trade, services and capital flows. Banking liberalization was a part of the AEC Blueprint and involved removing barriers in cross-border bank flows, consumption abroad, commercial banks presence and movement of natural persons. With the global crisis of 2008, the growth in deposits and credits continued in ASEAN banks. But liquidity decreased and provision for non-performing loans increased in ASEAN-5 since 2009. Contrary to the EU, there was no serious financial instability as interest rates and exchange rates remained stable in most countries thanks to the substantial reforms after Asian crisis.

In 2011, ASEAN Financial Integration Framework (AFIF) and ASEAN Banking Integration Framework (ABIF) were endorsed as parts of the AEC blueprint. The AFIF aimed to remove restrictions to capital flows and intra-regional services trade. The ABIF aimed to achieve multilateral liberalization in the banking sector by 2020 for ASEAN commercial banks. ABIF

includes four pillars in banking sector integration: Harmonizing prudential regulations (by adopting BASEL); bilateral supervision of banks by the home and host countries; setting the criteria for Qualified ASEAN Banks; and policies to reduce gaps between members' banking sector development. By 2018, each ASEAN-5 country should have a bilateral agreement and at least one Qualified ASEAN Bank (QAB) announced per country, which should have proper business plan, risk assessments and strong capital to make regional expansion.

Developmental differences between ASEAN-5 and BCLMV financial sectors is a roadblock on ASEAN banking integration. Regional expansion of banking sector remained limited and no ASEAN banks could expand their branch or subsidiary network to all ASEAN members. Limitations on foreign banks or foreign ownership differ in each country. On international basis, the ASEAN bank openness is generally low. Till now, non-ASEAN global banks were more interested in the ASEAN banking markets than ASEAN banks. Yet, this structure may change as many global banks pulled out of ASEAN after recent crisis and ASEAN members accelerated efforts for banking sector integration.

Finally, regionally inter-operable financial infrastructure is crucial both for banking and capital markets integration. Financial infrastructure includes payment systems (large value and retail payment systems), settlement systems and trade repositories as well as providers of these systems and related regulatory and supervisory agencies. The EU has regional payment systems in place, while work on single European platform (T2S) to settle securities continue. However, EU financial infrastructure is still fragmented due to inefficiencies in the clearing and settlement systems, divergent technical requirements, regulations and national tax procedures. Financial infrastructure development also varies widely across the ASEAN; some countries have modern systems while others lack even domestic payment or settlement systems but there is not yet a regional system.

Capital market development affects economic growth positively since it facilitates trade, business and investments by mobilizing savings and providing long term capital to productive firms. They also provide alternative to bank lending for firms, reduce cost of capital, diversify investment instruments for investors and enable hedging of currency, interest and exchange rate risks. Economic growth also relates to capital markets since countries with greater income levels, growth opportunities and financial openness tend to have more active capital markets. Development of capital markets also requires a solid domestic investor base (since their investments have more counter-cyclical nature), firms (especially non-financial and non-public firms) to issue bonds and equities, efficient financial intermediaries, infrastructure providers and regulatory and supervisory frameworks. Development of capital markets can be interrupted by small economic and financial sector size, (prevents the benefits from economies of scale and scope), low income levels, unproductive financial sector structure (bank domination, lack of institutional investors, inefficient cost and competition structure), insufficient legal, institutional and technical systems and inability to commit to long term policies.

Regionalization can address issues with small market size by linking markets and extending supply and demand. Larger markets can reduce costs of capital and financial services by economies of scale and scope and attract issuers and investors. Economies of scale and scope also apply to regulatory and institutional frameworks. Larger regional markets can diversify investment options, keep regional savings inside the region and mitigate effect of capital outflows. Harmonization of regulation and reporting and converging product/service standards can raise investor confidence, while building regional (equity and bond) indexes are also possible. On firm basis, mergers and acquisitions may be easier with equity securities, while governments use capital markets to privatize state enterprises, issue debt for fiscal management and finance long term infrastructure projects. However, regionalization of capital markets is a long process

with slow returns to costly investments since markets need time to build sustainability and credibility. Distribution of gains can be problematic across national markets, while less developed markets are afraid of being dominated. Divergence of economic and financial development, legal systems and administrative capacity negatively affect integration.

