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Financial Integration in East Asia and Pacific: Regional and Interregional Linkages

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During the last two decades, economies in East Asia and Pacific have been integrating internationally through trade and financial investments. One trend is puzzling. Whereas most of the trade integration has been within the region, most of the financial integration has been with countries outside the region. However, a closer examination of investment types shows that the relative lack of regional financial connectivity occurs mostly in equity, bonds, and bank syndicated loans (in so-called arm's-length investments). The region is much more connected through foreign direct investment (FDI) (through both mergers & acquisitions and greenfield investments).

The Puzzling Pattern of East Asia and Pacific's Financial Integration

Since the early 1990s, the East Asia and Pacific region has been growing faster than any other region and, by 2016, it had captured about 30 percent of the world's economic activity, up from about 21 percent in 1990. A significant part of this growth has been driven by the rapid expansion of China, whose GDP grew from around 2 percent of world GDP in 1990 to about 15 percent in 2016.

Economies in the East Asia and Pacific region have been integrating with the rest of the world in terms of trade and are changing the global trading patterns. Still, an important part of the expansion in East Asia and Pacific's trade has been associated with a trend toward regionalization. In 2016, about 60 percent of East Asia and Pacific's exports and imports went to, or originated from, elsewhere within the region.

Along with increasing trade integration, many East Asia and Pacific economies have undertaken significant efforts to liberalize and expand the scope and depth of their financial systems. Beyond the unilateral lifting of formal restrictions to capital flows, many East Asia and Pacific economies have engaged in bilateral investment treaties to boost their integration in global financial markets. As of 2016, 542 of these treaties involved a party in East Asia and Pacific. In addition, several initiatives have been launched to promote regional financial connectivity. For instance, the Association of Southeast Asian Nations (ASEAN) launched the ASEAN Comprehensive Investment Agreement (ACIA), which came into effect on March 2012. The Agreement's main objective is to boost ASEAN cross-border investments by establishing a free, open, transparent, and integrated investment regime for domestic and international investors throughout the ASEAN member states. Moreover, stock exchanges from Indonesia, Malaysia, Philippines, Singapore, Thailand, and Vietnam have been working together to form the ASEAN Exchanges, aiming to promote ASEAN capital market integration. This collaboration created the ASEAN Trading Link, launched in September 2012, which connects the region's stock markets, making it easier for investors inside and outside the ASEAN region to trade stocks listed on their stock markets. Other financial cooperation initiatives aimed at fostering integration within the region include the Chiang Mai Initiative, the ASEAN Capital Markets Forum (ACMF), the Asian Bond Markets Initiative (ABMI), and the Asian Bond Fund Initiative.

But the evidence so far suggests that the level of financial integration within the East Asia and Pacific region has remained lower than its links with countries outside the region, contradicting the trend in trade (Kim, Lee, and Shin 2008; Garcia-Herrero, Wooldridge, and Yang 2009; Lee 2010; Lee, Huh, and Park 2013; Ananchotikul, Piao, and Zoli; ADB 2017). East Asia and Pacific economies are more financially integrated with global markets than with regional ones. For instance, portfolio investments within the region accounted for only 23 percent of East Asia and Pacific's cross-border portfolio investments in 2016. Part of the low level of regional financial integration is explained by Asian economies sustaining large current account surpluses and accumulating U.S. financial assets, leading to the so-called "global imbalances" (Bernanke 2005; Caballero, Farhi, and Gourinchas 2008; Forbes 2010).

The relatively low levels of regional financial integration seem to be at odds with the complementarity between trade and financial flows, as well as with the negative effect of distance on the creation of financial links (Portes and Rey 2005; Aviat and Coeurdacier 2007;

