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Financial Integration in the Asia-Pacific:
FACT AND FICTION

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FOREWORD

Australia is poised to reap significant benefits from increasing integration with the Asia-Pacific region if the right actions are taken. However, the right way forward for businesses and policy-makers is unclear.

Finsia has sponsored the first phase of Australian Centre for Financial Studies (ACFS) research that seeks to clarify the role that Australian financial services can play as the economic pendulum continues to swing towards the Asian region.

In this exposition paper all stones, from trade in financial services to foreign banking claims, are unturned to distinguish fact from fiction. Among the findings:

> Australia's financial services industry is the largest single industry segment generating 9 per cent of total output.

> Economies in the ASEAN region are experiencing the fastest rates of financial integration in Asia.

> Despite phenomenal growth in Asian markets Australia still remains heavily oriented to its traditional trading partners of the United States, United Kingdom and New Zealand.

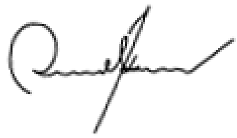
> Australian firms face significant regulation and compliance costs as they attempt to tap into Asia-Pacific markets.

These findings are only the first step in providing a holistic path for the future of Australian financial services in the Asia-Pacific region. Further investigation on the impact of financial integration and specific enablers and/or inhibitors of integration are vital to understanding the enormous opportunities in the region and their impact.

This research shows that while the Australian economy has already benefited from rapid and accelerating growth in the Asian region, it doesn't need to stop at mining. Understanding the markers and the extent of financial integration will aid the development of policies to promote Australian financial services in the Asia-Pacific region.

The timing is critical as large scale disruption is happening now. China's role in the world will continue to grow and with it will come deeper financial integration. Australia has an active portfolio of free trade agreements which will be expanded in the near future to include China, India and Indonesia. Moreover, the Trade in Services Agreement can expand the potential of the financial services industry even beyond the realm of Asia. The landscape is shifting dramatically and it is essential to understand the extent and impacts of financial integration or risk falling behind.

This venture with ACFS is the most recent project in Finsia's *Beyond Australia* series that aims to enable Australia's financial services industry in the Asian Century. For more, visit www.finsia.com/beyondaustralia



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EXECUTIVE SUMMARY

The Asia-Pacific region is arguably the most important region of our time. The Asia-Pacific — incorporating Northeast Asia, South Asia, Southeast Asia and Oceania — covers 30 per cent of global landmass, contains 60 per cent of the world's population, and contributes more than 30 per cent of global economic output. It is also deeply integrated with the global economy, accounting for over 30 per cent of the world's merchandise exports.

Australia has participated in, and benefitted from, the rise of Asia. Four of Australia's top five two-way trading partners are now in the Asia-Pacific region.[1] Of the five million overseas-born people living in Australia, almost two million were born in the Asia-Pacific — an increase from just 276,000 in 1981. Close to one in ten of Australia's population identifies with Asian ancestry.[2] Strong growth in the Asia-Pacific region, particularly in China, has had a profound impact on the Australian economy over the past decade.[3]

At the diplomatic level, Australia has re-oriented itself toward the Asia-Pacific through fora like APEC and a strategic partnership with ASEAN, through the promulgation of free trade agreements with major trading partners in Asia, and via the concentration of embassies and aid funding within the region relative to the rest of the world. Australia is the second largest aid donor to the region, and by far the largest to the Pacific Islands subregion.[4]

This report examines the extent to which Australia's deepening economic and political relationship with the Asia-Pacific region is reflected in the financial services industry — in other words, the degree to which economic and cultural connectedness has led to financial connectedness, or financial integration. It also examines the extent to which the Asia-Pacific has become more financially integrated both intra-regionally and with the rest of the world.

What we find is that the financial services sector is growing quickly in the Asia-Pacific region, and becoming more integrated across borders. Australia's financial connectedness appears to be lagging this growth; while Asia represents roughly two-thirds of Australia's global trading relationships, it still accounts for less than one third of Australia's cross-border financial relationships.

While Asia represents roughly two-thirds of Australia's global trading relationships, it still accounts for less than one third of Australia's cross-border financial relationships.

Understanding the financial implications of Asia's rise is vital for Australia's future. Financial services represents the largest single industrial segment of the Australian economy, contributing about 9 per cent of gross value added. Financial services firms are a major employer across all states, and the largest single source of corporate taxation revenue. The capacity of the financial services industry to maintain growth and profitability by adapting to new economic realities is therefore an important consideration.

Financial integration also alludes to the cross-border flows of payments, capital and investment that underpin economic growth. Australia is a medium-sized, open economy that has long depended upon foreign funding to support capital investment. Its large trading position (in both exports and imports) requires the ability to enter into financial transactions easily and dependably across geographic borders. At home, Australian firms rely on global capital markets to raise capital and manage financial risks, while Australian investors access overseas markets to enable diversification of portfolios.

Australia's position needs to be considered in the context of a changing financial landscape across the region. Decades of strong economic growth have generated increasing household wealth, leading in turn to growth in demand for financial services and products. Bank balance sheets are expanding, ageing populations are demanding more sophisticated services and products, and technology is enabling greater ease of transactions across national borders. All of these trends have the potential to impact upon Australia, in both the short and the long term.

Canvassing the available data and academic literature on the financial services industry and financial integration within the Asia-Pacific region yields interesting findings:

> **The financial services industry is expanding to accommodate Asia's rising commercial sophistication and wealth, generating an increasing share of value-added GDP in most economies.** In the case of China, Vietnam, Philippines and Hong Kong SAR, the industry has increased its contribution to value-added GDP by close to two percentage points (or more) over the past seven years. Another 1.5 percentage point increase in the size of China's financial services industry alone — which would bring China on par with the Philippines and Malaysia — represents US$140 billion in growth.

1. The top five nations, in order, are China, Japan, United States, South Korea, and Singapore.
2. Australian Government (2012), 'Australia in the Asian Century', White Paper, October, p. 98.
3. Plumb, M, Kent, C and Bishop, J (2013), 'Implications for the Australian Economy of Strong Growth in Asia', Research Discussion Paper, Reserve Bank of Australia, RDP 2013-03.
4. Lowy Institute for International Policy (n.d.), 'Australian Foreign Aid'.

- **Despite a high rate of system growth, there is still a degree of financial system underdevelopment in a number of Asia-Pacific countries.** Bank accounts are held by less than 40 per cent of the adult population in major economies such as the Philippines, Vietnam, Indonesia and India. Assets under management in the Asia-Pacific are only 15 per cent of the global total, and China is only the fifth-largest holder of assets under management in the region. Underdeveloped financial systems are inefficient in channelling credit to firms and households, and may both inhibit economic growth and threaten to undermine financial stability.
- **Amid this growth, financial integration in the Asia-Pacific region is deepening, bucking the trend of the advanced economies where financial integration has backtracked since the global financial crisis.** Cross-border capital flows as a share of GDP have fallen globally and within the EU and North America. In Asia, cross-border flows are growing faster than GDP and in many cases external assets and liabilities now exceed GDP. Cross-border flows in the region appear strongest in the areas of bank lending and foreign direct investment; portfolio investment lags. Despite the growth in cross-border direct investment in recent years, there still appears to be room for more. For example, if China's outbound direct investment were to reach the same share of GDP as Japan's, this represents an additional US$1.4 trillion of outflows when calculated off China's nominal GDP at end-2014.
- **Within the Asia-Pacific region, the Australian financial services industry is relatively large and the economy has a high degree of financial integration with global markets.** The industry is a significant recipient of foreign direct investment, the largest originator of offshore debt capital, and the source of Australia's substantial cross-border banking claims. However, Australia's investment relationships remain oriented toward the traditional trading partners of the United States, United Kingdom and New Zealand, which together account for 50 per cent or more of cross-border investment into and out of Australia.
- **The Australian financial services industry itself is a major exporter — of a magnitude not often understood in the community.** Analysis in this report suggests that the total annual value of financial services exports, including sales by Australian-owned affiliates or subsidiaries overseas, may have reached A$55 billion in 2013. This is equivalent to about 17 per cent of all exports of goods and services, larger than tourism exports and more than *double* the value of education exports. As in the case of investment, however, more than 70 per cent of Australian financial services exports are oriented toward the United States, United Kingdom, and New Zealand.

The total value of financial services exports annually, including sales by Australian-owned affiliates or subsidiaries overseas, may have reached A$55 billion in 2013. This is equivalent to about 17 per cent of all exports of goods and services, larger than tourism exports and more than double the value of education exports.

- **High barriers to financial services trade and cross-border investment in Asia may be inhibiting Australian firms and investors from growing their connections with the region.** According to the OECD, the major economies of Asia have highly restrictive regulatory and legal regimes in both commercial banking and insurance compared to OECD nations. Australia is among the most open economies in the Asia-Pacific region, with a degree of openness that exceeds the OECD average. There may be formal and informal inhibitors to financial integration with Asia arising from within Australia and its financial system.
- **There is strong potential for China to soon emerge as a major financial force in the Asia-Pacific region.** China's domestic market now holds the largest share of domestic banking credit outstanding in the region, the largest equity market in the region by market capitalisation, and the second largest bond market in the region by outstanding stock. Relatively rapid deregulation is increasing the access of foreign firms and investors to the Chinese market, while last year Chinese outbound direct investment exceeded inbound direct investment for the first time in modern history.
- **The economies of Southeast Asia — the ASEAN subregion — are demonstrating the fastest progress in financial integration of any singular economy or subregion in Asia.** Their financial services industries and elements of their capital markets are growing strongly, to a substantial share of GDP. Malaysia, Thailand and Vietnam are notable frontrunners, and Singapore is playing an increasing role in intermediating flows across the region. Integration is likely to continue apace as the ASEAN Economic Community formally comes into being in 2015.

The academic literature and practical experience suggest that deepening economic ties between Australia and Asia will also lead to deeper financial ties. The growth of the region's financial services industry and financial system over the past several years may provide further impetus for the re-orientation of Australia's financial relationships.

Deepening economic ties between Australia and Asia will also lead to deeper financial ties.

What this report finds, however, is that many of the enablers and impediments to this shift, or their potential impact, are not well-researched or understood. Our review suggests that policymakers, regulators and practitioners lack a strong evidence base from which to make well-informed strategic decisions on matters of significance to the entire Australian economy.

In fact, we find the benefits and costs of financial integration receive only limited attention in the academic literature — particularly compared with the substantial body of work documenting the benefits and costs of merchandise trade integration. There is a paucity of standardised data and analysis of trade in financial services. Integration, as measured by financial flows, has been extensively analysed in the United States and the common market of the EU, but the identification of enablers and barriers to cross-border flows — as well as best practice regulatory, taxation, and legal frameworks to maintain financial stability — is only now starting to be applied to the rapidly-growing markets of the Asia-Pacific.

However, many of the enablers and impediments to this shift, or their potential impact, are not well-researched or understood.

This report puts forward the case for research to illuminate both the current degree of regional financial integration and the scope for its future. The limitations of the data and of high-quality analysis and debate on this issue are documented here. The questions raised in this report necessitate a deeper understanding of what the Asia-Pacific region's rise will mean for Australia.

Accordingly, this report lays the groundwork for an Australian Centre for Financial Studies (ACFS) research program titled **Integration in the Asia-Pacific: The Future of Australian Financial Services**.

CONTENTS

1. INTRODUCTION

1.1. The Asia-Pacific region in context

The Asia-Pacific region is arguably the most important economic region of our time. It covers 30 per cent of global landmass and, with a population of 4.3 billion people in 2014, contains 60 per cent of the world's population.[5] It is economically dynamic: between 1970 and 2012, the region's real gross domestic product (GDP) rose from around US$3 trillion (A$3.9 trillion) to over US$16 trillion (A$21.1 trillion).[6] By 2019, the Asia-Pacific is expected to account for 42 per cent of global output, double the ratio in 1980. Over the same period, the combined economies of China and India will likely grow to represent over one quarter of the world's GDP, up from around 5 per cent in 1980.[7]

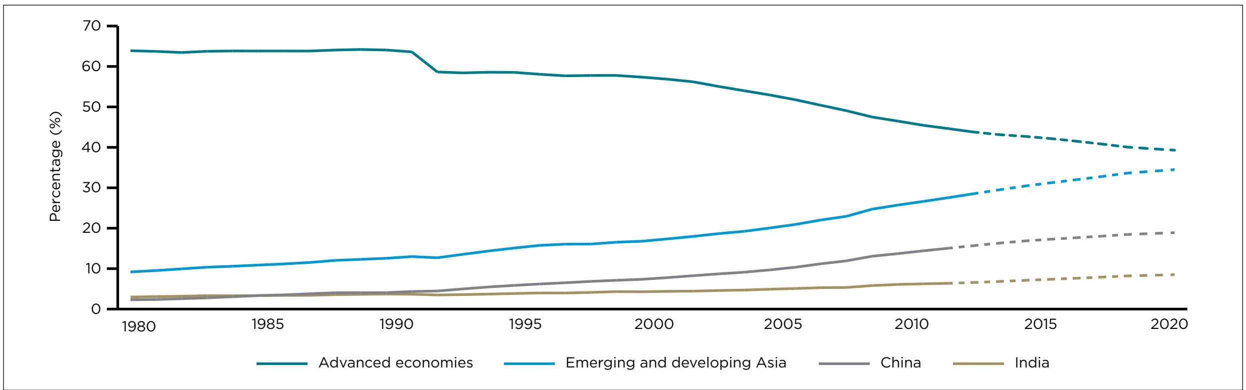
Figure 1 shows the share of world output attributable to the Asia-Pacific region's emerging economies.

The 'Asia-Pacific' as a geographic region carries a wide variety of possible definitions in its coverage of countries. In this report, the Asia-Pacific refers to Northeast Asia, South Asia, Southeast Asia and Oceania. Analysis of Asia will focus primarily on the largest economies in the region, namely China, India, Japan, Indonesia, South Korea, Thailand, Malaysia, Philippines and Vietnam; the financial centres of Hong Kong SAR and Singapore; and ASEAN[9] as a regional bloc.[10]

The region's impressive growth record over the past several decades has coincided with its expansion in global merchandise trade, to the point where the Asia-Pacific generates 31.5 per cent of the world's merchandise exports (up from 26 per cent two decades ago) and 31.8 per cent of the world's merchandise imports (up from 23.6 per cent two decades ago).[11] 53.3 per cent of the Asia-Pacific region's exports flow to other countries in the region.[12] Through an expansion of trade ties, the Asia-Pacific has achieved a high degree of both intra-regional trade integration and trade integration with the rest of the world.

In contrast, the Asia-Pacific region features a relatively lower degree of financial integration, both intra-regionally and with the rest of the world. 'Financial integration' here refers to the degree of financial connectedness, encompassing concepts like financial openness, free movement of capital and trade in financial services.[13] The academic literature suggests, and practical experience supports, the notion that trade integration is often followed by financial integration, as has been the case in North America and Europe. However, there does not appear to have been as clear a line of progression from trade integration to financial integration in the Asia-Pacific region.[14]

FIGURE 1: Projections for share of world output (GDP) on a purchasing power parity basis attributable to the advanced economies, emerging and developing Asia, China, and India[8]



Source: World Economic Outlook Database, April 2015.

5. United Nations Economic and Social Commission for Asia and the Pacific (2014), 'Statistical Yearbook for Asia and the Pacific 2014', p. 1.
6. Ibid, p. 24.
7. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015', p. 7.
8. 'Advanced economies' includes 36 countries: Australia, Austria, Belgium, Canada, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong SAR, Iceland, Ireland, Israel, Italy, Japan, Korea (South), Latvia, Luxembourg, Malta, Netherlands, New Zealand, Norway, Portugal, San Marino, Singapore, Slovak Republic, Slovenia, Spain, Sweden, Switzerland, Taiwan, United Kingdom, and United States.
   'Emerging and developing Asia' includes 29 countries: Bangladesh, Bhutan, Brunei Darussalam, Cambodia, China, Fiji, India, Indonesia, Kiribati, Lao PDR, Malaysia, Maldives, Marshall Islands, Micronesia, Mongolia, Myanmar, Nepal, Palau, Papua New Guinea, Philippines, Samoa, Solomon Islands, Sri Lanka, Thailand, Timor-Leste, Tonga, Tuvalu, Vanuatu, and Vietnam.
9. The Association of Southeast Asian Nations (ASEAN) includes Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand and Vietnam.
10. Different agencies and international organisations define 'Asia-Pacific', 'Asia' and 'East Asia' in different ways, and often the data do not allow country groupings to be disaggregated. Where the definitions of country groupings vary in this report, definitions will be offered in the footnotes. New Zealand, though part of Australasia and what is commonly known as the Asia-Pacific region, is not a focus of this study. The Asia-Pacific Economic Cooperation (APEC) forum, because it includes Canada, Mexico, Peru, Russia and the United States, is not examined in this report; nor is Western Asia or the Middle East.
11. World Trade Organization (2014), 'International Trade Statistics 2014', Table I.4.
12. Ibid, Tables I.5 and I.6.
13. Fung, LK, Tam, C and Yu, I (2008), 'Assessing the Integration of Asia's Equity and Bond Markets', BIS Papers, No. 42.
14. Pongsaparn, R and Unteroberdoerster, O (2011), 'Financial Integration and Rebalancing in Asia', IMF Working Paper, WP/11/243.

The Asia-Pacific region features a relatively lower degree of financial integration, both intra-regionally and with the rest of the world.

Why is this notion of financial integration important?

Financial systems are crucial to building and maintaining prosperity. The financial ecosystem — operating across banking, insurance and investment — is the grease that allows the wheels of commerce to turn, and for households and firms to manage their daily affairs while building capacity and wealth. Well-functioning financial systems support the safe and effective transfer of funds from one party to another, the generation of capital and credit, and the effective pricing and transfer of risk.

The financial ecosystem is the grease that allows the wheels of commerce to turn, and for households and firms to manage their daily affairs while building capacity and wealth.

Financial systems exist within economies, but in the modern era are rarely isolated from the global economy or financial systems in other countries. Linkages with other countries' financial systems:

- broaden the sources available to raise capital;
- allow for greater risk sharing and diversification;
- enable productivity growth, by supporting investment that facilitates knowledge and technology transfer;
- enhance liquidity available in local markets to increase price transparency; and
- improve the productivity of the financial services industry itself through external competition.

In some sense, Asia may have benefitted from lower financial integration over the past decade through reduced vulnerability to exogenous financial shocks, as was experienced through the global financial crisis. At the same time, lack of integration can impose economic costs. Fundamental concerns such as the cost of capital, the ability to diversify risk, and the efficiency of international trade and investment transactions are all impacted by the degree to which capital can flow across borders. The greater the degree of economic integration, the greater the need and impetus for financial integration.

The impact of a relatively lesser degree of financial integration within the Asia-Pacific region is evident in key economic aggregates. Domestic savings rates in Northeast Asia are high for middle-income economies, in part representing 'precautionary' savings in an environment where the financial system provides insufficient support for wealth preservation and creation.[15] Across the ASEAN region, some economies that are in desperate need of investment in fixed capital formation, including essential infrastructure, confoundingly also feature excess savings as evidenced by their current account surpluses.

Bond markets in many jurisdictions in Asia are shallow,[16] reducing transparency in pricing of risk and access to debt capital, while thin money markets mean limited liquidity for local currencies. Banking credit is still the primary channel for borrowing for the vast majority of firms in the region, and many Asian countries have a relatively high level of financial exclusion by households and small and medium enterprises (SMEs).[17] The banking system itself is rather fragmented, with few indigenous banks operating in more than one or two markets in the region.

Underdeveloped financial systems in the Asia-Pacific region, especially in lower-income economies, are inefficient at channelling credit. High interest rate spreads that raise the cost of finance are typical. In some cases, the over-allocation of credit to state-owned firms at the expense of the more dynamic private sector erodes the link between finance and growth.[18]

Empirical evidence points to growth benefits from closing the finance gap. For example, the Asian Development Bank has estimated that boosting developing Asia's average ratio to GDP of liquid liabilities (currency plus checking and interest-bearing accounts in financial institutions) from about 65 per cent to 75 per cent would add almost 0.4 percentage points to average annual GDP growth per capita. The evidence indicates that this growth can come from developing either banks or capital markets.[19]

15. Prasad, ES (2013), 'Saving in Developing Countries', National Bureau of Economic Research, NBER Reporter 2013: No. 1.
16. Pongsaparn, R and Unteroberdoerster, O (2011), 'Financial Integration and Rebalancing in Asia', IMF Working Paper, WP/11/243.
17. Park, C and Mercado, RV (2015), 'Financial Inclusion, Poverty, and Income Inequality in Developing Asia', Asian Development Bank, ADB Economics Working Paper Series, No. 426.
18. Asian Development Bank (2015), *Asian Development Outlook 2015: Financing Asia's Future Growth*, Manila.
19. Ibid.

Within this picture, Australia stands as one of the most advanced economies in the Asia-Pacific region, with a large financial services industry of significant economic importance. Australia's financial services industry is the largest industrial segment in the economy, the largest contributor to corporate income tax revenues, and a major employer across all states. The financial system also facilitates the cross-border flows of payments, capital and investment that, on a global scale, dwarf cross-border flows in trade.[20]

Australia's financial system is deeply integrated with the global market, and the data suggest that connectivity with Asia is gathering pace. However, the true extent of financial integration — within the Asia-Pacific region itself, and Australia's degree of participation — is not nearly as well captured in the data or analysed in the academic literature as is the case with cross-border flows of goods and trade integration.

The true extent of financial integration is not nearly as well captured in the data or analysed in the academic literature as is the case with cross-border flows of goods and trade integration.

In fact, we find the benefits and costs of financial integration receive only limited attention in the academic literature — particularly when compared with the substantial body of academic and policy work documenting the benefits and costs of merchandise trade liberalisation. There is a paucity of standardised data and analysis of trade in financial services relevant to the Asia-Pacific region, including on critical issues of licensing, taxation and other 'behind the border' barriers to trade. Integration as measured by financial flows has been extensively analysed in the United States and the common market of the European Union (EU), but the identification of critical enablers and barriers to cross-border financial flows is only starting to be applied to the rapidly growing markets in Asia.

In the Australian context, there is a similar relative lack of understanding of the current state of two-way financial integration with Asia. Baseline data on trade in financial services is poor, and data on inbound and outbound investment flows can be patchy. Research and analysis of the enablers and barriers to cross-border financial services trade and capital flows in respect of Asia — and estimates of the economic costs and benefits of maintaining or changing the status quo — are not commonly found in the Australian academic literature.

With a relatively superficial understanding of Australia's current place in Asia's financial evolution, the outlook for the future is difficult to assess. There has been little work undertaken to estimate the potential impact on the Australian economy and its financial services industry from some of the major changes now underway in Asia: the opening of China's capital account and increasing capital flows; the establishment of the ASEAN Economic Community; and the liberalisation of services trade through recent free trade agreements and the proposed Trade in Services Agreement (TiSA).

With a relatively superficial understanding of Australia's current place in Asia's financial evolution, the outlook for the future is difficult to assess.

For example, how will the Australian landscape adjust to increasing Chinese outbound foreign direct investment, which could triple over the next decade?[21] How might Australia fare under a scenario where an integrated ASEAN market claims a rising share of global debt capital raisings, and regional dominance of banking flows under the rise of an indigenous regional commercial bank? How will Australian listed firms compete with Asian listed firms for equity capital as regional financial centres grow and deepen?

For Australia, the Asia-Pacific's financial future represents the opportunity of new and growing markets, but also the threat of competition and capital arriving on Australian shores with the potential to displace current participants. The importance of maintaining stability, growth and employment in the financial services sector remains paramount as the Australian economy adjusts to declining activity in the mining sector and falling terms of trade.

This report puts forward the case for developing a greater evidence base to understand and respond to financial integration in the Asia-Pacific region. Our report comes at a pivotal time in the history of Australia-Asia-Pacific relations, with the recent conclusion of negotiations for the China-Australia Free Trade Agreement (following the signing of the Korea-Australia Free Trade Agreement and the Japan-Australia Economic Partnership Agreement); the announcement that Australia will participate in the establishment of the Asian Infrastructure Investment Bank (AIIB);[22] and the finalisation of arrangements for the Asia Region Funds Passport initiative under the auspices of APEC.

20. United States Department of the Treasury (2007), 'Report to Congress on International Economic and Exchange Rate Policies', December, Appendix I.
21. Anderlini, J (2014), 'China Foresees Outbound Investment of $1.25tn in a Decade', *Financial Times*, 9 November.
22. Abbott, T (Prime Minister) (2015), 'Asian Infrastructure Investment Bank', Media Release, 29 March.

This report puts forward the case for developing a greater evidence base to understand and respond to financial integration in the Asia-Pacific region.

1.2. Structure of this report

This report is organised as follows:

Section 2 provides a framework for understanding the meaning of 'financial integration', including an overview of the academic literature on this topic. We review recent studies of financial integration in the Asia-Pacific region (as well as in comparable regions, such as the euro zone), and the benefits and challenges of financial integration.

Section 3 examines trade in financial services, focusing on the import and export of financial services (including insurance and pension services) within the Asia-Pacific region and between Australia and the Asia-Pacific. Trade encompasses the provision of services across national borders — but also includes services provided by an on-the-ground commercial presence in a foreign country, as will be detailed in this section.

Section 4 analyses the degree of Asia-Pacific integration by looking at cross-border capital flows. We focus on three main categories of capital flows: foreign direct investment, portfolio investment, and cross-border banking claims.

Section 5 offers a summary of the main enablers and barriers to financial integration between Australia and the Asia-Pacific region. This section also briefly summarises deficiencies and limitations in the publicly available data, which are listed in more detail in **Appendix B**.

Section 6 discusses topical issues and events that have the potential to impact on Asia-Pacific financial integration, including the opening of China's capital account, economic and political integration in the ASEAN region, and recent free trade agreements.

Section 7 presents concluding thoughts.

Appendix A outlines a research proposal for a new ACFS research project on financial integration in the Asia-Pacific.

Appendix B provides further detail on identified gaps in the data that limit the ability to undertake a deeper level of analytical work on financial integration in the Asia-Pacific region, including gaps within the Australian datasets.

2. DEFINITIONS AND FRAMEWORK FOR FINANCIAL INTEGRATION

2.1. Defining financial integration

There is no universal definition of 'financial integration'. Nevertheless, the term typically encompasses concepts like financial openness, free movement of capital and integration of financial services.[23] Financial integration can be thought of as a multidimensional process through which the allocation of financial assets becomes increasingly borderless.[24] The Financial System Inquiry of 2014 considered financial integration to be a country's 'financial connectedness' with other countries, noting that greater financial integration tends to increase capital flows and equalise prices and returns on traded financial assets in different countries.[25]

Financial integration can be thought of as a multidimensional process through which the allocation of financial assets becomes increasingly borderless.

The approach of this report is to examine financial integration across two broad categories: trade in financial services, and cross-border capital flows. By incorporating both of these concepts, this report aims to understand financial integration as both the service that is provided — for example, when a bank subsidiary helps a company to raise debt capital offshore — as well as the flows that are created, such as the actual raising and cross-border transfer of that debt capital across borders.

Each term is defined here briefly.

Trade in financial services can be understood to cover the provision of financial services by a firm resident in one country to an individual or firm resident in another country. In the official balance of payments statistics, 'financial services' and 'insurance and pension services' are separate categories. This report examines both categories.

'Financial services' includes services provided in connection with transactions in financial instruments, as well as services encompassing deposit taking and lending, credit card services, clearing of payments, financial advice, financial asset management, and so on.[26] Insurance includes direct insurance (i.e. life, casualty or accident, health, general liability, fire, marine, aviation, etc.), freight insurance, and reinsurance.[27] Note that the value of insurance services is derived as the margin between the amounts accruing to insurers (premiums) and the amounts accruing to policyholders (claims).[28] Pension funds are often referred to as superannuation entities in the Australian context. Pension funds' transactions include receiving contributions, paying benefits and investing funds.[29]

Cross-border capital flows can be understood to cover multiple categories of transactions between economic agents.[30] Broadly speaking, there are five functional categories commonly distinguished in countries' financial accounts:

- **foreign direct investment**, which is associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy;
- **portfolio investment**, which is defined as cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets;
- **financial derivatives and employee stock options**;
- **other investment**, a residual category that includes positions and transactions (such as flows related to international banking transactions) other than those included in the other categories; and
- **reserve assets**, which are external assets that are readily available to and controlled by monetary authorities.[31]

23. Fung, LK, Tam, C and Yu, I (2008), 'Assessing the Integration of Asia's Equity and Bond Markets', BIS Papers, No. 42.
24. Park, C (2013), 'Asian Capital Market Integration: Theory and Evidence', Asian Development Bank, ADB Economics Working Paper Series, No. 351.
25. Financial System Inquiry (2014), Interim Report, Chapter 10.
26. Financial services includes, *inter alia*, deposit taking and lending; letters of credit; credit card services; commissions and charges related to financial leasing; factoring; underwriting; and clearing of payments. Also included are financial advisory services; custody of financial assets or bullion; financial asset management; monitoring services; convenience services; liquidity provision services; risk assumption services other than insurance; merger and acquisition services; credit rating services; stock exchange services; and trust services. Source: United Nations Department of Economic and Social Affairs (2012), *Manual on Statistics of International Trade in Services 2010*, United Nations, New York, p. 63.
27. Also recorded are agent commissions related to insurance transactions.
28. Australian Bureau of Statistics (2009), 'Insurance in the Balance of Payments', 5310.0.55.002 — Information Paper: Implementation of New International Statistical Standards in ABS National and International Accounts, Chapter 11, September.
29. Australian Bureau of Statistics (2009), 'Pension Funds in the Balance of Payments', 5310.0.55.002 — Information Paper: Implementation of New International Statistical Standards in ABS National and International Accounts, Chapter 10, September.
30. The conceptual framework used in Australia's balance of payments (BOP) and international investment position (IIP) statistics is based on the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual.
31. International Monetary Fund (2009), *Balance of Payments and International Investment Position Manual*, Sixth Edition, Washington DC, Chapter 6.

This report focuses on the three most important categories: foreign direct investment, portfolio investment and other investment (cross-border bank lending), which together are commonly known as private capital flows. Official capital flows, such as those related to central banks, are not a primary focus of this report. In addition, **cross-border payments** can arise from transfers (in cash or in kind) between residents and non-residents. Cross-border payments are linked to cross-border trade in goods — whether by firms or individuals — or to person-to-person transfers such as remittances resulting from income earned by offshore workers. The IMF refers to aid grants and remittances as 'capital-like' flows, as they can substitute for capital flows.[32] Capital-like flows are not a focus of this report, except for to note their ongoing importance to the smooth functioning of the economy.[33]

2.2. Measuring financial integration

Financial integration is measured in various ways in the academic and policy literature.

Fung et al. (2008) suggest two broad measurement categories: price-based measures, and quantity-based measures.[34] Price-based measures examine price differentials — or correlations — across markets. Many studies relate financial integration to the 'law of one price', which hypothesises that assets of similar risk and return profiles should be identically priced.[35] Discrepancies in prices or returns on identical (or comparable) assets would tend to be used as evidence that financial markets are not integrated. Price-based analytical approaches are commonly applied to markets for tradeable securities, such as foreign exchange, equities and bonds, where daily price movements allow for robust analysis.

Quantity-based measures are typically simple ratios intended to capture the extent of cross-border activities, like the ratio of total stocks of aggregate foreign assets and liabilities to GDP or the ratio of capital flows to GDP. Quantity-based measures are useful for non-tradeable financial flows (and those with a low frequency of data collection), such as cross-border investment, lending and payments.

In addition to price- and quantity-based measures, Park (2013) and others set out the case for the *de jure* approach that measures financial openness by quantifying legal and regulatory restrictions on cross-border trade or capital flows. *De facto* measures, on the other hand, assess actual cross-border trade or capital flows.[36]

2.3. Studies of financial integration in the Asia-Pacific

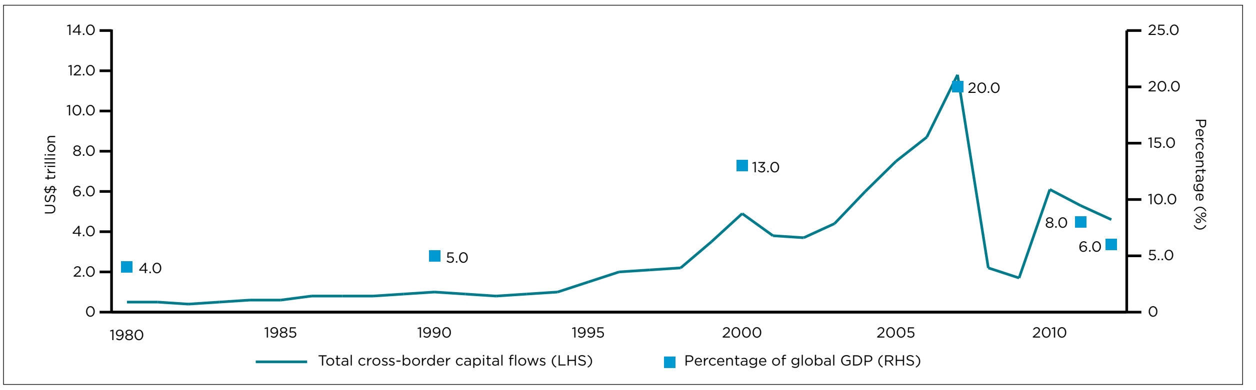
Recent studies of the Asia-Pacific region using the above measurement approaches have found varied degrees of financial integration. Overall, there does indeed appear to be a trend toward greater regional integration.

