

Zeti Akhtar Aziz: Potential for new linkages and opportunities between Japan and Malaysia

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Malaysia-Japan Business Forum "Enhancing New Linkages And Opportunities", Kuala Lumpur, 24 August 2007.

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It is my honour and great pleasure to be here to speak at this important forum which brings together government leaders and the business community from our two countries. I would like to take the opportunity to thank the Japan External Trade Organisation (JETRO) for inviting me to speak at this Forum. JETRO has played an important role in fostering the economic relations between Malaysia and Japan. While Japan and Malaysia has established strong economic ties, the environment in which we are operating has experienced pronounced changes. These changes present the potential for new linkages and opportunities between Japan and Malaysia.

Enhancing interlinkages and integration in Asia

Asia today is increasingly recognised as a dynamic growth region in the global economy. Asia's previous success was accomplished in part by strengthening its global interlinkages by exports to the rest of the world. Today, new regional interlinkages are emerging as Asia expands further its trade and investment within the region, a trend that has generated mutually reinforcing regional growth.

The Asian economic integration is now already well advanced through the intensification of intra-regional trade and investment. Trade within Asia now accounts for more than half of the total trade of the region. This change is partly the result of the rapidly growing economies in Asia, which has created a large and expanding cumulative export market. This economic integration is also the result of Asia's participation in the globalization of production. These trends have led to greater diversification of economic activity in the region and a reduction in the over-concentration in the traditional export markets. In the area of investment, Japan has for several decades been a major foreign direct investor in the Asian region. A more recent phenomenon is the more widespread cross-border investment undertaken in the region to capitalise on the growing opportunities arising from the diversity of economic strengths in the region.

These developments have increased the potential for Asia to be an important engine of growth in the global economy. The advancement that has been achieved in the increased economic integration needs to be reinforced by greater financial integration. Accelerating the regional financial integration process would serve as a powerful impetus, not only for reinforcing the trade and investment inter linkages, but more importantly to facilitate a more efficient international allocation of capital. In so doing it would contribute towards unlocking Asia's full potential in the global economy. Indeed, such greater financial integration would also play an important role in facilitating the allocation of some part of Asia's surplus funds into productive investments within the region. The more effective and efficient recycling of funds within the region will help reduce financing costs, stabilize financial prices, and increase the potential for the diversification of risks. All this would cumulatively promote stability and resilience of the financial systems in our region. The current turmoil in the global financial markets and the uncertainties it has generated underscores the need for greater financial stability and resilience of our financial systems.

There are several ways to enhance financial interlinkages, some of which are already in progress. In the financial sector, we have already seen Asian financial institutions expand

beyond domestic borders, thus strengthening the regional economic linkages. The regional authorities and regulators have also come together to develop the regional financial markets, including the capital markets, the supporting regional financial infrastructure and mechanisms for crisis management and resolution. These developments have paved the way for new forms of economic partnerships and strategic alliances and advance further the regional integration process and its inter linkages with the rest of the world.

Malaysia and Japan: interlinkages and opportunities

Malaysia is one of the most open economies in the world, with significant global trade and investment linkages, and has become a significant profit centre for foreign direct investment for several decades. Similarly, the volume of trade activity in Malaysia is two times the size of our economy, among the highest in the world. Our outreach for trade has been with both large and small economies. For several decades Malaysia has had an extensive economic relationship with Japan, with Japanese foreign direct investment being particularly significant since the mid 1980s. Japanese investments have also been important in making Malaysia part of the regional production network. To this day, Japan remains a significant partner in trade and investment for Malaysia.

While Japan's economic relationship with Malaysia through trade and investment is well-established, going forward there is significant potential for strengthening the financial linkages. In this recent decade, Malaysia has significantly transformed our financial sector. The restructuring, consolidation and reform of the financial sector has strengthened the capacity, flexibility and resilience of the financial system. In addition, there has been the development of several new segments of the market, including the bond market and Islamic finance. The Malaysian bond market is the largest in South East Asia with a vibrant private debt securities market. Malaysia has also continued to progressively liberalise its already open financial system to further enable free flow of funds into and out of the system. This transformation has opened up the potential for a range of new opportunities for participation in the financial sector in Malaysia and for facilitating greater financial flows within the region.

New linkages and opportunities offered by Islamic finance

This decade has also witnessed a rapid evolution and global expansion of the Islamic financial services industry. Malaysia has developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. More recently, its international dimension has gained significance as Islamic finance is becoming an increasingly important part of the international financial system. In doing so it is contributing to strengthening international interlinkages between financial markets and systems that is more widespread and inclusive. The number of Islamic financial institutions worldwide has increased to more than 300 spanning over 75 countries. Total assets of the Islamic financial system are estimated to exceed one trillion US dollars. It is among the fastest growing financial segments in the world with an estimated annual growth in the region of 15 to 20 percent. There is now a growing strong demand for Islamic financial product in the global market, far exceeding the current availability of financial products and services being provided by the Islamic financial institutions.

