Tharman Shanmugaratnam: Opportunities facing Islamic finance and challenges in managing capital flows in Asia

Outline of special address by Mr Tharman Shanmugaratnam, Chairman of the Monetary Authority of Singapore, at the 8th World Islamic Economic Forum, Johor Bahru, Malaysia, 4 December 2012.

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The Prime Minister of Malaysia, His Excellency Dato' Sri Najib Tun Razak

The President of Comoros, His Excellency Ikililou Dhoinine

The President of the Islamic Development Bank, His Excellency Ahmad Mohamed Ali

Chairman of the World Islamic Economic Forum Foundation Tun Musa Hitam

Ministers and distinguished guests

Ladies and gentlemen

Introduction

It is my pleasure to be here today and have the opportunity to share some thoughts.

Let me first congratulate the WIEF on the progress it has made in establishing itself as a leading international forum for economic leaders and opinion shapers from a broad range of countries to discuss issues of interest in Islamic Finance and related themes in global finance.

The theme of the Forum, "Changing Trends, New Opportunities" is particularly relevant. Allow me to first offer a brief perspective on opportunities facing Islamic finance. I will then go on to talk about the challenges we face in Asia in managing capital flows in the aftermath of the Global Financial Crisis.

Islamic finance: opportunities for growth

The Islamic finance industry is estimated to have grown by some 19% per year since 2006 – to record nearly US$1.3 trillion of total shariah compliant assets in 2012. But there is still considerable scope for its development:

- Islamic finance presently forms less than 1% the global financial industry.
- For a large number of countries, even in jurisdictions with substantial Muslim populations, Islamic finance currently constitutes less than 5% of their financial sector.[1]
- And despite a record level of sukuk issuance in 2012, the industry as a whole is still largely concentrated on the banking sector.[2] There is much ahead in the journey to develop Islamic capital markets and the takaful (Islamic insurance) industry.

I believe the next 10–15 years offer significant opportunities for the growth and diversification of Islamic finance. Let me highlight the reasons to be optimistic about its prospects:

[1] Based on surveys of the Islamic Financial Services Board (IFSB)'s members.

[2] The Islamic Finance Mar 2012 report by the UK Islamic Finance Secretariat, a private sector industry body, estimated that the banking sector accounted for 93% of the global Islamic finance industry, with capital markets at 5% and Takaful at 2%.

- First, Islamic financial institutions have in the main escaped significant damage in the global financial crisis. They are well-placed to grow, at a time when many of the global banks, especially the European banks, are deleveraging or focusing on consolidating their balance sheets.
- Second, Islamic finance has much potential to diversify into new growth areas such as trade and infrastructure financing in Asia and the emerging markets.
  - These new areas will allow Islamic banks to reduce their exposure to the real estate sector, and to take advantage of the stronger growth potential of the emerging market economies. There are gaps to be filled in structured trade finance and in funding for infrastructural projects as the emerging markets grow, and as global finance consolidates.
- Third, Islamic finance can also seek to meet the increased demand for simpler and more transparent products and 'back-to-basics' finance. Investors are now much more circumspect about complex products and their risks. The crisis taught investors worldwide not only about the damage they can face from the risks that are known and unsurprising, but of the risks of 'what we do not know'. Islamic finance, with its focus on transparency, price certainty and risk-sharing, can ride this wave of demand for simpler and more basic investments.

However, Islamic finance will have to overcome a few important challenges in order to grow its share in global finance and contribute to cross-border finance. These include the need to reduce fragmentation in Islamic finance markets due to differences in accepted standards of Shariah compliance between regions, jurisdictions, and in some cases even domestically within jurisdictions. This has hampered the flow of liquidity between jurisdictions, and is in part why there is yet no Islamic equivalents to the international money and bond markets.

There is considerable progress being made to address these challenges. Bodies such as AAOIFI,[3] IDB's Islamic Research & Training Institute, and Malaysia's International Shariah Research Academy (ISRA) have made significant efforts to narrow the differences in acceptability of Shariah compliance. The Islamic Financial Services Board (IFSB), in conjunction with international standards setting bodies such as the Bank of International Settlements (BIS), IOSCO[4] and IAIS[5] and various regulators from Islamic and conventional jurisdictions, are also formulating international standards and best practices for the industry.