Taking a price-based approach to equity markets, Brailsford et al. (2008) find that, after the Asian financial crisis, financial integration has continued in most ASEAN countries as well as between ASEAN countries and the larger Asia-Pacific region.[37] A later study, by Yu et al. (2010), finds that after slowing down between 2002 and 2006, equity market integration has picked up again since 2007. Price convergence appears to be more complete within the mature markets of Japan, Hong Kong SAR, Singapore and South Korea than in the Asia-Pacific's emerging markets.[38] Kim and Lee (2008) show that cross-country movements in government bond yields, overnight bank rates and stock markets have increasingly converged in East Asia since the Asian financial crisis. However, measures of 'covered interest'[39] differentials indicate that the degree of integration with global markets has been larger than the extent of intra-regional financial integration.[40] Similarly, Borensztein and Loungani (2011) find that declines in cross-country dispersion in equity returns and interest rates suggest increased Asian integration, but conclude that Asian countries remain more financially integrated with major countries outside the region than with those within.[41]

32. Dorsey, T (2008), 'A Capital Story', *Finance & Development*, International Monetary Fund, June.
33. For further reading on remittances in an Australian context, see: Davis, K and Jenkinson, M (2012), 'Remittances: Their Role, Trends and Australian Opportunities', Western Union.
34. Fung, LK, Tam, C and Yu, I (2008), 'Assessing the Integration of Asia's Equity and Bond Markets', BIS Papers, No. 42.
35. Pongsaparn, R and Unteroberdoerster, O (2011), 'Financial Integration and Rebalancing in Asia', IMF Working Paper, WP/11/243.
36. Park, C (2013), 'Asian Capital Market Integration: Theory and Evidence', Asian Development Bank, ADB Economics Working Paper Series, No. 351.
37. Brailsford, TJ, O'Neill, TJ and Penm, J (2008), 'A New Approach for Estimating Relationships Between Stock Market Returns: Evidence of Financial Integration in the Southeast Asian Region', *Asia-Pacific Financial Markets: Integration, Innovation and Challenges, International Finance Review*, Vol. 8, pp. 17–37.
38. Yu, I, Fung, K and Tam, C (2010), 'Assessing Financial Market Integration in Asia — Equity Markets', *Journal of Banking and Finance*, Vol. 34, pp. 2874–85.
39. 'Covered interest parity' refers to a condition where there are no interest rate arbitrage opportunities between two currencies.
40. Kim, S and Lee, J (2008), 'Real and Financial Integration in East Asia', Asian Development Bank, Working Paper Series on Regional Economic Integration, No. 17.
41. Borensztein, E and Loungani, P (2011), 'Asian Financial Integration: Trends and Interruptions', IMF Working Paper, WP/11/4.

Taking a quantity-based approach, James et al. (2014) argue that gross capital flows are an indicator of international financial integration or financial globalisation. By this measure, the pace of global financial integration increased markedly in the decade before the global financial crisis. Since then, there has been a well-documented decline in cross-border flows of capital, particularly from the banking sector, such that total annual flows have fallen to around one-third of their size in 2007.[42] This line of reasoning is supported by the McKinsey Global Institute (2013), which finds that cross-border capital flows have fallen sharply since the global financial crisis, sending financial integration into reverse. Global capital flows remain 60 per cent below their 2007 peak, as of mid-2012, led by a reduction in cross-border lending (Figure 2). The institute also finds that financial depth in Asia — as measured by the ratio of financial assets to GDP — is still less than half that of the advanced economies.[43]

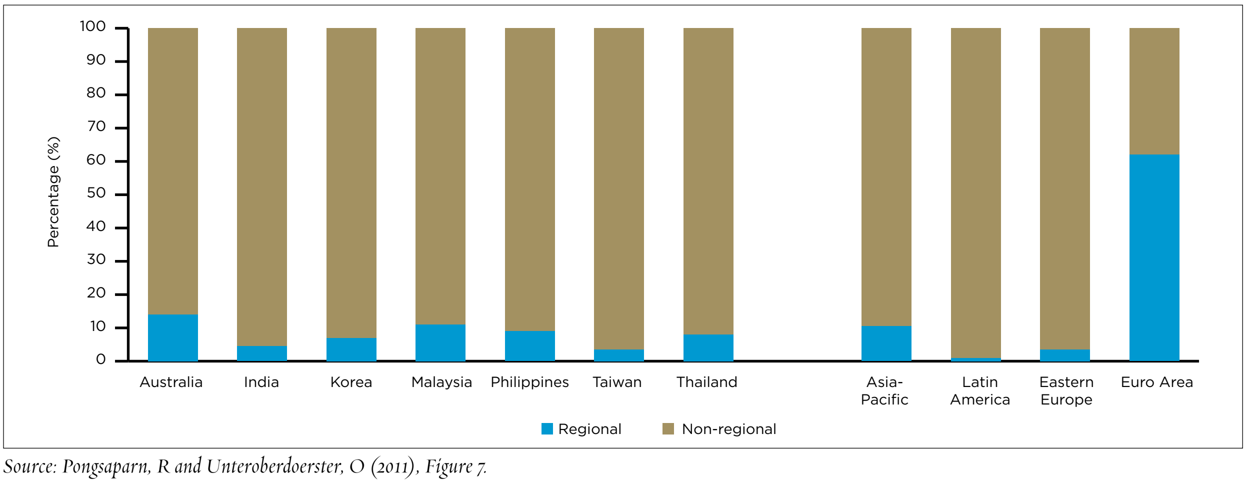
FIGURE 2: Global cross-border capital flows,[44] constant 2011 exchange rates



Source: McKinsey Global Institute (2013), 'Financial Globalization: Retreat or Reset?', Exhibit 9.

Pongsaparn and Unteroberdoerster (2011) offer a comprehensive analysis of quantity-based measures in the Asia-Pacific. In relation to portfolio investment, the authors find that inter-regional investment dominates intra-regional investment. For Asian economies, both the United States and the euro area are more important sources of portfolio investment than Asia itself. When the financial centres of Hong Kong SAR and Singapore are excluded, intra-regional portfolio investment accounts for less than 10 per cent of liabilities in the region. Australia is slightly more regionally integrated than the Asia-Pacific average (Figure 3).[45]

FIGURE 3: Regional and non-regional sources of portfolio investment liabilities (corrected for financial centre intermediaries), as of 2009[46]

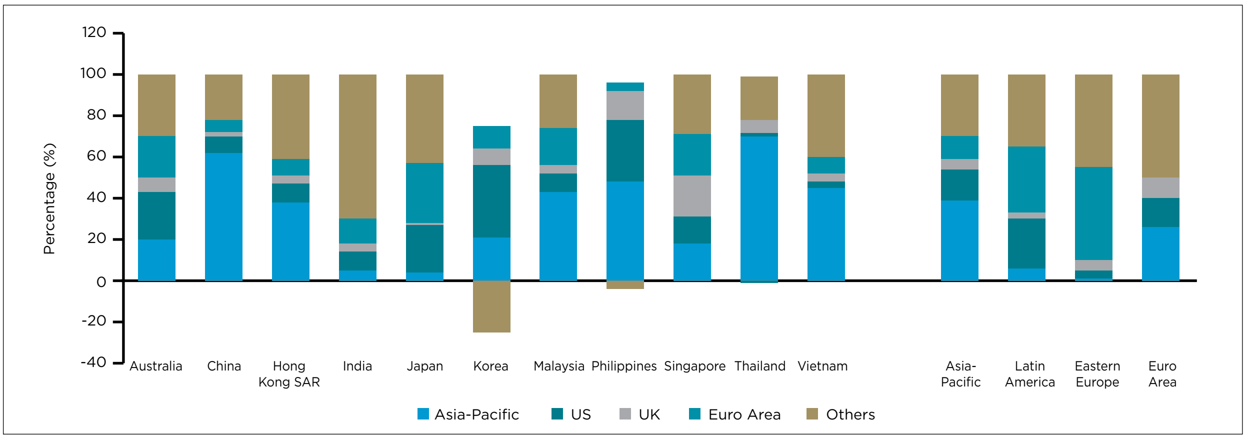


Source: Pongsaparn, R and Unteroberdoerster, O (2011), Figure 7.

42. James, E, McLoughlin, K and Rankin, E (2014), 'Cross-border Capital Flows Since the Global Financial Crisis', *Reserve Bank of Australia Bulletin*, June.
43. McKinsey Global Institute (2013), 'Financial Globalisation: Retreat or Reset?', March.
44. Includes foreign direct investment, purchases of foreign bonds and equities (i.e. portfolio investment), and cross-border loans and deposits.
45. Pongsaparn, R and Unteroberdoerster, O (2011), 'Financial Integration and Rebalancing in Asia', IMF Working Paper, WP/11/243.
46. 'Asia-Pacific' includes Australia, China, Hong Kong SAR, India, Indonesia, Japan, Korea, Malaysia, New Zealand, Philippines, Singapore, Taiwan, Thailand, and Vietnam.

On the other hand, much of the Asia-Pacific's foreign direct investment flows (approximately 40 per cent) have been intra-regional (Figure 4). Firms from more advanced economies, notably Japan and South Korea, invest in the developing economies of Asia to form regional production and distribution networks. However, a large proportion of these flows are a result of 'round-tripping' between mainland China and Hong Kong SAR.

FIGURE 4: Sources of foreign direct investment inflows, as of 2007



Source: Pongsaparn, R and Unteroberdoerster, O (2011), Figure 15.

Pongsaparn and Unteroberdoerster posit that one reason for the low degree of financial integration in the Asia-Pacific could be capital account restrictions in a number of countries. A low degree of integration tends to be mirrored by a lack of financial development, which is hampering the economic rebalancing that Asia needs. The authors conclude that greater financial integration can play an important role in strengthening domestic sources of growth — for example, by inducing more competition in domestic banking systems; by providing greater liquidity, leading to lower bond yields; and by reducing precautionary savings by providing a broader range of investment vehicles and products.[47]

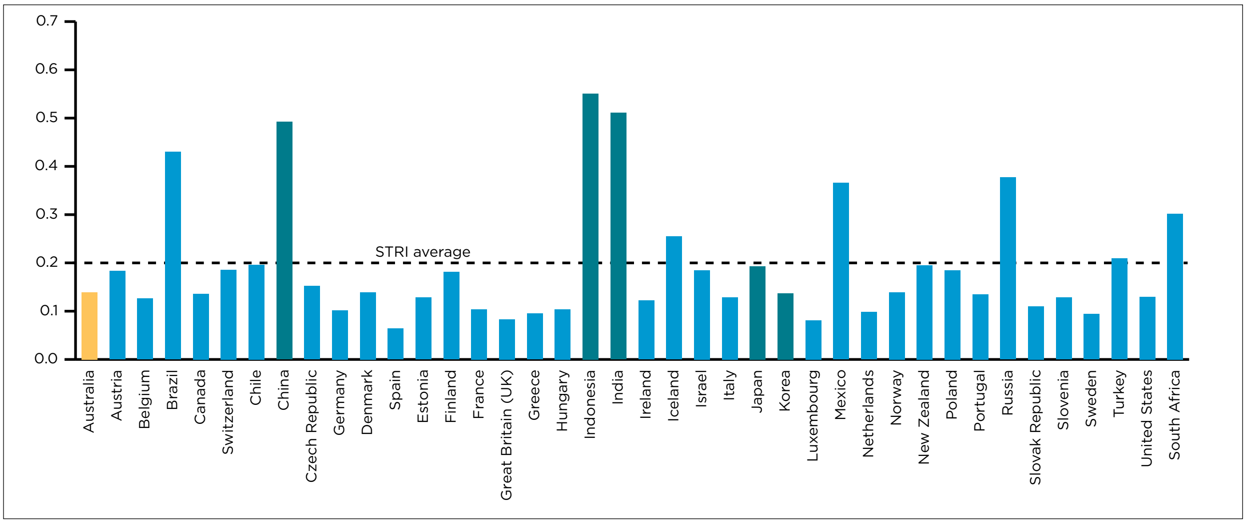
Several studies have pursued a *de jure* approach. Abiad et al. (2010) argue that a limitation of studies trying to understand the effects of financial liberalisation has been the lack of comprehensive datasets documenting actual policy changes. Using a new database of financial reforms covering 91 economies over 1973–2005, the authors find that the process of financial liberalisation in East Asia has been much more gradual than in Latin America.[48]

Advancing on the *de jure* approach, the OECD produces a series of 'trade restrictiveness' indices that measure the relative openness of economies by attempting to quantify the effect of relevant laws and regulations. In the area of trade in financial services, the OECD evaluates commercial banking (Figure 5) and insurance (Figure 6). According to these indices, Asia has among the most restrictive practices in both commercial banking and insurance, with China, Indonesia and India being the most restrictive. Australia sits below the OECD average in both indices, with the largest contribution to restrictiveness coming from Australia's restrictions on foreign ownership and other market entry conditions.

The OECD cites evidence that the presence of foreign banks in an economy is generally linked to greater competition and forces increased efficiency, improves lending quality, lowers net interest margins, and expands financial inclusion for households and firms.[49]

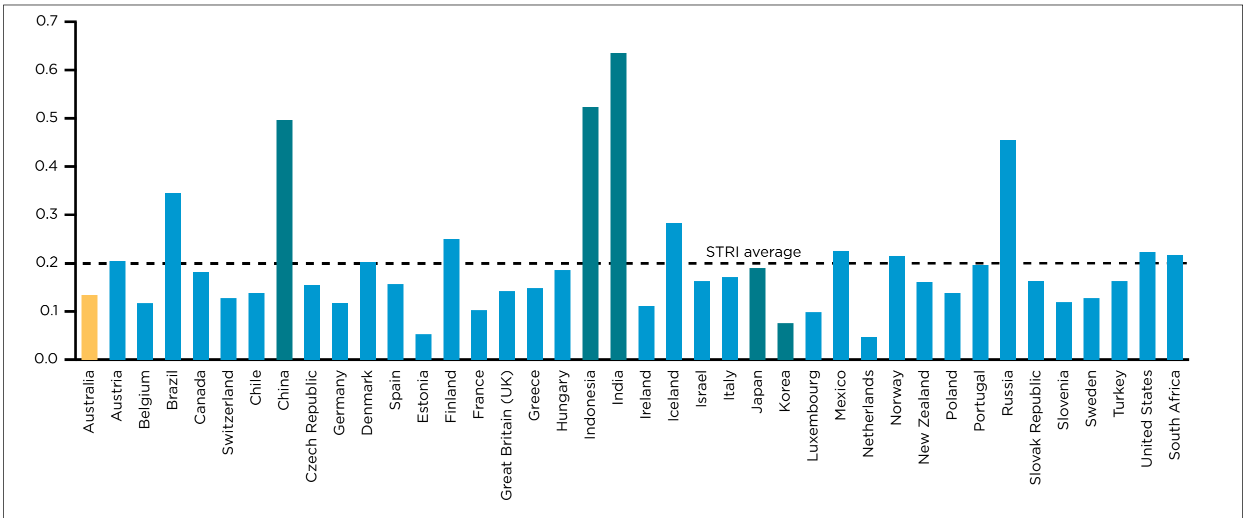
47. Pongsaparn, R and Unteroberdoerster, O (2011), 'Financial Integration and Rebalancing in Asia', IMF Working Paper, WP/11/243.
48. Abiad, A, Detragiache, E and Tressel, T (2010), 'A New Database of Financial Reforms', IMF Staff Papers, Vol. 57, No. 2.
49. Rouzet, D, Nordas, HK, Gonzales, F, Grosso, MG, Lejarraga, I, Miroudot, S, and Ueno, A (2014) 'Services Trade Restrictiveness Index (STRI): Financial Services', OECD Trade Policy Papers, No. 175, Box 1.

FIGURE 5: Services Trade Restrictiveness Index (STRI) for commercial banking, 2014[50]



Source: OECD.

FIGURE 6: Services Trade Restrictiveness Index (STRI) for insurance, 2014[51]



Source: OECD.

50. The STRI takes values between zero and one, one being the most restrictive. Values are calculated on the basis of a regulatory database that contains comparable, standardised information on trade and investment relevant policies in force in each country.
51. Insurance comprises life insurance, property and casualty insurance (i.e. 'general insurance'), reinsurance and auxiliary services. Private health insurance and private pensions are not covered.

Risks and challenges in financial integration

While financial integration may provide substantial benefit to households and firms, it can also carry risks. These include greater exposure to negative external shocks and contagion; challenges in relation to cross-border supervision and enforcement; and adverse effects from potential higher volatility in capital flows, which can cause rapid changes in domestic asset prices.[52]

These challenges became meaningfully apparent in Asia during the Asian financial crisis of 1997–98, leading to a shift toward a more conservative policy framework that appears to have contributed to the region's lower degree of financial integration. The Asian crisis was an example of the policy 'trilemma' that argues it is only possible to accomplish two out of three policy objectives — a stable exchange rate, free movement of capital (i.e. financial integration), and independent monetary policy. While the majority of Asian economies have moved toward a more freely floating exchange rate since the crisis, policymakers in the region are still operating in an environment of shallow financial systems, where even small capital movements can have large effects on domestic markets and the exchange rate.

This report discusses the merits of deeper cross-border capital flows, but recognises there can be drawbacks. Unfettered capital flows can increase correlations in the price movements of tradeable assets — equities, bonds, commodities, foreign exchange and derivatives — across jurisdictions. Increased correlation, by definition, reduces the benefits of portfolio diversification, while also creating channels for contagion. The global financial crisis highlighted the fact that large capital flows can increase vulnerabilities at the macroeconomic level and exacerbate systemic risks in the financial system.[53]

The Australian experience would seem to support the notion that strong institutions and regulatory practices can go a long way toward mitigating the risks of deeper financial integration. Australia is a net importer of capital where domestic investment has persistently exceeded domestic savings. As such, Australia is constantly exposed to foreigners' willingness to fund our current account deficit. Financial reforms of past decades and the integration of Australia's capital markets into the global system have delivered the basis for sounder macroeconomic policy, more diversified portfolios for Australian investors, and the development of tools for hedging risk.[54]

The sound policy framework in Australia was evident during the Asian crisis and the global financial crisis. These events both had an effect on Australian asset prices, liquidity, and capital availability. However, the Australian financial system remained (for the most part) stable throughout these crises, suggesting that Australia is well-placed to address potential risks arising from deeper financial integration with the Asia-Pacific region. The Financial System Inquiry also supported efforts to drive greater international financial integration, provided these efforts do not compromise standards for financial stability and conduct in Australia.[55]

52. Financial System Inquiry (2014), Interim Report, Chapter 10.
53. Claessens, S and Ghosh, SR (2013) 'Capital Flow Volatility and Systemic Risk in Emerging Markets: The Policy Toolkit', *Dealing with the Challenges of Macro Financial Linkages in Emerging Markets*, Chapter 3.
54. Lowe, P (2014), 'Some Implications of the Internationalisation of the Renminbi', Opening Remarks to the Centre for International Finance and Regulation Conference on the Internationalisation of the Renminbi, 26 March, Sydney.
55. Financial System Inquiry (2014), Interim Report, Chapter 10.

3. TRADE IN FINANCIAL SERVICES

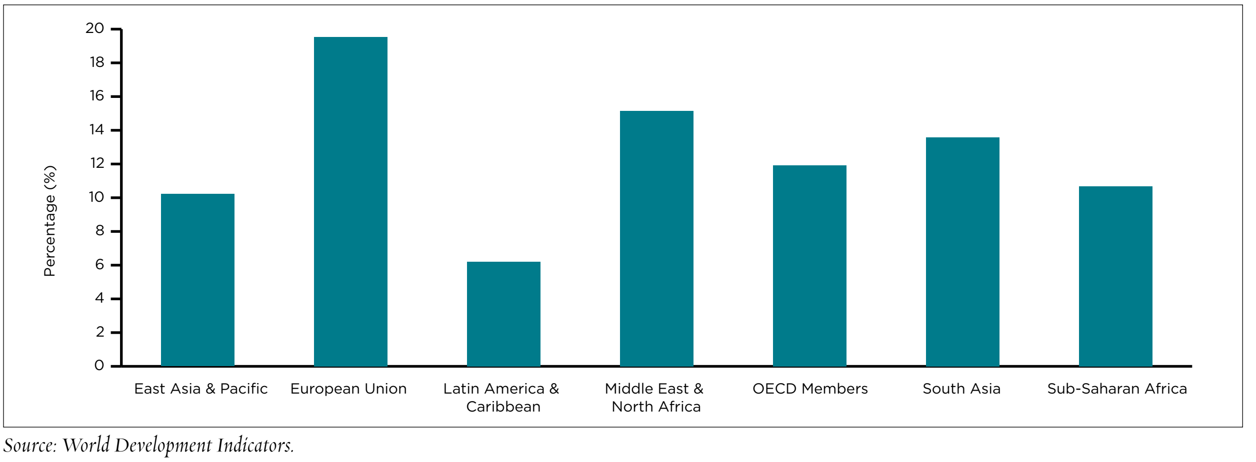
3.1. Introduction

At the high level, economic output is generated by three sectors: primary goods (agriculture, forestry, fishing, and extraction), manufactured goods, and services.[56] As the global economy has matured, the contribution of services as a share of global economic output has increased from 59 per cent in 1985 to more than 70 per cent today. The proportion of total trade generated by the services industry has also been increasing for much of the last three decades. World merchandise exports stood at US$19 trillion as of 2014, while world services exports stood at US$4.9 trillion.[57] The EU and the United States account for over 60 per cent of all services exports, with commentators suggesting that trade in services remains overlooked and untapped by many developing countries.[58]

The EU and the United States account for over 60 per cent of all services exports, with commentators suggesting that trade in services remains overlooked and untapped by many developing countries.

The World Bank calculates that the contribution of trade in services to GDP in East Asia and the Pacific (including Australia) lags behind that of the OECD and the EU (Figure 7). China's trade in services is equivalent to 6.1 per cent of its GDP. South Asia has seen rapid growth in the export of information technology and other services from nations like India and Bangladesh, such that India's services exports may soon exceed its exports of goods.[59]

FIGURE 7: Trade in services by region as a percentage of GDP, 2012[60]



Source: World Development Indicators.

Many of the benefits of liberalisation of trade in services derive not just from seeking better market access abroad, but from increased competitiveness and efficiency in the domestic market. Trade opens up economic opportunities for exporters, while also providing access to foreign capital and technology that can offer consumers more choice at home.[61]

This section focuses on trade in financial services, which has become increasingly important to the international economy. Technological developments have reached the point where the widespread provision of financial services across borders is now commercially feasible. Trade can also take the form of the establishment of branches or subsidiaries in a host country, although this mode of trade (as will be shown later) is more difficult to measure. Trade in financial services, whether across borders or through a commercial presence on the ground, can benefit consumers by contributing to competitive and efficient markets for financial services, thereby promoting economic growth and development.[62]

56. Services include business services; communication services; construction services; distribution services; educational services; environmental services; financial services (which are the focus of this section); health-related and social services; tourism and travel-related services; recreational, cultural, and sporting services; transport services; and other services not elsewhere included.
57. United Nations Conference on Trade and Development (2015), 'In 2014, World Merchandise Exports Grew by 0.6%, while Trade in Services Recorded a 4.2% Global Increase', News Release, 14 April.
58. Nasir, S and Kalirajan, K (2013), 'Export Performance of South and East Asia in Modern Services', ASARC Working Paper 2013/07.
59. Cattaneo, O, Engman, M, Sáez, S, and Stern, RM (eds) (2010), *International Trade in Services: New Trends and Opportunities for Developing Countries*, The World Bank, Washington DC, pp. 1–3.
60. Trade in services is measured as the sum of service exports and imports divided by the value of GDP, all in current US dollars.
'East Asia & Pacific' comprises: American Samoa, Australia, Brunei Darussalam, Cambodia, China, Fiji, French Polynesia, Guam, Hong Kong SAR, Indonesia, Japan, Kiribati, Lao, Macao SAR, Malaysia, Marshall Islands, Micronesia, Mongolia, Myanmar, New Caledonia, New Zealand, Northern Mariana Islands, North Korea, Palau, Papua New Guinea, Philippines, Samoa, Singapore, Solomon Islands, South Korea, Taiwan, Thailand, Timor-Leste, Tonga, Tuvalu, Vanuatu, and Vietnam.
'South Asia' comprises: Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, and Sri Lanka.
61. Cattaneo, O, Engman, M, Sáez, S, and Stern, RM (eds) (2010), *International Trade in Services: New Trends and Opportunities for Developing Countries*, The World Bank, Washington DC, pp. 6–7.
62. Organisation for Economic Cooperation and Development (2000), 'Cross-Border Trade in Financial Services: Economics and Regulation', Financial Market Trends, No. 75.

Cross-border trade in financial services is distinguished from cross-border capital movements, i.e. transactions between residents of different countries involving the creation, modification, transfer or liquidation of a capital asset. Cross-border capital flows are examined in Section 4 of this report.

This section begins with an overview of the Australian financial services industry and its contribution to the domestic economy. The industry is compared and contrasted with the financial services industries of various countries in the Asia-Pacific region, which are found to be, in general, relatively underdeveloped. The focus of this section is to scope the size of trade in financial services in the Asia-Pacific region, and between Australia and its Asia-Pacific neighbours.

3.2. Definitions

References to the 'financial services industry' in Australia refer to the Australian Bureau of Statistics (ABS) industrial division 'financial and insurance services'. The range of activities captured by this data include:

- raising funds by taking deposits and/or issuing securities;
- investment in financial assets;
- pooling risk by underwriting insurance and annuities;
- provision of retirement incomes; and
- specialised services facilitating or supporting financial intermediation, insurance and employee benefit programs.

Also included in this division are central banking, monetary control and financial regulation.[63]

3.3. The financial services industry in Australia

Australia has a services-based economy, with the services sector accounting for around 82 per cent of the economy's real gross value added (GVA)[64] and more than 85 per cent of employment. The financial services industry is the largest single industrial segment, generating A$131.7 billion or 9 per cent of total output[65] in Australia as at June 2014 — slightly more than the mining industry at 8.8 per cent (Figure 8).[66]

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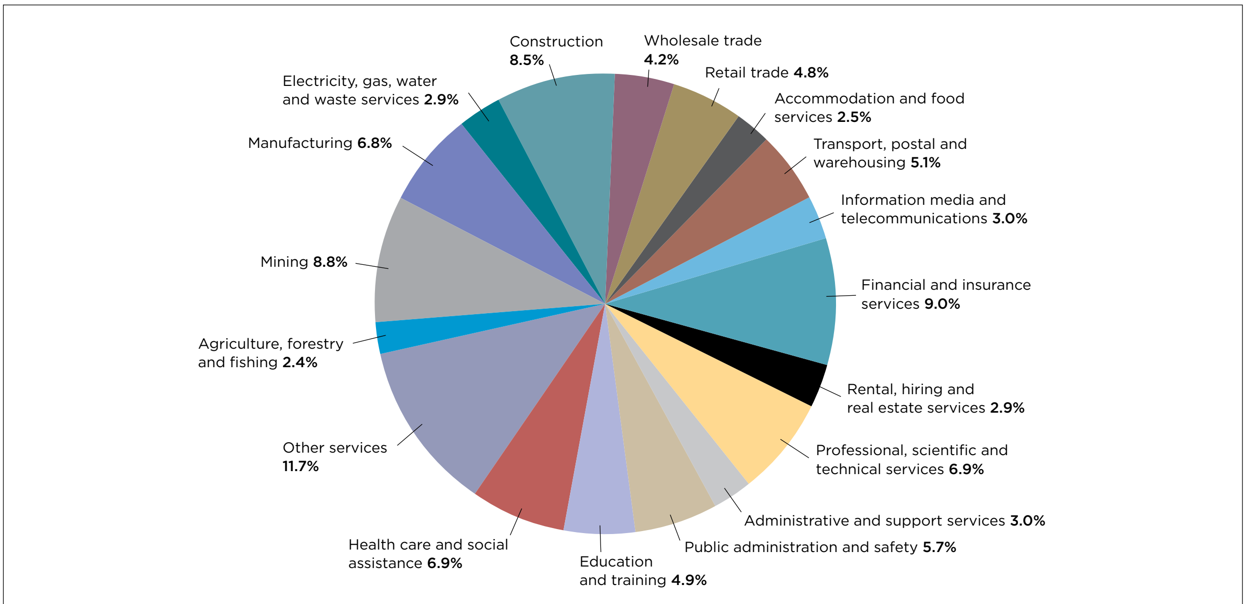
FIGURE 8: Composition of the Australian economy by industry GVA, June 2014



Source: ABS Cat. No. 5204.0, 2013-14, Table 5. 'Other services' here includes the categories Ownership of Dwellings (9.0%), Arts and Recreation Services (0.8%), and Other Services (1.9%).

63. Australian Bureau of Statistics (2013), '1292.0 — Australian and New Zealand Standard Industrial Classification (ANZSIC), 2006 (Revision 2.0)', 26 June.
64. Industry GVA is the term used to describe the unduplicated value of goods and services produced by individual industries. This measure removes the distortion caused by variations of taxes and subsidies across individual industries.
65. Note: The sum of industries' GVA does not exactly add up to GDP, as the former does not include taxes less subsidies on products.
66. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015'.

Over the last four decades, the financial services industry has grown in its contribution to the Australian economy.[67] The industry has recorded the second-highest average annual growth rate of any industry since 1992, behind only information media and telecommunications, with an average growth rate of 5.0 per cent per annum.[68]

The financial services industry employs 413,000 people (part-time and full-time workers). By way of comparison, the mining industry employs 229,000 people.[69] Financial services employment is concentrated in state capital cities — particularly in Sydney and Melbourne, where many financial institutions have their head offices.[70] The industry accounts for 5.0 per cent of all employment in NSW and 3.7 per cent of all employment in Victoria (Figure 9). In NSW, the industry contributes about 13.5 per cent of state total GVA. In Victoria, the equivalent figure is 11.1 per cent.

FIGURE 9: Percentage contribution of the financial services industry to state employment

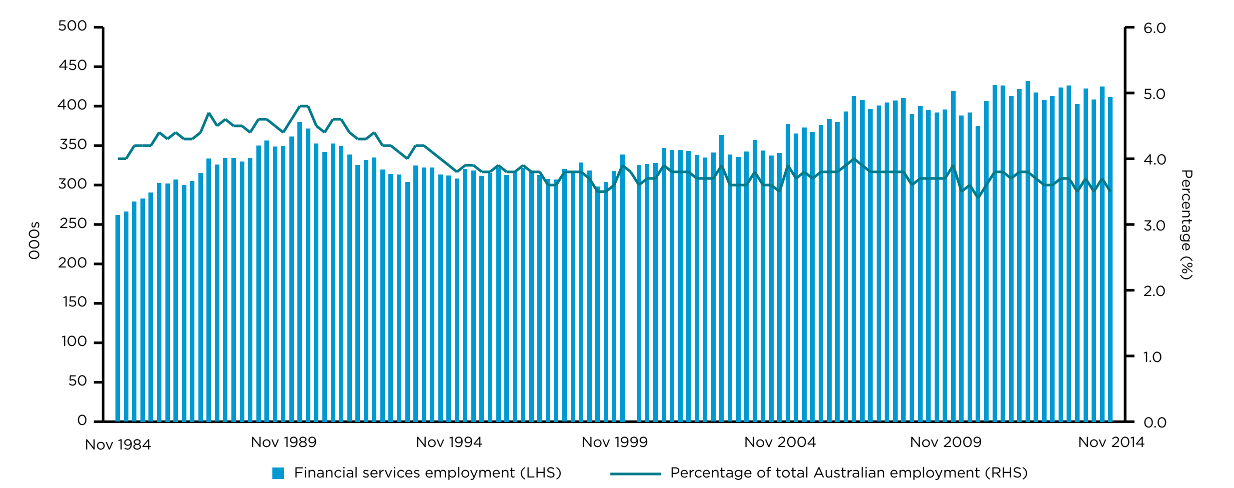
Source: ABS Cat. No. 6291.0.55.003, November 2014, Table 5.

The industry now contributes a smaller share of Australia's total employment (Figure 10), but the increasing share of GVA indicates that financial services workers have become comparatively more productive. The industry has the second-highest labour productivity in Australia, second only to mining, generating over A$160 per hour of labour worked.[71]

The financial services industry has the second-highest labour productivity in Australia, second only to mining, generating over A$160 per hour of labour worked.

67. Financial system growth has had three main drivers: a substantial increase in household borrowing since financial liberalisation in the 1980s; growth in the superannuation savings pool; and the very rapid growth of financial markets. Source: Maddock, R (2014), 'Is the Australian Financial Sector Too Big?', *ANZ BlueNotes*, 16 April.
68. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015'.
69. The largest employers are the health care and social assistance industry (1,385,000 people); the retail trade industry (1,249,000 people); and the construction industry (1,055,000 people).
70. Department of Employment (2014), 'Australian Jobs 2014'.
71. PwC (2012), 'PwC Productivity Scorecard', September, p. 4.

FIGURE 10: History of financial services industry employment in Australia



Source: ABS Cat. No. 6291.0.55.003, November 2014, Table 5.

