Zeti Akhtar Aziz: Global policy perspectives

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Federal Reserve Bank of Kansas City Economic Symposium: Overall Panel on "Global policy perspectives", Jackson Hole, United States, 1 September 2012.

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It is my honour to be invited to speak on this closing panel, to discuss global policy perspectives at this year's Economic Symposium, in this magnificent environment at Jackson Hole. My remarks will focus on global policies from the perspective of a policy-maker from an emerging economy, to discuss the evolving new frontiers of global policies, the global policy spillovers in particular to emerging economies, and on the policy priorities in emerging Asia in this environment.

The global economic and financial landscape has changed tremendously over this recent two decades. Yet the underlying motivation and progress in policy-making have not reflected these changes. The disparity between policy and the new landscape has become increasingly more evident since the 2008 global financial crisis. Policy-makers have thus been challenged in preventing the build-up of the risks and imbalances prior to the crisis, arresting and containing the crisis once it had erupted, and then managing its aftermath.

At the national level, these changes are well known. Driven largely by innovation and advances in technology, we now have more highly complex and more inter-connected financial systems with financial activity that has broadened to beyond the traditional financial intermediaries. More profound are the fundamental changes associated with the globalisation of finance, which has resulted in a more connected and inter-dependent world.

Since the onset of the crisis, the policy response at the national level has been extensive and on an unprecedented scale, aimed to restore the functioning of the financial system and to arrest the steep deterioration in economic activity. Monetary policy was eased substantially, with interest rates brought down swiftly to historical lows. The cumulative fiscal expansion during the period 2007–2009, amounted to close to an average of four percent of GDP. Meanwhile, financial sector policies gave priority to stabilising financial markets and restoring credit flows.

While an economic depression has been averted, monetary accommodation has continued with large scale financial market interventions to support the recovery. Fiscal policy, however, shifted to address fiscal sustainability and the increased public indebtedness, following the massive stimulus and support to the financial sector. The challenge is to achieve this consolidation, while ensuring that the economic recovery and market confidence are not undermined.

On the wide-ranging financial reforms to address the weaknesses that led to the crisis and to strengthen the resilience of the financial sector, the emphasis has been on enhancing regulation and addressing macro-financial concerns to avoid the build-up of financial imbalances. These policies have also been supported by wide-ranging changes to the legislative framework and institutional structures.

An area of policy that has not been as extensive is the cross-border dimension of policy-making, despite the growing inter-dependence between economies. The increased connectivity of the world has been exemplified by the swift spread of financial and economic shocks throughout the global economy and international financial system in 2008, and the global supply chain disruption emanating from Japan in 2011.

Despite these changes, institutional arrangements and governance for policy cooperation and coordination have yet to reach the levels that are commensurate with the degree of global economic and financial integration. While individual efforts by any single economy are vital to ensure that they do not become a source of instability to other parts of the world, they can no longer guarantee collective stability. Emerging economies that are more open and integrated with the global economy and international financial system are the most affected by these developments.

The global financial crisis forcefully demonstrated the importance of the international dimension of policy. In the early stage of the crisis, the coordinated policy rate cuts, the enhancement of U.S. dollar liquidity facilities by several key central banks, and the unprecedented and concerted fiscal expansion effort turned the tide of the global recession. The establishment of the Financial Stability Board (FSB) in 2009, together with the Basel Committee of Banking Supervision, has also been at the centre of much of the work on global financial sector reform. While this represents a positive step, the efforts remain recent and modest in an environment where the underlying changes were built up over an extended period of time, and had already become entrenched and widespread.

Challenges arising from global policy spillovers

Let me now turn to the challenges arising from the global policy spillovers, in particular to emerging economies. With cross-border inter-dependence and contagion being very much a phenomenon of this new environment, such global policy spillovers are rapidly transmitted to other parts of the world through economic and financial flows. While the repercussions of the global economic and financial disruptions have been well recognised, less discussed have been the consequences of the global policy spillovers.

Significant and continuous spillovers have emanated from the wide-ranging policies in the advanced economies, including the unprecedented monetary easing, the fiscal stimulus then consolidation, the repair and resolution of the financial sector, the initiatives to reduce public and private sector indebtedness, and the consequences of the global regulatory reforms.

