

# Southeast Asia Financial Integration and Infrastructure Investment

*What Role for the United States?*

By Murray Hiebert

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IN PARTNERSHIP WITH



*The CSIS Southeast Asia Program on April 17, 2018, hosted a small, high-level roundtable discussion on U.S.-Southeast Asia Financial and Investment Relations.*

*The first session of the roundtable focused on Southeast Asia financial integration and the role the United States might play in responding to a future financial crisis. The second session examined the state of infrastructure investment in Southeast Asia and the role the United States can play.*

*Participants included former senior American and Southeast Asian finance officials, regional financial experts, and economists.*

*This report summarizes the key findings and conclusions of the roundtables.*

*The roundtable was the first in a series of events on Southeast Asian economics and trade made possible with support from Bank Negara Indonesia.*

## THE ISSUE

- Southeast Asia has come a long way since the devastating financial turmoil of 1997 and has set up mechanisms to avoid the next shock. But in case a future crisis hits, it would be useful for the U.S. government to say upfront if it would support International Monetary Fund (IMF) support. Some in the Trump administration have said they oppose IMF bailouts.
- The newest opportunity—and challenge—to Southeast Asia’s financial system is the bursting onto the scene of fintech firms. These companies are meeting the urgent needs of underserved populations. Yet their activities outstrip the ability of traditional regulators to govern their activities and protect consumers.
- China’s Belt and Road Initiative could play a mighty role in meeting infrastructure needs in Southeast Asia if it is done right. But so far Beijing has said little about what it envisions the impact of its projects to be. “Will that spending help people who need it most?” asks Jonathan Hillman of CSIS’ Reconnecting Asia Project. “Will it go into viable projects...? Will it help or hurt climate change?”
- “[I]n countries where public debt is already high, careful management of financing terms [for infrastructure projects] is critical,” IMF Managing Director Christine Lagarde said during a conference in Beijing. “This will protect both China and partner governments from entering into agreements that will cause financial difficulties in the future.”

## SECTION ONE: FINANCIAL INTEGRATION

Southeast Asia has done well economically over the past five decades and remains one of the fastest-growing regions of the world. Per capita annual income has risen dramatically and the incidence of poverty has dropped to 14 percent from 40 percent. The region has some of the planet's highest growth in the world averaging around 5.2 percent. This growth has been supported by trade liberalization and freer capital flows, but it still needs a lot more investment, particularly in infrastructure.

More can be done to unlock the region's full economic potential. Stepped-up financial integration in Southeast Asia is of mutual interest to the region and to the United States because it can help balance risk, foster cooperation, and bring new sources of capital and growth. U.S. treasury officials meet regularly with their Southeast Asian counterparts, but the United States is not as deeply embedded in the regional financial architecture as it could be.

The newest opportunity—and challenge—to the financial system in Southeast Asia is the bursting onto the scene of financial technology, or fintech, firms. These companies and technologies are meeting the urgent needs of underserved populations and smaller firms. Yet many of their activities currently outstrip the ability of traditional regulators to govern their activities. This calls for urgent steps to update Southeast Asia's regulations governing fintech.

Since the Asian financial crisis in 1997, policymakers in Southeast Asia worked to reform their financial systems. They have built up domestic reserves through higher savings rates, introduced more flexible exchange rate regimes, applied Basel III measures to strengthen bank capital requirements, and moved cautiously to open their capital accounts.

They have worked to achieve greater financial cooperation and integration among themselves and the larger Asian region. One of their biggest achievements has been the establishment of arrangements for regional liquidity support in the face of a future crisis. These arrangements include the Chiang Mai Initiative Multilateralization (CMIM) and moves by individual countries like Indonesia and Malaysia to establish bilateral currency swap arrangements with countries including China, Japan, and South Korea.

Southeast Asian finance leaders participate in the Association of Southeast Asian Nations (ASEAN) Plus Three framework, which also includes China, Japan, and South Korea. The ASEAN countries are also joined in negotiations for a Regional Comprehensive Economic Community

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(RCEP) trade agreement, which includes Australia, China, India, Japan, New Zealand, and South Korea. It is expected that closer trade linkages under the RCEP will result in closer financial ties. Four ASEAN nations are also members of the new Comprehensive and Progressive Trans-Pacific Partnership (CPTPP) trade agreement.

