

Zeti Akhtar Aziz: Outlook and prospects for Asia

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Asia Pacific Bankers Club Conference, Kuala Lumpur, 15 September 2003.

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Ladies and Gentlemen

Introduction

Powerful forces of change reinforced by global political, economic and financial developments have had pronounced implications on the economic and financial environment we operate in. It has not only dramatically changed our economic and financial landscape but has brought with it new uncertainties, risks and challenges. Despite these developments, the Asian region has demonstrated resilience and continues to emerge as the fastest growing region in the world. The issue before us is - to what extent can Asia continue to prosper in this increasingly more difficult and changed global environment? To what extent can Asia's previous successes be sustained in these more challenging circumstances?

It is my pleasure to be here today on this occasion of the Asian Pacific Bankers Club Conference on "Financial Stability and Challenges". Let me take this opportunity to also welcome the delegates to Kuala Lumpur. Indeed, high priority has been accorded by the economies in this region towards achieving financial stability. Varying degrees of financial restructuring and reform have been undertaken to strengthen domestic financial systems. Five years since the countries in this region emerged from the financial crisis we have seen financial stability restored and the financial systems significantly strengthened. Despite the more challenging environment in the more recent period, the financial systems in this region have demonstrated resilience. While this is a positive development, challenges remain. In view of the increasingly more difficult environment these efforts to strengthen the financial systems need to continue.

Today, I would like to focus my remarks on the background against which these efforts are being undertaken. In particular, I will focus on the emerging changes that are taking place in our region that are likely to be important in sustaining the growth prospects for this region. In the context of these changes, I will touch on the important role that the banking sector has in contributing to the growth and development process.

Ladies and gentlemen,

The region is highly integrated with the world economy in terms of the high volume of trade and investment flows between the region and the rest of the world. While this has contributed significantly to the strong growth in the region, it has also brought with it increased vulnerabilities arising from shifts in demand and reversals in investment flows. Indeed, developments in the advanced economies arising from the bursting of the technology bubble, the unprecedented declines in the stock markets, uncertainties arising from international geopolitical tensions all had implications on this region.

In the current environment, clear signs are now beginning to emerge that the recovery in the advanced economies is strengthening and that this is already positive for the region. While the pace of growth in the major industrial countries is still below their potential, it has been revised upwards to reflect improved consumption and business investment activity. Most encouraging has been the indicators of business investment, particularly IT investment, which has been stronger-than-expected. This has been supported by improved corporate cashflows and the low interest rates environment. In Japan, signs of recovery have emerged while in the euro area, indicators of business sentiment suggest a stabilisation from the current weakness. These developments augur well for growth in the region in the second half of this year and in 2004. Indeed, the positive performance of the global stock markets reflected an anticipation of stronger future growth.

While these are encouraging trends for the region, we need to look beyond the prospects of the current cyclical recovery. Several significant imbalances however, still remain in the global economy.

An important issue that needs to be addressed is how the unbalanced growth that has taken place in the world economy can be resolved with orderly adjustments of both the economies concerned as well as of the respective financial markets. The adjustments need to take place while maintaining robust overall global growth. Global growth still remains dependent on the US as an important trading partner. This is reflected in the large and persistent current account and budget deficit in the US as it continues to be the net purchaser of world output. Asia and the Euro area, on the other hand, continue to record large surpluses. This is also reflected in the significant build-up of dollar assets in Asia as US deficits are partially financed by capital inflows from Asian economies. Meanwhile, the adjustments to the previous excesses in investment still continue to restrain new investment, leaving growth to be dependant on the sustainability of consumption. These global imbalances are unsustainable in the medium-term. Moreover, any large and disorderly adjustments in exchange rates would have disruptive implications on growth in the region and for the overall global growth. Despite the severity of the Asian crisis, geopolitical uncertainties in the past few years, and most recently, the SARS outbreak, Asia still remains the fastest growing region in the world. Growth for the region as a whole for this year is forecast to be about one and a half times faster than the global average.

