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CAPITAL MARKET DEVELOPMENT IN ASEAN ECONOMIC COMMUNITY: ISSUES AND OPPORTUNITIES FOR OTHER SUBREGIONS OF THE ASIA-PACIFIC REGION

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Capital market development in ASEAN Economic Community: issues and opportunities for other subregions of the Asia-Pacific region

by

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Abstract

It has long been argued that capital market improvement is a necessary and sufficient condition for fostering economic development. To achieve better living standards, the expected roles of the financial market include: increasing supply of capital, providing better use of (financial) resources and improving allocation of funds available. The ASEAN region is diverse in terms of economic development and the ways to narrow development gaps, particularly financial development gaps, has been among the key discussion issues in almost every regional economic integration agreements. This paper investigates the current status of the region's capital market development. After reviewing the state of financial market depth, accessibility, efficiency and stability in the ASEAN region, the paper provides an overview of the process of financial sector development and then discusses capital market integration in the region. It concludes by providing recommendations for further capital market development to help reduce financial development gaps in the region.

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I. Introduction

Thailand, as a small open economy, inevitably relies so much on the external sector both in trade and finance. Generally, capital accumulation is viewed and convinced that it is the significant engine for growth and prosperity. And thus, saving is identified as the important source of domestic funding in the process of economic development. It is pointed out that if the financial sector is working appropriately, the economy will benefit a great deal from improving efficient allocation of resources and hence, lead to poverty alleviation and economic growth. As the economy grows more rapidly, the needs for capital multiply and external financing becomes a more necessary sources. Consequently, the country is forced to liberalize its financial sector more to allow for greater capital inflows in response to its raising demand. To allow for more flexible movements of capital across border, the economy that is not well prepared will run a risk of mismanagement in the financial sector and ended up with huge negative impacts to the country in form of economic crisis. Therefore, shadows of concerns are all over the appropriate approaches to develop and regulate financial sector not only in the developing but also the developed economies.

The Asian financial crisis in 1997 and the recent economic crisis in the U.S. and Europe reemphasize on how crucial development and stability of the financial sector is to the path and pace of economic development. More importantly, the consequences of financial crisis have proven to be widely spread due to economic interconnection of economies around the globe through globalization process. Developing and least developed economies are alike in terms of its inability to manage the flows of capital (especially foreign capital) in and out of the countries. Seems like capital often flow out of the economy when it is needed most. And it floods into the economy when adequate amount of capital is already existed domestically. The size and speed of capital movements internationally have identified as major risks of economic instability in developing economies in trading off for foreign financial services. Recent development trend in Thailand's financial sector focuses more on regulatory framework and increasing market competition in the financial sector, its neighboring countries (e.g. Lao PDR, Myanmar and Cambodia) still have to develop their money market (i.e., banking sector) to support further development of capital market in order to attract very much needed capital, domestically and internationally, in fostering its rapid economic growth and development. Balancing in the financial market; including money market, capital market, and long-term saving market such as insurance and pension funds, is critical for efficiency improvement in the financial sector in Thailand, its neighboring countries, and the region as a whole so that fund mismatching problems can be mitigated.

Most of the Southeast Asia members are developing economies where capital adequacy is crucial obstacle for their economic development process. More capital inflows are badly needed in many member economies to move forward with their development path not only to narrowing the development gap but also to further improving living standard in the country. Evidences are obvious as we see countries compete intensively for foreign investment especially foreign direct investment (FDI) by providing greater investment incentives. On the other hand, Southeast Asia economic stability is also jeopardized by the highly volatile capital market and speculation in the global financial market. The 1997 Asian financial crisis provides us with a good illustration that some forms of financial integration are needed in the region. With a huge gap of financial market development among East Asia economies, it is worth considering research studies on regional financial integration in such a way that a larger proportion of saving generated within the region can be utilized for the regional economic development and shelter member economies when financial storms hit.

The pros and cons of capital market establishment greatly relies on the timing, regulations, and the management (ability of regulate included) such that the market can function and perform accordingly. In this paper, the first section reviews some of the evidences in Thailand's capital market development and its contribution s to economic performance; growth, stability (efficiency), and equity. Further improvement in the capital market and regional financial market integration will be discuss in comparison with more recently establishment of capital markets in the CLMV. The next section argues on the role of capital market in providing necessary funding to much needed infrastructure development in the region. Finally, in the last section, some policy implications and regulations as a guide to a successful financial development in supporting developing economies to narrow the development gap are discussed.

