

# Financial Services Liberalization and Integration in a Developing Region: The Case of ASEAN

Tulus Tambunan  
Center for Industry and SME Studies, University of Trisakti, Indonesia

## Abstract

*After the Asian financial 1997/98 crisis, ASEAN free trade area (AFTA) was extended to include regional cooperation in finance. Recently, the 10-members of ASEAN have agreed to speed up the liberalization and integration of financial services by 2015. With this recent development, the main aim of this paper is to assess the main challenges that ASEAN countries are going to counter in the near future in their efforts to speeding up the process of financial services liberalization and integration and to suggest best practices to be followed in order to achieve the objective. The paper argues that the successful of financial services liberalization and integration in ASEAN depends also on a good institutional cooperation, and this latter faces several challenges, including that economies of ASEAN are diverse and heterogeneous in terms of economic systems, per capita incomes, stages of economic and institutional development, and human and social conditions, and ASEAN countries are also diverse in political systems (e.g. Myanmar versus the rest of ASEAN, or Vietnam versus Indonesia) and in cultural and religious traditions (e.g. Indonesia and Malaysia versus Singapore and Thailand), without shared history of political integration under a hegemonic power.*

JEL Classification: F36, G2

Key words: Financial services liberalization, financial services integration, challenges, best practices, ASEAN

## Background

Compared with Europe, Asia is a relatively newcomer to regional integration. Before the Asian crisis, economic integration was primarily market-led and private sector-driven. Few major government-led cooperation initiatives existed, and those that did were limited to the areas of cross-border infrastructure and trade. These included, for example, the ASEAN Free Trade Area, both of which were initiated in 1992.

After the 1997-98 financial crisis, however, the market-led process was supplemented by a series of government-led initiatives. In addition, the scope of such initiatives was extended to include regional cooperation in finance, especially in East Asia. The introduction of the ASEAN+3 economic surveillance process, the establishment of regional resource pooling through the by now well-known Chiang Mai Initiative (CMI), and the implementation of the Asian Bond Markets Initiative are noteworthy achievements. Recently, the 10 members of the Association of Southeast Asian Nations (ASEAN) have agreed to speed up the liberalization of major financial services by 2015.

With this recent development, the main aim of this paper is to assess the main challenges that ASEAN countries are going to counter in the near future in their efforts to speed up the process of financial services liberalization and integration and to suggest best practices to be followed to achieve the objective.

#### Recent Development of the Financial Sector in the Region

While considerable disparities are observed among the ASEAN member countries affected by the crisis (i.e. Indonesia, Thailand, the Philippines, and to a certain extent, Malaysia and Singapore) their economy recovered at an accelerated pace from the Asian financial crisis of 1997/98. They are engaged in various structural reform programs, including the reorganization and restructuring of the financial and corporate sectors. While considerable progress has been achieved in these areas, banks, especially in Indonesia, have not fully regained their functions of financial intermediation, and problems remain here. While progress has also been made in removing non-performing loans (NPLs) from the balance sheets of banks, there are concerns that the restructuring of corporate liabilities may be delayed. Capital markets have not developed to the level where they can perform their market functions satisfactorily.

Market-driven financial integration in ASEAN has been underway since the crisis in 1997/98, as a result of the increased deregulation of the financial system, opening of financial services to foreign institutions, and liberalization of the capital account in member countries. Active commercial bank loans and portfolio investment flows have begun to link the economies in the region financially. Financial integration has yet to deepen through greater policy efforts to further deregulate impediments to the market based functioning of national capital markets and to harmonize market infrastructure and regulatory frameworks. As a result of market-driven economic integration, macroeconomic interdependence within ASEAN has become stronger.

For instance, Kawai (2005) found from data in the 1980s and 1990s that real macroeconomic activities (e.g. growth rates of real gross domestic product (GDP), real private consumption, and real fixed investment) of Singapore, Malaysia and Thailand are highly correlated with each other, while they are not strongly correlated with those of the United States or Europe. The deepening of economic linkages and interdependence calls for institutional cooperation to manage such links and interdependence (Kawai, 2005).

However, during the 1997/98 crisis, some of the member countries experienced negative economic growth, with Indonesia at the top with around -13 per cent, followed by Thailand at -10.5 per cent, and Malaysia -7.4 per cent. In 1999, these adversely affected countries started to recover (Table 1). This experience may also support the view that ASEAN economies, especially Indonesia, Malaysia, Thailand and Singapore are indeed closely correlated. Consequently, an economic collapse in one of these countries affects directly the others.

**Table 1: Growth Rates of Real GDP in ASEAN Countries (%)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	1.1	4.5	2.9	-1.5	-0.6	3.1	2.8	2.7	3.9	2.9	0.5	0.4	4.4	0.6
Cambodia	1.2	6.5	5.3	5.7	5.0	12.6	8.4	7.7	7.0	8.5	10.3	13.3	10.8	10.2
Indonesia	9.0	8.2	7.8	4.7	13.1	0.8	4.9	3.8	4.3	4.8	5.0	5.7	5.5	6.3
Lao PDR	6.7	7.1	6.9	6.9	4.0	7.3	5.8	5.8	5.9	5.8	6.9	7.3	8.3	7.5
Malaysia	9.0	9.8	10.0	7.3	-7.4	6.1	8.9	0.5	5.4	5.8	6.8	5.0	5.9	6.3
Myanmar	2.8	7.0	6.4	5.7	5.8	11.0	13.8	11.3	12.0	13.8	13.6	13.6	12.7	...
Philippines	3.0	4.7	5.9	5.2	-0.6	3.4	4.4	1.8	4.4	4.9	6.4	5.0	5.4	7.2
Singapore	9.2	8.2	7.8	8.3	-1.4	7.2	10.1	-2.3	4.0	3.5	9.0	7.3	8.2	7.7
Thailand	11.2	9.2	5.9	-1.4	10.5	4.4	4.8	2.2	5.3	7.1	6.3	4.5	5.1	4.8
Viet Nam	5.1	9.5	9.3	8.2	5.8	4.8	6.8	6.9	7.1	7.3	7.8	8.4	8.2	8.5

Source: ADB database

As discussed before that, based on 1980s and 1990s data, Kawai (2005) found that real macroeconomic activities, including real fixed investment, of countries within ASEAN are highly correlated with each other. Recent data from the ASEAN Secretariat show that the investment linkages through foreign direct investment (FDI) flows among the countries continue to increase. In 2004, the net value of FDI among them was 2,803.7 million US\$ and went up to 6,242.1 million US\$ in 2006. Look at the year-on-year change, it increased from 34.3 per cent for the period 2004-2005 to 65.8 per cent for the period 2005-2006, or the share to total net inflow of FDI to the region increased from 8.0 per cent in 2004 to 11.9 per cent in 2006.

