Dato' Ooi Sang Kuang: Malaysia – ready to face a new world

Keynote address by Mr Dato' Ooi Sang Kuang, Deputy Governor of the Central Bank of Malaysia, at the National Economic Outlook Conference 2010–2011, Kuala Lumpur, 1 December 2009.

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The global economic and financial environment of the past two years has been extremely challenging. Financial market events previously thought to be highly improbable, occurred to create a financial crisis on a global scale. The international financial system froze, wealth destruction not seen since the Great Depression took place, world trade collapsed, and many advanced and emerging economies entered into a deep synchronised recession. Several well-known global financial institutions disappeared overnight while many others were rescued by Government bailouts. The global financial crisis saw policy makers having to respond strongly and adopting a wide range of unorthodox policy measures. A prolonged recession was averted and now the global economy is recovering. What is uncertain is whether the current revival can be maintained and growth sustained. Risks remain that the current recovery could lose momentum.

Arising from the worst global financial crisis since the last depression, the world's economic order and the character of the global financial system will be undergoing a process of transformation that will be significantly different. In a transformed new world, Asia is set to emerge as one of the most vibrant regions, and will increasingly play a critical role in determining the shape of the future global economic landscape. In this context, there are several key issues that Malaysia needs to address to face a new world, a world in which trend growth will be lower, capital will be less readily available and at higher cost, competition more intense, short-term capital flows remain volatile and protectionism could rear its ugly head again. Malaysia also has to position itself to seize the opportunities to fully benefit from the growing economic integration and dynamism in Asia. Yet at the same time, Malaysia must be ready to face more intense competition for foreign direct investments (FDIs) and markets from key Asian neighbours.

Aftermath of the crisis – emergence of a new world

After one of the worst crises in modern history, the global economy – led by the emerging economies, especially China – is now en route to recovery but this revival is yet entrenched and risks remain on its sustainability. The global economy is still fundamentally weak, with the recovery uneven and growth remains highly dependent on policy support of very large fiscal stimulus and aggressive monetary easing around the world. The crisis-affected advanced economies continue to face rising unemployment, weak financial systems, on-going de-leveraging of households and financial institutions with weak balance sheet. Although financial markets have begun to stabilise following extensive policy support, the progress of financial sector resolution and reforms in the advanced economies is far from complete. Many of the financial institutions are still being constrained by large non-performing assets, and despite injection of capital and massive liquidity support, financial intermediation is still not fully functional. On the fiscal front, the continuation of large fiscal deficits and rising public sector debt are increasingly placing a limit on fiscal flexibility while quantitative easing and very low interest rate environment globally are fuelling some asset prices to rise.

Given these challenges, it will be a mistake to believe that the world is on the mend. In many ways, the global economic structure and the character and governance of the international financial system will be fundamentally different. First, ***overall global growth will, for a prolonged period, remain below its past trend***, with the growth trajectory in advanced economies lower than its average in the decade before the crisis. Several structural weaknesses in the advanced economies will require considerable time and resources to be resolved. While the advanced economies address these issues, the global economy will increasingly be driven by the emerging market economies, particularly China, Brazil, Russia and India. Despite Asia's large potentials and as a growth leader, it is unlikely that in the immediate term, Asia and other emerging economies would be able to lift global growth in the short-term back to the pre-crisis level. In the short to medium term, the emerging economies will take time to fully compensate for the weak growth in the advanced economies.

Second, ***major shifts in the management and conduct of financial institutions and financial markets*** can be expected in order to address the pro-cyclical nature of international financial system and the many weaknesses that have surfaced. Tighter regulation and supervision of financial institutions to prevent large financial leverage and accumulation of excessive risks will be in place. The challenge for regulators is to ensure that greater regulatory activism do not curtail the ability of the financial system to innovate and intermediate capital allocation efficiently.

Third, given greater regulatory guidance and less leverage, ***global financial markets pricing of capital can be expected to be higher***. Similarly, as corporations restructure their operations to adapt to slower growth in global demand, foreign direct investment (FDI) is likely to be lower, while competition for FDI will become more intense. On the other hand, short-term capital flows will remain very volatile. Promoting financial stability will require greater policy coordination at both the regional and global levels.

