

Zeti Akhtar Aziz: Three trends and their post-crisis implications

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Inaugural Official Monetary and Financial Institutions Forum (OMFIF) Global Lecture, Frankfurt, 1 March 2010.

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It is my great pleasure to be here in Frankfurt to participate in this inaugural OMFIF meeting, and to speak at this evening's inaugural lecture at the Goethe University.

These are significant times for policymakers and the financial industry. As we come out of the worst international financial crisis in decades, there still remain some unresolved issues that need to be addressed. The recovery has prompted focus on exit strategies and on the search for more permanent solutions that will put the financial system on a more solid foundation. These issues are however being considered during a period of exceptional conditions. Of concern, is that this might significantly influence the direction of the reform agenda with its medium and long term implications which could be counter to solutions that would lead us to a path of stability and sustainable growth.

My remarks this evening will focus on three trends that are gaining significance in the global economy and the international financial system and their implications as we progress forward in this post crisis era. The first, is the increasing significance of Asia in the global economy; second, the extensive international regulatory reforms that is being envisaged by the international community; and third, the rapid growth of Islamic finance and its integration into the international financial system. These trends are set to become significantly more pronounced in the aftermath of this global financial crisis.

Asia and the global economy

After one of the worst economic crises in modern history, the global economy is now on the path of recovery but with a pace that is set to be uneven. There is now a global shift taking place arising from an increasing growth divergence between the advanced and emerging economies resulting in a change in the configuration of the global economy. This is not only a consequence of the crisis related factors but also due to structural factors prevailing prior to the crisis.

We have seen extraordinary and unprecedented measures been taken by the advanced economies to restore stability and the functioning of the financial systems, and to contain the effects of the financial crisis on the economy. While a catastrophe has been averted, the recovery in the advanced world continues to be reliant on policy support, with structural factors yet to be addressed. The IMF's projection is for growth in the advanced economies for the period 2009 and 2014 to be 1.3% per annum, which is half of what was registered during the period 2000 to 2008.

The emerging economies, in general, and the Asian region in particular, have emerged with stronger growth. Several key factors have enabled this faster and stronger rebound. Firstly, is the policy flexibility to implement the monetary and fiscal stimulus. Strong fiscal positions and relatively low public debt levels have allowed many Asian governments to implement larger fiscal stimulus measures. Second, the financial sector in the region is in good shape, avoiding any disruption of credit flows to the private sector. The region has benefited from the decade long of financial reforms and development of the domestic financial infrastructure. The financial systems in Asia have remained resilient throughout this global financial turmoil. This will be an important factor in sustaining the economic recovery to support domestic private sector economic activity when the fiscal measures are gradually withdrawn. Third, households and the corporate sectors are not over-leveraged, and thus better positioned to sustain consumption and investment activity. Fourth, increased intra-regional trade in Asia

has supported the recovery in regional trade activity. This has been reinforced by the strengthening of the domestic demand in the region.

While domestic sources of growth have gained significance, trade will continue to be important but with a distinct change in the pattern of trade. Trade among the emerging economies has already increased, with this trend being most evident among the emerging economies in Asia. Intra-regional trade in Asia has already risen from 32% of total exports in 1995 to an average of 50% in 2008. Rapid trade liberalisation across Asia has improved market access. Rising incomes in the Asian region where more than half of the world population resides has generated a huge cumulative market. This increase in consumption demand has led to the development of an extensive modern retail sector across the region.

Supported by stronger economic fundamentals, emerging economies are expected to grow at higher rates over the next five years compared to the period prior to the crisis in 2000 to 2008. The IMF projects that emerging economies in Latin America, the Middle East, Africa and Asia will, on the average, grow by 6.1% in the period 2010–2014, higher than compared to the period 2000–2009. Asia's prospects during this period will be sustained by several structural factors. First, Asia has a favourable demographic structure with a relatively young population with a higher propensity to consume. The high savings rate in Asia also allows for higher consumption demand with more than adequate surplus to finance the required investments activity. In addition, financial intermediation in Asia is progressively deepening to meet the new financing needs of households and businesses.