In the literature, stock market development increases economic growth: Equity markets facilitate entrepreneurship, innovation, and foreign capital inflows, provide firm valuation, support privatization of state enterprises and create an exit for private equity investors. By requiring regular reports, they promote better corporate governance and protect investors. Integration of equity markets enable firms to raise foreign capital by issuing equities abroad and connect to foreign investors and partners.

Well-developed bond markets provide alternative financing to governments and firms, reduce cost of domestic capital and dependency on banking sector for loans. They also reduce currency and maturity mismatches between assets and liabilities, provide financing for infrastructure investments and enhance fiscal and monetary policy management. For investors, bonds can provide stable income and guaranteed returns at maturity. Bond markets highly relate to macroeconomic policy through public debt issuance, interest rates, inflation and exchange rates. Government securities are especially important as they provide a benchmark yield curve for pricing corporate bonds and establish cost of capital for companies. However, bond markets are harder to develop and operate than stock markets: Minimum size for viable bond markets (\$100-200 billion) is a lot higher than stock markets (\$15-20 billion). Bond markets are less transparent and liquid than stock markets mainly because they are more heterogeneous with varying amounts, prices, yields, maturities, and currency denominations, while buyers and sellers are matched by dealers and dissemination of trade data is limited.

The review of the EU and ASEAN capital markets suggests that efforts to integrate these markets started only recently, while the markets remained fragmented with developmental differences, bank domination in financial systems, vulnerability to crises, insufficient common regulatory framework and infrastructure. Thus capacity of these markets to support companies and trade is limited in under-developed sub-regions, which triggered migration of issuing firms and investors into developed markets.

EU capital market integration is more institutionalized than ASEAN by major recent milestones such as foundation of European Securities and Markets Authority (ESMA-2011) to work on securities legislation, “Markets in Financial Instruments Directive” (MiFID-2007, MifIDII-2014), focused on supervision, competition and customer protection in investment services, and “Regulation on markets in financial instruments” (MifIR-2014), set rules for financial instruments. In 2015, “Action Plan on Building a Capital Markets Union” was adopted to establish main elements of an integrated EU capital market by 2019. The plan aims to; improve funding choices for businesses; improve regulations for infrastructure investments; diversify investment choices; enhance capacity of banks as capital market participants; establish a pan-European covered bond market; promote equitable development of capital markets; improve supervisory convergence; address divergent national laws such as tax or securities laws.

EU stock markets have been growing since 1990’s with vulnerability to crises. Total stock market capitalization grew from €1.3 trillion (22% of GDP) in 1992 to €8.4 trillion (64% of GDP) in 2014, but much weaker than its peers such as the US. Capital markets grew in mainly larger and advanced states, attracting listings from less developed markets. Moreover, European financial system is still bank dominated and firms have limited use of equity markets; only 6% of small, 8% of medium and 9% of large businesses used financing from equity markets in 2014 since the EU cost structure favors use of bank loans over equities and bonds. The integration was

also undermined by negative effects of crisis on banking sector, which represent significant share of stock market capitalization and delay of economic recovery, which affected performance of listed firms and investor confidence. Although integration is improving, equity markets remained fragmented due to developmental differences and limited interconnectivity and integration can be improved by reduction of transaction costs and taxes, promoting entrepreneurial culture and stronger insolvency frameworks.