Of course, opening of financial services in ASEAN has enormous policy implications for macroeconomic and financial stability, economic growth<sup>1</sup> and development of financial sector in a member country. As demonstrated by the Asian financial crisis of 1997/98, mismanagement of financial opening may lead to disastrous economic consequences. In other words, the liberalization of financial sector per se was not the cause of the crisis, but the management of the process and financial policies were poor. That is why after the crisis, ASEAN governments started to speed up financial services liberalization together with financial integration in the region to meet two main goals, namely in order to prevent the recurrence of the Asian currency and financial crisis in 1997/98<sup>2</sup> and to realize the stable economic growth. Other needs for financial services liberalization and integration in the region include: (1) re-channel regional savings into the regional economies; (2) reduce the stock of international reserves; (3) contribute to regional financial stability; and (4) promote intra-ASEAN trade and ASEAN monetary integration. It is generally believed that financial services liberalization with prudent financial policies, including orderly opening and

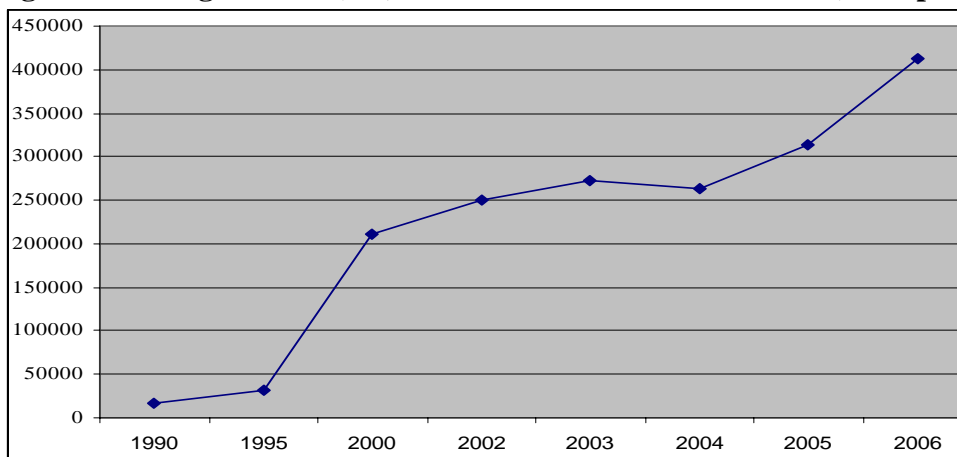
<sup>1</sup> For theoretical discussion and empirical evidence on the relationship between financial liberalization and economic growth, see, e.g. Rajan and Zingales (1998), Vlachos and Waldenstrom (2002) and Bekaert et al. (2001).

<sup>2</sup> To avoid double mismatch that exacerbated the 1997/98 crisis, following the words of Lee (2007).

implementation of commitments under the General Agreement on Trade in Services (GATS),<sup>3</sup> can result in macroeconomic stability, sustained output growth, and financial sector development (Kim, 2000, 2002).

In Indonesia, for instance, efforts to liberalize financial sector in Indonesia in a gradual way from the early 1980s have shown some results.<sup>4</sup> The share of foreign and joint banks in the country has risen every year from 9.4 per cent in 1996 to 27.7 per cent in 2001. The growth rate of foreign and joint banks loans has been higher than that of domestic banks at the time the Indonesian economy was hit by the crisis in 1997/98, foreign capital flows, both direct and indirect (portfolio), reversed, and enormous financial and corporate restructuring efforts were made. This pattern notes that foreign banks' lending was more countercyclical and stable than that of domestic banks, contributing to financial and economic recovery and private sector investment. Sector lending performance indicates that the share of foreign banks' loans to manufacturing has steadily increased in the post-1997/98 crisis period but the services and trade sectors suffered a sharp decline in the same period. Foreign banks should have also contributed to manufacture of goods for exports and employment opportunities. Another positive result of liberalization of domestic financial sector is the significant increase of foreign assets in the sector, which started significantly since the beginning of 1990s. As shown in Figure 1, in 1990 total foreign assets (net) were slightly more than 16 trillion rupiah, and reached at more than 413 trillion rupiah in 2006.

**Figure 1: Foreign Assets (net) in Indonesian Financial Sector (bn rupiah)**



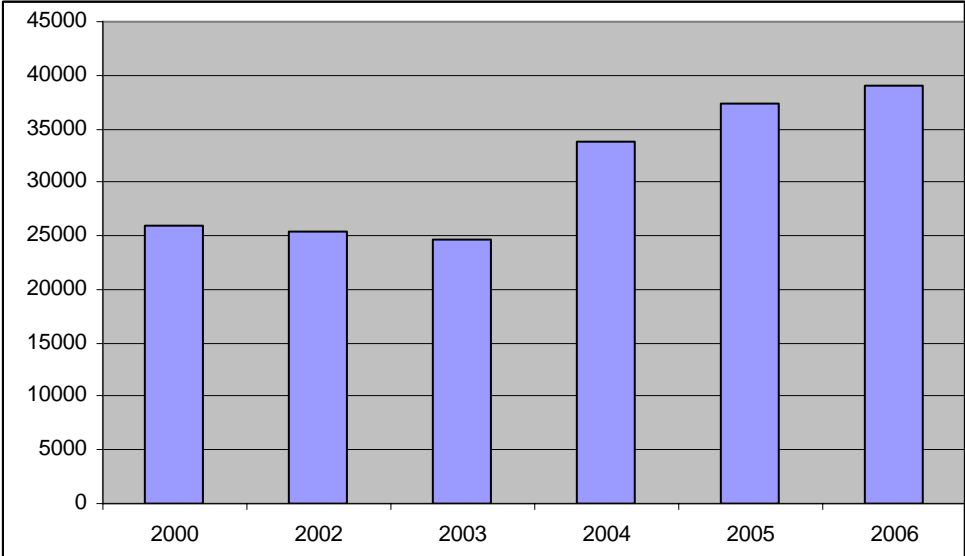
Source: ADB database

<sup>3</sup> Financial service is a major component of GATS. GATS covers virtually all of the world trade in financial services. Four (4) different models of financial services trade identified by GATS: cross-border (mode 1); consumption abroad (mode 2); commercial presence (mode 3); and presence of natural persons (mode 4).

