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Research paper

Does Financial Sector Development facilitate in the ASEAN Economic Community's Financial Integration?

Liberty S. Patiu

RVR-COB Financial Management Department
De La Salle University, Taft Manila

Abstract

The development of the financial services industry is crucial to the harmonious financial integration in East Asia. The ASEAN region is a host of member states with different levels of financial and economic developments. This study determines the level of development in the financial services sector among the ASEAN5 member states from 2002 to 2013 and explores the opportunities where financial integration may be undertaken in the light of the establishment of the ASEAN Economic Community in 2015. Member states exhibited high economic growth levels since the Asian Financial Crisis, which was spurred by the heightened competitiveness in the region brought about by the increase in inter- and intra-regional trade, investments and production network. It was found that there is high intermediation in the financial system and majority of the ASEAN5 Member States still employ the bank-based financial system compared to non-banks and financial markets. The region will slowly shifts from bank-based to market-based system, as changes in the financial architecture will become increasingly evident in the near future to enable smooth transition of the region into an economically integrated region. Financial supervisors are faced with the challenges of providing sound financial environment, strong supervisory/regulatory framework and better institutional arrangements to stimulate further development of the financial services industry. Advanced economies will lead the region in increasing depth, in promoting financial soundness and in deepening collaboration among member states where reform priorities and financial convergence are crucial.

Keywords: *Financial Sector, Banks, Financial Development, Financial Integration, ASEAN Economic Community. ASEAN5 Member States*

1. Introduction

The advent of globalization led countries to liberalize their financial system to provide level playing field in the provision of financial services. In Southeast Asia, levels of recovery measures, prudential regulations and institutional infrastructures were undertaken to make the financial system competitive.

Financial development encompasses financial regulation and supervision, measurement of financial openness, and other measures of developments. It also involves the widening and deepening of the financial system. This is evident from the increase in the number of financial institutions, increase in the level of intermediation, the efficiency of its institutional underpinnings, and access to the financial services by the people.

To date, there is a growing number of studies that focus on financial development, especially those that are linked to economic growth. A country requires complex and efficient financial services to enhance and maintain a sound financial system. Wadud[1] evaluated the long-run relationship between financial development and growth and found causality existing between them where financial development facilitated in the growth of the country's economy.

In Vietnam, Anwar and Nguyen[2] evaluated their linkage and found a positive effect of credit to GPP and economic growth and a negative effect of the stock of foreign direct investment on economic growth. In fact, Estrada, Park and Ramayandi[3] examined the important role of financial development to the medium and long-term growth of the region.

It is surprising that Delke and Pundit[4] found convergence by the financial systems in lower- to middle-income economies with those in advanced economies. They recognized the role of financial markets in increasing foreign direct investment in the country and in developing the financial system.

This study aims to examine the current state of the financial sector development. This study will serve as a guide in evaluating the readiness of the ASEAN region, particularly the original Member States (ASEAN-5) in implementing an Integrated Financial System under the ASEAN Economic Community.

2. Research methodology

Descriptive research design was be used in the study as it presents the stylized fact of the financial sector development, particularly banks using aggregate country data gathered from the financial development database of the World Economic Forum and World Bank.

It presents the stylized facts on the level of financial development among ASEAN-5 countries and evaluates how the financial development indicators can facilitate in the liberalization and integration of the financial system under the ASEAN Economic Community. For most of the analysis, most indicators were be assessed as a ratio of gross domestic product (GDP to facilitate benchmarking of the state of financial development in each country.

The original five (5) member states of the ASEAN countries, namely, Indonesia, Malaysia, Singapore, Thailand and the Philippines are used in the study, as the other five members have under-

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developed financial systems and most of the data are not available for the period 2000-2013. Years 2000, 2004, 2008, 2012 and 2013 were utilized in the analysis. Cross-country and industry comparisons are undertaken to analyze level of finance development existing among them.

3. Results and discussion

Over the past years, Southeast Asia experienced remarkable economic growth spurred by increased trade in goods and services and cross-border transactions in the international market. In 1967, alliances among five countries in the region to form the Association of South East Asian Nations (ASEAN) was undertaken to bolster regional cooperation among them. Since its establishment, the region had come a long way in coordinating policies, especially with the accession by Brunei, Cambodia, Lao PDR, Myanmar and Vietnam (BCLMV).