The industry is also the biggest net contributor to corporate income tax. In tax year 2011–12 (the latest year for which data are available), the industry paid A$18.3 billion in net company tax, equivalent to 28.5 per cent of all net company tax paid in Australia.[72] In 2011, the Treasury calculated that the average tax rate (ATR) paid by the financial services industry was 36 per cent above the economy-wide ATR average — second only to the transport and storage industry, with an ATR 59 per cent above the average.[73]

Australia's financial system is sound, resilient, and well-managed. In the aftermath of the global financial crisis, both the Australian economy and the financial system outperformed most of their peers. According to the International Monetary Fund (IMF), Australia's financial regulatory and supervisory framework exhibits a high degree of compliance with international standards, and efforts have been made to strengthen the financial safety net and crisis management framework in recent years.[74]

Financial services companies (excluding conglomerates like Wesfarmers, which have subsidiaries that engage in financial services) comprise eight of the top 20 ASX-listed companies by market capitalisation, and the 'big four' banks had a combined market capitalisation of approximately A$469 billion at the end of March 2015. Listed financial services companies account for around 40 per cent of the benchmark ASX 200 index and are thus a major component of the average Australian investment portfolio.[75]

Australia's big four banks (Commonwealth Bank, Westpac, ANZ and NAB) are among a small minority of banks globally to maintain an AA- (or AA2) credit rating by the three major ratings agencies.[76] In the lead-up to the financial crisis, the average return on equity of the major banks was around 16 per cent, and has since averaged about 14 per cent. These rates are comparable to those achieved by other large Australian companies, as well as by major foreign banks before the crisis.[77]

Australia's financial services industry has significant depth, with assets of around A$6.4 trillion — over four times nominal GDP. Australia's A$1.6 trillion superannuation system is the fourth largest in the world. This pool of assets is expected to grow to A$7.6 trillion over the next two decades,[78] largely on the back of the legislated superannuation guarantee.

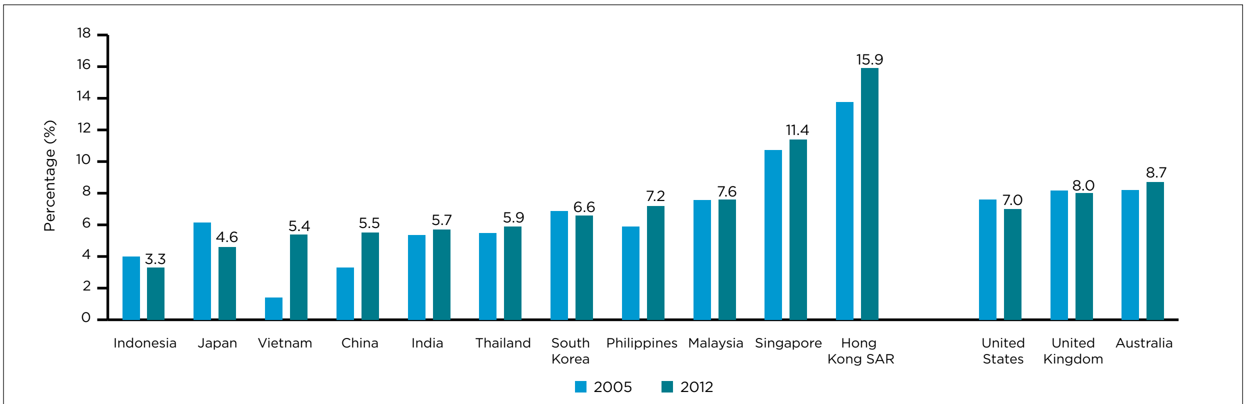
72. Australian Taxation Office (2012), 'Company Tax Table 4 — Selected Items, by Industry, 2011–12 Income Year', Taxation Statistics 2011–12, Detailed Tables.
73. Clark, J, Greagg, P and Leaver, A (2011), 'Average Rates of Company Tax Across Industries Revisited', *Economic Roundup*, The Treasury, Issue 2. Some of the possible explanations for the financial services industry's high ATR include the effect of reconciliation items (such as capital gains and losses, R&D tax concessions, and exempt income), which are not uniformly distributed across industries, and the industry's above-average level of investment in intangible assets, which are more heavily taxed than other investments in Australia.
74. International Monetary Fund (2012), 'Australia: Financial System Stability Assessment', IMF Country Report No. 12/308.
75. AMP Capital (2014), 'How Exposed are You to Australian Banks?', Insight Paper, December.
76. Cunningham, A (2014), 'World's Safest Banks 2014', *Global Finance Magazine*, 13 November.
77. Financial System Inquiry (2014), Interim Report, Chapter 2.
78. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015'.

3.4. The financial services industry across the Asia-Pacific region

The financial services industry is an important contributor to economic output in a number of countries across the Asia-Pacific, but on average is smaller — as a proportion of the overall economy — than in the United States, the United Kingdom and Australia. Figure 11 shows that the industry's GVA ranges from about 3.3 per cent of economic output in Indonesia to 5.5 per cent in China and 7.6 per cent in Malaysia. Japan and South Korea have seen their financial services industries contract, on a proportional basis, over the past seven years largely as a result of the global financial crisis. However, a number of countries have witnessed considerable financial industry growth over the past several years, including China, Vietnam, the Philippines, Singapore, and Hong Kong SAR.

The financial services industry is an important contributor to economic output in a number of countries across the Asia-Pacific, but on average is smaller — as a proportion of the overall economy — than in the United States, the United Kingdom and Australia.

FIGURE 11: Gross value added by the financial services industry as a proportion of total economic output, 2005 and 2012

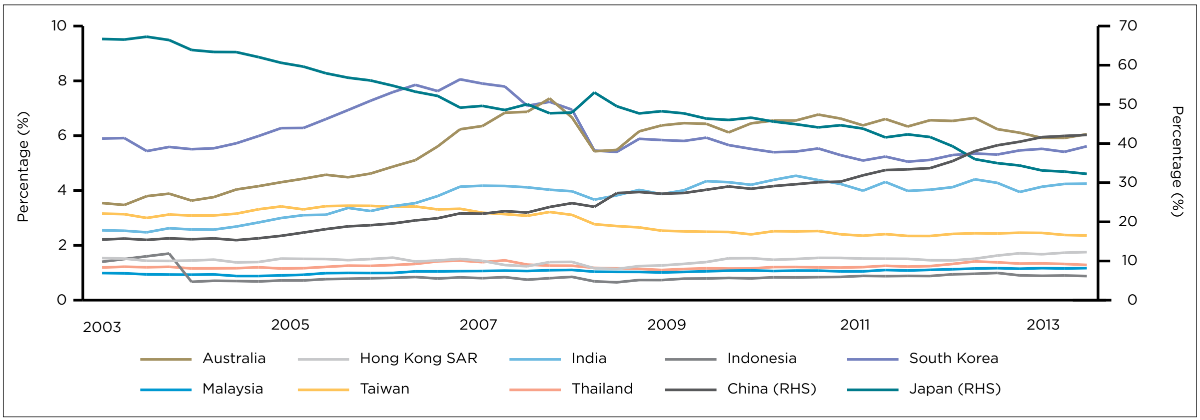


Source: United Nations Department of Economic and Social Affairs, National Accounts Statistics: Main Aggregates and Detailed Tables, 2013; United States Bureau of Economic Analysis; ACFS calculations.[79] Figures for India are at 2005 and 2011 because of a lack of 2012 data.

79. Data for 'financial and insurance activities' was used for those countries reporting on an ISIC (International Standard Industrial Classification) rev. 4 basis, i.e. Australia, Hong Kong SAR, Japan, Philippines, South Korea, Singapore, United Kingdom, United States and Vietnam. Data for 'financial intermediaries' was used for those countries reporting on an ISIC rev. 3 basis, i.e. China, India, Indonesia, Malaysia and Thailand. United States data is presented as a percentage of GDP rather than GVA. All countries report on a calendar year basis except Australia (fiscal year beginning 1 July) and India (fiscal year beginning 1 April). Calculations were based on nominal prices.

Comparing outstanding credit across economies in the Asia-Pacific further illustrates the growth in the size of the financial system in specific countries relative to the region. Total credit outstanding in the Asia-Pacific region has doubled in the past decade, growing from US$16.6 trillion in June 2004 to US$38.7 trillion in June 2014. The dominance of Japan in the banking credit market has eroded, with Japan's share of total outstanding credit in the region falling from more than 60 per cent in 2003 to just over 30 per cent today. Rapid growth in outstanding credit in China — and, to a much lesser extent, India — has led to a somewhat more even spread in the distribution of credit across the region. China now has the region's largest share of domestic credit outstanding, at 40 per cent of the total (Figure 12).

FIGURE 12: Share of domestic credit outstanding as percentage of total Asia-Pacific[80] domestic credit



Source: CEIC database; ACFS calculations.

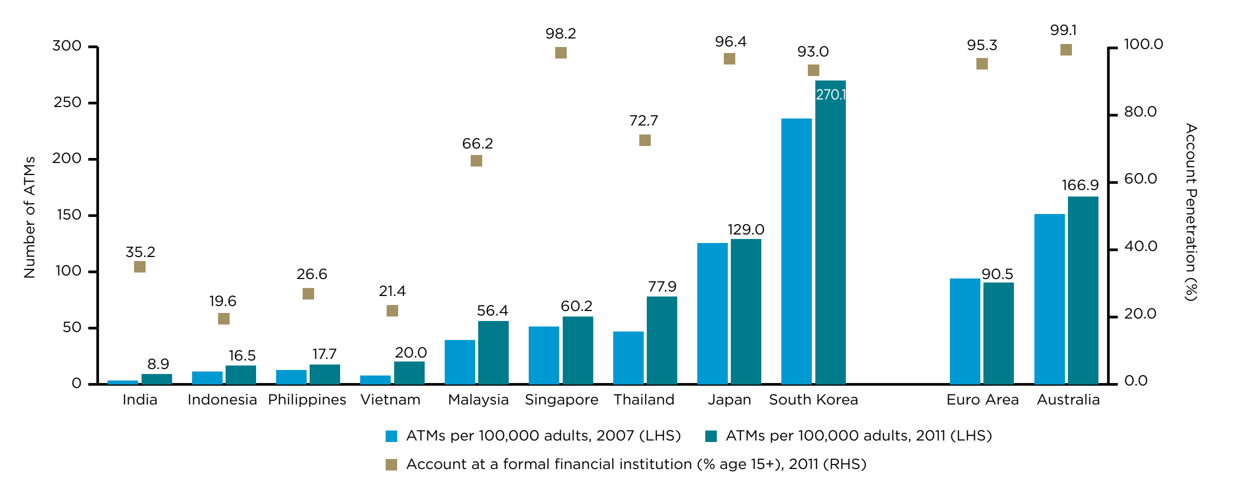
Despite a high rate of system growth, there is still a degree of financial system underdevelopment in a number of Asia-Pacific countries. Figures 13 to 15 display some useful metrics for measuring financial services penetration and financial system depth and development.

At the basic retail banking level, Figure 13 shows that the number of ATMs per capita in much of the Asia-Pacific lags behind the developed economies of Japan, South Korea, Australia and (to a lesser extent) the euro area. Account penetration rates (measured by the proportion of people over 15 years of age with an account at a financial institution) remain comparatively low, except for in Singapore, Japan, and South Korea. In Australia, 99.1 per cent of people over 15 years of age have a financial account, while the equivalent figure is just 21.4 per cent in Vietnam and 19.6 per cent in Indonesia.

In Australia, 99.1 per cent of people over 15 years of age have a financial account, while the equivalent figure is just 21.4 per cent in Vietnam and 19.6 per cent in Indonesia.

80. 'Asia-Pacific' here includes Australia, China, Hong Kong SAR, India, Indonesia, Japan, Malaysia, New Zealand, Philippines, Singapore, Sri Lanka, South Korea, Taiwan, and Thailand.

FIGURE 13: Number of ATMs per 100,000 adults and proportion of adults (age 15+) with an account at a formal financial institution[81]



Source: World Bank Global Financial Development Database. Note: ATM data are not available for China, and are not available for Hong Kong SAR prior to 2010. ATM figures for South Korea are at 2007 and 2010 because of a lack of 2011 data.

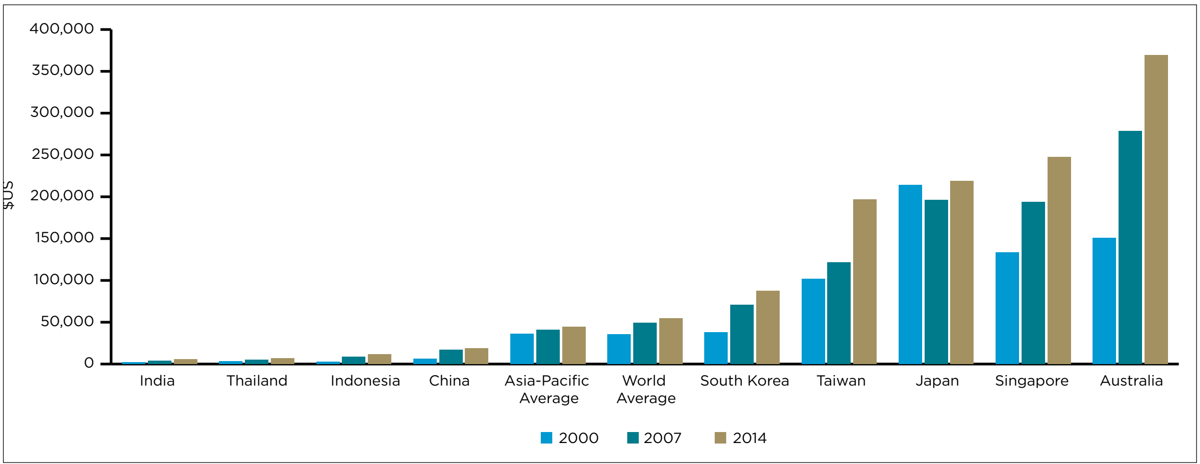
Asia's funds management industry is also relatively small in most countries, excluding the major financial centres. Australia's pool of assets under management (AUM), at A$2.4 trillion, or US$1.8 trillion, is the third largest in the world and the largest in the Asia-Pacific region. Hong Kong SAR has AUM of US$1.7 trillion, while Singapore has US$1.5 trillion. The rest of the region holds assets on a much lower order of magnitude: Japan has US$825 billion — or about half the AUM in Hong Kong SAR — followed by China (US$561 billion), South Korea (US$309 billion), and India (US$127 billion).[82]

The comparatively small pools of assets under management stand in stark contrast to the growing accumulation of wealth in Asia in this century. Total household wealth in the smaller economies of the Asia-Pacific region (i.e. excluding China, Japan, and India) has more than tripled since the start of the millennium, according to Credit Suisse. Over the same period, wealth per adult (at constant exchange rates) in India and China has risen by a factor of 2.9 and 2.8, to US$5,764 and US$18,515, respectively. Across the Asia-Pacific, excluding China and India, wealth per adult in US dollar terms stood at US$44,708, only just below the world average of US$54,715. Figure 14 shows wealth per adult in countries across the Asia-Pacific region.

The comparatively small pools of assets under management stand in stark contrast to the growing accumulation of wealth in Asia in this century.

81. 'Account at a formal financial institution' means respondents with an account (self or together with someone else) at a bank, credit union, another financial institution (e.g. cooperative or microfinance institution), or the post office (if applicable), including respondents who reported having a debit card.
82. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015'.

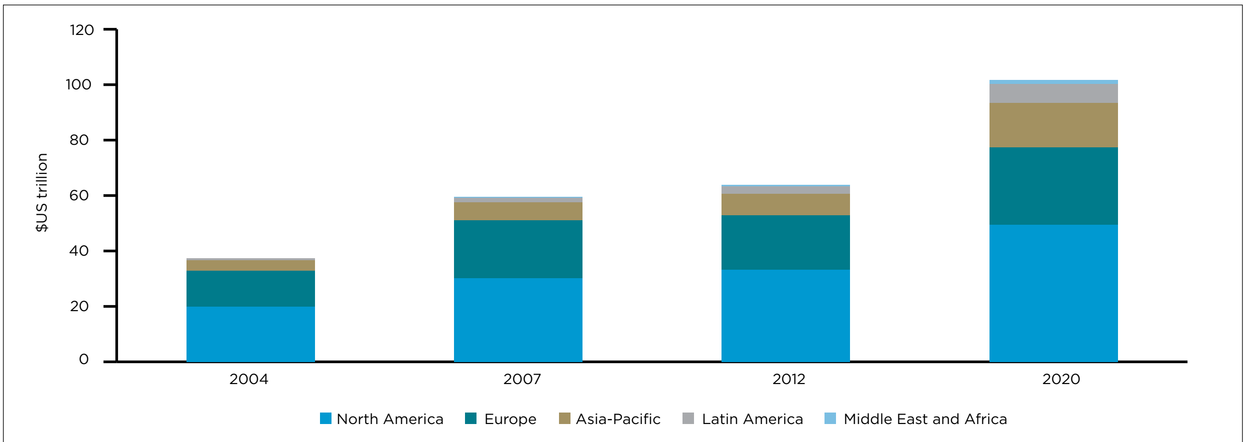
FIGURE 14: Wealth per adult (in USD) at constant exchange rates for 2000, 2007 and 2014



Source: Credit Suisse Global Wealth Databook 2014, Table 6.2.

China accounts for 8.1 per cent of global wealth, but in per capita terms has only half the average wealth per adult of the Asia-Pacific region average.[83] Despite China's position as the second-largest economy in the world (in purchasing power parity terms), its high economic growth rate and the fact that it has some 20 per cent of the world's population, China at present is only the fifth-largest holder of assets under management in the region. Anticipation of China's increasing role in global asset management contributes to PwC's forecast of 9.8 per cent compound annual growth rate in AUM in the region, to reach US$16.2 trillion by 2020 (Figure 15).

Figure 15: Projections for assets under management by region



Source: PwC, 'Asset Management 2020: A Brave New World.'

There is a large body of empirical literature that examines the link between development of the financial system and economic development. Much of it supports a positive causal link of financial development as a facilitator of economic growth and development. This provides a rationale for policies to support the development of the financial services industry, one aspect of which is policies to increase the involvement of foreign financial institutions and to grow trade in financial services.[84]

83. Credit Suisse (2014), 'Global Wealth Report 2014', October.
84. Davis, K (2012), 'Trade in Financial Services', paper prepared for the Melbourne APEC Finance Centre Workshop, Singapore, 27–28 November.

3.5. Australia's cross-border trade in financial services

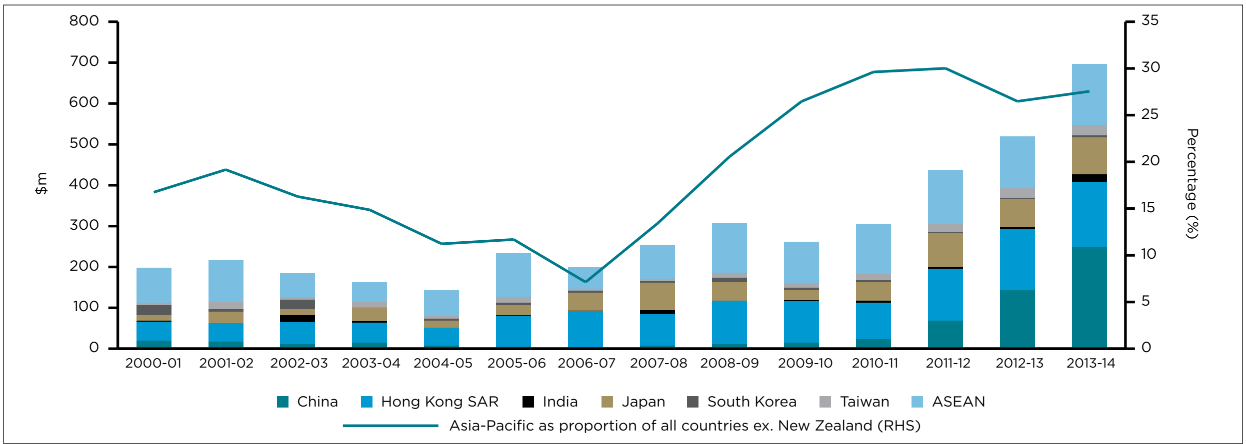
Australia's recent economic record reflects its unique position within, and increasingly strong ties to, the Asia-Pacific region. Australia's total two-way trade in goods and services in 2013–14 totalled A$669 billion, equivalent to about 42 per cent of GDP. Goods and services exports totalled A$331 billion. Exports of services, however, contributed only A$57.4 billion (or 17.3 per cent) of Australia's total global exports in 2013–14,[85] of which Asian markets claimed approximately A$30.6 billion or 53.4 per cent.

Financial services exports are separated into 'financial services' and 'insurance and pension services' in the official data. Total exports of both categories stood at A$3.3 billion in 2013–2014, or just 5.7 per cent of Australia's services exports and less than 1 per cent of overall exports. Financial services account for A$2.8 billion (85 per cent of the total), and insurance and pension services account for the remaining A$530 million (15 per cent) of financial services exports. However, as discussed in the next section, these data do not capture the full extent of financial services exports.

Figures 16 and 17 show the recent trend in exports of Australian financial services and insurance and pension services to the Asia-Pacific region, relative to the world.[86] The Asia-Pacific region accounts for 80 per cent of all insurance and pension services exports (ex. New Zealand), but only 28 per cent of the larger financial services export segment. China and Hong Kong SAR are the largest purchasers of Australian financial services exports, followed by Japan. Financial services exports to ASEAN nations have also increased over time.

The Asia-Pacific region accounts for 80 per cent of all insurance and pension services exports, but only 28 per cent of the larger financial services export segment.

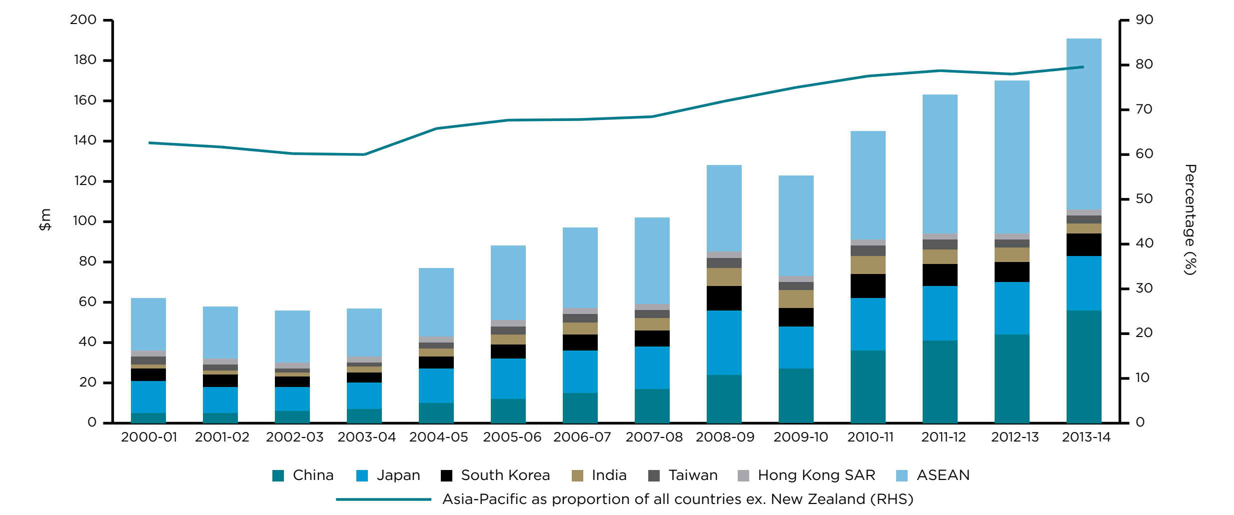
FIGURE 16: Australia's exports of financial services to the Asia-Pacific region



Source: ABS Cat. No. 5368.0.55.003, Table 5. Care should be taken in interpreting the country allocations in ABS data because approximately 15 per cent of credits (e.g. A$427 million in 2013-14) are unallocated to a particular country.

85. Australian Trade Commission (2015), 'Why Australia Benchmark Report 2015'.
86. We exclude New Zealand, given the close integration between the Australian and New Zealand financial systems.

FIGURE 17: Australia's exports of insurance and pension services to the Asia-Pacific region



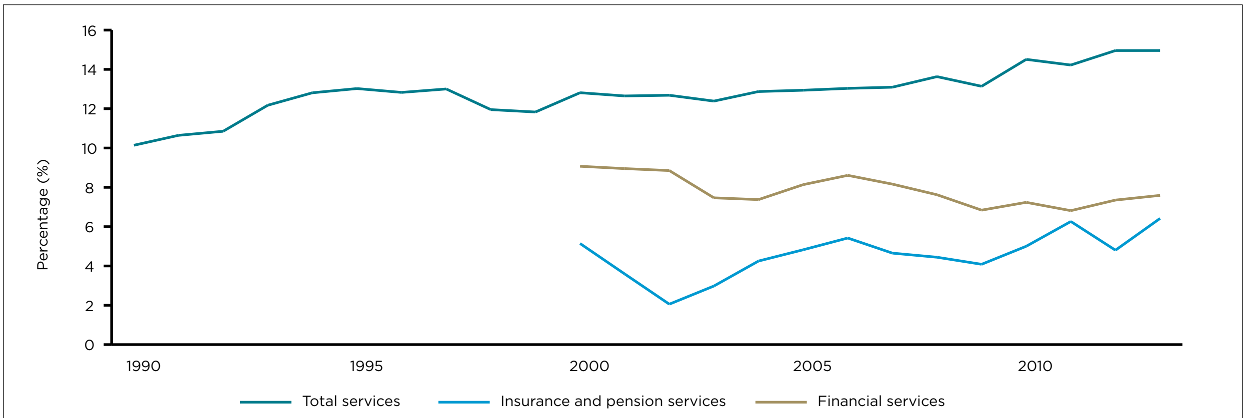
Source: ABS Cat. No. 5368.0.55.003, Table 5.

3.6. Asia-Pacific cross-border trade in financial services

Obtaining a full picture of the global trade in financial services is challenging, and attempts to drill down into detail on the Asia-Pacific region are even more so. A range of international organisations compile statistics on international trade in services.[87] The most useful dataset that permits apples-to-apples comparison comes from the United Nations Conference on Trade and Development (UNCTAD). Data are presented for the East Asia and Southeast Asia (ASEAN) subregions.

UNCTAD data show that East Asia[88] was responsible for 15.0 per cent of the world's total services exports in 2013, with this share growing over the past two decades (Figure 18). However, exports of insurance and pension services and financial services have not kept pace with growth in exports of other services such as construction, which now account for 28.9 per cent of the world total.

FIGURE 18: East Asia's total services exports, insurance and pension services exports, and financial services exports as a percentage of total world exports

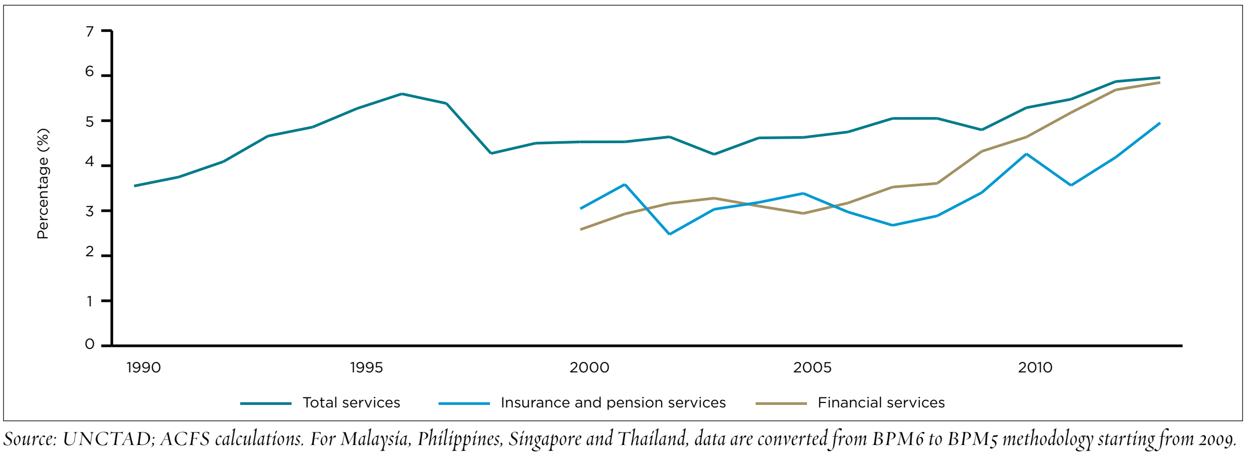


Source: UNCTAD; ACFS calculations. For Hong Kong SAR and Macao SAR, data are converted from BPM6 to BPM5 methodology starting from 2009.[89]

87. These include Eurostat, the IMF, the International Trade Center (ITC), the Organisation for Economic Cooperation and Development (OECD), the United Nations, the World Trade Organization (WTO), and the UNCTAD. See: United Nations Statistics Division (2010), 'Overview of Database on Statistics of International Trade in Service'.
88. 'East Asia' includes China, Hong Kong SAR, Japan, Macao SAR, Mongolia, North Korea (for which no data is available), South Korea, and Taiwan.
89. BPM5 classifies 'insurance services' and 'financial services' among its 11 standard services components. BPM6 classifies 'insurance and pension services' and 'financial services' among its 12 standard services components.

The UNCTAD data show ASEAN[90] contributed 6 per cent of the world's total services exports in 2013. ASEAN's growth trajectory has been stronger than in East Asia in financial services exports (Figure 19). ASEAN's strongest services industry for exports was travel (9 per cent of the world total).

FIGURE 19: ASEAN's total services exports, insurance and pension services exports, and financial services exports as a percentage of total world exports



Source: UNCTAD; ACFS calculations. For Malaysia, Philippines, Singapore and Thailand, data are converted from BPM6 to BPM5 methodology starting from 2009.

The UNCTAD database shows Australia was responsible for 1.1 per cent of the world's total services exports, but just 0.5 per cent of insurance and pension services exports and 0.7 per cent of financial services exports. These figures are significantly smaller than Australia's 1.9 per cent share of global nominal GDP. Australia's strongest services industry for exports was travel, capturing 2.6 per cent of the world total. Travel (i.e. tourism) is the only services industry for which Australia's share of world exports exceeds its share of world GDP.

3.7. Financial services trade — foreign affiliates

The above figures would suggest that the export performance of the financial services industry in Australia is dismal: Australia's largest industry by GVA generates only 5.7 per cent of the nation's services exports and 1.0 per cent of total goods and services exports. However, the official data do not tell the full story.

A major limitation of the trade statistics, as captured in Australia's balance of payments, is that they do not cover services provided by an Australian commercial presence abroad or services provided in Australia by a foreign-owned enterprise. The General Agreement on Trade in Services (GATS) takes a wider view of 'trade', which is defined to include four modes of supply:

> *Cross-border supply* (mode 1) occurs when a service is delivered from a supplier abroad to a consumer in their country of residence without either supplier or consumer moving into the country of the other.

> *Consumption abroad* (mode 2) occurs when a consumer resident in one country moves to another country to obtain a service.

> *Commercial presence* (mode 3) occurs when a commercial presence abroad is established (i.e. subsidiary, branch or joint venture) to supply services to the consumer in their country of residence.

> *Presence of natural persons* (mode 4) occurs when an individual moves to the country of the consumer in order to provide a service without becoming a resident of that country.[91]

90. ASEAN includes Brunei Darussalam, Cambodia, Indonesia, Laos, Malaysia, Myanmar, Philippines, Singapore, Thailand, Timor-Leste and Vietnam.
91. ABS Cat. No.5485.0 — Australian Outward Finance and Insurance Foreign Affiliate Trade, 2009–10, 'Explanatory Notes'.

Modes 1, 2 and 4 are combined and classified as exports or imports in the official balance of payments data. The ABS collects only data on modes 1, 2 and 4 on a regular basis. As such, the official data do not ordinarily capture the majority of financial services provided offshore by any of Australia's multinational financial services companies. Unlike in goods trade, for services companies to deliver services they often need to establish a commercial presence (known as a foreign affiliate) in the host country. The services provided by foreign affiliates are referred to as Foreign Affiliates Trade in Services (FATS).[92]

The official data do not ordinarily capture the majority of financial services provided offshore by any of Australia's multinational financial services companies.

Cross-border activity tends to be concentrated in wholesale business and financial services for sophisticated customers. However, at the retail level, the fiduciary nature of many financial services (e.g. deposit-taking or the provision of life insurance) demands a level of consumer trust that may be more easily met by an institution physically located in the market. Easy contact with a bank or insurance company underpins a customer's confidence. Regulators may also require a commercial presence to better ensure prudential soundness and consumer protection.[93] For these reasons, provision of financial services through mode 3 is often necessary for financial institutions wishing to build market share abroad.

Table 1 presents an indicative summary of major Australian financial institutions' operations in the Asia-Pacific region. These eight institutions are all in the top 25 largest companies listed on the ASX by market capitalisation.

92. 'Foreign affiliates' refers to enterprises that are majority owned by Australian resident enterprises (more than 50 per cent of the ordinary shares or voting stock). This includes offshore subsidiaries, branches and majority-owned foreign joint ventures.
93. Organisation for Economic Cooperation and Development (2000), 'Cross-Border Trade in Financial Services: Economics and Regulation', *Financial Market Trends*, No. 75.