<sup>4</sup> The initial banking/financial sector reform in Indonesia was introduced in 1983. Interest rate regulations on state banks and credit ceilings in general were removed. The banking sector, which up to then was channeling oil revenues to priority sectors, began to face competition. The dominance of state banks started to erode. However, priority credits still enjoyed subsidized interest rates and funding from the Central Bank. In 1988, more significant reforms were introduced. These included the opening of the banking industry to new entrants, reduced restrictions on foreign exchange transactions, and increased access of domestic banks to international financial markets. Further reforms along the same direction and affecting state-controlled banks came in the 1990s. Partly as a result of these reforms, the number of private domestic banks increased and they dominated the sector in terms of number and total assets. But in terms of assets per bank, state-owned banks were still among the biggest. (Husnan, 2001).

If financial liberalization in Indonesia generates more foreign financial services operate in Indonesian market, then, the growth of *invisible imports*, that is, earnings by foreign countries from selling financial services within Indonesia plus interest paid on investments in Indonesia by overseas countries can also be used as an indicator to assess the success of opening Indonesian financial market. These foreign earnings and interest payments are included in the debit side of services and income in the Indonesian balance of payments (BoP), which increased from 26046 million US dollar in 2000 to 38937 million US dollar in 2006 (Figure 2).

**Figure 2: Debit in Services and Income in the Indonesian BoP (mn US\$)**



Source: ADB database

In Malaysia, another example, the share of foreign banks’ lending in total lending has been stable at 23-24 per cent but increased steadily year by year since the 1997/98 financial crisis. The rate of increase of foreign banks’ lending appears to be slightly higher than that of domestic banks since the crisis. Foreign banks in Malaysia did not cut down their lending after the crisis, rather, showed a countercyclical lending pattern that must have contributed to the country’s economic recovery, employment creation, and financial stabilization in this period.

Annual growth in domestic saving is also a good indicator of good development of domestic financial/banking sector. Theoretically, financial services liberalization is expected to lead to more efficient and stable domestic financial system, and the later, in its turn, encourage people to save their money in banks if not invested it in capital market, and, so, domestic saving increases. As an empirical illustration, based on data from Asian Development Bank (ADB), Table 2 shows that gross domestic saving as a percentage of GDP (at current market prices) in Indonesia is still relatively lower than that in, for instance, Singapore. Of course, this can also be explained by the fact that income per capita (as the most important

source of saving) in Indonesia is still lower than that in Singapore. However, this may also due to the fact that the degree of soundness of financial sector in Indonesia, which was hit hard during the 1997/98 crisis, is still lower than that in Singapore.

**Table 2: Gross Domestic Saving in ASEAN (per cent of GDP)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	51.5	36.6	36.1	35.5	29.9	36.9	49.4	44.3	47.2	48.6	51.4	59.1	62.1	59.1
Cambodia	2.3	2.5	-1.0	6.4	2.3	7.6	8.1	11.6	8.5	9.1	8.5	9.9	13.8	16.1
Indonesia	32.3	30.6	30.1	31.5	26.5	19.5	31.8	31.5	25.1	23.7	24.9	27.5	28.7	28.2
Lao PDR	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Malaysia	34.4	39.7	42.9	43.9	48.7	47.4	46.1	41.8	42.0	42.5	43.4	42.8	43.2	42.2
Myanmar	11.7	13.4	11.5	11.8	11.8	13.0	12.3	11.5	10.2	11.0	12.1	...	...	...
Philippines	18.7	14.5	14.6	14.2	12.4	14.3	17.3	17.1	19.1	19.7	21.2	21.0	20.1	20.9
Singapore	44.0	50.1	50.6	51.5	51.8	48.7	46.9	41.6	40.6	43.6	47.1	48.6	49.9	51.4
Thailand	34.0	36.9	36.0	35.3	34.8	32.5	32.5	31.4	31.7	32.0	31.7	31.0	32.3	33.9
Viet Nam	2.9	18.2	17.2	20.1	21.5	24.6	27.1	28.8	28.7	27.4	28.5	30.3	30.6	29.1

Source: ADB database

Sound banking system encourages the increase in demand and time deposits or quasi-money, which leads to the increase in broad money supply (M2). Theoretically, the better domestic financial sector, accompanied with the higher income per capita, the higher the growth of M2 is as well as the higher M2 as a percentage of GDP is (*financial sector depth*). This is well evident in the combination of Tables 3, 4, and 5. For example, higher ratios in Singapore, Malaysia and Thailand (as the most leading economies in the region) with much lower ratios in Indonesia (middle level developed/income country) and Cambodia (low income country). In those three countries, income per capita is higher than that in Indonesia, reflecting that their levels of economic development are higher than that in Indonesia.