Asia as the new locomotive of global growth

Asia is today in a significantly much better position to adjust to a world where capital is no longer cheap and global demand is weaker. Asia is not experiencing a financial crisis. Asia's banking and financial system is functioning and financial intermediation is deepening and broadening. Asia has a very large growing middle class, high saving rates to fund investments and has room for larger consumer demand to support growth. A relatively young and dynamic population with increasing knowledge content will also support Asia's faster pace growth.

As Asia gathers strength and has a more forceful impact on the global economy, opportunities arise for Asia to shape a global order of greater stability, sustainable growth and shared prosperity. One area that Asia has begun to recognise is the importance of a more balanced growth strategy both for the benefits of Asia and the world in general. Indeed, three particular trends within Asia are already emerging and they will continue to gain momentum as policy places greater focus on them. First is the ***balancing of an outward-oriented development strategy with efforts to promote the greater role of domestic demand***. For some Asian economies, this takes the form of promoting domestic investment activity to meet the immense development needs within Asia, as well as to accelerate the transformation of Asian economies towards higher value-added output. For many, policy content to build broader social safety net and institutions to increase the role of private consumption in contributing to growth is gaining importance.

The second trend in Asia is ***the acceleration of regional economic integration*** as intra-regional trade and investment flows rise rapidly and financial markets are increasingly interlinked. Following the rapid trade liberalisation across Asia to improve market access is the growing pace of intra-regional investment flows. Increasingly, a vast market for goods and services will be created. Within Asia, as China becomes the locus of economic growth and transformation, the speed of ASEAN economic integration as one common market will provide added support to Asia's pace of growth and dynamism. ASEAN is now home to some of Asia's fastest-growing economies, contributing 17% of Asia's total output and 20% of Asia's total trade. The region presents a large and fast-growing market of more than

500 million people. Of importance, the fast-rising income levels, broadening affluence and the growing middle class in ASEAN augur well for private consumption. Similarly, the diversity and different development stages in ASEAN is a repository of strength that can be harnessed. With its range of resource endowments, economic structures and income levels, the ASEAN economies must leverage on their respective comparative advantages to accelerate economic growth within ASEAN and for ASEAN to complement and compete with North East Asia.

The third trend is ***deeper financial integration within Asia***. This is a crucial complement for the region's economic integration. Its success would significantly enhance the competitiveness and dynamism of Asia. In particular, financial integration will result in a more efficient recycling of Asian savings into investments within Asia. The effective channelling of Asia's large pool of savings into productive uses within the region will certainly support more rapid growth and development in Asia. Deeper financial integration within Asia has made progress and there is intensification of regional efforts to accelerate this process.

Indeed, within ASEAN, the agenda is now focused on increasing the pace of regional financial integration. The ASEAN Finance Ministers have agreed in 2003 on the Roadmap on Monetary and Financial Integration of ASEAN in the areas of capital market development, capital account liberalisation, financial services liberalisation and ASEAN currency cooperation. In 2007, the ASEAN Central Banks established a task force, chaired by Malaysia, to chart the milestones and timeliness for ASEAN financial integration. To complement the AEC Blueprint, leaders in early 2009 have agreed to an Implementation Plan to promote the development of an integrated capital market within ASEAN. These initiatives along with other regional efforts will effectively transform ASEAN into a single integrated market, and thus strategically position ASEAN as an important economic zone with a role to play in contributing towards global stability and growth.

With the broad diversity within Asia, the pace of development will not be equal for all economies. The general agreement is that growth within Asia will be led by China, India and Korea. In a large part, the shape of Asia's future will be dictated by the dynamic engagement of these prominent growth drivers with other Asian economies and the rest of the world. The prospects for ASEAN to thrive would depend crucially on its ability to engage with these growth drivers and seize on the opportunities that they offer. However, ASEAN must also recognise that at the same time, the level of competition will further intensify within Asia. For ASEAN, this challenge will involve countries in the region to identify areas of comparative advantage and leverage extensively on the complementarities that the rise of China and India present. For Malaysia, enhancing our competitiveness and positioning ourselves much higher in the global value-added production chain will be critical.