Like stock markets, bond markets across the EU also indicate developmental problems. Total size of the EU bond markets is larger than the stock markets with a total of 163% of GDP, while most of the issuance is made by financial institutions and then by government. Issuance of bonds in all types (public, private, local or foreign currency, domestic or cross border) increased over between 2006 and 2015. Especially public local currency bonds almost tripled between 2006 and 2015 due to governments' funding needs to bail out banks and to stimulate economy during recession. Corporate bonds, which directly relate to firms, account for less than 10% of the bond market. Only large firms, with high credit ratings and financial strength can access bond markets. Still, only 10% of large companies issue bonds (4% debt, 6% mezzanine) as issuance by smaller firms remained very limited.

Developmental differences among European bond markets are remarkable across the sub-regions. West Europe is the strongest bond issuer of all types and Northern Europe has highest outstanding cross border bonds, mostly issued by private sector and the UK. Debt issuance in the Central & Eastern Europe is minimal compared to other sub-regions. In the Southern Europe, local currency outstanding debt increased since the crisis, consistent with their governments and firms' funding needs. The banking crisis reflected into sovereign debt markets since banks were also issuers of debt and government-bank relations have been very close in the EU. The ECB's quantitative easing and reduction of interest rates to the negative zone (to stimulate the economy)

also hit the bond markets. By the late 2015, total amount of negative yielding bonds increased from €1.4 trillion to €2 trillion in the Eurozone.

Development of EU bond markets still remain below peers such as the US and Japan, due to high fragmentation of across national bond markets and insufficient development of regulatory, institutional and technological infrastructure. EU debt markets have shown greater integration over the years, (especially in government and financial firms' bonds) driven by wholesale dealer banks after the monetary union and financial reforms. However, the impact of the financial crisis on wholesale banks produced a reversal of capital flows and integration. The initiatives for integration should address differing regulatory and tax treatment, cost of issuance and compliance costs across the members. Technology should be also improved in markets to enhance data management to identify potential holders or buyers of bonds, as well as improve connectivity across the markets.

Major recent milestones for ASEAN capital market integration include ASEAN Capital Markets Forum (2004), which proposed a plan for integration of capital markets. In 2010, stock exchanges of ASEAN-5 and Vietnam introduced ASEAN Exchanges collaboration on regulatory harmonization and cross listing of ASEAN securities. In 2011, ASEAN Stars Index was launched to create an "ASEAN asset class" and ASEAN Financial Integration Framework was adopted to create a semi-integrated financial market by 2020. Thereafter, ASEAN Trading Link (2012) was introduced to connect Malaysia Singapore and Thailand stock exchanges (holding 2/3 of ASEAN market capitalization), and ASEAN Fund Passport (2014) to allow cross border operation of qualified investment funds. Meanwhile, other initiatives under ASEAN+3 framework include Asian Bond Market Forum (2010) to foster harmonization of regulations and market practices, Asian Bond Market Initiative (2013) to promote development of the local

currency bond markets and Multi-Currency Bond Issuance Framework (2014) for common regional bond issuance program.

Economic growth, capital inflows and demand from global investors to Asian equities supported development and liquidity in Asian markets, while connectivity of these markets became stronger. ASEAN capital markets were less affected by global crisis and recovered more quickly than the EU: Intra-ASEAN equity investments rose by three times to \$42 billion, between 2008 and 2014. ASEAN stock markets have large developmental differences as Singapore and Malaysia have the most developed stock markets with capitalization more than 100% of GDP. Some least developed Cambodia, Lao and Myanmar are still in the stage of developing banking sector, prerequisite to capital market development.

Econometric analysis on ASEAN-5 stock markets suggests that both regional and global integration of these markets have been increasing since two decades and regional integration almost caught up with integration with the US and Asian markets. Despite progress, ASEAN stock markets are still not well integrated regionally and need to address fragmentation in infrastructure, regulations and supervision. In addition, the progress with the ASEAN trading link was slower than expected and remained limited to three countries due to limited capacity and speed of clearing & settlement systems.

