

**8th Islamic Financial Services Board Summit :
Panel Session 2- Financial Stability: Regional and Global Cooperation
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Speech by

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It is now more than three years since the onset of the global financial crisis. Yet, its repercussions continue to reverberate across the world. Efforts to return the global economy on a sustainable growth trajectory have been challenged by risks and uncertainties that continue to prevail in many parts of the world. Most of all, this crisis has demonstrated the greater degree of international interdependence arising from the increased international financial and economic integration. Global financial stability has therefore become a shared responsibility. In today's more interconnected financial systems and stronger economic interlinkages, the enormous challenge in securing effective and efficient functioning financial systems and financial stability will demand for unprecedented collective action and international cooperation.

It is my pleasure to be here in Luxembourg on this occasion of the 8th IFSB Summit on 'Enhancing Global Financial Stability: Challenges and Opportunities for Islamic Finance'. I am honoured to speak on the scope for international collaboration and cooperation in Islamic finance in our collective endeavor to safeguard financial stability.

The internationalisation of Islamic finance and its increased role in the international financial system

Since the turn of the millennium, the internationalisation of Islamic finance has accelerated. Its internationalisation is manifested by the increased presence of Islamic financial institutions in new jurisdictions, the increased international participation in Islamic financial markets and the increased cross border flows that are Shariah compliant. Today, there are more than 600 Islamic financial

institutions that operate in more than 75 countries. The sukuk market in particular, has evolved as a major contributing factor driving the internationalization of Islamic finance. It has become an important avenue for international fund raising and investment activities, generating significant cross-border flows. Following the return of investor confidence reflected by the strong performance of financial markets in 2010, activity in the sukuk market also gained momentum. Islamic finance has become the fastest growing segment in the international financial system. Moving forward, the international dimension of Islamic finance is set to become even more pronounced in this post crisis-era.

With the intensification of this globalization process, we need to be mindful of the important lessons from the recent global financial crisis of ensuring the quality and soundness of the financial integration process. Whilst the growing internationalization of Islamic finance essentially reflects its ability to be competitive and its ability to meet the changing demands of businesses, its resilience has been important in supporting this trend. This resilience is essentially underpinned by two inherent strengths of Islamic finance. First, is its strength that is derived from the emphasis on having a close linkage between Islamic financial transactions and economic activity and from having built-in checks and balances which inherently make Islamic finance a stable form of intermediation. Second, are the initiatives that have been taken to strengthen the international infrastructure of Islamic finance to promote the sound and orderly development of Islamic finance. Importantly, these initiatives are being taken while the Islamic financial institutions and Islamic financial markets are still at a relatively early stage of development.

With its internationalization, Islamic finance will contribute to the more efficient mobilization and allocation of funds across regions. This trend will also strengthen the international financial and economic interlinkages between jurisdictions, bringing with it mutually reinforcing gains. It also influenced the patterns of global financial and economic integration, in particular, facilitating the revival of financial and economic integration between Asia and the Middle East and between emerging economies and the more established financial markets, thereby contributing towards a more balanced growth in the global economy.

Initiatives to strengthen the cross-border financial stability framework

As Islamic finance increasingly expands beyond national boundaries, it has called for **developing the framework for cross-border financial stability** to further strengthen the resilience of Islamic financial system and to address cross-border challenges in an integrated manner. This recent decade has seen such international cooperation and collaboration to safeguard financial stability in the international Islamic financial system be taken to a new level. This is to ensure its orderly evolution as an integral component of the international financial system.

Strengthening international financial infrastructure

The focus of cooperation has been particularly significant in the area of the development of the international financial infrastructure relating to financial stability. A key development since the setting up of the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in 1990 has been the establishment of the Islamic Financial Services Board (IFSB) as the international prudential standard setting body for the Islamic financial services industry in 2002. The important goal of strengthening the foundation of the global Islamic financial system was recently reinforced further following the recent global financial crisis, through the work of the IFSB-IDB Task Force of Islamic Finance and Global Financial Stability. In its report that was released in 2010, eight building blocks were identified to deal with the potential

risks and vulnerabilities to the Islamic system in this now more challenging international financial environment. These include steps that need to be taken for the implementation of the prudential standards; the development of a liquidity management infrastructure; the introduction of strong financial safety nets; the development of an effective crisis management and resolution framework; the development and implementation of accounting, auditing and disclosure standards; the formulation of an effective macro prudential framework; the development of credible credit rating institutions and processes; and finally, to strengthen efforts for capacity building and talent development for the Islamic financial services industry. Given the global dimension of these building blocks, international cooperation and collaboration is significantly vital to advance these important agendas.

Regulatory harmonization

Commanding the highest level of international cooperation is particularly vital in the implementation of common prudential standards to safeguard the stability of the Islamic financial system. This will contribute towards the harmonization of the regulatory and supervisory framework in Islamic financial systems across borders. Of importance is advancing the international standards and best practices that takes into account the distinct characteristics of Islamic finance. Such prudential regulation that considers the unique mix of risks associated with Shariah-compliant financial business would enhance the effectiveness of the regulatory outcomes intended for Islamic finance.

Much progress has already been made by the IFSB in promulgating an extensive set of prudential standards for the Islamic financial services industry since its establishment in 2002. The IFSB has already introduced standards for capital adequacy, risk management, corporate governance and Shariah governance. This important work has been significant in promoting international uniformity of regulatory frameworks and international best practices for the Islamic financial system in different jurisdictions. Its significant progress has benefited from the strong international cooperation and collective

support from its member countries and global institutions. Indeed, as an evolving global industry with varying stages of development across borders and various business structures and operating models used in the different markets, this close engagement has also allowed for the attainment of balanced views.

