

Zeti Akhtar Aziz: ASEAN – towards a more integrated market

Keynote speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the 19th ASEAN Banking Conference 2012 “ASEAN – towards a more integrated market”, Kuala Lumpur, 7 November 2012.

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As we enter a new phase of globalisation, Asia’s role in the world economy is being significantly transformed both in terms of its significance and influence. ASEAN economies are very much a part of this process. This trend has become more pronounced following the global financial crisis. Five years into the crisis, the world economy continues to be challenged to hold a sustained recovery. The financial sector restructuring and reforms, and the structural adjustments being undertaken by the crisis-affected economies will not only take time to produce results, but in the more immediate term, these efforts will involve costs to the economy.

While emerging markets such as those in the ASEAN region are not insulated from these developments, the region has displayed remarkable resilience during this period. The region has benefitted from the decade of restructuring and financial reforms following the Asian financial crisis. In addition, structural adjustments undertaken during this period and have resulted in more diversified economies, in which domestic sources have become increasingly important in sustaining growth performance. The region’s more favourable growth prospects are also underpinned by the relatively sound fundamentals that include strong external and fiscal positions, stable macroeconomic conditions, low unemployment and resilient financial systems. This has also enabled the region to better manage the large and volatile capital flows that we are experiencing, thereby mitigating its destabilising effects on economic activity. These strong foundations have supported ASEAN economies through the challenging external developments that have taken place and have well positioned the region to realise its full potential as a dynamic growth centre.

It is my great pleasure to be here to speak at this 19th ASEAN Banking Conference, hosted this year by the Association of Banks in Malaysia (ABM) here in Kuala Lumpur. This Conference takes place at an important juncture for our region, as concrete plans are being advanced to achieve an ASEAN Economic Community (AEC) by 2015. The AEC Blueprint, adopted by ASEAN leaders in 2007, envisages ASEAN to become a single market and production base that is characterised by the free movement of goods, services, investment and skilled labour, and freer the flow of capital. Despite the recent global financial crisis, the drive for this vision to be realised remains resolute. This is well supported by the prevailing strong foundations and the tremendous growth prospects for ASEAN in the medium to longer term. My remarks today will focus on the elements of the prospects for the ASEAN economies, and the state of ASEAN financial integration and its importance in enhancing the regional growth potential. My remarks will conclude with some thoughts on imperatives for the banking sector going forward into the future.

Prospects for ASEAN economies

ASEAN is currently one of the most dynamic and fastest-growing regions in the world economy. The region’s GDP is expected to triple to USD3 trillion by 2017 relative to a decade ago. Economic expansion is expected to be sustained at a rate of 5.8% in the next five years, significantly outpacing global growth. In tandem with this, is the notable rise of the middle class population. The Asian Development Bank estimates that the share of ASEAN’s middle class population is expected to increase to 65% by 2030, consequently contributing to altering the global consumer landscape. With a sizeable population of 600 million people, this underscores the evolving role of ASEAN as a significant consumer market base with distinct needs and increasing purchasing power. Given that the share of the working population in

ASEAN is estimated to reach 58% by 2050, ASEAN will benefit from its demographic dividend and abundant workforce.

An accompanying trend is the rise of entrepreneurship in the region. The emergence of home-grown businesses with prospects of becoming large national and multinational corporations has generated attention and priority to be accorded to supporting the development of small and medium scale enterprises (SMEs). Currently, SMEs account for 50%–85% of domestic employment in ASEAN economies and 30–50% to GDP. Given the substantial contribution to income and employment generated by this sector, its development will be vital in creating employment and sustainable long-term growth in the ASEAN economies. On the corporate front, local corporations and businesses have fared well in establishing a stronger footprint in the region, as evidenced by their expanding regional presence and cross-border acquisition activity which has increased from USD10.9 billion during the first half of 2011 to USD26.2 billion for the same period in 2012. This vibrance of economic activity has been well supported by the continued access to financing by businesses in the region and resilient and strong ASEAN-based financial institutions.