The issue before us is, to what extent can Asia ensure sustainability of the growth prospects over the long-term in this more difficult global economic environment? To what extent will the global imbalances place the burden of adjustment on the region? How can the region contribute towards a more balanced global growth? In dealing with these risks and pressures, the region is supported by several strong underlying factors that provide the foundations for securing our future growth.

Factors underlying Asia's Growth Prospects

First, domestic demand led growth

Domestic demand in the regional economies is becoming an increasingly important driver of growth that has considerable potential to contribute further in sustaining growth prospects for the Asian region. The stronger domestic demand has also been reflected in the rising intra-regional demand for goods and services, thus providing a positive mutually-reinforcing effect for the region. While externally driven growth will continue to be important, the increased focus on strengthening domestic demand will reduce vulnerability to external developments.

Second, the role of private consumption

Given the focus on domestic demand to harness a more self-sustained and balanced economic growth, an important catalyst is the role played by private consumption. Private consumption is well positioned to further build the capacity of domestic demand in the region. The contribution of consumption to economic growth in regional economies has increased over time, supported by the expansion in per capita income in the region, which has increased by 4% per annum during the period 2000-2002. Consumption has also been supported by the fiscal and monetary stimulus that has been implemented in the region. This has enhanced incomes and strong credit expansion for household spending including for the purchase of housing. The tradition of high savings ranging to between 20% to 45% of GNP allows scope for encouraging a higher rate of consumption without undermining its sustainability. Household debt levels are also generally low. In addition, the household sector generally has a good track record in servicing their debt. Previous prudent fiscal policies have allowed an expansionary stance to support the growth while low inflation and excess capacity has allowed for the monetary stimulus.

Third, favourable demographic factors

The Asian region accounts for more than half of the world's population and continues to grow at a relatively high and stable rate. Of importance is that the region has a relatively young demographic structure with rising education, which augurs well for securing a large and dynamic labour force going into the future. These favourable demographic prospects of the region increase the potential for creating a consumer group with high purchasing power, thus providing an increased potential for growth in domestic demand.

Four, rising middle-income consumers

Rising income and urban migration in Asia has produced a large and vibrant middle-income group, creating a pivotal change in the pattern of consumption to deliver the positive benefits in domestic demand growth. The cumulative effects of policies that have been implemented previously have resulted in increasing income and living standards and established the foundations to accentuate the transformation of domestic demand in the region. China's domestic market with a population of more than 1.2 billion, is already the world's largest market for mobile phones and is poised to be the world's largest market for personal computers. By 2005, it is estimated that 15% of China's population would consist of about 200 million middle-income consumers equipped with a high propensity to consume. By 2010, middle-income consumers in China are expected to increase to 400 - 500 million thus making the China market comparable to that of the US.

Five, rising intra-regional trade

Rising economic integration has enabled the region to be more resilient in an increasingly volatile and uncertain external environment. The East Asian region has already developed a significant degree of economic integration as manifested in its fairly high level of intra-regional trade. The rise in intra-regional exports, which accounts for 34% of the East Asian region's exports in 2002, stemmed in part from the higher contribution of domestic demand, which leveraged on the robust economic growth achieved by regional countries. Estimates indicate that about 30-70% of intra-regional trade is for final demand in the region. Of significance is the positive economic performance of China and India, which has generated increased sources of final consumer demand. Since 1993, China's role in the region has reversed from a net exporter to a net importer in regional trade. Intra regional trade within ASEAN has also increased significantly to account for 24% of the region's trade, exceeding the trade by the region with the United States.

Six, supportive policies for endogenous sources of growth

The region's commitment to harness domestic driven growth has been reinforced with pro-active economic policies to provide an enabling environment to enhance the development of domestic businesses, in particular, small and medium scale enterprises. Policy makers in the region recognise the challenges that emanate from a more competitive environment and have continued to re-examine and redefine strategies geared towards building the capacity of domestic enterprises and thereby enhancing their contribution to growth of the domestic economy. In addition, efforts have also been made to develop new areas of growth to ensure a more diversified economy. Countries have increasingly shifted to areas of their natural comparative advantages, whether in agriculture, ICT, construction and infrastructure or services-related sectors in order to benefit from their inherent strengths.