However, the opening of financial services in ASEAN countries has been relatively limited (even under ASEAN Framework Agreement on Services, AFAS). Thus, financial services liberalization is a big indeed challenge to the ASEAN countries, especially Indonesia, Thailand, Malaysia and Singapore, as the most developed economies as compared to the rest of other member countries. According to Lee (2007), financial integration in Asia (including ASEAN) is still weak. The main reasons are the followings: (a) low incentives for portfolio diversification within the region; (b) low degree of development and deregulation of financial markets (although the degree may vary by country); (c) instability in monetary and exchange rate regimes; and (d) dominance of global “foreign” players, especially from the United States (US) and European Union (EU). In addition to these reasons, others such as (e) administered low nominal interest rates, often resulting in negative real rates; (f) low ratios of real money to national income; (g) small and oligopolistic financial sectors (relative to the size of the economy) dominated by intermediation in short-term financial assets; (h) dual economies with capital-intensive modern sectors served by cheap foreign exchange and low-interest finance and labour-intensive traditional sectors left to be served by informal

finance; and (i) large government deficits that pre-empted the resources of the formal financial sector and generated inflation (by inducing excess money creation), at least in some, less developed member countries could also play an important role.<sup>5</sup>

**Table 3: Growth rates of M2 in ASEAN (%)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	8.2	6.7	-2.3	-4.6	-12.9	16.8	25.9	-7.1	-1.4	12.9	27.0	6.8	-3.9	...
Cambodia	240.9	44.3	40.4	16.6	15.7	17.3	26.9	20.4	31.1	15.3	30.0	16.1	38.2	62.9
Indonesia	44.2	27.6	29.6	23.2	62.3	11.9	15.6	13.0	4.7	8.1	8.1	16.4	14.9	18.9
Lao PDR	7.8	16.4	26.7	65.8	113.3	78.3	45.9	20.1	27.0	19.2	22.3	8.2	30.1	38.7
Malaysia	12.8	24.0	19.8	22.7	1.5	14.2	5.3	2.3	6.0	11.1	25.2	15.6	17.1	9.5
Myanmar	41.4	40.5	38.9	28.9	36.5	29.6	42.2	44.8	34.2	0.2	34.5	24.1	...	...
Philippines	18.4	25.2	15.8	20.5	8.0	19.3	4.8	...	9.6	4.2	10.0	9.8	22.1	9.4
Singapore	20.0	8.5	9.8	10.3	30.2	8.5	-2.0	5.9	-0.3	8.1	6.2	6.2	19.4	13.4
Thailand	26.7	17.0	12.6	16.4	9.5	2.1	3.7	4.2	2.6	6.4	5.7	6.3	6.2	1.2
Viet Nam	53.1	22.6	22.7	26.1	25.6	39.3	56.2	25.5	17.6	24.9	29.5	29.7	33.6	46.0

Source: ADB database

**Table 4: M2 in ASEAN (% of GDP)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	70.8	120.9	109.9	98.0	97.2	98.7	93.6	89.7	84.8	87.7	95.6	85.7	71.7	...
Cambodia	10.3	7.7	9.9	10.5	10.5	10.8	13.0	14.1	17.2	18.0	20.3	19.6	23.3	32.3
Indonesia	40.1	49.0	54.2	56.7	60.4	58.8	53.8	50.1	48.5	47.5	45.0	43.4	41.4	41.5
Lao PDR	7.2	13.6	14.2	18.4	20.4	14.9	16.5	17.2	18.7	18.2	18.8	17.7	19.9	24.9
Malaysia	70.5	89.4	93.9	103.7	104.7	112.6	100.0	103.4	100.9	102.5	113.4	118.9	126.8	124.2
Myanmar	28.8	30.7	32.5	29.7	28.2	26.8	32.7	34.1	28.9	21.1	24.1	...	...	...
Philippines	27.6	39.6	40.3	43.4	42.7	45.6	42.4	46.2	46.4	44.4	43.3	42.6	46.9	46.5
Singapore	92.6	85.3	85.8	86.7	116.6	124.6	106.9	117.9	114.1	120.1	112.2	110.2	120.9	122.4
Thailand	70.0	79.1	80.8	91.7	102.7	104.7	102.2	102.1	98.7	116.4	112.2	109.0	105.0	98.0
Viet Nam	27.1	23.0	23.8	26.0	28.4	35.7	50.5	58.1	61.4	67.0	74.4	82.3	94.8	118.0

Source: ADB database.

**Table 5: GDP per capita at PPP in ASEAN (current international dollar)**

Country	2002	2001	2002	2003	2004	2005	2006
Brunei Darussalam	43292	44456	45430	47007	47221	47465	49370
Cambodia	910	986	1048	1142	1274	1457	1633
Indonesia	2421	2594	2660	2809	2995	3207	3471
Lao PDR	1328	1408	1486	1569	1689	1821	2032
Malaysia	9486	9680	10092	10667	10826	11531	12314
Myanmar	464	518	579	659	750	...	...
Philippines	2316	2364	2460	2583	2769	2935	3127
Singapore	32610	31775	33470	35919	39991	43334	47065
Thailand	4952	5146	5473	5940	6437	6877	7403
Viet Nam	1416	1530	1645	1777	1943	2143	2363

Source: ADB database

In addition, Stiglitz (1994) suggested that seven market failures are pervasive in financial markets, which can be as serious constraints to the smooth process of further financial liberalization: (a). monitoring of the financial system as a public good; (b). externalities of monitoring selection and lending; (c) externalities of financial disruptions; (d) missing and incomplete credit and insurance markets; (e) imperfect competition; (f) failure to meet the information criteria for efficient competitive markets; and (g) the behavior of uninformed investors;

<sup>5</sup> For theoretical explanations on these added reasons, see McKinnon (1973) and Edward Shaw (1973).

## Some Main Challenges Ahead

Liberalization or opening of financial services is often referred to as “internationalization” of the financial sector, involves the establishment and operation of foreign-owned financial institutions in the domestic market, providing services in competition with domestic players.<sup>6</sup> It is therefore a form of foreign direct investment. Although opening of financial services is closely associated with capital account liberalization, as in the context of WTO, ASEAN negotiations on financial services liberalization are not concerned with capital account liberalization; foreign companies allowed to provide financial services will be subject to capital controls in force.<sup>7</sup>

According to Shaw (1973), among others, financial liberalization meant: (a) market-determined interest rates; (b) greater ease of entry into the banking sector to encourage competition; (c) the elimination of directed credit programs; (d) reduced fiscal dependence of the state on credit from the banking system (to allow for greater expansion of credit to the private sector); (e) the integration of formal and informal markets; (f) a movement towards equilibrium exchange rates and, eventually, flexible exchange rate regimes with open capital accounts.