ASEAN as a grouping has also moved toward greater financial services integration and harmonization of regulations under the ASEAN Economic Community (AEC). Under this framework, the Southeast Asian banking community is establishing the ASEAN Banking Integration Framework (ABIF) to increase market access and operational flexibility to qualifying regional banks.<sup>1</sup> The goals of these steps by the 10 economies, which are at very different stages of development, are to bring new sources of capital for economic growth, improve the allocation of savings, foster increased cooperation, and help balance risk.

Increased financial integration also carries some risks like greater vulnerability to contagion of financial troubles across the region. To minimize risk, regulations need to be harmonized across the region and information must be shared quickly. This can help level the playing field between countries and lower the cost of financial services across Southeast Asia.

Although financial integration within Southeast Asia has increased, it still lags integration on the trade side, which is much more robust. Only a small fraction of portfolio investment comes from within the region, while the majority still originates from the advanced economies of the United States and Europe. To see an uptick in capital market links would require reduced regulatory barriers and increased harmonization of regulations, including contract enforcement.

To be sure, another financial crisis is possible, but much has changed in Southeast Asia since the 1997 crisis. The region's finances are in better shape. Most of the countries are less dependent on foreign capital flows and have current

account surpluses instead of the earlier deficits. In addition, most countries have bigger foreign exchange reserves and depend much less on short-term foreign credit.

## *If the IMF is involved in responding to a crisis, how would President Donald Trump's administration, which includes officials skeptical of IMF bailouts, respond to requests from Southeast Asia for IMF help?*

### **CHIANG MAI INITIATIVE MULTILATERALIZATION**

The International Monetary Fund (IMF) with strong support from the United States played a key role in responding to the 1997 financial crisis by committing some \$700 billion to affected members. However, the policy tightening required under IMF programs and the popular backlash that ensued led to concerns that they had become too dependent on the IMF, prompting the ASEAN countries to strengthen the regional financial safety net in the year 2000 by expanding an earlier bilateral ASEAN swap arrangement to include China, Japan, and South Korea, creating the Chiang Mai Initiative (CMI).

The CMI's first test came in 2008 following the collapse of Lehman Brothers in the United States when short-term capital quickly exited many emerging market economies. But instead of turning to the CMI, the members moved quickly to secure bilateral swaps with the United States, China, Japan, and others. This prompted an effort in 2009 to multilateralize the CMI to form the Chiang Mai Initiative Multilateralization (CMIM) which would provide short-term liquidity help in case of balance of payments challenges.

The CMIM included more currency swap line arrangements than the earlier initiative, and in 2014 the size of the fund was doubled to \$240 billion. Officials also increased the amount available without an accompanying IMF program to 30 percent. And the members set up an independence surveillance unit in 2011, named the ASEAN+3 Macroeconomic Research Office (AMRO).<sup>2</sup>

These are important developments, but several issues are still left hanging. One issue is the size of the swap

arrangement. The \$240 billion may not be sufficient in a truly regional crisis.<sup>3</sup> Would a troubled financial system be able to turn only to the CMIM or would the IMF also need to be involved in the support arrangements? Would it be possible for a country to circumvent the IMF entirely?

If the IMF is involved in responding to a crisis, how would President Donald Trump's administration, which includes officials skeptical of IMF bailouts, respond to requests from Southeast Asia for IMF help? Would the de facto "preferred creditor status" of the IMF prevail in a situation where shorter-term swap arrangements are also part of an overall financial package?

### **FINTECH REVOLUTION**

Another challenge for Southeast Asia's banking industry is the need to embrace the digital revolution, including the emergence of fintech to meet the growing demands of the region's underserved consumers and small and medium-size enterprises (SMEs). Fintech is the use of technological innovation to deliver financial services such as digital payments, investments, financing, and insurance to consumers and smaller businesses.<sup>4</sup>

The McKinsey Global Institute estimates the region has nearly 270 million "financially excluded" people who don't have access to bank accounts and credit cards and some 30 million SMEs facing a credit shortage of about \$175 billion.<sup>5</sup> It is to these needs that fintech startups are trying to respond by providing consumers greater financial opportunity and inclusion.

Southeast Asian banks watched the rise in China of Alibaba's Ant Financial and Tencent's Tenpay as major financial players in response to the fact that traditional banks were slow to meet the needs of Chinese consumers. "Alibaba and Tencent are carving up Southeast Asia," one roundtable participant observed. "These are the competitors of the twenty-first century—they aren't Maybank versus DBS anymore."