Seven, a new wave of FDI in the region

Apart from intra-regional trade, intra-regional foreign direct investment (FDI) flows have increasingly operated as a strong force for growth in the East Asian region. Regional FDI has largely been trade-related. Early FDI in East Asia was mainly derived from Western multinationals, particularly the US. The second wave of FDI after the late 1970s was predominantly Japanese capital which flowed into East Asia, in search of lower costs of production. Today, the cumulative stock of Japanese FDI has surpassed that of American investments. Since the late 1980s, as Taiwan, Hong Kong and Singapore transformed into capital surplus economies that moved up the value chain, investments by these newly industrialised economies gained significance in Asia. This has represented the "third wave" of FDI in the region. The East Asian region is thus witnessing a steady inflow of FDIs from the NIEs to ASEAN and China. In the more recent period, this trend has been reinforced with increased overseas investments by Korea and Malaysia.

Eight, engaging the emergence of large new markets in the region.

Overall, as a high level of integration exists at the regional level in terms of trade and FDI, shifts in trading and investment patterns both from external sources into the region and within the region itself have been a dynamic process. Hence, given the emergence of large new markets in the region, the opportunities present in these markets show complementarities in the region. Countries in the region need to therefore focus on these complementarities in new potential areas of growth. In an

increasingly competitive environment, economic progress in the region is benefiting from the strategic specialisations which are supported by the leverage on comparative advantages.

Nine, regional cooperation gathers momentum

Given the existing mutual interest amongst countries in the region, regional cooperation efforts are gathering momentum in East Asia, notably in the context of ASEAN+3 and EMEAP. To-date, the focus of such cooperation by Governments has been on regional surveillance, developing institutional arrangements and according high priority to co-operation in trade and investment. The drive toward regional cooperation will continue to increasingly focus on enhancing regional trade and investment linkages to maximise the comparative advantage of each member country. Toward this end, studies have already been commissioned to explore the feasibility and identify the preconditions for the creation of an Asian common market, a logical long-term objective of regional cooperation.

Ten, strong underlying economic and financial fundamentals

The underlying fundamentals in the region are expected to continue to remain positive. Sustainable current account surpluses and strong international reserves positions all continue to support the growth prospects. The high savings rate, of between 20-45%, which allows for financing of pro-growth policy measures from domestic sources will continue to support the growth prospects. Unemployment in the region as a whole is also relatively low. Financial stability has generally been restored and there has been a resumption in credit growth.

The Financial Sector as an Enabler of Growth in Asia: The Vital Role of the Banking System in Facilitating the Economic Growth Process

Ladies and gentlemen,

The banking sector in particular and the financial sector in general have an important role in facilitating the growth process. The financial system in emerging market economies represents an important means to an end. For emerging market economies, the financial sector is an important enabler of growth. It is therefore important to embrace the long-term agenda of the economy.

Despite the trend of the increasing significance of alternative means of financing, the banking sector in emerging market economies will for some time to come remain the most important source of financing in the economy. The banking system therefore needs to effectively and efficiently perform its intermediation function. Of importance, is the need to recognise the on-going economic transformation that is taking place in the region and to facilitate a more balanced growth between domestic and external sources of growth, between public and private sector-led growth, between the balance of consumption and investment, and between the different sectors of the economy, regions and communities within the country. Facilitating a more balanced growth will contribute toward sustainability of the growth process.

With new areas of growth emerging, and new business models being adopted, new and more differentiated customer requirements need to be met. The level of innovation will need to be accorded increasingly important attention. While for the most part, pricing for products and services need to reflect the costs and risks, the industry needs to recognise that in emerging market economies, the basis to do so should take into account the social agenda that is an integral part of the sustainable performance of the country. The ability to achieve socio-economic stability will produce a more balanced growth. Ultimately, the objective of increasing competition and therefore enhancing efficiency in pricing needs to be balanced against providing basic financial services to the less advantaged retail customers at very minimal costs. Such trade-offs need to be made and managed.