In this more recent decade, greater financial integration is taking place. This financial integration will result in a more efficient recycling of Asian savings into investments within Asia. It has been estimated that Asia needs to invest about USD 8 trillion in infrastructure development over the next ten years. The effective channelling of Asia's large pool of savings into such productive investment activity in the region will certainly support more rapid growth and development in Asia. Economic and financial linkages are also being established with other emerging economies in other parts of the world thereby mutually reinforcing the prospects for growth in the global economy. This will in turn contribute towards the rebalancing of global growth. The concentration of economic power in the global economy will become more dispersed.

International regulatory reforms

Let me now turn to the issue of financial regulatory reform.

The enormous scale, scope and costs of the global financial crisis has led governments, and regulatory and supervisory authorities from around the world to mount one of the most aggressive agendas of reform to financial regulation seen in recent times. The extent of these reforms has been almost as dramatic as the events that led to their creation. In particular, the potential impact that these reforms will have in re-defining the financial landscape in the future are significant, with broader implications for competition, innovation and ultimately, on the overall economic activity.

Certainly, strengthening financial regulation is an important goal. And the need to improve the design of financial regulation is not a point of contention. For many emerging economies – certainly in Asia – strengthening financial regulation and supervision and the development of the financial system has been an important priority, particularly in this recent decade and well before the onset of this crisis. Our resolve on this agenda has not changed since the crisis. On the contrary, it has served to sharpen our focus in contemplating measures to place our financial systems on a firmer foundation.

This crisis has focused attention on some important issues that calls for wide ranging regulatory responses. The degree of consensus on the spectrum of recommended reforms by the international community has however been mixed. Nevertheless, on some areas there has been a clear consensus. There is agreement that the regulatory framework needs to be

more responsive to risk. Equally, there is agreement on the need to materially improve risk management in financial institutions, and to strengthen the role of supervisors in the oversight of financial institutions. The need to enhance safety nets, in particular, in the liquidity support arrangements and deposit insurance, has also been widely acknowledged, as is the need for greater disclosure and transparency, particularly on off-balance sheet exposures. These have also been the areas of focus of most of the authorities in emerging Asia as we set to modernise our financial systems post the Asian financial crisis.

In other areas, there has been substantial debate by the international community. The first concerns the degree of balance of regulation. This crisis has shown that market discipline needs to be complemented by regulation. The question however has centred on how far the pendulum should swing towards greater regulation. Should regulatory constraints be imposed on size, leverage and activities of financial institutions? This would have significant implications on the role of the financial sector in the overall economy. The main reservation with such reforms has been whether they will in fact deliver greater financial stability beyond more basic and well designed changes to the regulatory architecture. It also raises the question as to whether it would significantly raise the cost of financial intermediation.

A central piece of the ongoing international debate on the regulatory reform agenda is the proposal on limiting the size of institutions. Whether this in itself will effectively reduce systemic risks has yet to be demonstrated. The experiences of Australia and Canada which have highly concentrated banking systems suggest that the control of systemic risk has less to do with size, and more to do with the effectiveness of risk management and supervision of the large institutions.

Malaysia shares this view. Following the Asian financial crisis, measures were taken to prompt the consolidation of our banking sector, thus creating larger institutions with enhanced capabilities not only to operate effectively in the domestic financial system but also beyond domestic borders. The focus is to emphasise on the investment in the risk management capabilities of not only management but also the board of the institutions. It is plausible that artificial restrictions on size or scope could result in a shift of systemic risks to closely inter-connected networks of smaller institutions which collectively pose a similar degree of systemic risk.

