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Financial services integration in East Asia: Lessons from the European Union

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Contents

List of tables

List of figures

Introduction

Economic integration in the European Union[1] has, arguably, been one of the most significant developments in the global economy in the last half-century. How could countries that just a few decades earlier were at war and culturally disjointed now aim at closer economic and political integration, and appear en route to forming one virtual "country" under a proposed European Constitution? The formation of the European Union, the adoption of the single currency, and many other erstwhile targets that were deemed "too difficult", but which are now realities, have proved many skeptics wrong. Other regions in the world, to a greater or lesser degree, appear to be in quest of a similar goal – the integration of their regional economies. What lessons could they learn from the European Union experience? Specifically, as closer cooperation appears a clarion call at the level of Asian politicians, can East Asia learn some lessons from the European Union?

East Asia has had several mechanisms for integrating the national economies into a regional trading area. The ASEAN+3 frameworks and dialogues, involving the 10 members of the Association of Southeast Asian Nations (ASEAN),[2] plus China, the Republic of Korea and Japan, are meant precisely to establish contacts and foster mutual trust among these economies as well as to progress, albeit incrementally, towards freer movement of goods, services and capital within the region. In the financial sphere, in addition to the overall political leaders' meeting, there are also meetings such as the Executives' Meeting in East Asia-Pacific central banks (EMEAP), which launched the Asian Bond Fund, as well as other forms of cooperation such as the ASEAN+3 Economic Review and Policy Dialogue Process for economic surveillance. The countries in the region have bilateral swap arrangements through the Chiang Mai Initiative (CMI) and have started initiatives to develop the Asian bond market. It can truly be said that the wheel of integration started for East Asia. In the same way that these types of cooperation in the European Community eventually turned out to be preludes to an eventual monetary integration for some, and tighter economic (trade) integration for all, the ongoing processes in East Asia might also turn out to be pieces of the East Asian integration puzzle.

However, at this juncture, it might be too early to tell. After about a decade since ASEAN Free Trade Agreement (AFTA) was signed and other mechanisms including the 'plus 3' economies were established, East Asia has not yet reached the level of trade integrations that the original six members of the European Union achieved at the end of the 1960s. The EU-6,[3] after 10 years since the Treaty of Rome, has accomplished a

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[1] The discussion of European Union reforms in this paper mainly refers to the EU-15, which had carried out these reforms. The EU-15 countries are Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

[2] ASEAN's 10 members are: Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, the Philippines, Singapore, Thailand, and Viet Nam,

[3] The original EU-6 economies are Belgium, France, former West Germany, Italy, Luxemburg and the Netherlands.

formation of the customs union.[4] East Asia's trade integration, in contrast, has barely begun. Many bilateral trade agreements between ASEAN and other East Asian economies have been negotiated, and some have been signed, but thus far have not yet delivered a true free trade area in the sense of zero tariffs for all products. What exist, at the moment, are a collection of preferential trade agreements rather than free trade agreements (FTAs). In the financial markets, regional integration is in an even more infantile state than in goods trade. At least, in trade in goods, multilateral and regional agreements forced tariffs and other trade barriers down and volumes of trade have shown growth. In the financial field, the region has yet to show bigger intraregional transactions, while capital markets have yet to deepen and a host of financial market barriers yet to come down. Each domestic economy remains highly protected by different regulations and restrictions on capital flows, as discussed later in this paper.

An advantage of the present East Asian situation is that being at the start of the process presents an opportunity to observe the experiences of other regional integration efforts, the European Union phenomenon in particular, and learn from both their positive achievements (and to imitate them) and negative experiences. Indeed, the European experience serves as a reference point for determining the policy requirements and operational aspects of regional integration process.

Chapter I discusses the state of play in the financial integration process in the European Union, its characteristics and noteworthy features, and the remaining tasks that are being addressed to complete the Single Market Programme. By financial integration, this paper is not referring to the monetary union leading to the single currency condition, but more to the integration of financial services sectors. Thus, it focuses more on improved facilitation of cross-border financial flows rather than discussions of optimal currency areas and other macroeconomic aspects. Chapter II tackles East Asian progress in different areas of financial integration, its current state of integration, the different regional mechanisms working towards financial integration, the existing policy landscape for cross-border regional financial flows, and steps forward. Chapter III considers some policy lessons and challenges ahead for East Asia.

[4] The establishment of a customs union for industrial goods was completed by 1 July 1968, 18 months ahead of schedule, while the final arrangements for agricultural products were completed by 1 January 1970. Later entrants into the European Union have been allowed a transitional period before the customs union applies fully in their territory.

I. European Union financial and monetary integration

This chapter discusses the experience of the European Union, the steps taken to liberalize the financial sector, the specific features of its liberalization programme, the results achieved so far from these reforms and an assessment of potential lessons for other regional trading arrangements.

