

“A More Integrated and Cohesive Asia in the Global Economy”

by
Zeti Akhtar Aziz
Governor Bank Negara Malaysia

Foreign Bankers’ Association of the Netherlands
Amsterdam
22 June 2010

Asia is one of the more diverse regions in the global economy. Yet over the decade following the Asian financial crisis in the late 1990s, Asia has become a more integrated and cohesive region. The accelerated economic transformation of Asia during this period has reinforced this trend to sustain Asia as a high growth centre in the global economy. Asia has also been distinctive in terms of the resilience of its financial system in withstanding the recent international financial turmoil. This has allowed Asia to emerge with an early recovery in its economic growth process.

2. It is my honour and great pleasure to be here on the occasion of the Annual General Meeting of the Foreign Bankers’ Association of the Netherlands to speak on the developments that are taking place in Asia and the potential role of Asia in the global economy and the international financial system. Greater interdependence in the world economy is particularly relevant to Asia, As highly open economies, Asia is highly connected to the rest of the world and therefore vulnerable to external developments. At the same time, with its growing significance in the world economy, developments in Asia will also have implications on other parts of the world.

Accelerated Transformation of Asia

3. For more than five decades Asia has sustained high economic growth. More important, however, is the significant economic transformation that has occurred during this recent decade, in response to the changing domestic and international environment. Asia now and Asia previously is therefore significantly different. Asia today contributes about one third of world output and 28% of world trade. Asia’s progress and development has lifted millions out of poverty, creating extensive employment and improving living conditions with better education and healthcare opportunities.
4. The economic transformation has essentially resulted in more diversified sources of growth for Asia. From being export-led, domestic demand has now become an increasingly important source of growth. This is also reinforced by the shift from the public sector to the private sector as the main driver of growth. While Asia is highly diverse, a common feature prevailing is the tremendous economic flexibility of the Asian economies. Institutional development, the large skilled workforce, the shift to greater market orientation and the general macroeconomic stability have allowed resources to continuously shift to new areas of comparative advantage and for the Asian economies to remain competitive. Being highly diverse, Asia has also been able to leverage on the complementarities that exist in the different economies. This has generated an expansion in intra-regional trade, intra-regional investment activities and an increase in financial linkages between the economies in Asia.
5. The Asian financial crisis was a defining moment for Asia. While most economies were able to recover in just over a year, in the decade that followed, wide ranging financial reforms were implemented. In addition, the development of the financial markets and the financial infrastructure were aggressively pursued to strengthen the capacity of the financial system. The legal framework and the regulatory and supervisory framework of the financial sector were also strengthened. Several important lessons from the crisis were also addressed, in particular, avoiding the excessive accumulation of debt whether by the household, corporate, financial sector or the

public sector. Measures were taken to avoid the build-up of such leverage and excesses largely through prudential regulation. In addition, buffers were built during the good times.

6. These reforms have yielded tremendous payoffs for Asia. With more developed financial markets and with better capitalised banking institutions equipped with strengthened risk management and governance practices, Asia did not experience any disruptions in financial intermediation during the 2008 - 2009 global financial crisis. The continued access to financing has in fact been important in sustaining domestic demand and in supporting Asia's rebound from the recent global crisis.
7. The International Monetary Fund estimates that the emerging economies in Asia will grow by an average annual rate of 8.6% in the next five years. Asia is therefore very much part of the global shift that is taking place in which the economic power in the world will become increasingly more dispersed with the emergence of several growth centres in the global economy. Should Asia continue to grow by an average annual rate of 7% over the next ten years, it is estimated that Asia's share of the global GDP will increase to 40%.
8. Let me further elaborate on these two developments, namely the strengthening of domestic demand in Asia and the intensification of regional economic and financial integration, that are mutually reinforcing in sustaining Asia's economic growth prospects. A more recent phenomenon supporting this trend is the strengthening of regional financial cooperation not only to preserve regional financial stability but also to enhance the prospects of the region.

Strengthening Domestic Demand

9. The strengthening of domestic demand is part of the structural changes taking place in Asia to diversify its sources of growth. Growth in most of the Asian economies was previously export-led. While several measures have been taken to promote domestic demand, the favourable demographic structure, the low levels of unemployment, the relatively low level of household debt and the policy flexibility to implement supporting monetary and fiscal policies have contributed to higher consumption. Other measures initiated are the social safety nets in the form of schemes and programmes for unemployment benefits, healthcare, education and retirement that have been put in place to reduce the need for high savings. The consequent increase in consumption demand has not only resulted in a significant expansion of the retail trade sector but Asia is also increasingly becoming an important consumer in the global economy.
10. Private investment activity is also beginning to pick up after a period of over capacity due to the excesses prior to the Asian financial crisis. There are also plans for massive investment in infrastructure development to sustain the economic competitiveness of the region. The Asian Development Bank estimates that Asia will require about USD8 trillion of infrastructure investment in the next decade. Most important is that Asia has the internal capacity from its high savings to finance these infrastructure requirements.
11. The stronger domestic demand in Asia is also well supported by the strengthened financial systems following the restructuring of the banking sector, the development of the capital markets and the strengthening of the regulatory and supervisory systems in the post-Asian financial crisis period. The reforms implemented also included the progressive deregulation and the move to greater market orientation and increased liberalisation.
12. Today, Asia's capital markets are significantly deeper and more liquid. The bond market in emerging East Asia has increased by more than seven-fold since 1996, with a current value of USD4.2 trillion dollars. Emerging East Asia accounts for 7.2% of the total worldwide bond market at end-2009 compared to 2.5% in 1996¹. Asian banks have stronger fundamentals with improved risk management and governance practices, with capitalisation well above the regulatory requirements

¹ BIS data

and with non-performing loans maintained at historical lows. Risk-based approaches to supervision have also been widely adopted across Asia. In addition, efforts also continue to be directed towards building institutions to protect consumers, to promote financial inclusion, enhance market discipline and to augment management capabilities. These efforts have ensured continued financial intermediation process and that this access to finance remains an important factor that supports the growth of the economies in the region.