Malaysia – agenda for sustained economic growth

The full impact of the global recession was felt in Malaysia in the first quarter of 2009 when the economy contracted by 6.2%. Since then, timely counter-cyclical fiscal and monetary policy responses, together with a sound financial sector have contributed significantly to improving domestic economic conditions. In the third quarter, real year-on-year GDP contraction slowed to 1.2%. Of significance, the economy had registered two consecutive quarters of quarter-on-quarter growth, growing by 4.8% and 5.7% in the second quarter and third quarter respectively. Domestic demand has been the key driver of these improvements. Recent indicators have suggested that a more broad-based recovery is gathering momentum. Better labour market conditions, improving private sector confidence and continued access to financing have supported the increasing strength of domestic activity. Prospects are that year on year GDP in the fourth quarter will show positive growth.

The recovery is expected to gather some strength in 2010. The economy will be driven primarily by domestic demand, with private expenditure contributing a growing share while the gradual recovery in external demand will provide a further support to growth.

As economic revival gathers pace, the immediate policy priority is to ensure that the domestic foundations for recovery are more firmly entrenched and the medium and longer term growth potential is established. The private sector will need to resume its primary role in driving economic activity. Of particular importance is the growth of private investment. Towards this end, the Central Bank will continue to ensure that access to financing across all segments remains in place. While it is critical for the public sector to play a counter-cyclical role, sustained fiscal stimulus that leads to excessive fiscal burden would be detrimental to longer-term economic prospects. Thus, the Government's current commitment to fiscal consolidation and enhancing efficiency in public spending reflects a measured and sound approach in budgetary management.

As for ***monetary policy***, it is recognised that a prolonged period of low interest rate globally could lead to potential market distortions, particularly in an environment of ample liquidity. While consumer inflation is expected to remain low in the international environment, there is a need to be watchful of developments in asset markets and asset prices.

Promoting monetary and financial stability is complicated by the frequency of very large short-term ***capital flows***. Better prospects for recovery and expectation of a head start in the unwinding of policies in the Asian region compared to the rest of the world could lead to strong capital inflows. This could in turn fuel asset prices, thereby increasing the risk to financial stability which could undermine the process of economic recovery. Indeed, some countries in the Asian region are already facing these issues and have introduced measures to reduce the risks associated with capital inflows. For Malaysia, however, it should be noted that the financial industry, the private sector and the country have the capacity to manage these challenges, given the stronger overall financial conditions in the country, low levels of corporate leverage, a sound banking system and a strong external balance of payments position.

Beyond the immediate priority of establishing economic recovery and preserving macroeconomic stability, it is also acknowledged that the Malaysian economy currently stands at a pivotal juncture. In order to secure continued medium and long-term growth and development, the structure of the economy has to undergo several important changes – changes that would better position Malaysia in meeting the new challenges and reaping the opportunities that the future Asian and global landscape brings.

Foremost, the events of the past two years have brought to the forefront the importance of having ***a more balanced and diverse model of development***. Malaysia's openness and integration with global trade and investment flows is an important source of our economic strength, and must remain so going forward. However, given the more dispersed growth prospects of the global economy in the future, it is important that the export structure of Malaysia evolves to be more diverse too. This will both increase our economic resilience and decrease our reliance on the traditional markets for our export growth. Encouragingly this trend of export market diversification has already started before the onset of the crisis. A decade ago, the share of Malaysia's exports to emerging and developing economies were below 50% of our total exports, but now, the figure has exceeded two-thirds. Going forward, it is important that this trend is reinforced.

However, to achieve a more balanced growth, we need to not only leverage on our competitive advantage in the external sector, but also ***expand the strength of our domestic sector***. Since 2003, domestic demand has been a main contributor to our economic growth, especially private consumption, in which growth has consistently outstripped that of the overall economy. Going forward however, a more sustainable balanced growth would require higher contribution from private investment. It is important to recognise that no country has ever managed to consume its way to prosperity. Both economic theory and the history of economic development point to the lesson that high-level of consumption does not guarantee higher rate of economic growth for a sustained period.

Investment, on the other hand, is a prerequisite for a dynamic economy that is moving towards a higher level of income and development.