Emerging economies have great interest in the direction of these reforms. For the emerging economies in Asia, the banking system remains the largest component of the financial system. Regulatory, supervisory and legal reforms have generally focussed on effective governance and commensurate risk management capabilities. In Malaysia, the banking system leverage ratio is less than 11 times while the banking system risk-weighted capital ratio is 14.1% with Tier-1 capital at 13.6%.

Equally important is the incentive structure in place for such financial institutions, the level of transparency and disclosure, effective surveillance and forward looking oversight by the authorities and the institutional arrangement for effective resolution of problem institutions that will facilitate the orderly exit of such institutions.

Ultimately, the consideration of appropriate reforms should not overlook the main goal of regulation. It needs to be recognised that achieving financial stability is a means to an end. The ultimate objective is sustainable growth and a shared prosperity. High regulatory costs and the increased burden on the intermediation process would materially affect economic activity while doing little to alter the risk taking behaviors which was a major factor causing the crisis. There needs to be an understanding of the impact of the proposed measures from the many dimensions including how they ultimately influence institutional behaviours. The challenges of carrying out such an assessment on a global scale is daunting, but the policy response must rise to the challenge in order to avoid unintended consequences that will be difficult to roll back without adding further burdens on the financial system.

The second key area of debate concerns the design of the institutional framework for financial stability. The main issues have tended to centre on the role of the central bank in

financial stability and as to whether there should be a single or multiple supervisory authorities. Given that the central bank is the lender-of-last-resort in a crisis, the central bank is invariably in the frontline of action to restore stability. While there is no general agreement on the optimal structure for the supervision function, it is recognised that financial systems have become increasingly complex and interconnected and whether a country adopts an integrated model or a model that is organized along sectoral lines, effective coordination is critical to support assessments of the overall risk exposures in the financial system. Moreover, the potential for regulatory arbitrage should be avoided.

A further case made for central banks to assume the banking supervision function is the informational efficiencies particularly for effective crisis management. The insights gained from the economic analysis and market operations performed by central banks for monetary policy objectives also contributes significantly towards more informed financial supervision. This includes providing a better understanding of the potential for macro-prudential measures as part of the supervisory responses. The chosen supervisory structure needs to credibly demonstrate that it is able to respond and adapt effectively to the fast-changing environment. Additionally, the capacity and capability of the authority in terms of the calibre, skills and expertise needs to be continuously reinvented to keep pace with the new and more complex developments. For most emerging economies, the largest concentration of talent generally resides in the central bank.

Malaysia has adopted an institutional arrangement in which the Central Bank is responsible for banking and insurance supervision. This arrangement has significantly benefited Malaysia, both during normal times and in crises, as demonstrated during the Asian financial crisis and during the recent market turbulence. During the episodes of crises, this arrangement has enabled the Bank to quickly harness the diverse set of critical skills, experience and information that resides in the Bank and allowed for prompt decisions and actions. The Bank has also been able to leverage on the established internal processes, structures and relationships that are already in place during normal times as part of performing our integrated surveillance function.

Islamic finance, global growth and stability

While these issues continue to be decided by the international community, the sustained and largely uninterrupted expansion of global growth in Islamic finance has drawn significant interest. Today, Islamic finance has evolved to become a viable and competitive component of the international financial system. Following the global financial crisis, discussions have increasingly turned to the prospects of the potential role and relevance of Islamic finance in contributing to global financial stability and in support of overall economic growth.

Islamic finance is predicated on Shariah, the Islamic law which requires that an Islamic financial transaction be supported by an underlying economic activity, thus ensuring that there is a close link between financial and productive flows. This fundamental principle is all about the basic banking function of providing financial services that adds value to the real economy. Financial flows in Islamic finance are therefore accompanied by the expansion of genuine productive activity. Under this arrangement it also avoids over-exposure to risks associated with excessive leverage. Secondly, Islamic finance is based on profit-sharing and therefore risk sharing. Islamic financial transactions, clearly defines the arrangements at the onset, and provides the incentive for the Islamic financial institutions to undertake appropriate due diligence to ensure that the profits are commensurate with the risks being assumed. Aspects of governance and risk management are therefore strongly emphasised in the arrangements. In particular, such contracts demand higher standards of disclosure and transparency to be observed which, in turn, act to strengthen market discipline and minimise informational asymmetries. There are also clear value propositions in Islamic finance for both investors and issuers. For investors, Islamic financial products offer portfolio diversification and new investment opportunities as they avail themselves to this new asset class. For

issuers, Islamic finance allows access to a new source of funds and liquidity in addition to providing new risk management options.

