Deutsches Institut für Entwicklungspolitik

German Development Institute

REGIONAL FINANCIAL INTEGRATION – SOMEONE'S GOTTA GIVE

Ulrich Volz, German Development Institute (DIE)

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Overview

- The merits of financial integration
- Potential problems associated with financial integration
- Recent European experiences
- Some examples from East Asia
- Concluding remarks

The merits of financial integration

The merits of financial integration

- Contributes to financial stability by creating larger, more liquid and competitive markets which offer increased possibilities for risk diversification and risk sharing
- Fosters economic growth and welfare by enhancing the development and efficiency of the financial system
- Facilitates the smooth implementation of monetary policy and the balanced transmission of its effects

The merits of financial integration

Banking markets:

- As integration facilitates market entry of foreign institutions, domestic institutions will find themselves exposed to increased competitive pressure from more sophisticated and cheaper foreign intermediaries
  → This is likely to set new standards in management and efficiency, and enhance the quality and range of financial products offered

The merits of financial integration

Securities markets:

- Help reduce the double mismatch problem (currency & maturity)
- Reduce over-dependence on bank borrowing and diversify financial risks
- Reduce information asymmetries
- Reduce risk of governments relying too heaviliy on central bank funding
- Provide alternative sources of financing for long-term private and public investment
- Provide alternative mode of wealth holding for households

The merits of financial integration

Regional cooperation can contribute to deeper and more sophisticated markets:

- Regional initiatives can help strengthen market infrastructure for bond markets
- Can serve as model for developing regional bond markets and for enhanced regional integration and cooperation

Potential problems associated with financial integration

Potential problems of financial integration

- Regional financial integration requires, at least to a certain extent, an opening of capital accounts
- Money that flows in, might flow out as well
  $\rightarrow$ Danger of sudden stops & reversal of capital flows associated with an opening of the capital account
- Regulation arbitrage if regulation is not harmonised
- Unclear responsibilities among regulators of different countries of the integrating area regarding the supervision of cross-border financial institutions
- Who bears the cost of bank failure?

Recent European experiences

Recent European experiences

- EU Single European Act of 1986
  → Single Market in Banking 1993
- "Single passport": if a bank is licensed to do business in one EU state, it is similarly entitled to do business in any other EU state
- Home country control: banks are regulated in accordance with the legislative frameworks of their home country, the domestic regulator being the 'parent'
  → If a bank in one EU Member State conducts business in another EU state, the regulatory authority in the 'host' will recognise the primacy of the home country

Recent European experiences

- The Irish government's decision to guarantee a large portion of domestic bank deposits helped stabilise Irish banks, but it hurt banks elsewhere, especially in Britain, as investors started withdrawing their money to put it into "safe" Irish banks
- As a consequence, other European governments -- including Greece, Sweden, Austria, Britain, Germany, Denmark and Iceland -- followed suit and announced higher deposit guarantees
- Who is going to pay if a large cross-border European bank needs to be bailed out? E.g., after the Lehman collapse, France, Belgium and Luxembourg stepped in to rescue Dexia, a Franco-Belgian group

Recent European experiences

- Effective European crisis management is complicated by the fact that authority for financial regulation and supervision are scattered all around the place
- At present, financial-sector regulation & supervision is still a national affair, executed by national central banks and financial supervisory authorities
- With a single market for financial services, it is long overdue that the EU updates its regulatory structures and establishes a pan-European regulatory authority

The East Asian example

The East Asian Example

- East Asian countries have started to try develop a regional bond market
- Various initiatives:
  - Asian Bond Market Initiative
  - Asian Bond Fund I & II
- Supported by initiatives for surveillance and government liquidity support
  - Economic Review and Policy Dialogue
  - Chiang Mai Initiative

The East Asian Example

The underdevelopment of financial markets and institutions in East Asian economies is an impediment to financial integration

Asian Local Currency Bond Markets

FX controls
Capital controls across various local bond markets prevent seamless trading of bonds in different currencies.

No standard legal framework
Documentation and disclosure requirements vary across markets.

Different tax regimes
No standard tax concessions or withholding tax arrangements in the Asian region.

Multiple rating agencies
Different rating methodologies and criteria for various rating agencies e.g., RAM, Pefindo, TRIS etc.

Differing regulatory frameworks
- Different degrees of approvals required for bond issuances.
- Not all economies recognise the concept of Bond Issuance Programmes.

Separate Settlements/ Clearing Systems
No comprehensive linkage of Settlements/Clearing systems across all Asian currency markets.

Lack of sophistication of markets
Lack of developed swap, repo and futures markets in certain economies.

Source: Lotte Schou-Zibell (2009)

Concluding remarks

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Requirements for regional financial integration

- “Level playing field”
- Strengthening of financial supervision and regulation & harmonisation of regulatory frameworks
- Prudently ease capital controls
- Strengthen transparency
- Develop market infrastructure
- Remove discriminatory taxes and the withholding of interest and capital gains taxes earned by foreign investors

Concluding remarks

In the face of the global financial crisis

- Further development of financial markets in developing countries and emerging economies is key
  $\rightarrow$ More banking and securities markets needed – not less!!!
- Strong rationale for strengthening of national and regional financial markets to better channel developing countries' savings to investments