TABLE 1: Examples of Australian financial institutions' operations in the Asia-Pacific region

Company	Selected Asia-Pacific operations
AMP	Presence in China, Hong Kong SAR, India, and Japan.[94] Building preferential distribution partnerships in select Asian markets, particularly China and Japan.[95]
ANZ	Presence in Cambodia, China, Hong Kong SAR, India, Indonesia, Japan, Laos, Malaysia (representative office), Philippines, Singapore, South Korea, Taiwan, Thailand (representative office), and Vietnam. Pacific presence in American Samoa, Cook Islands, Fiji, Guam, Kiribati, New Caledonia, Solomon Islands, Timor Leste, Tonga, and Vanuatu. Largest Australian bank operating in the Asia-Pacific.[96] 2.6 million customers in the Asia-Pacific (up from 925,000 in 2007), supported by 9,100 employees and 94 branches and points of representation (up from 30 branches in 2007).[97]
Commonwealth Bank	Presence in China, Hong Kong SAR, India, Indonesia, Japan, Singapore, and Vietnam.[98] China and Indonesia identified as main focus for the future. [99]
IAG	Presence in China, India, Malaysia, Thailand, and Vietnam. Indonesia identified as a market of interest. Goal for Asian businesses to represent 10 per cent of gross written premium on a proportional basis by 2016.[100]
Macquarie	Presence in China, Hong Kong SAR, India, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, and Thailand. A$558 million net operating income earned in Asia (13.3 per cent of group total) in second half of 2014.[101]
NAB	Presence in China, Hong Kong SAR, India, Indonesia (representative office), Japan, Singapore, and Vietnam.[102] A$256 million income earned in Asia (1.3 per cent of group total) in 2014.[103]
QBE	Presence in China, Hong Kong SAR, India, Indonesia, Malaysia, Macau SAR, Philippines, Singapore, Thailand, and Vietnam.[104] Pacific presence in Fiji, Papua New Guinea, Solomon Islands, and Vanuatu. Asia region (ex. Pacific) generated gross written premium of A$671 million,[105] or 4.1 per cent of group total.
Westpac	Presence in China, Hong Kong SAR, India, Indonesia (representative office), and Singapore. Pacific preference in Cook Islands, Fiji, Papua New Guinea, Samoa, Solomon Islands, Tonga, Vanuatu.[106] Goal to increase Asian revenue to A$750 million by 2017.[107]

Source: Company websites, news media.

According to data compiled by *Business Review Weekly* (*BRW*), four of these financial institutions — ANZ, IAG, QBE and NAB — are among Australia's 50 largest exporters to Asia as measured by company revenue generated in Asia (Table 2). The *BRW* estimate of ANZ's revenue from Asia alone, at A$4.8 billion in 2013, exceeds the A$3.3 billion figure provided in the ABS statistics for Australia's exports of financial services to the entire world.

94. AMP (2015), 'About AMP' <https://www.amp.com.au/amp/about-amp>
95. AMP (2014), '2014 Annual Report', p. 10.
96. ANZ (2013), 'Why Choose ANZ' <http://www.anzbusiness.com/why-choose-anz.html>
97. ANZ (2012), 'ANZ's Super Regional Strategy Five-Year Progress Report'.
98. Commonwealth Bank (2015), 'Asia' <https://www.commbank.com.au/about-us/our-company/international-branches/asia.html>
99. Murdoch, S (2012), 'Commonwealth Bank Pledges 'Discipline' Amid Asian Expansion', *The Australian*, 19 April.
100. Insurance Australia Group (2015), 'Asia' <http://www.iag.com.au/about-us/what-we-do/our-business/asia>
101. Macquarie Group (2014), '2014 Annual Review', p. 5.
102. National Australia Bank (2015), 'About Us' <http://www.nabasia.com/asia/about-us/en/index.html>
103. National Australia Bank (2015), 'Annual Financial Report 2014', p. 98.
104. QBE (2014), 'Asia' <http://www.qbeap.com/operations-asia.php>
105. QBE (2014), 'Annual Report 2014', p. 43.
106. Westpac (n.d.), 'Asia' <http://westpac.asia>
107. Kehoe, J (2013), 'Westpac's Bit-by-bit Asian Push', *Australian Financial Review*, 25 February.

TABLE 2: Financial institutions among Australia's top 50 exporters to Asia, 2013

Rank	Company	Asian revenue (A$ million)	Total revenue (A$ million)	Proportion of revenue from Asia (%)
6	ANZ	4,801.0	40,036.0	7.0
19	IAG	533.0	11,539.0	4.6
20	QBE	525.5	20,173.8	2.6
35	NAB	189.0	48,556.0	0.4

Source: BRW. Note that companies do not break out revenue by the same geographical definitions, making like-for-like comparisons difficult. Different industries also look at different figures — insurers, for example, focus on gross written premiums rather than statutory revenue figures.

It is difficult to capture the activities of foreign affiliates and their effects on host economies and parent enterprises. Only a few countries collect comparable statistics at present, including Canada, Japan, the United States, and a limited number of European countries.[108]

The ABS has conducted two FATS surveys to date. The first, in 2002–03, measured the economic activity of foreign affiliates of Australian enterprises for all industries. The survey results revealed that the finance and insurance industry division was one of the most significant for foreign affiliates in terms of employment and revenue with sales of A$26.3 billion, or 40 per cent of total sales of services from foreign affiliates in 2002–03.[109]

The ABS and DFAT survey found that Australia's finance and insurance affiliates abroad had sales valued at A$38.9 billion in 2009–10. This figure is larger than Australia's travel exports and double Australia's education services exports.

The ABS and the Department of Foreign Affairs and Trade (DFAT) then undertook a foreign affiliate survey focused specifically on the outward activities of the finance and insurance industry division. This was called the Survey of Outward Finance and Insurance Foreign Affiliate Trade in Services (SOFI FATS), conducted in respect of the 2009–10 financial year.[110]

This survey found that Australia's finance and insurance affiliates abroad had sales valued at A$38.9 billion in 2009–10.[111] By way of comparison, this figure is larger than Australia's travel (tourism) exports, which were valued at A$31.1 billion, and double Australia's education services exports, which were valued at A$19.1 billion in the same financial year.[112] Cross-border exports of financial services (including insurance and pension services) totalled just A$1.4 billion in the ABS data for the same financial year.

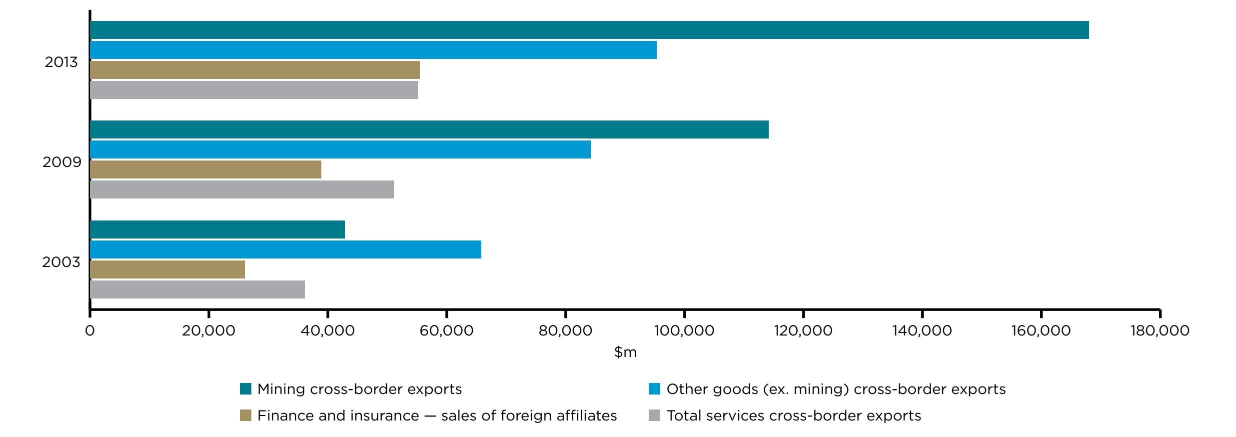
A comparison of the 2002–03 and 2009–10 surveys shows Australian finance and insurance affiliates expanding their presence abroad. Australian resident enterprises had 463 finance and insurance foreign affiliates abroad in 2002–03; this figure nearly trebled to 1,245 in 2009–10. The number of staff employed in overseas affiliates rose from 51,407 to 75,919, while wages and salaries paid increased from A$3.0 billion to A$6.7 billion.[113]

In 2015, AsiaLink released a study estimating that sales of foreign affiliates across all industries increased to approximately A$138 billion in 2013 and forecast a rise to A$174 billion by 2020. If the share of the finance and insurance industry division remained at 2002–03 levels (i.e. 40 per cent), this estimate suggests that finance and insurance foreign affiliates sales may have been A$55.4 billion in 2013 — a figure that exceeds the entire A$55.1 billion of cross-border services exports reported by the ABS for 2013 (Figure 20).

This estimate suggests that finance and insurance foreign affiliates sales may have been A$55.4 billion in 2013 — a figure that exceeds the entire A$55.1 billion of cross-border services exports reported by the ABS for 2013.

108. Department of Foreign Affairs and Trade (2012), 'Australia's Trade in Services with the United States'.
109. Australian Bureau of Statistics (2004), 'Australian Outward Foreign Affiliates Trade, 2002–03, Experimental Results', Feature Article, May.
110. The survey only included finance and insurance affiliates where Australia had a majority ownership (over 50 per cent), unless ownership restrictions in the host economy prevented the Australian head office from acquiring a 50 per cent stake. In these cases, affiliates with less than 50 per cent Australian ownership were also included in the survey.
111. This figure includes explicit fees and charges on the sale of services valued at A$28.1 billion and implicit service charges valued at A$10.7 billion. Implicit service charges, or Financial Intermediation Services Indirectly Measured (FISIM), are payments for financial services not achieved by direct sales but by the margin between interest rates applied to depositors and borrowers. See Bingham, F (2011), 'Australia's Outward Finance and Insurance Foreign Affiliates Trade in Services, 2009–10', Department of Foreign Affairs and Trade, revised 29 August.
112. Department of Foreign Affairs and Trade (2011), 'Analysis of Australia's Education Exports'.
113. ABS Cat. No. 5485.0 — Australian Outward Finance and Insurance Foreign Affiliate Trade, 2009–10, 'Analysis and Results'.

FIGURE 20: Cross-border exports and estimated sales of finance and insurance foreign affiliates at 2003, 2009 and 2013



Source: ABS Cat. No. 5368, February 2015; ABS Cat. No. 5368.0.55.004, 2013; ABS Cat. No. 5495.0, 2002-03; Department of Foreign Affairs and Trade; ANZ, PwC and AsiaLink; ACFS calculations.

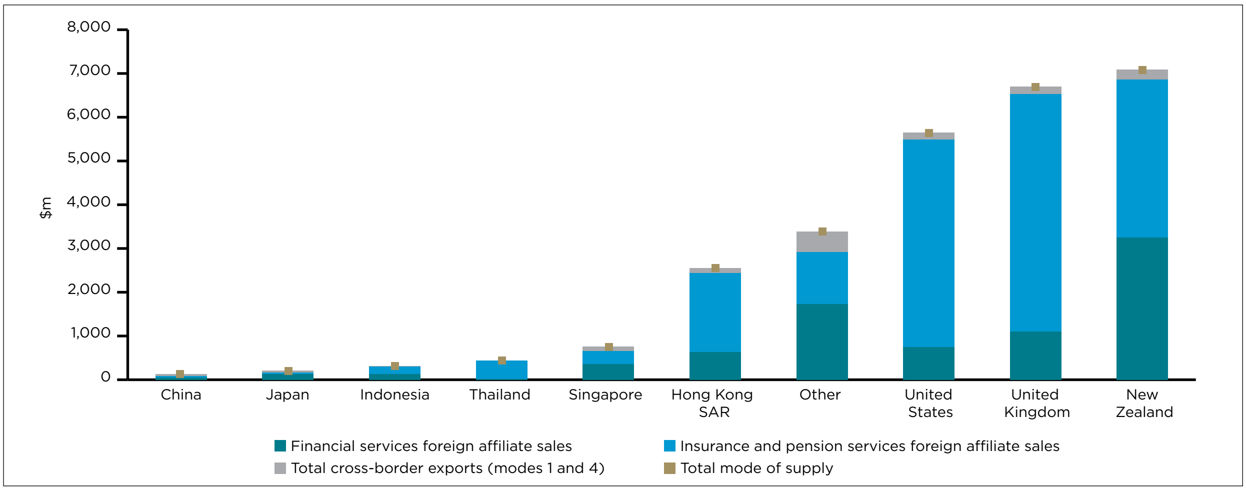
While inclusion of the FATS data series increases the value of Australia's exports of financial services by an order of magnitude, the geographic destinations remain broadly similar. New Zealand, the United States, and the United Kingdom together accounted for 72 per cent of total sales of Australian finance and insurance foreign affiliates. Between 2002–03 and 2009–10, sales grew the strongest for the Americas, up A$3.4 billion (or 87.2 per cent) followed by the Asia-Pacific, up A$1.6 billion (or 13.1 per cent). Sales to Europe (including Africa) fell A$2.4 billion (or 24.4 per cent).[114]

Figure 21 illustrates total financial services exports from Australia by destination to the major markets for those exports, incorporating all modes of supply.

Of interest is the fact that while the financial services category generates greater cross-border exports, insurance and pension services is actually the larger category once foreign affiliate sales are accounted for.

While the financial services category generates greater cross-border exports, insurance and pension services is actually the larger category once foreign affiliate sales are accounted for.

FIGURE 21: Total sales of financial services and insurance and pension services by Australia by mode of supply, 2009-10[115]



Source: ABS Cat. No. 5485.0, Table 4a. Caution should be exercised in interpreting this chart as the ABS does not allocate FISIM to individual countries for mode 3, but does for modes 1, 2 and 4.

114. Country groups here are based on the Standard Australian Classification of Countries (SACC).
115. The 'other' category includes all countries that have not satisfied confidentiality requirements. Sixty-one countries contribute to this category, with the largest contributors being Bermuda, Canada, the Cayman Islands, Germany, India, Ireland, Luxembourg, Mauritius, Mexico, South Africa, and South Korea.

Overall, the data reveal that while Australia's financial services industry is much more integrated into the global economy than the balance of payments data suggest, the orientation of these exports has not yet followed the shift of goods exports from traditional markets in New Zealand, United States and the United Kingdom toward the fast growing economies in the Asian region. However, as Table 1 indicates, this story is changing.

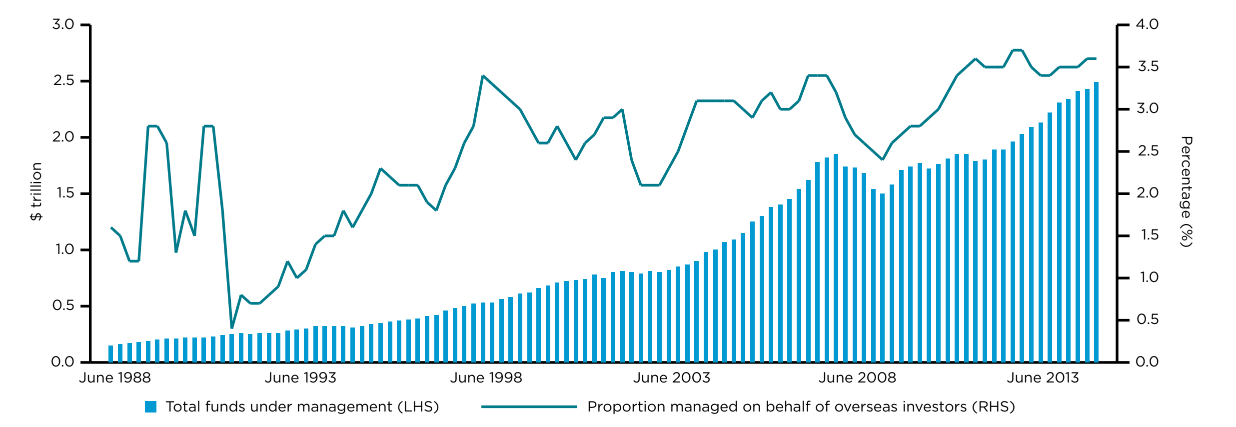
As was the case with outward foreign affiliate trade, inbound importation of financial services also shows the dominance of foreign affiliate sales. In 2013–14, foreign banks in Australia booked A$18.4 billion of revenue, greatly exceeding the A$1.5 billion figure for financial services imports recorded by the ABS for that year.[116] Seven foreign banks are authorised to operate subsidiaries and 40 are authorised to operate branches in Australia;[117] there are a number of foreign-owned insurers with Australian subsidiaries; and there is provision for unauthorised foreign insurers (UFIs) and eligible foreign life insurance companies (EFLICs) to provide certain services in Australia. Detailed data are not available on UFIs and EFLICs, but deposit-taking institutions and insurers are ordinarily required to seek authorisation from APRA and appear on APRA's public registers.

The majority of foreign banks' clients are large corporations, financial intermediaries and high net worth individuals.[118] Australia's status as a major trading partner with emerging Asian markets has encouraged foreign banks from these countries to expand into Australia. Japanese banks have been keen to expand their international presence, with Bank of Tokyo-Mitsubishi doubling its business loan book over the past five years.[119] Foreign banks in Australia employed 16,503 people in 2013–14. Foreign banks' combined revenue is forecast to grow at an annualised 3.6 per cent over the next five years.

3.8. Funds management industry exports

The ABS produces statistics that show the value of funds managed by Australian investment managers on behalf of overseas investors. At end-December 2014, the quantum of funds from offshore was A$90.1 billion.[120] The proportion of funds sourced from offshore represents only 5.4 per cent of funds managed by resident investment managers, or 3.6 per cent of the total (unconsolidated) A$2.4 trillion managed funds industry (Figure 22). Industry bodies have contrasted this figure with leading financial centres like Singapore, Hong Kong SAR and the United Kingdom, where 80 per cent, 65 per cent and 40 per cent of funds are sourced from offshore respectively.[121]

FIGURE 22: Proportion of funds under management in Australia managed on behalf of overseas investors



Source: ABS Cat. No. 5655.0, Table 1; ACFS calculations.

A report for the Financial Services Council (FSC) by Deloitte Access Economics estimates that the export of funds management services contributed A$336 million of direct value to the Australian economy in 2012–13 and added 1,426 full-time equivalent jobs. Total funds managed on behalf of overseas investors have seen a compound annual growth rate of 18.2 per cent since the global financial crisis. Deloitte modelling estimates that if funds management export revenue were to double, from its current level of A$442 million to A$884 million, this would result in an increase to GDP of approximately A$330 million by 2029–30, and increase the number of full-time employees in the industry by 1,500.[122]

116. ABS Cat. No. 5368.0.55.003, 2014, Table 7.
117. Australian Prudential Regulation Authority (2015), 'List of Authorised Deposit-taking Institutions', as updated 1 April <http://www.apra.gov.au/adi/pages/adilist.aspx>
118. The Banking Act does not allow foreign bank branches to accept deposits of less than A$250,000 from Australian residents.
119. Gargano, S (2014), 'Foreign Banks in Australia', IBISWorld, Industry Report K6221b, November.
120. These funds do not include investments held by Australian nominees on behalf of overseas investors.
121. Financial Services Council submission to Financial System Inquiry Stage 2, Chapter 4.
122. Deloitte Access Economics (2014), 'The Economic Impact of Increasing Australian Funds Management Exports'.

4. CROSS-BORDER CAPITAL FLOWS

4.1. Introduction

One of the critical roles of the financial system is to intermediate the flow of funds, both domestically and across national borders, that enable economic activity. The safe and secure transfer of payments, credit and investment is an essential economic function. The more open an economy is to international trade and investment, the more important the smooth flows of cross-border capital are for economic prosperity.

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Capital flows are a key aspect of the global monetary system. They can result in substantial benefits for countries, including through enhancing efficiency, promoting financial system competitiveness, and supporting long-term income growth through a more efficient international allocation of saving and investment.[123] From the perspective of investors, cross-border capital flows are important for diversification of investment. The benefits of diversification are well established in the academic literature, with an international portfolio of assets typically yielding a higher risk-adjusted return than a home-biased portfolio.

Diversification is based upon the assumption of low correlations in asset returns across markets. A recent study by the APEC Policy Support Unit found that an investment portfolio with funds from across the Asia-Pacific region would have lower correlations with other portfolios than one constructed within individual economies, indicating that investors can indeed gain in diversification by investing across Asian markets. In Australia the median correlation between domestic portfolios was 84 per cent, against 89 per cent in Singapore, 88 per cent in China, 81 per cent in Taiwan, and 70 per cent in South Korea. This contrasts to a correlation of just 59 per cent for a regional portfolio.[124]

Increasing integration in capital flows can also lead to surges in cross-border inflows or outflows, however, which in turn can generate high levels of asset price volatility.[125] The resulting challenges were particularly evident during the Asian financial crisis of 1997–98, when an abrupt and extraordinary reversal of private capital flows into South Korea, Indonesia, Thailand, Malaysia and the Philippines led to a spectacular financial crash and significant economic dislocation.[126]

The recent global financial crisis repeated past history, and its impact is still being felt. Relative to the size of the global economy, cross-border capital flows have shrunk since 2007 (Table 3). In that sense, the crisis unwound some of the financial integration in the developed economies of the United States and Europe that had occurred in years prior. In particular, portfolio investment flows have diminished, as have 'other investment' flows, much of which reflects a fall in cross-border lending by banks.[127]

The majority of this decline has occurred in relation to flows within the EU and between the EU and the rest of the world, reflecting the ongoing economic crisis there and the need for European banks to shore up their balance sheets under new regulatory requirements.

TABLE 3: Gross annual capital outflows as a percentage of GDP

	Yearly average			
	1980–89	1990–99	2000–07	2008–12
Foreign direct investment	1.0	1.5	2.9	2.9
Portfolio investment	1.2	2.3	4.2	1.4
Other investment	2.7	1.9	5.0	0.4
Reserves	0.8	0.5	1.2	1.5
Total	5.7	6.2	13.3	6.2

Source: James et al. (2014). Note: financial derivatives are excluded, and RBA estimates are used for some capital flows prior to 1994. 'Other investment' includes flows related to international banking transactions.

123. Organisation for Economic Cooperation and Development (2011), 'Getting the Most Out of International Capital Flows', OECD Economic Outlook, Vol. 2011/1, Chapter 6.
124. APEC Policy Support Unit (2014), 'Asia Region Funds Passport: A Study of Potential Economic Benefits', July, p. 35.
125. International Monetary Fund (2012), 'The Liberalization and Management of Capital Flows: An Institutional View', 14 November.
126. Grenville, S (1998), 'The Asia Crisis, Capital Flows and the International Financial Architecture', Talk to Monash University Law School Foundation, Melbourne, 21 May.
127. James, E, McLoughlin, K and Rankin, E (2014), 'Cross-border Capital Flows since the Global Financial Crisis', *Reserve Bank of Australia Bulletin*, June.

Having responded to the Asian financial crisis through thorough policy mechanisms that encouraged persistent current account surpluses, the Asia-Pacific region emerged relatively unscathed from the global crisis that followed a decade later.[128] Today, there is large variation in the size of capital flows across countries. At one extreme, the region includes financial centres like Hong Kong SAR and Singapore that channel capital flows several times the size of their GDPs, while at the other extreme capital flows are negligible relative to the size of the economy in some of the less-developed economies.[129]

The importance of Hong Kong SAR and Singapore in the region from a flow-of-funds perspective is difficult to overstate. The Global Financial Centres Index now ranks Hong Kong SAR and Singapore alongside New York and London as two of the four top global financial centres. The index also indicates that Asia continues to grow its financial standing; the top nine Asia-Pacific centres all saw increases in their rankings in 2015. Sydney ranked 21st and Melbourne 28th in 2015, behind Hong Kong SAR, Singapore, Tokyo, Seoul, and Shanghai in the Asia-Pacific region.[130]

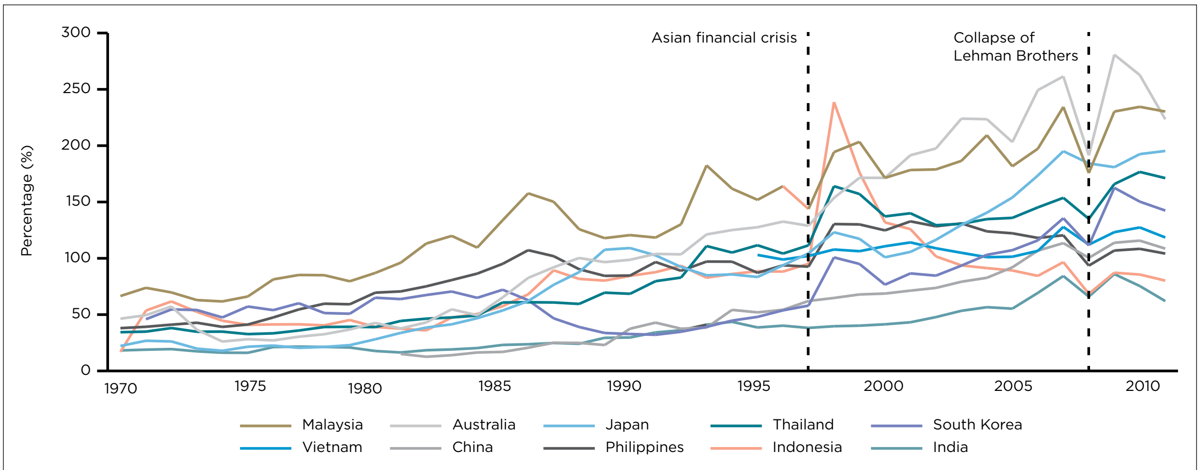
This section will examine Asia-Pacific financial integration from the perspective of cross-border capital flows between economies. We measure financial integration primarily through quantity-based measures (discussed in Subsection 2.2) that capture capital flows as simple ratios. The section begins with an overview of the international investment position of Australia and nations across the Asia-Pacific. Each type of capital flow is then discussed in turn: foreign direct investment, portfolio investment, and cross-border bank lending.

4.2. Growth of foreign assets and liabilities across the Asia-Pacific

The story of cross-border payments, investment and capital flows in the Asia-Pacific region has been one of expansion for the past several decades. Figure 23 shows total foreign assets and liabilities as a share of GDP for the major Asia-Pacific countries since 1970. All countries in the region (except for Malaysia, as of 2011) trail Australia on this measure of integration. However, there is a clear trend toward greater integration over the past four decades, with the global financial crisis appearing to have been only a temporary setback. While the ratio of foreign assets and liabilities to GDP varies considerably across the region, it has grown from less than 50 per cent in 1970 to more than 100 per cent in 2011 for most economies. India and Indonesia are notable exceptions.

The Australian economy has become more financially integrated with the global economy over the past several decades in terms of cross-border capital flows. Australia has been a net recipient of capital inflows for almost all of its modern economic history. Net capital inflows — or the difference between foreign investment in Australia and Australian investment abroad — are the financial counterpart to Australia's current account deficit. Put differently, investment in the Australian economy has consistently exceeded domestic saving and this gap has been funded from offshore.[131]

FIGURE 23: Sum of foreign assets and liabilities as a percentage of GDP for selected countries



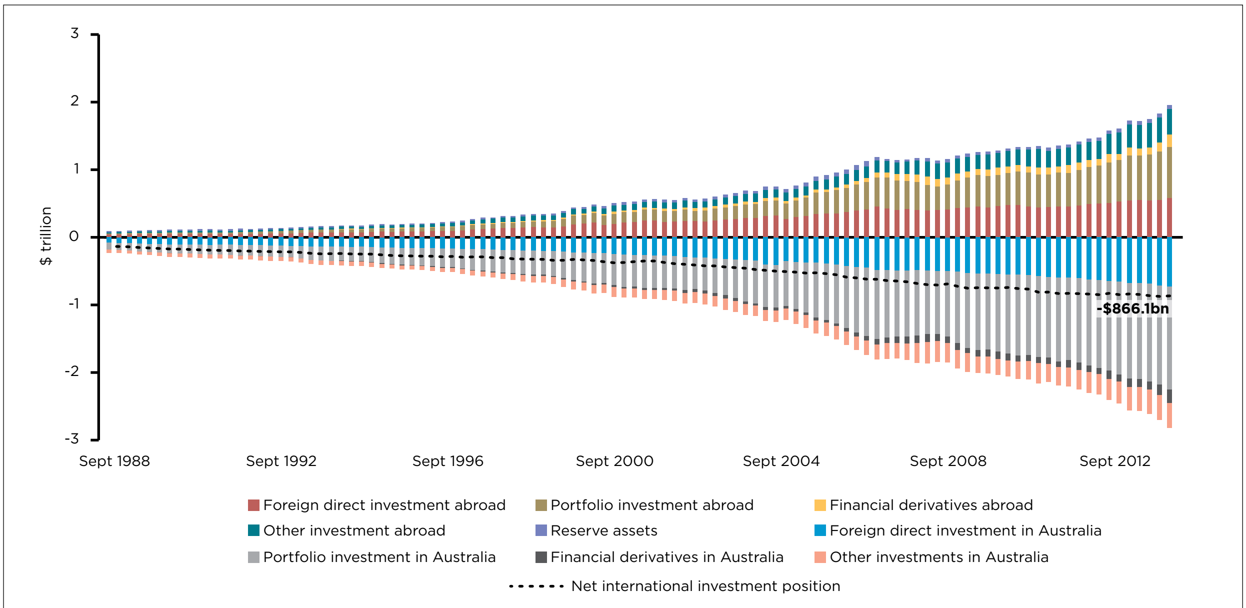
Source: Updated and extended 'External wealth of nations' dataset, 1970-2011. Note: The financial centres of Hong Kong SAR and Singapore are not shown, as their ratios (2,212 per cent and 1,576 per cent respectively, in 2011) are vastly larger.

128. Park, D and Shin, K (2009), 'Saving, Investment, and Current Account Surplus in Developing Asia', Asian Development Bank, ADB Economics Working Paper Series, No. 158.
129. Molnar, M, Tateno, Y and Supornsinchai, A (2013), 'Capital Flows in Asia-Pacific: Controls, Bonanzas and Sudden Stops', OECD Development Centre, Working Paper No. 320.
130. Z/Yen Group and Qatar Financial Centre Authority (2015), 'The Global Financial Centres Index 17,' March.
131. Debelle, G (2014), 'Capital Flows and the Australian Dollar', Speech to the Financial Services Institute of Australasia, 20 May.

The persistent need for Australia to fund its economic activity from overseas suggests that this element of financial integration is crucial to the real economy. Australia's net international investment position was a liability of A$866.1 billion at 31 December 2014, or about 54 per cent of GDP at current prices. Figure 24 shows the composition of Australia's foreign assets and liabilities, the net of which equals the net international investment position (IIP).[132]

Although Australia is financially integrated with the global economy, its orientation remains toward the mature markets of the United States, the United Kingdom and New Zealand.

FIGURE 24: Australia's gross foreign assets, gross foreign liabilities, and net international investment position



Source: ABS Cat. No. 5302.0, December 2014, Tables 28, 29 and 39. Note: The ABS does not provide data on reserve liabilities.

Portfolio investment is the largest component of Australia's two-way investment, totalling A$757.8 billion of assets and A$1.52 trillion of liabilities. This is followed by foreign direct investment (A$579.2 billion of assets and A$726.8 billion of liabilities), and 'other investment' (A$370.0 billion of assets and A$375.6 billion of liabilities), as at December 2014. Financial derivatives and central bank reserves are relatively small components of Australia's two-way investment profile.

Although Australia is financially integrated with the global economy, its orientation remains toward the mature markets of the United States, the United Kingdom and New Zealand. Together, these three economies account for 50 per cent of outbound and inbound investment. Japan is the only country in the Asia-Pacific region to rank in the top six investment destinations for outbound Australian direct investment (Table 4). The Asia-Pacific features more prominently in inbound investment into Australia (Table 5).

TABLE 4: Gross Australian investment abroad by counterpart country as at 31 December 2013

Partner country	Value (A$ billion)	Proportion of total (%)
United States	471.7	29
United Kingdom	255.7	16
New Zealand	81.1	5
Germany	56.5	3
Canada	53.7	3
Japan	50.2	3

Source: ABS. Cat. No. 5352.0, 2013.

132. Financial investors sometimes use the net IIP-to-GDP ratio to gauge the creditworthiness of a country. The more negative the ratio, the more a country becomes vulnerable to volatility in international financial markets. Many countries that accumulated a large negative net IIP in the run-up to the crisis lost access to financial markets when the crisis struck and needed international financial assistance to bridge their deficits.

TABLE 5: Gross foreign investment in Australia by counterpart country as at 31 December 2013

Partner country	Value (A$ billion)	Proportion of total (%)
United States	657.9	27
United Kingdom	562.9	23
Japan	131.0	5
Singapore	60.5	2
Hong Kong SAR	51.3	2
Switzerland	47.1	2

Source: ABS. Cat. No. 5352.0, 2013.

The following subsections analyse the three key components of international capital flows: foreign direct investment, portfolio investment, and cross-border bank lending.

4.3. Foreign direct investment

Foreign direct investment is defined as cross-border investment by a resident entity in one economy with the objective of obtaining a 'lasting interest' in an enterprise resident in another economy. The lasting interest implies the existence of a long-term relationship and a significant degree of influence by the investor on the management of the enterprise.[133]

Data from the UNCTAD and IMF suggest increased financial integration with respect to foreign direct investment globally.[134] For the 88 economies that reported data in both 2012 and 2013, inward direct investment positions increased 8.2 per cent from US$25.8 trillion in 2012 to US$27.9 trillion in 2013, outpacing global GDP growth. At the same time, growth appears limited to a handful of well-integrated countries, with 67 per cent of total inward direct investment received by the top 10 recipient economies[135] and 80 per cent of total outward direct investment originating from the top 10 investor economies.[136] In the Asia-Pacific region, China, Hong Kong SAR and Singapore are among the 10 largest recipient economies; Japan and Hong Kong SAR are among the 10 largest investor economies.

Table 6 provides a sense of where the largest economies in the Asia-Pacific sit with respect to integration through foreign direct investment, and how this integration has progressed over the past decade. The majority of Asian economies have seen strong growth in foreign direct investment relative to GDP, and are taking a greater share of the world total, indicating increased integration. This is particularly true for the larger economies of ASEAN, where the stock of foreign direct investment relative to GDP is rapidly approaching or above the norm in developed economies. Taken together, the total stock of foreign direct investment in the ASEAN countries included in table 6 is US$1.48 trillion, just above the stock of foreign direct investment reported in Hong Kong SAR as at 2013.

