# ASEAN Financial Integration without Monetary Union

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**Abstract:** ASEAN Economic Community (AEC) is the vision of 10 nations in South East Asia to form a single common market and production based that will foster growth in the region. One of the pillars of AEC is financial integration which goaled to allow a seemingly interconnected capital market in South East Asia. This means that there will be free flow of capital through current account and financial service liberalization. This paper will review experience of other regional financial integration such as the EU and draw conclusion of how ASEAN financial integration can be implemented and how we can resolve future crisis.

**Keywords:** current account liberalization, contagion, financial integration

## 1. INTRODUCTION

ASEAN Economic Community (AEC) is the vision of 10 nations in South East Asia to form a single common market and production based that will foster growth in the region. One of the pillars of AEC is financial integration which goaled to allow a seemingly interconnected capital market in South East Asia. This means that there will be free flow of capital through capital account and financial service liberalization, which is two component of AEC financial integration.

Capital account liberalization (CAL) allows investor to purchase and issuer to float securities within in region without restriction. AEC aims of placing appropriate financial infrastructure and regulatory environment that will promote capital mobility in the region. Cross listing of securities and creating a common settlement system is also a major task needed to be undertaken to allow seamless trading in member state's exchanges.

Financial service liberalization (FSL) on the other hand is integrating AEC banking system by allowing cross branching of member states bank without respect of country of origin within the region.

In recent years we see increasing intra – ASEAN trade with annual growth rate of 10.5 percent and foreign direct investment (FDI) grew at average of 8.5 annually from period of 1993 – 2013. Based on estimate by 2015 AEC will become the 6$^{th}$ largest economy in world and 3$^{rd}$ largest in Asia. The region will home of 629 Million people whom 50 percent of its population will be below 30 years of age and 47.7 percent of its people will live in urban areas.

This paper will review experience of other financial integration specially, but not limited to EU and draw conclusion of how can we implement AEC financial integration.

## 2. FRAMEWORK

This section will be mainly divided into two parts. First is the survey of different literature relating to global financial integration, its issues and resolution; and secondly, the experience of EU which is the one of the most successful regional integration.

### *2.1 Literature of Global Financial Integration*

The first financial integration seems to rise when Italian city states establish modern financial centers between 9$^{th}$ to 13$^{th}$ centuries (Kindleberger, 1984). After several centuries two mighty empire of Dutch and Britain established Amsterdam and London as their financial center that dominate banking, foreign exchange; and trading of different financial assets and commodities. During those times financial market was relatively contained geographically and securities are quite simple in structure. Modern era of financial markets is more interconnected and more complex in terms of assets being traded and its method of execution as we witness the rise of high frequency traders (HFT). Regulatory environment is tight and institution such central banks are keener on the health of banks.

#### *Financial Globalization and Foreign exchange*

Foreign exchange (FX) is the mechanism which one country can quote its currency versus another country, like buying one foreign currency in unit term of domestic currency. The FX market allows countries to trade and facilitate globalization of finance.

Over the years many study is conducted to the effect of financial integration to the real exchange rate (RER). Caporale, Hadj Amor and Rault (2009) shows that financial integration drive RER of emerging economies, based on 39 sample countries from Latin America, Asia, Middle East and North Africa. Obstfeld (1984) in his research presents model that shows appreciation and deprecation of long run RER because of the removal of the capital control.

McKinnon (1973, 1993) reported that rapid inflow of capital will lead to the real appreciation of the exchange rate. This will mean there will be potential disruption in the economy as agents (e.g. exporter and importer) who are using foreign exchange heavily will find it difficult to adjust in the new rates. These agents are tied over to a long term commitment on the old rates, without using currency hedge this foreign exchange user will be in misery of currency market volatility.

*Capital Control and Current Account Liberalization*

After the collapse of the Bretton Wood system country start to relax their capital control, an event where countries abandoning fixing their rate to the US dollar, allowing market forces to determine the appropriate exchange rate of their currency against the US dollar.

The world has experience many crises such as the Latin American debt crisis of 1980, the Asian financial crisis of 1990, Russian ruble crisis on 1998 – 1999; and lastly the 2008 global financial crisis. Crisis such this highlighted the potential risk of surging capital inflow to the economy. According to Bhagwati (1998) and Stiglitz (2002), high capital mobility resulted in macroeconomic instability.

Dooley and Isard (1980) based on their study about investor's preferences between assets of two different countries, shows that capital control make investor less willing to invest in a country with which impose capital control. Countries imposing capital control limits investors' ability in moving their capital (money) out of the country.

*2.2 European Union (EU) Experience*

*European System of Central Bank*

Central bank goals are managing inflation and ensuring full employment in the economy. It is important to the survival of a country and also plays a major role in well integrated financial market of EU.

The EU is divided into two groups of countries: the euro area, which composes the 19 of 28 countries of EU member states which used the euro as their currency; and 9 other countries of EU which don't used euro as their currency. Even though the none Eurozone countries are not using euro as their currency, most of them are explicitly peg their respective national currency to Euro to harmonize to the Eurozone.

Monetary policy in the Eurozone is managed by European Central Bank (ECB) and Eurosystem which compose of the ECB and national central bank of the Eurozone member states. ECB as primary arm of Eurosytem, is responsible for design and implementation of monetary policy for the Eurozone. Countries not belong to Eurozone are free to perform their independent monetary policy and don't have any power over ECB and the Eurosystem.