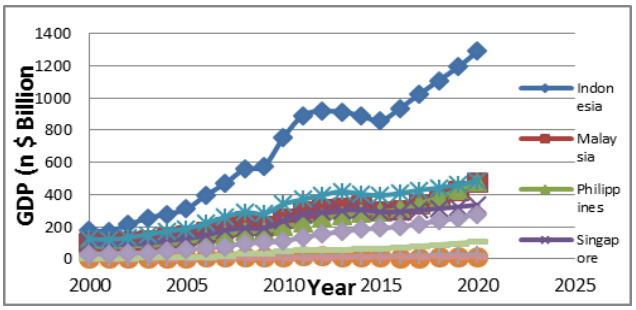


Fig. 1: Gross Domestic Product of ASEAN Member States (AMS) for the Period 2000-2020)[11,22]

Figure 1 shows big disparity in the levels of economic development among ASEAN Member States (AMS) especially between ASEAN-5 and BCLMV countries for the period 2000-2020. For the year 2000, ASEAN-5 members' total GDP output is ten times the value of GDP output of BCLMV countries. Indonesia showed a very robust economic growth despite slow growth or decline in its GDP from 2012 to 2014. Myanmar, Lao PDR and Cambodia exhibited very slow economic growth.

The region is expected to gain more power in the international market, as it registered approximately $2.22 Trillion in combined GDP output in 2014. The ASEAN Secretariat[5] reported that it is the seventh largest group regional alliance worldwide and the fastest growing hub for international investments. Within ASEAN, trade among the member states was posted at 24.1% in 2014. As most of the country's GDP grew by almost two-fold from 2000 level to 2014, the forecasted years' GDP showed positive signs of economic growth (see Figure 1).

The financial development in the ASEAN is crucial in evaluating the readiness of the AMS in providing the necessary financial architecture for an integrated financial services sector and markets under the ASEAN Economic Community. Figures 3-6 shows the different sub-indices that make up the development of the financial system for 2008 and 2012. The FD Index in Figure 2 provides a holistic perspective of the country's financial system and how the country's policies and practices contribute to its long-term development.

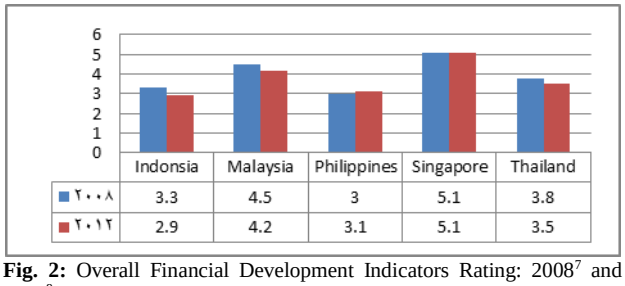


Fig. 2: Overall Financial Development Indicators Rating: 2008[7] and 2012[8]

Figure 2 shows that Singapore and Malaysia scored high in the financial development rating during 2008 and 2012. Figures 3 and 4 shows that the banking sector was high for both Thailand and Singapore.

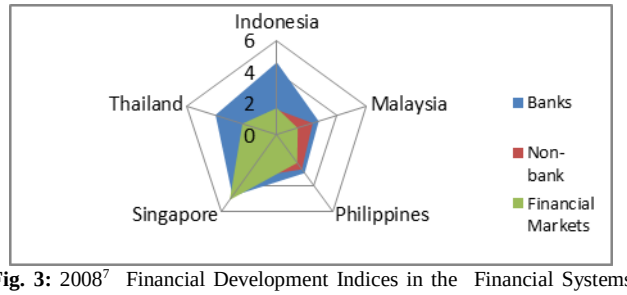


Fig. 3: 2008[7] Financial Development Indices in the Financial Systems Grouped by Sector

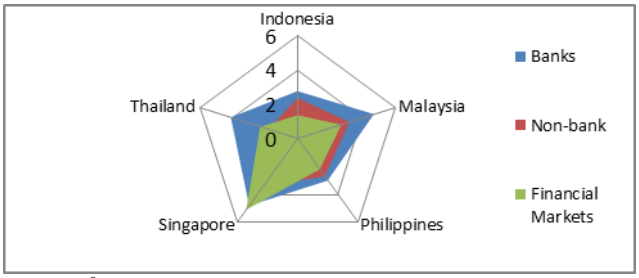


Fig 4: 2012[8] Financial Development Indices in the Financial Systems Grouped by Sector

While Indonesia revealed more bank-based system, the rating declined in 2008 Malaysia's low rating improved in 2012 not only for the banking sector but also for financial markets.