However, in many economies the stock of foreign direct investment relative to GDP remains lower than for peers in the Americas and Europe. Notably, despite huge inflows of foreign direct investment into China since its economic opening, its stock is less than half that of the United States or Australia and has actually declined over the past decade relative to GDP.

For the 88 economies that reported data in both 2012 and 2013, inward direct investment positions increased 8.2 per cent from US$25.8 trillion in 2012 to US$27.9 trillion in 2013, outpacing global GDP growth.

133. The direct investor must own at least 10 per cent of the voting power of the direct investment enterprise. Source: *OECD Benchmark Definition of Foreign Direct Investment*, 4th Edition.
134. The UNCTAD's annual foreign direct investment statistics provide data for 206 countries, covering inflows, outflows, inward stock and outward stock by region and economy. To provide global coverage for bilateral statistics, the UNCTAD database uses data from partner countries ('mirror data') as well as international organisations' data where national data is not available. The IMF's Coordinated Direct Investment Survey (CDIS) is conducted annually, starting with data for end-2009. Participation is voluntary.
135. Netherlands, Luxembourg, United States, China, United Kingdom, Hong Kong SAR, Germany, France, Switzerland, and Singapore.
136. Netherlands, United States, Luxembourg, United Kingdom, Germany, France, Switzerland, Japan, Hong Kong SAR, and Canada.

TABLE 6: Changes in share of global foreign direct investment stock, 2003–13

Economy	FDI stock (US$ billion) 2003	FDI stock (US$ billion) 2013	FDI as % of GDP 2003	FDI as % of GDP 2013	% share of world FDI 2003	% share of world FDI 2013	% CAGR 2008-13
World	*9,563*	*25,464*	*25.1*	*34.2*	*100.0*	*100.0*	*10.3*
Developed economies	*7,332*	*16,053*	*24.8*	*36.6*	*76.7*	*63.0*	*8.2*
Developing economies	*2,085*	*8,483*	*26.3*	*30.9*	*21.8*	*33.3*	*15.1*
United States	2,455	4,935	21.2	29.2	25.7	19.4	7.2
United Kingdom	635	1,606	33.8	63.4	6.6	6.3	9.7
Hong Kong SAR	432	1,444	267.4	523.6	4.5	5.7	12.8
China	228	957	13.8	10.3	2.4	3.8	15.4
Singapore	184	838	191.4	294.2	1.9	3.3	16.4
Australia	237	592	42.6	39.1	2.5	2.3	9.6
Indonesia	10	230	4.4	26.5	0.1	0.9	36.4
India	33	227	5.5	11.8	0.3	0.9	21.4
Thailand	51	185	33.7	45.4	0.5	0.7	13.7
Japan	90	171	2.1	3.5	0.9	0.7	6.7
South Korea	66	167	10.3	13.7	0.7	0.7	9.7
Malaysia	41	145	35.9	46.6	0.4	0.6	13.4
Vietnam	19	82	47.8	47.8	0.2	0.3	15.8
Taiwan	37	63	12.0	13.0	0.4	0.2	5.5
Philippines	11	33	13.6	12.0	0.1	0.1	11.1

Source: UNCTAD, Austrade.

Figures 25 and 26 below illustrate the trend of rising outbound and inbound foreign direct investment, as a share of GDP, across the Asia-Pacific region. Comparing these charts produces some interesting observations, namely:

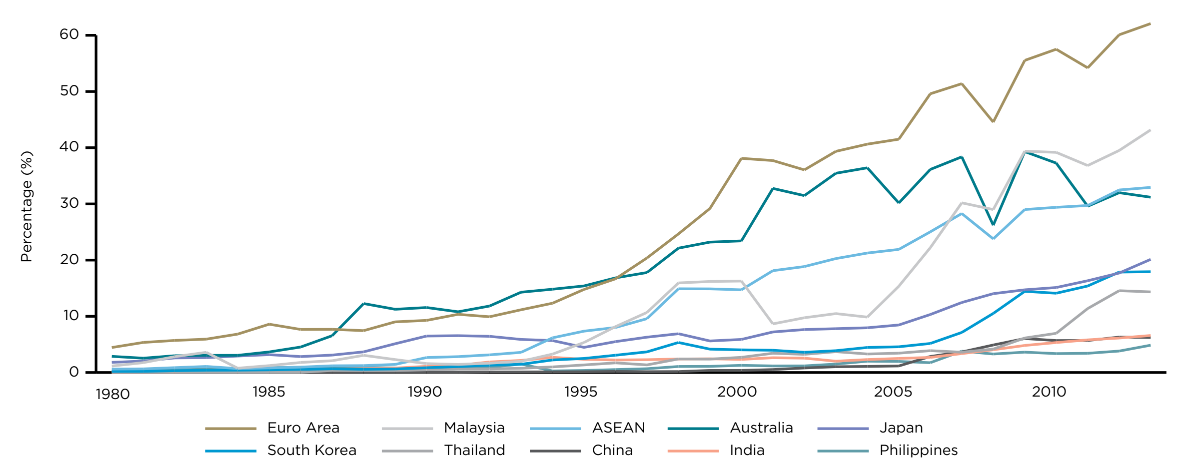
> **Across the region, countries like Malaysia, Thailand (to a lesser extent) and the ASEAN bloc have increased their outward and inward foreign direct investment positions relative to GDP.** In Malaysia, outbound foreign direct investment has grown from negligible levels in 1980 to over 40 per cent of GDP at present.

> **In China, inward foreign direct investment has actually gone backwards, declining from a peak of about 17 per cent of GDP prior to the turn of the century to about 10 per cent at present.** Outward foreign direct investment has trended upwards in recent years, but at a level of only around 6 per cent of GDP there appears to be substantial room for future growth. By comparison, Japan's level of outward foreign direct investment is 20 per cent of GDP. A 14 percentage point increase in China's outbound foreign direct investment is equivalent to US$1.4 trillion of outflows if calculated as a share of China's 2014 nominal GDP.

> **ASEAN as a region has demonstrated a more rapid pace of financial integration in foreign direct investment than Northeast Asia or South Asia.** Inward foreign direct investment has surpassed 60 per cent of regional GDP from less than 30 per cent in the late 1990s, while outward foreign direct investment has risen to more than 30 per cent of regional GDP from less than 10 per cent over the same time period. In addition, ASEAN data suggest that intra-ASEAN flows have grown to become a major source of foreign direct investment in most member states.[137]

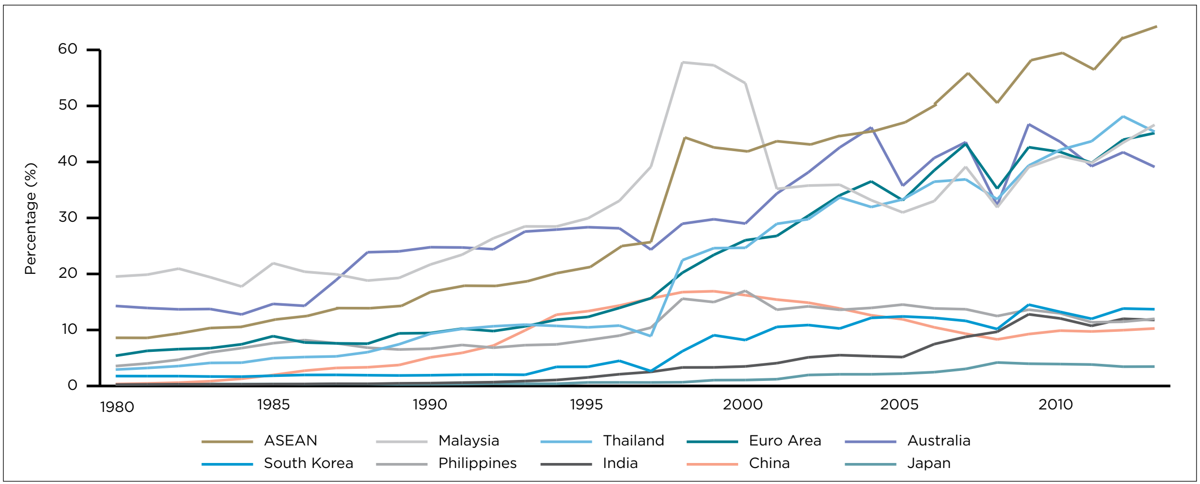
137. ASEAN Secretariat and United Nations Conference on Trade and Development (2014), *ASEAN Investment Report 2013–14*, Jakarta, October.

FIGURE 25: Outward foreign direct investment, as a percentage of GDP, in selected countries and regions



Source: UNCTADStat.

FIGURE 26: Inward foreign direct investment, as a percentage of GDP, in selected countries and regions



Source: UNCTADStat.

Australia plays a prominent role within this picture of deepening integration. Foreign direct investment has always played an important part in helping to fund Australia's domestic investment needs, accounting for around one-third of all capital formation in Australia since 2000 and almost half in the mining sector. Despite this, its relative importance has declined over time. In the 1960s, foreign direct investment was responsible for over 60 per cent of all foreign investment into Australia but has declined to just 26 per cent as at 2013, reflecting the increasing prominence of portfolio flows.[138]

As suggested by Figures 25 and 26, Australia's inbound and outbound foreign direct investment as a share of GDP is high relative to the Asia-Pacific average. ABS data further details Australia's international investment position by counterpart country (on an annual basis). The disaggregation by country is important for investigating integration with different geographic regions.[139]

The data show that while Australia is deeply integrated with the global economy through foreign direct investment flows, this integration is oriented toward the developed markets of the United States and United Kingdom. The United States is the largest foreign direct investor in Australia, with A$149.5 billion of stock or 23.7 per cent of the inward total. The United Kingdom, with A$86.7 billion of stock (13.8 per cent), is second largest.

138. ANZ (2014), 'Caged Tiger: The Transformation of the Asian Financial System'.

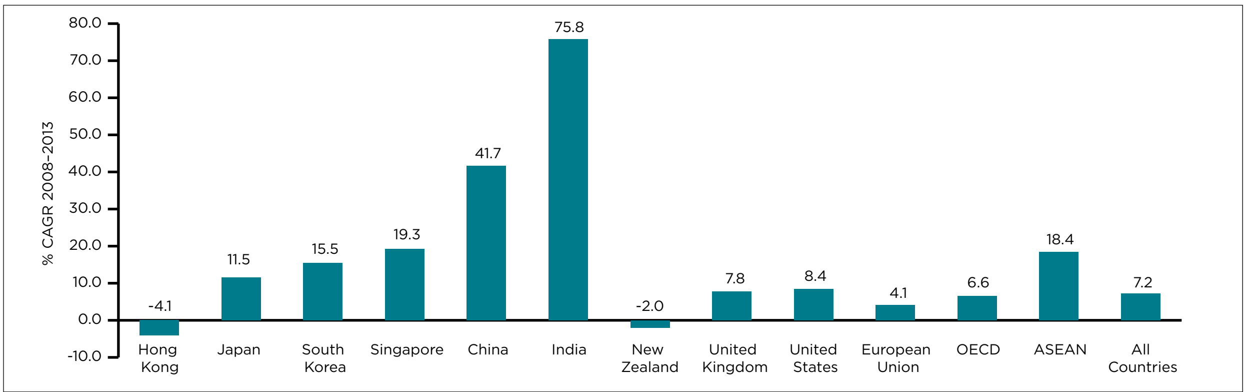
139. For foreign investment in Australia (liabilities), ABS data includes details of country of investor, investment stocks, flows, and associated income. For Australian investment abroad (assets), similar detail is provided in respect of country of investment. Non-transaction changes which contribute to changes in levels of these assets and liabilities (such as exchange rate and price effects) are not reported.

While the stock of foreign direct investment is dominated by countries outside the Asia-Pacific, the Asia-Pacific region is the fastest-growing source of foreign direct investment into Australia. Figure 27 shows the compound annual growth rate of foreign direct investment from selected regions and countries over the past five years.

Much of this growth, however, is off a low base. India, for example, was responsible for just A$69 million of foreign direct investment in 2008 and A$1.3 billion in 2013. China has overtaken Switzerland and Canada as the sixth largest foreign direct investor in Australia, with a value of almost A$21 billion.[140] Foreign direct investment from the ASEAN countries is growing significantly faster (at 18.4 per cent per annum) than from the EU and OECD.

While the stock of foreign direct investment is dominated by countries outside the Asia-Pacific, the Asia-Pacific region is the fastest-growing source of foreign direct investment into Australia.

FIGURE 27: Compound annual growth rate (CAGR) of foreign direct investment in Australia for selected countries and regions, 2008–13



Source: ABS Cat. No. 5352, Table 2; ACFS calculations.

Australia's financial services industry is one of the largest foreign direct investors abroad, with a stock of foreign direct investment of A$140.4 billion in 2013 (just behind the mining industry, with A$144.4 billion).[141] The financial services industry looks set to overtake the mining industry, though, as Australian financial institutions invest more in foreign affiliates and equity stakes in international joint ventures.

One source of further detail on the origins of foreign direct investment in Australia is the Foreign Investment Review Board (FIRB), which publishes annual data on foreign investment approvals.[142] In 2012–13, approvals were given for A$135.7 billion of proposed investment. The real estate sector was the largest destination by value, with approved proposed investment of A$51.9 billion.[143]

Aggregated data is presented on the number of applications received, approved subject to conditions, approved without conditions, withdrawn, and exempt. Aggregated data is also offered on approvals by industry. Of relevance to this report is the data on country of investor. Within the Asia-Pacific region, China, Japan, Singapore and Malaysia are among the 10 largest source countries for proposed foreign direct investment in Australia, with China taking 11.6 per cent of the world total (Table 7). The United States remained the largest source of proposed foreign direct investment in Australia. Switzerland replaced Japan in the top five sources of proposed investment, with a handful of high-value applications for investment in the minerals exploration sector in 2012–13. Interestingly, although China ranked third in terms of value of proposed investment, the number of approvals submitted for consideration represented almost half of all submissions to FIRB in 2012–13.

140. Australian Trade Commission (2014), 'Australia's Inward FDI Stock Exceeds A$600 Billion in 2013', Data Alert, 6 May.
141. ABS Cat. No. 5352.0, 2013, Table 17a.
142. It is important to note that approvals do not always result in actual foreign investment taking place.
143. Foreign Investment Review Board (2013), 'Annual Report 2012–13'.

TABLE 7: Top 10 countries by value of FIRB-approved proposed investment, 2012–13

Country	Number of approvals	Total (A$ million)	% of world total
United States	264	20,627	15.2
Switzerland	51	18,387	13.5
China	6,102	15,803	11.6
Canada	218	14,392	10.6
United Kingdom	1,197	6,849	5.1
Japan	111	4,589	3.4
Qatar	26	3,482	2.6
Singapore	675	3,145	2.3
Malaysia	894	2,785	2.1
Germany	113	2,117	1.6
World	13,421	135,699	100.0

Source: Foreign Investment Review Board 2012-13 Annual Report, Table 2.11.

4.4. Portfolio investment

Portfolio investment is defined as cross-border transactions and positions involving debt or equity securities (including investment fund shares or units), other than those included in foreign direct investment or reserve assets. Portfolio investment is not just limited to securities traded on financial markets — the acquisition of shares in hedge funds, private equity funds, and venture capital are examples of portfolio investment that occur in less public and more lightly regulated markets.[144]

Over the last decade, portfolio investment flows from the Asia-Pacific region indicate that savings have largely been invested in developed countries *outside* the region rather than developing countries within the region. Concentration outside of the region is puzzling for at least three reasons: (1) theory predicts that capital should flow to emerging economies, where marginal returns are higher; (2) numerous studies have shown geographical proximity to be an important determinant of capital flows; and (3) intra-regional trade (especially merchandise trade) has grown markedly, while portfolio flows do not appear to have followed.[145]

The IMF's Coordinated Portfolio Investment Survey (CPIS) is the only global survey of portfolio investment holdings. It collects information on cross-border holdings of equities and long- and short-term debt securities, classified by the economy of residence of the issuer.[146] Participation in the CPIS is voluntary. Most significant portfolio investment-holding countries participate in the CPIS. (China is one notable country that does not.)[147]

The global market value of cross-border holdings of securities reached US$46.7 trillion at the end of 2013. Like in the case of foreign direct investment, financial integration via cross-border portfolio investment globally is limited to a handful of large economies and financial centres, with 70 per cent of total portfolio investment assets concentrated in just 10 economies. The United States, the United Kingdom, Luxembourg, Japan and Germany rank in the top five, with Japan the only Asia-Pacific nation in the top 10.[148]

Over the last decade, portfolio investment flows from the Asia-Pacific region indicate that savings have largely been invested in developed countries outside *the region rather than developing countries within the region.*

144. International Monetary Fund (2009), *Balance of Payments and International Investment Position Manual*, Sixth Edition, Washington DC, p. 110.
145. García-Herrero, A, Wooldridge, P and Yang, DY (2009), 'Why Don't Asians Invest in Asia? The Determinants of Cross-Border Portfolio Holdings', *Asian Economic Papers*, Vol. 8, Issue 3.
146. The CPIS has covered end-of-year holdings since 2001, and has reported semi-annually (for a smaller subset of countries) since mid-2013. 74 economies submitted end-December 2013 data.
147. International Monetary Fund (n.d.), 'Frequently Asked Questions', Coordinated Portfolio Investment Survey.
148. International Monetary Fund (2014), 'IMF Releases Results of December 2013 Coordinated Portfolio Investment Survey', Press Release, No. 14/448, 30 September.

Portfolio investment is the largest component of Australia's international investment position. Australia holds A$757.8 billion of portfolio investment assets and A$1.52 trillion of portfolio investment liabilities, as at December 2014.[149] Of the liabilities, equity securities (including investment fund shares) accounted for A$458.0 billion (30 per cent) and debt securities accounted for A$1.1 trillion. Debt securities therefore comprise the largest share (37.8 per cent) of total foreign investment into Australia.

The financial sector in Australia is the largest borrowing sector in global debt markets. The stock of debt securities issued by deposit-taking corporations totalled A$512.9 billion, while debt securities issued by the general government sector totalled A$261.7 billion, as at December 2014.[150] Australian banks borrow heavily offshore, reflecting the banking system's role in channelling funds from foreign (non-resident) savers to Australian (resident) borrowers. The bulk of banks' international liabilities is owed to United States and United Kingdom residents and is denominated in United States dollars.[151]

The geographic distribution of Australia's portfolio investment assets is shown in Table 8. The picture here is similar to that of foreign direct investment — while Australia has a high degree of financial integration with overseas markets, that integration is primarily with the United States and (to a lesser extent) the United Kingdom. Japan is the only Asia-Pacific nation to feature in the top 10 recipients of Australian portfolio investment.

TABLE 8: Distribution of Australia's portfolio investment assets by top 10 partner countries, December 2013

Partner country	Value (A$ billion)	Proportion of total (%)
United States	240.2	42
United Kingdom	56.5	10
Germany	32.3	6
Japan	21.9	4
Cayman Islands	20.9	4
France	18.4	3
Canada	16.6	3
Netherlands	15.2	3
Luxembourg	12.4	2
Switzerland	10.7	2

Source: IMF Coordinated Portfolio Investment Survey (CPIS).

Portfolio investment is growing more quickly from the ASEAN region than from the EU and OECD, but the advanced nations still dominate in terms of nominal stocks. There are important differences between regions in the composition of investment into Australia. The EU has A$156.1 billion of foreign direct investment stock in Australia, but twice as much (A$393.8 billion) in portfolio investment stock. The United States invests almost three times as much portfolio investment (A$422.6 billion) in Australia as foreign direct investment, while the United Kingdom invests almost four times as much (A$335.4 billion). In contrast, China had a stock of A$20.8 billion of foreign direct investment in Australia in 2013 but just A$426 million of portfolio investment.

The data taken together suggest that Australia's main financial relationships are with Europe and the United States. These are the markets where Australia invests and also where it raises capital — with around three-quarters of corporate bond issuance conducted offshore, predominantly in the United States. Since the abolition of capital controls and the floating of the Australian dollar in the 1980s, banks and other corporations have obtained a significant proportion of funding from offshore bond markets,[152] with about 80 per cent of issuance by Australian corporates now taking place offshore.[153] Australia also provides a funding source for foreign companies. 36 per cent of the total issuance (stock) of non-government bonds were 'kangaroo bonds' issued by foreign entities in the Australian domestic market, as of March 2014.[154]

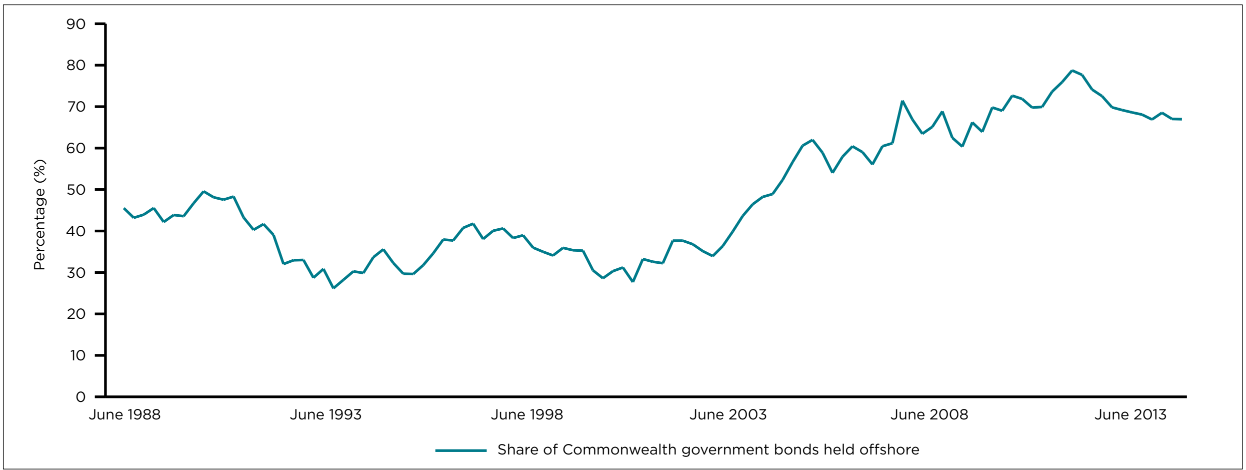
The financial sector in Australia is the largest borrowing sector in global debt markets.

149. ABS Cat. No. 5302.0, December 2014, Tables 28 and 29.
150. Ibid, Table 29.
151. Bailey, O, Van Uffelen, L and Wood, K (2012), 'International Activities of Australian Banks', Reserve Bank of Australia, Bulletin, December.
152. Debelle, G (2013), 'Some Recent (and Not So Recent) Trends in Australian Debt Markets', Address to the KangaNews DCM Summit, Sydney, 19 March.
153. Financial System Inquiry (2014), Interim Report, Chapter 3.
154. Ibid, Chapter 10.

Similarly, the share of Commonwealth government bonds held by foreigners stood at 67 per cent as at December 2014 (Figure 28). In dollar terms, a record A$261.2 billion of Commonwealth government bonds was held offshore.[155] The evidence as to the ownership of these bonds (in terms of investor country) is only anecdotal, but market participants suggest increased holdings by Asian institutions and Asian central banks in particular.[156]

The participation of foreign investors in the Australian market appears to exceed Australian equity investors' participation in offshore markets.

FIGURE 28: Percentage share of Commonwealth government bonds held by foreigners



Source: ABS Cat. No. 5232.0, Table 1.

The data suggest a high degree of financial integration in the listed equities market. At the aggregate level, retail investors directly own slightly less than 20 per cent of all Australian listed equities, and domestic institutions own slightly less than 40 per cent. Foreign investors own slightly more than 40 per cent.[157]

The participation of foreign investors in the Australian market appears to exceed Australian equity investors' participation in offshore markets. The ASX's Australian Share Ownership Study reports that among direct share owners, approximately 10 per cent (or 4 per cent of the Australian population) have invested on an overseas stock exchange. The vast majority of those owning shares on the ASX do not hold shares on overseas exchanges.

Superannuation, through broad asset allocations, adds diversification and stability to the Australian financial system. APRA-regulated superannuation funds allocate approximately 22 per cent to overseas equity, 7 per cent to overseas fixed interest and 1 per cent to overseas unlisted infrastructure, for a total of 30 per cent of assets under management invested overseas (as at the end of December 2014).[158] MySuper funds have similar allocations: 26 per cent to overseas equity, 6 per cent to overseas fixed interest, and 2 per cent to overseas unlisted infrastructure, for a total of 33 per cent invested offshore.[159]

The difference between the international exposure of professionally-managed funds and self-managed superannuation funds (SMSFs) is stark. SMSFs allocate just 1 per cent to overseas assets, effectively demonstrating extreme home bias. SMSFs carry much higher allocations to cash (including term deposits) than APRA-regulated superannuation funds, at 27.6 per cent.[160]

155. ABS Cat. No. 5232.0, December 2014, Table 1.
156. Auster, A (2012), 'Blame it on the Bonds', *Australian Financial Review*, 7 May 2012.
157. Australian Securities Exchange (2010), 'Capital Raising in Australia: Experiences and Lessons from the Global Financial Crisis'.
158. Industry Super Australia (2014), 'Superannuation and the Financial System', March.
159. Australian Prudential Regulation Authority (2015), 'Quarterly Superannuation Performance', December 2014, issued 19 February, Tables 1d and 2a.
160. Australian Taxation Office (2015), 'Self-Managed Super Fund Statistical Report — December 2014'. Overseas assets are the sum of the categories: overseas shares, overseas non-residential real property, overseas residential real property, overseas managed investments, and other overseas assets.

4.5. Foreign banking claims

The two decades prior to the global financial crisis saw a remarkable increase in cross-border bank lending activity. Between 1995 and 2012, total cross-border claims almost tripled to reach US$20 trillion.[161] Since the crisis, global cross-border lending as a share of total banking assets has declined, mostly because of the retrenchment of European banks.

While global banking flows have declined in aggregate since the crisis, there are marked differences across countries and regions.[162] The contraction in European banking flows is consistent with the protracted sovereign debt and banking concerns in the region.[163] In contrast, the allocation of cross-border bank lending to Asia excluding Japan, as a proportion of the world total, has risen by four percentage points since 2008 (Table 9), according to data from the Bank of International Settlements (BIS). Claims on China have continued to grow at annual rates of close to 50 per cent, taking the outstanding stock of cross-border claims on China to US$1.1 trillion.[164]

The allocation of cross-border bank lending to Asia excluding Japan, as a proportion of the world total, has risen by four percentage points since 2008, according to data from the Bank of International Settlements (BIS).

TABLE 9: Percentage of global outstanding claims by BIS reporting banks[165]

	Origin		Destination	
	2008	2013	2008	2013
Major advanced economies	80	77	74	68
Japan	*8*	*11*	*2*	*3*
Euro area	*40*	*35*	*36*	*30*
Asia ex. Japan	N/A	N/A	5	9

Source: BIS Locational Statistics; James et al. (2014).

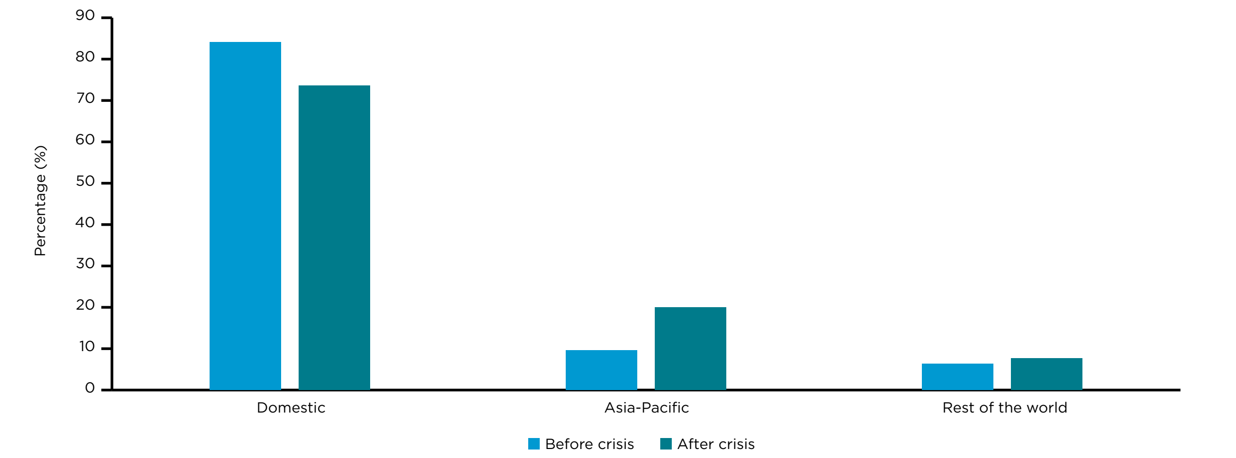
Asia's financial centres have taken a lead role in intermediating bank flows into and out of the region. Banks headquartered in Hong Kong SAR and Singapore expanded their claims on the Asia-Pacific from US$119 billion in mid-2008 to US$225 billion in mid-2012, or some 11 per cent of total foreign claims on the region, which stood at US$2.1 trillion in mid-2012.[166] Hong Kong SAR's cross-border bank lending has increased to about 200 per cent of GDP from around 100 per cent in 2007. This in part reflects its close relationship with mainland China.[167] Singapore's increasing role as a regional financial intermediary appears linked to banking sector reforms introduced there in 2001.[168]

Japanese banks have replaced retreating European banks, and have recently become once again the biggest suppliers of cross-border bank credit. In 2011, Japanese banks replaced German banks as the world's largest international lenders. Japanese banks' share in the consolidated international claims of all BIS reporting banks rose from 8 per cent in early 2007, prior to the start of the crisis, to 13 per cent at end-March 2013, with increased lending to both the Asia-Pacific region and Latin America.[169] Banks headquartered in Taiwan, India and Malaysia also doubled their intra-regional claims, to US$111 billion.[170]

Figure 29 illustrates the rising level of intra-regional lending in the Asia-Pacific region. The share of regional assets more than doubled between the pre-crisis and post-crisis periods, rising from under 10 per cent to close to 20 per cent of total assets, whereas the share of domestic assets declined from 84 per cent to 74 per cent.

161. Ceruitti, E, Hale, G and Minoiu, C (2014), 'Financial Crises and the Composition of Cross-Border Lending', IMF Working Paper, WP/14/185.
162. BIS locational data capture outstanding claims and liabilities of banking offices located in the BIS reporting countries, including positions between related offices. The consolidated statistics capture the worldwide consolidated claims of banks headquartered in the BIS reporting countries, including claims of their own foreign affiliates but excluding positions between related offices.
163. James, E, McLoughlin, K and Rankin, E (2014), 'Cross-border Capital Flows Since the Global Financial Crisis', *Reserve Bank of Australia Bulletin*, June.
164. Bank for International Settlements (2014), 'Highlights of the BIS International Statistics', BIS Quarterly Review, December.
165. 'Major advanced economies' includes the euro area, Japan, Switzerland, the United Kingdom and the United States.
'Asia ex. Japan' includes China, Hong Kong SAR, India, Indonesia, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.
166. Bank for International Settlements (2012), 'Highlights of the BIS International Statistics', *BIS Quarterly Review*, December.
167. Much of the increase in cross-border bank lending to China has been by banks in Hong Kong SAR. It is likely that much of the increase in cross-border bank lending to Hong Kong SAR reflects lending by Chinese banks, although this cannot be verified using the BIS banking statistics.
168. Batten, JA and Szilagyi, PG (2011), 'Bank Internationalisation during the Global Financial Crisis: An Asia Pacific Perspective', Social Science Research Network, 4 September.
169. Bank for International Settlements (2014), 'Highlights of the BIS International Statistics', *BIS Quarterly Review*, September.
170. Bank for International Settlements (2012), 'Highlights of the BIS International Statistics', *BIS Quarterly Review*, December.

FIGURE 29: Geographic breakdown of assets of Asian banks as a percentage of total assets[171]



Source: IMF Global Financial Stability Report (2015), April, Figure 2.4.

For their part, Australian banks' claims on the region have risen almost threefold from mid-2008 to end-2012, to US$54 billion.[172] This suggests that it is the area of cross-border lending that is leading Australia's financial integration with the Asian region, with Asia accounting for 19 per cent of all cross-border credit exposures on an ultimate risk basis. Australian banks are increasingly providing trade finance services to corporates in Asia, where it is estimated that 68 per cent of all letters of credit globally are written.[173]

Australia's exposure to emerging Asia[174] in bank lending has grown from A$10.5 billion (4 per cent of total international exposures) in March 2003 to A$95.6 billion (11 per cent of total international exposures) in September 2014[175] (Table 10). International exposure is concentrated in a handful of major Australian banks; the majority of authorised deposit-taking institutions (ADIs) have limited or no international operations.

TABLE 10: Australian-owned banks' international exposures on an ultimate risk basis, September 2014

	Total exposure (A$ billion)	Share of international exposures (%)	Share of global consolidated assets (%)
New Zealand	319	38	8
United Kingdom	143	17	4
United States	116	14	3
Asia	163	19	4
– Emerging Asia	96	11	2
Europe	52	6	1
– Emerging Europe	1	0	0
Other	48	6	1
– Emerging other	5	1	0
Total	**840**	**100**	**22**

Source: Reserve Bank of Australia (2015), Financial Stability Review, March, Table 2.1. Note: 'Asia' includes Hong Kong SAR and Singapore.

