Zeti Akhtar Aziz: Asian market integration and financial innovation

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the International Conference on "Asian market integration and financial innovation", Tokyo, 10 February 2012.

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The world economy and international financial system is entering into a new phase of globalisation. Far from having an effect of slowing the pace of globalisation, the recent global financial crisis has intensified the process, resulting in a more connected and interdependent world. While – previously – globalisation manifested itself in the form of trade and investment between the emerging and developed world, emerging economies are now becoming more connected with each other within and across regions. This trend is being reinforced by similar changes in the pattern of financial flows. While previously, financial flows were predominantly between the developed and emerging world, greater financial integration among the emerging economies is facilitating the intensification of this connectivity.

While unable to be in Tokyo, it is my pleasure to speak at this international conference on the topic of Asian Financial Integration. My remarks will touch on the main motivation for pursuing financial integration in Asia, despite the fact that its absence has not previously hindered economic integration in the region. Whilst Asia may draw lessons from the European experience, I will discuss the different approach that is being pursued in Asia. The growing internationalisation of Islamic finance is also contributing to strengthened economic and financial ties among emerging economies including in Asia and the Middle East. Finally, I will discuss the current global regulatory reform and its possible implications for regional financial integration in Asia.

The aspiration for greater economic and financial integration in Asia is to achieve greater shared prosperity that is mutually reinforcing for the economies in the region. Regional financial integration will achieve more efficient and effective intermediation of funds to enable at least some part of the surplus savings of the region to be channeled to productive investments in the region, and at lower costs with improved risk diversification. Improved access to financing would also support intra-regional trade while a more cohesive region will facilitate greater collaborative efforts on safeguarding financial stability. Collective actions would also enhance the ability to better manage and respond to risks to the region. And finally, as a cohesive group, our perspectives and position would be better represented in the governance structure and processes in the international financial system.

Approach of financial integration in Asia

Asia comprises a highly heterogeneous group of countries that are different in terms of economic structure, natural resources, degree of market orientation, stage of development, size and degree of openness. Asian economies have however, recognised the respective individual comparative advantages and have leveraged on the prevailing complementarities. Given the diverse nature of the region, it would be highly ambitious and challenging to achieve the necessary preconditions for achieving an integration that is similar to that in Europe.

The integration process in Europe was taken forward with the establishment of supranational institutions with mandates to promote common approaches and frameworks across the member states in the union. In contrast, Asia is adopting a more flexible approach. Regional financial integration in Asia has manifested itself mainly in the form of greater regional presence and participation in domestic financial systems. This is taking place with the gradual and sequenced liberalisation of the financial sector and the capital account. Capital account liberalisation in particular is prompting increased intra-regional investment and portfolio flows which in turn contributes to the deepening of the financial markets.

By itself, the liberalisation of the financial sector and the capital account will however, not be sufficient to achieve regional financial integration. Most important, is the development of regional financial markets, the financial infrastructure including the regional payments and settlement systems, harmonising the financial standards and practices including the regulatory and supervisory regime and building the institutional capacity of the domestic financial intermediaries. For the ASEAN region, an agreement has already been reached to allow for different speeds of integration depending on the state of readiness of the respective member countries. This is being reinforced by arrangements for surveillance for assessments of risks to the region and regional frameworks for crisis management and resolution, including arrangements for mutual assistance. Equally important in this process is the cooperation and collaboration among regulatory authorities for sustaining regional financial stability. Much of this work has focused on putting in place strong and effective institutional arrangements to preserve regional financial stability.

In the decade following the Asian Financial Crisis, most of Asia has accelerated the pace of financial sector development and reforms. Several of the Asian economies have made significant strides in improving the soundness and efficiency of financial institutions and in developing domestic financial markets. At the regional level, key initiatives have included the development of the regional bond markets through the creation of various Asian Bond Funds and the ASEAN+3 Bond Market Initiatives, the regional arrangements for crisis management that includes liquidity support, and the collaborative efforts advanced under EMEAP to facilitate liquidity management for financial institutions operating in the region through Cross-Border Collateral Arrangements. Currently, while intra-regional cross-border portfolio investments within Asia is relatively small, it has already increased to 28 percent of total assets holdings in 2011 compared with 21 percent in 2001.