In the context of global trade liberalization, every country faces two main challenges: can domestic made products compete with imported similar products and can domestic made products be exported. In the context of global investment liberalization, the challenges are: can domestic industries compete with foreign direct investment-based companies and can domestic industries expand their activities abroad. In the context of financial services liberalization and integration in ASEAN, the challenges are similar: can domestic banks compete with foreign-owned financial institutions and can domestic banks operate abroad. In other words, whether financial services liberalization and integration in ASEAN will give benefits to all member countries, it depends on whether individual countries are able to meet those two challenges.

In addition to those two challenges, there is another challenge: how can, say, Indonesia, compete with other ASEAN countries to attract foreign direct investment in financial sector from other ASEAN countries, since Indonesia may benefit from banking, insurance and securities companies from more developed ASEAN countries (e.g. Singapore),<sup>8</sup> as: (1) they are able to provide more outlets for domestic

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<sup>6</sup> The justifications for policies of financial liberalization find their initial expression in the propositions contained in the independent (and nearly simultaneous) publications of Ronald McKinnon (1973) and Edward Shaw (1973). These propositions, taken together, have since become known as the McKinnon-Shaw hypothesis or the financial liberalization thesis.

<sup>7</sup> The most noteworthy about financial services liberalization is the opening of domestic financial sector which is often accompanied by capital account and banking liberalization. On the other hand, financial crises in most cases (as with the Asian financial crisis in 1997/98) are often associated with capital account and banking liberalization. Or, the main reason for such crises not the liberalization of domestic financial sector as such, but due to wrong adopted sequences of liberalization measures.

<sup>8</sup> It is often said that a good financial services liberalization if it satisfies the following three goals: it increases resource mobilization; it does not disturb financial stability; and it promotes market competition. These are often stated as three guiding principles of financial services liberalization.

savings; (2) increase the capacity of the domestic financial services market through enhanced competition and managerial efficiency; (3) with better developed foreign-owned financial institutes, domestic financial services market is better able to withstand the effects of financial instability; (4) foreign financial institutions bring with them new capital to provide financing for infrastructure and other long-term projects development by recycling domestic and foreign savings (low capital cost especially for long-term investment); (5) they are able to help recapitalize the domestic banks' capital base by purchasing ailing domestic institutions, in particular, during the crisis period; (6) in circumstances where domestic institutions are burdened by NPLs and assets, foreign banks may be able to maintain the flow of credits to industry; (7) the competition effects of new financial services institutions should also bring with it consumer gains (in terms of consumption smoothing, risk diversification, and lower transaction costs as their presence facilitates economies of scale and reduces price markups); and (8) foreign financial institutions that enter into partnerships with local companies can train local staff and provide know-how. Knowledge spillovers take place when employees move to other domestic financial institutions (Wang, 2002; Lee, 2007).

No doubt that for gaining benefits of financial services liberalization and integration in ASEAN, local financial institutions in, say, Indonesia, must be able to compete with financial institutions in other ASEAN countries, and for that Indonesia must develop an efficient and stable financial system. To have this, many necessary factors should be in place, including good governance and transparency should be ensured. Financial services liberalization efforts should also be pursued with a view to (1) encourage market competition, (2) mobilize foreign direct investment (FDI), and (3) maintain financial market stability. Within this context, Asian Development Bank (ADB) in its Fourth Asian Development Forum in 2002 made several policy recommendations, including sequencing of liberalization, formulation of appropriate regulatory and macroeconomic frameworks, focus on commercial presence in the liberalization process, and gradual opening of equity markets.<sup>9</sup>

However, successful of financial services liberalization and integration in ASEAN depends also on a good institutional cooperation, and this latter faces several challenges. First, economies of ASEAN are diverse and heterogeneous in terms of economic systems, per capita incomes, stages of economic and institutional development, and human and social conditions. Diversity and heterogeneity imply that low-income member countries (e.g. Lao PDR, Cambodia, Myanmar and Vietnam), where market infrastructure is insufficiently developed and institutional capacities are limited, will be slow in trade, investment and financial liberalization and market opening and, hence, will not be able to integrate themselves quickly with

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<sup>9</sup> The Forum program is attached in the Appendix. Speeches and papers presented at the Forum are available at <http://www.adb.org/Documents/Events/2002/ADF/agenda.asp>.

the rest of ASEAN. This constitutes an obvious impediment to financial services integration for the whole of the region. For the governments of member countries to take joint action at the regional level, there must be substantial economic convergence. Second, ASEAN countries are also diverse in political systems (e.g. Myanmar versus the rest of ASEAN, or Vietnam versus Indonesia) and in cultural and religious traditions (e.g. Indonesia and Malaysia versus Singapore and Thailand), without shared history of political integration under a hegemonic power. As a result, establishment of a common value, mutual trust or strong political will for financial services (or economic in general) integration is one of ASEAN's most challenging issues.<sup>10</sup>

Besides the above critical factors that need to be taken into account, macroeconomic stability prior to liberalization is also very important.<sup>11</sup> Financial liberalization is an extremely important component of a successful development strategy. This means that if financial deregulation is implemented in isolation, it is unlikely to promote growth and may, in fact, impede economic development. Macroeconomic stability must be accompanied with structural reform and institutional development in the financial sector, especially prudential financial supervision, are equally essential as liberalization proceeds.

Finally, measuring the results of financial reform/liberalization is extremely important if policy is to be well designed and implemented. The effects of financial liberalization itself may distort the inferences drawn from conventional measures of financial deepening about the success of reform. Consequently, a wide range of performance indicators should be monitored by policymakers. This is especially important in member countries, where conventional measures may exaggerate the success of countries' reform programs in their early stages and thereby obscure underlying problems (notably, fiscal imbalances) that will require attention if financial reform is to be successful in the medium term

## **Looking for the Best Development Strategy**

Since domestic conditions vary by member country, it is not easy to have a common formula or blueprint to develop efficient and stable financial systems. However, a combination of many experiences in many other

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<sup>10</sup> A brighter side is that the ASEAN countries do share the view that "peace and security" is the basis for sustained economic growth and development. From this perspective, Indonesia, Malaysia, Thailand, and other ASEAN countries have so much to gain from their good political relationship, without which the region cannot make substantial progress on economic integration.