171. 'Before crisis' represents the average of the period 2002–07. 'After crisis' represents the average of the period 2008–13.
172. McGuire, P and Van Rixtel, A (2012), 'Shifting Credit Patterns in Emerging Asia', *BIS Quarterly Review*, December.
173. Abernethy, M (2014), 'Banks Seek to Cash In on Asia's Growth', *Australian Financial Review*, 11 September.
174. Emerging Asia ('Asia and Pacific' in the RBA statistical tables) includes Afghanistan, Armenia, Azerbaijan, Bangladesh, Bhutan, British Overseas Territories, Brunei, Cambodia, China, Fiji, French Polynesia, Georgia, India, Indonesia, Kazakhstan, Kiribati, Kyrgyz Republic, Laos, Malaysia, Maldives, Marshall Islands, Micronesia, Mongolia, Myanmar, Nauru, Nepal, New Caledonia, North Korea, Pakistan, Palau, Papua New Guinea, Philippines, Solomon Islands, South Korea, Sri Lanka, Taiwan, Tajikistan, Thailand, Timor Leste, Tonga, Turkmenistan, Tuvalu, US Pacific Islands, Uzbekistan, Vietnam, and Wallis and Futuna.
175. RBA Statistical Tables, B13.2.1.

Australian-owned banks' international exposures arise from the activities of their overseas branches or subsidiaries, and the direct cross-border activities of their Australian-based operations.[176] According to APRA, the most significant exposures to Asia in terms of allocation of tier 1 capital are to Singapore, Hong Kong SAR, China and Japan.[177] Longer-term lending to households and businesses represents only a small proportion of these exposures; the majority of banks' exposures are instead shorter-term and trade-related, lending that typically poses lower funding and credit risks.[178]

176. Australia's banks are somewhat more globally integrated on the funding side of their balance sheets as they are large borrowers in offshore wholesale debt markets. Debt issuance is discussed in the preceding subsection, on portfolio flows.

177. Australian Prudential Regulation Authority (2013), 'ADI Industry Risks', APRA Insight, Issue 2.

178. Reserve Bank of Australia (2015), *Financial Stability Review*, March, Chapter 2.

5. ENABLERS OF AND BARRIERS TO FINANCIAL INTEGRATION

This section will elucidate some of the critical factors that may be described as either enabling or driving financial integration, or acting as a barrier to it. We focus on factors that are specific to the Asia-Pacific region, and/or to Australia, with particular attention paid to impacts on Australia's ability to integrate with the Asian region.

These factors will be described first in relation to trade in financial services, and then in relation to cross-border capital flows. This section will conclude with a discussion of some of the data limitations that hamper our collective ability to analyse the extent of financial integration — or lack thereof — in the region, and therefore to understand the impacts of changes in policy, regulation, or commercial decisions that take place in the region.

5.1. Factors impacting on trade in financial services

As discussed in Section 3, the financial services industry is the largest single industrial segment in the Australian economy in value-added terms. On a relative basis, the financial services industries of most nations across the Asia-Pacific are significantly smaller and less sophisticated (Hong Kong SAR and Singapore excepted), but strong growth rates have been recorded in many jurisdictions in recent years.

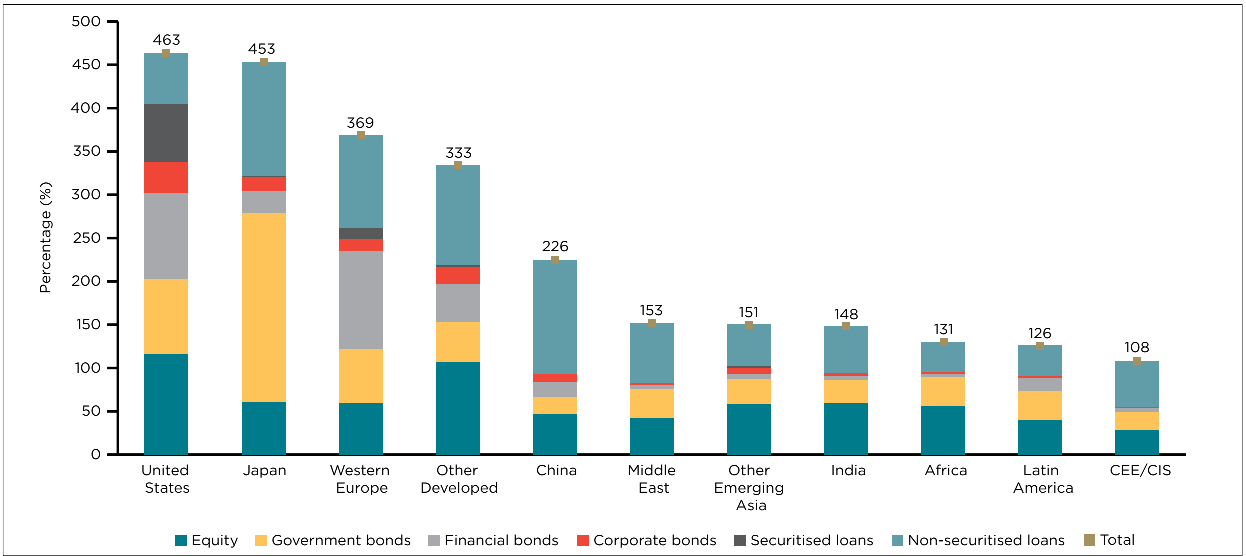
Within the broad category of 'financial services', we can consider the performance of the banking sector, pension and funds management sector and insurance sector as distinct sub-segments. Each faces a slightly different set of enablers and barriers to integration.

One of the critical enablers of this integration is the sheer size of the banking sector relative to other sectors (such as the capital markets), as measured by the size of balance sheet assets and liabilities, as well as the prevalence of multinational banking groups with overseas branches and subsidiaries.

Banking

The data presented in Subsection 4.5 on cross-border banking claims suggest that banking may already be one of the more financially integrated sectors across the Asia-Pacific region, including for Australia. One of the critical enablers of this integration is the sheer size of the banking sector relative to other sectors (such as the capital markets), as measured by the size of balance sheet assets and liabilities, as well as the prevalence of multinational banking groups with overseas branches and subsidiaries. As Figure 30 shows, non-securitised loans (or bank credit) account for roughly a third of the total financial stock in emerging Asia and India, and more than half of the financial stock in China.

FIGURE 30: Financial depth in selected countries and regions as a percentage of GDP, 2012



Source: McKinsey Global Institute (2013), 'Financial Globalization: Retreat or Reset?', March. 'CEE/CIS' means Central and Eastern Europe and the Commonwealth of Independent States.

In keeping with the relative size of their balance sheets, banks are among the largest financial services firms by market capitalisation in many countries in the Asia-Pacific, as well as in Australia. Asian corporates remain largely dependent on banks, rather than market-based sources, for finance.[179]

Although the Australian banking system remains domestically oriented — when measured, for example, by onshore versus offshore profits or balance sheet allocations — the impetus for greater international integration through increased exports of financial services seems to be gathering pace. One of the key drivers of interest in offshore expansion is the limited opportunity for growth in the domestic banking market. A sustained, intense competitive environment amid subdued credit growth continues to impact on Australian banks' net interest income.[180] System credit growth is sluggish at around 6 per cent, having fallen from an average of around 15 per cent in the four years prior to the global financial crisis.[181]

Meanwhile, for banks operating in emerging Asia, profits have continued to be supported by relatively wide interest margins and strong credit growth (although these have moderated in recent months).[182] A mixed record of expansion into the more distant and fully developed markets of the United States and United Kingdom by Australian banks, combined with a 'follow the customer' lead by Australian corporates into Asia, has seen all of the big four banks speaking more proactively about growth opportunities within the region.[183] A key motivation for expansion into Asia is to facilitate the large and growing trade and investment flows in the region. Accordingly, banks have focused on providing cross-border banking services (such as trade finance and foreign exchange) to corporate clients. Australian banks are also involved in the provision of long-term corporate loans in Asia, such as through participation in syndicated lending, although to a lesser extent than some large Asian banks that are expanding in the region.[184]

On the flipside, foreign banks also remain active in the Australian market. The competitive role played by foreign banks is particularly notable in the corporate and investment banking subsector, as well as in the provision of specialised retail banking services and products. Return on equity in the Australian banking sector (at around 15 per cent) has remained well above the average for advanced economies, and above returns on equity in a number of key Asia-Pacific economies.[185] More recently, non-bank competitors such as digital and mobile payments and credit providers have further increased the level of domestic competition.

Another enabler to foreign participation in the Australian banking market is the comparatively low barriers to entry. Australia is one of the least restrictive economies for commercial banking in the region.

Another enabler to foreign participation in the Australian banking market is the comparatively low barriers to entry. According to the OECD's Services Trade Restrictiveness Index, Australia is one of the least restrictive economies for commercial banking in the region, and ranks below (i.e. less restrictive than) the OECD average.[186] Barriers to entry were relaxed in the 1980s and 1990s. Upon entry to the Australian market, foreign banking providers are subject to the same rules and regulatory regime as local providers.[187]

One of the key drivers of interest in offshore expansion is the limited opportunity for growth in the domestic banking market. A sustained, intense competitive environment amid subdued credit growth continues to impact on Australian banks' net interest income.

179. Ahmadjian, CL (2014), 'Corporate Governance and Business Systems in Asia', *The Oxford Handbook of Asian Business Systems*, Chapter 6.
180. KPMG (2014), 'Major Australia Banks: Half Year Results 2014', May.
181. Reserve Bank of Australia (2015), 'Chart Pack Credit and Broad Money Growth', 8 April.
182. Reserve Bank of Australia (2015), *Financial Stability Review*, March, Chapter 1.
183. Yeates, C (2015), 'HSBC says Australian Banks Well Positioned to Meet Growing Asian Demand', *The Sydney Morning Herald*, 14 April.
184. Reserve Bank of Australia (2013), *Financial Stability Review*, March, Box A.
185. India, Singapore, South Korea and Taiwan feature lower returns on equity. Hong Kong SAR, Malaysia and Thailand feature comparable returns on equity. Returns on equity are higher in China and Indonesia, at around 19 per cent. See Reserve Bank of Australia (2014), *Financial Stability Review*, September, Graph 1.18.
186. See Subsection 2.3.
187. However, significant barriers still exist, including: costs and requirements associated with licensing and related conditions; ongoing regulatory burdens and compliance costs; increasing prudential standards, such as Basel III; and the need to obtain approval from the Treasurer for ownership in excess of 15 per cent. See Deloitte Access Economics (2014), 'Competition in Retail Banking', report commissioned by the Australian Bankers' Association, March.

In contrast, Australian banks (and insurers) face substantial barriers to entry in markets in the Asia-Pacific region. Indeed, one of the features that differentiates the Asia-Pacific region from other regions is the limited degree of foreign participation in the domestic banking sector.[188] Barriers to entry are an important impediment to increasing Australia's exports of financial services — as we have seen, foreign affiliates are by far the largest mode of supply for the export of financial services, including banking. The critical barriers (regulatory or otherwise) to greater export of commercial banking services include:

- **The diverse and fractured nature of the banking sector in the Asia-Pacific region — which encompasses 40+ countries, each with its own regime of licensing and regulation.** In Asia, the authorities in some instances are protective of their domestic banking systems, leading to the adoption of regulatory or 'behind the border'[189] rules that impede or increase the cost of foreign banks' entry. These include licensing, data housing restrictions, employee nationality rules, and capital requirements. While foreign banks have made some inroads into emerging Asia, especially in Indonesia, South Korea and Thailand, the extent of penetration as a whole has been relatively low compared to that of Central or Eastern Europe or Latin America. China and India have been particularly cautious liberalisers.[190] Australian banks are not alone in these challenges; more than 70 per cent of commercial banks listed in the Asia-Pacific generated 90 per cent or more of their revenue from only domestic operations.[191]
- **The impact of regulation.** Commercial banks are among the most heavily regulated of corporations, and the impost of opening in new jurisdictions from a compliance perspective is significant. The global financial crisis and subsequent adoption of the Basel III reforms have further complicated the regulatory picture. For example, banking regulators may now prefer foreign banks to create local subsidiaries (holding local capital) rather than branches to better ensure regulatory oversight.
- **Home regulators may consider overseas expansion to be an increased risk and impose greater capital costs, as has reportedly been the case in APRA's treatment of Australian joint ventures abroad.[192]** This could, for example, inhibit Australian firms' take-up of opportunities provided by free trade agreements that raise the maximum threshold of foreign equity in a joint venture financial services firm in Asia.
- **The need to justify long-term investment in offshore entities, potentially at the expense of short-term profits or investments at home.** This can raise challenges for CEOs and boards of listed financial institutions. With the mixed record of success of Australian commercial banks' offshore ventures, analysts have been on the record as questioning the shareholder value arising from an Asian growth strategy.[193]

Australian banks (and insurers) face substantial barriers to entry in markets in the Asia-Pacific region.

Pensions, funds management and insurance

The size of the market for non-bank financial intermediaries is not as large in the Asia-Pacific region as the banking market.[194] This is to be expected, given the small number of mature economies in the region. As noted earlier, Australia holds the largest pool of assets under management in the region, followed by the financial centres of Hong Kong SAR and Singapore, with Japan, China and South Korea distantly behind. Pension funds, mutual funds and insurance companies have been gaining space in Asia in recent years. There is nonetheless considerable variation in the size of each type of intermediary across countries, reflecting, in large part, differences in institutional and regulatory environments.[195]

188. Hishikawa, I (2003), 'Financial Sector FDI in Asia: Brief Overview', 6 March.
189. Behind-the-border barriers are aspects of the domestic investment climate that deter both domestic and foreign investment. The World Bank defines the investment climate as 'the location-specific factors that shape the opportunities and incentives for firms to invest productively, create jobs and expand'.
190. Gopalan, S and Rajan, RS (2010), 'Financial Sector De-Regulation in Emerging Asia: Focus on Foreign Bank Entry', *The Journal of World Investment and Trade*, Vol. 11. Note: In China, the regulations governing the establishment of foreign banks remain quite stringent compared to those of other countries in the region.
191. Wong K, Wadhera, S, Wilson, S and Auster, A (2012), 'Banking in the Asian Region: Collaboration as a Strategic Imperative', ANZ Banking Group.
192. Ferguson, A (2014), 'ANZ's Asian Ambition Doesn't Come Cheap', *Australian Financial Review*, 27 October.
193. Durie, J (2014), 'ANZ Banks on Organic Growth in Asian Strategy', *The Australian*, 18 March.
194. Estrada, G, Park, D and Ramayandi, A (2010), 'Financial Development and Economic Growth in Developing Asia', ADB Economics Working Paper Series, No. 233.
195. Didier, T and Schmukle, SL (2014), 'Financial Development in Asia', *Financial Development and Cooperation in Asia and the Pacific*, Routledge, Chapter 6.

At the same time, the rate of wealth accumulation in Asia is accelerating — most visibly in China, but also in the rapidly growing ASEAN economies such as Indonesia and Malaysia. This growth should act as an enabler of further financial integration, as opportunities to provide investment advice and services to a growing middle class continue to expand. Gains in information technology have diminished the importance of geography, allowing international corporations to sometimes service several markets from one location.[196]

The low level of penetration for insurance products — general, life and health insurance — in many Asian economies stands out as a particular opportunity.[197] According to EY, the ongoing liberalisation of trade barriers (e.g. the establishment of a Shanghai Free-Trade Zone in 2013) and continuing growth in the number of middle-class and high net-worth consumers is highly favourable for the insurance sector. Demand for health insurance is expected to rise for several reasons: the ageing population, strains on public resources, and rising consumer affluence. Currently, 10 per cent of the population in Asia is over 65 years old, but that number is expected to double within the next three decades.[198] All of these drivers create a need for the entry of sophisticated financial services providers.

The low level of penetration for insurance products — general, life and health insurance — in many Asian economies stands out as a particular opportunity.

Singapore and Hong Kong SAR appear to be leveraging their status as financial hubs to grow their respective funds management sectors, attracting both domestic business as well as exporting expertise. A related enabler in favour of increased integration is the need for access to offshore markets for the purposes of risk diversification. Particularly in the case of Asian economies, many of which have shallow equity markets and small bond markets, the opportunities to invest in a mix of asset classes are limited. Australia's increasing attraction of outbound investment from Asia speaks to this need for diversification.

At the same time, there are a number of important barriers to deeper ties in pensions, funds management and insurance:

> **As was the case with banking, there are regulatory and licensing barriers across the Asia-Pacific — with great variation between jurisdictions.** The cost of compliance in multiple markets can be significant. In the hedge fund sector, for instance, funds headquartered in the Asia-Pacific seem to allocate a disproportionately high level of operating costs to compliance.[199] In some countries, it can take 12 months or longer to obtain a licence to market a fund.[200] In addition, the lack of transparency associated with government regulations and decision-making processes across the region negatively affect the regional market for financial services.[201]

> **Many jurisdictions in Asia require a degree of 'on-shoring', which imposes additional costs.** Fund managers may be required to hire a certain share or number of locally-based staff in order to win mandates; renting local premises may also be a prerequisite. Australian policy settings impose few of these costs, allowing offshore fund managers to service Australian-based clients from abroad. This 'fly in, fly out' approach, which represents a lower-cost model and promotes a more competitive environment in Australia, is not common in Asia. In addition, Australia's system of double taxation of offshore profits places businesses operating offshore at a major competitive disadvantage, reducing the appeal of establishing foreign affiliates.[202]

> **The impetus for Australian fund managers to seek growth offshore may be tempered by the reality that the compulsory superannuation system effectively guarantees continued growth in system assets, regardless of performance.** (On the other hand, an alternative view is that the huge growth of assets under management may cause investment funds to 'outgrow' a domestic market that is dominated by a handful of industries.[203] However, to the extent that SMSFs grow faster than other fund structures, international diversification may be slower than would otherwise be the case because of the smaller international exposures in SMSF portfolios.[204])

196. Schmukler, S, Zoido, P and Halac, M (2013), 'Financial Globalization, Crises, and Contagion', The World Bank.
197. Swiss Re (2014), 'World Insurance in 2013: Steering Towards Recovery', *Sigma*, No. 3, Figure 18.
198. EY (2014), '2014 Global Insurance Outlook'.
199. KPMG (2013), 'The Cost of Compliance', 2013 KPMG/AIMA/MFA Global Hedge Fund Survey.
200. PwC and Financial Services Council (2010), 'Asia Region Funds Passport', Appendix 2.
201. Department of Foreign Affairs and Trade (2012), 'Barriers to Australian Trade and Investment in Regional Comprehensive Economic Partnership (RCEP) Participating Countries', December.
202. ANZ (2014), 'Submission to the Financial System Inquiry', 31 March.
203. Somasundaram, N (2014), 'Here's Why Australia's Biggest Funds are Moving Huge Amounts of Money into Overseas Stocks', *Business Insider Australia*, 14 April.
204. Maddock, R (2014), 'Superannuation Asset Allocations and Growth Projections', paper prepared for the Financial Services Council, 17 February.

- **The rapid advance of technology is changing the nature of the funds management sector.** For instance, easy access to low-cost exchange traded funds (ETFs) that provide exposure to overseas markets may reduce the appetite of investors to seek out higher-cost investment advisors or products offshore. At the same time, technological developments increasingly make it possible to supply financial services from distant locations (such as the purchase of insurance over the internet) which may reduce the dominance of domestic providers.

The final report of the Australian Financial Centre Forum ('the Johnson report') documented many reasons for the inward focus of Australia's financial services industry. Among the barriers to trade listed in the report were: uncertainty regarding the tax treatment of funds under management sourced from offshore; the complexity of the Offshore Banking Units (OBU) regime; overseas investors' unfamiliarity with Australian trust structures; high state taxes on insurance; the lack of competition between market exchange operators; and the lack of a diversified and liquid corporate bond market in Australia.[205]

The Asia Region Funds Passport (ARFP) is being developed under the auspices of APEC as the preferred regional vehicle for cross-border marketing of managed funds. Six participating Asia-Pacific nations have signed onto the scheme. Proponents argue that the ARFP will not only boost choice for investors, but also increase regional cross-border capital flows, trade and investment. In the longer term, the ARFP could also facilitate funds from the Asian region being marketed in Europe through an Asian/European mutual recognition agreement.[206]

An APEC study of the ARFP's potential benefits and costs noted that as of 2012 Asia had become the second wealthiest region in the world, with US$45.2 trillion in assets, equivalent to 33 per cent of global financial wealth at that time. In contrast, Asia's total assets under management amounted to only 16 per cent of the world's assets under management. The study found that the ARFP could bring significant benefits to the regional economy by helping to channel resources from surplus markets to capital-deficient markets, and by introducing to local fund managers technical know-how, competitive pricing and higher standards of disclosure and performance.[207]

There are a number of tax and regulatory reforms required in the next 18 months if the ARFP is to deliver on its promises. Implementation of these reforms will be critical to ensuring that the ARFP is functional in Australia when it is launched in 2016.[208]

Finally, the Productivity Commission is part-way through a study into barriers to growth in Australian services exports, focusing on the education, financial services, health services, information technology, professional services and tourism sectors. The focus of the study will be on identifying policy-relevant barriers that directly affect the export of services — those barriers that can be addressed by Australian governments either through domestic policies or regulations, or through international agreements to reduce or remove barriers in other countries. A final report is due in December 2015.[209]

An APEC study of the ARFP's potential benefits and costs noted that as of 2012 Asia had become the second wealthiest region in the world, with US$45.2 trillion in assets, equivalent to 33 per cent of global financial wealth at that time. In contrast, Asia's total assets under management amounted to only 16 per cent of the world's assets under management.

205. Australian Financial Centre Forum (2009), 'Australia as a Financial Centre: Building on our Strengths', November.
206. Asia-Pacific Economic Cooperation (n.d.), Asia Region Funds Passport, 'Background'.
207. APEC Policy Support Unit (2014), 'Asia Region Funds Passport: A Study of Potential Economic Benefits', July, p. 5.
208. Financial Services Council (2014), 'Financial System Inquiry Phase Two', Submission, Chapter 4.
209. Productivity Commission (2015), 'Barriers to Services Exports', Issues Paper, April.

5.2. Factors impacting on cross-border capital flows

As shown in Section 4, global financial integration, as measured by cross-border flows of investment and capital, has retreated since peaking before the global financial crisis. The Asia-Pacific region has bucked this trend somewhat, with cross-border flows and holdings of foreign assets and liabilities continuing to grow as a share of GDP in recent years. Much of this growth has been in cross-border bank lending and in foreign direct investment. Within the region there is also rising evidence of intra-regional integration, as growth in intra-regional capital flows exceeds growth of flows to and from the rest of the world.

Global financial integration, as measured by cross-border flows of investment and capital, has retreated since peaking before the global financial crisis.

In this subsection we consider the enablers and barriers to further integration in foreign direct investment, portfolio investment and cross-border bank lending, sequentially.

Foreign direct investment

As might be expected, growth in foreign direct investment has played an important role in financial integration in the Asia-Pacific. This is a natural outcome of increased economic integration through trade, whereby multinational firms acquire trading partners and build supply chains and distribution networks as overseas markets become increasingly familiar and important to their business. Foreign direct investment has also benefited from more liberal policy and regulatory regimes in many Asia-Pacific jurisdictions, with the transfer of knowledge and technology associated with foreign direct investment viewed as preferable to the shorter-term, often more volatile nature of portfolio investment.

Foreign direct investment flows depend upon the expected rate of return on investment and the certainties and uncertainties surrounding those returns. Broadly speaking, the determinants of foreign direct investment can be grouped under two categories: (i) economic conditions, and (ii) host country policies. Empirical research suggests that foreign direct investment is sensitive to the host country's overall economic policies. Policies to create a more conducive investment environment can help to maximise investment flows.[210]

A key enabling factor of foreign direct investment is the size of the market. Larger markets may be associated with higher investment due to greater potential demand and lower costs as a result of scale economies. There is evidence of 'clustering', with multinational firms following one another in investing in countries that appear welcoming of prior investors. Political stability and good governance are also important determinants.[211] For these reasons, foreign direct investment in much of the Asia-Pacific region may be expected to continue growing, as investors are drawn to the region's high growth rates, favourable demographics, and relative stability.

The primary barriers to foreign direct investment are often regulatory ones. According to A.T. Kearney, the global financial crisis resulted in a rise in restrictive investment policies that set back cross-border mergers and acquisitions due to antitrust rulings, security concerns, or political opposition. The total gross value of the 21 largest cross-border deals was just US$265 billion between 2008 and 2012. Primary industries were the most affected, but financial services also suffered from lower volumes during this period.[212]

Another economic barrier to foreign direct investment is differentials in taxation. Australia's overall tax burden is relatively low compared to other developed countries. However, total tax revenue as a percentage of GDP is slightly higher in Australia than in China, and considerably higher than in Malaysia, India, Singapore, Hong Kong SAR and Indonesia.[213] Australia relies heavily on income taxes, particularly company income tax, compared to other developed countries as well as competitors in the Asian region. Corporate tax rates have trended downward in nations like China and Singapore (as well as in the OECD on average), but have remained flat in Australia and the United States over the past decade.[214]

The post-crisis shift toward greater investment restrictions may be starting to reverse. The latest UNCTAD Investment Policy Monitor finds that liberalisation and investment promotion measures have trended upward over the past year, with numerous countries relaxing restrictions on foreign ownership or opening up new business activities to investment. For instance, China introduced new rules on outward foreign direct investment requiring only investment in countries or industries identified as 'sensitive' to gain approval from the Ministry of Commerce.[215]

210. Sahoo, P (2006), 'Foreign Direct Investment in South Asia: Policy, Trends, Impact and Determinants', ADB Institute Discussion Paper, No 56.
211. Walsh, JP and Yu, J (2010), 'Determinants of Foreign Direct Investment: A Sectoral and Institutional Approach', IMF Working Paper, WP/10/187.
212. AT Kearney (2014), 'Ready for Take-off', The 2014 AT Kearney Foreign Direct Investment Confidence Index, p. 5.
213. Australian Government (2015), 'Re:think', Tax Discussion Paper, March, Chart 2.2.
214. Ibid, Chart 2.10.
215. United Nations Conference on Trade and Development (2015), 'Investment Policy Monitor', No. 13, January.

Within the Asia-Pacific region, the ongoing pro-growth economic agenda and the opportunities this creates represent a major driver of cross-border investment. However, there are still many barriers to the free flow of foreign direct investment in the Asia-Pacific. A recent World Bank report found, for example, that while ASEAN receives more foreign direct investment relative to GDP than any other developing region, many ASEAN countries restrict foreign ownership by law, with more stringent de jure restrictions than any other region, particularly in the area of services. On a de facto basis, the Philippines and Indonesia were the most restrictive, while Malaysia, China and Thailand also ranked in the top 10 most restrictive economies with respect to foreign ownership rules and practices.[216]

For Australia, which as noted earlier is a persistent importer of capital, maintaining an enabling environment for foreign direct investment is imperative. The data presented in Section 4 provide strong evidence of increasing inbound direct investment from Asia into Australia. A miniscule number of the tens of thousands of applications submitted to FIRB annually are rejected.[217] The fact that Australia's stock of inward foreign direct investment sits at almost 40 per cent of GDP suggests that Australia is one of the most open, least restrictive jurisdictions for direct investment in the Asia-Pacific region. Continued investment restrictions in some of Australia's key Asia-Pacific trading partners may explain, in part, the imbalance which sees Asia's foreign direct investment into Australia far exceed Australia's foreign direct investment into Asia.

Continued investment restrictions in some of Australia's key Asia-Pacific trading partners may explain, in part, the imbalance which sees Asia's foreign direct investment into Australia far exceed Australia's foreign direct investment into Asia.

At the same time, more cross-border mergers and acquisitions were withdrawn for regulatory or political reasons in Australia than any other country between 2008 and 2012. These withdrawals related to proposed deals with a total value of A$87.8 billion.[218] Some FIRB-related restrictions continue to toughen. A federal government media release on 25 February 2015 announced the introduction of a new A$55 million screening threshold for foreign investment in Australian agribusiness. This complemented a previously announced lower screening threshold for foreign investment in agricultural land of A$15 million (cumulative), and the introduction of a foreign ownership register.[219]

Inhibitors to Australian outbound investment into Asia have not garnered much academic study or attention. It is difficult to know whether Australian outbound foreign direct investment remains more oriented toward the United States and United Kingdom due to specific barriers in Asian economies, due to a lack of appetite or perception of an unfavourable risk/reward trade-off on the part of Australian firms, or both.

Portfolio investment

While Asia has increased its integration though cross-border flows of goods under the current account, many countries have restricted the cross-border investment flows that take place under the capital and financial account. Restrictions strengthened in some countries in the years following the Asian financial crisis,[220] and while many have since been loosened capital controls are still in place in a number of jurisdictions across the region.

The literature suggests that intra-regional cross-border portfolio investment in the Asia-Pacific region is lower than in other geographic regions. Some of the explanations given for the low degree of regional integration include controls on credit and foreign exchange; 'institutional' restrictions (such as the lack of hedging instruments, complicated taxation rules, and inefficient clearing and settlement infrastructure); and information costs (i.e. the additional costs associated with seeking out investments in foreign countries).[221]

216. The World Bank (2014), *Preserving Stability and Promoting Economic Growth*, Washington DC, pp. 65–6.
217. In 2012–13, no proposals were rejected (compared with 13 real estate related proposals rejected in 2011–12).
218. Financial Services Institute of Australasia (2014), 'Regulating Foreign Direct Investment in Australia', February.
219. Abbott, T and Hockey, J (Prime Minister and Treasurer) (2015), 'Government to Strengthen Australia's Foreign Investment Framework', Media Release, 25 February.
220. Beginning in 2002, some countries in Asia began to re-employ capital control measures as foreign bank flows into Asia turned to net inflows from outflows, while both portfolio equity flows and carry trades accelerated and became more volatile and sensitive to developments in global equity markets. See Gochoco-Bautista, MS, Jongwanich, J and Lee, J (2010), 'How Effective are Capital Controls in Asia?', ADB Economics Working Paper Series, No. 224.
221. Park, D and Shin, I (2013), 'What Hinders Cross-Border Portfolio Investment in East Asia?', *The Singapore Economic Review*, Vol. 58, No. 2.

The Australian Investment Managers Cross-Border Flows Report, jointly produced by the FSC and Perpetual since 2012, surveys fund managers that represent about half the market in cross-border fund manager flows. The latest report finds that from 2010 to 2013, foreign investment flows into Australia through managed investment trusts (MITs) almost doubled, rising from A$20.3 billion in 2010 to A$40.4 billion in 2013. The Asia-Pacific[222] accounted for 55 per cent of these inflows. On an individual country basis, Japan was the largest source of funds (33 per cent of all inflows) followed by New Zealand (14 per cent), the United States (10 per cent), the United Kingdom (7 per cent) and South Korea (3 per cent).[223] However, incoming funds from Asia declined as a share of the total overall (Table 11), perhaps suggesting increased competition for Asian funds from within Asia.

TABLE 11: Change in origin of Australian managers' funds from overseas, 1 January 2010 to 31 December 2013

	Funds at 2010 (A$ billion)	% of total	Funds at 2013 (A$ billion)	% of total
Asia-Pacific	14.75	67.6	17.46	54.5
Europe	2.79	12.8	3.5	11.0
United States	0.67	3.0	3.14	9.8
United Kingdom	2.32	10.6	2.30	7.2
Middle East	1.21	5.6	1.99	6.2
Total	**21.8**	**100**	**32.1**	**100**

Source: 2014 Australian Investment Managers Cross-border Flows Report, Table 2. 'Asia-Pacific' includes New Zealand, which accounted for A$4.3 billion in 2013.

Importantly, over one third of inflows into Australia in 2013 were being invested offshore, demonstrating the demand for Australian funds management expertise. The most popular asset class for foreign investment was Australian fixed interest and cash, attracting 25 per cent of funds invested, with Australian property following at 20 per cent.[224]

Industry bodies in Australia have called for a regulatory and tax framework that removes impediments to the free flow of capital across borders; removes arrangements that favour one type of investment or savings vehicle over another; and provides ready access to intermediated and non-intermediated capital markets.[225]

The track record of growth in outbound Australian portfolio investment into Asia does not appear to be as strong as inbound investment. Standard economic models imply that investors seeking to diversify their portfolios should hold assets in different markets, roughly in proportion to the share of these markets in total market capitalisation.[226] In Australia, the shares of foreign assets in investment portfolios are still much lower than indicated by this rule, a phenomenon known as 'home bias.' High dividend yields (partly as a result of dividend imputation), as well as information asymmetries and behavioural biases, may result in home bias on the part of domestic fund managers and investors.

An additional barrier is the limited availability of products or avenues to invest from within Australian borders into, for example, overseas equities. Non-institutional investors are usually unable to open trading accounts offshore. This barrier has been recognised and, subject to regulatory approval, the ASX hopes to add international equities to its product suite in the near future.[227] A consultation paper released by the ASX in 2012 proposed to broaden the range of international equities available by quoting UDRs (unsponsored depositary receipts).[228] The original proposal was rejected by ASIC, but recent media reports indicate that the ASX is considering putting forward a fresh proposal. The CEO of the ASX proposes an international board which quotes the top 100 (foreign) companies, initially only for institutional investors.[229]

222. Including New Zealand.
223. Financial Services Council and Perpetual (2014), '2014 Australian Investment Managers Cross-border Flows Report', pp. 4–5.
224. Ibid, Chart 4.
225. Australian Bankers' Association (2014), 'Critical Influences Shaping Australia's Financial Future', Banking Regulations Forum, November.
226. Moreno, R (2000), 'What Explains Capital Flows?', Federal Reserve Bank of San Francisco, Economic Letter, 21 July.
227. Australian Financial Markets Association (2014), '2014 Australian Financial Markets Report', p. 13.
228. Standard & Poor's and Australian Securities Exchange (2012), 'S&P/ASX Index Consultation: Index Eligibility and Treatment of Unsponsored Depositary Receipts', March.
229. Smith, M (2014), 'ASX Revives Push for Funds to Trade in Foreign Shares', *The Sydney Morning Herald*, 13 March.