As part of ongoing measures to further strengthen the resilience of Islamic finance, the Islamic Development Bank (IDB) in collaboration with the Islamic Financial Services Board (IFSB) has formed a Task Force on Islamic Finance and Global Financial Stability in 2008 to analyse and propose specific recommendations on the role and contribution of Islamic finance in promoting global financial stability and to outline the areas for strengthening the Islamic financial infrastructure including for putting in place the building blocks for liquidity and crisis management in the Islamic financial system.

In this recent decade, the increasing internationalisation of Islamic finance is being accompanied by new emerging global patterns of financial and economic interlinkages. This can be observed in the strengthening of ties in recent years between Asia and the Middle East in trade and investments in a wide range areas. Both Asia and the Middle East are increasingly recognised as dynamic growth regions in the global economy. The two regions have a history of strong trade ties that flourished on the old Silk Road, which served as a major global conduit between the ancient civilisations in the East and West until about the 14th century. Islamic finance today has revitalised these economic ties with the strengthening of the financial linkages between Asia and the Middle East, a trend that will generate mutually reinforcing growth prospects. The emergence of these new financial centres in Asia and the Middle East and their increased integration has paved the foundations for a New Silk Road. It has also opened up the prospects for developed economies to forge stronger financial linkages with these dynamic growth regions of Asia and the Middle East.

Islamic finance is well positioned to be a vehicle on the New Silk Road as the enabling supporting infrastructure is already in place. The required regulatory and legal frameworks for Islamic finance have also been established, not only growing in a number of countries in Asia and the Middle East, but also at the international level. It was with the establishment of the prudential standard-setting body, the IFSB in 2002 based in Malaysia that efforts to enforce common prudential standards have significantly progressed. Efforts towards the harmonisation of Shariah interpretations and issues concerning mutual recognition are also at an advanced stage.

Today, Malaysia has a comprehensive and well-developed Islamic financial system, including a vibrant banking and takaful sector, and well-developed Islamic capital and money markets that operates in parallel with the conventional system. Our sukuk market is the largest in the world. The Islamic financial system in Malaysian is also well-supported by comprehensive Shariah, legal and regulatory and supervisory framework to ensure the soundness and stability of the Islamic financial system. We have also invested in human capital development to ensure a deep pool of talent and expertise to support the development of Islamic finance. For this purpose, Malaysia has established the International Centre of Education in Islamic finance (INCEIF) and The International Shariah Research Academy (ISRA) to support advanced education and research in Islamic finance.

With this now more developed Islamic financial services industry in Malaysia that includes the advanced development of Islamic financial institutions and markets, more aggressive liberalisation initiatives have been made in this sector to strengthen our interlinkages with financial markets in other parts of the world. This has also been reinforced by the further liberalisation of the capital account of the balance of payments and the implementation of tax neutrality measures. These initiatives are aimed at supporting the strengthening of trade and cross border investment activities through Islamic finance.

Concluding remarks

Let me conclude my remarks on these three major trends occurring in the world economy and the international financial system. Asia's role in the global economy, the international

regulatory reform agenda and the development and expansion of Islamic finance is likely to have a growing influence on the global economy and financial system going forward. As we participate in this rapidly evolving environment, these new trends need to be taken into account in creating a global economic and financial order that is profoundly better than the one we have today.

Thank you.