Mrs Akhtar Aziz discusses the international financial architecture

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Introduction

The significant fundamental changes that have taken place in the international financial environment has brought with it new challenges and consequences to the global community and individual economies at large. Change has become the only constant. The evolution of the changes in the international financial environment has been facilitated by the significant advances in technology, market innovations, financial liberalisation and the consolidation process in the financial services sector. These developments have resulted in the intensification of the process of globalisation and integration of financial markets. As a consequence, there has been a widespread transformation in the international financial landscape reflecting the changes in the relative significance of players in the market, the nature of the financial instruments and the volume of activity in the market.

This process of globalisation is supposed to result in enhanced opportunities for the world economy that would lead to a more efficient allocation of resources across borders and thereby result in higher growth and development across countries. The experience however, has shown that globalisation has also brought with it risks that can lead to highly destabilising consequences that can result in costs that far outweigh the benefits. The challenge facing the international community is how to ensure an efficient functioning financial system, a system that is not vulnerable to market failures, a system that would lead to an efficient allocation of resources across borders and provide enhanced prospects for the world economy. At the individual country level, the challenge is how to participate in this changed environment, how to be an integral part of the world economy without being vulnerable to violent destabilising developments. The challenge for individual countries is to be able to be in a position to experience the benefits of these changes while at the same time enhancing the potential for survival.

Changing trends in the world financial environment

As a result of the changes that have facilitated globalisation, financial flows have now far exceeded world trade flows by four times. Such flows have now become the dominant factor in determining exchange rate movements. While previously, exchange rate developments reflected the performance of the balance of payments current account position, in the current environment, the capital account performance has become the dominant factor in determining exchange rate movements. In particular, the developments in the short-term capital account have become the important factor. In this current environment the expansion of international financial activities has resulted in international developments having a greater influence on the domestic economy.

The increased cross border flows also reflects the increased institutionalisation of savings and the now relative importance of institutional investors in financial markets. In efforts to diversify risk and enhance returns participation in foreign markets by institutional investors have increased exponentially. This trend should in theory improve the allocation of world financial resources and increase competitiveness and efficiency of the financial markets as well as open up new avenues for enhancing prospects for growth.

In this process of globalisation the domestic financial conditions of individual countries have become significantly influenced by international capital movements and external economic and financial conditions and policies. The extreme form of this has been demonstrated by the contagion that has occurred during the financial crisis that has been experienced in recent years, in particular during the ERM crisis, the Mexican crisis and the East Asian crisis. The challenge has therefore been to operate in an environment that has become more susceptible to greater uncertainty and volatility. In such periods of excessive volatility and wide swings, market failure is seen to result as markets become unstable, moving further and further away from equilibrium levels following over reaction and irrational market behaviour amplified by herd behaviour. At the extreme, these eventually become trigger factors for domestic outflows resulting in total collapse and devastation.

The sudden nature of capital movements also imply the increasing short-termism of the global market. Such flows have tended to focus on short-term and immediate gains rather than having a more medium-term perspective, taking into account structural elements for investment decisions. This has led to excessive risk taking, reflecting the intense pressure for high returns. Market behaviour under these circumstances has been characterised by sudden shifts from extreme exuberance to over pessimism. These flows, in effect, do not reflect the underlying fundamentals.

In this environment, the challenge has been for enhanced access to information to allow for better decision making. There have been calls for greater transparency and disclosure. Scrutiny and surveillance by multilateral agencies, rating agencies and the market have intensified. At the same time, however, there has not been adequate surveillance on short-term flows to allow greater understanding of their nature and the dynamics of such flows. The increasing degree of sophistication of the financial instruments and the complex nature of their operations has not allowed for a true assessment of the implications of these developments. Of equal importance on the issue of transparency, is the need to also ensure appropriate utilisation of the information.

In the context of these developments, the regulatory structure has lagged behind the financial innovations and their internationalisation. It has been widely recognised that there is a widening gap between outdated regulatory structures and advanced market instruments and developments. Given the global dimension of the forces of change, the call for the strengthening of individual nations' financial systems also needs to be matched by efforts to strengthen the international financial system.

In the past, changes in the financial environment have been met with corresponding changes in the international financial system. Since the Plaza Accord in 1985, however, the changes in the financial environment have not been matched by a parallel change in the management of the global financial system, particularly in the 1990s. The international financial system has continued to operate within a framework designed for a global environment of the 1970s and 1980s.

In this era of the expansion of capital flows there has essentially been an absence of the development of the appropriate parallel prudential framework for the efficient functioning of the international financial markets. In the case of trade, the push towards free trade was matched by adequate rules to ensure orderly development. International rules on market opening measures and procedures for dispute settlement were established. More importantly, there are safeguards to protect countries facing balance-of-payments difficulties. In contrast, the push for a liberal environment for capital movements has not been matched by a parallel development to establish rules for the efficient functioning of the markets and for safeguards to individual economies from the adverse consequences of capital movements. The challenge is therefore not only for the international community to evolve a viable international system that can function efficiently in the current global environment, but also one that is relevant to expected future changes.

Quest for a reformed international financial architecture

The forces of change that we are confronted with are essentially international in character. A global perspective is therefore required to evolve a system in which all countries can participate and benefit from the globalisation process. A permanent and sustainable outcome would be one that is developed by the global community, taking into account the diverse backgrounds of countries that make up the global community as well as its implications on the private sector. Efforts by individual countries to strengthen their domestic systems and capabilities are important, but this is not a sufficient condition for ensuring economic and financial stability.

