

## **Zeti Akhtar Aziz: Asia in the world – sustaining the region’s transformative momentum**

Keynote address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Wharton Global Alumni Forum: “Asia in the world – sustaining the region’s transformative momentum”, Jakarta, 22 June 2012.

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The global economy is experiencing a period of profound change. Asia is very much at the centre of this global change. Asia’s changing role in the global economy has not only been in terms of its growing size, but also in terms of its influence in global economic and financial developments. The issue before us is whether Asia will continue its transformative momentum over the medium to longer term, to become an increasingly important source of global growth and stability.

It is my very great honour and pleasure to be here in Jakarta to speak at this Wharton Global Alumni Forum. Exactly a decade ago, I was actually invited to speak on the same subject on the state and future of Asia at the Wharton School in Philadelphia. Then, having just emerged from the Asian financial crisis, the region was again being challenged by a series of economic and financial shocks, in particular, the bursting of the dot com bubble in the United States in the year 2000. Observers had questioned the sustainability of the region’s medium and longer term growth prospects.

Now, five years into the global financial crisis, Asia is faced with an even more challenging and uncertain global environment, as significant spillovers originating from Europe and the United States are being felt by the region. Again, questions on the sustainability of the region’s economic growth prospects are being raised. My remarks today will focus on the new challenges that are confronting Asia, and whether its resilience built in this decade will now enable Asia to rise to these greater and more complex challenges.

### **Challenges arising from global spillovers**

Given the degree of openness of most of the Asian economies, Asia is highly integrated with the global economy. While Asia benefited from this openness, it also resulted in the region being more vulnerable to global financial and economic developments. Many previous episodes of economic recession and crisis were triggered by external shocks, which at times exacerbated and amplified domestic vulnerabilities. These include the commodity price shocks in the 1970s and ‘80s, the large swings of destabilising capital flows in the 1990s, the bursting of the tech bubbles and the SARs epidemic in the early 2000s, and finally the global recession which saw an unprecedented decline in global trade.

The ongoing global financial and economic crisis is resulting in turbulence in the international financial markets. In part, this is emanating from the global policy spillovers arising from the unprecedented monetary easing, which has resulted in surges of capital inflows in search of higher returns in a low interest rate environment. This is followed by reversals arising from the deleveraging efforts to reduce public and private indebtedness. These volatile capital flows in the international financial markets have increased the volatility in exchange rates and asset markets. The low international interest rate environment has also been a factor that has increased the prospect for the financialisation of commodity markets.

Finally, there is the impact of the potential unintended consequences of the global financial regulatory reforms. The effort to implement the new global regulatory reforms is already underway in Asia, with many jurisdictions making significant progress. These reforms are aimed to significantly enhance financial institutional soundness and safeguard financial stability. Concerns have, however, been raised on the unintended consequences that may

arise in the emerging economies, including its potential ramifications on the real economy. This underscores the importance to implement these reforms cautiously, including the need to conduct impact and behavioural studies, and to consider how the national implementation of these global standards should reflect the respective domestic experiences and circumstances.

### **Factors underlying the transformation of Asia**

Asia's rapid growth trajectory over several decades has been underpinned by a number of fundamental characteristics. These same characteristics are still present and will continue to support the ongoing transformation that is currently taking place. More recently, distinct strategies have been implemented to strengthen further the macroeconomic fundamentals and financial system soundness in the region. These stronger foundations, of steady growth, low unemployment, relatively low inflation, and strong and more developed financial systems, have strengthened Asia's resilience and its ability to manage external vulnerabilities. They have placed Asia today in a stronger position to secure and sustain its future growth and stability, compared to a decade ago

Three prominent characteristics that are common to most countries in the region have contributed to Asia's economic success. First and most important is the economic flexibility of Asia – the ability to adjust to changing conditions without being weighed down by structural impediments and policy rigidities. The significant investment in productivity enhancements and technology is complemented by the high degree of capital and labour mobility. Financial reforms for deregulation and greater market orientation and liberalisation have also facilitated the region to continually shift resources to new areas of comparative advantage. These have not only enhanced Asia's competitiveness, but also yielded a more diversified economic structure. More recently, the policy strategy has been to strengthen domestic demand as an important driver of growth. This will serve to anchor Asia's growth prospects. As domestic demand strengthens, Asia is transitioning from being global producers to becoming global consumers. This trend will also contribute towards more balanced global growth.

Asia is one of the most diverse regions in the world – in terms of market size, stage of development, resource endowment, economic structure, financial sector development, and market systems. Asia has leveraged on the complementarities arising from this diversity. This is reflected in the increased cross-border production networks in Asia, where substantial gains have been experienced from the region being involved in the entire supply chain for a wide range of products and services. Increased intra-regional trade and investment over the recent decade has also resulted in a more diversified export structure – in terms of markets and products. Going forward, this diversity will continue to present significant opportunities in the form of large and growing markets across a wide spectrum of goods and services.

Accounting for 60 percent of the world's population, Asia is by far the most populous region of the world. This demographic advantage is a key economic asset for the region. In this current decade, a young middle class population has emerged, and it is growing both in number and in affluence. Asia's current middle class of 500 million people is projected to increase by more than six-fold, to exceed 3 billion people, by 2030. This tremendous increase in scale will significantly raise Asia's potential to be important consumers in the global economy. In parallel, urbanisation and infrastructure development will reinforce this trend. This increase in consumption and the greater need for investment will anchor the growing importance of domestic demand in Asia.