Finally, ASEAN has also become an attractive foreign direct investment destination not only due to its stable macroeconomic environment but also due to its market size and the abundance of natural resources. ASEAN's proximity to major markets such as China and India reinforces its status as an important global value chain player and a preferred production base for many multinational corporations. In 2010, foreign direct investments into the region registered an impressive growth of more than 100% from the preceding year. The strong ties between the ASEAN economies are also underpinned by the continued growth of intra-regional trade, which now accounts for 25% of ASEAN's total trade. Going forward, this trend is set to continue. The growing consumer market and the expansion of production networks in Asia will continue to be a major driving force in promoting this increased intra-regional trade. In addition, the measures taken to boost investment, as well as infrastructure development will reinforce this trend.

Regional integration: the ASEAN model

We stand today on the brink of very exciting times for ASEAN as we draw closer to the vision of an ASEAN economic community in 2015. If the AEC vision was aspirational when it was first conceived, it is now clearly an imperative. This has prompted an increased momentum in efforts to realise an integrated ASEAN economic community, notably by achieving increased financial integration, higher levels of intra-regional trade and greater two-way cross-border investment flows. Like most regional blocs, the integration process for ASEAN seeks to promote greater regional connectivity which will in turn expand and reinforce the region's growth potential. The region's integration process however, has followed its own path. Given the diverse nature of our economies within ASEAN, the integration model adopted for ASEAN has been one that focuses on (i) strengthening preconditions through collective capacity building to promote more open market access among the economies in ASEAN; (ii) progressively reducing barriers to facilitate cross-border trade; (iii) developing the market infrastructure and enabling environment to promote efficient and effective intermediation of cross-border financial flows; and (iv) establishing the appropriate safeguards for financial system stability.

Progressive financial integration through this ASEAN model has been a strategy that has augured well for the region, allowing for the greater integration at a pace that is based on readiness and strength of the financial sector. Since 2007, ASEAN has achieved considerable progress in its efforts to deepen financial integration. ASEAN has undertaken gradual and sequenced liberalisation of identified financial services sub-sectors through the ASEAN Framework Agreement on Services (AFAS). Five rounds of negotiations have been concluded, with the sixth round of negotiations expected to be concluded by next year. In the area of financial markets, an Implementation Plan for an Integrated Capital Market has been developed to enhance market access, linkages and liquidity. ASEAN has also made

significant advancements in the areas of supporting financing for infrastructure development, as reflected by the establishment of the ASEAN Infrastructure Fund in 2011.

Notwithstanding these developments, a crucial driver for greater financial integration within the core of ASEAN financial systems is the banking sector. ASEAN banks have a significant role in supporting the financial integration process. Over the recent decade, we have witnessed the rising prominence of ASEAN financial institutions within the region, driven by the growing business fundamentals in the region and the strengthened capacity of the financial institutions. ASEAN commercial banks are predominant mobilisers of financial funds, as our experience shows, the banking sector is the most matured component in the financial sector of most jurisdictions. The banking sector therefore serves as an important conduit to increase connectivity among all ASEAN nations and in fostering financial integration.

Towards this end, the ASEAN central banks have endorsed the ASEAN Financial Integration Framework in 2011 and are in the final stages to launch the framework for banking sector integration. This will pave the way for a more meaningful presence of qualifying ASEAN banks within the region, while promoting regional financial stability. Recognising the diversity of ASEAN economies and the varying stages of financial sector development, the framework allows flexibility for ASEAN countries to participate in the integration process based on their readiness and willingness. Under the framework, qualifying ASEAN banks that have the capacity and that are well managed will serve as the regional standard bearers, and will be accorded more flexible access into regional markets. Greater flexibilities will also be given to facilitate the regional expansion plans of qualifying ASEAN banks to become important conduits of financial intermediation in the region. Tremendous opportunities can be harvested from this new framework. Hence, I welcome and look forward to the greater participation by financial institutions from all ASEAN countries in this process.

Imperatives for banking sector going forward

At this juncture, let me turn to imperatives for the banking sector going forward. There is a fundamental rethinking of banking by the international community in the aftermath of the recent global crisis. These are both driving and shaping the raft of reforms at the global level. I would like to touch briefly on four developments which could serve as a foundation for sustainable banking in the medium and longer-term. **First**, is for reduced complexity and increased transparency in the banking sector. Consistent with the more traditional banking models in this region, there are now increasing calls for a return to basic banking and its clear separation from higher risk-taking activities. This is part of the broader efforts to create a safer global financial system where markets and institutions are more transparent, less complex, and less leveraged than they are today.

