Zeti Akhtar Aziz: Growth and stability – implications and priorities for Asia

Keynote speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the IIF Annual Membership Meeting 2012: "Growth and Stability – Implications and Priorities for Asia", Tokyo, 12 October 2012.

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Introduction

It is my honour and great pleasure to speak at this 2012 Annual Membership Meeting of the IIF here in Tokyo. These continue to be times of great uncertainty, with financial institutions being very much at the centre of the global efforts to restore stability and growth. Confidence in financial institutions however continues to remain fragile in several parts of the world. This is a time when strong and responsible leadership in the financial industry has never been more important. The IIF is well-positioned to lead this charge through its role in advocating the industry standards and best practices, drawing on the collective experience of its broad membership. Indeed, it has performed this role most commendably.

The common theme during the meetings throughout this week has been centred on growth and stability. I appreciate this opportunity to speak on the global economic and financial developments from the perspective of Asia. My remarks will also include a view of Asia's development priorities to firmly anchor our future growth and stability prospects. Finally, I will conclude with a few words on the implications of the evolving financial regulatory landscape for large international financial institutions from the view of a host country, given that many of the world's largest financial institutions have a presence in our financial systems.

Part 1

Half a decade into the global financial crisis, the world economy continues to be significantly challenged by the inability to hold a sustained recovery. This clearly has important implications for Asia. While continuing to register positive economic growth, the momentum of the growth in 2012 has begun to moderate in most of emerging Asia. In addition, global policy spillovers and the deleveraging activities in US and Europe have contributed to increased and more volatile capital flows with its consequential implications on the financial markets in Asia.

While the extraordinary policy actions taken, in particular, by central banks have been important in averting a major global economic recession, it has proven to be insufficient to support a sustained recovery. In the recent months, the global economy has again experienced a broad based moderation in growth from an already modest pace. The most pressing challenge confronting policymakers in the crisis-affected economies is to develop an optimal policy mix that will address the fiscal imbalance and impaired financial sector, and structural adjustments that will enhance competitiveness while at the same time be able to reduce the adverse impact these policies would have on the economy. However, it is important to recognise that drastic actions will have drastic consequences. While there is a general consensus that fiscal consolidation and structural adjustment are necessary to regain competitiveness and sustainable growth in the future, in the immediate term it will involve costs to the economy. As the experience in previous crises has shown, including during the Asian Financial Crisis, there are threshold levels that when breached the economy will be pushed into an even deeper recession. This will in turn increase the cost of the resolution of the crisis and result in an even more prolonged period of weakness. The concern is also the potential huge financial and social costs.

The Asian experience during the financial crisis in the late 1990s has also shown that the potential for effective results is enhanced when the policy package is comprehensive.

Financial restructuring and repair, fiscal consolidation and structural adjustments have their best chance to yield results in an environment in which there is some economic growth. Piecemeal policy measures that primarily focus on addressing the immediate problems will be inadequate and will not be able to garner sufficient growth momentum and thus sustain confidence. The financial restructuring and repair, the fiscal consolidation and structural adjustment urgently needs to be complemented with wide-ranging pro-growth policies.

Another challenge confronting the world economy lies in the manner in which policy coordination may be improved, both within and across borders, to maximise the impact of policy measures while minimising the unintended spillovers on other parts of the economy or financial system and across borders. Enhanced coordination can also provide increased clarity on the direction of policy and reduce overreactions by the market while boosting confidence in prospects for the policies to achieve their intended outcomes.

Strong fundamentals in Asia will continue to support our prospects in this more challenging environment. Following the Asian financial crisis, several emerging economies in Asia have strengthened their economic and financial fundamentals, improved their fiscal and external debt positions, and reformed their banking sectors. This has yielded tremendous payoffs. It has supported our economies to withstand the effects during this recent global financial crisis. Structural adjustments to diversify our economic structure and sources of growth have been an important part of this resilience. Asia also continues to have considerable policy flexibility to respond to external and domestic developments, although a prolonged delay in the recovery in the advanced economies will erode this policy flexibility in the future.

Part 2

Asia's development agenda also forms a key part of the efforts to firmly anchor our future growth. Several imperatives in the development of the financial sector are key in enhancing and maintaining both growth and stability in our region. ***First***, is the further financial deepening in the Asian economies through the development of market-based and diversified channels of intermediation to support the region's economic transformation. Since the Asian financial crisis, Asia has already made significant progress in this direction, in particular, in the progress and growth of the capital markets. Across Asia, the development of the financial system also continues to be pursued with vigor. In the previous decade, during a period of relative stability, Asia had focused on building and solidifying our financial system. Deep, diverse and progressive financial systems have contributed significantly to increasing the resilience of our economies.

Looking ahead, the next phase of Asia's transformation will see a rising and more affluent middle income population. There will also be massive investments required for infrastructure and development and for a higher contribution to growth by small and medium businesses. This will substantially increase demand for a wider spectrum of high quality financial products and services. The strategy is also for the intensification of financial deepening in Asia to meet the increased demands of domestic investors in the management of their surplus funds. A large part of Asian funds are still intermediated through the global financial markets and then recycled back into Asia. This increases Asia's exposures to volatile capital flows. To reduce the existing gap between the supply of and demand for financial assets within Asia, it will require the development of a vibrant risk capital ecosystem comprising intermediaries, financial markets and the supporting financial infrastructure to facilitate the efficient allocation of savings to productive investments.

Second is the strengthening of financial linkages and connectivity, within the Asian region, and between Asia and other economies including other emerging economies. Asia has reached the stage of development where its further advancement calls for deeper regional integration that will result in greater capital mobility across borders, facilitated by more interconnected financial systems. As a rapidly growing region, greater regional financial integration will support the more effective and efficient intermediation of Asia's sizeable funds towards meeting the investment opportunities of the region.

