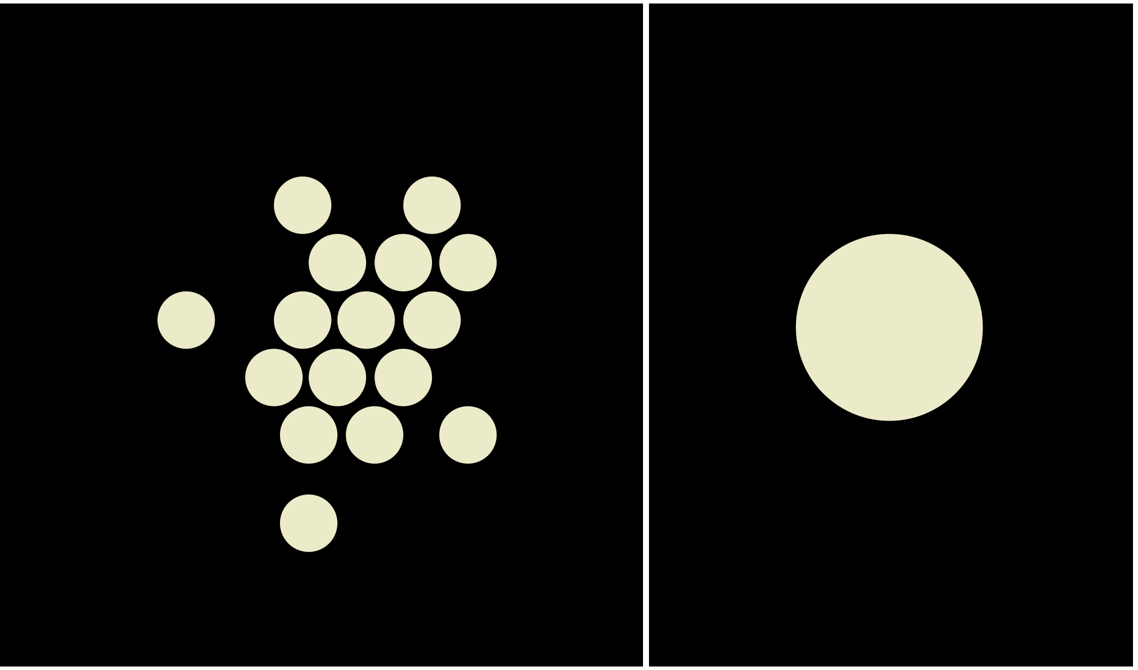
The emerging single market in South-East Asia

The ASEAN countries are fully embarked on a long journey towards a fully integrated regional economy which they call the ASEAN Economic Community (AEC). Financial market integration, built on co-operation between banks and regulators and on standardized connectivity between market infrastructures, is in the vanguard of development. Paul Gwee, Secretary General of the ASEAN Bankers Association (ABA) says that, with member-states already capturing a growing share of international flows of goods, services and capital, and the major cities of the region growing fast, the AEC is one of the most attractive markets for financial services in the world.

In January 2007, leaders of the Association of Southeast Asian Nations (ASEAN) affirmed their commitment to the creation of the ASEAN Economic Community (AEC) by 2015.[1] As a single market, the AEC will allow the free movement of goods, skilled labour, services and investments throughout the region, and *freer* movement of capital between member-states.

The creation of a single market of 600 million consumers represents a huge economic opportunity. ASEAN as a whole had a combined gross domestic product (GDP) of more than S$3 trillion in 2013. If it grows at the 5 percent annual rate projected for the years between

1 The ASEAN Economic Community: A Work in Progress, Asian Development Bank and Institute of Southeast Asian Studies, December 2013



2014 and 2018[2], the collective GDP will increase to S$3.8 trillion. And 5 percent is a conservative estimate: as a collection of economies, the member-states of ASEAN have grown by 6.5 percent a year since the onset of the global financial crisis in 2008. Rates of that magnitude remain a dream in most other regions of the world.

Financial integration, built on international standards and a common platform, is likely to accelerate the pace of growth. Certainly it will support the wider integration of ASEAN economies, since it will open access to the region for global companies and investors (and vice-versa).

The AEC is now poised to become a reality by the end of this year. Since 2015 will go down in history as a milestone in the development of ASEAN, it is a timely moment to take stock of the progress that the Association has made in terms of financial integration. More importantly, now is the right time to evaluate the role of financial services in accelerating and deepening regional economic integration.

2 Local businesses to have new growth opportunities with ASEAN Economic Community, Channel NewsAsia, 2015

What will govern the financial integration of ASEAN

The ASEAN Central Bank Governors are in agreement on the end-goals of financial integration. However, the process of integration has to proceed on the basis of two important considerations. First, each member-state of ASEAN starts from its own initial conditions. Secondly, each member-state is free to define its own intermediary goals and timelines to achieve the common end-objective of full financial integration.