The highly accommodative global monetary environment has generated higher global liquidity. While contributing to the resumption of credit flows, it has exacerbated the recent surges in capital inflows to emerging economies. These inflows have resulted in significant strengthening of currencies, rising asset prices, stronger credit growth, and for some, overheating conditions in the economy.

These inflows have, however, been punctuated by reversals in capital flows, following deleveraging activities mainly by the banking groups in the crisis-affected countries. Deleveraging by sovereigns and by households, in particular the United States, have also reinforced this trend. The deleveraging by banks was, in particular, felt in 2009, following the actions by banks in the United States to strengthen their capital positions, and more recently by banks in the Europe to meet the new capital adequacy requirements. In view of the challenging conditions for capital raising, this is being achieved, in part, by asset reduction, either by asset sales, in particular in performing economies, or the withdrawal of credit lines.

These operations not only have implications on asset prices but on currency movements, as funds from the asset disposal are remitted back to the home country. The reversal of capital flows following such deleveraging is thus accompanied by a correction in asset prices and depreciation in the currencies. For emerging economies, the more developed and liberalised the financial markets, the more significant will be the impact of such activities, and the greater will be the amplitude of the volatility in the asset prices and currency movements.

Global policy spillovers have also been transmitted to the real economy through trade and investment flows. The world economy, including emerging economies, benefitted immensely from the fiscal stimulus that supported the economic recovery. However, as the deterioration in fiscal sustainability became a concern, the effects of the pull-back in public expenditure on growth have contributed to slowing world trade and cross-border investment activity. Emerging economies, in particular in Asia, have seen the export sector slow significantly.

While foreign direct investment continues to gravitate to emerging economies, in particular to Asia, the scale of such investment activity has also moderated.

Finally, the international regulatory reforms and the unilateral initiatives in a number of the major advanced economies have also had their intended and unintended consequences. The reforms, which have focused on building a stronger global regulatory framework and raising the resilience of the banking system, are still in their early stages of implementation. While it is too early to verify the concerns raised on the new prudential standards, the call has, however, been for the need to ensure that the benefits of greater systemic resilience will exceed any costs to the efficient functioning of the financial intermediation process and to the real economy.

For Asia, the new standards contribute positively for regional financial integration, as they promote a more consistent regional approach to regulation. They also work to strengthen regional financial stability arrangements, through more robust frameworks for the oversight of systemically important financial institutions at the regional level. These reforms have, therefore, encouraged increased communication and closer coordination on financial stability developments between regulators in the Asian region.

These financial reforms are, however, not without challenges for emerging economies. In particular, the standardised regulatory prescription goes against the grain of regulation that is proportionate to risk. Other unilateral regulatory initiatives, although not being imposed outside the respective countries, are also charting a path forward that is likely to have wider ramifications, given the significant cross-border operations of the affected institutions.

Policy priorities in emerging Asia

Let me turn to the policy priorities in emerging Asia. While most emerging economies entered the global financial crisis from a position of strength, policy-makers continue to be challenged by the weaker global economic environment and the effects of the global policy spillovers. While the emerging economies in Asia have been affected by these external developments, most have demonstrated resilience during this period. Let me confine my remarks to the policies that have contributed to this resilience. First, it is the payoff from a decade-long of policies and financial and economic reforms following the Asian financial crisis. Second, it is having an enhanced policy toolkit and the policy flexibility to manoeuvre in this environment. Third is the increased cooperation and collaboration in Asia, in the areas of surveillance, in the assessments of the risks and vulnerabilities to the region, and in the consideration of the policy options to address many of the new challenges.

An important policy shift following the Asian financial crisis is to rebalance the economy and to diversify our sources of growth. This has involved wide-ranging policies and reforms to promote domestic demand, in particular domestic consumption and investment activities by the private sector. Accommodative macroeconomic policies were generally supported by policies and reforms to strengthen the financial system, to ensure that domestic demand was supported by the financial sector. With rising incomes, private consumption and investment activities have expanded significantly to become the major engine of growth in Asia. Cumulatively, the increase in domestic demand in the region has transformed Asia into becoming a huge consumer market. This has also prompted greater inter-regional trade which has become mutually reinforcing on growth in the region. From being export-led, domestic demand has now become an important source of growth. Asia is, therefore, now shifting from being global producers to becoming global consumers.