The global development of the Islamic financial system has become particularly important in this more challenging financial and economic environment. As the international financial system becomes more diversified and as this new form of financial intermediation develops, it has presented businesses with alternative means of raising funds while investors are presented with new asset classes. It has contributed towards greater diversification of risks. More importantly, the very fundamental requirement of Islamic finance is that it requires an underlying economic transaction thereby avoiding emphasis on speculative purposes. It also prohibits the commoditisation of risks, which leads to its proliferation through multiple layers

of leveraging and disproportionate distribution. Islamic finance as a form of financial intermediation will also contribute towards enhancing the efficient mobilisation and allocation of funds across regions. This will bring about strengthening of a more wide spread and inclusive global financial integration. The greater diversification of risks also contributes towards promoting international financial stability. The transparent nature of Islamic financial contracts and the need for underlying economic transaction reinforces the stability of the Islamic financial system.

Going forward, in the current liberalised and globalised environment, Islamic finance is at the threshold of a new dimension in strengthening financial interlinkages between nations across the globe. Just as the Old Silk Road in the 14th century offered a route that facilitated the trade in goods from the East to the West, we can now envisage the New Silk Road that facilitates financial flows across borders between the East and West. As regional financial integration intensifies, it will be a route that will facilitate this process. The previous trade linkages between the Middle East and Asian regions also has potential to strengthen, being the two of the fastest growing regions in the global economy. While the world trade has on the average expanded by 9 percent over the period 2002-2006, Asia's trade with the Middle East has increased on the average by 30 percent. In 2006 alone, mega transactions involving corporate acquisitions and real estate purchases from the Gulf to Asia, are estimated to total more than USD18 billion. Going forward, the value of such investments are expected to increase. Over the next five years, it is estimated that Asia will need USD1 trillion in terms of infrastructure investment and is in search of new partnerships and strategic investors to co-invest in these undertakings. This trend would benefit the economic regions with high savings and surpluses such as Asia and the Middle East because it would promote intermediation of a part of the surplus funds in the region to be channelled to productive investments in the region.

Several financial centres in the West, Middle East and Asia are now introducing Islamic finance as an integral part of their financial markets to offer the wide range of financial products and services. This trend is envisaged to stretch the New Silk Road from East Asia and Middle East and extend to Europe and the rest of the world. Indeed, we are already seeing the participation of global investors and the international financial community.

The Malaysian experience

Let me share with you Malaysia's experience in developing on Islamic financial system in a highly liberalised environment. Malaysia has developed a comprehensive Islamic financial system that includes the banking and takaful industries, and the Islamic money and capital markets – a matrix which mutually reinforces the integrity and stability of the Islamic financial system. Significant progress has in particular, been achieved, in the development of the Malaysian sukuk, or Islamic bond market. The Malaysian sukuk market has now evolved into the world's largest Islamic bond market. In 2007, Malaysia accounted for about two third of the global sukuk outstanding amounting to about USD47 billion. In 2002, the Government of Malaysia issued the first global sovereign sukuk. With this issuance, it became an international benchmark for the issuance of global sukuk. There have since been several further sovereign issues in the global capital market. The sukuk market has been an important source of financing for productive investment activities, while for investors, it provides greater potential for diversification into new asset classes.

The development of the Malaysian sukuk market has involved wide ranging initiatives to facilitate an efficient issuance process, the price discovery process, the broadening of the investor base, the establishment of a benchmark yield promoting the liquidity in the secondary market and strengthening of the regulatory framework. These initiatives have been reinforced by the legal and Shariah framework and the supporting financial infrastructure including the settlement system and the bond information system.

The international prudential standards for Islamic finance is set by the Islamic Financial Services Board (IFSB), is located in Malaysia . The IFSB thus formulates the international regulatory and supervisory standards for Islamic financial institutions aimed at achieving best practices in order to secure soundness and stability of the Islamic financial system. With the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), appropriate accounting standards have also been put in place to reflect the true and fair value of banking operations to ensure greater accountability and responsibility of the financial institutions.

With the increased maturity of our domestic bond market, further steps have been taken by Malaysia to allow foreign corporation, multinational corporations and multilateral agencies to raise funds in the Malaysian bond market with no restrictions for the utilisation of these funds. These funds maybe used to finance foreign investment activities outside the country. Following this liberalisation, the inaugural ringgit denominated sukuk issue was in 2004 by the International Finance Corporation (the investment arm of the IBRD World Bank), followed by the issue by the IBRD World Bank in 2005. In November of 2006, our market was further liberalised to allow for the raising of foreign currency sukuks from our domestic market. More recently, a landmark issuance the 750 million dollars exchangeable sukuk Musyarakah by Khazanah Nasional, the Government's investment arm, marked the world's first issue of its kind, incorporating full convertibility features common to conventional equity-linked transactions. These issues have attracted investors from outside of Malaysia, thereby strengthening our interlinkages with other international financial markets.

I am pleased to mention that a memorandum of understanding between the Central Bank of Malaysia and the Japan Bank for International Corporation (JBIC) has been signed this year for us to advance relations in this area between JBIC and the central Bank of Malaysia. In addition, a Japanese consumer credit company based in Malaysia marked another significant milestone by issuing an Islamic commercial papers early this year.

The changes that have occurred in the economic and financial environment in our region and the global environment have presented us with wide ranging new opportunities. The partnership between Malaysia and Japan thus not only needs to evolve not only in the trade in goods and direct investment but also needs to encompass growing financial ties. Islamic finance represents a vehicle that could further deepen our financial relationship and the regional integration process. In enhancing these new linkages and greater integration, it would contribute towards unlocking the new potential opportunities for our mutual prosperity.

Thank you.