Zeti Akhtar Aziz: Global trends for the emerging market economies

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 22nd ACI Asia-Pacific Congress on Financial Markets in the K-economy, Kuala Lumpur, 31 October 2002.

* * *

The recent decade has experienced a dramatic transformation of financial markets with far reaching implications on the growth prospects for the global economy. The single most important source of this change has been the rapid advancement in technology. Indeed, the revolutionary process brought about by the advances in technology has created new challenges and opportunities. These developments have been reinforced by the process of financial deregulation and liberalization. The recent decade has also witnessed a new wave of international crises, although in the more recent episodes, widespread contagion has been contained. Nevertheless, with highly volatile financial flows and heightened uncertainty in the global financial markets, the potential for contagion remains.

It is my pleasure to be here at this 22nd ACI Asia Pacific Congress on Financial Markets in the K-economy. In this more globalised, digitised and knowledge-driven environment, the challenge of restoring calm in financial markets is no longer a challenge being encountered by small emerging market economies alone, but is also a challenge being faced by the larger advanced economies. These developments have indeed tested policy makers across the globe. The focus of my remarks today will be on the implications of these global trends for the emerging market economies in general, and the East Asian region in particular and the potential for achieving enhanced growth in this more challenging environment.

Ladies and gentlemen

The recent decade has also witnessed a dramatic change in the form and nature of the globalisation process. The initial waves of globalisation in the form of trade have been followed by globalisation of corporations and in the recent years by globalisation of financial flows. While it has been acknowledged that these developments have brought more complex and new risks, their impact is significantly more pronounced and far reaching for emerging economies. In this environment, emerging economies have been presented with a global landscape in which their very ability to participate effectively in the globalisation process has been rendered increasingly more difficult.

Globalisation is not a new phenomenon for the East Asian economies. Indeed, the globalisation process has been an important element in the remarkable growth and prosperity that has been achieved by the East Asian economies. East Asia was able to ride the successive waves of globalisation in the 1960s, 1970s and 1980s. Many of the economies experienced a quantum leap into the industrialisation process as trade flows expanded at double-digit rates during most of this period. While the East Asian economies benefited from this global trend, the economies have not however, been immune to external shocks arising from shifts in international demand. The economies were affected by factors such as swings in commodity prices, significant oil price adjustments, and the slowdown in the major economies. While the impact of these trade - related shocks on the domestic economies of the East Asian countries involved costs, in terms of slower growth and dampened domestic economic activity, these economies were able to adjust to the sudden changes. In such an environment, there was also greater predictability in the direction of the economic trends, providing the basis on which appropriate policy responses were implemented to manage the economic adjustment process.

Emerging economies in particular, in the East Asian region participated in this globalisation process and benefited from the enhanced trade activities. In the recent decade however, there has been a distinct change in the nature of the globalisation process. Globalisation is no longer confined to trade and direct investment, but increasingly involves large cross- border financial flows. Over the recent decade, these financial flows have dominated the global market place. An emerging concern is that this trend would result in a widening of the divide between the developed and emerging and developing economies.

In a world in which the magnitude of the financial flows are significant, in which the financial transactions have instantaneous implications, in which the flows are unconstrained by any regulatory framework, then size, the degree of development and the degree of resilience of economies will matter. Countries that are small, and have less developed economic and financial systems, are open and liberalized, and that do not have the range of policy options at their disposal, will be highly disadvantaged in this global market place. It is this globalisation process that will contribute towards widening the existing disparities between nations.

Against this trend, the current global economic and financial environment has been characterised by increased uncertainty. There is uncertainty in the global economic outlook, financial markets and geopolitical developments. The expected strengthening of recovery in the advanced economies has yet to occur. Financial reporting irregularities and the weakening of the corporate sector has affected confidence, contributing to the increased volatility in the global equity markets. Further risks also remain on the horizon, including those emanating from structural imbalances in some of the advanced economies. These developments have resulted in unstable and highly volatile conditions in both the asset and currency markets. However, despite the major declines in asset markets, large shifts in financial flows, significant movements in major currencies, financial stress in the corporate and financial sectors in a number of countries followed by overall economic weakness, the East Asian economies have emerged relatively resilient.

