Zeti Akhtar Aziz: Global financial stability and the internationalisation of financial systems in emerging economies

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Euromoney-Qatar Conference "Global financial stability and the internationalisation of financial systems in emerging economies", Doha, 11 December 2012.

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It is my honour to be here in Doha to speak at this Euromoney-Qatar Conference on "Global Finance Re-designed". I wish to thank the Qatar Central Bank for the invitation to speak at this event. In this current global environment, the unprecedented and wide ranging global policy responses have yet to produce financial stability and a sustainable recovery of the global economy.

The intensification of the globalization of finance in this decade has resulted in an even more connected and interdependent world. While the financial systems and economies in most parts of the world felt the effects of the recent global financial crisis, it has not discouraged the pace of internationalization of financial systems, in particular, in emerging economies. My address this morning will be on financial stability and the internationalization of financial systems in emerging economies. My remarks will cover the benefits and challenges of such internationalization, the lessons that can be drawn from the recent global financial crisis, the Malaysian experience on the internationalization of our financial system.

Benefits and challenges of internationalisation of financial systems

While there are significant benefits from internationalization of financial systems, the resulting increased international financial integration brings with it new risks and challenges. The case for increased financial liberalization and internationalization maintains that it would foster the development of a more efficient and robust financial system. While the resulting more competitive financial system will enhance the efficiency in the financial intermediation process and contribute towards reducing the cost of intermediation, the supervisory oversight needs to ensure over competition does not result in the mispricing of risk with adverse consequences on financial stability.

Other benefits are the increased opportunities for technology transfer, new expertise and greater innovation and new product offerings. Increased foreign participation in the domestic financial markets would also contribute to increased liquidity and more competitive pricing in the domestic financial markets and encourage a more efficient allocation of capital within the economy. It is also maintained that it will contribute to the expansion and development of the domestic financial markets in particular, the capital market, proving an important access for financing of investment activity. With the more efficient functioning of domestic financial markets, it would also improve the transmission mechanism of monetary policy.

Meanwhile, the increased capital inflows following the capital account liberalization represents another source of financing that would contribute towards increased investment and growth. It will allow jurisdictions with surplus funds to be channelled to those regions with productive investment opportunities and thus contribute towards a more efficient allocation of funds across international borders. The stronger cross border financial linkages has the potential to enhance international trade and investment opportunities. It allows countries to leverage on the respective comparative advantage and complementarities to reinforce mutual growth. This would be important in the current environment to facilitate cross border economic activity.

The liberalisation of the capital account in the form of removing restrictions to foreign exchange transactions would also increase the flexibility of managing such foreign exchange transactions. This would increase the potential to better manage its associated risks, while the increased efficiency gains would also reduce the cost of doing business. Finally, it is also argued that in a more liberalised environment, there would be greater market discipline which would in turn promote financial stability in the domestic financial system. This however, relies on a sufficient level of disclosure and transparency to allow the efficient functioning of the markets.

The internationalization of financial systems is however, not without risks and challenges. The risk of contagion following from the increased connectivity increases significantly, in terms of the extent and speed. The contagion can result from external events and developments that can range from failure of large and important international financial institution to the eruption of wars or political incidents that have regional or global repercussions. Meanwhile, global developments including from global policy spillovers have also resulted in more volatile capital flows. The increased openness of the financial system also increases the vulnerability to economic cycles in other parts of the world. The increased interdependence of financial systems and economies and the contagion effects can be expected to be among the significant outcomes of financial internationalization.

Financial liberalization could for example amplify further the implications of financial stress from other parts of the world on the domestic financial system. It could also accentuate and amplify asset bubbles and boom bust cycles. Other implications are that it could contribute to the widening of income disparities and also to the marginalization of domestic financial institutions if they are not able to perform in a more competitive environment. Finally, volatile capital flows may not only affect the efficient functioning of the financial markets but could result in misaligned exchange rates that do not reflect underlying fundamentals. These potential risks and vulnerabilities continue to be a challenge not only to emerging economies but also to the more developed financial systems and economies.