Another important development that has contributed to greater regional financial integration is the increasing role of Islamic finance in the international financial system. In its early stages of development, Islamic finance was highly domestic-centric in its orientation. This recent decade has seen the rapid internationalisation of Islamic finance resulting in significant growth in cross border financial flows. The development of Islamic financial markets, in particular, the sukuk market, the progressive financial sector liberalisation, and the establishment of international arrangements and institutions to safeguard financial stability, cumulatively have contributed to enhance the international dimension of the industry. There are now more than 600 Islamic financial institutions operating in more than 75 countries.

Given that Islamic financial transactions require an underlying economic transaction, it is a form of financial intermediation that is well anchored to serve the real economy. With its internationalisation, it has become an increasingly more important channel for the efficient allocation of financial resources across borders and for the diversification of risks. This new international dimension of Islamic finance has facilitated stronger financial ties between Asia and the Middle East. The sukuk market in particular has become an important avenue for international fund raising and investment activities that generate significant cross border flows.

While the efforts to put in place these pre-conditions will continue, equally important is the role of the private sector in driving the Asian regional financial integration agenda, particularly in building the institutional capability to effectively intermediate funds in the region. While foreign presence throughout our region facilitates this process, it needs to be complemented by strong domestic regional intermediaries whose operations would be more inclusive and thus increase the potential for balanced growth in our region.

Asia has demonstrated its resilience to the many shocks from the international financial markets and the global economy during this recent global financial crisis. As highly open economies, most economies in Asia have been highly affected by these developments. Stronger domestic demand, greater intra-regional trade and investment, reinforced by resilient financial systems and strong macroeconomic fundamentals, have supported the economic performance of our region. There have been tremendous payoffs for the region from the decade long of financial reforms, institutional building and development of financial infrastructure. Despite the highly challenging environment of slower trade and volatile financial markets, financial intermediation in Asia has continued uninterrupted and financial markets, while more volatile, have remained orderly. It is thus on these strong foundations that the regional financial integration in Asia is not being set back. On the contrary, despite these global developments, the integration process has continued and regional financial cooperation and collaboration has strengthened, reinforced by the increased regional participation and presence of the private sector.

Global regulatory reforms

Let me now turn to the global regulatory reforms and its implications for Asia. The global regulatory response to the financial crisis is now moving into the implementation phase. At its core are the reforms to build a stronger global regulatory framework to significantly raise the level of resilience of the banking system. While that work has now been largely finalised, the complex task of implementing the new global capital and liquidity standards is just beginning. Indeed, this implementation is proceeding at a time of a difficult global financial and economic environment. Several countries have however, announced their timelines, with some that are moving faster and further than the Basel III standards.

Asia is in a relatively stronger position to transition to the new standards. We are, however, vigilant over the global economic and financial consequences of its implementation in other parts of the world. As open economies, we are not insulated from these consequences. While the work of the Basel Committee suggests that the effect of tightening conditions on economic growth will be modest, the highly dynamic global financial conditions imply that regulators will have to continue to proceed cautiously, and on a fully informed basis, in implementing the new standards. Of importance is the need to recognise the point beyond which the costs to the real economy exceed the desired benefits of greater systemic resilience.

The reform agenda has also focused on the fundamental and no less significant changes to institutional arrangements and market structures. Some of these, such as reforms involving the OTC derivatives markets and policy frameworks for systemically important financial institutions (SIFIs), are being advanced through global platforms, notably the Financial Stability Board (FSB). Other reforms, such as the structural changes to banking models that are being contemplated in the UK and the implementation of wide-ranging reforms under the Dodd-Frank Act in the US, although not being imposed outside these countries, are nevertheless charting a path forward that is likely to have wider ramifications, given the significant cross-border operations of affected institutions, including in Asia.