These fundamentals have been reinforced by the implementation of distinct strategies that have been undertaken in this recent decade following the Asian financial crisis, to strengthen the region's ability to manage external shocks. The effectiveness of these reforms was put to test during the recent global crisis. While affected by the crisis, the effects on the domestic economies and financial systems have been relatively contained. Importantly, financial

intermediation has not been disrupted, and the financial systems have continued the supply of credit to support the real economy.

Following the Asian financial crisis, wide-ranging financial reforms were undertaken to strengthen the financial systems of the region. The building of sufficient capital and liquidity buffers during good times provided the ability to support the continued credit intermediation process. Improved regulatory and supervisory approaches, underpinned by enhanced governance and risk management practices, have enhanced financial stability in the region. Enhanced surveillance arrangements and a wider range of policy tools have placed policymakers in better state of readiness to deal with problems in the financial system pre-emptively. Macroprudential policies have also been extensively relied upon to mitigate the risks from excesses and imbalances in the financial system. Continued efforts were also made to further advance financial sector development in the region. In particular, the development of the domestic bond market has served to reinforce the foundations for financial stability in Asia. Financial activities have also remained generally anchored by productive real economic activities. In addition to the region's strong external position, high international reserves and more flexible exchange rates have also enabled Asia to absorb and adjust to changing external conditions.

The increasing cohesiveness of Asia is also a core strength and source of stability for the region. Steps have been intensified during this recent decade for greater financial integration. The motivation for greater financial integration is not only to unlock the growth potential of the region, but to achieve more effective and efficient intermediation of funds in the region, particularly by channelling the large surplus funds in the region to productive investments in the region. This would also support regional economic integration. While Asia's trade with economies outside the region has doubled since 2000, intra-Asia trade has tripled. Now, more than fifty five percent of Asia's total export is within the region. Intra-regional investment activity has also increased significantly during this decade.

It is important to recognise that the approach to a more integrated Asia is different from that adopted by Europe. In the early 2000s, a study undertaken by the ASEAN ten economies concluded that the region did not have the preconditions for a single currency. A different route would therefore be taken to achieve greater integration. For the ASEAN region, it would involve a sequenced liberalisation of the financial sector and capital account, and the development of regional financial markets and financial infrastructure including the regional payments and settlement system. This arrangement also allows for a gradual pace of integration to ensure domestic readiness and the flexibility to take into account the prevailing conditions and stage of development of the participating financial system. Regional collaborative efforts also have been significantly enhanced in the area of crisis management. The region is now well ahead in the areas of regional surveillance and supervisory arrangement, and in crisis prevention, management and resolution. Regional support mechanisms have also been established. There are also regional institutional arrangements in place for the active sharing of information on the emerging risks to regional stability and on building domestic capacities and to coordinate regional responses in the event of eminent risks to the region. These efforts will be further strengthened into the future.

### **Islamic finance as a growth area in Asia**

The rapid integration of Islamic finance into the international financial system is a growing feature in the financial landscape of Asia. Developments in several emerging economies in Asia have seen the rapid expansion of Islamic finance. Global Islamic financial assets are now estimated to be more than 1 trillion US dollars. While more than 60 percent of the world's Muslim population is in Asia, the interest in Islamic finance transcends to beyond this community. The inherent principle of Islamic finance, which requires financial transactions to be accompanied by underlying economic activity, ensures the close link between the expansion in financial assets with the real economy. It also increases its potential in fostering

sustainable growth. This has positioned Islamic finance to be well-anchored to serve the real economy, and enhances its potential as a sustainable and stable form of financial intermediation.

With the intensification of the internationalisation of Islamic finance, it has an increasing role in bridging economies through the mobilisation and channelling of funds to productive investment activities across borders. More than 600 Islamic financial institutions operate in more than 75 countries. The sukuk market is fast becoming an important platform for international fund raising and investment activities that are generating increased cross-border flows. From an outstanding amount of 33 billion US dollars in 2006, the sukuk market has expanded to 180 billion US dollars by the end of 2011, of which 66 percent originated from Asia. There has also been a growing trend for multi-currency sukuk issuances in Asia, attracting global investors to participate in this market.

In reinforcing the internationalisation of Islamic finance, global initiatives have been taken to strengthen its institutional and international infrastructure, with emphasis in ensuring financial stability. International prudential standards and best practices have been issued by the Islamic Financial Services Board, which was established in 2002. The industry is also guided by international accounting standards that have been issued by the Accounting and Auditing Organisation for Islamic Financial Institutions, which was established in 1990. The International Islamic Liquidity Management Corporation (IILM), established in 2010, is a further global collaborative effort to enhance liquidity management in the Islamic financial system.

## **Conclusion**

To fully realise the Asian potential, continuing the transformative momentum of the region will not be complete without ensuring that the benefits of development are widely shared. Experience has shown, even in the advanced economies, that when inequality is high and a significant proportion of the population is excluded from the opportunity to participate meaningfully in income and wealth generation, instability follows. To ensure that rapid economic growth and transformation does not further widen the social divide and disenfranchise those who remain excluded from its benefits, access to high-quality, healthcare, social security and financial inclusion is now an important focus of the region.

The contour of the global economy is fundamentally changing amidst mounting challenges and continued uncertainties. In this environment, Asia has become an important source of stability. While the region is affected by the ongoing economic and financial crisis originating from Europe and the United States, the Asian region continues to remain on a growth trajectory, although at a more modest level. Greater regional cohesiveness and cooperation, however, has enhanced Asia's potential to address these new challenges that are confronting the region. The success of the region is not only in the interest of the Asian economies, but the world.