Intensification of Regional Economic and Financial Integration in Asia

13. The second major development that has been taking place in Asia is the intensification of **regional economic and financial integration**. While the individual economies in Asia continue to implement policies and reforms at the national level, greater attention is being placed on strengthening economic and financial linkages in the region. **Intra-regional trade** which has been a major contributor to the recent recovery in Asia, has risen from an average of 32% of total exports in 1995 to exceed an average of 50% in 2008. Of importance is the rising share of intra-regional trade for final demand in Asia. This reflects an important change in the pattern of trade amongst the Asian economies. The pace of **intra-regional investment flows** has also gained momentum. Businesses in the region are increasingly leveraging on regional complementarities as well as taking advantage of the opportunities created by the growing markets throughout the region.
14. A more recent development is the strengthening **financial integration** within the Asian region. While regional financial integration will further facilitate the already strong trade and investment linkages in the region, a more important aspect of the increased financial integration in Asia is the more efficient intermediation of funds in Asia. This includes the recycling of some part of the sizeable savings in Asia to productive investments in the region. The average savings rate in Asia is 35% of GDP and Asia as a group has a total of USD4.8 trillion in foreign reserves. With greater liberalisation of the financial sector and the capital account, and the increased linkage of the national payments systems in Asia, there are increased financial flows within the region. This trend is reinforced by the increased presence of regional institutions in the individual domestic financial systems and Asia's favourable economic prospects and more developed financial markets. This has already resulted in volatile capital flows to the Asian region. Going forward, papers issued out of Asia will also likely assume greater importance as an asset class. It will serve to facilitate the further diversification of risks and thus, contribute to stability of the international financial system. It will also expand the options for investors and borrowers and thus, contribute to more efficient allocation of financial resources across borders.
15. Asia's economic and financial integration, however, extends beyond its own region to the traditional markets in the developed economies, and more recently to other emerging economies in other parts of the world. Today, the economic and financial linkages between the emerging economies have also gained significance. While world trade has, on average, expanded by 16% over the period 2004-2008, Asia's trade with the Middle East and Latin America has increased on average by about 30%. Asia's trade with other emerging economies² now stands at 13% of Asia's total exports.
16. A further recent development is the increasing international dimension of Islamic finance which is also influencing the global patterns of financial and trade flows. Islamic finance today has contributed to increasing the financial and economic ties between Asia and the Middle East. The emergence of new financial centres in Asia and the Middle East has seen stronger investment and financial flows between the two regions. With the greater internationalisation of this form of financial intermediation, it has also opened up the prospects for the developed economies to forge stronger financial linkages with these dynamic growth regions of Asia and the Middle East.

² Includes Latin America, Middle East, Commonwealth of Independent States and Africa

17. The inherent features of Islamic finance require that financial transactions are supported by an underlying economic activity, thus ensuring that there is a close link between financial and productive flows. Islamic finance is also based on the principle of profit-sharing and therefore risk sharing. Islamic financial transactions clearly define the arrangements at the outset, and provides the incentive for the appropriate due diligence to be undertaken by the Islamic financial institutions 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. This arrangement also demands for higher standards of disclosure and transparency which in turn, acts to strengthen market discipline.

Regional Monetary and Financial Cooperation

18. The Asian financial crisis has also prompted greater regional monetary and financial cooperation. Earlier regional cooperation had focused mainly on trade, investment and development. This decade has seen the cooperation shift to efforts to address financial stability issues, namely surveillance, crisis management, liquidity support arrangements, financial supervision and financial market development. Other areas include the payments and settlement system and capacity building in the financial sector.
19. The route that Asia is taking to forge greater financial integration will therefore be different from that of Europe. Unlike in the European Union, Asia does not have centralised institutions to coordinate financial integration but rather has leveraged on the existing intra-regional groupings and networks to forge greater cooperation and collaboration in areas of common interest. This is mainly through the ASEAN+3 and EMEAP which comprise the East Asia Pacific central banks. Secondly, a common currency is not on Asia's medium term agenda. To minimise exchange rate risks and to facilitate intra-regional trade and investment, a number of countries have initiated bilateral arrangements to use domestic currencies for trade settlement. There is also now a pooling of reserves so as to have in place liquidity support facilities for the region.

Conclusion

20. Let me conclude my remarks. Asia is very much part of the changes that are taking place in the global economy and the international financial system. Going forward, the pace of Asian regional economic and financial integration will gain momentum, driven by structural factors, by the conscious policy to put in place the enabling environment and by the benefits derived that are mutually reinforcing.
21. The evidence in this decade has demonstrated that a more integrated and cohesive Asia contributes towards more balanced global growth, while a more resilient Asia contributes to greater global financial stability. While a more connected world in this new phase of globalisation will bring new vulnerabilities, it also brings with it the promise of new opportunities, new relationships and partnerships in the world economy, and thus, new prospects for a greater shared prosperity.

Thank you.

22 June 2010