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## Regional Financial Integration: When Leadership is Needed

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*As global capital flows expand and global payments imbalances persist, the risks to the stability of Southeast Asian economies increase. Political leadership at the regional level is needed to prepare for future problems that are beginning to surface.*

**AS THE** Thirteenth ASEAN Summit approaches, there is one important issue for the region that should not be overlooked, or forgotten – the consequences of increasing global capital flows.

Since the crisis, most of the affected countries have made substantial improvements in their macroeconomic policies. Countries now exhibit greater credibility with regard to inflation targeting, and exchange rate flexibility has reduced countries' vulnerability to a capital flow induced crisis. Economic recovery has likewise occurred quickly; GDP levels are higher in 2007 than before the crisis, growth rates are around 4-6%, and since 2005 the value of capital flows into these countries has exceeded the pre-crisis peaks. Additionally, the crisis-hit countries have reduced their external debt positions from a peak of over 70% of GDP in 1998 to around 30% currently. The bolstering of countries' external positions has been accompanied by a massive build-up of foreign reserves as self-insurance against the risk of a sudden stop in capital flows.

### Limits of institutional reforms

Institutional reforms have also been introduced. For example, banking system reforms have been implemented in several of the crisis affected countries; they are now better capitalized, lending rules and regulatory oversight have improved, and bankruptcy laws and procedures have been strengthened. But in addition to this, there is now a reduced reliance on bank borrowing as a result of authorities' active encouragement of the development of bond markets.

However, while many institutional reforms look good on paper, they have in fact remained quite limited, and considerable improvements are needed. Although the corporate sector across most countries has seen increased privatisation since the crisis – and the reduction of the state's influence – progress has been slow. This is largely attributable to underlying political interests which remain entrenched and influential. This has prevented necessary corporate governance reforms that would enhance transparency, protect minority investors (and foreign investors), and remove any vestiges of crony capitalism.

Of all the affected countries, Indonesia has the furthest to go. With regard to its banking institutions, the most pressing problem is the lack of prudential regulation, including the implementation of strict lending criteria to ensure loans are repaid (i.e., no connected lending and no special relationships

between state banks and state enterprises), as well as a strong legal system and well-functioning bankruptcy procedures. The continuing underdevelopment of the country's capital markets denies alternative financing sources to many domestic firms, reflecting the continuance of close business-government ties.

### **Regional Economic Changes**

Progress in regional economic integration in Southeast Asia has occurred primarily in the areas of trade, foreign direct investment (FDI), and production networks. Financial cooperation and integration has been slower, yet the 1997 crisis clearly illustrated the importance of financial arrangements that accompany the linkages in these other domains. As a result of the increasing magnitude and velocity of global capital flows, countries have come to recognise their limited effectiveness in asserting national control over them. A regional cooperative arrangement offers an intermediate choice between the national level and the international arena where large financial institutions and the interests of the United States and other countries dominate. Such arrangements would complement the increasing trade ties among nations in the region, particularly as production networks expand and deepen.

Regional coordination since the crisis has been enhanced. This makes regulatory standards more sensitive to the regional countries' specific political economic arrangements while maintaining international confidence. To enhance regional financial cooperation, central bank governors have developed regional fora for policy dialogues. Regional bond markets have also grown and deepened as a way to reduce the double-mismatch problem that led to the 1997 crisis. (The first mismatch was foreign lending in US dollars to local banks which in turn loaned out in the local currency; the second mismatch was when local banks took short-term loans from international banks and then made long-term loans to local borrowers.) Progress has occurred in creating a regional reserve pooling framework in which a swap agreement exists among Southeast Asian nations. This enables countries to exchange currencies with one another in the event of a liquidity shortfall.

While it has been strengthened over time, a heavy reliance on IMF support remains since only 20 percent of the initial amount requested would come from the swap agreement; the remaining 80 percent from the IMF. But the substantial amount of reserves accumulated by individual countries lessens the perceived need to bolster this regional framework. While there is a greater emphasis after the crisis on developing regional economic cooperation, political support is lacking. This is a problem, as there are serious risks to the region's financial stability that require political will to be addressed properly.

### **Future Risks**

Since 1998, East Asian countries have kept interest rates low and stable to encourage export-oriented growth and to build up reserves to insure against a repeat of the crisis. A low exchange rate is also important for maintaining competitiveness with China. But keeping the exchange rate artificially low delays the inevitable appreciation; if the nominal rate does not appreciate at some point, the real rate will -- by way of increasing inflation. Indeed, some countries have witnessed run-ups in the prices of their stock markets and real estate. Seeing the appreciation is inevitable, speculation ensues, which makes the costs of adjustment greater. The problem for Southeast Asian countries is maintaining competitiveness relative to China if their currency appreciates.

Higher equities and real estate prices create greater risks for the banking sector in these countries, which have been ramping up their business activities in the securities arena. With the exception of Singapore, many countries' banking systems already suffer from a continuing lack of transparency and full disclosure, uncertainty about the continuing level of non-performing loans, as well as the effectiveness of supervision, regulation and risk management.

**In the long-run**

Further, the persistence of global payments imbalances is not sustainable in the long-run, and heightens the existing risks. Several adjustments are possible to accommodate an orderly wind-down. These include stronger domestic demand in East Asia; a savings increase in the US; an orderly depreciation of the real effective exchange rate of the US dollar; and an appreciation of East Asian currencies to reduce the US current account deficit and the East Asian surplus.

The risk is that these adjustments will not be orderly, and that further increases in the imbalances could trigger abrupt exchange rate swings. Or perhaps more likely as a result of countries' use of flexible exchange rates, rapid adjustments in domestic economies and financial markets. The risks to the banking and corporate sectors are exacerbated by the gap between formal and behavioural compliance – or the difference between what they appear to do on paper and what they do in practice. If an economic downturn exposes this gap, foreign investors may run for the exits – again. Political leadership is needed to expand and deepen the existing regional arrangements in order to shield the economies from the excesses of global capital flows.

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