## *The region has nearly 270 million "financially excluded" people who don't have access to bank accounts and credit cards.*

But DBS of Singapore and Maybank of Malaysia have seen the writing on the wall. They have responded by setting up incubator programs to support fintech startups, while fintech startups are looking to banks as anchor investors

in their companies. Singapore-based ride-sharing app Grab has established a partnership with Lippo Group of Indonesia to provide a digital payment system for Grab's over 50 million users in Indonesia.<sup>6</sup>

Alibaba and Tencent are entering Southeast Asian countries with e-commerce and mobile payment services through hookups with local players to help them adapt to local cultural norms, provide reassurance about security, and get approvals and licenses from local governments. Alibaba invested \$1 billion in 2016 to gain control of Lazada Group, Southeast Asia's largest electronics and clothing portal.<sup>7</sup>

Ant Financial, an Alibaba spinoff running multiple financial services, the same year took a major stake in Thai online payment provider, Ascend Money.<sup>8</sup> Alipay, China's most popular online payment service and an Alibaba affiliate run by Ant Financial, is working with international payment providers to ensure that the growing numbers of Chinese travelers can easily use this payment service when they are abroad.

Tencent, which owns WeChat, is investing in companies providing mobile money and gaming services, and has taken a stake in Grab, Southeast Asia's ride-hailing service.<sup>9</sup> Tencent has been cleared for a Malaysian electronic payment license that allows locals to debit domestic bank accounts to make payments. WeChat is implementing an ecosystem that will include messaging, social media, money transfers, and online shopping targeting particularly ethnic Chinese in Malaysia.

Alibaba has also recently even branched out into infrastructure development. The Chinese firm recently signed a \$345.2 billion deal to become the first big-name company to help Thailand redevelop the country's eastern seaboard industrial area.<sup>10</sup> Alibaba is urging Thai universities and institutes to step up their technology-related curriculum ahead of rising demand for digital skills prompted by the company's investment in the eastern seaboard.

## *Alibaba and Tencent are carving up Southeast Asia.*

"WePay and Alibaba are setting the standards," an Asia discussant warned. "We'll wake up one day and find we live in an Alibaba universe. The banks are asleep on the payment side."

"There's some risk because [fintech firms] are being governed by the same rule book as banks," an American participant said. Governments in Southeast Asia are

scrambling to regulate this exploding new sector to prevent fraud and ensure customer confidentiality. Bank Indonesia, the country's central bank, in 2016 issued licensing, approval, and reporting regulations to govern e-wallet providers and gateways for payment. It has set up a fintech monitoring squad to supervise moves toward a cashless world.

Singapore has unveiled a raft of new fintech policies, including the launching of a regulatory "sandbox," which allows qualifying startups to test new technologies in a less strict environment for a set period of time. Malaysia and Thailand were the first two countries in Southeast Asia to enact equity crowdfunding regulations for fintech firms.<sup>11</sup>

U.S. companies are still relatively minor players in fintech in Southeast Asia, despite long having been active in providing regular banking services. But today U.S. banks are facing several regulation changes that could make their operations in the region more difficult.

One issue in Indonesia that concerns U.S. financial service companies is the data localization requirement being proposed by Bank Indonesia that requires financial sector companies to establish data centers in Indonesia. Similar requirements are being discussed in Malaysia, Thailand, and Vietnam. U.S. companies express concern that this requirement will make it difficult for them to leverage economies of scale from existing data centers and hinder cross-border data flows. This could create particular burdens for SMEs.

Secondly, several countries, including Indonesia and Vietnam, are considering regulations on a national payment gateway to support electronic payments for credit card payments through one or two local banks. One U.S. participant warned that this single gateway could create "a single point of failure." A discussant from Asia said that "if everyone wants national actors, including from Vietnam and Laos, the system could become suboptimal." This new regulation also could have the effect of cutting off market access for U.S. and other foreign credit card and foreign payment companies.

A Southeast Asia speaker urged the United States to continue to play an active role in the region despite the Trump administration's decision to pull out of the 12-nation Trans-Pacific Partnership. He argued that this move had created an "absence of the United States in ASEAN," adding "China doesn't look at ASEAN as a unity but bilaterally, which weakens the role of individual countries." This, he said, makes it important that Washington "ensure that the political bonds are still there."

