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# Asian Financial Connectivity: Room for more

**Asian portfolio assets make up less than 20% of Asia's total cross-border holdings. While financial integration within Asia has increased over the years, it is limited by the diverse levels of financial sector development across the region. As Asia pursues greater financial connectivity and the benefits it potentially brings, policy co-ordination and surveillance frameworks will need to be strengthened.**

Financial integration, according to research, is a function of trade and distance[1]. Cross-border movement of capital and financial services should increase as countries trade more with each other and are located close to each other. Yet, this has not fully materialised in Asia.

## WEAK LINKS

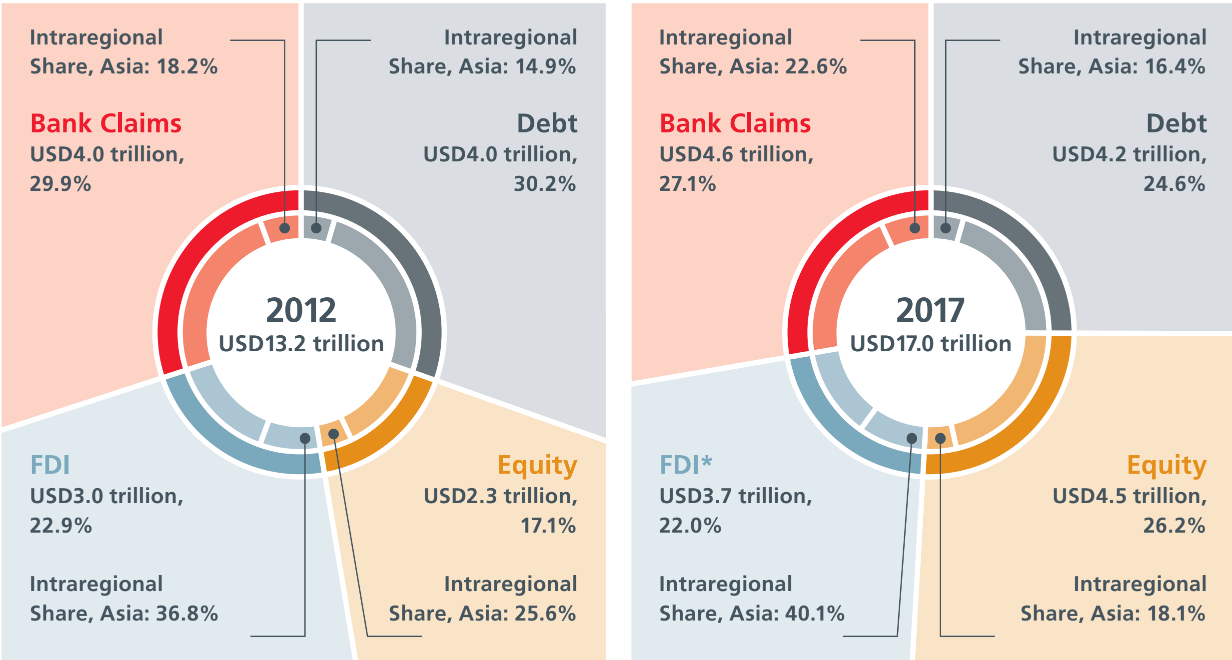
Financial integration in Asia is much less advanced than the level of trade integration. While more than 50% of trade flows in Asia are within the region[2], intraregional investments only account for 20% of portfolio investments between 2003 and 2016, and 32% of syndicated loans[3]. On the other hand, Foreign Direct Investments (FDI) have fared better, with investments in the region accounting for around 50% of Asia's FDI within this period.

Financial integration has remained low in the region despite the number of initiatives which has been set up over the years to promote greater financial connectivity. The Asean Comprehensive Investment Agreement (ACIA), for example, aims to establish a free, open, transparent and integrated investment regime for domestic and international investors throughout the ASEAN member states. Other initiatives include the ASEAN Trading Link, the ASEAN Capital Markets Forum (ACMF), the Asian Bond Markets Initiative (ABMI) and the Asian Bond Fund Initiative.