<sup>11</sup> From their study on financial change in many African and Asian countries (including Indonesia, Malaysia, Philippines, and Thailand) in the pre-1997/98 crisis period, Pill and Pradhan (1995) conclude that macroeconomic stability is a prerequisite for successful financial liberalization. In generally successful Asian cases, macroeconomic imbalances were largely eliminated before financial reforms were introduced. Balance of payments and fiscal deficits were manageable, and inflation was relatively low. The Asian countries included in their research which were exceptions to this rule such as the Philippines and Sri Lanka were notably less successful in expanding their financial sectors following reforms. For example, in Indonesia, as shown in their study, where macroeconomic conditions were favorable, the ratio of broad money to GDP rose dramatically, from a pre-liberalization level of 9 percent in 1983 to well over 40 percent in 1991. In contrast, in Sri Lanka, the ratio of broad money to GDP was largely unchanged after the reforms. Only credible and sustained macroeconomic stabilizations produce the increased demand for money that is the counterpart to financial deepening.

countries which now have well developed financial systems may give an idea about best practices (EG, 2002). First, establishing a sound banking system through the following measures: (a) the function of the banking sectors should be strengthened and the capital markets should be developed. For this purpose, it is important to establish an economically rational division of functions between local and foreign banks, between private and public financial institutions, and between the banking sector and the securities market. This division of functions must be designed to draw out the merits of each component part; (b) solving problem of non-performing loans (NPLs) and their disposal must be proceeded smoothly. For instance, in Indonesia, although series of measures have been implemented, including the disposal of non-performing loans, recapitalization, consolidation and dissolution of banks, non-performing loans have been eliminated from the balance sheets of banks and transferred to asset management companies, the final disposal of non-performing loans is not proceeding smoothly. Table 6 shows that in the region, at least among member countries where data are available, Indonesia is the biggest country with the NPL problem. However, the banking sector in Indonesia has been in a good track in solving its NPL problem, as also shown in more detail in Table 7; (c) supervisory and regulatory frameworks should be reinforced. Since the 1997/98 crisis, Indonesia, for instance, has been strengthening their prudential regulations.<sup>12</sup> However, not only in Indonesia but also in some other ASEAN countries, considerable room for improvement remains, especially in rationalization and reduction of policy intervention in the financial system; easing of entry restrictions on foreign banks in accordance with the stage of financial development; reform of the ownership structure of banks; adoption of higher standards of statutory disclosure, arrangements for the early exit of failed banks, and the development of operational rules which conform to international standards and principles, as well as to the domestic conditions of individual countries. On the other hand, in response to the liberalization and integration of finance sector, banking audit must target the international consolidated operations of banks; (d) good governance in banking must be established as it is an essential factor in the development of sound financial systems. For this purpose, banks must be independent of government policies and must not be the "institutionalized banks" of corporate groups as was the case in Indonesia before the crisis; and (e) local banks must be revitalized, and especially for small banks this can be done with the consolidation of through e.g. mergers. This is one way to improve the competitive position of local banks, as it increases economies

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<sup>12</sup> After the liberalization of the financial sector in Indonesia during the pre-crisis period, the regulatory environment was not prepared to supervise the increasing number of banks and non-bank financial institutions. In the first place, the banking regulatory framework was inadequate in regulating banks' dealings with affiliated non-financial companies. The ownership of banks (including finance companies) by share-holders of non-financial companies undermined the capability of these banks to conduct prudential credit management. Consequently, most of banks' NPLs resulted from credit to companies within the same group. The regulatory framework was also weak in supervising and monitoring foreign transactions. When finance companies were used to channel offshore loans in lieu of commercial banks, the Government lost monitoring and control powers over foreign fund flows (Husnan, 2001)..

of scale, and thus with this way it is hope that local, especially small banks can survive in a process of liberalization and integration. Although in many countries, including Indonesia, the corporate lending activities of local, especially small banks, have declined in total due to the full-fledged entry of foreign banks subsequent to the easing of regulations, local banks still have a crucial role to play, namely in financing the development of small and medium enterprises (SMEs) which in all ASEAN countries constitute the foundation of domestic industries (Tambunan, 2006). And, since the majority of SMEs in countries such as Indonesia, Thailand and the Philippines are located in rural areas, local or especially small banks have opportunities to grow in rural areas. Other ways to strengthen local banks are through strengthening the monitoring function of local banks; development of an environment for autonomous and efficient bank management which is independent of intervention by government and corporate groups; improvement of human resources; reform of management structures; and, further promotion of information disclosure.

**Table 6: Bank nonperforming loans in ASEAN (% of total gross loans)**

Country	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	...	...	...	...	...	...	...	...
Cambodia	...	...	...	...	...	...	...	...
Indonesia	34.4	31.9	24.0	19.4	14.2	14.2	3.1	3.5
Lao PDR	...	...	...	...	...	...	...	...
Malaysia	15.4	17.8	15.9	13.9	11.7	11.7	8.5	8.2
Myanmar	...	...	...	...	...	...	...	...
Philippines	24.0	27.7	26.5	26.1	24.7	24.7	8.6	...
Singapore	3.4	8.0	7.7	6.7	5.0	5.0	2.8	2.5
Thailand	17.7	11.5	15.7	12.9	10.9	10.9	7.5	...
Viet Nam	...	...	...	...	...	...	...	...

