Zeti Akhtar Aziz: South East Asia – potential and perspectives in the New Asia

Luncheon address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 2010 Institute of International Finance (IIF) Annual Membership Meeting, Washington DC, 8 October 2010.

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Generating growth and a long lasting recovery is the primary priority for the global economy in this aftermath of the recent crisis. The massive life support that was provided to avert a deep recession was to be temporary – to provide the opportunity to address the weakness in the system and to rebuild the capacity for a self-sustaining recovery. Recent indications are that this prospect has not been realised. The emerging world has however performed well with the potential to generate such a sustained recovery. These developments have drawn significant interest to the Asian emerging economies and on their changing role in the global economy and in the international financial system.

It is my honour and great pleasure to speak at this 2010 Institute of International Finance Annual Membership Meeting. My remarks today will focus on the challenges in managing such a sustained recovery with specific focus on the potential for emerging Asia to rise to these challenges in this new global economic and financial environment. The final part of my remarks will be on the changes taking place in the international financial environment from the perspective of emerging Asia.

As growth in the developed world slows, weighed down by structural factors, will the global environment of increasing interdependence then dampen the prospects for the Asian emerging economies? Asia comprises highly diverse economies. South East Asia, with a population of more than 500 million people is strategically located south of China and east of India, has been since the 13th century an important trading hub connecting Asia to the West. Being the most open economies in Asia, and perhaps in the world, we, therefore stand to be the most vulnerable to global developments.

While economic stimulus is vital for crisis containment, it will not, however, be sufficient to produce a self-sustaining recovery. The challenge is essentially the economic restructuring and transformation, the reform and rebuilding of the institutional capacity so as to remain effective in the new environment and to be well positioned to manage future shocks.

As emerging economies in Asia transition into this post crisis era, three important structural shifts are transforming the region. The first is the economic restructuring and the strategy to pursue more balanced sources of growth. This has involved significant shifts to new areas of comparative advantage and new areas of growth, and the greater emphasis on domestic demand as a driver of growth. While the export sector continues to be important, the pattern of trade has changed significantly with the growing importance of trade with emerging economies, in general, and with Asia, in particular.

Perhaps the most important factor that has for several decades sustained the economic success of the emerging Asian economies is its economic flexibility to adjust to the changing conditions in the global environment. This economic flexibility is supported by the high degree of labour and capital mobility within the national economies and the significant investment accorded to education and to infrastructure development. The region has also adopted a pragmatic approach to policy that is not constrained by rigid ideology. In this more recent decade, institutional development, extensive financial reforms, and the adoption of new business models have been an important part of this transformation process.

Several of the economies in emerging Asia's have transformed their production capacity in the manufacturing and services sector to meet the changing demands of the global economy and the growing consumer market in Asia. Given the different stages of development and endowment of natural resources in the region, the emerging economies in Asia have also leveraged on their respective distinct comparative advantages. This has resulted in intra-regional division of labour and specialisation, and the capacity to undertake the entire spectrum of the supply chain for a wide range of products and services.

Part of the economic restructuring has also involved the greater emphasis on domestic demand as an important source of growth. This has involved significant increases in domestic private consumption and investment activities. Rising income levels and the presence of a young demographic structure with a high propensity to consume has resulted in a huge consumer market and the development of an extensive modern retail sector across the region. The potential sustainability of this trend is supported by the absence of inflationary trends, of large scale unemployment, or of high levels of indebtedness.

The second fundamental trend is the intensification of regional economic and financial integration. This has been facilitated by the ability to leverage on complementarities in the region arising from diversity and differences in comparative advantage. Intra-regional trade has been a major contributor to the recent recovery in Asia. Intra-regional investment flows have also gained momentum. Businesses in the region are increasingly leveraging on regional complementarities and taking advantage of the growing markets in the region through regional trade agreements to achieve the aspiration for ASEAN to become an Economic Community by 2015.

As high saving economies, it is recognized that there is an important need for a more efficient intermediation of the surplus funds in the region. This is to not only effectively channel these funds into productive investment opportunities in the region, but also to finance the massive development of infrastructure required by the region. As part of the increased regional financial integration, there is now increased regional presence and participation in the domestic financial systems of the region. This phenomenon has been supported by the progressive financial liberalisation, the development of domestic financial markets, the greater use of domestic currency to facilitate bilateral trade activities and the development of the payments and settlement systems.

The economic and financial regional integration has also been reinforced by a higher level of regional cooperation. Earlier regional cooperation had focused mainly on trade, investment and development. This decade has seen the cooperation shift to efforts to address financial stability issues, including in surveillance, crisis management, liquidity support arrangements, financial supervision and financial market development.

The approach in forging greater financial integration in Asia will be different from that adopted by Europe. The region does not have centralised institutions to coordinate financial integration but has leveraged on the existing intra-regional groupings and networks to forge greater cooperation and collaboration in areas of common interest. The region has its own monetary and financial stability committee that is supported by arrangements for regional surveillance to identify risks and vulnerabilities to the region. Also in place is an integrated crisis management framework that will be operationalised in the event of an imminent financial crisis in the region. Recently the region successfully organised two schemes for reserve pooling, the Asian Bond Fund and the ASEAN+3 Chiang Mai Multilateralised Swap arrangement as a liquidity support facility.