Lessons from the financial crisis

While there are benefits to be gained from the internationalization of financial systems, the risks to financial stability have also increased immensely. The risks generally emanate from the greater prospects for contagion following the greater degree of interdependence. These risks would be even more pronounced in emerging economies in which financial systems have yet to become more developed and matured. To be better positioned to reap the benefits from internationalization of financial systems in emerging economies, the crisis provides us with several lessons. Firstly, is to recognize that the different parts of the domestic financial system is highly interconnected. This also includes those parts that may not be under the regulatory capture. Financial stress in a specific segment may no longer be confined to that segment but may rapidly be transmitted to the rest of the financial system. Thus, a piecemeal policy response would not be sufficient. It would require a comprehensive response to ensure that such stressed conditions does not evolve into a major financial crisis.

Secondly, the build-up of risks to financial stability need to be identified early. Pre-emptive action would reduce the cost of the crisis on the financial system and the economy. Third, the regulatory authorities need to be accorded the necessary powers to manage the risks to financial stability. Fourth, the optimal policy mix may not only include policy actions to address immediate term issues but would also need to simultaneously address the underlying structural problems. Fifth, is to give recognition to the importance of enabling conditions that will render the implemented policies to yield the desired outcomes. Finally, to facilitate effective policy decision making there needs to be a platform and governance process for policy coordination across agencies within an economy and for this to be extended for regional and international collective action.

Following the recent global financial crisis, the policy response at the national level has been extensive and on an unprecedented scale. While there has been wide ranging financial reforms at the international level to strengthen the resilience of the financial sector, the cross border dimension of policy-making has not been as extensive. This is despite the swift spread of financial and economic shocks throughout the global economy and international financial system following the eruption of the financial crisis in 2008.

Despite these increased challenges, the institutional arrangements for policy cooperation and coordination have yet to reach the levels that are commensurate with the degree of global economic and financial integration. While the individual efforts by any single economy is vital, it can no longer guarantee global financial 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 crisis has forcefully demonstrated the importance of the international dimension of policy.

Finally, a consequence of financial crisis that deserves increased attention is the widening of income disparities within economies. The recent crisis has worsened this trend given the conditions of high unemployment in many parts of the world. At the national level, the development of inclusive financial systems and the development of social safety nets will contribute to containing this trend.

Financial internationalisation and the Malaysian experience

In pursuing financial sector liberalisation to transition to a more internationalised financial system, Malaysia adopted a gradual and sequenced approach. This was to ensure that the necessary preconditions were in place so that the benefits of increased financial internationalisation would be realised, while ensuring that the associated risks inherent to a more open economy and internationally integrated financial system could be effectively managed.

Seven preconditions were identified as being important to this process. The first was to accord priority to building the capacity of the intermediaries in the financial sector, and to strengthen their resilience and competitiveness. At the time of the Asian financial crisis, Malaysia had a highly fragmented banking sector with more than seventy banking institutions, many of which were small and highly vulnerable. During the financial crisis, a major restructuring exercise was undertaken. This was followed by an industry-wide merger exercise, prompted by an increase of the capitalisation requirements. The restructuring strengthened the balance sheets of the banking institutions, while the consolidation produced larger and stronger financial groups.

The second was to undertake financial reforms which focused on the transition to a more market-oriented financial system. This involved interest rate reforms that would support the more efficient pricing of financial products and services. The more competitive environment that was generated became an important driver of efficiency gains and innovation in the financial system.

Equal attention was also given to the development of the financial infrastructure, in particular, the payment and settlement system and the modernization of the legal framework to give greater clarity to the legislation governing the financial sector. This involved seven new legislation that have been enacted in the areas of central banking, the payments system, money services, deposit insurance, and the regulation of the banking, insurance, Islamic finance, development financial institutions and cooperatives. This has given greater certainty and predictability in the functioning of the financial system.