## RECOMMENDATIONS FOR THE UNITED STATES

- [The Trump administration should provide explicit support](#) for IMF engagement, if Southeast Asia is hit by a major economic or financial crisis. Some members of the Trump administration have said in the past they are skeptical about IMF bailouts, so it would be helpful if Washington could clarify if the U.S. government would sign off on IMF support if it were needed in a crisis.
- [The administration should encourage senior-level engagement](#) of U.S. government economic officials with ASEAN counterparts, including in the context of the ASEAN finance ministers and other high-level regional economic forums.
- [Southeast Asian governments should keep pressing](#) to quickly adopt regulations to regulate the fintech sector to protect consumer confidentiality and reduce the chances of fraud. U.S. industry and government officials should offer assistance by feeding more U.S. policy expertise to ASEAN regulators and into the regional fintech discussion.
- [Southeast Asian governments should include](#) U.S. financial services companies and government officials in discussions about their plans to enforce a single gateway for credit card payments and insist on bank on-shoring their data. Implementing these measures could make it much more expensive and difficult for U.S. financial services companies to operate in the region.

## SECTION TWO: INFRASTRUCTURE DEVELOPMENT

The year 2018 may well turn out to be the one in which infrastructure construction in Southeast Asia is thrust into high gear. Countries in the region have over \$320 billion in the pipeline for infrastructure spending on everything from ports to high-speed rail and roads to airports, according to calculations by Bloomberg News. Governments are kicking in significant spending increases for infrastructure in their budgets and are being supplemented by massive injections of funding from China's Belt and Road Initiative (BRI) and Japan's Partnership for Quality Infrastructure.

The Philippines has allocated \$20 billion in its 2018 budget for roads and railroads across the archipelago. Malaysia has earmarked over \$50 billion in this year's

budget for its East Coast Rail Link and Kuala Lumpur to Singapore high-speed rail, while Thailand has pledged some \$46 billion over five years to develop its Eastern Economic Corridor. Indonesia has announced more than 200 infrastructure projects that will need almost \$70 million in the five years to 2019. Vietnam has committed \$6.6 billion but needs \$480 billion more to fund projects it prioritized until 2020, including a 1,100-mile expressway from Hanoi to Ho Chi Minh City.<sup>12</sup>

The most grandiose vision for the region is the BRI announced by China in 2013, which includes not only infrastructure projects, but also trade agreements, people-to-people exchanges, and has recently been expanded to include the Arctic and outer space. The popular narrative in the media is that China is far ahead of Japan in Southeast Asia, but data compiled by BMI Research about infrastructure projects in Southeast Asia shows a more complicated picture.

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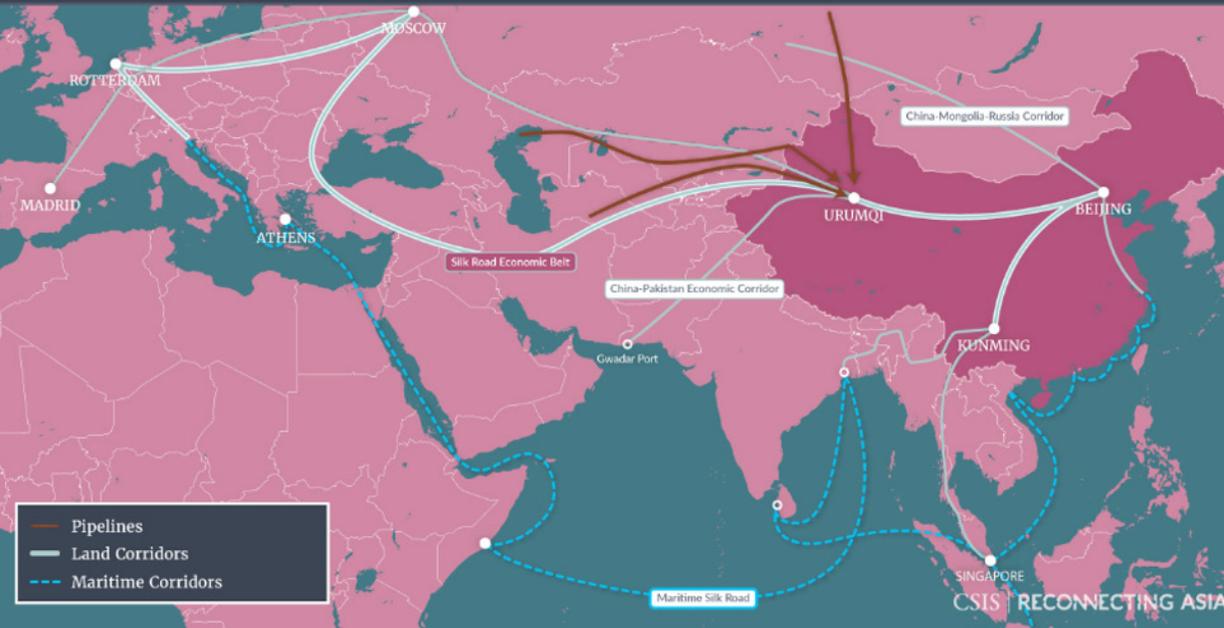
BMI finds that Japan since the 2000s has completed projects costing \$230 billion, with those from China reaching \$155 billion. Over 90 percent of the projects have actual or planned construction dates after 2013. Japan is ahead in Indonesia, the Philippines, Singapore, and Vietnam, while China leads in Cambodia, Laos, and Malaysia.<sup>13</sup> Japan may have a head start but it could be only a matter of time until China pulls into the lead.