As economic and financial systems in Asia continue to transform and as the region becomes more integrated and cohesive, this has not only enhanced the potential for the region to contribute to global growth but also enhanced the resilience of the region and thus its role in contributing to global financial stability. These trends support the global efforts by the various international groupings and multilateral agencies in the search for solutions to achieve global financial stability and sustainable growth.

The transition from G7 to G20 is recognised as a positive step forward that extends its reach beyond the developed world. But the representation in G20 is by virtue of the size of the economy and not by representation of specific groups of countries. Its outreach and inclusiveness is therefore limited, and small and medium sized emerging economies are not part of this process. The G20 is, nevertheless, an important global forum for considering global issues and will have an important role in setting the direction for global policies. Earlier, the cohesiveness, the sense of purpose and urgency of the G20 did indeed contribute to restoring confidence in the global financial system and the coordinated policy stimulus was an important catalyst for the economic recovery. In recent months, however, the momentum for this coordinated actions have dissipated and there have been differing positions on several important issues. At the same time, a number of the major crisis affected countries have implemented their own financial reform plans. In view of the far reaching implications of any reform agenda, it is an important global responsibility to ensure that the reforms achieve their intended results and that this new phase of globalisation will result in a more inclusive international financial system that will allow for the effective participation in the global economy and international financial system regardless of size or stage of developments.

On the specific regulatory reforms to address the issues and problems that caused the crisis, of importance, is that the goal of such regulatory reform should not be overlooked – promoting financial stability is a means to an end and the ultimate goal is to achieve sustainable growth and development. Many have already highlighted the potential increased regulatory costs on intermediation and hence on economic activity. This is even more relevant in Asia where there is greater reliance on the banking sector for financing. The efforts undertaken to comprehensively assess the macroeconomic impact including by the IIF is highly relevant and will be important to the reform process.

A further concern and one that is less discussed is on the implementation of the regulatory reform. With greater capital mobility across borders, the stricter regulations could result in the migration of financial business to less regulated market segments, institutions or financial centres. Important to this is the need for the development of the framework for cross border policy coordination and resolution. In Asia, efforts are underway to address these specific issues recognising that in this interconnected environment, the execution of remedial and containment measures will be highly complex and challenging. Focus is also being given to having enhanced surveillance and oversight that is complemented by a robust framework for governance, transparency and accountability.

Given the strong presence of international institutions in the Asian region, we have strong interest in the establishment of an effective cross border resolution mechanism so that any failure of such large and systemically important institutions with cross border representations can be dealt with effectively in an orderly manner. This will require cooperation and coordination across countries, taking into consideration their differing regulatory and legal systems.

A further priority in emerging Asia is the promotion of responsible market practices and consumer protection given the stage of development and level of financial literacy. There is significant scope for creating greater global momentum for improvements in regulatory standards on market practices.

Much work still remains ahead and would require resolve and commitment in this reform agenda. The more inclusive global process is critical to this effort and should be further deepened to truly reflect the global dimension of the financial system in this 21st century.

On the recent increasingly intense debate on the role of the exchange rate as the solution to the global imbalances, it needs to be recognised that the foreign exchange market is not like any other markets. With a daily transaction amounting up to USD4 trillion, it is the most liquid and dynamic market in the world. It is a market that is prone to excessive movements and overshooting. Any effort to engineer a significant exchange rate adjustment within a short period of time carries the risk of highly destabilising consequences. Global imbalances that have been built up over several years need to be unwound by a combination of adjustments in demand, prices and exchange rates. Over reliance on the exchange rate to do the adjustment may not only not produce the desired result, but it also risks becoming a trigger factor to causing instability and future crisis.

The final development that I wish to say something on is the global development of Islamic finance and its increasing role in enhancing global economic and financial linkages particularly among emerging economies. Islamic finance is all about basic banking that is always supported by underlying economic activity. Its profit sharing feature provides for risk sharing and thus the necessary due diligence, disclosure and transparency, risk management and governance. The industry is also well supported by the regulatory and supervisory standards issued by the Islamic Financial Services Board (IFSB). While the focus has been on keeping the regulation abreast with the developments in the financial system, emphasis is also given on the supervisory oversight, capacity building, and institutional and financial infrastructure development as part of the efforts to ensure financial stability. The most recent significant development was the establishment of the International Islamic Liquidity Management Corporation (IILM) that will issue highly rated short-term Islamic instruments to facilitate more efficient liquidity management of cross border investments.

The global challenges call for a collaborative approach to strengthen the prospects for a global recovery. The way forward is also to recognise the relative strengths of different parts of the world and the potential to leverage on these strengths. The transformation of Asia in this new environment offers the prospects for a greater shared responsibility towards a greater shared prosperity in the world.