Going forward, it is recognized that a higher tolerance level to sudden changes in economic conditions and to the more volatile market conditions is necessary. Building such tolerance levels involves enhancing the capacity, strength and resilience of the economy to cope with the external shocks to the system. Indeed, the East Asian region has the potential to enhance its capacity to deal with the risks and vulnerabilities and the potential to continue its growth process.

While countries in the East Asian region have many common characteristics, they are also diverse in several aspects. Common features include openness and export orientation and a high rate of growth of manufactured exports. Most countries have a high rate of capital accumulation supported by a high rate of savings. Macroeconomic stability has prevailed in most countries. Inflation has been relatively low and any external imbalances were of manageable proportions while the fiscal deficits have been modest and Government debt levels have been kept low. The countries in the region are, however, diverse in terms of natural resource endowments, the stage of financial sector development, the degree of market orientation of their economies, the choice of exchange rate regime and the degree of public policy activism. The overall growth strategy of the region has essentially been based on an export-oriented industrialisation drive. This model, which is based on high savings and investments, has indeed served the region well. In the current environment of slower growth, the strategies adopted by several of the East Asian economies have been to implement a series of pro-growth policies to contain the impact of the global slowdown on the domestic economy. The strong initial conditions in an environment of an improving outlook in the major economies, lends support for increased optimism for stronger growth in the near term. Going forward, however, the growth prospects in the East Asian economies are likely to continue to depend to a greater extent on domestic demand. The strength of export growth will depend on the overall pace of the global recovery.

The strategies that Malaysia has adopted include initiatives to strengthen and diversify the economic base and to develop and strengthen the financial infrastructure including the regulatory and supervisory framework. The emphasis was on pacing the liberalisation process according to the ability of the system to absorb a more competitive environment, and developing important policy instruments to enhance the effectiveness of policy. Measures were also instituted to strengthen risk management practices at the national and corporate level, establish an institutional arrangement to undertake surveillance and maintain an appropriate exchange rate regime that will effectively and efficiently facilitate international trade and investment. Finally efforts were also focused on promoting regional co-operation.

There are a number of other reinforcing sources of impetus that have potential of enhancing the growth prospects for the region. Demographically, Asia as a whole has a relatively young population. As a result, the region going forward will possess the largest pool of labour in the world. Harnessed in a productive and efficient manner, this pool has the potential to generate sustained growth for Asia.

There is also potential for intra-regional trade and financial flows to grow in East Asia. The ASEAN region alone consists of more than 500 million people. The market within East Asia provides an important new source of endogenous growth within the region. The changing structural pattern of trade in the region reflects the growing intra-regional trade which now accounts for almost half of Asia's total trade from just a fifth a decade ago. Intra-regional trade has also been enhanced by the opening up of large regional markets such as China. The share of East Asian exports to China has doubled in the past decade to about 10%. While there has been significant attention on the competition that China will create for other countries in the region, the focus should also be on the complementarities that are already feeding the regional growth process.

A third discernable trend in the region is the growing importance of domestic demand in the regional economies, supported by domestic-oriented policies in recent years, which would ensure that the gains in intra-regional trade could be sustained. In terms of financial flows, the development of regional markets is contributing towards strengthening the prospects for a deepening of Asian financial markets and promoting greater regional financial integration. The region is also studying the feasibility of establishing an Asian Bond Market to recycle part of the region's high level of savings to finance productive activity within the regional countries. To encourage the regional flows to be recycled into investments in the region, efforts have been taken to develop the capital market particularly in the area of securitisation, credit guarantee and market infrastructure. The regional economies recognize the importance of developing these markets thus co-ordinated efforts through various initiatives have been undertaken to remove impediments to these developments. With further lowering of trade barriers under the ASEAN Free Trade Area and ASEAN+3 initiatives, intra-regional investment flows would further increase.

