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By

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**"Preserving Monetary And Financial Stability In The New Global Financial Environment"**

Mr. Dominique Strauss-Kahn, Managing Director, the International Monetary Fund,

Mr. Nout Wellink, President of De Nederlandsche Bank (President, the Central Bank of Netherlands),

Mr. Hervé Hannoun, Acting General Manager, the Bank for International Settlements, Honourable Governors,

Distinguished guests,

Ladies and gentlemen,

Assalamualaikum Warahmatullahi Wabarakatuh, Salam Sejahtera and a very good morning.

1. It is my great pleasure to welcome Governors of the South East Asia Central Banks (SEACEN) Group to Kuala Lumpur on this occasion of the 44th Annual SEACEN Governor's Conference. "Preserving Monetary and Financial Stability in the New Global Financial Environment", the theme of this meeting is undoubtedly of great significant interest to central bankers given the mounting challenges that are facing national Governments and central banks around the world in the face of the current global financial turmoil. The breadth and depth of the disruption that has affected global financial markets has spurred coordinated responses of a scale that has not been seen before. It is, therefore, both appropriate and essential that SEACEN takes this opportunity to examine the issues surrounding monetary and financial stability going forward. SEACEN is one of the longest standing regional groupings of central banks. As a group, it can contribute towards strengthening the region's cooperation among its members and towards achieving the overall resilience of the region.

2. This morning, I would like to share some views on the current and future challenges facing Asia. While the immediate challenges are significant, responses by Governments and authorities must also take into account the direction of trends underlying our economies and financial systems, and the implications it has for the future growth and development of our economies. In this context, several key trends I believe will continue to shape Asia's financial landscape. Finally, I will briefly discuss some of the considerations for reform in Asia to secure the region's continued resilience in this new global financial environment.

Ladies and gentlemen,

## Challenges facing Asia

3. The international financial crisis that originated from the sub-prime mortgage market in the United States is deepening. Increased volatility in the global financial markets with sharp declines in equity markets, continued vulnerabilities of financial institutions in the affected economies, and tightening of credit conditions, have occurred. Inter-bank borrowing costs remain at elevated levels, resulting in difficulties faced by the private sector and emerging economies in securing financing. While sizable liquidity injections and other emergency measures by the world's major central banks have provided some easing of funding pressures in global financial markets, conditions remain distressed. Uncertain and unsettled conditions in the external environment will continue to prevail in the near term. Of particular concern, as the full extent of subprime-related losses is not yet known, investors have continued to demand higher risk premiums on their holdings of debt obligations, thus further weighing on broader economic activity.

4. Indeed, as the effects of the financial turmoil on the real economy unfold, the global economy has entered into a major synchronised downturn - its first since 1982, with most advanced economies in recession in the second half of 2008. The financial turmoil has precipitated sharp corrections in asset prices that resulted in significant wealth destruction, while households and firms face greater difficulty gaining access to credit. This has driven a sharp downward adjustment in investment decisions and household consumption patterns, creating a vicious cycle of de-leveraging between the real economy and the financial sector. The IMF has forecast that the major advanced economies will contract further in 2009, its first annual contraction in the post-war period.

5. Against this backdrop, emerging economies in Asia are facing risks of

significantly slower international trade and highly volatile capital flows associated with external financing and liquidity problems. The resulting sharp declines in equity markets and exchange rates in the region - by as much as 65% and 35% in 2008 - is also having a dampening effect on domestic consumption and investment which have been major drivers of growth in several of the Asian economies. Major commodity exporters also face additional risk from the sharp declines in commodity prices that have come off from the peak levels observed in mid- 2008.

6. Asian economies, however, have several factors in their favour to weather the current financial turmoil. First, the region's financial institutions have relatively small direct exposure to the US sub-prime mortgages and structured credit products. Second, the banking systems are fundamentally stronger since the Asian financial crisis, with strengthened supervisory systems, lower levels of nonperforming assets, higher levels of capital and with overall improved risk management practices. Third, sound external positions have continued to shore up investor confidence in the regional economies. And fourth, structural reforms, including the efforts to develop the region's capital markets and prudent macroeconomic management have contributed towards mitigating the extent of the impact of external shocks.