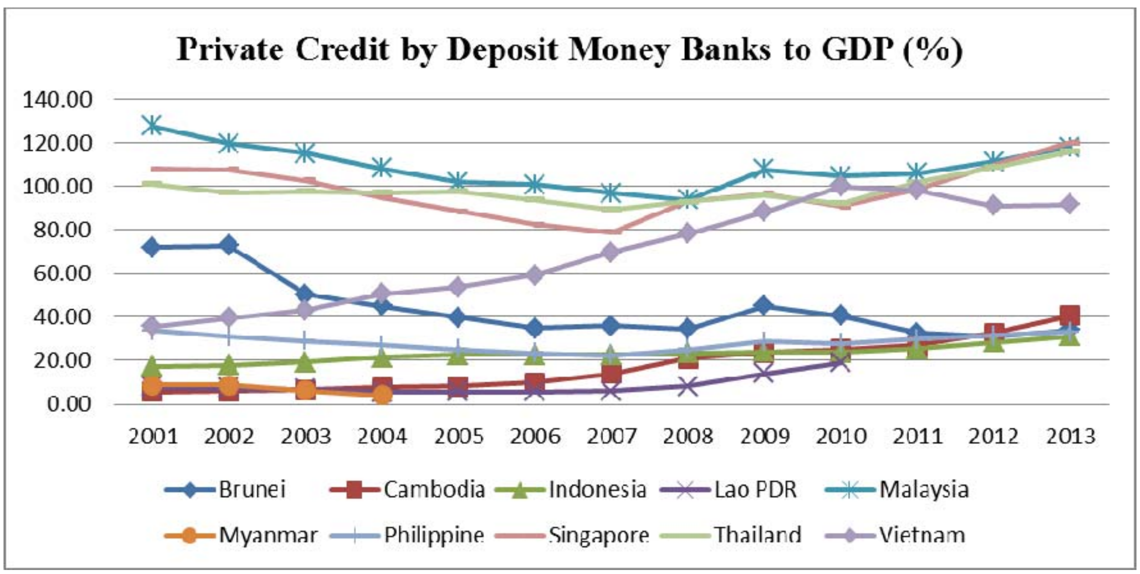
II. Capital Market Development Status in ASEAN

It has long been argued that capital market improvement is a necessary and sufficient condition fostering economic development. To achieve better living standard, the expected roles of the financial market include; increasing supply of capital, better use of (financial) resource and improve allocation of funds available, are the fundamental elements needed. Because ASEAN has been known to be a region with diversity in terms of economic development where narrowing development gaps have been the key discussion issues in almost every regional economic integration agreements, it is important, as a prior information, to investigate the current status of the region capital market development. At a difference stage of economic development, the interests and capability of carry out changes in financial market are very much diverse ranging from simply providing more access to funding necessary to focusing more in efficiency in the financial market and harmonisation of regulatory framework. In this section, development status of ASEAN financial market will be reviewed according to the "matrix of financial system characteristic" used for benchmarking of the financial system suggested in Martin, Demirguc-Kunt, Feyen and Levine (2012). The financial characteristic for the financial market covers the measurement of financial depth, access, efficiency, and stability.

A. ASEAN financial depth

The depth of the financial sector is first investigated as a factor to determine its contributions on the region economic development process. Financial depth is basically a measure of the availability of financial infrastructure including necessary financial institutions, financial products, and financial regulatory framework to deliver financial services demand in the economy. It has been pointed out in numbers of studies that providing greater access to financial services is a key factor for developing economy to promote growth and reduce poverty. Bird (2015), Martin, Demirguc-Kunt, Feyen and Levine (2012), Beck, Demirguc-Kunt and Levine (2009) are some of the examples in recent studies to show such a positive relationship between economic growth and financial depth. At the initial stage of financial development, it is very common to see most of the financial services to support economic activities are provided by the banking system. A bank-base measure of financial depth is employed first because of the different stages of financial development of ASEAN members. Less developed economies has a tendency to rely more on the banking sector than financial market (which includes bond and equity market as they are making progress) for financial services compared to more advance economy. As the economies grow, more and various types of financial services are demanded. Creation of financial products, more sophisticated financial institutes or more specialized unit will be needed to effectively handle those raising demands. The private credit providing by the banking sector as a percentage of GDP is used as countries, at the relatively early stage of economic development, rely more on commercial bank to provide most of the necessary funding. As indicated in figure 1, ASEAN, as a region, has been experiencing an increasing trend of financial depth. Malaysia, Singapore, and Thailand have led the group on this aspect and Vietnam has been catching up at a greater pace. This is consistent with the economic performance of the respective economies. Greater economic growth requires more capital and financial services and hence, a rising number of financial depth. The figure also suggests an upward trend for the CLM countries (Cambodia, Lao PDR and Myanmar). Funding of the capital needed and financial services to facilitate economic growth (the countries are growing at a greater rate than the ASEAN5) in those countries were not only coming from capital inflows but also from the improvement of the financial environment (mainly banking system) domestically.

Figure 1. ASEAN financial depth (bank-base measure)



Source: Global Financial Development Database (GFDD).

For a more advance economies, especially in the financial sector, financial services are not supplied only through the banking system. Bond, equity, and derivative markets are introduced as alternatives to offer wider range of financial products in response to the needs in the private and public sector. Infrastructure investment projects funding can be viewed as an example for such demand. A well-established and functioning liability and equity markets an example that the availability of capital markets allow for more involvement of private sector in larger investment projects which deem to be more efficient than being handled by the public sector. The economy as a whole benefits from improving utilization of capital and more efficiently operation in the financial sector through gains from economies of scale. Hence, the development of those infrastructure institutions helps facilitate liquidity and risk management in the economy. Figure 2 shows the ASESN5 members have been increasingly developing the depth in its capital market. Thailand has been one good candidate illustrating a clear trend of financial market depth after 2000. This is consistent with the financial development plan in the country to promote more activities in the bond market for the private sector. The issuance of corporate bond by state owned enterprise and some of the relatively larger firms has been highlight as another step forward in the financial development process. Long-term capital needs are not merely rely on the banking sector but there are alternatives which make possible by the bond and equity market providing liquidity for the corresponding financial instruments. Furthermore, it is also argued that the mechanism helps reduce financial mismatching practices which identified as one of the key reasons blamed for the 1997 financial crisis.

Figure 2. ASEAN5 financial market depth (market-based measure)