Within ASEAN-5, bond markets in Malaysia and Singapore are the most and Indonesia is the least developed. Government bond markets are more developed than corporate bond markets. Government bond markets are strongest in Thailand, Malaysia, Singapore and Philippines, while corporate bond markets are strongest in Malaysia and Singapore. ASEAN-5 countries mostly raise funds from domestic markets to avoid foreign debt, while cross border issuance almost doubled after 2009 crisis, showing global investors' demand to safer Asian bonds. During the

crisis years of 2008, Asian corporations turned to local corporate bond markets to raise funds. Secondary markets for corporate bonds are still under developed and mostly large corporates access to these markets.

Developmental problems of ASEAN bond markets include differences in regulatory standards, administrative processes and institutions, as well as high transaction costs, capital controls, barriers to foreign entry and lack of cooperation between public and private sectors. Exchange rate risks and difference in taxation and lack of coordinated oversight should be addressed. ASEAN bond markets is characterized by large holdings of the US, EU and Japan. In general, correlation of ASEAN-5 local currency government bond markets with Asia, China and the US increased over the last two decades. Unlike equity markets, ASIANS-5 bond markets are more vulnerable to regional volatility than global.

The review of ASEAN and EU financial sectors suggest that EU is definitely more integrated than ASEAN with necessary institutional structure is mostly in place. But the EU integration was more vulnerable to global crisis and developmental differences are more pronounced in the ASEAN. Both regions still need to improve financial infrastructure, regulatory harmonization, market practices and taxation of capital gains to promote regional integration. Given the bank dominance in both regions, most functions –relating trade and infrastructure- are performed by banks rather than the capital markets. In this context, trade regionalization can be expected to be highly connected with banking sector, followed by equity and bond markets, while developmental differences suggest that strongest trade-finance links can be found in developed countries. The model in STATA confirms that change in trade intra-regional trade is positively related to banking development (Domestic credits/GDP), banking openness (foreign banking assets/total) and stock market correlations through random effects

model when controlled for changes in GDP per capita, FDI, Global Competitiveness Index and tariffs.

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APPENDIX A

FUTURE TRENDS IN CAPITAL MARKETS

Based on the insights from the previous sections, the expected trends for capital markets can be summarized as follows:

- (i) Competitiveness in capital markets are expected to intensify due to technological advances, higher costs of sustaining exchanges, removal of capital controls, easier movement of investors/issuers between markets, and more availability of competitive financial services and trade venues. Developed markets will keep on facing competitive pressures from emerging markets due to the latter's economic dynamism and growth potential. Indeed, the share of emerging markets in global GDP rose from 25% to 40% (approximations) between 2005 and 2014¹, while both debt issuance and stock market capitalization increased more than three times. Although developed countries still hold majority of assets in equity and bond markets, Emerging Markets will account for half of the total global capitalization by 2030 if their capitalization grows along the GDP.¹⁸⁸ By 2025, the major international centers are expected to lose their dominancy in foreign listings against the emerging markets since the number of firms seeking capital will multiply in emerging countries.²⁴³ As total financial assets, the share of emerging markets in global financial assets are expected to jump from 20% in 2010 to 30-36% by 2020 (nominally around \$114 - \$141 trillion), which makes them increasingly important in the global financial system.² However, the uncertainty of the regulatory and political

¹ IMF data

² (China and India will have \$ 65 and \$ 8 trillion respectively). "The Emerging Equity Gap: Growth and Stability in the New Investor Landscape." McKinsey Global Institute, December 2011.

environment, a slowdown of economic growth, and risk aversion of investors are the main disadvantages of emerging and developing countries³ along with fear of government intervention, weak corporate governance, lack of mature investor base, and inadequate investor protection.