This also includes enhancing access to financing to the various sectors in the economy, to both the large and small borrowers. In emerging market economies, providing other ancillary financial services especially to small businesses will enhance the potential quality of such assets. This therefore, not only includes providing greater access to financing but the complete financial services solution to the small- and medium-sized enterprises. In addition, monitoring loan performance during the lifetime of the loan rather than only during the approval process will allow for early remedial action to be taken well before difficulties emerge.

A further important contribution in emerging market economies is to enhance consumer literacy through consumer and investor education to increase the potential for well-informed financial decisions. Another area that is important is the investment in human capital to create a workforce that is skilled and competent, as this will bring substantial long-term benefits. Finally, foreign institutions that have a presence in the region need to recognise the meaningful role that can be realised in the region not only in meeting the requirements of the domestic environment but also to promote investment and business opportunities from their established networks in other parts of the world.

The Asian Financial Crisis not only presented the opportunity to improve the region's resilience to external shocks, but also underscored the importance of breadth in the financial sector, in particular, the development of alternative avenues of financing. Historically, bank loans, as well as funds raised through equity markets have assumed significant roles in Asia as the main sources of financing. By providing another avenue for financing with the development of the corporate bond market, firms are able to improve their ability to balance debt and equity to better manage the degree of leverage while reducing the impact of shocks arising from over-dependence on any single form or source of financing.

The development of corporate bond markets in the region has also enhanced the efficiency of capital allocation by providing an avenue for investing one of Asia's hallmarks - its large reserve of savings arising from trade surpluses. By developing the regional bond markets, it would enable firms to tap alternative sources of financing at competitive cost thereby contributing to increased efficiency, higher investment and consequently to overall growth.

The launch of the Asian Bond Fund (ABF) in June 2003 marks the first significant step in regional financial co-operation and integration, and augurs well for the future development of the Asian regional bond market. The Asian Bond Market will not only serve to facilitate the re-investment of a portion of Asia's reserves back into the region but what is equally important is that it allows for the efficient allocation of savings for productive investments and at the same time broadens and deepens the regional bond markets. In the process, the level of corporate governance in the region would be enhanced as well.

Indeed, developing such an alternative source of financing would serve as a more resilient source of long-term financing with improved matching of the currency and maturity profiles of assets and liabilities. Finally, institutional investors with longer-term liabilities would benefit from reduced currency risk by purchasing longer-term bonds denominated in their home currency. This would contribute towards diversifying risks arising from borrowing in foreign currencies, reducing the potential for systemic risk in the financial system.

At this juncture, there is still much potential for improvement in the regional corporate bond markets. Certain countries have taken measures to develop their bond markets with varying degrees of progress with efforts focused on strengthening the market infrastructure, establishing benchmark yield curves, augmenting the number of issuances and new instruments, and further liberalizing markets to enhance foreign participation.

This has resulted in the evolution in the roles played by commercial banks. In the process of developing corporate bond markets, commercial banks are becoming increasingly active as investment bankers, with roles as corporate advisors, major issuers, deal originators, underwriters, dealers, brokers and providers of a broad range of risk management and hedging instruments. Such an evolution follows the sequence in developing deeper, more active and increasingly integrated and competitive financial markets.

In the pursuit to develop regional bond markets and options for raising capital, new mindsets of looking at regional and global capital markets and a broader range of tools in managing risk and hedging need to be adopted. In this environment regulators have directed efforts at increasing transparency, competition and strengthening the market and legal infrastructures. These efforts, coupled with Asia's history of enterprise and value creation augurs well for Asia as a region.

Conclusion

Ladies and Gentlemen

In conclusion, prospects for Asia continue to remain positive. Asia can expect to continue to remain the fastest growing region in the world. The economic and financial sectors in the region have now strengthened significantly and are better positioned to mobilize the region's surplus capital to provide

broader, deeper and more liquid sources of financing to facilitate the region's growth. The new emerging trends in the region point to increased economic and financial integration. This is reinforced by greater regional co-operation. All this would result in an Asia that is a more mutually-reinforcing region of growth. In the process, the Asian region would emerge as a stronger engine of growth which in turn can facilitate more balanced growth in the world economy.