Efforts to enhance cross-border financial linkages and advance financial integration have also intensified in Asia in this decade, mainly through the progressive liberalization of the financial sector, the pooling of resources to promote the development of domestic capital markets and the integration of payments and settlement systems. These developments have also seen the growing presence of Asian financial institutions in the region. In 2011, central banks in the ASEAN region have endorsed an ASEAN Financial Integration Framework which will pave the way for greater market access and operational flexibility for qualifying financial institutions. This represents the collective commitment of the region in the efforts to strengthen the region's capacity to intermediate regional and international financial resources to productive activity in the region.

A ***third*** imperative is the alignment of the financial sector to Asia's demographic trends. Demographic profiles vary widely across Asia and have a significant impact on economic potential of the region. For many parts of Asia, demographic developments foreshadow significant changes in consumption, health and educational patterns. These changes have reinforced the significance of domestic sources of growth. Asia's rising domestic demand has been supported by the development of a much broader range of financing options. Going forward, the access to financing for healthcare, education and retirement will reduce the need for high levels of precautionary savings, and thus strengthen further domestic demand in the economy.

The ***fourth*** imperative relates to ongoing efforts to expand financial inclusion. Financial inclusion has been, and must continue to be, a key component of Asia's overall strategy to achieve balanced and equitable growth. Indeed, in the advanced economies, there is a now greater focus and attention on expanding financial inclusion to support the strength of recovery. Emerging Asia has achieved remarkable progress on this front. The period of higher growth has been accompanied by lifting millions out of poverty. Asia however still remains the home of two-thirds of the world's poor. Therefore, much still remains to be done.

The imperative is to arrest the widening income disparities and in inequality through providing more households and small businesses with meaningful access to financial products and services, thus bringing them into the economic mainstream. Another is ensuring that as Asia develops, households, particularly in the lower income groups, do not become financially excluded because financial products and services become increasingly unaffordable or complex, or due to practices of financial institutions which increase barriers to access.

Finally, Asia is now building on the progress that has been made in strengthening the resilience of our financial systems. Authorities in Asia are at various stages of translating the global financial reform measures into local standards. In a number of countries in Asia, the global financial crisis has also sharpened the focus on risks in financial institutions which are more systemically important. This includes having the regulatory reach that extends to institutions outside the formally regulated system.

The implementation of global financial reforms has however, also substantially increased the regulatory complexity associated with the proliferation of binding "one-size-fits-all" prescriptions. While these rules mainly aim to address the fundamental weaknesses of the global financial system exposed during the crisis, it is important not to lose sight of other critical elements of sound regulation and supervision. The crisis has underscored the need for judgment to have a greater role in regulation and supervision. The implementation of global reforms is also proceeding at a time of tighter global financial conditions and weaker global growth. While the work of the Basel Committee, now more than two years old, suggests that its effects on economic growth will be modest, the highly dynamic global financial conditions needs to be taken into account in the implementation of the new standards.

In addition, in a more interconnected world, building Asia's resilience to future shocks has also included significant progress in the arrangements to respond to potential threats of a crisis on a regional scale. These arrangements are currently being strengthened in Asia, through regional platforms for cooperation and more developed home-host supervisory arrangements that reflect the wider regional footprint of financial institutions in Asia.

Part 3

At this point, allow me to offer some reflections on the changing economic and financial landscape for internationally active financial institutions. Asia is host to a diverse group of foreign financial institutions, many of which have a long history and entrenched presence in the region, with strong roots in our local economies. For the most part, these institutions have made important contributions to the development of domestic financial systems and economies. This includes meeting the demands for financial services in areas not being extensively served by the domestic financial system.

While the international policy response to the global financial crisis has been extensive and on an unprecedented scale, an area that has not been as extensive is the cross-border dimension of policy making. More specifically, the global financial crisis has highlighted the gaps in the international framework for the regulation and supervision of the cross-border activities of financial institutions. This has generated renewed concerns on the extent to which external shocks might be transmitted to the domestic economies as a result of the presence of such international foreign financial institutions.

As part of the international regulatory reforms, significant progress has been made to ensure that systemically important financial institutions have a higher degree of resilience and stronger incentives to reduce their systemic risks over time. This includes through the holding of higher capital, and requirements for all global SIFIs (systemically important financial institutions) to develop recovery and resolution plans. Although intended to reduce the externalities associated with the failure of these institutions, it remains unclear whether the implementation of these measures will ultimately produce balanced effects on both home and host economies.

In addition, the unilateral measures being taken by some countries to protect domestic financial systems have also created specific challenges for host economies. In addition, potential issues may arise in the implementation of such reform measures. If not addressed and well-coordinated, it could affect the development of Asia's financial markets, disproportionately increase the costs of intermediation or present new sources of contagion to domestic host economies. The call thus is for closer cooperation between the authorities to avoid such unintended consequences.

Within host economies, the expectations on global financial institutions will increase to reinforce the safety valves against the propagation of systemic risks across borders. There is thus greater focus on promoting operating models that are more stable while continuing to encourage a meaningful contribution to the domestic economies. The experience has been that financial institutions that have maintained a long presence in Asia have for the most part pursued sustainable strategies and have in turn reaped tremendous payoffs from their long-term commitment to their operations in Asia.

Conclusion

Let me conclude. Mahatma Gandhi once said "You must be the change that you wish to see in the world". This might be said for Asia today. Even as our minds are also pre-occupied with addressing the current financial and economic challenges before us, our agenda is also to build a stronger future. Asia is therefore committed to taking the important steps today to ensure our resilience to future shocks and thus secure the stronger foundations for our collective growth and stability.