The foreign exchange markets are important for facilitating financial integration. The reality of operating in so many currency markets acts as a significant barrier to regional financial integration, particularly when compared with the single-currency Economic and Monetary Union (EMU) in Europe or in respect of the United States dollar's dominance of the North American market. In many Asian jurisdictions, currency exposures are difficult to manage or hedge due to low liquidity in foreign exchange and derivatives markets, or outright bans or limitations on types or sizes of transactions. While the region is becoming internally more integrated through capital flows and trade, it will remain segmented due to the absence of a common currency and the dependence on the United States dollar as the primary currency for settling international trade, financial market trading and portfolio transactions.[230]

The lack of liquid and well-functioning bond markets limits the availability of long-term local currency funding for viable and profitable investment projects. Given that most national bond markets remain fragmented and lack liquidity, it is perhaps not surprising that an integrated Asia-Pacific bond market has yet to develop. There has been a low level of issuance by borrowers as many governments in the region record consistent fiscal surpluses, while corporations reduce their indebtedness. Another feature of the region has been the lack of demand from bondholders in a prevailing environment of low interest rates — particularly in Japan, which has the region's largest bond market. Several Asian economies limit the issuance of local currency bonds, limit investment in foreign bonds by domestic investors, and prevent foreign borrowers from issuing bonds denominated in different currencies in Asian markets.[231]

Several regional initiatives aim to spur bond market development, like the Asian Bond Fund, which invests in domestic currency bonds issued by sovereign and quasi-sovereign issuers in East Asia,[232] and the Asian Bond Markets Initiative (ABMI), which was launched in 2002 under the ASEAN+3 framework and which attempts to strengthen regional financial integration by expanding cross-border bond transactions. The quest for regional bond market integration stems from the realisation that although Asian countries have generally had substantial excess savings since the financial crisis, most of that money has flowed into the capital markets of advanced economies, such as the United States, rather than becoming a source of funds for capital investment and infrastructure development within the region.[233]

There are signs that the bond markets of Asia are beginning to take shape. Corporate bond market capitalisation reached 24.2 per cent of the region's GDP in 2012, from just 16.7 per cent in 2008. The stock of outstanding corporate bonds amounted to US$3.2 trillion in 2013, almost triple the value recorded at the end of 2008. China stands out as having doubled the size of its corporate bond market as a share of GDP over the past four years (to reach 16.4 per cent of GDP in 2013). In dollar terms, the Chinese corporate bond market grew more than fourfold, from US$280 billion at end-2008 to more than $US1.4 trillion in 2013.[234]

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Still, the lack of deep and liquid bond markets across the Asian region and in specific jurisdictions acts as a major inhibitor to Australia's ability to integrate with Asia from a portfolio investment perspective. As discussed earlier in this report, Australia's largest channel for cross-border investment is in the issuance of debt capital, with debt securities totalling 37.8 per cent of total foreign investment into Australia. The majority of this funding continues to come from the United States, where the bond market remains the largest and most liquid in the world. There are signs, however, that Australian corporate issuers are beginning to take advantage of Asian interest by raising more debt capital in Hong Kong SAR, Singapore, and even Malaysia and Taiwan.[235]

230. Batten, JA and Szilagyi, PG (2011), 'Bank Internationalisation during the Global Financial Crisis: An Asia Pacific Perspective', Social Science Research Network, 4 September.
231. Asian Development Bank (2008), 'Integrating Financial Markets', *Emerging Asian Regionalism*, Philippines, Chapter 4.
232. Bank for International Settlements (2012), 'Weathering Financial Crises: Bond Markets in Asia and the Pacific', BIS Papers, No. 63.
233. Shimizu, S (2014), 'Asian Bond Markets Initiative', *Financial Globalization and Regionalism in East Asia*, New York, Chapter 5.
234. Levinger, H and Li, C (2014), 'What's Behind Recent Trends in Asian Corporate Bond Markets?', Deutsche Bank, 31 January.
235. Staff Reporter (2013), 'Asian Investors Keen on Aussie Bonds', *The Sydney Morning Herald*, 22 August.

Over the last year, LCH.Clearnet's interest rate derivative (IRD) clearing service, SwapClear, significantly increased its activity and presence in the Asia-Pacific, particularly in Australia. The service currently clears 99 per cent of all cleared Australian dollar IRDs and over 41 per cent of the entire Australian dollar IRD market. Following approval from the Australian government in 2013, Australian banks are now able to join SwapClear as direct clearing members, dramatically increasing the depth of liquidity available to Asia-Pacific participants.[236]

China looms as one of the biggest potential future jurisdictions for financial integration, from both a trade in services and a flow of funds perspective. Australia is already highly integrated with China in two-way merchandise trade, following Chinese trade liberalisation beginning two decades ago. Foreign direct investment from China into Australia has been rising rapidly over the past several years. The biggest barrier to deeper integration is the ongoing restrictions in China's capital account. Another related inhibitor is the non-convertibility of the renminbi (RMB), which raises the cost of cross-border transactions by increasing the complexity of transactions required to hedge foreign currency exposures.

China looms as one of the biggest potential future jurisdictions for financial integration, from both a trade in services and a flow of funds perspective.

In 2014, the ASX launched a renminbi settlement service, enabling Australian companies to take or make payments in Chinese currency in near real time, reducing their risk and cost of doing international business.[237] 2015 saw the launch of an official Australian renminbi clearing bank.[238] These developments serve as important enablers of increased integration between Australia and China.

Cross-border banking claims

Many of the drivers of cross-border banking are similar to those for foreign direct investment and portfolio investment. Internationally active banks tend to be attracted to economies with high economic growth rates (which lifts demand for credit), political stability and rule of law. In an environment of low interest rates, banks may tend to lean their foreign activities toward higher-yielding markets.[239] Banks also tend to follow their customers. Banks that provide services to multinational companies will tend to expand in countries where those companies are active, and may also establish foreign affiliates in countries with large migrant populations from their home jurisdictions.

Perhaps the major impediment to cross-border banking is the impact of regulation. Regulatory policies are important push and pull factors of foreign credit. After the experiences of the recent global crisis, national regulators may aim at a lower degree of banking globalisation in order to better facilitate the resolution of large, internationally active banks, and hence to better protect taxpayers from potential losses. Thus, part of the retrenchment in international bank lending in recent years may be due to increased financial protectionism since the crisis.[240] In addition, an increase in capital requirements in a bank's home country may cause it to cut back on 'risky' foreign lending in order to deleverage. One analysis suggests that the Basel III banking reforms could result in an overall decrease of 20 per cent in cross-border banking flows.[241]

Other regulatory barriers include licensing (some jurisdictions impose substantial costs and waiting periods to obtain a licence); foreign equity limits on joint ventures; market restrictions (for instance, in Australia foreign banks cannot accept retail deposits); and outright bans on foreign participation. While cross-border banking may promote domestic competition and product innovation, national regulators concerned about consumer protection may enforce onerous requirements on the establishment of local subsidiaries and the holding of local capital that are unattractive to international banks.

The weak home economies of major banking conglomerates have also acted to slow, or reverse, the pace of cross-border lending. The BIS finds that most of the contraction in cross-border lending to emerging Asia in 2011 was caused by home country factors — in other words, the withdrawal of banks headquartered in Europe during the euro area crisis.[242] Global as well as country-specific factors are important determinants of cross-border bank flows. Greater risk aversion and expected financial market volatility seem to have been the most important factors behind the decrease in cross-border bank flows during the crisis of 2007-08.[243]

236. Australian Financial Markets Association (2014), '2014 Australian Financial Markets Report'.
237. Australian Securities Exchange (2014), 'ASX and Bank of China to Deliver New RMB Settlement Service', Media Release, 18 February.
238. Stevens, G (2015), 'Remarks at the Launch of the Official Australian Renminbi Clearing Bank', Sydney, 9 February.
239. Banks borrow short term and lend long term, so their domestic investment opportunities are less profitable when the yield curve is flatter. See: Cerutti, E, Claessens, S and Ratnovski, L (2014), 'Global Liquidity and Drivers of Cross-border Bank Flows', IMF Working Paper, WP/14/69.
240. Bremus, F and Fratzscher, M (2015), 'Drivers of Cross-Border Banking Since the Global Crisis', *VoxEU*, 28 January.
241. Figuet, J, Humblot, T and Lahet, D (2015), 'Cross-border Banking Claims on Emerging Countries: The Basel III Banking Reforms in a Push and Pull Framework', *Journal of International Financial Markets, Institutions and Money*, Vol. 34, pp. 294–310.
242. Avdjiev, S, Kuti, Z and Takáts, E (2012), 'The Euro Area Crisis and Cross-border Bank Lending to Emerging Markets', *BIS Quarterly Review*, December.
243. Herrmann, S and Mihaljek, D (2010), 'The Determinants of Cross-border Bank Flows to Emerging Markets — New Empirical Evidence on the Spread of Financial Crises', Deutsche Bundesbank, Discussion Paper Series 1: Economic Studies, No. 17.

5.3. Data and analysis as an enabler of policy decisions

This section has detailed some of the key barriers to further financial integration in the Asia-Pacific region. Many of these barriers relate to 'behind the border' regulatory, tax and licensing regimes as well as to issues of government policy stance, investor bias and behaviour, and market infrastructure and development. These issues are complex, and require solutions that take time and effort on the part of politicians, regulators and industry practitioners.

One of the overwhelming themes arising during the course of preparing this report was the lack of data in the areas of both trade in financial services and cross-border capital flows. The patchy state of the existing data make it difficult if not impossible to understand or forecast the impact of policy changes — let alone to utilise an evidence base to evaluate which policies should be prioritised to promote financial integration.

Table 12 provides an overview of key data issues and gaps. A further, detailed discussion of datasets can be found in Appendix B.

One of the overwhelming themes arising during the course of preparing this report was the lack of data in the area of both trade in financial services and cross-border capital flows.

TABLE 12: Examples of primary datasets and key gaps

Measure	Official data sources	Private data sources	Key gaps
Trade in financial services	> International organisations (e.g. OECD, UNCTAD, United Nations Statistics Division) > National statistics bureaux (e.g. ABS)	> Company annual reports > Company data aggregators (e.g. Dun & Bradstreet, IBISWorld, Thomson Reuters) > Financial Services Council/ Perpetual (MITs only)	> Poor coverage of trade in services and bilateral (i.e. disaggregated by partner country) trade data, particularly in developing Asia > Absence of data on sales of foreign affiliates in many nations, including Australia
Foreign direct investment	> Foreign Investment Review Board > International organisations (e.g. IMF, UNCTAD) > National statistics bureaux (e.g. ABS)	> Economist Intelligence Unit > KPMG/University of Sydney Database (China only) > Thomson Reuters Mergers and Acquisitions Database	> Official data is highly aggregated and contains gaps due to confidentiality > Significant 'round-tripping' and 'trans-shipping' through financial centres > FIRB data measures applications and approvals, not actual investment; only captures investments above a certain threshold
Portfolio investment	> Australian Office of Financial Management (for government debt) > IMF Coordinated Portfolio Investment Survey > National statistics bureaux (e.g. ABS)	> Bloomberg LP/Dealogic/ Thomson Reuters > Emerging Portfolio Fund Research (EPFR) Global > Institute of International Finance > McKinsey Global Payments Map > Morningstar > Public exchanges	> IMF reporting is voluntary and does not cover some large holders of external assets (e.g. Taiwan) > Data on beneficial holder of financial securities not readily available > Hong Kong SAR and Singapore intermediate large proportion of regional flows
Foreign banking claims	> Bank for International Settlements > Central banks and national regulators	> Individual banks' balance sheets and financial reports	> BIS coverage of only 44 countries; poor coverage of the Asia-Pacific (e.g. China) > Data on global banking groups is highly aggregated

Source: ACFS.

6. ANTICIPATED EVENTS IMPACTING ON FINANCIAL INTEGRATION

This report has canvassed the evolution and current state of financial integration within the Asia-Pacific, and between Australia and the Asian region. We have also discussed some identified enablers and barriers to further integration. This penultimate section offers an overview of anticipated events that could impact upon the current state of affairs with regard to financial integration.

6.1. China's financial system development and capital account opening

China stands ready to exert significant influence over how financial integration proceeds in the Asia-Pacific region in the coming decade. Throughout China's period of major economic reform up until the global financial crisis in 2008, its balance of payments regime featured an open trade account — allowing for two-way merchandise trade — and opportunities for foreign direct investment into China. Maintaining a closed capital account required China to regulate domestic interest rates and manage the value of the renminbi (RMB) as a non-convertible currency.

China stands ready to exert significant influence over how financial integration proceeds in the Asia-Pacific region in the coming decade.

This economic strategy was largely successful, with China's dollar GDP quadrupling in size in the decade after China's entry into the World Trade Organization (WTO) in 2001.[244] China's growth continued throughout the global financial crisis, supported by a stimulatory fiscal policy setting; in the past six years, China contributed nearly 40 per cent of global GDP growth.[245]

A report prepared for Finsia on the opportunities in China for Australia's financial services firms points out that China's economy has started to evolve in new ways in the post-crisis period. The headline rate of GDP growth has slowed, but the Chinese government seeks to rebalance growth away from resource-intensive production and toward both consumption and services. Domestic consumption in China contributes only 36 per cent of GDP, lower than in advanced economies like Australia (at 80 per cent) but also lower than the average for developing economies (at around 55 per cent). Premier Li Keqiang has noted that the services sector represents just 40 per cent of the Chinese economy, again lower than the developing country average of 46 per cent.[246]

The development of a more mature financial system that permits a greater range of investment products, both onshore and offshore, as well as a wider set of insurance and pension products, would go a long way toward reducing China's very high savings rate.

Within this picture, the growth of financial services stands out as a particular opportunity. Financial services contributes 5.5 per cent of Chinese gross value added;[247] with China's GDP now valued at around US$9.6 trillion, a 1 to 2 percentage point increase in this contribution equates to a US$140 billion opportunity. Perhaps more importantly, improving the delivery of financial services within the economy would open up the potential for more balanced growth. The key here is in lowering China's very high savings rate, which many observers[248] view as 'precautionary' given the low rate of return on domestic assets combined with a dearth of financial products to grow personal wealth and mitigate risks. The development of a more mature financial system that permits a greater range of investment products, both onshore and offshore, as well as a wider set of insurance and pension products, would go a long way toward reducing China's very high savings rate.

In some respects, China's financial system is already very large, albeit insulated from the global economy by ongoing restrictions in the capital account. We can look at the growth of credit as an example. In keeping with the post-crisis focus on maintaining economic growth, China has led the region in growth of credit, with total outstanding domestic credit rising by more than 200 per cent since 2008 to stand at just over CNY100 trillion, or 170 per cent of GDP.[249] The size of credit stock in the Chinese economy puts China on par with Australia (160 per cent of GDP), Korea (158 per cent), Malaysia (149 per cent) and others. China now has the largest domestic credit market in Asia.

244. Editorial (2011), 'All Change', *The Economist,* 10 December.
245. Jericho, G (2015), 'China: The Economic Behemoth Gives Australian Mining a Glimmer of Hope', *The Guardian*, 27 April.
246. Brown, K (2014), 'The Development of Financial Services in China: The Role for Australia', Finsia and the University of Sydney China Studies Centre.
247. See Figure 11.
248. See, for example: Choi, H, Lugauer, S and Mark, NC (2014), 'Precautionary Saving of Chinese and US Households', NBER Working Paper, No. 20527.
249. CEIC data, ACFS estimates.

However, not all of this credit sits within the banking system. Small and medium-sized businesses in China do not have the level of access to the formal banking system that they need to grow, and to support China's economic rebalancing. The past several years have seen huge growth in China's shadow banking system as an alternative to traditional banking channels. Total assets in the regulated banking system are CNY76 trillion, against CNY20-35 trillion of assets in the shadow banking system and CNY8 trillion in the informal lending market — meaning that up to half of all credit creation in China is happening outside of the formal banking system.[250] Much of this is happening in the digital space via peer-to-peer lending platforms and similar distribution channels.

Although the total credit market in the Asia-Pacific has grown dramatically — led by China — the tools are only now emerging to buy, sell, trade, swap or hedge these liabilities in a liquid market, or across borders.[251]

This makes China now the third-largest bond market in the world after the United States and Japan, although the total stock of outstanding bonds as a share of GDP has actually declined since 2007.

A similar picture emerges with respect to the Chinese fixed income market. The stock of outstanding bonds in China was CNY35.9 trillion (US$4.24 trillion) as of December 2014, representing a doubling of the size of the market in just five years. This makes China now the third-largest bond market in the world after the United States and Japan, although the total stock of outstanding bonds as a share of GDP has actually declined since 2007.[252] The government has taken deliberate steps to develop the liquidity of the bond market, and to encourage corporates to diversify their funding sources away from bank lending and equity issuance. Secondary market trading in the domestic bond market has grown, reaching a volume of US$57 trillion last year — most of which was in the repo market.

China's equity market has shown similar rates of growth. The stock market rally of the past several years, combined with more than 100 initial public offerings in 2014, bring the total value of Chinese shares to US$4.8 trillion, coinciding with China taking over from Japan as the second-largest share market in the world. The Chinese equity market added more than US$600 billion of value in December 2014 alone, more than the size of Singapore's entire equity market.[253] Whether that value is maintained remains to be seen — in respect of the crash of 2007, the value of China's share market is still 50 per cent below its peak — but the size of the domestic market is clearly significant.

Across China's credit, bond and equity markets, foreign participation is limited. Offshore investors suffer from an extensive list of restrictions on who can invest and how, leading to a complex process for participating. Data indicate that less than 5 per cent of mainland stocks are under foreign ownership.[254] Inward portfolio investment is channelled through a restrictive Qualified Foreign Institutional Investor (QFII) regime.

However, this picture of restrictions on foreign participation is changing, and rapidly. China has liberalised the rules applying to foreign direct investment, particularly in respect of outbound investment. In 2014, China's outbound direct investment exceeded its inbound direct investment for the first time in its economic history. China's 12th Five-Year Plan pledges to accelerate capital account liberalisation. This would be a major event for the global financial architecture. Despite steps to ease restrictions and some circumvention over the past decade, much of China's capital account and, especially, portfolio investment flows remain severely restricted to date.[255]

Finally, but importantly, the opening of China's capital account is taking place simultaneously with the liberalisation and increased convertibility of the RMB. There is evidence that the RMB has already become one of the largest currencies for merchandise trade invoicing globally. Over time, as the RMB becomes an increasingly traded currency, both trade flows as well as capital flows have the potential to be RMB-denominated. This represents a huge change for the region and for the Australian dollar, which itself is one of the most traded currencies in the global foreign exchange markets.

The opportunities and challenges for the Australian economy and its financial services firms around China's opening to financial flows over the next five to ten years are just as significant — if not more so — as the opportunities and challenges that arose from China's opening to trade flows in the last decade.

250. Bai, C (2014), 'Promote the Financial Inclusion in the "Double Dual Financial Sectors" of China', Presentation to the Asia Microfinance Forum 2014.
251. Auster, A (2015), 'The Next Phase: China and Australia', The Foundation for Development Cooperation, February.
252. Goldman Sachs (2015), 'FAQ: China's Bond Market'.
253. Frost, R and Chan, B (2014), 'Five Charts that Show China's Stock Boom is Unprecedented', *Bloomberg Business*, 9 December.
254. Deng, C (2014), 'Shanghai Stock Exchange Raises Shareholding Cap for Foreigners', *The Wall Street Journal*, 20 March.
255. Bayoumi, T and Ohnsorge, F (2013), 'Do Inflows or Outflows Dominate? Global Implications of Capital Account Liberalization in China', IMF Working Paper, WP/13/189.

Australia's relationship with China is arguably its most important bilateral economic relationship. Two-way trade between China and Australia stands at A$150 billion. Australia is China's largest single source of iron ore,[256] and its second largest destination for Chinese students studying abroad. China is one of Australia's fastest-growing sources of foreign direct investment, and the size of its financial markets already dwarf Australia's offering.

The only notable area where Australia's economic relationship with China has proceeded at a relatively slow pace is in financial services and cross-border investment. China's longstanding barriers to the entry of foreign affiliates act as an inhibitor to Australia's export of financial services, but there is little question of the forthcoming demand for these services. As an example, in March 2015 the Chinese government announced the launch of a deposit insurance scheme that represents a critical step toward liberalising deposit interest rate caps and allowing commercial entities to set their own borrowing and lending rates.[257]

Whether or not Australian firms take up future opportunities in China, there are clear signals that Chinese investment will continue to flow into Australia. At the World Economic Forum in 2013, Chinese Premier Li Keqiang announced that China was expected to invest US$500 billion overseas over the next five years.[258] According to KPMG and the University of Sydney, this cumulative target appears conservative based on recent outflows. An extension of recent trends over the next five years would in fact result in a total volume of approximately US$750 billion. If Australia maintains its current average share of 12 per cent of Chinese outbound direct investment, this would amount to a US$60-90 billion increase in foreign direct investment from China into Australia over five years.[259] This increase would be positive for industries that are capital intensive, such as mining. However, a surge in Chinese investment, assuming it did not simply substitute for investment from other countries, could put further upward pressure on the Australian dollar.[260]

All types of cross-border capital flow (foreign direct investment, portfolio investment, and bank lending) would be expected to increase if China were to undergo a material liberalisation. Importantly, there would likely be even larger increases in cross-border portfolio and banking flows than foreign direct investment flows. China's gross international investment position could increase from around 5 per cent to 30 per cent of world GDP by 2025.[261]

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6.2. Deeper financial integration within ASEAN, and the rise of Singapore

ASEAN is intensifying efforts to realise a regionally-integrated ASEAN Economic Community (AEC) by 2015 — achieving a single market and production base; the free flow of goods, services, investments, and skilled labour; and the freer movement of capital across the region.[262] Of the 176 'priority actions' laid out in the AEC Blueprint, nine relate to increasing the free flow of financial services, strengthening capital market development and allowing greater capital mobility.

Financial integration in ASEAN could accelerate in coming years under the AEC. The building of a modern, integrated financial system in ASEAN together with greater integration with capital-abundant regions, including the 'ASEAN+3' nations of China, Japan and South Korea, could end up pulling large amounts of capital into ASEAN from the high-saving economies of the north to the investment-hungry economies in the south.[263]

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256. Bingham, F and Perkins, B (2012), 'Australia's Coal and Iron Ore Exports 2001 to 2011', Department of Foreign Affairs and Trade, July.
257. Wildau, G (2015), 'China Deposit Insurance Paves Way for Deregulation of Interest Rates', *Financial Times*, 31 March.
258. Li, K (2013), 'The Chinese Economy: Reform and Innovation for Sustained and Healthy Development', Speech at Summer Davos Opening Ceremony, 11 September.
259. KPMG and the University of Sydney (2014), 'Demystifying SOE Investment in Australia: A Report Prepared for the Business Council of Australia', August, p. 4.
260. Laurenceson, J (2012), 'The Liberalisation of China's Capital Account will be a Game-changer for Australia', *The Conversation*, 10 August.
261. Hooley, J (2013), 'Bringing Down the Great Wall? Global Implications of Capital Account Liberalisation in China', Bank of England, Quarterly Bulletin, Q4.
262. Asian Development Bank (2014), 'ASEAN Economic Community: 12 Things to Know', 18 August.
263. Almekinders, G, Fukuda, S, Mourmouras, A and Zhou, J (2015), 'ASEAN Financial Integration', IMF Working Paper, WP/15/34.

The ASEAN region is already highly integrated with the global economy from a trade perspective, with its sum of exports and imports exceeding 100 per cent of regional GDP. ASEAN is also highly regionally integrated, with intra-regional trade now accounting for 23 per cent of total trade from member countries. The scope for increased financial integration under this magnitude of economic integration appears to be significant. Member nations will substantially remove restrictions on their insurance and banking sectors and capital markets from 2015, and substantially remove restrictions on trade in services by 2020.[264]

An ADB report in 2013 argued that the ASEAN region should support the growth of globally competitive banks from within. An 'ASEAN banking framework' could give market access preference to ASEAN banks over those from other regions, including Australian banks. ASEAN could provide a customer base large enough to support the growth of large competitive banks with a foothold in the global market.[265]

According to ANZ, there has been limited progress on deepening capital markets and liberalising financial and capital accounts in recent years.[266] There appears to be scope for increased flows of cross-border capital and investment in the years ahead. The policy framework in ASEAN that has maintained relatively tight controls on capital outflows has also acted to dampen capital inflows from within ASEAN, while encouraging inflows from advanced countries outside the region.[267] Policy stances that have promoted high domestic saving rates and current account surpluses in the aftermath of the Asian and global financial crises are now being relaxed, leading to a greater balance between inflows and outflows of capital. The signing of the ASEAN Comprehensive Investment Agreement in 2012 appears to be an important first step.[268]

6.3. Free trade agreements

Australia has a number of free trade agreements (FTAs) with Asian nations and regions currently in force, with the Japan-Australia and Korea-Australia FTAs being recent high-profile additions. FTAs signed with Japan and Korea and finalised with China in 2014 explicitly recognised the need to balance the playing field in respect of Australian financial services, with agreements seeking to provide Australian financial services firms with treatment that is on par with domestic and foreign financial services firms.[269]

The Japan-Australia Economic Partnership Agreement (JAEPA), which entered into force on 15 January 2015, guarantees Australian services suppliers access to the Japanese market in key areas of commercial interest, including financial services. Japan will allow cross-border access for Australian fund managers providing investment advice and portfolio management services in Japan. Japan has also guaranteed access for Australian financial services firms to conduct cross-border securities transactions with Japanese institutions. These commitments by Japan will help secure and protect Australia's access to one of the largest funds management markets in the world.[270]

TABLE 13: Australian FTAs in force, in negotiation and concluded.

FTAs in force	FTAs in negotiation	FTAs concluded
ASEAN-Australia-New Zealand FTA (AANZFTA)	Australia Gulf Cooperation Council (GCC) FTA	China-Australia FTA (ChAFTA)
Australia-Chile FTA (ACI-FTA)	Australia-India Comprehensive Economic Cooperation Agreement	
Japan-Australia EPA (JAEPA)	Indonesia-Australia Comprehensive Economic Partnership Agreement	
Korea-Australia FTA (KAFTA)	Pacific Agreement on Closer Economic Relations (PACER) Plus	
Australia-New Zealand CERTA (ANZCERTA)	Regional Comprehensive Economic Partnership	
Australia-United States FTA (AUSFTA)	Trade in Services Agreement	
Malaysia-Australia FTA (MAFTA)	Trans-Pacific Partnership Agreement	
Singapore-Australia FTA (SAFTA)		
Thailand-Australia FTA (TAFTA)		

Source: Department of Foreign Affairs and Trade; Austrade.

264. Association of Southeast Asian Nations Secretariat (2008), 'ASEAN Economic Community Blueprint'.
265. Asian Development Bank (2013), *The Road to ASEAN Financial Integration*, Philippines.
266. Cornell, A (2015), 'Financial Integration Lags the ASEAN Boom, Is That a Problem', *ANZ BlueNotes*, 28 April.
267. Park, YC and Takagi, S (2012), 'Managing Capital Flows in an Economic Community: The Case of ASEAN Capital Account Liberalisation', ADB Institute Working Paper, No. 378.
268. Balboa, JD and Wignaraja, G (2014), 'ASEAN Economic Community 2015: What is Next?', Asia Pathways, 12 December.
269. Department of Foreign Affairs and Trade (n.d.), 'Free Trade Agreements'.
270. Robb, A (Minister for Trade and Investment) (2014), Statement on the Japan-Australia Economic Partnership Agreement, 15 July.

The Korea-Australia Free Trade Agreement (KAFTA) entered into force on 12 December 2014. Under KAFTA, Australian financial services providers will have the newfound ability to supply cross-border financial services without the need to open a full commercial presence; to provide and transfer financial information, data processing and supply financial services software; to access more streamlined licensing procedures and more transparent regulatory decision making; to establish offices in Korea that provide consultancy services on international and Australian accounting law; and to establish representative offices in Korea to advise on Australian and public international law. Direct investment opportunities will also become more attractive with a quadrupling of FIRB's screening threshold for Korean investments in non-sensitive sectors.[271]

Negotiations on the China-Australia Free Trade Agreement (ChAFTA) concluded late last year. ChAFTA has reportedly secured Australia the best ever market access provided to a foreign country (excluding Hong Kong SAR and Macau SAR) by China on services. China has committed to deliver new or improved market access to Australian financial services providers in the banking, insurance, funds management, securities, securitisation, and futures sectors. The central banks of China and Australia have signed a Memorandum of Understanding facilitating the establishment of an official RMB clearing bank in Sydney.[272] ChAFTA will also promote further Chinese investment in Australia by raising the FIRB screening threshold for private companies from China in non-sensitive areas from A$248 million to A$1,078 million.[273]

Australian banks will get better access to the heavily protected Chinese market in terms of joint ventures, where ownership is currently capped at 19.9 per cent. Australian financial services firms will be able to establish joint venture companies with up to 49 per cent Australian ownership. China will remove the minimum CNY100 million working capital requirement for branches of Australian banks operating as subsidiaries in China, facilitating faster growth and new business opportunities. Australian securities firms in China will benefit from new commitments raising foreign equity limits to 49 per cent for participation in underwriting of domestic A and B shares as well as Hong Kong SAR listed H shares, guaranteeing the ability to conduct a domestic securities funds management business. Australia has also been granted access to the RMB Qualified Foreign Institutional Investor (QFII) program, with an initial aggregate quota of CNY50 billion. This should facilitate Australian fund managers investing in eligible Chinese assets.[274]

For Australian financial institutions, increased trade flows from the three new regional FTAs have potential to increase the demand for financial services such as trade finance, insurance and foreign exchange trading and hedging. There is also increased scope for locally based institutions to intermediate cross-border capital flows and to provide funds management, insurance and other services directly to consumers and business in regional economies.[275]

Financial services exports from Asia are likely to increase too. While the most vibrant financial centres in the region — Hong Kong SAR and Singapore — are likely to strengthen and consolidate their positions, emerging centres in Shanghai, Beijing and Seoul are expected to grow rapidly as well.[276] Bilateral FTAs within Asia will help to lower trade barriers within the region, facilitating intra-regional flows.

Negotiations on the Trans-Pacific Partnership (TPP) are underway. In a recent AT Kearney survey of Australian firms, 22 per cent of respondents reported that the prospect of a Trans-Pacific Partnership has already affected their planning on foreign direct investment allocations for the Pacific Rim countries participating in the negotiations, and a full 53 per cent say that the trade agreement, if implemented, will influence their investment decisions.[277] There are currently 12 parties negotiating the TPP, five of which are among Australia's top 10 trading partners for goods and services.[278]

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271. Chaaya, M (2014), 'Free Trade Agreements Trigger Financial Services Opportunities for Australia', Corrs Chambers Westgarth, 8 May.
272. Department of Foreign Affairs and Trade (n.d.), 'Key Outcomes', China-Australia Free Trade Agreement.
273. Robb, A (Minister for Trade and Investment) (2014), 'Landmark China-Australia Free Trade Agreement', 17 November.
274. Kirchner, S (2014), 'Regional Free Trade Agreements and their Implications for Australian Financial Services', Australian Financial Markets Association, December.
275. Ibid.
276. EY (2012), 'Beyond Trade: New Patterns of Trade in Asia-Pacific'.
277. AT Kearney (2014), 'Ready for Take-off', The 2014 AT Kearney Foreign Direct Investment Confidence Index.
278. Department of Foreign Affairs and Trade (n.d.), 'Trans-Pacific Partnership Agreement'.

Australia is jointly leading, with the United States and the EU, negotiations on a services-only free trade agreement known as the Trade in Services Agreement (TiSA). Since discussions began, participation in the TiSA has expanded from 16 to 24 parties, with the European Union representing its 28 member states, for a total of 51 WTO members. Only a handful of Asia-Pacific nations — Hong Kong SAR, Japan, South Korea and Taiwan — are among these parties. China has indicated interest in joining the negotiations.[279]

While the current parties to TiSA negotiations already have relatively liberal market access laws in relation to commercial banking (compared to the developing economies of Asia), ANZ has proposed that TiSA be used to set baseline standards on market access and regulatory harmonisation to be incorporated into broader agreements in the future.[280]

279. Department of Foreign Affairs and Trade (n.d.), 'Trade in Services Agreement'.
280. ANZ (2013), 'ANZ Submission on Trade in Services Agreement Negotiations', 10 September.

7. CONCLUSION

The aim of this report has been to consider what the rise of Asia in the 21st century will mean for the future of the financial services industry and financial markets, across the Asia-Pacific region and in an Australian context. It is believed that the increasing depth of economic and political interconnectedness within the Asia-Pacific region, including Australia, is likely to lead to increasing financial interconnectedness over time. A shift of this nature would have profound implications for the financial services industry in Australia, as well as for the broader economy.

Throughout this report, we have drawn upon public datasets and existing academic and policy research to understand the current degree of integration within the Asia-Pacific region, as well as enablers of and barriers to deeper integration in the future.

From this research, some key findings emerge:

> **The financial services industry is expanding to accommodate Asia's increasing commercial sophistication and wealth, generating an increasing share of value-added GDP in most economies.** Despite rapid growth in recent decades, there is room for further growth for many Asian economies to reach advanced economy averages.

> **Financial integration in the Asia-Pacific region is deepening**, bucking the trend of the advanced economies where financial integration has gone backward since the global financial crisis.

> **The Australian economy has a high degree of financial integration with global markets, led by Australia's financial services industry.** The industry not only intermediates cross-border flows of investment and capital, it is itself a major source and recipient of those flows. In addition, the industry is the largest services exporter, with exports (including sales of foreign affiliates) equivalent to just under 20 per cent of the value of all Australian exports recorded in the official balance of payments.