The intensification of regional co-operation has been enhanced in recent years. In the aftermath of the Asian financial crisis, there has been an increase in the level of financial co-operation among the Asian countries. These efforts have revolved around swap facilities to provide emergency liquidity assistance, regional surveillance and peer review to enhance regional financial and monetary co-operation, regional capacity building and the enhancement of skills and capabilities of regional financial regulators and policymakers. Regional surveillance and peer review in particular is an important step forward as it will contribute to confidence building and would complement the implementation of the various regional financing schemes. Significant progress has been made in achieving the objectives of the Chiang Mai Initiative to create swap facilities to provide emergency liquidity assistance for the region. Closer co-operative efforts in the standardisation of systems and documentation procedures would also contribute to facilitating intra-regional trade and investment among economies within the region, as well as with the rest of the world. Effective co-operation in these areas will augment the foundations for realising the tremendous potential that this region possesses for future growth and prosperity.

Ladies and gentlemen,

An important transformation in the international financial landscape is the introduction of the euro which has indeed been a defining event. The objective was clearly to facilitate trade and investment within the region by removing the distortions in economic relationships introduced by exchange rate volatility. As a result, where there were previously 12 currencies, there is now only one. Corporations dealing with the 12 euro countries are now able to keep their books in one set of accounts and make operating and investment decisions without having to be concerned about exchange rate changes. For the rest of the world, it has been described as “island of price stability” in addition to the dollar area, to which capital can flow. Four factors are important in determining a currency's international role: relative stability, which would reduce the risk of holding assets in that currency; a strong exchange rate; so that capital losses can be avoided; deep and liquid financial markets for that currency, to enable holders to diversify, liquidate and adjust their investment portfolios; and finally, a strong regulatory support to minimise the possibility of crises. Indeed, the international success of the euro in coming years would depend on the extent to which these criteria are met.

The introduction of the euro has of course given impetus to other regional initiatives to pursue similar efforts to unify national currencies into a single regional currency. Such initiatives are being pursued in Latin America, Africa and the Middle East. In ASEAN, a taskforce has be set up to look into the issue. Clearly, with growing regional economic integration, not just within ASEAN but also among the ASEAN+3 countres, enhanced regional financial cooperation would play a beneficial and complementary role. Regional policy makers recognise that a single currency is a long-term option for the region. An important pre-condition for a single currency would be a significant degree of economic and financial convergence and integration. It would also require greater labour and capital mobility in the region.

While the single currency may be not in the region's immediate future, this does not preclude greater cooperation on exchange rate issues and other forms of financial co-operation among regional economies. There is indeed potential to benefit from enhanced financial cooperation and for the creation of mechanisms that would enable the region to better cope with periods of highly unstable financial market conditions. Institutional infrastructure such as regional surveillance and financial support mechanisms achieved under the Chiang Mai Initiative can be further enhanced over time to provide temporary liquidity support to regional countries and prevent the type of violent exchange rate movements observed during the Asian financial crisis. Such institutional arrangements need to be reinforced with greater regional economic integration.

In addition, to encourage part of the financial flows from the region to be recycled into investments in the capital market, efforts have been taken to further develop the capital market, particularly in the area of securitization, credit guarantee and market infrastructure. The regional economies recognise the importance of developing the capital market. Thus, coordinated efforts through various initiatives have been undertaken to remove impediments to the development of these markets.

Confronted by the current climate of uncertainty in the global economy and financial markets, our resolve has most certainly been to maintain constant vigilance towards all sources of risks and vulnerabilities and to preserve economic and financial stability. Efforts are also on going in financial and corporate sector reforms to strengthen our financial and economic foundations. The progress achieved thus far has strengthened the resilience of regional economies and financial systems. At the same time, measures have also been put in place by many of the regional economies to manage the risks from both external and internal sources.

From the Malaysian perspective as a small emerging market economy, the long-term solution is to enhance resilience and increase the tolerance level to absorb volatility and to be in a position to withstand external shocks and any slowdown in global growth. It is the underlying economic and financial foundations and its strength that will determine the capacity and resilience, and thus, the ability to ride out the storms and take advantage of the opportunities that the external environment accords to achieve sustainable performance over the medium and longer-term.