

Zeti Akhtar Aziz: Building institutions to support economic development

Special lecture by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the SEACEN Conference on Central Bank Cooperation and Mandates “Building Institutions to Support Economic Development”, Sasana Kijang, Kuala Lumpur, 14 March 2016.

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Introduction

It is my great pleasure and honour to speak at this conference in honour of Dr. Puey Ungphakorn on the subject of “Building Institutions to Support Economic Development”. The topic is highly relevant in the current environment which places greater demands on institutions given the significant structural shifts that are taking place in the global landscape and the changing character of the economic cycles that has brought with it a great many new challenges that need to be managed.

Given that building institutions is about creating a positive environment for the economy to function, one that will shape the incentive structure that will drive economic activity and encourage the efficient use of resources, the new evolving environment would place a further urgency for institutional building. There is thus a great motivation for building effective institutions to serve this purpose. In particular, the urgency is for strong institutions that will transcend the passage of time and will ensure the path towards sustainable economic growth and development. Experience has shown us that institutions are pivotal to any economic success. However, institutional building is in itself an arduous task. And building institutions that are relevant for the future is even more challenging. But it is something that needs to be done now if we are to prepare the ground for our future generations.

It is from the legendary Dr. Puey whom we can draw significant inspiration. Dr. Puey had long recognised the importance of institutions to economic development and dedicated a major part of his life to this endeavour. He was a true leader, whose contribution to his country’s economic progress extended beyond the Central Banking sphere to several other areas of public service, to education, and to beyond the national borders of Thailand. We are now the beneficiaries of Dr. Puey’s efforts which laid the foundation for the greater Central Bank cooperation that we see in the region today. Dr. Puey was a true visionary. He had consistently demonstrated his vision, dedication and foresight and in the process, created highly regarded institutions not only in Thailand but also for the region.

The subject of institutional building has generally referred to institutions that support the functioning of markets. It is maintained that markets allow for the more efficient use of skills and resources to engage in activities with higher productivity. As stated by Douglass North, known for his work on institutional economics, institutions comprise a set of formal rules that provides the framework for interaction and which shapes the incentives for the functioning of the economy. These include the incentives for people to invest in more efficient technology, to increase their skills and to organise efficient markets. Therefore, in strengthening the effectiveness of institutions, it is about putting such institutions in an environment in which they are able to rise to the demands for performance and discipline. This therefore places emphasis on following a certain order, rules and regulations that would bring value to society.

While mature and developed economies have benefitted from effective institutions, the changing global and national landscape that is becoming increasingly more interconnected now demands for new institutional arrangements for the way in which engagements or interface takes place. Equally important are the arrangements for the management of the new emerging challenges. Experience has shown us that this can be highly challenging when it involves changes in relationships when the structures of institutions have not changed. Such institution building is particularly important for public policy decision making. This is particularly

relevant when coordination arrangements for inputs from the different parts of the public sector become necessary. For the economies in the emerging world that are at a different phase of development, the creation of strong and effective institutions is even more pressing. Not only do existing institutions need to be strengthened but new institutions need to be built to facilitate the effective functioning of the economy.

We have heard this morning in the tribute to Dr. Puey, his tremendous role in institution building in Thailand and his role in the Asian region. There are numerous examples in his legacy, in being resolute in pursuing his convictions and about his effective management of the interface with the political process, given that politics is an important part of the ecosystem of institution building. He achieved this without compromise, sustaining always the integrity of the institutions he was associated with. Institutional building therefore needs to be viewed from the broader perspective to include strengthening the institutional arrangements of how economies and financial systems can more effectively function, adding value for greater economic wellbeing. Just as we have seen that with the advances in technology, we need to change the hardware and software. So is the case for institutional building to support economic development. It will also involve changing the institutional “hardware” and the “software”

Increasingly, emerging economies are in transition towards greater market orientation in which the market has become an important mechanism in generating economic growth. While market mechanisms are generally successful in achieving greater productive efficiency, it does not always result in greater allocative efficiency. As a consequence, disequilibrium conditions and market failures may not only be detrimental to social welfare, but may also weigh on an economy’s growth and development prospects. Strong institutions that provide regulatory and supervisory oversight are therefore necessary, in order to facilitate the effective functioning of markets while having the institutional capability to manage disruptions.

The sustainability and continuity of effective policy management depends on the performance of public institutions that have sound policies and governance processes that are formalised in a clear, structured and well-defined framework. Equally important is the accountability. In this aspect, the institutionalisation of policies and processes, which culminates in sound governance serves to preserve good practices and imposes the necessary discipline for objective policy making. The gaps in the market infrastructure in the emerging economies however increase the vulnerability of our respective economies to external shocks. Such shocks have increased in frequency and magnitude, with the risk of prolonged implications on our economic growth. With its important role in the management of domestic macroeconomic and financial stability, Central Banks in this changing environment also need to be strengthened in order to enhance its effectiveness in facilitating conditions to support economic development.