Source: ADB database

**Table 7: Recent Development of Banking Sector in Indonesia**

Main Indicator	Dec-03	Dec-04	Dec-05	Dec-06	Jul-07	Agt-07	Sept-07
Total Asset (Trillion Rp)	1,196.2	1,272.3	1,469.8	1,693.5	1,801.1	1,820.4	1,850.5
Deposits (Trillion Rp)	888.6	963.1	1,127.9	1,287.0	1,379.2	1,392.6	1,400.6
Loans (Trillions Rp) *	477.2	595.1	730.2	832.9	915.6	936.8	956.7
BI's certificate (Trillion Rp)	102.3	94.1	54.3	179.0	239.6	221.1	205.1
Securities (Trillion Rp)	375.9	348.1	350.5	342.9	342.4	352.6	353.8
NII (Trillion Rp)	3.2	6.3	6.2	7.7	8.7	8.0	8.1
CAR (%)	19.39	19.36	19.47	20.47	20.51	20.29	19.96
NPLs Gross (%)	8.21	5.75	8.30	6.98	6.46	6.31	5.75
NPLs net (%)	3.04	1.72	4.82	3.63	2.95	2.84	2.60
ROA (%)	2.50	3.46	2.64	2.63	2.83	2.85	2.78
BOPO (%)	88.80	76.69	87.73	86.45	84.24	83.55	84.19
LDR (%)	53.70	61.79	64.73	64.72	66.38	67.27	68.30
Number of Banks	138.0	133.0	131.0	130.0	130.0	130.0	130.0

\*) including channelling

Source: Bank Indonesia

Second, improving long-term funding mechanisms. This should be done through heightening the capability of domestic financial systems to supply long-term credit. For this end, large pools of domestic savings must be sustained, which, if properly utilized, can finance the necessary investments for achieving high economic growth rates. Tables 8 and 9 show development of gross capital formation in the region. Thus, the capability of domestic financial systems to supply long-term credit maintains high levels of sustained economic growth without becoming excessively dependent on foreign funds. For this purpose, further steps should be taken: (1) the procurement of investment funds based on market mechanisms, as well as to work towards strengthening of market mechanisms must be promoted; (2) the capability of local banks to supply long-term credit should be heightened. For this purpose, the following lines of action are important: (2a) development of an environment conducive to the supply of long-term credit by banks, (2b) improvement of risk-management and maturity formation-capacities, (2c) boosting of bank capitalization, (2d) use of syndicated loans and other risk-reducing methods, and (2e) promoting the entry of foreign banks with the ability to accept higher risk burdens; (3) systems for direct procurement of long-term funds from investors through the issue of corporate bonds should be strengthened;<sup>13</sup> and (4) development of the systemic infrastructure.<sup>14</sup>

**Table 8: Gross Domestic Capital Formation in ASEAN (% of GDP)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	...	...	...	...	...	...	13.1	14.4	21.3	15.1	13.5	11.4	10.4	12.9
Cambodia	8.3	14.3	14.5	14.8	11.8	16.7	16.9	18.5	18.1	20.1	16.2	18.5	20.6	20.8
Indonesia	30.7	31.9	30.7	31.8	16.8	11.4	22.2	22.0	21.4	25.6	24.1	24.6	24.6	24.9
Lao PDR	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Malaysia	32.4	43.6	41.5	43.0	26.7	22.4	26.9	24.4	24.8	22.8	23.0	20.0	20.9	21.9
Myanmar	13.4	14.2	12.3	12.5	12.4	13.4	12.4	11.6	10.1	11.0	12.0	...	...	...
Philippines	24.2	22.5	24.0	24.8	20.3	18.8	21.2	19.0	17.7	16.8	16.7	14.6	14.5	15.3
Singapore	37.1	34.5	35.4	38.7	31.1	32.2	33.3	26.5	23.7	16.0	21.7	19.9	20.0	22.6
Thailand	41.4	42.1	41.8	33.7	20.4	20.5	22.8	24.1	23.8	25.0	26.8	31.4	28.5	26.8
Viet Nam	12.6	27.1	28.1	28.3	29.0	27.6	29.6	31.2	33.2	35.4	35.5	35.6	36.8	41.7

Source: ADB database

Third, developing transparent and fair capital markets. While the banking sector is expected to continue playing a central role in ASEAN countries, when financial development reaches a certain stage, the proper growth of capital markets becomes indispensable from the perspective of promoting the effective use of savings. Recent development of capital markets in the region (in selected countries), reflected by the growth in the share of equity versus the share of domestic credits in GDP, are shown in Figure 3, and the growth of

<sup>13</sup> Because banks hold a dominant position in the financial systems of ASEAN countries, in the early stages of this process, it is important to utilize credit-evaluation function of banks to generate information on borrowers. While the provision of bank guarantees on corporate bonds is a possible approach, such measures as loan participation and loan securitization should be more effective (EG, 2002, p.4).

<sup>14</sup> The expansion of long-term credit requires the development of the systemic infrastructure and the training of experts. It is appropriate to gradually add new methods for the supply of long-term credit in line with the various stages in the development of systemic infrastructure as follows: increasing the supply of long-term credit by banks; introduction of new risk-sharing methods by banks; collaborative development of long-term credit by banks and institutional investors; and, involvement of general investors in the expansion of long-term credit (EG, 2002, p.4).