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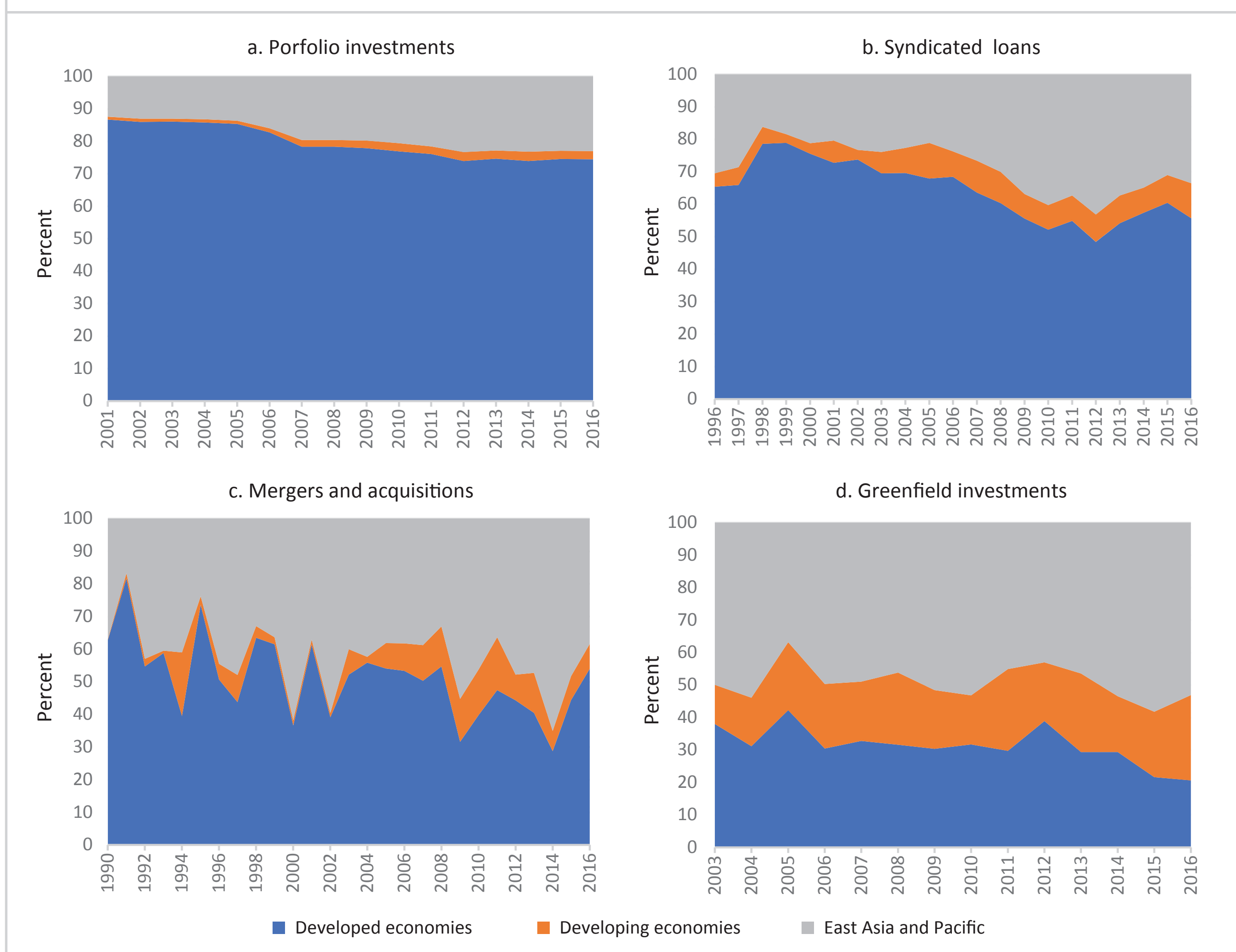
Figure 1. East Asia and Pacific's Cross-border Investment Shares by Region



Source: Coordinated Portfolio Investment Survey (IMF), SDC Platinum, and fDi Markets.
Note: This figure shows the share of developed, developing, and East Asian and Pacific economies in the value of East Asia and Pacific's cross-border investments (sent and received together). Developed economies comprise the G-7 members, excluding Japan, and 15 other Western European economies. Developing economies comprise the countries not in the East Asia and Pacific region or the developed economies group. Offshore financial centers are excluded from the sample.

Lane and Milesi-Ferretti 2008). Both trade and distance would predict much more financial integration within the region.

There is, however, a marked difference across different financial instruments, mainly between arm's-length investments (portfolio investments and syndicated loans) and foreign direct investment (FDI), comprising mergers & acquisitions (M&As) and greenfield investments.

New Evidence to Explain the Puzzle

Despite the puzzlingly low levels of regional integration in arm's-length investments, the East Asia and Pacific region seems to be well regionally connected in terms of FDI (ADB 2017; Didier, Llovet Montanes, and Schmukler 2017). Investments within the region accounted for around half of East Asia and Pacific's FDI between 2003 and 2016, whereas this share was 23 percent in the case of portfolio investments and 32 percent for syndicated loans (figure 1).

To understand the compositional differences across investment types, it helps to partition the economies with which East Asia and Pacific is connecting into developed and developing economies. Most of East Asia and Pacific's investments with the rest of the world occur with developed economies. In fact, developed economies accounted for over 80 percent of East Asia and Pacific's interregional investments in 2016, except for greenfield investments, where this share was around 44 percent.

The differences across investment types could be related to the relative underdevelopment of financial markets in East Asia and Pacific compared to those in developed economies. As an example, the share of domestic credit to the private sector over GDP was 95 percent for the median developed economy between 1990 and 2016, but 42 percent for the median East Asia and Pacific economy. The size of nonbank financial institutions' assets was on average equivalent to 132 percent of the US GDP between 1990 and 2015, whereas it was 3 percent and 5 percent in Indonesia and

the Philippines, respectively. In line with this argument, the literature on global imbalances suggests that Asian economies lack enough "safe" assets in which they can allocate their excess savings, and thus they invest in assets from developed economies. The higher degree of financial development increases not only the availability of financial instruments to both domestic and foreign savers in developed economies, but also the sophistication and depth of the financial markets and institutions that are able to invest abroad and diversify risk internationally.