Islamic finance is also seeing increasing interest in Asia. ***We are seeing financial institutions leveraging on the strengths and expertise that have been developed in both Islamic and conventional financial markets***. This is expanding the range of Shariah-compliant products and allowing the Islamic finance industry to tap on broad and deep investor pools globally and in Asia.

- Malaysia is widely recognised as a leader in Islamic finance, in particular for the issuance of sukuks.
- Islamic finance is also seeing growing interest in other Asian financial centres such as Singapore, Hong Kong and Tokyo.
- Just recently in mid-November 2012, institutional and private investors in Singapore and HK were the largest investors in the US$15.5 billion global sukuk issued by the Abu Dhabi Islamic Bank (ADIB).

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3 AAOIFI is Accounting & Auditing Organisation for Islamic Financial Institutions

4 International Organisation of Securities Commissions

5 International Association of Insurance Supervisors

- Between our two countries, we are seeing Malaysian banks collaborating with Singapore corporates and financial players to structure S$ denominated corporate sukuk programmes. And Singapore-listed companies are venturing out to tap the Ringgit sukuk market in Malaysia. These are trends that we are keen to encourage.

To repeat therefore, I am optimistic that we can realise the significant growth potential for Islamic finance in the next 10–15 years.

Managing the challenge of capital flows in the post-crisis era

Let me move on now to say a few things about the challenges that many in the emerging world face in managing capital flows, particularly in the face of the extremely low interest rates being set in the advanced economies (AEs).

We are in an unprecedented situation. Interest rates are expected to stay extremely low in the US and much of the advanced world for a few years, reflecting decisions by their central banks to keep monetary conditions highly accommodative until their economies resume normal growth. There is debate among economists on how effective these activist monetary policies, such as the US Fed's QE3 strategy, will be in reviving entrepreneurial spirits and private investments. If the strategy succeeds and the US economy recovers, it will be a plus for Asia as well.

In the meantime, however, there are significant implications for emerging market economies, as global investors search for better returns – better than the near-zero rates they get on cash and treasury bills. ***With large amounts of liquidity now moving between markets, short-term shifts in investor sentiment leads to volatility in capital flows.*** We have seen how a shock in the European periphery can send money that was invested in emerging markets rushing back to the US or other safe havens.

To be clear about it, there is a lot that is good about capital flows, including even short term flows. They ***add liquidity to markets***, by bringing more buyers and sellers together. However, we know too that capital inflows can also be too much of a good thing. They ***can lead to asset prices, or exchange rates, becoming disconnected from fundamentals***. And the sudden withdrawal of capital from emerging economies when investors switch from 'risk on' to 'risk off' in their portfolios can be destabilising.

As I mentioned, the current global condition is unprecedented. The policy responses in the advanced countries too are without precedent. Globally therefore, we need some humility in understanding the benefits and costs of QE3 and easy monetary policies in the advanced countries. But ***it will be wise to strengthen our policy toolkits in Asia, so that we can deal with unpredictable and often excessive capital flows***.

There are some lessons that come out of our experiences in Asia and elsewhere, and policy responses that we can learn from each other. I will mention three sets of policy responses that will inevitably have to figure in our toolkits.

First, there is much sense in curtailing volatility in the exchange rate over the short-term. The costs of volatile and uncertain exchange rates are high in small open economies especially – which is what most of our ASEAN economies are. Accordingly, Malaysia, Singapore and several other Asian countries have not felt comfortable leaving their exchange rates entirely to market forces. Their central banks, within each of their monetary policy frameworks, have sought to instil a focus on longer term fundamentals.

There is merit in ***allowing exchange rates in Asia's emerging economies*** to ***appreciate gradually over the long term***, reflecting their more rapid growth. If we resist these long term trends, we are likely to see more inflation in our economies. But ***some stability in the short term is wise***.