Indeed, many new areas of growth in Malaysia would benefit from higher investment, such as in niche growth segments in the services sector, as well as in the development of enabling infrastructure such as in broadband and green technology. Investment in green technology has the potential to not only increase the efficiency of the economy, but also to open up new sources of growth.

As Malaysia moves from a cost-competitive economy to one that is more knowledge and innovation-driven, it is not just the quantity of investment that matters, but the quality of investment that would dictate our ability to move up the value-chain. An important consideration in ensuring high quality investment is the availability of complementary factors. Here, I would like to highlight three of these factors, namely a private sector-led competitive environment, high quality workforce and the availability of enabling infrastructures. A business friendly environment with minimal market distortions is critical to ensure that the private sector can direct its investment activities efficiently and to areas of the greatest growth and return potentials. Similarly, the availability of skilled workforce and modern infrastructures such as high-speed broadband is key in ensuring that high value-added and high knowledge-content investments take place.

Much is currently being discussed and debated on the issues of high quality workforce and information age enabling infrastructures, especially given the Government's renewed emphasis on them in the recent efforts to transform the Malaysian economy. Allow me to elaborate more on the key complementary factor that has been in my opinion receiving relatively less focus in current public debate, and, this is the need to develop an extensive market-driven private sector-led competitive environment.

As an economy moves up the value-added chain, and develops knowledge intensive industries, the dynamics of interplay and balance between the private sector and the public sector changes significantly. In a developing economy, the role of the public sector is broader and it actively drives many economic decisions – from development of appropriate infrastructures and institutions to more direct allocation of resources. But as an economy becomes more developed, with progressively more complex, sophisticated and knowledge-intensive activity, it is increasingly untenable for the public sector to hold comparative advantage in allocating resources efficiently. It is thus crucial that the private sector takes on a more dominant role in driving economic growth and for price mechanism to be widely market driven in order for resources to be efficiently and productively allocated across all segments of the economy.

For the private sector to develop and to drive economic growth, two crucial prerequisites are needed. First, the economy-wide market-based ***incentive structure*** must underpin economic motivations and clear market signals must be allowed to guide decisions of economic agents. This implies that productive investment, employment and entrepreneurial decisions are not to be hindered by direct or indirect market distortions. Second, ***competition*** is needed to drive economic efficiency and dynamism. A vibrant economy cannot exist without competition. In particular, with an ever globalised world, competition is no longer local – the private sector cannot just compete locally when the flows of goods, capital and talent are global. Furthermore, in a global stage, long-term relevance can only be sustained through genuine competition-driven competitiveness rather than through public sector support.

To develop both an appropriate incentive structure and a market-driven environment, it is crucial that market and price distortions are removed and greater competition is introduced, such as through deregulation, liberalisation and greater transparency of rules and regulations. While the government moves towards this, the private sector must be ready to operate in this more open and competitive environment. An example of an industry within Malaysia in which a private sector-led competitive environment is being developed is the financial sector. Over the last several years, the domestic financial sector has been gradually liberalised and subjected to greater global competition, with the dual aims of enhancing the role of the financial sector as a source of growth and as a key enabler and catalyst of economic growth. Growth of the financial sector also strengthens Malaysia's economic inter-linkages with other economies. Liberalisation is done after ensuring that the financial institutions are in a state of readiness to compete in a more competitive and challenging environment. Through the financial reforms and capacity building efforts undertaken over the years since the Asian financial crisis, domestic financial institutions are now well capitalised and resilient with strengthened corporate governance, efficient internal structures, robust risk management practices and diversified sources of income. Indeed, the domestic financial institutions have extended their presence regionally.

Conclusion

The global financial and economic system over the past two years has gone through an equivalent of a cardiac arrest due to the excesses of the past. With swift, strong, coordinated and committed policy responses around the world, however, stability has been gradually restored and a repeat of the last depression averted. Now, a new world is emerging, one that is very different from the one before the crisis. In this new world, the prospects for Asia is encouraging, in both contributing to and assuming greater responsibility for supporting global stability and longer-term growth. For Malaysia, sustained growth and successful transformation of the economy towards a higher level of development would depend crucially on how we prepare ourselves in facing the coming challenges and seizing the emerging opportunities.