THE UNIVERSITY OF MELBOURNE

Financial Regulation in Asia
Regional Financial Architecture

The debate on regional financial architecture in (East) Asia gained particular momentum after the 1997 financial crises that began in Thailand and embroiled a number of its neighbours. These crises and their aftermaths illustrated the growing interdependence of financial markets in the region and their dependence on developed country markets and policies.

We can discuss regional financial architecture under four headings: market integration, safety-nets, monitoring and surveillance, and regulatory coordination.

Market Integration

Financial integration in the region remains relatively low compared to trade and production integration. There are also significant national differences in levels of financial development. Financial openness also varies substantially; capital controls and market access limits are common across the region but vary widely in degree. As in many developing economies, there can also be a preference to attract international foreign banks as opposed to regional ones to provide access to advanced managerial expertise and technology. There is also a clear tendency for governments to see banks and the financial system generally as strategic tools for national economic development and control, with correspondingly high levels of political intervention in the financial sector and of government ownership in a number of cases. Limits on financial openness can also reflect weaknesses in the capacity of domestic regulatory and supervisory agencies and banks to manage the effects of financial internationalization.

In 2002, members of ASEAN articulated an aspiration to integrate their financial markets by 2015 (as part of the broader ASEAN economic community project). Its success depended upon significant domestic regulatory and policy changes including some regional harmonization and mutual recognition of regulation. Progress to date has been limited for reasons outlined above.

Beyond ASEAN, the main attempt at integrating financial markets has centred on bond markets through the Asian Bond Market Initiative and Asian Bond Fund Initiative. The promotion of regional bond markets after the Asian crises was seen as a means of reducing reliance on short-term and external funding and of promoting the development of capital markets.

The Asian Bond Market Initiative was first mooted in November 2002 at the ASEAN+3 Finance and Central Bank Deputies' Meeting. Concrete developments under the initiative have so far been limited and due mostly to domestic rather than regional efforts. Through the Executives' Meeting of East Asia Pacific Central Banks (EMEAP), two Asian bond funds were launched to invest in sovereign issued bonds. These funds were criticized variously for being too small to have any effect, or for crowding out private actors and/or affecting the value of local currencies and interest rates. In May 2010, ASEAN+3 finance ministers agreed to established a credit guarantee and investment facility (as a trust fund under the ADB) to support the issuance of corporate bonds in the region.

Safety-Nets

The key initiative here is the Chiang Mai Initiative (CMI), subsequently expanded (and arguably improved) by the Chiang Mai Initiative Multilateralised (CMIM).

The CMI was originally a network of bilateral swap arrangements that was expanded from a pre-existing ASEAN Swap Arrangement in 2000 as a response to the crises of the late 1990s and to the widespread distrust of the IMF they produced. Its original form had a number of important shortcomings: the requirement that recipients simultaneously agree to conditionality under and IMF program substantially reduced its attractiveness to potential borrowers; the funding available was limited, in particular the portion not linked to an IMF program; and the disbursement of funds was comparatively slow (up to 2 weeks). The CMI was never utilized by member countries. South Korea notably turned to the US Federal Reserve when it needed extra US dollar liquidity in 2008 during the GFC.

The CMI was expanded in May 2009 into the CMIM (it came into effect in March 2010), which addressed some of the shortcomings of its predecessor. It went from a network of bilateral swap arrangements to become a self-managed reserve pooling scheme, and the portion of funds available that was unlinked to IMF conditionality was increased from 10% to 20%. This portion was further raised to 30% in May 2012, and may be increased to 40% in 2014. In May 2012, a new crisis prevention facility, the CMIM Precautionary Line, was also created. It remains to be seen whether these changes address the reluctance of member countries to use the facility or indeed its effectiveness. The precedent of the IMF's unused Contingent Credit Line (1999-2003), which suffered from concerns about potential stigmatization, is not promising.

Monitoring and Surveillance

The creation of an 'early warning system' to avoid crises was seen as an important counterpart to the provision of a regional safety net. This led to a series of proposals for the closer monitoring and surveillance of macroeconomic and financial variables in the region and beyond.

Two regional mechanisms were established in the period immediately after the 1997-8 financial crises: the ASEAN Surveillance Process in 1998 and the Economic Review and Policy Dialogue (ERPD) in 1999 by the ASEAN+3 finance ministers. The South East Asian Central Banks (SEACEN) Expert Group on Capital Flows was also set up in 2000. These mechanisms, together with the EMEAP, have neither a coordinating secretariat nor full-time staff, with implications for their effectiveness.

The ASEAN+3 Macroeconomic Research Office (AMRO) was established in 2011 in Singapore as a counterpart to the CMIM with a small staff of about 20 economists. There is, however, no strong norm of policy coordination in the region, with member countries generally reluctant to exert peer pressure and to adjust policies in response to external advice. Monitoring and surveillance mechanisms like ERPD and AMRO are better seen as fora for policy dialogue and the exchange of information rather than coordination mechanisms.

Regulatory Coordination

The Basel II negotiations that began in 1999 also prompted growing dissatisfaction with the direction of standard setting in financial regulation among the advanced countries. Their determination to provide incentives for banks to move to an 'internal' approach for determining capital requirements was seen in Asia as inappropriate to regional conditions and likely to be discriminatory. Calls for an 'Asian Basel Committee' in the early 2000s in regional fora such as EMEAP came to little, however, foundering on Japan's insider status in the Basel process and the individual incentives of other countries to indicate their willingness to converge upon Basel standards. The broad pattern in Asia has been one of unilateral implementation of these standards rather than the adoption of a regionally coordinated approach. This has continued since 2008, with countries announcing a series of uncoordinated and often differing plans for the implementation of Basel 2.5 and Basel III standards. Whether the expansion of Basel Committee membership to include Australia, China, India, Indonesia and South Korea has deterred the development of a more coordinated regional approach is an open question. At present, however, discussion of financial regulatory reforms and the monitoring of their implementation is concentrated at the global rather than the regional level in Asia.