Importance was also given to strengthening the surveillance capabilities of the Central Bank and the effectiveness of the regulatory and supervisory regime. This involved the transition from a rule-based regulation to an enhanced principle-based regulation regime with focus on governance practices and risk management. This was reinforced by the shift to a risk-based supervision. The supervisory oversight has however continued to remain intrusive, with a pre-emptive intervention framework to ensure that the potential risks to financial stability would continue to be addressed including in a more regionally and internationally connected financial sector.

In parallel with these efforts was the development of the securities market. From a financial system in which there was an over-reliance on the banking system for financing, the financial system has now become more diversified with greater access to financing from the bond and sukuk market. The domestic securities market has now evolved to become a vibrant part of the Malaysian financing ecosystem, and has served to disperse the concentration of risk in the financial system thereby contributing towards preserving financial stability. The Malaysian securities market has expanded significantly to become the largest in the ASEAN region.

Malaysia also made significant investments in talent development for the financial services sector. Given its significance in defining performance and resilience of the financial sector, comprehensive institutional arrangements have been put in place for all levels of the industry; at the entry point, at the working and specialist levels, at the professional level and at the leadership levels including for the boards of financial institutions.

Finally, as the financial system became more regionally and internationally more integrated, regional financial stability arrangements have also been established. These included advancing collective initiatives in the areas of regional surveillance, the development of regional financial markets and payments infrastructure, and cross-border supervision. Forums for assessment of risks to regional financial stability have also been initiated, and work on establishing an integrated crisis management and resolution framework for the region is in progress. As part of these initiatives, a regional support mechanism has also been established.

With these pre-conditions in place, Malaysia commenced initiatives to internationalise our financial system beginning 2003. The internationalisation of the financial sector entailed the advancement in two main areas; financial sector liberalisation and capital account liberalisation. In pursuing greater regional and international financial integration, the aim was to enhance the diversity of the financial system in terms of its product offerings, to improve further the competitiveness of the financial system and to strengthen our economic linkages with the region and other parts of the world.

The financial sector liberalisation involved increased foreign entry and participation in our financial system. New licences were issued to foreign conventional and Islamic banking institutions, while the minimum foreign strategic stakes in the insurance and takaful industry were increased. Increased operational flexibilities were also accorded to the existing foreign banking institutions in the financial system which now account for about 30% of the banking system. At the same time, the foreign participation in our securities market was liberalised in 2007 to allow foreign corporations to raise financing either in domestic or foreign currency.

The capital account liberalisation throughout the first decade in the 2000s has involved the progressive removal of restrictions on foreign exchange administration rules. This liberalisation was intensified after 2005, taking into account the state of readiness of the financial system and the economy to manage the consequential increased cross border financial flows. In July 2005, Malaysia migrated from a fixed exchange rate regime to a flexible exchange rate regime to accord greater flexibility to adjust to changing structural conditions in the region and the global economy. With the progressive dismantling of restrictions, businesses now had the flexibility to manage their financial exchange exposures. This encouraged two way capital flows and contributed towards stabilising the volatile capital flows to our economy.

Finally, in addition to being accorded with the necessary powers in the new legislations, the policy toolkit of the Central Bank has also been expanded to address the potential build-up of financial imbalances and its risks to financial stability following increased internationalisation. This includes macro-prudential and supervisory measures to collectively address the underlying causes of financial stability. A platform has also been established for the greater coordination among policy makers within the country, among the regulators and the public sector.

Conclusion

Let me now conclude my remarks. While many lessons can be drawn from the various episodes of financial crisis experienced by the world economy, there is no one approach to the liberalization and internationalization of financial systems. Its success depends on the prevailing circumstances and the state of readiness of financial systems and the economy and its capacity to manage its associated risks. Premature internationalization can result in highly destabilizing conditions. The liberalization process also needs to be pragmatic, taking into consideration the different objectives that need to be achieved. With sufficient development of the financial infrastructure, the safeguards and the buffers, emerging economies have every potential to participate in a more internationally integrated financial system that will facilitate mutually reinforcing global growth and development.