7. These factors will support Asia's growth prospects over the middle and longer term. While growth would likely decelerate due to the financial crisis and deepening recession in the advanced economies, most parts of Asia are expected to sustain positive growth. Domestic demand remains the main factor driving growth in this environment. Asia is the most populous region that has experienced rising incomes. This is supported by relatively uninterrupted access to financing. Pre-emptive measures such as deposit and lending guarantees which were introduced by national authorities to maintain public confidence and ensure financial stability have supported this trend. Trade within the region, as a share of the region's total trade, has also expanded in the recent years from 31% in 1990 to 40% in 2007. Further, Governments across the region have the policy flexibility to introduce measures to cushion their domestic economies from an increasingly

difficult international environment. Monetary easing has been undertaken in most Asian countries to support growth amidst declining inflation. Fiscal stimulus packages have also been introduced to shore up domestic demand against weaker external demand.

Ladies and gentlemen,

Trends shaping the future financial landscape in Asia

8. While we are clearly facing very immediate and significant challenges in the near term, it would be remiss to limit our attention only to the present challenges. After the dust from the current financial crisis has settled and as the process of recovery begins to take place, Asia will continue to face challenges from trends and developments that will continue to bring change in the global financial system. The pace of financial innovation prior to the crisis is unlikely to abate going forward despite the current reservations that have suggested that some brakes need to be applied and tighter regulation be introduced. Financial innovation in Asia in particular, will continue to be driven by advances in new information and communications technologies and changing consumer preferences, as well as continuing financial liberalisation in the region. Despite their role in precipitating the current financial crisis, new instruments such as financial derivatives used in securitisation structures will be used more widely by institutions to manage exposures to credit risk, in addition to interest rate and exchange rate movements. The evolution of such financial structures is bound to test and challenge the understanding of risks among market participants and regulators in the region.

9. Competitive forces will also quickly regain their intensity. Trends in financial convergence and increased capital mobility are unlikely to be reversed after this

crisis. Indeed, deregulation in the more developed markets in Asia will likely continue. The region's capital markets and a wider array of investment banking service offerings are also likely to resume their increased importance relative to banks and other traditional providers of financial services. Despite an increased scrutiny by financial regulators, global financial firms with complex financial and corporate structures are likely to remain a feature of the modern financial system.

10. These trends will continue to be accompanied by greater economic and financial integration as a result of financial market liberalisation. The Bank of International Settlements (BIS) has reported that on average, USD 3.2 trillion transactions flowed through the foreign exchange markets daily in 2007. This represents an unprecedented increase in cross-border financial activity. It is also worth noting that the share of emerging market currencies in total turnover had increased to almost 20%, from 15% in the preceding survey in 2004. One of the factors identified for the expansion in turnover is the increasing depth and openness of domestic financial markets in these economies. Greater integration will also bring about an increased involvement of our national banking systems in the global financial system. The trend towards regional banking is already evident among the Asian banks, including Malaysian, Singaporean and Thai banks that have a presence in most parts of the region. Malaysian banks are already present in all ASEAN countries to support the growing intra-regional trade and investment flows.

Ladies and gentlemen,

11. Going forward, Malaysia remains committed to the process of progressive liberalization. For the Malaysian financial sector, it will reinforce its role in the development and transformation of the Malaysian economy. In the recent decade, Malaysia has progressively increased the levels of foreign participation in our financial sector, thus contributing to diversify further the financial system. This

has also included the liberalisation of the Islamic banking and takaful sectors, adding new entrants and widening the range of Islamic products and services available in the market.

12. The benefits to economies flowing from these developments are widely acknowledged. They include improved economic efficiencies, growth in productivity and higher living standards. Financial innovations also improve the efficiency of financial markets, while technology transfers enable the application of more sophisticated approaches for managing risk.

13. That said, however, we know only too well that they will not be without problems if the changes to occur at a pace which outstrips the ability of the system. This has been a central consideration in Malaysia's own assessment of the benefits and costs of liberalization and in managing our liberalisation. Policymakers and authorities today must contend with new sources of systemic risk that are associated with the confluence of several factors - the liberalisation of financial markets, larger and more complex institutions, and more sophisticated financial instruments. The challenge for Asia lies in ensuring that the sources of risk to the stability of the financial system is identified and adequately managed. In particular, the greater interconnectedness between financial markets presents specific challenges to small and open economies in Asia in managing the volatility of capital flows and channels through which contagion is transmitted. Focus on this challenge is essential given the increasing costs and the difficulties of managing the successive crises in this recent decade.