Second, macro-prudential policies are now an important part of the policy tool kit. Many Asian countries have introduced new macro-prudential measures to try and avoid bubbles in their property markets over the last two years. Malaysia brought in stricter limits on loan-to-value ratios on housing loans. Singapore and Hong Kong have done similarly, and have introduced additional stamp duties or transaction taxes to discourage speculative demand for residential properties.

These ***targeted administrative and prudential measures*** are not conventional macro-economic tools. But they are likely to ***remain part of our policy toolkit, at least for the foreseeable future***, given the real risks to macro-economic stability that an environment of very low global interest rates poses.

A ***third*** and more fundamental strategy has to focus on ***building greater depth in Asia's capital markets***, while ensuring that our banking systems remain sound. A good example of this strategy is in fact in Malaysia. Bank Negara's Financial Sector Blueprint II (2012–2020), released as part of the government's Economic Transformation Programme (ETP), will build on the solid foundations of Malaysia's financial system, including developing a deep and vibrant bond market.

The banks in several leading Asian countries, including Malaysia and Singapore, are generally well-managed and well-capitalised. They were a source of strength for us during the global financial crisis. However, Asia's capital markets, and ***especially the corporate bond markets***, need much more depth. ***Broader and deeper capital markets will allow investors to invest for the long term while hedging against risks.*** They will help us meet the growing infrastructural and other long term investment needs of the region.

This is therefore a very important priority in the region, and there is in fact significant scope for future development of Asian capital markets. Regulators are working to harmonise rules and market practices across the region, such as issuance procedures and settlement standards. We also need to develop the securitisation markets, with appropriate safeguards, so that banks can recycle their capital.

More too is being done to boost linkages between our markets and economies. We have to pool liquidity across our markets, so as to add depth to the Asian capital market. An example is how the Malaysian stock exchange, Bursa Malaysia, the Singapore Exchange and the Stock Exchange of Thailand recently launched an ASEAN Trading Link.

We are also cooperating to encourage financing for infrastructure projects in the region. The ASEAN Infrastructure Fund (AIF), an initiative that was led by Malaysia, is a good example. It will pool resources, knowledge and experience among ASEAN governments and the Asian Development Bank (ADB) for loans to sovereign or sovereign-guaranteed infrastructure projects. The Fund will also issue bonds, so as to bring in private sector and institutional investors.

Another example of such cooperation in the region is the Credit Guarantee and Investment Facility (CGIF) amongst the ASEAN+3 countries, which aims to help companies in ASEAN+3 countries raise long term financing for infrastructure investment by providing the governments' guarantees on their corporate bonds, thereby reducing risk for bond-holders.

Projects such as Iskandar Malaysia are also a prime example of how intra-regional investments can be encouraged, and how countries in our region can develop competitive strengths jointly.

- Iskandar Malaysia's performance has been impressive – poised to exceed its targeted RM100 billion investment mark by the end of this year.
- I am glad there is good progress on the joint venture by Temasek Holdings and Khazanah Nasional, Pulau Indah Ventures Sdn Bhd to co-develop two separate sites in Medini.
- Other significant projects include a S$1.5 billion integrated eco-friendly tech-park by Ascendas and Malaysia's UEM Land Berhad in Nusajaya (one of the five flagship

zones in Iskandar). Once completed, the park will accommodate a range of industries including electronics and precision engineering.

- Just in the last month, we have seen other significant investment commitments in Iskandar reported by Singapore companies.

Iskandar Malaysia will enhance the complementary space between our two economies. It is a win-win. To ensure continued progress in Iskandar, Singapore and Malaysia will continue to take steps to improve connectivity, cross-border trade facilitation, and immigration processes.

Conclusion

I would like to conclude by emphasising once again that I am basically optimistic about the prospects in our bilateral and regional cooperation. We face many challenges in this post-Global Financial Crisis era. But the opportunities for us in Asia are intact, and our ability to cooperate with each other to achieve our full potential as a region is an asset for all our countries.