The development of the financial sector is a key determinant of arm's-length investments, whereas it plays a less important role in FDI. This could partly explain the larger participation of developed economies, and thus the weaker regional integration in arm's-length investments. The role of developed economies is particularly important in portfolio investments (equities and bonds) compared to syndicated loans. Several studies suggest that, despite the growth in equity and bond markets, the East Asia and Pacific's financial sector is still not well diversified and remains highly concentrated in the banking sector. Although capital markets in various countries in the region have expanded significantly, becoming rather large, in several other countries they are small and characterized by low liquidity, high transaction costs, and a narrow investor base when compared to those of developed countries (Lee and Park 2008; Lee 2010; Didier and Schmukler 2015; IMF 2015).

As East Asia and Pacific and developing economies continue growing, becoming richer and developing their financial systems, they will start playing a larger role in East Asia and Pacific's portfolio and bank investments. Although developed economies have historically captured the bulk of East Asia and Pacific's investments, their role has decreased over time (figure 1). Recent trends, which are common to all investment types, indicate a change in the geographical composition of East Asia and Pacific's investments toward regional and developing economies. In the case of developing economies, the growth in financial investments can be traced to expansions not only in the value of the financial connections (the "intensive margin"), but also in the number of active connections (the "extensive margin"). The increasing role of developing economies in East Asia and Pacific's investments is part of a broader trend that includes the rise of developing economies in the global financial scene (World Bank, 2017; Broner et al., 2018).

The lack of regional connectivity in arms'-length investments (compared to that in FDI or trade) is not an issue specific to the East Asia and Pacific region (table 1). This pattern also occurs in other developing regions such as Latin America and the Caribbean, Europe and Central Asia, and Sub-Saharan Africa. In fact, when compared to other developing regions, East Asia and Pacific stands out as the most regionally integrated region across all investment types.

However, the East Asia and Pacific region comprises a wide range of economies. Consider this extreme: in 2016, Singapore's GDP per capita was US$52,961, whereas Cambodia's was US$1,270. Similar disparities exist with respect to the extent of their financial sector development. For example, equity market capitalization of listed domestic companies was 995 percent of Hong Kong's GDP in 2016, but it was only 33 percent in Vietnam. Not surprisingly, the more developed East Asia and Pacific economies (as measured by their GDP per capita) account for the bulk of the value of East Asia and Pacific's investments. Nevertheless, their participation is more important in East Asia and Pacific's arm's-length investments than in East Asia and Pacific's FDI. For instance, the more developed East Asia and Pacific economies accounted for 92 percent of East Asia and Pacific's inter-regional portfolio investments between 2003 and 2016, but only 46 percent in greenfield investments.

Table 1. Degree of Regional Integration by Type of Investment and Region, 2003-16

Percent

Type of connection	East Asia and Pacific	Latin America and Caribbean	Europe and Central Asia	Sub-Saharan Africa	South Asia	Middle East and North Africa	Developed economies
Portfolio investments	20.29	3.08	4.18	2.70	0.02	14.80	83.60
Syndicated loans	32.28	4.88	3.12	10.99	0.84	26.27	81.12
Mergers & acquisitions	44.48	21.55	22.48	7.86	0.54	18.16	79.32
Greenfield investments	49.59	15.14	22.80	16.82	4.25	38.01	41.12
Trade in goods	59.15	18.57	30.97	17.48	5.60	13.78	64.89

Source: Coordinated Portfolio Investment Survey (IMF), SDC Platinum, fDi Markets, and Direction of Trade Statistics (IMF).
Note: This table shows the share of intraregional investments in the value of the region's total cross-border investments (sent and received together) over the period 2003-16. Developed economies comprise the G-7 members, excluding Japan, and 15 other Western European economies. Offshore financial centers are excluded from the sample.

Policy Implications

The latest developments in the East Asia and Pacific's financial integration process could yield significant benefits to the region. Greater regionalization and the increasing presence of developing economies in East Asia and Pacific's investments could be a sign of East Asia and Pacific's strategy for diversification away from developed economies, which would allow the region to benefit from greater risk sharing.

Increasing regional financial integration could have some specific advantages compared to a strategy of global integration. First, it could reinforce economic integration and foster growth by facilitating coordination of regulations and supervisory policies across countries, given that this tends to be easier to achieve at the regional level. Second, it could promote the financial inclusion of previously underserved segments, given that information and transaction costs are typically lower across neighboring countries. Although financial institutions from developed economies typically have superior financial technology and expertise, they might not always serve local needs best.

On the other hand, greater regionalization might also pose additional risks. Because business cycles tend to be more correlated among neighboring countries than among distant ones, regionalization can limit the benefits of risk sharing. It can also lead to a larger exposure of a country to regional shocks and a faster spread of foreign shocks once they hit one of the countries in the region. Financial stability might also be negatively affected by a potential laxer regulatory and supervisory environment in developing economies relative to developed economies (Klomp and de Haan 2014; Claessens and van Horen 2016). Given the cross-border nature of the investments, appropriate macroprudential policies and stronger international policy cooperation could be used to boost resilience and mitigate risks to stability from more integrated markets.

Initially, both the benefits and risks of regionalization are expected to have a greater impact on FDI, an area in which regional connections play an important role. However, as East Asia and Pacific continues to develop its financial systems and promote common standards across countries, regional investments can be expected to capture an increasing share of portfolio and bank investments.

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