The contest to construct Asia's architecture is a "tug of war between quantity and quality," writes Jonathan Hillman, who directs CSIS's Reconnecting Asia Project. The BRI is by any measure an enormous undertaking with its pledge to deliver \$1 trillion worth of infrastructure to connect around 70 nations. To be sure, Asia requires mountains of cash to meet even its basic infrastructure needs.

"We can't afford to say we don't need you to China," an Asian participant observed. "So we play Japan and China off against each other to get the best from both."

China's BRI could play a mighty role in meeting these needs if it is done correctly. But so far Beijing has said little about what it envisions the impact of its projects

## China's Vision



*Increasingly there is a concern that some low-income countries may be borrowing excessive and unsustainable amounts in nontransparent deals from China and private creditors.*

to be, Hillman says. “Will that spending help people who need it most? Will it go into viable projects or white elephants? Will it help or hurt climate change? Will it create or destroy value?”<sup>14</sup>

As China gets more involved in infrastructure projects in Southeast Asia, it is bumping headfirst into problems faced earlier by other investors. Chinese projects have faced land acquisition headaches (high-speed train from Jakarta to Bandung, Indonesia), environmental challenges (hydropower projects in Laos and Cambodia), and corruption charges and huge cost overruns (the sky train in Hanoi, Vietnam).

Some Chinese projects are turning out to be downright difficult to negotiate and implement. The railroad project across small, underdeveloped Laos, which will connect Kunming in southern China to Bangkok, Thailand, took roughly five years to negotiate. Work has now begun, but before getting agreement officials were bogged down in protracted, complex negotiations over the terms of

China’s loan, how much of the cost Laos would bear, and how much land Chinese companies would get on each side of the track.

Increasingly there is a concern that some low-income countries may be borrowing excessive and unsustainable amounts in nontransparent deals from China and private creditors. U.S. Treasury Secretary Steven Mnuchin, during the

