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Ties That Bind?
Asian and European Financial Integration Compared

Richard Carney[*]

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ASIAN financial integration featured prominently during seminars on the sidelines of the just-concluded Singapore meetings of the International Monetary Fund/World Bank. Speakers universally advocated integration because it would make resource allocation more efficient and less costly, and ultimately accelerate economic growth. However, few addressed the considerable obstacles to achieving it. As Asia mulls over the possibility of financial integration for itself, some lessons could perhaps be learned from the European experience.

What is Financial Integration?

Regional financial integration generally refers to cross-country linkages along three related dimensions of national financial systems – capital markets, banks and exchange rates. Issues in capital markets include the development of institutional investors, the strengthening of corporate governance regulations, linking clearing and payments systems, liberalizing capital flows, and harmonizing regulations. Issues in banking include improving lending criteria and capital adequacy ratios and reducing cross-border banking restrictions. Issues in exchange rates usually involve moving from flexible rates to a pegged float (or crawling band like the European Currency Unit) and finally to a common fixed currency (like the euro).

Obstacles to Asian Financial Integration

There are two ways in which financial integration occurs: (1) from a bottom-up market-driven approach; and (2) from a top-down politics-driven approach. In the first approach, financial integration proceeds by actors seeking to reap the gains that result from lower transactions costs. However, market-driven integration can only go so far without regulatory reforms from above. In both these approaches, there are clear differences between Europe and Asia that point to greater obstacles to integration in Asia.

Market-Related Obstacles

In the market-driven approach, Asian economies have far greater diversity in their economic development than the original EU-15 countries. With regard to the integration of banking services and capital markets, countries will have different preferences based on the size of their domestic industries. Lesser developed countries tend to have smaller firms, and they consequently depend more on banking services since their firms are not large enough to sell shares or bonds in capital markets. Consequently, firms in these countries fear that regulatory

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reforms that permit financing to flow freely across borders will see capital drain out of the periphery toward financial centres, leaving them deprived of capital. This could lead to regulations that preserve the reliance on local banking in many developing countries.

The diversity of Asian economies also raises obstacles for the adoption of a regional exchange rate regime. For example, countries that lack a well-diversified economy will have a more difficult time adjusting to the volatility of global markets. If the health of the economy depends on few sectors, and one of them gets hit badly, the entire economy will suffer. Consequently, that country's government will face severe pressure to use monetary policy to compensate for the resulting unemployment problems and business downturn. This will put strains on domestic fiscal policy and create interest rate differences, which will lead to exchange rate differences.

While arguments have been made for an exchange-rate band like the ECU, or the EMU before the adoption of the euro, these agreements were difficult to sustain even in the relatively comparable economies of Europe. Such widely differing economies in Asia make an exchange rate band highly unlikely to be practically feasible in the near future. The lack of labour mobility among Asian nations compounds the problem associated with adopting some sort of regional currency regime. This is because if countries sacrifice monetary policy autonomy to gain fixed rates (or floating bands) in the presence of capital account liberalization (the 'impossible trinity'), labour must be able to move freely to those countries in which jobs exist. This is necessary to alleviate unemployment in one part of the region without sacrificing the commitment to a regional currency regime. In this regard, Asia faces further obstacles that Europe did not have to face, which brings us to the additional problems inherent in the top-down politics-driven approach.

Political Obstacles

A top-down politics approach is necessary to overcome resistance to reforms that the market would not otherwise implement. Since sectors differ in the kinds of reforms they favour (for example, many companies may prefer not to make their financial statements transparent, or to adopt common accounting practices, etc.), there will likely be resistance to adopting such measures by relying purely on market mechanisms. Political pressure must often be exerted to force change. To implement these changes requires sufficient political willpower, frequently determined by a high level of popular political support. In this regard, Asia has greater difficulties than Europe in three crucial dimensions: (1) the motivation to integrate; (2) more diverse political institutions; and (3) greater cultural heterogeneity.

In Europe, the memory of two world wars was a critical motivation for the popular support of regional integration. They saw political and economic integration as their best option for ensuring long-term peace, and so Europeans were willing to make short-term sacrifices in order to achieve it. While Asia endured the 1997 financial crisis, this event did not have the same kind of impact as two world wars; political and economic institutions changed, but not as dramatically as in Europe after World War II. Consequently, there is less of a perceived need to integrate in Asia, and less popular support than that which existed in Europe.

The political commitment to integrate is further undermined by the large number of unstable and non-democratic political regimes, which makes long-term credible commitments more difficult to sustain. If shocks cause an economy to falter, the non-democratic nature of some governments could permit them to easily break their commitment to a regional exchange rate

regime, or to restrict capital flows, or to undo various other reforms that violate a commitment to regional financial integration. European countries partly succeeded in their efforts to integrate because democratic institutions create stronger credible commitments to international agreements (because of a larger number of veto points that prevent easy changes to an existing policy).

Culturally, the EU countries are more similar than their Asian counterparts who have a diversity of languages and religious beliefs. This creates difficulties for the pursuit of a fixed exchange rate regime since labour must be able, and want, to move to those parts of the region where jobs are available.

Is Integration Possible?

In view of these considerable difficulties, what progress can be made towards financial integration? As the recent entrance of Central and Eastern European countries to the EU has shown, regional financial integration can occur even among economically diverse nations. This experience offers limited reasons for optimism towards certain aspects of market-driven integration, particularly with regard to capital markets and banks. However, it is important to keep in mind that financial integration in Europe has occurred alongside broader economic and political integration, which reinforces and strengthens the effort towards financial integration.

Compared to the European experience, financial integration in Asia will therefore occur more slowly given the many obstacles ahead. But there is one way to get started on the path: The more developed and politically stable nations -- Japan, South Korea, Singapore, Australia, New Zealand – should begin integration as a first step. After some time, they can offer carrots to other Asian nations to encourage them to harmonise their reforms and join the process.

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[*] *Dr Richard Carney is an Assistant Professor with the International Political Economy Programme at the Institute of Defence and Strategic Studies, Nanyang Technological University.*