It follows that, while the end-goal is common, the routes taken will vary. The extent to which each country will open up its financial sector will differ from country to country. As the Asian Development Bank (ADB) pointed out it in its 2013 report, “the distinctive feature of the financial sector liberalization under the AEC is that first, the liberalization target is extended to the year 2020 instead of 2015 and, secondly, there is no pre-specified scope of liberalization.”[3]

Financial integration is a crucial element of regional integration, but it presents challenges. Across ASEAN, markets

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3 The ASEAN Economic Community: A Work in Progress, Asian Development Bank and Institute of Southeast Asian Studies, December 2013, page 109.

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are still divided by different legal regimes, currencies, regulatory systems and foreign ownership restrictions. This makes it difficult to introduce a single set of international standards across the region quickly.

The result, explained in a 2014 Bloomberg report, is that “within the financial services sector, integration will continue beyond 2015, as measures will be consistent with national laws, and appropriately paced to suit the level of development of individual members.”[4]

Concrete steps towards financial integration

Even if ASEAN financial integration remains a work-in-progress, ASEAN finance ministers and central bankers can point to concrete progress. The ASEAN Financial Integration Framework (AFIF), in conjunction with the ASEAN Banking Integration Framework (ABIF), is a crucial pair of instruments for deepening financial and economic integration.

4 ASEAN Integration 2015: A Progress Report, Bloomberg, December 2014

With the finalization of the ABIF by all ASEAN central bank governors, any two ASEAN countries may now enter into reciprocal bi-lateral agreements to allow banks that have acquired Qualified ASEAN Bank (QAB) status to operate in neighbouring countries and receive equal treatment as local banks. In December 2014, the Bank Negara Malaysia, Bank Indonesia and Otoritas Jasa Keuangan - the Indonesian Financial Services Authority – signed heads of agreement under the ABIF.

The Malaysian-Indonesian agreement is the first to fulfil the promise of ABIF: to provide QABs with greater access to third country markets and operational flexibilities consistent with those of domestic banks. By giving banks readier access to the domestic markets of ASEAN member-states, ABIF will support the expansion of small and medium-sized enterprises (SMEs) and corporates from ASEAN countries to other member-states. This is an important contribution to trade in a region which is fast emerging as the production centre of the world economy.

ABIF will also strengthen other initiatives designed to accelerate regional financial integration, increase cross-border trade, and boost regional investment flows. To enhance the efficiency of trade settlement and regional payment across and between ASEAN economies, for example, member-states of ASEAN adopted in January 2015 the Principles of Product Transparency on Cross-Border Trade Settlement.

There is recognition within the region that adoption by banks of the ISO 20022 messaging standard would further accelerate the growth of trade. The standard, which enables banks to exchange detailed payments information in standardized, machine-readable formats, would not only hasten the integration of payments systems in the region but make invoicing, reconciliation and payment in commercial transactions more efficient. This would make cross-border payments faster, richer in accompanying detail and more secure.

In recognition of this, the ASEAN Bankers Association - in partnership with national banking associations in ASEAN, the ASEAN Working Committee on Payments and Settlement Systems (WCPSS), the Electronic Transaction Development Agency of Thailand (ETDA) and SWIFT - last year conducted a series of workshops across ASEAN capital cities. Their aim was to raise awareness of ISO 20022 and, by improving understanding of its benefits, promote local adoption of the standard.

Another standard – financial reporting - is already being adopted. In Cambodia, Laos, Myanmar and Vietnam (known collectively as the CLMV states), accountants, corporate financial officers and bankers have benefited from training courses on International Financial Reporting Standards (IFRS). Encouraging issuers to adopt common accounting standards is an important element in the integration of Asian capital markets, because it facilitates investment in different markets across the region.

These efforts are mirrored by study events designed to encourage the adoption of best practices in financial markets. All efforts of this kind play their part in helping the AEC achieve its

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AEC: A Single Emerging Market

Financial integration across the AEC requires global standards and ubiquitous access to common platforms.

Concrete Steps Towards Financial Integration

SWIFT, regional banks and governments have been taking concrete steps towards financial integration in ASEAN.

Benefits of Financial Integration

The benefits of financial integration will result in higher economic growth and more gainful employment for South-East Asia's communities.

objectives of greater connectivity between ASEAN capital markets, and greater accessibility of ASEAN investments.

ASEAN is already increasing trade and investment flows

The success of these various initiatives in driving the integration of ASEAN markets is evident in the gathering momentum of the AEC. The ASEAN countries are experiencing an increase in trade and capital flows, both within the region and internationally. Simultaneously, these flows are enhancing the competitiveness of ASEAN businesses.

Intra-ASEAN trade now accounts for 23 percent of total ASEAN trade, up from 21 percent at the turn of the century. ASEAN has become the fourth-largest exporting region in the world, accounting for 7 percent of global exports. This is expected to rise still further as member-states develop more sophisticated manufacturing capabilities and diversify their exports.