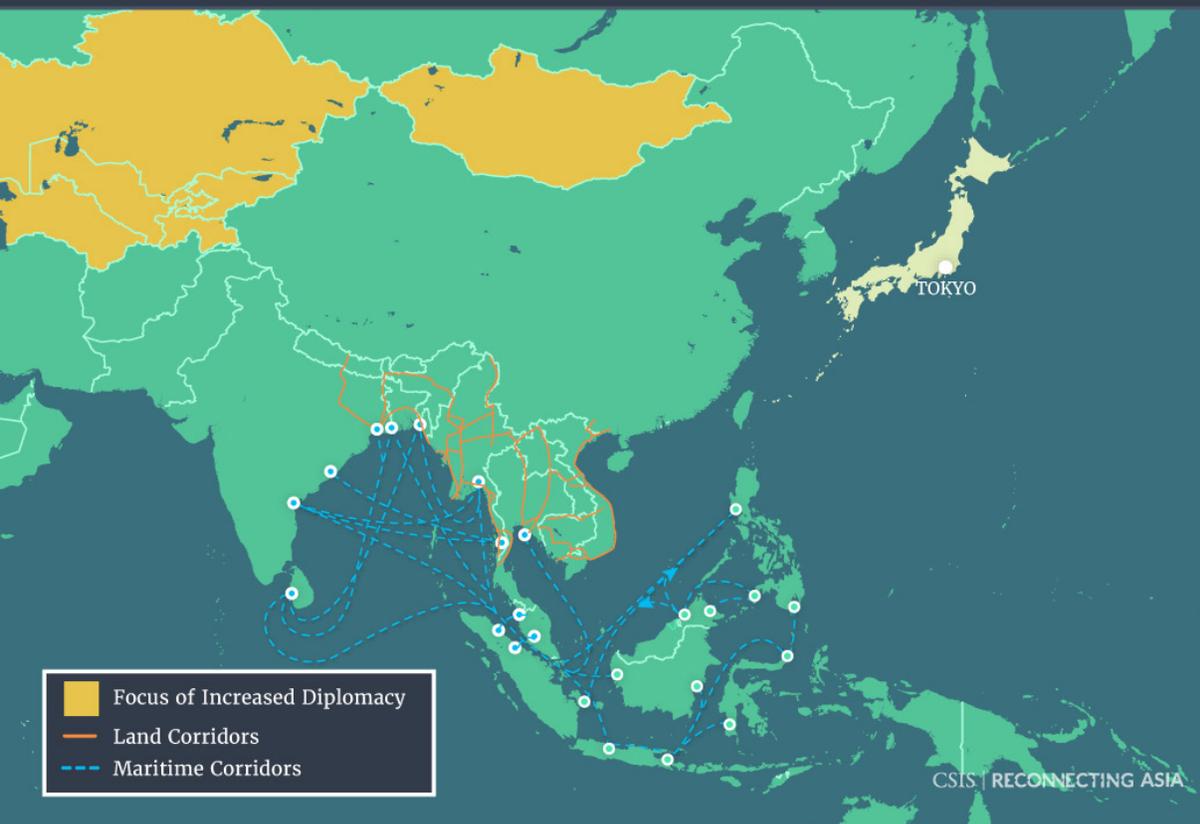
World Bank-International Monetary Fund (IMF) meetings in April, called on these financial institutions to launch a “joint action plan” to monitor lending from China’s BRI, which is signing so many deals to build infrastructure that it is almost impossible for international observers to keep track.<sup>15</sup>

IMF Managing Director Christine Lagarde during a recent conference in China argued for more transparency and prudent stewardship in Chinese-backed projects. “[I]n countries where public debt is already high, careful management of financing terms is critical,” Lagarde said. “This will protect both China and partner governments from entering into agreements that will cause financial difficulties in the future.”<sup>16</sup>

In response to some of the concerns about China’s projects, Japan mounted a \$200 billion Partnership for Quality Infrastructure in 2015. Japan has defined the characteristics of quality infrastructure as including safety, sustainability, and reliability.

One Asian participant in the roundtable argued that to help address the challenges posed by China’s ramped-up role in the region’s infrastructure projects might require that governments like that of Japan change their tactics from a “confrontation stance against China” to more active engagement in Chinese-led projects. He argued that involvement by other countries in Chinese projects might help reduce regional competition between China and Japan and the United States, which “would reduce

## Japan's Vision



*In projects implemented by multilateral banks, 41 percent of the work goes to domestic contractors, while that number drops to less than 8 percent in Chinese-funded projects.*

anxiety” in the region about which nation is closer to which power and make it more feasible to ensure the effectiveness of projects.

Some participants argued that the involvement of private-sector financing from sources like long-term pension funds could help ensure that projects are more sustainable. One idea suggested by roundtable participants to make projects more “bankable” for private companies would be to provide opportunities for real estate development alongside the project, which is already being done in Chinese projects such as the railroad in Laos.

To help tap into the huge demand for infrastructure in Asia, Singapore is setting up an Infrastructure Office that

will bring together a cross-section of international and local companies ranging from institutional investors and developers to accounting, financial, and legal services to develop, finance, and implement projects.<sup>17</sup>

Already the World Bank’s International Finance Corporation (IFC) is opening an Asia treasury hub in Singapore to help companies raise local currency funds for regional infrastructure projects. Late last year, the pension fund for municipal workers in the Canadian