Several international forums over the last two years have engaged in this exercise and have brought to the forefront the issues and challenges at hand. While there is a general consensus among the international community that the international financial system needs to be reformed to ensure a system that is relevant to the current changed environment, there is no general consensus of how this might be achieved.

The more recent initiatives by the G7 have provided the most encouraging progress that has been made with the establishment of the Financial Stability Forum. It provides the opportunity for the proposed changes to be translated into concrete implementation. While efforts are underway, it still remains to be seen as to the degree to which changes will be made and the time frame for its implementation. The urgency for the development of an efficient functioning system that would avoid future crisis is vital, given that the strains and costs of such crisis occur not only for the affected individual countries but also have widespread consequences across countries.

Rising to the challenge of change

While individual countries will continue to be vulnerable to changes in the external environment, initiatives can be taken to build the foundation to enhance capabilities and capacities to not only absorb change but also to be in a position to take advantage of the opportunities that globalisation accords.

An important area towards achieving this is the process of liberalisation. There is now an international consensus that the process of managing the liberalisation should ensure that countries have the institutional framework to deal with international capital flows before liberalising capital transactions. Financial liberalisation implemented in an orderly and well sequenced manner would allow the domestic system to be adequately developed to cope with the challenges emerging from the globalisation process. The necessary set of preconditions should therefore be in place prior to capital account liberalisation. The East Asian crisis demonstrated that countries that have liberalised too rapidly in the absence of the preconditions became relatively more vulnerable. All too often, external pressure has been applied to emerging economies to hasten the pace of liberalisation without taking into account the risks that would emerge.

However, it should also be noted that in spite of the best institutional framework, a country can still be subsumed by a liberalised capital account framework under the current international financial system that does not have any financial regulatory framework for capital flows. Management of domestic risks must be matched by measures to ensure efficient markets. A parallel institution building and surveillance system at the international level is necessary to secure greater stability.

Another important area where safeguards are necessary are the strategies for financing growth. In this regard, development strategies by individual economies need to make balanced choices between debt and equity, and the share between domestic and foreign financing. Excessive reliance on external debt financing increases vulnerability to changes in interest rates of creditor countries as well as exchange rates of both creditor and debtor countries. The different strategies pursued by the East Asian countries in their financing strategies have resulted in different degrees of vulnerability to the external developments. Here, the development of a deep and liquid capital market is important to provide alternative sources of financing and thereby reduce excessive reliance on the banking system for such financing.

For an individual country, the changed environment that has resulted in greater unpredictability and uncertainty, makes risk management vital. Decisions need to be made on the acceptable levels of risk, the degree of risk tolerance and for the development of strong risk culture. The methodology and technology need to be developed to measure and monitor the increased risks. Adequate controls and checks and balances need to be in place to ensure there is no excessive risk taking that could result in adverse implications.

The process of globalisation and change also implies the need for the domestic financial system to enhance its capacity to compete in world markets. In this regard, increased efficiency would provide the competitive edge. The move for consolidation would enhance this process in obtaining gains from increased economies of scale and cost saving. Gains from increased efficiency in the utilisation of physical and human resources as well as higher technology become essential in this more competitive environment. In the context of technological advantage, the application of IT will represent an important enabling tool in this process. Efforts to upgrade skills will also be required. An enlarged size will enable significant increases in investment in cutting edge technology and human resources. In essence, in an environment of scarce resources, the efficient utilisation of resources becomes important.

The process of globalisation and change also implies a need for the domestic economy to enhance its capacity to compete in the world markets. Small open economies such as Malaysia face the challenges to build a competitive edge in a product and service market that is also characterised by rapid change. Many of Malaysia's exports face rapid technological and market changes. In this context, the strategy has been for the diversification of the economic base, while at the same time enhancing efficiency and increasing labour mobility. For this purpose there is also a need for more diversified and efficient sources of financing. In relation to this, a financial system that is efficient and competitive as well as an efficient functioning capital market is a key element in the process. Labour mobility also needs to be enhanced through human resource development. On the corporate front, the current restructuring and consolidation taking place would make the industries more resilient and efficient. As corporations become more focused on their core activities and as their activities are streamlined, this will increase the prospects for enhanced efficiency and competitiveness. The ability to tap IT and engage in innovation becomes increasingly important to meet the increasingly more sophisticated demand. Greater efforts will also be needed to promote more efficient flow and use of information. This will enable industries to respond faster to the changing environment and move towards a more knowledge based economy.

Conclusion

In this global environment of uncertainty and change, it is difficult to anticipate future risks. While the future is unpredictable, it is important to understand how the future might change, not only to gauge the viability of existing initiatives but also to develop new capabilities to operate in the changed environment. Therefore, in moving forward, we need to look beyond the horizon to have an ability to face an environment that is fundamentally different from the present one. What is needed is an understanding of the range of possibilities that might occur and to be in a position to implement strategies that will succeed under different circumstances. It is therefore important to identify the forces that could determine these different possible environments. The ability to recognise the potential future developments and to be able to adapt and adjust to these developments would provide safeguards and increase our resilience and our prospects for survival and sustained growth.