Asia's cross-border asset holdings grew to USD17.0 trillion in 2017, with higher intraregional share of bond investments, bank deposits and FDI compared to 2012. (See Fig. 1)

While the intraregional share of Asian assets has increased on average, assets held outside the region still account for majority of total cross-border assets. Intraregional share only accounted for 18% of inward equity investments and 16% of inward bond investments in 2017. Most of the intraregional

Fig. 1: Cross-border Assets - Asia[4]




investments come from Hong Kong, Singapore and Japan - accounting for around 80% of intraregional portfolio equity and bond investments. These investments go mostly to China, Japan and Australia, although other notable destinations for intraregional bond investments have included Singapore and South Korea in 2017.

## WHY AREN'T MORE ASIANS INVESTING IN ASIA?

Asia's relatively larger holdings outside the region arises from its large account surpluses over the years and hence, accumulation of US assets[5]. Asia's more muted appetite for intraregional portfolio investments is also partly linked to the relative underdevelopment of some of the financial markets within Asia. At the same time, Japan and China are currently the two largest equity markets in Asia and the latter has been less accessible, opening up its capital markets gradually only in the recent years. Even then, the relatively lower levels of corporate transparency and limited availability of hedging instruments have deterred some Asians from investing significantly in China to date.

While diversity in economic development and growth helped create a complementary trade eco-system and supply chain network (link to trade article), the same cannot be said for financial integration. Although capital markets in various economies in the region have expanded significantly, some are still small and characterised by low liquidity, high transaction costs and narrow investor bases. For example, equity market capitalisation of listed domestic companies was 1052% of Hong Kong's GDP in 2018, but only 54% in Vietnam.

The share of domestic credit to the private sector, another leading indicator of financial development, was 39% of GDP for Indonesia in 2018 versus the global average of 129%. Meanwhile, Asia's financial sector is also highly concentrated in the banking sector. Nonbank financial institutions' assets, for example, make up only 49% of GDP in Thailand versus 154% in the US[6].

Given the less developed financial sectors in some economies within the region, the range of financial instruments, sophistication and financial market depth needed to help regional savers diversify and hedge their risks may not be available. Notably, the relative underdevelopment of some of the financial sectors in Asia appears to play a less important role in attracting intraregional FDI.

## MOVING FORWARD

Financial integration helps financial sector development, which can in turn improve efficiencies and lower costs. It is also expected to encourage greater trade and investments in the region, by facilitating the development of financial instruments that can help different parties hedge their risks. Deep, liquid and efficient capital markets can also enable the region to channel its huge savings into productive investments and diversify the sources of funding for economic development.

Greater financial integration will come about as Asia presses on with its various initiatives and financial markets evolve with economic growth. For example, Ngo The Trieu, CEO and CIO of Eastspring Vietnam believes that the adoption of global corporate governance standards and further progress on Vietnam's State-Owned Enterprise (SOE) reforms will make the Vietnam equity market more attractive to regional and international investors.

As Asia pursues greater financial connectivity, it will need to balance the benefits against the risks of financial instability and financial contagion. Business cycles within Asia may be more closely correlated with shocks potentially transmitted quickly from one country to its neighbour. As such, Asia will require closer co-ordination of regulations, surveillance and crisis management frameworks going forward.

Sources: [1]Portes and Rey 2005; Aviat and Coeurdacier 2007. [2]Asia's future is now. McKinsey Global Institute. 2019. [3]Coordinated Portfolio Investment Survey (IMF), SDC Platinum, fDi Markets, and Direction of Trade Statistics (IMF). [4]*data for 2016. FDI = Foreign direct investment. Notes: FDI assets refer to outward FDI holdings. Bank assets refer to bank claims of Asian economies. Asia includes ADB regional members for which data are available. Sources: ADB Calculations using data from Bank for International Settlements. Locational Banking Statistics. https://www.bis.org/statistics/bankstats.htm (accessed August 2018). International Monetary Fund. Coordinated Portfolio Investment Survey. http://data.imf.org/CPIS (accessed September 2018) and International Monetary Fund. Coordinated Direct Investment Survey. http://data.imf.org/CDIS (accessed February 2018). [5]Financial Integration in East Asia and Pacific: Regional and Interregional Linkages. Ruth Llovet Montanes. Sergio L. Schmukler. May 2018. [6]World Bank. 2016 figures.