Zeti Akhtar Aziz: Brief remarks on managing financial instability and shocks in a globalising world

Introductory remarks by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Tun Ismail ali Chair Public Lecture, Kuala Lumpur, 6 February 2004.

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We are indeed honoured and privileged to have Dr. Yilmaz Akyüz, holder of the Tun Ismail Ali Chair in Monetary and Financial Economics at the University of Malaya, to speak to us today on "Managing Financial Instability and Shocks in a Globalizing World". The Chair on Monetary and Financial Economics at the University of Malaya was established by Bank Negara Malaysia in recognition of the contributions of the late Tun Ismail bin Mohamed Ali, the first Malaysian Governor of Bank Negara Malaysia. It is our hope that this Chair would contribute to enhancing expertise and knowledge in the area of monetary and financial economics.

Ladies and gentlemen,

Let me make a few brief remarks on the topic of today's lecture, based on our experience in managing the Malaysian economy. Uncertainty and instability are the defining feature of the international financial system today, as borders have become more porous, financial markets more integrated and as financial flows have surpassed trade flows as the dominant determinant of the international financial environment. Emerging market economies have become more vulnerable to international shocks which can have a significant adverse impact on the economy. Malaysia has approached this more challenging environment by increasing our own resilience and tolerance level to these shocks. There are three factors that are key to enhancing our resilience to external shocks.

Capacity building: strengthening the economic and financial base

The first is strengthening the economic and financial base. A deliberate policy to diversify the economy to achieve a greater balance between domestic and external sources of growth, to avoid excessive concentration in any activity and to reduce over-dependence on any particular market has increased the resilience of the economy. This has required shifting into new areas of comparative advantage and seeking new market opportunities and new areas of growth, while shifting out of those areas where comparative advantage has been eroded. Having flexible labour and capital markets has facilitated this process of adjustment.

Of equal importance is the development of a resilient institutional framework and institutions. This includes the promotion of strong private and public institutions. In the public sector, strong institutions can be measured in terms of building efficient and strong delivery systems that promote coordination in the government machinery to provide an enabling environment for operations in the economy. At the same time, sound private sector institutions are crucial. In addition to healthy financial positions, good systems of risk management and corporate governance would ensure better management and a healthy corporate sector. Another important aspect is the availability of timely and reliable financial information and the strengthening of the legal and regulatory framework for enforcement of the laws and regulations. Strong professional organisations can also play an important role to improve and enforce the standards and best practices.

Developing and diversifying the financial infrastructure is another important component of capacity building. In this respect, our Financial Sector Master Plan which was released in 2001 represents a ten-year strategy that charts the development of the financial sector. The focus of the initial phase of the plan is on the development of the financial infrastructure and financial markets as well as capacity enhancement and institutional development, in particular, of the domestic financial institutions, thereby putting in place the pre-conditions for moving forward to a more liberalised and competitive environment. Gradualism has been adopted to avoid disruptive and unstable conditions. The aim is to evolve a more diversified financial system with financial institutions that are efficient, innovative and resilient. The Masterplan places priority on good corporate governance and transparency within an effective regulatory and supervisory framework and a strong structure for consumer protection.

Liberalization of capital account

The second factor in enhancing national resilience is the approach to liberalising the capital account. While liberalisation of the capital account has potential benefits, it also carries substantial risks. For emerging economies, where the financial infrastructure is still relatively less developed, the premature liberalization of capital flows could lead to an accumulation of risk factors that could lead to instability and culminate into a financial crisis. The approach for the liberalisation of the capital account in Malaysia has been to adopt appropriate sequencing so that the increase financial integration will not have destabilising implications. It is important to have sufficiently developed domestic financial markets, sound macroeconomic conditions and sound institutions in place. Also important is a surveillance mechanism to monitor capital inflows and outflows. Of particular importance is the monitoring of the accumulation of external liabilities by the financial system and the private sector. Advance knowledge of imbalances and risks would facilitate early actions to manage emerging vulnerabilities.

An appropriate exchange rate regime

Finally, I would like to mention the significant value to national resilience of having an exchange rate regime that is aligned to the economic fundamentals. It is important to understand that the exchange rate is a means to an end and not an end in itself. Its purpose is to provide a fair rate of exchange between goods and services that are produced in the domestic economy with those that are produced abroad. Trade and investment is facilitated by an exchange rate that is stable and reflective of economic fundamentals, not by one that is volatile and unstable and subject to speculative capital flows. The exchange rate should also not be manipulated to cater to narrow sectoral interests. For every change in the exchange rate that benefits one sector, there would be another sector that is disadvantaged. Therefore, the exchange rate policy has to rise above sectoral interests and consider the overall economic implications in deciding on the appropriate exchange rate. It is also not prudent to respond to short-term trends or to focus solely on developments in bilateral exchange rates. Malaysia has trading and investment relations with many nations. We therefore, cannot look at movements of any particular currency pair as a basis for determining the appropriate valuation of the ringgit. A longer-term perspective to exchange rate policy is taken, looking at the relationship between the exchange rate and economic fundamentals. Of greater importance is to focus on enhancing our overall productivity and competitiveness against all our major trading partners.

The pegged exchange rate has served Malaysia well. It continues to serve Malaysia well. This is manifested in terms of the significant growth in the volume of trade and the steady inflow of foreign direct investment. In trade-weighted terms, the exchange rate is not misaligned. Since the ringgit peg to the US Dollar, the ringgit real effective exchange rate (REER), which is the trade weighted value of the ringgit against our major trading partners' currencies after taking into account changes in our inflation relative to those of our trading partners, has fluctuated within a range of plus or minus 7%. This is well within an acceptable range. More importantly, the ringgit REER has not experienced a sustained trend towards increasing appreciation or depreciation. The ringgit has essentially gravitated around its fair value and has not experienced misalignment. Finally, the Malaysian economy has both external balance in the form of a sustainable current account and internal balance in the form of price stability. This again supports the ringgit being fairly valued. In addition, foreign direct investors have placed more importance on factors other than just the exchange rate alone. In managing exchange rate policy, no amount of exchange rate manipulation would satisfy the interests of all parties at all times. Indeed, it is a stable and fundamentally sound exchange rate system that will best serve the overall economic interests of the country. This will continue to be the objective of our exchange rate policy.

Ladies and Gentlemen,

Dr. Yilmaz Akyüz's lecture today would provide an international perspective on managing financial instability and shocks in a more globalised world and touches on some of the issues I have mentioned. Although the regional financial crisis occurred more than six years ago, the issues it raises are not history. They are still very relevant and important. Emerging economies need to continue to evolve approaches and solutions on how best to manage the vulnerabilities and to promote and preserve stability. In this endeavour, there is potential to not only consider what individual economies can do but also the opportunities for regional arrangements or regional solutions. As the region becomes increasingly more integrated in terms of trade and investment flows, the potential for this will be greater. The desired outcome is to achieve stability, which in turn, will contribute to the overall stability of the international monetary system and thus, enhance the prospects for shared global prosperity.