Like most jurisdictions, the options for central clearing for domestic OTC derivatives are also being examined. These reforms are already under way in the world's larger financial markets to meet the G20 mandate for standardised OTC derivatives transactions to be centrally cleared by the end of 2012. For smaller OTC derivatives markets in Asia, the effects on domestic market efficiency and stability are key considerations in contemplating a move towards central clearing arrangements. A key concern is the potential for the offshore central clearing of transactions in key domestic markets to increase the stability risks to the domestic financial system. There will also be limited scope for domestic regulatory authorities to have oversight on such offshore central counterparties (CCP) and to respond during periods of financial stress. Domestic central clearing arrangements, however, could have negative effects on efficiency and the functioning of the market, in particular for cross border transactions. In addition, fragmented clearing arrangements could reduce netting opportunities and collateral efficiencies, in turn raising costs to participants. There is also a need to close important information gaps on the rules that will govern global CCPs, including the criteria for mutual recognition of CCPs and membership conditions, as well as details on the arrangements to mitigate the concentration of risk to the CCP itself or its members. These gaps are currently limiting a more complete assessment of domestic and regional options for central clearing.

The global reforms for the most part would contribute to the promotion of more consistent approaches to regulation which is an important precondition for greater financial integration in Asia. In a number of countries, the global reforms have had a role in accelerating further domestic priorities to strengthen financial resilience. Initiatives that are being advanced at the global level also work to strengthen regional financial stability arrangements. This includes putting in place more robust frameworks for the oversight of systemically important financial institutions at a regional level. Within Asia, a clear evolution of such frameworks can already be seen in the operationalisation of cross-border supervisory colleges for financial institutions with a significant regional presence. The reforms have further encouraged closer coordination and communication on financial stability developments between countries in the region. This has been borne out of common perspectives and challenges shared among countries in the region on the direction and impact of the reforms, and the need to bring forward the collective views of the region. These implications will further strengthen the foundations for regional financial integration in Asia.

Policy shifts and the proliferation of binding “one-size-fits-all” regulatory prescriptions however, goes against the grain of regulation that is proportionate to risk which has been a well established principle of sound regulation. There is therefore considerable risk to simply following new “trends” which may lead us down yet another potentially misguided path. In particular, the significant efforts made in the region over the recent decade to bolster financial sector efficiency and innovation, which in turn promotes financial integration, could be disproportionately curtailed.

In addition, it has only been recently that the global attention has also turned to enhancing supervisory intensity and effectiveness as an essential component of the financial reform effort. This is a welcome move and will add a critical dimension to the consideration of future reforms by national authorities. In Asia, financial reforms were already accompanied by a significantly strengthened supervisory approach and safety net arrangements, which served to check unfettered innovation and reckless risk-taking behaviours and promote strong incentives for prudent risk management. For these reasons, our banking systems have been resilient through the global financial crisis and have continued to remain strong since, despite continued risks in the global economy. As we contemplate the raft of reforms that will continue to occupy the global agenda in the next few years, our considerations should be to pursue domestic and regional solutions that will deliver a more resilient financial system without impairing the continuous provision of efficient financial services that are vital for our economies.

Let me conclude my remarks. While many challenges remain, Asia is at the cusp of experiencing significant collective economic growth and development. Asia should however significantly draw important lessons from the global financial crisis and recognise the implications of greater interdependence. In addition, the sovereign debt crisis in Europe relates not only to fiscal matters but to debt management which has significant implications for financial markets. While fiscal issues may remain a national matter, its financing and its broader consequences needs to be addressed. Given the positive environment in Asia, the opportunity needs to be taken to put in place the necessary arrangements to best address these challenges. The world is increasingly now looking towards Asia. With these enabling conditions, Asian economies would be better positioned to collectively strive and work towards achieving the shared vision of financial and economic integration that will not only unlock our potential but also enhance the prospects to contribute towards a more balanced and sustainable global economy.