Editorial

Asia's Financial Integration – Developments and Challenges

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As highlighted in the IMF's latest *Asia and Pacific Regional Economic Outlook* (IMF 2007), gross capital inflows into emerging Asia are exceeding again the highs reached during the pre-Asian crisis boom years. In 2006, gross capital inflows are estimated to have reached 8% of GDP, or some US$455 billion. A less well known fact is that gross capital outflows have risen even faster. In 2006 they reached an unprecedented level of nearly 7% of GDP – some US$380 billion – or roughly double the levels a decade ago. These trends are consistent with greater financial integration through banks and capital markets, both within Asia and world-wide. While more financial integration can facilitate economic growth and development by allowing firms and households to better diversify investments and savings, it has also increased countries' exposure to sudden shifts in flows. In the past, this caused economic problems in many parts of Asia. Hence, a key-policy question going forward is how to maximize the benefits of further financial integration, while minimizing the risks associated with larger and potentially volatile cross-border capital flows.

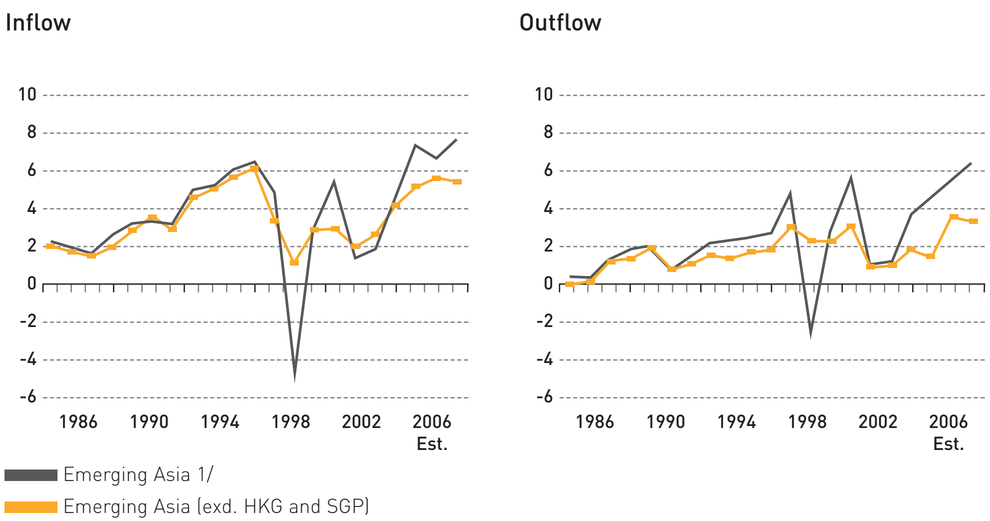

Figure 1: Emerging Asia : Gross Capital Flows (In percent of GDP)
Sources: CEIC Data Company, Ltd.; IMF, International Financial Statistics; WEO database; and IMF staff estimates. 1/ Excludes Hong Kong SAR until 1997.

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Approaches of meeting this dual objective fall broadly into two categories: The first relate to short-term macroeconomic management. For example, up until recently, a number of countries in Asia have been experiencing capital inflows in the context of higher inflation. However, tighter monetary policy could encourage further inflows. The challenges become more acute when inflows surge. The tools of macroeconomic management at hand, such as greater exchange rate flexibility, foreign exchange market intervention, policy interest rate changes or administrative controls, can result in significant costs, however, and need to be carefully calibrated. For example, abrupt movements in the exchange rate can disrupt trade and affect financial stability, while administrative controls hamper market development and investor confidence.

The second set of approaches relate to longer-term structural reforms to enhance the resilience and efficiency of financial systems. The overall objective of policies should be to promote investor confidence and sound risk management; provide high quality, timely and relevant information; facilitate the productive use of investments; and reduce risks associated with high levels of leverage or mismatches. Policymakers in Asia have recognized the importance of strengthening financial systems and many initiatives have been launched at the national and regional level. Under the Asian Bond Market Initiative, countries cooperate to develop deeper local currency bond markets by strengthening information disclosure, corporate governance, legal and regulatory frameworks, as well as accounting, and creditrating standards. Moreover, foreign banks will likely be a key driver in the process towards further financial integration as WTO commitments (e.g., China and Vietnam) and banking sector consolidation (e.g., Taiwan (POC), Malaysia, Indonesia) offer new investment opportunities.

Reference

(IMF 2007) International Monetary Fund, Asia and Pacific Regional Economic Outlook, April 2007, Washington, DC.