- (ii) Trade and listings among South-to-South capital markets continue to increase as regional investments and integration intensify among these countries.⁴ Estimations show that between 2000 and 2011, South-to-South investment assets rose from \$0.3 to \$1.9 trillion, while South-to-North investments assets rose from \$1.5 to \$5.9 trillion.¹⁹¹ Improving economic and financial relations and capital flows among Southern countries; their development potential in real and financial sectors; and similarities in technology, business and investment environment are likely to increase cross-border investments and convergence of capital market practices.
- (iii) It is also expected that the hardest competition among capital markets will take place among similar ones: Markets compete more, especially when they provide similar products or services, operate under similar regulatory standards and cost structures, and have similar sectoral/industrial composition. This situation will be even more intensified if they are in the same geographical region or time zone. These markets can be considered as “natural competitors” and “the fiercest competition will be between those regional exchanges that aspire to attract dual listings from issuers originally listed on smaller exchanges.”⁵

³ Capital markets in 2025: The future of equity capital markets

http://www.pwc.com/en_GX/gx/audit-services/publications/assets/Capital_Markets-The_future_of_Equity_Mrks.pdf

⁴ Capital markets in 2025: The future of equity capital markets

http://www.pwc.com/en_GX/gx/audit-services/publications/assets/Capital_Markets-The_future_of_Equity_Mrks.pdf

⁵ Coffee, John J. Jr. “Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

- (iv) Markets will become more technology-intensive and organized to improve sustainability. Technological advances transform markets to have faster and accurate trading, payment, clearing and settlement functions. With changing ownership structures, exchanges will focus more on reducing costs and value added services to remain competitive. OTC markets can also experience similar pressures to become more organized and technology-driven.
- (vi) New regulatory and supervisory challenges may arise from advancing technology and financial innovation, which lead to new systems, applications, or products. Regulations and oversight will need to evolve faster with more flexibility to address quickly these new issues and reduce market risks. OTC markets may also be subject to better reporting standards and central reporting systems. Stronger regulations will increase regulatory compliance costs and affect supply and demand for capital market products.
- (vii) Exchanges with different level of regulatory standards will coexist since the complexity of regulations need to reflect the development level of financial system and capital markets. Although many studies suggest that markets with the lowest cost of trade, highest liquidity and advanced technology will be the most competitive, markets differ in terms of ownership, regulations, assets, risk and return structures. Preference of investors and traders regarding anonymity and transparency of transactions may differ and exchanges can survive without the highest legal standards.⁶ However these exchanges move in different directions due to path dependence.
- (viii) Exchanges can select to accommodate specific firms, industries or instruments with different risk-return structures as they can also serve special niches, such as regional

⁶ Coffee, John J. Jr. "Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

extension of major international markets.⁷ Niche specialization can also be achieved by mergers and alliances.

- (viii) Alliances, consolidations and mergers among exchanges are expected to increase as a result of competitive pressures. Horizontal and vertical integration of markets provide benefits related to market size and enable division of costs of institutional and technological infrastructure across markets. In this context, regional integration of capital markets can be a viable policy of choice for many markets.

⁷ Coffee, John J. Jr. "Competition among Securities Markets: A Path Dependent Perspective. Columbia University Law School, The Center for Law and Economic Studies. Working Paper No. 192, 2002.

APPENDIX B

GOVERNMENT AND CORPORATE BOND MARKETS

Moderate levels of non-inflationary government debt (as a share of GDP and of bank deposits) positively affect economic growth mainly by improvements in monetary policy, public budget, financial intermediation, domestic institutions and accountability.⁸ Seventy-five percent of impact on growth takes place via investment efficiency and factor productivity rather than capital accumulation, while these positive effects are strengthened when government bonds are marketable, have real positive interest rates and held by diverse investors other than the banking system.⁹ Moreover, government bonds provide the corporate bond markets with a benchmark yield curve, which helps pricing of corporate bonds and establishes cost of capital. In addition, government bonds provide stable income to investors and serve as collateral especially in interbank lending. Public debt issuance improves governmental budgetary and institutional discipline due to reporting and transparency requirements of the process. Effective government debt management requires sound government cash management, analysis of debt options and determination of optimal duration, size and frequencies of bonds since issues should be spread across the yield curve, and focus on key maturities. Other crucial factors include supporting operations, estimation of public funding needs and efficient issuance and auction strategies. Funding plans and issuance calendars need to be announced, since non-transparent funding plans can lead to reduced credibility and failure of bond auctions.