There is a general consensus in the banking sector development among five countries compared to their non-bank financial services and financial markets (Figures 3 and 4). In 2012, lower confidence in Indonesia and Malaysia's banking financial services was evident as shown in the decline in their ratings.

Indonesia and Thailand's FD index decreased substantially, especially in Indonesia whose banking services and access to capital was viewed as weak compared to other countries. The potential financing constraints in some sectors have resulted from the drain in its banking system's funds. This supports the findings of Eichengreen[6] which characterizes Asian Financial System as mostly dominated by banks which supply most of the financing within the region. Despite the move to accelerate the development of the financial markets as sources of additional capital, development process is slow, except in Malaysia and Singapore where a market-based financial structure is adopted.

The non-bank financial sector's FD rating improved in 2012, especially in Indonesia and Singapore. Aside from the disparities in the financial market development, the ratings are still low with the exception of Singapore. The Philippines' rating slightly improved from the 2008 level (see Fig. 5 and 6). This can be ascribed from with the improvement in its institutional framework, non-bank financial services and financial stability ratings and the development of its financial markets.

In the integration process related to trade in services among member countries, the Community is committed to implement an ASEAN-wide financial system through the harmonization and coordination of regulatory measures and policies within the region. Assessment of the member countries' readiness towards deeper economic integration through the measure of the level of its financial development is crucial.

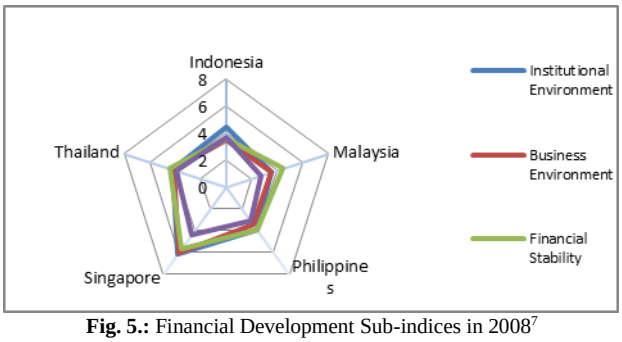


Fig. 5.: Financial Development Sub-indices in 2008[7]

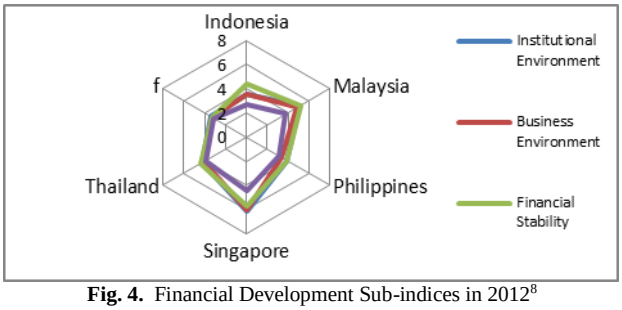


Fig. 4. Financial Development Sub-indices in 2012[8]

Figures 5 and 6 reveal that institutional and business environment sub-indices were considerably high compared to the other FD indicators; especially in Singapore and Malaysia which showed good enabling environment for the period. Both enabling environments are important pre-conditions or foundational support mechanisms in the development of a country's financial system. Despite the mixed results derived from financial stability sub-index, it garnered one of the highest rating. Improvement in the financial stability sub-index in 2012 is expected to happen as policymakers introduced measures to mitigate devastating effects of the global and euro crises.

The IMF utilizes the overall size of the financial system using the value of financial assets relative to the country's Gross Domestic Product (GDP) as a measure of financial development.