While the banking sector in ASEAN has not reached the degree of complexity observed in the advanced economies, the region has to be mindful of the consequences as financial institutions evolve to become increasingly regional in orientation. Indeed, such growth must be commensurate with the capacity and capability of both the financial institutions and the regulators to manage and oversee the associated risks. Strengthened supervisory intensity and effectiveness, a core component of the financial sector reforms, is an essential pillar to check against unfettered innovation and risk-taking behaviours and promote strong incentives for prudent risk management. ASEAN will have to pursue an outcome that facilitates innovation and efficiency, without resulting in undue risks and unwanted costs on both the financial system and the overall economy.

Second, is the stronger focus on more responsible and sustainable financial business practices. Following the recent global financial crisis, there is a stronger international emphasis for appropriate risk-aligned mechanisms, particularly on compensation frameworks, which provide incentives for financial innovation and growth, while not compromising financial stability. This includes the increased pressure on financial institutions

and regulators to have incentive systems, governance, accountability and controls to address the issues of over-emphasis on short term performance, reckless risk-taking and the pervasive conflict of interests. In tandem with this, is the stronger focus to spur consumer activism as a means to encourage more responsible and sustainable business practices. It is in this area that financial institutions can have an important role in creating positive conduct and behaviours among financial participants in the industry, as well as contributing towards uplifting the state of financial education and consumer awareness.

Third, is the strengthening of boards' effectiveness and accountability, and sound governance of financial institutions. Following the crisis, i.e. the global financial crisis, corporate governance practices in the financial industry have come under significant scrutiny. There have been increased expectations on the management, boards of financial institutions and on regulators to significantly improve governance practices, particularly in the area of risk management policies and procedures. At the international level, substantial enhancements have been made to standards on corporate governance. The growing expansion of ASEAN banks in the region, must therefore be accompanied by an increased emphasis for the boards and senior management of financial institutions to provide the leadership and oversight of group-wide risks arising from cross-border operations. Greater diversity of boards to appreciate cultural nuances and competitive dynamics in different markets will hence be key to support sustainable cross-border operations of the institutions.

Fourthly, is reinforcing buffers to withstand future shocks. This is a key area of the international reform package that aims to significantly raise the resilience of the international financial system and to promote sound risk-taking activities. The standards will see financial institutions holding larger amounts of capital, including buffers which can be drawn down as losses occur. At the same time, the standards will also require banking institutions to significantly strengthen their liquidity and funding positions. Collectively, these standards aim to strengthen the banking institutions' ability to continue to support orderly credit intermediation, particularly during periods of instability. While carrying more equity entails greater costs of capital for banks especially in the short-term, this investment will support a more stable financial system and overall global economy as well as build the confidence of consumers and investors, particularly during periods of stress.

In view of these imperatives, this is a timely juncture for the industry to reflect and take charge of the efforts to rebuild and strengthen the foundations for more sustainable finance. Critical to this is the realisation that the creation of long-term shareholder value is consistent with, and not at odds with prudent risk taking and responsible business practices. Indeed, financial institutions with a regional footprint in ASEAN have the potential to contribute to the development of the financial systems in countries where they operate. There will be tremendous payoffs to be reaped from pursuing such sustainable strategies. Such long-term commitments to ASEAN will not only contribute to mutually reinforcing regional growth, but will become an important source of stability to the region.

Conclusion

Let me now conclude my remarks. There is less than three years to achieving the 2015 ASEAN aspirations. While many challenges remain, ASEAN is well positioned to collectively strive ahead towards the shared vision of a one ASEAN market. The financial industry has an important role in realising this vision, through its market conduct, business strategies and participation in domestic and regional collaborative initiatives. This conference provides an excellent strategic platform for the ASEAN industry to come together, share ideas and develop a greater understanding on the important issues towards building a stronger foundation for sustainable growth in ASEAN. On that note, I wish you an engaging and productive conference.