Ladies and gentlemen,

Reform in Asia

14. These future trends suggest that structural reform in Asia need continued attention given the heightened risks in the global economic and financial environment. This does not diminish in any way the relevance and critical importance of Asia's achievements since the Asian financial crisis in putting in place stronger and significantly more resilient financial systems. Rather, these achievements, particularly the stronger banking system and institutional framework that have evolved, provide the necessary foundation for further reforms to take place.

15. There is now an extensive body of work that is underway at the international level aimed at strengthening the resilience of the global financial system. Much of this work will no doubt have a significant influence on Asia's own reform agenda going forward. The list of areas that are being reviewed and recommendations made is long and addresses a broad range of important issues including the design of financial safety nets, institutional arrangements for crisis management and resolution, alignment of incentives structures, the appropriate degree of oversight over financial systems, regulatory reform and the issues concerning financial reporting and disclosure. More specific to emerging economies, is accelerating the development of auxiliary markets that support hedging activities which will also become more important to enable market participants to more effectively manage heightened risks in the environment going forward.

16. National authorities will need to carefully consider the proposals for reforms that are coming out of the various international fora, and consider their implications to their own domestic environment. In this current environment, the immediate need is for financial policies to support continued lending activity by banks and appropriate monetary and fiscal actions needed to facilitate economic recovery. In the final analysis, the proposals for reform need to contribute towards better financial stability. Clearly, this prospect would be significantly improved if

a more inclusive process is adopted in the development of the policies and standards in international fora.

17. Within Asia, following the financial crisis which engulfed East Asia in 1997-98, many observers concluded that the region lacked effective mechanisms for co-operative responses to shocks, and particularly lacked institutional arrangements which could withstand the vagaries of international capital flows. More importantly, under-developed local capital markets, small financial systems and economies relative to the potential size of capital flows, and weak banking systems needed to be addressed. This lies behind the more targeted and determined efforts to achieve meaningful regional monetary and financial cooperation that would support national initiatives to strengthen Asia's financial markets and overcome fragmentation. Several important regional initiatives that have come out of these efforts include the ASEAN Surveillance Process, the Chiang Mai Initiative, and the Asian Bond Markets Initiative, the Asian Bond Fund and the strengthening of institutional arrangements for cooperation in monitoring and surveillance as well as crisis management between EMEAP (Executive Meeting of East Asia Pacific) central banks.

18. The benefits from the more recent efforts at cooperation suggest considerable scope to further deepen cooperation within Asia. This would involve greater degree of commitment to the undertaking of more expansive joint work to accelerate the development of financial infrastructure in the region and a greater degree of policy coordination.

Ladies and gentlemen,

Role of SEACEN

19. This brings me to the role of SEACEN in the context of the new global financial environment. With a membership consisting of economies that are highly open and integrated into the global economy, SEACEN members have had to deal with the impact of economic cycles in the developed markets, greater demands to liberalise their financial sectors and structural changes in their own economies, all of which have tested and challenged its policy makers. The establishment of the SEACEN Centre more than 25 years ago embodies both the foresight and the commitment of SEACEN Governors to develop the skills and capabilities of financial regulators and policy makers to preserve monetary and financial stability. In its training of successive generations of central bankers, the SEACEN Centre has helped to build the domestic capabilities in its membership that is essential to having the capacity to understand the rapid changes in the global financial environment.

20. SEACEN has shown its willingness to act collectively to support the region in areas beyond training. This will continue to have positive effects for the region. The establishment of SEACEN's own surveillance mechanism to exchange information on regional capital flows has enhanced the region's risk management of volatile capital flows. SEACEN's ability to galvanise itself will also enhance its relations with the international institutions, including the International Monetary Fund and World Trade Organization, to ensure that the international community give due consideration to the views and concerns on global issues affecting developing economies. The SEACEN grouping can certainly take pride that its cooperative efforts and in the meaningful outcomes of its efforts. This spirit of cooperation through much of the region's transformation has, and will continue to provide important support to SEACEN members as we confront the current and future challenges.

21. On that note, I wish you all a highly productive conference as you contemplate some of these challenges.

Thank you.

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