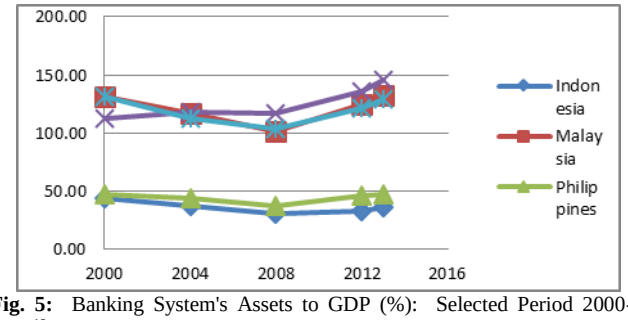
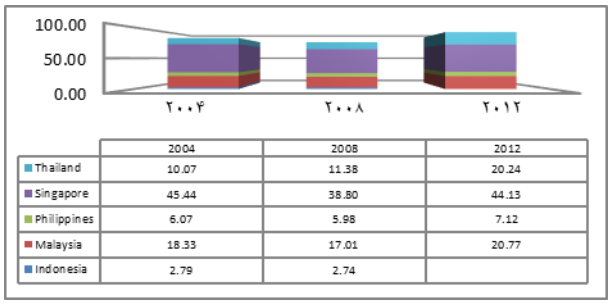


Fig. 5: Banking System's Assets to GDP (%): Selected Period 2000-2013[10]

The banking sector in Singapore, Malaysia and Thailand's play a big role in the country's long-term development, as the value of their banks' assets exceeded GDP. The assets held by banks in Indonesia and the Philippines are not even close to half its GDP and most banks in these countries are relatively small. As can be gleaned in Figure 7, the effect of the global financial crisis was not as bad as the Asian Financial Crisis as reflected from the slight decline in the banks' asset values.

Non-bank financial institutions are smaller compared to the banks in ASEAN. The size of the insurance companies to GDP is shown in Figure 6. There is a big disparity among countries in the way non-bank FIs operate. Except for Singapore, development of this industry is quite slow in Indonesia, the Philippines and Thailand.



	2004	2008	2012
Thailand	10.07	11.38	20.24
Singapore	45.44	38.80	44.13
Philippines	6.07	5.98	7.12
Malaysia	18.33	17.01	20.77
Indonesia	2.79	2.74	

Fig.6: Insurance Companies Assets/GDP (%): Selected Period 2000-2012[10]

There are several small insurance companies in the Philippines but their resources are quite small. Milo[9] mentioned that the low competition existing in the financial system stems from the absence of government restrictions on entry/exit barriers and the market power gained by few large companies. Barth and Calari[11] cited that the distortion of the macroeconomic policies, financial institutions' weaknesses, inefficient markets, weak governance and institutional capacity contribute to the low level of financial sector development.

Like any other emerging markets, banks play a major role mobilizing savings and investments in the financial system. Figure Nos. 7-10 further reflect financial depth in the region. Financial intermediation is quite effective in Malaysia, Singapore and Thailand as the ratio of total deposits generated (Figure 7) and the ratio of stock of credit provided to the private sector to GDP by the financial institutions were quite high (Figure 8).

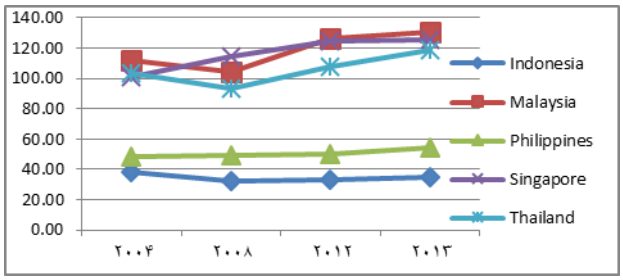


Fig.7: Financial System Deposits to GDP (%): Selected Period 2004-2013[10]

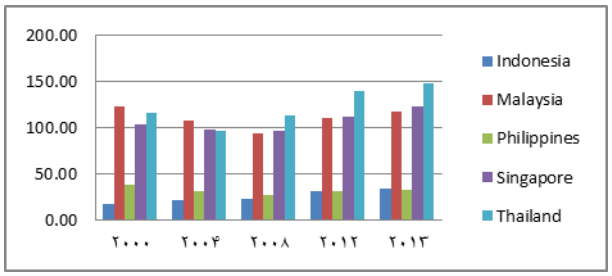


Figure 8: Financial System's Private Credit/GDP: Selected Period: 2000-2013[10]

Financial Institutions in Malaysia and Thailand provide more credit to the private sector compared to the deposits they generate. There is a low intermediation among financial institutions in the Philippines and Indonesia. In 2013, banks in Indonesia increased their credit activities.