> **However, Australia's financial relationships, whether considered through the lens of cross-border capital and investment flows or through trade in financial services, remain oriented toward the traditional markets** of the United States, United Kingdom and New Zealand. Impediments acting against further integration with Asia include economic, regulatory, legislative, commercial and behavioural factors.

> **A handful of anticipated future events appear likely to shift the current picture of financial integration within the Asia-Pacific region**, regardless of any steps Australia may or may not take. The emergence of a more financially active China; the increasing integration and growth of ASEAN; and the pending series of free trade agreements (both bilateral and multilateral) hold great potential to impact on the region, and Australia's role within the region.

Impediments acting against further integration with Asia include economic, regulatory, legislative, commercial and behavioural factors.

At the same time, the research for this report has also revealed critical gaps in our knowledge and understanding of the current state of financial integration, as well as implications for any changes going forward.

It is appropriate to make some observations on these gaps in the body of research work.

The existing literature and analysis can be categorised into three groups:

> Research that quantifies the degree or extent of financial integration. As discussed throughout this report, these approaches include *price-based* measures, *quantity-based* measures, and *de jure* or *de facto* measures.

> Research that estimates the economic impact of deeper (or shallower) financial integration. These studies tend to be macroeconomic in nature and seek to explain and/or quantify the economic benefits and risks of integration.

> Research which looks at specific factors that either support or impede cross-border trade or capital flows. The majority of these studies focus on matters of public policy such as regulations, licensing etc.

Within each of these areas, there is scope for further extension of the research in order to better understand the potential for deeper financial integration in the Asia-Pacific in the future, as well as its likely impact.

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Relative to the analysis undertaken in respect of the EU or OECD economies, there is a paucity of substantial research that measures financial integration in the Asia-Pacific region. ASEAN appears to be the most studied subregion in this regard — perhaps because of the move toward an ASEAN Economic Community — and China always garners significant attention. However, the wider Asia-Pacific is rarely considered, as is the role of large players such as Japan or up-and-coming major economies such as India. Within this body of research, there are really no substantial papers that look to quantify Australia's financial integration within the region in any significant way.

The studies that do seek to quantify financial integration in the Asia-Pacific primarily rely on quantity-based measures — similar to the data discussed in this report. This is the simplest method of calculation. The work of the OECD (and others) on databases that measure openness to trade in financial services on a *de jure* basis is helpful, but generally cover only the largest economies in the Asia-Pacific.

There are surprisingly few studies that delve into price-based measures of financial integration. Yet, this measure holds the potential to contribute much understanding to the impact of financial integration. One example is the APEC Policy Support Unit's work documenting the correlations of returns on domestic versus cross-border funds; such a field of inquiry could not only help to understand the opportunity of greater financial integration (i.e. the potential for higher return/lower risk portfolio allocation for Asia's ageing population) but also when integration is approaching its useful upper bound.

For Australia, an economy in which cross-border portfolio investment flows dominate the international investment profile, understanding the impact of the 'law of one price' is critical for households and firms. Is there any evidence that the correlations of Australian assets with offshore assets are starting to weaken with some jurisdictions or strengthen with others? Observers have noted for some time that Australian market movements now react strongly to Chinese data releases; are we starting to see Australian markets move more closely with those in Hong Kong SAR, for example, than has been the case in the past? How might these shifts influence the characteristics of the Australian market over time — its trading cycle, volatility, and opportunities for diversification through investment in Asia?

In addition to prices in financial markets, the 'law of one price' could apply to the cost of service provision, which tends to equalise across borders as integration advances. This can be observed, for example, in the case of offshoring. To what extent might deeper financial integration, including through an increased presence of foreign financial institutions and firms within Australia, impact upon the competitive pricing dynamics within the Australian market itself?

Finally, there does not appear to be much analytical work on a single measure of integration that would combine all three of the above approaches. Such research could help inform strategic decision-making for industry practitioners and policymakers as they look to understand in a quantifiable way how barriers to integration vary across jurisdictions, and the costs and benefits that lowering or raising barriers would have.

The topic of the economic impact of financial integration in the Asia-Pacific region has attracted more research output than the measurement of financial integration itself, but there is still plenty more to do. One obvious missing strand of evidence is an estimate of the economic benefits and costs that arise from Asia's higher barriers to financial services trade and cross-border investment. While many authors point to the theoretical literature that provides a framework for thinking about costs and benefits, there are not many econometric studies estimating the economic impact.

China's rapid pace of financial evolution is a particular point of interest in this regard. With the second- or third-largest domestic asset market across banking credit, equities and bonds, the gradual opening of portfolio investment into and out of China is bound to have significant effects across many sectors. The enormity of the change is appreciated in the academic community, but as yet has not been quantified.

Within Australia, only a handful of studies have been undertaken to simulate deeper financial integration with the Asian region. When compared with the extensive body of research by Australian trade economists modelling the gains from liberalising trade in goods, the lack of modelling of trade in services liberalisation emerges as a yawning gap.

The deepest body of research on financial integration sits within the third category described above: research on public policy settings that encourage or impede financial integration. The puzzle here is how to understand the impact of changes in regulation, taxation or other policy settings if the major building blocks of understanding the impact — measuring integration and quantifying the economic outcomes — are not fully developed. There would appear to be a need for a greater evidence base within the first two groups of research, in order to better inform and support the third.

Finally, this project has thrown up two research questions that are largely unanswered in the academic literature, but may merit further attention.

The first area is the intersection between behavioural decision making and cross-border integration in financial services. The issue of 'home bias' was briefly discussed as a potential impediment to financial integration; is there good evidence of this in the Asia-Pacific region? What about corporate risk-taking culture? There are lingering animosities and rivalries between some countries within the Asian sphere; is the lack of financial integration symptomatic of this? And if so, what would be the means or methods to address this barrier? By comparison, to what extent has deep financial integration in the EU shifted popular or corporate culture? Australia, as noted throughout this report, is financially active across borders, but the deepest ties remain with the United States and United Kingdom. Are there cultural or behavioural factors operating within Australia that impede financial integration, and if so how can we understand them?

The second area relates to Australia's own experience with financial integration. Australia is a medium-sized, open economy with a large, generally stable financial system and a well-performing, globally-significant funds management industry. The literature around financial integration often points to the risks that can arise from integration, particularly from sudden surges or stops in capital flows. These risks have deep resonance in Asia, where the memories of the Asian financial crisis cast a long shadow. What lessons can be found in the experience of Australia that could help inform the path toward safe deregulation of cross-border restrictions on financial services and flows in the Asia-Pacific region?

Having considered the available data and literature — and with appreciation for the important role that financial services plays in the Australian economy — the Australian Centre for Financial Studies now puts forward the case that this is an area that merits further research by academics and industry practitioners alike.

An outline of a research proposal for the next stage of this project may be found in **Appendix A**.

APPENDIX A. RESEARCH PROPOSAL

This report has provided a high-level review of the state of financial integration in the Asia-Pacific region, and the connections between Australia and the Asia-Pacific. In undertaking this research, which reviewed the available data and body of academic literature as well as public policy-oriented studies, it became clear that there remain substantial gaps in the evidence base to guide policymakers and industry practitioners on the way forward with regard to financial integration in the Asia-Pacific region. The Australian Centre for Financial Studies (ACFS) is now proposing a research program to better understand and assess the impact of financial integration in the Asia-Pacific region.

In examining the available literature, a few areas for suggested new research have emerged:

> While a substantial amount of research has been performed by academics on financial integration within Asia, relatively fewer studies have looked at the financial relationship between Australia and Asia, or between Australia and specific markets in Asia. There is scope for a greater body of research to be developed that would measure financial integration through price-based, quantity-based, *de jure* and *de facto* measures.

> Compared to the extensive macroeconomic analysis and modelling that has been undertaken throughout the years on reduction of tariffs on merchandise goods, very little econometric analysis or modelling appears to have been applied in research on the reduction of barriers to trade in financial services. The data on trade in financial services is so poor that this report has taken steps to provide an estimate of current levels. This should be rectified, particularly in light of the importance of trade in the Asia-Pacific region.

> Improving the data for trade in financial services and cross-border capital flows should support greater analysis of the impact of current barriers to trade and capital flows. What, if any, has been the impact on Australia and the Australian financial services industry from operating under conditions of substantially lower barriers to entry in financial services, relative to major trading partners? Are there lessons to be learned in Asia from the Australian experience? Is Australia disproportionately impacted by higher barriers to trade and capital controls in many jurisdictions in Asia given its close geographic and economic relationship with the region, relative to peers in North America and Europe?

> The Asia-Pacific region has been a participant in the post-global financial crisis process of regulatory reform. There is relatively little research looking at the impact of regulation coming out of Basel III and the Financial Stability Board on the Asia-Pacific region, including, for example, the institutional mechanisms that drive reforms and Asia's voice in these mechanisms. How can we better understand the interaction between financial integration and the impact of the next wave of regulations on the Asia-Pacific region, vis-a-vis the United States and Europe?

> The research on co-integration, or the law of one price, has tended to focus on equity markets within Asia. Not many studies have compared, for example, the extent of Australian co-integration with Asia, or whether there is any evidence that the patterns of co-integration are shifting from Australia's traditional financial partners in the United States and United Kingdom toward the newer Asian markets. Other traded markets, such as foreign exchange, commodities and fixed income, have not featured heavily in co-integration studies of the region to date.

> As documented throughout this report, there are several areas where the Australian financial services industry punches above its weight. These include: the Australian dollar, which is the fifth most traded currency in the world; the share of foreign direct investment that Australia receives relative to peers in the Asia-Pacific region; the share of debt capital raised by Australia relative to peers in the Asia-Pacific; and the Australian funds management sector in terms of assets under management. What is the scope for Australia to face increased competition for funds and capital from its peers in the Asia-Pacific region? What, if any, might be the impact upon the Australian economy and financial services industry?

> There is little substantive research analysing the impacts of the opening of China's capital account on the Australian economy, from a whole-of-economy perspective. Some industry studies have estimated increased investment or commercial flows in particular segments, but no studies have looked at the Australian economy as a whole, or the impact on relevant sectors within financial services.

> Similarly, the integration of ASEAN and the role of Singapore in that integration from a financial perspective is a rapidly evolving picture that is important to Australia, both economically and politically. There is substantial research on ASEAN integration, but relatively less on the implications for Australia as ASEAN evolves and the role of Singapore as a regional financial hub grows.

Key questions that this research program will hope to address are as follows:

1. **What are the size and key features of cross-border trade in financial services and financial flows, both between Australia and the Asia-Pacific region and within the Asia-Pacific region?**
   a. What are the features of inbound/outbound trade in financial services, and in particular how can the activities of foreign affiliates be better quantified and understood? Is proxy data available on the activities that *support* trade, such as trade finance, supply chain finance, and foreign exchange management?
   b. What are the features of inbound/outbound cross-border direct investment, portfolio investment and banking flows, in terms of quantum, partner country, channels and providers, instrument type, and changes over time?
   c. What are the features of inbound/outbound payments, such as remittances?
2. **How inter-connected are capital markets in the Asia-Pacific region?**
   a. What are the common features of the equity markets, such as correlations in pricing and dual listings?
   b. What are the common features of the bond markets, including listed bonds and funds, and what will be the impact of developments like the Asian Bond Markets Initiative (ABMI)?
   c. What data is available on alternative assets such as infrastructure and property, both listed and unlisted?
3. **What are the emerging trends that will influence the current state of play?**
   a. What will be the impact of recent free trade agreements and ongoing negotiations such as the Trade in Services Agreement (TiSA) and Trans-Pacific Partnership (TPP), particularly in respect of the Australian financial services industry?
   b. What will be the impact of continued Chinese growth, the opening of China's capital account, and the ascent of Hong Kong SAR and Shanghai as important gateways to the Chinese mainland?
   c. What will be the impact of the growth of Australia's neighbours in Southeast Asia, in particular Indonesia, Malaysia, Thailand, Singapore and Vietnam, and the mooted ASEAN Economic Community?
4. **What are the benefits, costs and risks for Australia — for financial services providers, households and firms — as financial integration in the Asia-Pacific region deepens?**

A key aspect of this research program will be the development of new datasets or the mining of previously unexplored data. Researchers, for instance, may look to explore the use of data from digital payments systems, such as SWIFT, PayPal or even data collected by the Australian Transaction Reports and Analysis Centre (AUSTRAC).

The program will be supported by a consortium of research partners. Stage One of this research program is expected to commence in late-2015 and will focus on a more comprehensive literature review and analysis of existing datasets, including identification of gaps. Stage Two, scheduled for 2016, will consist of an analysis of the issues and modelling of impacts. Stage Three, scheduled for 2017, will produce final outputs, including policy recommendations.

APPENDIX B. COMMENTARY ON DATA GAPS

As referenced in Section 5, this section features a summary of some of the critical data gaps that, if filled, would assist in measuring the evolution of financial integration.

Limitations of data on trade in services by partner country

The quality of data for international trade in services is far from comparable to the data for trade in goods. Because of the long tradition of tariff revenues, the trade data for goods is of high quality. Services are intangible and non-storable, and at-the-border-duties cannot be collected. When service work moves across borders, no customs forms are filled out and no such data are generated. As a result, the trade in services data are much less accurate.

The OECD, Eurostat, and United Nations provide limited data on bilateral trade in services flows by partner country and balance of payments code. The OECD database has 30 reporter countries and more than 200 possible partner countries. However, most OECD data are reported for the same 66 partner countries as Eurostat.[281] There is no IMF database for trade in services that is comparable to its widely-used Direction of Trade Statistics (DOTS) database, which contains extensive statistics on merchandise trade disaggregated according to a country's primary trading partners.[282] Similarly, data on international trade in physical goods and commodities are available in considerable detail through the United Nations' Commodity Trade Statistics Database (known as Comtrade). Over 140 reporter countries submit annual statistics, detailed by commodity and partner country. Comtrade provides information on imports and exports by value and in some cases by the number of units or volume shipped according to seven different product (commodity) lists, the most detailed being the 2002 Harmonized Tariffs Code list, which at the six-digit level includes more than 8,000 product descriptions.

The easy availability and richness of Comtrade and similar datasets has tilted research on trade toward the goods sector. The ABS produces partner country data on trade in services for just 13 service categories (of which financial services and insurance and pensions services are two). Contrast the poor detail in traded services with detail on goods in the Comtrade database (8,000 product codes) and the magnitude of the data gap becomes clear.[283]

The most comprehensive coverage on trade in services is by the United Nations' ServiceTrade database, which ostensibly provides data on 190 reporter countries.[284] Disaggregation of bilateral trade in services data is improving over time, but there are still few data points for individual categories of services. Analysis of trade patterns in particular service categories, e.g. financial services, is ultimately hampered by the low number of countries that actually collect and report comprehensive country partner data. Data availability is particularly poor for developing countries in Asia, inhibiting analysis of bilateral and intra-regional patterns of trade in services.[285]

In addition, the reporting for trade in services is not free from country bias, concealing of data, and over- and under-estimation. For example, in 2003, the United States reported US$420 million of business, professional and technical (BPT) service imports from India, whereas India reported US$8.7 billion of BPT exports to the United States.[286]

International organisations have highlighted the need for detailed geographic allocations of services statistics, according to the economy of residence of trading partners. Such statistics provide a firm basis for trade in services negotiations. Bilateral comparisons of one economy's data with those of a trading partner, using 'mirror statistics', constitute an important tool for investigating and improving data quality.

281. Nasir, S and Kalirajan, K (2013), 'Export Performance of South and East Asia in Modern Services', ASARC Working Paper 2013/07.
282. International Monetary Fund (IMF) (n.d.), 'Direction of Trade Statistics'.
283. Sturgeon, TJ and Gereffi, G (2009), 'Measuring Success in the Global Economy: International Trade, Industrial Upgrading and Business Function Outsourcing in Global Value Chains', *Transnational Corporations*, Vol. 18, No. 2.
284. Sáez, S, Taglioni, D, van der Marel, E, Hollweg, CH, and Zavacka, V (2014), *Valuing Services in Trade: A Toolkit for Competitiveness Diagnostics*, World Bank Group, Washington DC, p. 12.
285. See: Economic and Social Commission for Asia and the Pacific (2015), 'Progress in implementing the Regional Programme for the Improvement of Economic Statistics in Asia and the Pacific', Committee on Statistics, Fourth Session, Bangkok, 25–27 March, Table 2.
286. Nasir, S and Kalirajan, K (2013), 'Export Performance of South and East Asia in Modern Services', ASARC Working Paper 2013/07.

Limitations of data on foreign affiliates

As noted previously, a number of countries produce inward and outward FATS data. Eurostat publishes FATS data for the European Commission as part of its Structural Business Statistics database. The OECD's Activity of Multinational Enterprises (AMNE) database presents detailed data on the activities of foreign affiliates in OECD countries (inward and outward activity of multinationals). Several OECD countries report annual data. Australia appears to be an outlier in having submitted to AMNE data for just one financial year (2009-10) and for one industry division (financial and insurance activities).[287] At present, non-OECD countries are not encouraged to collect FATS statistics.[288]

Ultimately, the lack of recent data on foreign affiliates' trade in services is a major impediment to our understanding of Australia's trading relationships. In financial services, the sales of foreign affiliates of Australian enterprises exceed the cross-border export figures captured in the official statistics many times over.

The ABS has conducted two surveys on foreign affiliates' trade in services, but these are not recent and do not provide time series data. Notably, the 2009-10 financial year of the last survey was characterised by severe financial instability in many countries, and there is the possibility of substantial growth in sales by foreign affiliates in the Asia-Pacific in the five years since. The ABS surveys measure outward foreign affiliate trade only. To calculate a complete balance for services, additional information would be required on Australia's inward foreign affiliate trade, for which no recent data are available.[289]

Limitations of data on foreign direct investment

Foreign direct investment data are inconsistent globally. UNCTAD provides the most comprehensive database, but data on inflows and outflows do not match exactly and datasets for many countries are incomplete. Different reporting practices sometimes create bilateral discrepancies between foreign direct investment flows reported by source and host countries — and the differences can be quite large. For example, data on foreign direct investment flows to mainland China, as reported by the Chinese authorities and by the investing countries' authorities, differ by roughly US$30 billion in 2000, by US$8 billion in 2001 and by US$2 billion in 2002.[290]

Within UNCTAD data some of these flows are overstated as they involve 'recycling' or 'round-tripping' of funds (especially between mainland China and Hong Kong SAR), while others are understated as they involve 'trans-shipping' via offshore financial centres. Investment data reflects the country of the immediate investor, rather than the country of the ultimate owner or investor. Many international investments are made through financial intermediaries, holding companies or investment managers which are often incorporated in third-party countries. Examples include the British Virgin Islands and the Cayman Islands in the Caribbean, Hong Kong SAR and Singapore in Asia, and to a lesser extent Switzerland and Luxembourg in Europe. In some cases these centres are the result of preferential tax arrangements.[291] Offshore financial centres accounted for 8 per cent of global foreign direct investment inflows in 2013, with growth rates similar to global foreign direct investment.[292]

In relation to stocks of foreign direct investment, some countries report stock data as simply the accumulation of past flows. This is problematic, because it does not account for changes in the value of assets. Some countries base their valuations on market prices, and others use book values. Cross-border mergers and acquisitions have assumed a growing importance in global foreign direct investment flows, and data on cross-border mergers and acquisitions are mainly published by private organisations like Thomson Reuters.[293] Academics have also attempted to compile 'micro' datasets on foreign direct investment deals.[294]

287. For a breakdown of country responses, see: http://stats.oecd.org/wbos/fileview2.aspx?IDFile=8ecdfda9-9380-4d8f-be1e-eac8434d06aa (last accessed 29 April 2015).
288. Maurer, A, Marcus, Y, Magdeleine, J and d'Andrea, B (2008), 'Measuring Trade in Services', *A Handbook of International Trade in Services*, The World Bank, Oxford University Press, Chapter 4.
289. ABS Cat. No. 5494.0, 2000–01 offers some data on inward foreign affiliate trade in respect of the 2000–01 financial year.
290. Hattari, R and Rajan, RS (2009), 'Understanding Bilateral FDI Flows in Developing Asia', *Asian-Pacific Economic Literature*, Crawford School of Economics and Government, Australian National University and Blackwell Publishing Asia.
291. Department of Foreign Affairs and Trade (2014), 'International Investment Australia 2013', Box J.
292. United Nations Conference on Trade and Development (2014), *World Investment Report Overview 2014*, p. xlvii.
293. Thomson Reuters offers data on over 900,000 merger and acquisition events announced since the late 1970s, including 85,000 deals in the Asia-Pacific region ex. Japan. The database claims to be the longest and deepest collection of deals available.
294. See, for example: Tang, H and Chen, H (2014), 'The Dragon Soars: Micro Evidence on Chinese Outward Direct Investment', *VoxEU*, 22 September.

In recent years, some private companies have also started to provide information on investment related to greenfield and expansion projects, although their databases typically record announced projects and do not necessarily reflect actual implementation of projects. The geographical coverage and other methodological aspects vary according to the source.[295]

The ABS data on Australia's foreign direct investment relationships with individual countries have significant limitations. Many entries are listed as 'NP' (not for publication).[296] Even for a significant investor like China, there is a break in the data for inbound foreign direct investment in 2007 and no public data before 2006. In addition, the ABS datasets on sectoral investment are not integrated with the datasets on partner countries. In other words, it is impossible to understand from the data which industry sectors, such as mining or financial services, a foreign nation is investing in in Australia.

FIRB reporting *does* indicate the sectors that are receiving investment, but figures are likely to represent an upper limit on the actual level of foreign direct investment in Australia, since not every approval granted by FIRB results in a sale to a foreign investor or temporary resident. Real estate investment data are particularly problematic. There is no adjustment made to the data to reflect whether proposed purchases were subsequently completed. Developers of some proposed new residential projects can receive pre-approval from FIRB to sell up to 100 per cent of the resultant dwellings to non-residents, after which no further approval from individual buyers is required. As a consequence, the published data do not reflect the share of new residential dwellings actually sold to foreign citizens or temporary residents, or the timing of these sales.

Perhaps more importantly, the FIRB data reflect only gross approvals by foreign buyers; the subsequent resale of properties back to Australian citizens or permanent residents (required, for instance, when temporary residents vacate the property) is not measured.[297] Other limitations of the FIRB data include the lag in their availability as well as series breaks (such as changes to reporting requirements in 2009 and 2010). ABS data on real estate cannot be split between foreign and local ownership. The ABS has recommended that if comprehensive data on real estate investment is a priority, FIRB and the state offices for transfers and titles could be required to collect it.[298] FIRB recently proposed a national register for property transactions to help track buying by foreigners.[299]

In addition, investment below FIRB's approval thresholds is not reflected in the data, unless it is made by state-owned enterprises. The state titles and transfers offices do not record the nationality of parties in property transfers. The ABS has noted that data on foreign purchases of local property below the FIRB thresholds are unreliable.[300]

Some private organisations have compiled their own databases to partially fill these gaps. According to KPMG and the University of Sydney's China Studies Centre, despite strong public interest, little detailed factual information has been previously available about the nature and distribution of China's direct investment in Australia. The two organisations have combined to produce a dataset that covers investments into Australia made by entities from China through mergers and acquisitions, joint ventures and greenfield projects.[301]

Limitations of data on portfolio investment

The cross-border portfolio flow data also contain many gaps. Perhaps most significant is the fact that there is little information on the ultimate holders of financial securities. Thus, it is difficult for analysts to observe cross-border holdings of important assets like government debt, a limitation made clear when weak sovereigns and weak banking systems investing in government debt in the euro zone almost took each other down in a vicious cycle.

Currently, international investment position datasets measure foreign assets and liabilities on a functional category basis. Only a limited number of countries report the sectoral identities of international investors (i.e. banks, other financial corporations, non-financial corporates, households and governments). Even in those cases, the sectoral identities of their cross-border counterparts are typically not reported. Similarly, the available official data on the currency composition of cross-border positions is quite sparse.

295. Fujita, M (2008), 'A Critical Assessment of FDI Data and Policy Implications', *Transnational Corporations*, Vol. 17, No. 2.
296. ABS Cat. No. 5302.0, December 2014, 'Quality Declaration — Summary'.
297. Gauder, M, Houssard, C and Orsmond, D (2014), 'Foreign Investment in Residential Real Estate', *Reserve Bank of Australia Bulletin*, June.
298. McKenzie, M (2014), 'Little Hard Data in the Hard Area of Foreign Investment', *The Conversation*, 24 July.
299. Rose, S (2015), 'Authorities Helpless to Stop Foreign Home Buyers', *The Age*, 25 March.
300. Iggulden, T (2014), 'ABS Admits Data on Foreign Real Estate Buyers is "Hit and Miss"', *ABC News*, 25 June.
301. KPMG and The University of Sydney China Studies Centre (2013), 'Demystifying Chinese Investment in Australia', March.

The prominence of official reserves and sovereign wealth funds in aggregate foreign assets (especially for emerging and developing economies) means that greater transparency around the asset and currency composition of these holdings would improve the overall understanding of cross-border positions. On the liability side, more information on the identities of foreign investors in sovereign debt markets would help governments in understanding the nature of their investor base.[302]

In practice, identification of counterparties for securities positions is difficult for various reasons, including that (a) the issuer is not always aware of current holders of securities, (b) transactors in securities markets may not be aware of the identity of the counterparty, and (c) security holders may be unaware that income on securities positions may be payable by a financial intermediary that created a 'short' or reverse position in the security rather than by the issuer of the security. Issues arise when a tradeable instrument is sold by a holder to another party. Such transactions involve only an exchange of assets, in contrast to the initial issue of a new instrument, which involves the creation of a new liability.[303]

In addition, most available data on bilateral portfolio investment positions is based on the concept of residence. Residence-based data will tend to overstate exposures to and of financial centres, like Hong Kong SAR and Singapore, which play an important role as international financial intermediaries. There can be a 'custodial bias' as surveys identify only the first holder of a financial asset in a chain.[304] Official statistics are also believed to substantially underestimate the net foreign asset positions of rich countries because they fail to capture most of the assets held by households in offshore tax havens. One analysis finds that around 8 per cent of the global financial wealth of households is held in tax havens, three quarters of which goes unrecorded.[305]

Data limitations in the euro area are being addressed through initiatives to develop securities holding statistics. The European System of Central Banks (ESCB) has taken steps to collect data on the holding of securities on an instrument-by-instrument basis, through its Centralised Securities Database (CSDB).[306] The collection of the extra data required to improve understanding of cross-border financial linkages would be greatly facilitated by the standardisation of financial data. Since 2012, there has been considerable progress in the promotion of legal entity identifier (LEI) codes, with the establishment of the Global LEI Foundation in June 2014 an important milestone. The widespread adoption of LEI codes will make it easier to identify counterparts in a consistent manner.[307]

Finally, in Australia, while the ABS reports on funds sourced from overseas by Australian investment managers (A$80.79 billion at 31 December 2013) the data are not broken down any further. The ABS coverage is wider than that of the FSC and Perpetual's Australian Investment Managers Cross-Border Flows Report (which examines only Australian MITs), as it includes both wholesale and retail registered MITs as well as individual portfolios, such as mandates for institutional investors and separately managed accounts for individuals.[308]

Limitations of data on foreign banking claims

Large global banks are composed of thousands of entities located in many countries. They can lend cross-border directly from headquarters, and/or be active in host countries through subsidiaries or branches that also take local deposits. Analysing banks' operational structures purely using group-level consolidated data, as are available through the BIS official datasets, can be problematic.

302. Lane, PR (2015), 'Cross-border Financial Linkages: Identifying and Measuring Vulnerabilities', *VoxEU*, 26 January.
303. International Monetary Fund (2009), *Balance of Payments and International Investment Position Manual*, Sixth Edition, Washington DC, Chapter 6.
304. Milesi-Ferretti, GM, Strobbe, F and Tamirisa, N (2010), 'Bilateral Financial Linkages and Global Imbalances: a View on The Eve of the Financial Crisis', IMF Working Paper WP/10/257.
305. Zucman, G (2013), 'The Missing Wealth of Nations: Are Europe and the US Net Debtors or Net Creditors?', *The Quarterly Journal of Economics*, Vol. 128, Issue 3.
306. Sola, P and Strobbe, F (2011), 'Addressing Data Gaps Revealed by the Financial Crisis: European Central Bank Statistics on Holdings of Securities', Irving Fisher Committee on Central Bank Statistics, IFC Bulletin, No. 34.
307. Office of Financial Research (2015), 'Remarks by OFR Director Richard Berner at the Financial Regulation Summit: Data Transparency Transformation', 24 March.
308. Financial Services Council and Perpetual (2014), '2014 Australian Investment Managers Cross-border Flows Report'.

The official BIS data contain several limitations. For instance, no explicit data are collected on banks' foreign liabilities on a consolidated (group-wide) basis. Regulators consider that data on cross-border exposures are not sufficiently granular. There is also no breakdown of claims (or liabilities) by currency on a consolidated basis.[309]

Data that are collected by national bank supervisors are not widely shared, and only broad aggregates (if anything) are publicly disclosed. Bank-level data available outside the supervisory community are generally not detailed. Commercial databases compile information from banks' annual reports, but have considerable data lags and gaps. Information on the counterparty sector and country are generally missing, and coverage of branches is particularly poor. In many countries, standard balance sheet data (e.g. capital asset ratios) are not even publicly disclosed. Moreover, many banks disclose only their globally consolidated financial statements, which aggregate their positions across all of their subsidiaries and branches.[310]

In response to several data gaps identified during the global financial crisis, the G-20 countries recently agreed to expand the BIS international banking statistics. These extensions will enable better analysis of the funding risks of particular countries and the transmission of funding shocks in the event of a crisis. An important element of the plan is improved disclosure, with national authorities being encouraged to review their confidentiality rules to make the BIS data more accessible to the public. In response to this and other domestic considerations, APRA recently removed confidentiality rules that had previously restricted the granularity of the data that was able to be published by the RBA and BIS.[311]

309. Hoggarth, G, Mahadeva, L and Martin, J (2010), 'Understanding International Bank Capital Flows During the Recent Financial Crisis', Bank of England, Financial Stability Paper, No. 8.

310. Cerutti, E, Claessens, S and McGuire, P (2012), 'Systemic Risks in Global Banking: What Can Available Data Tell Us and What More Data Are Needed?', BIS Working Papers, No. 376.

311. Bailey, O, Van Uffelen, L and Wood, K (2012), 'International Activities of Australian Banks', *Reserve Bank of Australia Bulletin*, December.

GLOSSARY

ABMI	Asian Bond Markets Initiative
ABS	Australian Bureau of Statistics
ACFS	Australian Centre for Financial Studies
ADI	Authorised Deposit-taking Institution
AEC	ASEAN Economic Community
AIIB	Asian Infrastructure Investment Bank
AMNE	Activity of Multinational Enterprises Database
APEC	Asia-Pacific Economic Cooperation
APRA	Australian Prudential Regulation Authority
ARFP	Asia Region Funds Passport
ASEAN	Association of Southeast Asian Nations (Brunei Darussalam, Cambodia, Indonesia, Lao PDR, Malaysia, Myanmar, Philippines, Singapore, Thailand, and Vietnam)
ASEAN+3	ASEAN plus China, Japan and South Korea
ASIC	Australian Securities and Investments Commission
ASX	Australian Securities Exchange
ATO	Australian Taxation Office
ATR	Average Tax Rate
AUM	Assets Under Management
AUSTRAC	Australian Transaction Reports and Analysis Centre
BIS	Bank for International Settlements
BPM	Balance of Payments and International Investment Position Manual
BPT	Business, Professional and Technical Services
CAGR	Compound Annual Growth Rate
CDIS	Coordinated Direct Investment Survey
ChAFTA	China-Australia Free Trade Agreement
CPIS	Coordinated Portfolio Investment Survey
CSDB	Centralised Securities Database
DFAT	Department of Foreign Affairs and Trade
DOTS	Direction of Trade Statistics
EFLIC	Eligible Foreign Life Insurance Company
EMU	Economic and Monetary Union
EPFR	Emerging Portfolio Fund Research
ESCB	European System of Central Banks
ETF	Exchange Traded Fund
EU	European Union
FATS	Foreign Affiliate Trade in Services, or Foreign Affiliate Trade Statistics
FDI	Foreign Direct Investment
FIRB	Foreign Investment Review Board
FISIM	Financial Intermediation Services Indirectly Measured
FSC	Financial Services Council
FTA	Free Trade Agreement
GATS	General Agreement on Trade in Services
GDP	Gross Domestic Product
GVA	Gross Value Added
IIP	International Investment Position
IMF	International Monetary Fund
ISIC	International Standard Industrial Classification of All Economic Activities
ITC	International Trade Center
JAEPA	Japan-Australia Economic Partnership Agreement
KAFTA	Korea-Australia Free Trade Agreement
LEI	Legal Entity Identifier
MIT	Managed Investment Trust
OBU	Offshore Banking Unit
OECD	Organisation for Economic Co-operation and Development
QFII	Qualified Foreign Institutional Investor
RBA	Reserve Bank of Australia
RCEP	Regional Comprehensive Economic Partnership
RMB	Renminbi
SAR	Special Administrative Region
SME	Small and Medium Enterprise
SMSF	Self-Managed Super Fund
STRI	Services Trade Restrictiveness Index
SWIFT	Society for Worldwide Interbank Financial Telecommunication
TiSA	Trade in Services Agreement
TPP	Trans-Pacific Partnership
UDR	Unsponsored Depositary Receipt
UFI	Unauthorised Foreign Insurer
UNCTAD	United Nations Conference on Trade and Development
WTO	World Trade Organization

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