*Eurozone Crisis 2008*

It is widely believed that the Eurozone crisis is a sovereign debt crisis (Storm and Naastepad, 2015), which cause many Eurozone leaders to adopt austerity, believing in the doctrine of expansionary fiscal austerity. Fiscal austerity is debt consolidation, narrowing deficit by raising taxes and cutting government spending but this is proven to be ineffective in Euro countries.

Neagu and Mihai (2013) provide an alternative explanation on the crisis, based on their seminal work, the Eurozone crisis may have been an issue of sudden stop of capital flow. Liquidity shock such as deposit withdrawal, leverage and funding structure of financial institution and asymmetric information over the health of the banking system; will cause lost of confidence in the financial system and that will result in credit reduction. This type of shock first hit the banking system then will eventually spill over to the real economy.

## 3. DISCUSSION OF THE RESULT

*3.1 Policy Coordination*

Most economy relies over to the action of its central bank to stabilize the financial system. Hence on the same manner AEC must form governing bodies, maybe a council of ASEAN member state's central bank governor and finance minister, that will help formulate a region wide monetary policy. Experience from the Eurozone crisis tells us that despite of existence of monetary union, ECB find it difficult to resolve the issue. In such mature financial integration, policy coordination is being needed to resolve the crisis, in that regards AEC must also adopt such same framework for not only resolving future crisis but also for economic policy harmonization among member state.

*3.2 Exchange Rate Mechanism*

The 1997 Asian financial crisis tell us the effect of exchange rate fixing and large current account deficit on the over health of the economy. The crisis starts with the currency attack on bath which creates pressure on the dollar denominated debt of both public and private sector of Thailand. The crisis on Thailand spread to its neighboring country of Indonesia, Philippines, Singapore, and Malaysia; and then the rest of Asia.

It is recommended that that AEC adopt flexible exchange rate however shall establish exchange rate harmonization among member state but shall not adopt an exchange rate mechanism that will restrict policy makers in using appropriate tools in conducting monetary policy in their national jurisdiction.

Mundell (1961) stated that region which tries to integrate financially shall create a common currency. The optimum currency area (OCA) will be benefited from the decrease asymmetric information; and more fluid flow of capital and trade across the region. Due countries of AEC are not yet ready to adopt a common currency, in such absence of currency union, AEC must harmonize exchange rate across the region to replicate the benefits of OCA.

*3.2 Current Account and Financial Service Liberalization*

In the work of Neagu and Mihai (2013) shows that sudden stop of capital will cause issue on balance sheets of bank that will eventually spill over to the real economy. Also on McKinnon's (1973, 1993) study it shows that rapid inflow of capital creates sharp appreciation of foreign exchange.

Policy maker must be watchful over to the flow of capital not only within the region but even how the region is connected to the rest of the world. We can conduct similar study by Fed called the flow of funds, which track the flow off dollar from one entity to another entity regardless of jurisdiction. This allows the Fed to monitor the movement of capital from US to other jurisdiction from different channel such as investment and trade.

We also need to consider countries in the region which experience a long period of strict capital control such as Laos and Myanmar. These countries are more vulnerable to sudden inflow of capital.

*3.3 Financial Integration: Risk Sharing and Contagion*

Obstfeld (1994) reported that international risk taking can yield positive economic growth through an efficient used and allocation of capital. On the downside increasing financial integration will expose countries into risk contagion (Devereux and Yu, 2014).

There must be region wide assessment of systemic risk that financial institution possesses to the host country and the whole region. A mechanism must be in place in monitoring, regulating and reducing the concentration of risk to either one financial institution (e.g. bank and securities dealer) or to one member country of AEC.

If AEC policy makers fail to recognize that capital mobility sometimes result concentration of risk, then we must face the consequence of making the region vulnerable to another Asian financial crisis.

*3.4 ASEAN Common Reserve Fund*

Gross international reserve (GIR) serve as cushion for country in difficult times. It serves a very important role in the global economy as mean for country to stabilize volatility in the foreign exchange market. Most often central banks will defend their currency by intervention through open market operation.

Experience of most of the country tell us that GIR help many of them in avoiding potential crisis, but the potency of the GIR as stabilizer is much more dependent on the size of reserve versus to the country's economy. In that regards, if a crisis struck in the region; we learn from many literatures that as the economy is more integrated, the risk of contagion is larger; there is no reserve of one member state can save the entire region. Nationalism and divergence of political ideology, will delay any cooperation among members to put up a large amount of money to stop the crisis.

It is suggested for the region to set up a common reserve fund, ideally a member state shall contribute to the fund depend on the size of its economy.

**4. CONCLUSION**

Financial integration will result on lower cost of capital for company on the region. It will also facilitate more trade due to lower cost of transaction.

The recommendation that is suggested on this study is such a great endeavor for policy makers that required keen details, in such this study is not intended to provide detailed plan of how can we eliminate any potential crisis or how can we successfully integrate the region.

Many literatures suggest that as a region is well integrated the risk of contagion is increasing. This contagion can trace in different channeled which foreign exchange rate and current account is the common way of risk transfer among member state.

Financial integration had a goal of having common market but this as well result in complexities of financial regulation and the market itself.

AEC is well diverse region politically and culturally. Due this, policy divergence is the most pressing concern in the event of crisis, in such government shall laid not only equitable rule but also transparent and inclusive for all members.

**5. LIMITATIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH**

This research is not intended of providing detail solution based on the experience of EU and other region that gone from financial integration rather provide a general overview of possible scenario that will happen and how we can be better prepare.

Readers may observe that there is lot of area for research. Risk sharing and risk concentration in financial integration is one of the areas that require more studies.

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