A recent report by ANZ Bank forecast that the bi-lateral trade between Australia and New Zealand and ASEAN countries would more than double by 2025, from

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US$100 billion today to US$230 billion.[5] If that happens, South-East Asia will replace China as the leading manufacturing region of the world economy within the next ten years. One reason that it is likely to happen is rising labour costs in China.

Another reason for the rise of South-East Asian manufacturing is the growing sophistication and dynamism of the burgeoning urban middle classes, which are driving the production of a wider range of goods and services. Already, cities in South-East Asia account for more than 65 percent of the output of the region, and their population is expected to rise by 2030 to more than 90 million consumers.

According to McKinsey, the 67 million "consuming class" households of the ASEAN member-states will double to 125 households by 2025,[6] creating one of the largest and most valuable consumer markets in the world. This will boost trade within the region, and attract imports and capital into the region.

ASEAN banks are already capitalizing on the consequent increase in trade flows within and between markets in South-East Asia, by offering automated trade services. Many are exploring the use of the industry-wide Bank Payment Obligation standard, not only to raise levels of automation, but to enhance their collaboration with banks outside the region.

But banks also need to consider how they can best capitalize on the opportunities created by the rapidly growing cities of the region, and their rising standard of life. The urban consumers of South-East Asia will need not only a higher quality of food, entertainment, household goods and savings products, but also massive investments in infrastructure, transport and housing.

The role of infrastructure and regulation in ASEAN financial integration

The financial market infrastructures of the region are making their contribution to the growth and integration of ASEAN economies by connecting national settlement systems. An efficient regional payments network is essential to free investors to invest and withdraw capital in different markets throughout the region and to enable industrial and commercial businesses to spend money at home and pay suppliers and distributors abroad.

The biggest challenge to overcome is the scale of the investment needed to harmonize domestic payment clearing and settlement systems across multiple jurisdictions. Different markets need to agree on a comprehensive set of open market message standards and a secure and standardized digital communications platform.

In ASEAN, the financial services industry and government authorities are encouraging the adoption of SWIFT messages in general, and those that comply with the ISO 20022 standard in particular. It is obvious to market participants that the adoption of ISO 20022 gives them better visibility into financial transactions, and their customers a higher degree of transparency. In addition, ISO 20022 makes it easier to resolve problems that arise.

ASEAN has been making good progress in promoting wider adoption of the standard. As a result, the region is witnessing convergence on a common data standard to underpin the integration of the payments systems of the region. The ISO 20022 standard has been endorsed for use in the region by the Working Committee on Payment and Settlement Systems (WCPSS), which is the regional grouping of central banks.

At the same time, the payments infrastructures of Brunei, Thailand, Malaysia, Singapore and the Philippines are all using SWIFT messaging services in their domestic systems to clear and settle payments. This not only helps their participant banks fulfil their compliance obligations, but also reduces their technology costs, and improves their connectivity with banks outside the region.

This improved connectivity between banks is supported by the efforts of ASEAN governments. They are not only looking to remove obstructions to the cross-border movement of capital, without disrupting exchange rate stability or undermining the supervision of cross-border transactions, but by developing a regional financial market infrastructure. A good case in point is the ASEAN Trading Link, established in September 2012 as a single gateway to the Malaysia, Singapore and Thailand stock exchanges.

Regulators are also keeping pace with increasingly complex banking institutions

5 ASEAN: The Next Horizon", ANZ Research, April 2015

6 "Understanding ASEAN: Seven things you need to know", McKinsey Insights, May 2014

operating across borders. They are working closely with banks to design and implement prudential policies that support a regionally integrated banking system that is both efficient and resilient. This ambition is echoed in the AEC blueprint, which emphasizes the need for regulatory harmonization and policy co-ordination between the member-states.

Looking beyond the achievement of AEC

In widening and accelerating this process of integration, SWIFT is assisting ASEAN in two ways. First, with the ABA it has initiated a regional market practice guide, not only to facilitate the inter-operability of markets within the region, but to enhance the accessibility of its markets from outside the region. Secondly, SWIFT is facilitating an ASEAN Credit Transfer Scheme. This connects the market infrastructures and financial institutions in ASEAN, by ensuring that the rules for payments are fully documented, widely shared and transparent.

One of the principal advantages of these initiatives is to help SMEs access and penetrate the markets of the region through the smaller and local banks they tend to use. By lowering the cost of financial transactions, standardization opens markets up to companies of all sizes.

But the benefits spread wider than that. Standardization makes it easier for market infrastructures to inter-operate. It increases transparency for consumers. It makes it easier for regulators and central bankers to monitor the financial system for signs of instability. Standards reduce costs. They make it easier to attract and support investment.

These are the fruits of financial integration. By promoting it, ASEAN nations are encouraging the liberalization of the flow of goods, services and capital. They are delivering economies of scale and value-enhancing transfers of data and technology. All of these developments are positive for growth and employment – and it is growth and employment which are bringing more and more of the people of South-East Asia within the scope of a sophisticated financial services industry.