The shifts in credit activities was described by Anderson and Moreno[12] as being influenced by some macroeconomic volatilities where banks undertook conservative lending before these uncertainties can potentially undermine their profitability and performance. These tighter lending activities were used to manage lemons arising from borrowers' default and have facilitated in undertaking non-interest income activities.

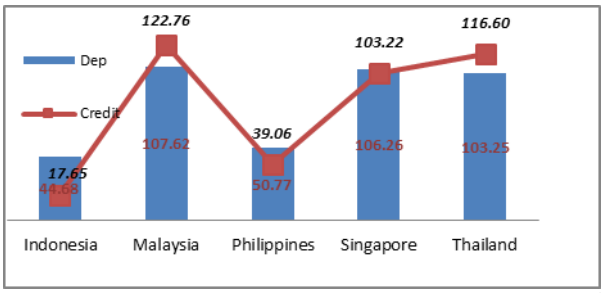


Fig. 9.: Financial System's Deposit and Private Credit Ratios to GDP for Y2008[10]

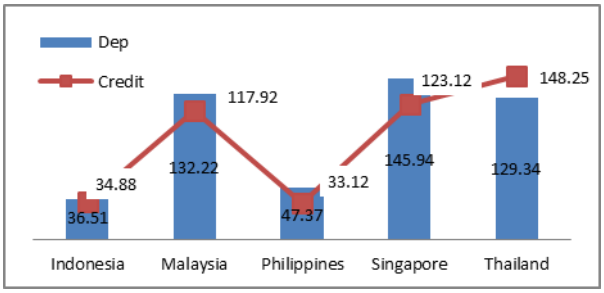


Figure 10: Financial System's Deposits and Private Credit Ratios to GDP for Y2013[10]

An evaluation of the ASEAN financial services sector reveals that the integration of the banking sector is the most feasible program that the ASEAN Economic Community can utilize to achieve goal of the first pillar of financial development. Despite the goal to create the ASEAN Banking Integrated Framework, progress can be seen between Singapore, Malaysia or Thailand to undertake the initial step, followed by Indonesia and the Philippines. Although the country's banking regulatory framework are already in line with the international standards as shown in Table 2, domestic policy, institutional arrangements and business environment have to be reviewed and improved to make this happen.

Table 2: ASEAN-5 Banks' Compliance with the Banking Regulatory Standards (BASEL) [13]

	Indo	Mal	Phil	Sin	Tha
Basel II	FI	FI	FI	FI	FI
Basel III	FI	FI	FI[14]	FI	FI

It can be said that Global Financial Crisis did not affect banks as much as the 1997 Asian Crisis. Deloitte[15] reported that the credit market problems in 1997 were associated with bank insolvencies arising from lack of information or transparency.

Prior to the establishment of the Community, several initiatives to improve the financial services sector had been undertaken to facilitate flow of capital and investments within the region. This integration became evident with the launching of the ASEAN Economic Community in December 2015 compared to the initiatives during the early 1990s.

The ASEAN Secretariat reported that the Community is a strategic move among ASEAN Member States (AMS) to provide integrated flow of goods and services, promote intraregional investments, increase economic growth in the region and become competitive in the international arena.[5] It is based on the four pillars, namely, a single market and production base, competitive economic region, equitable economic development and integration of the ASEAN into the global economy, which commits member state to work toward attaining AEC Blueprint.

For each pillar, detailed implementation objectives, timelines and action points were laid out to monitor the community's progress towards the achievement of its goals as an Integrated ASEAN Market[5]. The ASEAN Economic Community was viewed by Mocker[16] as a stepping stone for the ASEAN Member States (AMS) towards a deep economic integration.