My remaining remarks this afternoon will focus on institutional building and economic development from the perspective of Central Banks in emerging economies. In particular, on the role of Central Banks in supporting the development agenda and as an institution building agent. In most emerging market economies, the mandate of the Central Bank is generally broader beyond monetary and financial stability to include development of the financial system to ensure effective and efficient functioning of the financial system, financial inclusion to maintain balanced growth and more recently preserving the environment to secure sustainability of our progress and development

Special role of Central Banks in emerging economies

Allow me to focus on the special role of Central Banks in emerging economies. Central Banks in most emerging economies are frequently called upon to have a role in the development of the financial system. A well-developed and robust financial system constitutes an essential foundation for sustainable economic growth as it enhances the efficiency of financial

intermediation, contributing towards lower transaction costs and increased competitiveness. Many Central Banks have drawn up masterplans and blueprints for this purpose.

The key building blocks are the strengthening of financial infrastructure, such as the payments and settlement system, the development of money and bond markets and in the implementation of financial reforms involving the deregulation and greater market orientation and liberalisation resulting in greater integration with the global financial system. Central Banks in many emerging economies are also tasked with promoting financial inclusion. Greater financial inclusion is a key component for an economy towards achieving a more balanced growth and thereby increasing the prospect for a more sustainable growth.

What are the factors that have allowed Central Banks in the emerging economies to perform these roles? Honed by international benchmarks, best practices and the scrutiny of a global audience, Central Banks are institutions that over the years, have built a strong reputation for intellectual rigour, credibility and independence. Given this, Central Banks are often called upon to be the institution that drives important and often challenging financial reforms in an economy. Additionally, in most emerging economies, the largest concentration of talent resides in the Central Bank, providing it with the resources and intellectual capacity to undertake multi-faceted developmental roles that extend beyond our core mandates. The fact that Central Banks are often a highly-regarded public institution in a country also lends it to having greater legitimacy in addressing challenging domestic issues. In managing this role effectively, three elements are key: clarity of the outcomes to be achieved, a governance process which gives clarity on the decision making process and accountability, and finally, ensuring the integrity and the independence of the Central Bank is not undermined.

Another recent important element of Central Banking in the emerging economies that contributes to the effectiveness of the Central Banks in policy making is the close collaboration amongst Central Banks in the emerging economies – in particular in the Asian region. The formation of formal regional platforms for collaborative initiative facilitates the sharing of information, experience and knowledge which are crucial in driving the national, regional and even international agenda. It also has involved cooperation in not only the areas of surveillance and harmonisation of rules and regulations, but also the assessment of risks to the region and the building of regional financial safety nets.

Finally, allow me to say something about the current environment. While Asia has not been immune from the effects of the turbulence and upheavals taking place in the different parts of the world, the region has been able to demonstrate time and again the ability to manage a swift rebound. Factors that have contributed to this resilience is not so much what we have done in response to the development but it is what we have done previously that prepared us to manage these developments. We have been better able to absorb and intermediate the financial turmoil and turbulence, while the series of financial reforms we have implemented have also increased our flexibility and produced better price and exchange rate adjustments. This has been reinforced by our sound macroeconomic fundamentals and the policy space we have to manage the implications of these challenging developments.

Looking ahead, there is much to be done by all of us. I have always said that the business of Central Banking is an unfinished business. There will always be new challenges on the horizon. In Asia, while we have successfully prepared ourselves for the current environment, we now need to prepare ourselves for the future. Among the future challenges that are likely to confront Asia is the sustainability of our prevailing growth model given the consequences arising from the erosion of our demographic advantage, the rising indebtedness, the rising cost of living despite an apparent period of low inflation, the need to meet the massive infrastructure requirements and the need to address the rising income disparities and the environmental challenges. What then are the ways economic management can prepare us for the future? This will involve policies and reforms that will reduce leverage, that will address the widening

income disparities, that will effectively manage infrastructure development and urbanisation, that will accord environmental sustainability and finally that will accord importance to governance, accountability and integrity in the implementation and execution of the many endeavours to achieve a sustainable advancement. This implies an important role of institutional building that will support the ability to address these challenges.

For most Central Banks in the emerging world, our mandate is broader. Most certainly we are expected to have a role in contributing to addressing many of these challenges both directly and indirectly. Some of these issues include financial inclusion, financing of infrastructure, putting in place financial and social safety nets, and environmental sustainability. As much of these efforts will involve interface with other parts of the public sector, it has been my experience that the participation of the Central Bank in many of these agendas will require careful boundary management and a signing off when it is completed so that it does not remain permanently with the Central Bank. New institutional arrangements will need to be developed to render effective coordination across the public sector. Of great importance in this process is also to carefully safeguard the independence of the Central Bank.

Conclusion

As policy makers in emerging economies, we have the added responsibility of building institutions for the country. Our quest is filled with challenges but we can learn much from each other. Going forward, the transitions that are taking place in the global economy necessitate continuous institutional building at the national, regional and international level. A regional institution such as SEACEN has an important role in enhancing future talents, facilitating the sharing of knowledge, ideas and insights on policy management in the region and from its research on subjects important to the region.

In conclusion, allow me to express my deep gratitude and appreciation to my fellow governors and to all my colleagues at the SEACEN member Central Banks and to SEACEN for all the cooperation and support that has been extended to me and to Bank Negara Malaysia throughout my career. For the friendship and for the collaboration, it has truly been enriching and special for me. It has been a great privilege for me to be part of this Central Bank community.