The wide-ranging financial reforms in several emerging economies in Asia, have resulted in financial intermediaries with strong capital and liquidity buffers, and improved risk management and governance practices. This has allowed for the financial intermediation process to continue without disruption during the recent global financial crisis. The more comprehensive regulatory frameworks have also been complemented by enhanced surveillance arrangements and a relatively more intrusive supervisory oversight. Wide-ranging policy tools, including macro-prudential policies, have been relied upon to mitigate and manage the risks emanating from excesses and the build-up of imbalances in the financial system. The opportunity was also taken by most central banks in the region to normalise interest rates once recovery had commenced. Interest rates, while still remaining accommodative, were raised from their historical lows. Finally, with more developed financial markets, shocks were now more dispersed throughout the financial system. This has allowed the financial system to better intermediate highly volatile capital flows.

Despite this, the surges and reversals of capital flows continue to present a major challenge to policy. Specific policy strategies have also been adopted to reduce the prospect of being destabilised by these flows. Financial reforms following the Asian financial crisis have transitioned financial systems in Asia towards greater market orientation and increased exchange rate flexibility. This has facilitated greater capacity to adjust to the increased volatility in the financial system. Further progress on liberalisation has also increased the potential to undertake foreign exchange transactions, including engaging in outward portfolio and direct investments abroad. This has resulted in stronger two-way capital flows, contributing to more orderly conditions in the financial markets.

Liquidity management measures, prudential regulations including macro-prudential measures, and more interventionist measures that include restrictions on such flows, have also been implemented in varying degrees to cope with the volatile capital inflows. For the most part, prudential regulations, such as the imposition of ceilings and limits on external exposures, or minimum holding periods for specified domestic instruments, but which have not discriminated according to residency, have been implemented. Overall, they have enabled the financial sector, markets and the economy to function without disruption during the period of the global financial crisis.

While policies at the national level are important, these have been complemented by a higher level of regional collaboration and cooperation. The Asian region is now well ahead in the areas of surveillance arrangements, financial safety nets and crisis management. These frameworks, which have been put in place during the good times, are also being supported by ongoing work, in the area of building a consistent regulatory environment given the increasing presence of Asian banks in each others' jurisdictions. This is reinforced by cooperation among national supervisors and in the development of arrangements for cross-border resolution.

Regional platforms have been established for structured forums for the assessment of risks and vulnerabilities to the region, to increase the prospect for pre-emptive actions to be taken. Collaborative efforts are also ongoing in the area of building regional financial infrastructure, including the financial markets and payment systems to facilitate the efficient intermediation of financial resources in the region. Collaborative efforts are also accorded to the area of anti-money laundering, to ensure the integrity of the increasingly integrated financial systems in Asia. Finally, collaboration has also progressed in the area of capacity building, to strengthen the institutional capability of the central banks in the region to deal with the new challenges of the new environment.

Finally, one of the most significant but often under-appreciated trends across most economies in these recent two decades, is the significant rise of inequality within economies. The economic crisis has worsened this trend given the conditions of high unemployment in many parts of the world. In many areas of policy-making, inequality is often not given explicit consideration. In Asia, this is being addressed at two levels – at the national level to develop inclusive financial systems and better social safety nets, and at the regional level, for regional initiatives to be inclusive, to ensure that regardless of the stage of development, countries in the group will build up their capacity and capability to benefit from the progress of the region.

Conclusion

Let me conclude my remarks; the new global policy frontiers are now addressing the challenges of the new global economic and financial landscape. Given the more connected and inter-dependent world, the call is for strengthening the cross-border dimension of policy-making.

Asia has taken advantage of this period of relative stability to advance economic and financial integration, and to strengthen our economic potential. Asia will, however, continue to be vulnerable to external developments and future shocks. To be in a better state of readiness to withstand these eventualities, the policy priority is to build resilience. Not only having the buffers and institutional capacity, but also to come together collectively to manage the new challenges, and thus be positioned to contribute constructively to global stability and growth.