⁸ Abbas, M.Ali and Jakob E. Christensen. "The Role of Domestic Debt Markets in Economic Growth: An Empirical Investigation for Low-income Countries and Emerging Markets." IMF Working Paper, WP/07/127, June 2007.

⁹ Abbas, M.Ali and Jakob E. Christensen. "The Role of Domestic Debt Markets in Economic Growth: An Empirical Investigation for Low-income Countries and Emerging Markets." IMF Working Paper, WP/07/127, June 2007.

On the other side, excess government debt (more than 35% of bank deposits) can undermine growth by crowding out lending to the private sector (since both government and corporate bonds seek to borrow from national saving pool) and risking bank balance sheets. In middle- or low-income countries, institutional investors, including banks, pension, insurance and investment funds are more likely to become “captive investors,” and required to buy government debt to finance public investments or budget. Such arrangements destabilize banks and institutional investors, of which assets become subject to government credit and default risks.

Corporate bond markets provide an alternative funding option for companies and infrastructure projects and reduce their dependency on bank loans, while competition in lending lowers the cost of capital. Therefore, private debt issuance, especially by non-financial corporations, positively relates to economic development.¹⁰ Bond market size and liquidity have positive effect on probability of issuance¹¹ as growth of corporate bond markets encourage more firms to enter. This way, reallocation of capital by bond markets into productive sectors can support the real economy and growth. Corporate bond markets started to become important during mid-1990s, when they began to grow in advanced economies such as Europe, Japan and Canada.¹²

Economic and financial stability is crucial to achieve liquid and deep corporate bond markets since private debt issued by financial and non-financial corporations is negatively related to interest rate and exchange rate volatility.¹³ Money markets are also important for providing the basis for the short end of the yield curve. Corporate bond markets are more sensitive to systemic adverse effects since they are less liquid than government bonds or equities

¹⁰ Adelegan, Janet O. and Bozena Radzewicz-Bak. “What Determines Bond Market development in Sub-Saharan Africa?” IMF Working Paper Wp/09/213, September 2009.

¹¹ Mizen, Paul and Serafeim Tsoukas. “What Promotes Greater Use of Corporate Bond Market? A Study of Issuance Behaviour of Firms in Asia.” Oxford Economic Papers, March 15, 2013.

¹² Corporate Bond Market in the US was most developed at the time.

¹³ Adelegan, Janet O. and Bozena Radzewicz-Bak. “What Determines Bond Market development in Sub-Saharan Africa?” IMF Working Paper Wp/09/213, September 2009.

because they are fragmented, non-fungible and more complex, while lacking the features that promote secondary market liquidity such as predictable issuance or wide and transparent distribution.¹⁴ Private issuances are less transparent than public debt since they are done under negotiations and outcomes may not be disclosed. Moreover, some private debt securities, especially corporate infrastructure bonds, require a lock-in period to ensure longer term commitment. Given these conditions, investment on private bonds require better access to information and stronger credit assessment capabilities, which are generally available to large institutional investors rather than retail investors. Still, institutional investors can reinforce illiquidity when they follow a buy-and-hold strategy to meet their long-term obligations. Factors such as costly issuance of corporate bonds, lack of credit/business history, and insufficient collateral prevent smaller companies from entering to these markets, while more general problems hampering development of corporate debt markets should be addressed such as tax structure, issuance procedures, costs of regulatory compliance, investment restrictions on foreign and institutional investors, and lack of accurate credit pricing and risk management. To issue corporate bonds, businesses should have financial strength, a sound credit risk profile and improved corporate governance (with focus on investor rights), adopt modern accounting and reporting systems, and have the ability to disseminate information to different stakeholders.

¹⁴ “Corporate Bond Market Activity: An Overview” *Economic and Political Weekly*. Vol. 46, No 17 April 23, 2011.

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