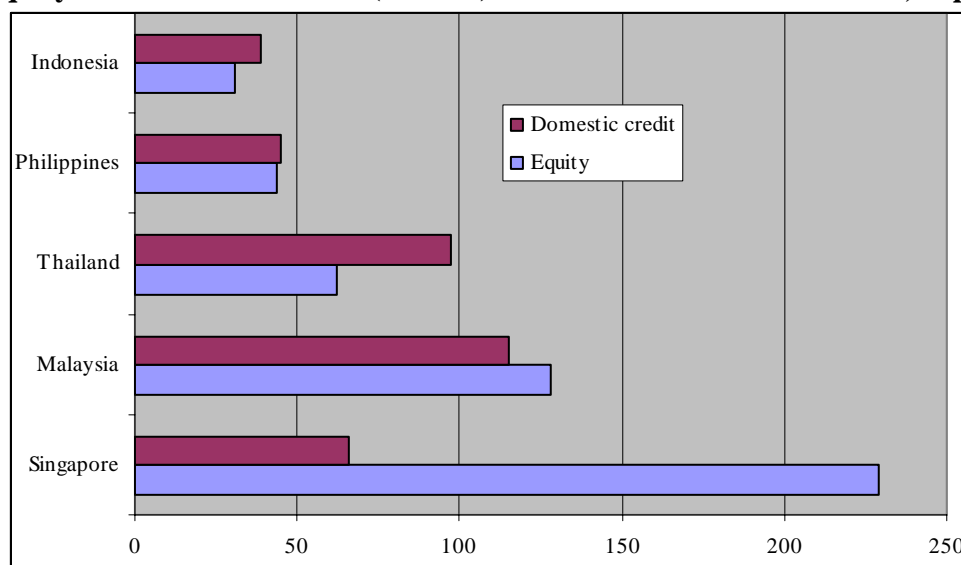
portfolio investment, another indicator of development of capital market, in Indonesia and some other countries as a comparison (Singapore, Brunei, Cambodia) is shown in Figure 4. The proper function of capital markets depends on their efficiency (appropriate pricing function and the ability to facilitate the transfer of risks and maturities), and fairness (transparency in price formation and transaction process, equal opportunity for market participation). In an effort to develop transparent and fair capital markets, the following matters should be considered concerning the development of the ASEAN capital markets. First, the diverse possibilities of complementarity between the financial system and the banking sector should be considered, while taking into account the diversity in the developmental stages and financial structures of financial systems. Secondly, attention must be paid to create transparent and fair markets capable of winning the confidence of overseas investors.

**Table 9: Growth Rates of Real Gross Domestic Capital Formation in ASEAN (% of GDP)**

Country	1990	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
Brunei Darussalam	...	...	...	...	...	...	...	6.7	45.7	-20.8	2.8	0.5	1.4	26.5
Cambodia	-23.5	39.4	2.7	16.4	-20.4	48.3	8.6	21.3	3.8	21.7	-7.9	29.9	24.8	13.7
Indonesia	10.9	13.1	4.9	6.3	-39.0	-23.2	12.9	10.3	-1.8	10.8	6.9	12.4	1.2	2.0
Lao PDR	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Malaysia	21.4	20.3	5.8	11.2	-43.0	-3.9	29.2	-9.3	7.9	-1.5	6.9	-2.5	11.5	3.9
Myanmar	29.2	28.5	13.0	10.5	19.2	13.8	11.3	2.8	10.1	24.8	24.3	...	...	...
Philippines	15.8	3.5	12.5	11.7	-16.3	-2.0	5.5	-7.3	-4.3	3.0	7.2	-8.8	5.0	11.2
Singapore	17.7	14.5	9.6	19.5	-24.1	10.4	24.1	-22.4	-4.9	-30.7	48.1	-1.0	15.2	21.4
Thailand	31.2	14.3	5.2	-21.9	-50.9	8.5	11.3	2.7	6.0	13.5	12.8	12.9	-3.2	0.3
Viet Nam	...	...	14.2	9.4	12.6	1.2	10.1	10.8	12.7	11.9	10.5	11.2	11.8	24.2

Source: ADB database

**Figure 3: Equity and Domestic Credit (%GDP) in Selected ASEAN Countries, September 2006**

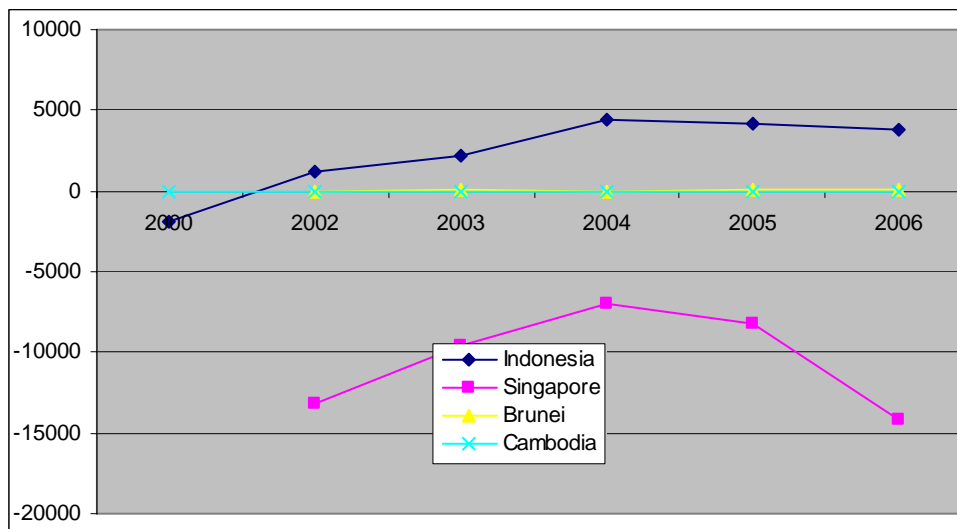


Source: AsianBondsOnline

The challenges facing the ASEAN (or Asia in general) capital markets can be summarized as the followings (EG, 2002, p6-7): a) the development of government bond markets represents an urgent issue from the perspective of providing a benchmark for gauging the risks of bonds in general, and for serving as a sound

foundation for corporate bond markets; b) to avoid excessive dependence on banks and to promote the stable transfer of long-term funds, it is necessary to promote the development of corporate bond markets and to promote bond ownership by a large population of general investors. There is the view that the participation of banks in the issue of bonds can reduce the information gap and contribute to the smooth expansion of the bond market. However, if the capital-market operations of banks are to be conducted through their internal organizations, it is important to erect firewalls to separate these operations from other banking functions; c) investment banks have an important role to play as market intermediaries from the perspective of promoting the development of capital markets in line with the stages of economic development and financial structure. It is probably necessary to utilize foreign investment banks to launch new capital markets; d) from the perspectives of autonomy in asset management and corporate governance, and to perform those functions which are expected of institutional investors, it will be necessary to develop an asset-management industry in the private sector; e) the presence of foreign investors can contribute to promoting the vitalization of the market and achieving greater transparency. Cross-regional listing can improve corporate disclosure and corporate governance and can also have a complementary effect on augmenting the function of home markets and heightening possibilities for the expansion of regional markets.

**Figure 4: Growth of Portfolio Investment in Selected ASEAN Countries (mn US\$; net)**



Source: ADB (Key Indicator, 2007)

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