A. Steps towards financial integration, and features of European Union liberalization

The present integration of financial services in the European Union, which started in the 1970s, rests on three major framework directives on banking, insurance and investments. The first banking directive (Council Directive 77/780) focused on the freedom of establishment of credit institutions within the European Community (EC) subject to national legislation.[5] This banking directive is similar to a country that liberalizes its financial services market to foreign entrants, allowing them access to the domestic market but under the laws and regulations of the domestic regulatory regime. Thus, other EC banks wanting to establish themselves in another member country had to obtain authorization from the supervisory body of each host country. National treatment, in this context, meant substituting restrictions on entry with explicit restrictions on the range of activities allowed (Bongini, 2003), akin to many the General Agreement on Trade in Services (GATS) commitments in financial services of many World Trade Organization (WTO) member countries. What is noteworthy is that this condition existed in the European Union in the 1970s, while the similar legal framework for WTO member countries took place only in the 1990s.

The second banking directive (Council Directive 89/646) amended the first banking directive and introduced the single banking licence, home country supervision for overall solvency and minimum capital requirements (minimum harmonization) across the Community. With the single passport and home country supervision, many authorization requirements and restrictions among the national authorities of member countries ceased to be imposed on banks headquartered in other EC member economies. The single banking licence is revolutionary and, so far, has no parallel in other economic integration agreements anywhere else.

In addition to the first and second banking directives, there were other directives affecting banks that were related to consolidated supervision, harmonized accounting rules, capital adequacy requirements, reporting and monitoring of large exposures, and deposit guarantee schemes. Table 1 provides a summary of the "legal itinerary" for banking services up to 1996.

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[5] The directive provided national treatment to both EC and non-EC headquartered banks, under a reciprocity condition. It allowed banks to compete on a level playing field, as long as they followed the rules of the national supervisory regime.

Table 1. Single market banking services – sequence of liberalization

Directive	Issue date	Implementation date	Objective
First EC Banking Directive (77/780/EEC)	1977	1979	Establishes authorization procedures for deposit taking institutions
Consolidated Supervision Directive (86/635/EEC)	1983	1985	Brings EC supervisory arrangements in line with the revised Basel Concordat
Bank Accounts Directive (86/635/EEC	1986	1993	Harmonizes accounting rules and reporting requirements
Capital Liberalization Directive (88/361/EEC)	1988	1992	Removal of exchange controls with the aim of enabling free capital movement within EC
Own Fund Directive (89/299/EEC)	1989	1993	Provides common definition of bank capital in accordance with Basel Accord
Solvency Ratio Directive (89/647/EEC)	1989	1993	Sets common minimum risk-adjusted capital adequacy requirements in accordance with Basel Accord
Second EC Banking Directive (89/646/EEC)	1989	1993	Provides single passport and gives a broad definition of banking activities
Monitoring and Control of Large Exposures Directive (92/121/EEC)	1992	1994	Annual reporting to supervisory authorities detailing large exposures
Capital Adequacy Directive (93/6/EEC) and (93/31/EEC)	1993	1996	Extend the risk-adjusted capital requirements to investment firms and set capital requirements for market risks
Deposit Guarantee Directive (94/191/EEC)	1994	1996	Common rules for the implementation and functioning of depositor compensation schemes in all member countries.

Source: http://europa.eu.int/eur-lex/en/index.html as cited by Bongini, 2003.

The legal path of insurance and investments mirrored the liberalization steps in banking services. In particular, the first sector directives bestow national treatment on foreign banks subject to national supervisory rules, then with subsequent further relaxation of access rules as well as home country regulation while at the same time complementing these with minimum conditions for prudential rules.[6] All in all, the legal

[6] The first insurance (direct insurance except life) Council Directive 73/239 paralleled the first banking directive, establishing authorization procedures within the Community. The second insurance Council Directive (88/357) put in home country control and strengthened the power of supervisory authorities. Council Directive 92/49 established the single passport, further enhanced home country control and financial supervision, and specified certain supervisory provisions (e.g., ceilings for individual investment categories that insurance companies are allowed to hold). For life insurance, various Council Directives

itinerary of financial services liberalization provides a glimpse of some characteristics and features of European Union liberalization.

1. Pillars

The European Union approach rested on three pillars: minimum harmonization, mutual recognition and home country control. Minimum harmonization entailed a minimum level of coordination and harmonization of national standards to secure a functioning integrated internal market. This meant uniform reporting requirements, accounting treatment of income and expenses, consolidated reporting, capital requirements etc. The principle is intended to ensure that “basic public interest” is safeguarded in a single market with different national rules and standards. Harmonization facilitates free competition by stopping member States from erecting “standards barriers” against one another’s products and services, but it can, likewise, hinder free competition by barring certain products or practices from the market altogether (Steil, 1999).

Mutual recognition means that once minimum agreement has been reached on essential rules, member States agree to recognize the validity of one another’s laws, regulations and standards, and thereby facilitate free trade in goods and services without need for prior harmonization. The single passport concept directly derives from this condition, under which a financial service provider incorporated in any European Union member State and which thus satisfies the basic standards in one member country, may carry out a full range of “passported services” throughout the European Union.

Home country control puts the main responsibility of supervising national financial institutions on the home country supervisory authority even when doing business in territories of other member countries.

To be sure, the principles themselves have not co-existed without tension. From the beginning, prior to the formal launch of the Single Market initiative in 1985, the EC’s White Paper considered mutual recognition as an inferior integration mechanism that was chosen only on pragmatic grounds because of the Council’s obstructionism in the EC’s pursuit of common rules. On the other hand, the political dynamics of the Council have shown that, in general, harmonization of rules and standards operates to curtail liberalization, whereas the combination of mutual recognition and home country control

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