Table 3 shows the initiatives undertaken by some countries to implement ABIF. Malaysia has taken the lead in implementing the framework using the principle of reciprocity with other AMS. With this type of arrangement going on in the region, integration will be far from progressing. This confirms Besler's viewpoint reported that achievement of the AEC Blueprint will take a long time before AMS can achieve targeted deadlines. [17] It is by far crucial in the liberalization process to remove obstacles for smoother transition and integration within the region. To enhance AEC's attractiveness for foreign portfolio investments and capital, these hurdles need to be addressed.

Table 3: ASEAN Banking Integration Framework Initiatives Undertaken

Date	Countries	Arrangement
Feb-15	Singapore-Myanmar	MOU Between MAS and CBM on Cooperation related to banking supervision and capacity building
Mar-15	Malaysia-Philippines	Heads of Agreement for the entry of 3 Qualified ASEAN Banks
31-Dec-15	Indonesia-Malaysia	Heads of Agreement (entry of similar number of banks in each country)
Aug-16		
14-Mar-16	Thailand-Malaysia	Heads of Agreement for the entry of 3 Qualified ASEAN Banks
Mar-16	Indonesia-Malaysia	Letter of Intent- Agreement on the preparation of bilaterla agreement to implement ABIF

Pomfret[18] sees the ASEAN as already economically integrated even without the AEC considering all its regional arrangements prior to its establishment. Given the diversities among AMS in the levels of economic development, political and social differences, and other issues, some authors[19, 20] consider the alliance among member states as a struggle for the Community. Yean and Basu Das indicated that conflicts arising from domestic policies and practices serve as an impediment for the success of the Community.[19]

Dosch also cited that the capability of the AMS in meeting the conditions necessary for the harmonization of laws, policies and practices are yet to be found. He stressed that the "ASEAN Way/Approach" towards regional integration will contribute to its slow development as the built-in flexibilities are classified as non-binding and less efficient with governments arriving at consensus in an informal way to minimize potential disputes among them.[21] Issues on foreign equity, land ownership restrictions and etc. also exacerbate the problem towards the trade-in services liberalization especially in the banking and financial services sector[21]

5. Conclusion

Based on the findings, the following conclusions can be drawn:

1. The level of financial development varied among countries. Singapore and Malaysia have better financial development indices compared to the other countries in ASEAN. Despite some disparities among ASEAN5 countries in their financial development ratings, coordination among member states and the implementation of the scheduled commitments can provide opportunities for faster bilateral arrangements in implementing reforms outlined in the AEC Blueprint.

2. Financial deepening in Southeast Asia will continue to flourish, with a bank-based financial set-up dominating the lead. Non-bank FIs will grow slowly compared to the financial markets due to its market structure and underdevelopment in other sectors. Policy-makers should bolster this industry by designing better institutional infrastructures that promote its development and facilitate in the introduction of newer products or instruments provided by these institutions to make up the portfolio of assets that the investors can choose from.

3. High financial intermediation exists in ASEAN region's financial system, which has been spurred by the relationship-based financing to the borrowers. To date, progress has been undertaken

by the region in establishing the ASEAN Economic Community and in undertaking policy reforms necessary for the long-term development of the financial system. However, the community is faced with the challenge of formulating robust and balanced sets of policies that can be drawn and incorporated in the existing arrangements in ensuring implementation among countries of their commitments toward the integration process.

The proposed ASEAN Banking Integration Framework under the AEC is seen as an initial step for greater and better financial services, especially with the proposed entry of Qualified ASEAN Banks. This may be achievable within the next five to ten years among the ASEAN-5 member states. As far as the BCLMV Member States are concerned, the implementation process may take a decade or two, before full integration of the banks may happen. AEC leaders must review and reconsider a better approach towards its implementation other than the "ASEAN way" formula being used.

5. Singapore and Malaysia's financial services sector has provided financial stability and efficiency in the provision of services. However, the market power of the banking system in developing countries had resulted to costly transaction for customers even with the broad pool of savings or fund sources. The lessons learned from the series of crises had increased resiliency in the financial services sector as credit risks have contracted from high levels with the decrease in non-performing loans. Policymakers need to be concerned about the excessive use of provisions in the management of credit. Another study can also be undertaken to measure the sectoral distribution of credit to determine the alignment of these funds with the distribution of domestic output.

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