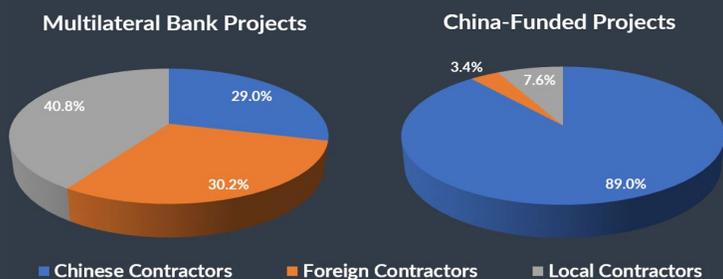
province of Ontario opened an office in Singapore to identify investment opportunities in the region.<sup>18</sup>

In some countries like Indonesia and Malaysia, there is a fairly widespread public perception that governments have become too dependent on Chinese aid for infrastructure projects. One popular concern is that Chinese infrastructure projects have a minimal multiplier effect. Chinese companies bring mostly workers from China, from the top manager to ordinary labor. “They use little Indonesian labor, causing resentment,” one participant noted. “In contrast, Japan brings the top managers from Japan, but uses local labor.”

An analysis by CSIS highlights these concerns. In projects implemented by multilateral banks, 41 percent of the work goes to domestic contractors, while that number drops to less than 8 percent in Chinese-funded projects. In multilateral bank projects, Chinese contractors snare 29 percent of the contracts, but in those funded by China they get a whopping 89 percent.

The massive spending on infrastructure by Southeast Asian governments is causing concern about budget shortfalls in other sectors. About one-third of Indonesia’s money for infrastructure comes from the government’s

## OPENNESS: “Beneficial to All”? CONTRACTOR DISTRIBUTION



Data drawn from CSIS Reconnecting Asia database.<sup>19</sup>

## RECOMMENDATIONS FOR THE UNITED STATES

Washington doesn't have a grand vision about how the United States could become involved in Southeast Asian infrastructure. The U.S. private sector, particularly institutional investors, would be interested in infrastructure projects if the risks were more manageable. A key challenge is that many infrastructure projects such as highways or railroads are not guaranteed to generate enough revenue to cover the costs of operating them and repaying the loans leading to concerns about projects going into default as happened with a Chinese-built port in Sri Lanka.

Some recommendations suggested by participants:

- [The U.S. government should consider working with the World Bank and Asian Development Bank](#), both of which are supported by the United States, to cobble together a consortium of lenders, including private commercial banks and government development agencies to finance infrastructure projects.
- [One possible tool in the U.S. arsenal](#) for providing loan guarantees for infrastructure projects is the Export-Import Bank (Ex-Im Bank) and the Overseas Private Investment Corporation (OPIC). President Trump in April appointed an acting head of the Ex-Im Bank and the administration should follow this move by supporting the nomination of four nominees to the bank board, which have been stuck for months. The

budget, while another third from Indonesian banks and the balance from foreign donors. “Infrastructure projects are crowding out other items in the budget like education and health,” an Asian economist said. “Many of these projects are being delayed.”

bank was established to assume credit and country risk that the private sector is unwilling or unable to accept. Unfortunately, the agency's board has been without a quorum (that requires at least three members of a five-member board) since 2015, which means it hasn't been able to approve loans of more than \$10 million.<sup>20</sup>

- [The United States, Japan, and other donors](#) should set up a mechanism to help Southeast Asian governments calculate the life-cycle costs of a project when they get bids from different potential funders. This would involve helping determine the total costs of a project over its life time, including the initial cost of construction and the expense of maintaining and repairing it over the years it's in use. This could help give borrowers more awareness about what they are signing up for when they take out an infrastructure loan.
- [Japan could consider launching a revenue bond scheme](#) in which international financial institutions and equity funds could invest and provide loans for infrastructure projects. An income tax exemption might be provided as an incentive for investors.
- [The Organization for Economic Cooperation and Development \(OECD\) has developed some useful guidelines](#) to help govern donors and recipient countries investing in and building infrastructure. These guidelines should be circulated and highlighted to the governments in China and Southeast Asia working on infrastructure projects to help them avoid some of the best-known pitfalls that hobble infrastructure projects.

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## APPENDIX: CSIS-BNI ROUNDTABLE

### PARTICIPANTS LIST

This report is a summary of the roundtable discussion. It does not necessarily reflect the views of the participants. Their involvement should not be interpreted as endorsing this summary of the discussion, either in their personal or organizational capacity.

*Roundtable on U.S.-Southeast Asia Financial and Investment Relations April 17, 2018*

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