Whilst Islamic finance has demonstrated resilience during the recent crisis, the IFSB has moved quickly to review its existing capital standards for possible enhancements and to incorporate new liquidity measures in its ongoing work in developing liquidity standards for Islamic banking. This work is currently being addressed through the Working Groups for Capital Adequacy Standards and for Liquidity Risk Management. The overarching objective is to ensure that the salient features of Islamic finance are effectively and adequately addressed while taking into account the issues that had surfaced in the crisis in the conventional financial system.

The next stage is the **implementation of these standards in the different jurisdictions**, which is just as important as the development of the standards itself. This is an area in which global cooperation and collaborative action is critical so as to ensure the consistent implementation of the regulatory framework. The full adoption of IFSB standards will eliminate the opportunity for regulatory arbitrage, in particular, regulatory arbitrage due to cross-sectoral differences, cross-border differences and the differences between conventional and Islamic finance. The more consistent implementation of these standards will also ensure greater certainty in the regulatory treatment of Islamic financial transactions, thereby enabling comparability among institutions as well as surveillance by regulatory authorities. This harmonization will not only contribute towards global financial stability, but will also promote greater transparency across borders.

The application and enforcement of the international prudential standards promulgated by the IFSB will contribute towards achieving these objectives. Technical cooperation programmes can be developed and designed for both ex-ante and ex-post implementation of the IFSB standards. In the pre-implementation

period, structured technical programmes can be tailored to individual countries to enhance jurisdictional preparedness in adopting the standards if so required. Similarly in the post-implementation period, a framework for self-assessment can be developed to assess jurisdictional effectiveness in implementing the IFSB standards. These developments would potentially lead to the inclusion of the IFSB standards and rules for adherence and implementation across jurisdictions, along with the core principles and standards of the Basel Committee, IAIS and IOSCO within the context of the IMF-World Bank Financial Sector Assessment Program. This would further contribute towards the efforts of achieving global financial stability in the international financial system.

Cross-border supervisory cooperation

The increasing internationalisation of Islamic finance has a significant extent been facilitated by the expansion of the operations of Islamic financial institutions beyond their domestic borders, motivated by the search for new growth opportunities. In addition to the increased interconnectedness of Islamic financial markets, this trend calls for greater cooperation among supervisors to ensure financial stability of the Islamic financial system. The recent global financial crisis has in fact put to a test the strength of cross border supervisory cooperation. Challenged by information asymmetries due in part to the lack of arrangements for cooperation, supervisors faced the challenging task of understanding the extent of the systemic risk and its contagion across borders.

In the rapidly evolving world of Islamic finance, supervisors are also confronted with an even greater task, of keeping abreast with the pace of innovation, taking into account the uniqueness of Islamic financial contracts in addition to the universal scope of Islamic banking business. This warrants supervisors to recognise the different aspects of risk management in Islamic finance. Islamic financial institutions in most jurisdictions have evolved within the confines of the conventional system and have been accustomed to business practices in their respective jurisdictions. This could result in

distinctly different business and risk taking activities. Collaboration among supervisory authorities of such internationally active Islamic financial institutions thus needs to become part of the overall supervisory framework.

These efforts would require **regular engagement between home and host supervisors** to ensure alignment of the supervisory oversight. This will allow for a more holistic evaluation of risks and vulnerabilities for Islamic finance businesses that operate across borders. Effective sharing of surveillance information and assessments of other supervisory issues on Islamic financial institutions is already taking place through bilateral cooperation between supervisory authorities and other informal arrangements. Going forward, a more structured framework for collaboration among supervisors is needed so as to enhance supervisory informational efficiencies, and ultimately, contribute to an effective assessment and early detection of any cross-border risk-transmissions from the group-wide activities. The home-host information sharing can be facilitated through the supervisory college arrangement as an institutionalised mechanism for greater cooperation.

The recent financial crisis has also revealed the failure to understand the inter-relationship between financial and the broader sector, particularly in understanding the potential spill-over and second-round effects that are transmitted between sectors. Post-crisis regulatory efforts have focused on macro-prudential measures to complement micro-surveillance and supervision. This entails horizontal assessment of risks across institutions, sectors and national borders, as well as risks in asset markets across time. This is particularly relevant for the Islamic financial services sector. Given the **close ties of Islamic finance with the real economic sector** through the various modes of Islamic financing contracts, a complete understanding of the entire risk spectrum often encounters much difficulties. It is therefore important for the regulators to also establish **an integrated framework of macro surveillance for Islamic** financial activities across jurisdictions. The global database for prudential Islamic **finance statistics** to be initiated by the IFSB, would therefore need to go far beyond

ensuring standardised data collection among jurisdictions, but also to enable the generation of various macro and financial indicators, and global sharing of best practices in macro surveillance. The engagement by supervisors would also contribute towards the understanding of the systemic risk and its origins and would support the maintenance of timely and accurate economic and financial data. This would in turn contribute towards more effective surveillance and management of financial stability issues.

Indeed, developing an **integrated surveillance mechanism, identification and prevention of emerging risks** in the Islamic financial system, as well as the establishment of an **integrated crisis management and resolution framework**, are crucial to the maintenance of financial stability in the global Islamic financial system. This would allow for a comprehensive and prompt response to a financial stress, and thus increase the prospects for an early recovery. This was the basis behind the setting up of the Islamic Financial Stability Forum (IFSF) in 2010, as a platform to build closer cooperation among regulatory authorities. More specifically, the IFSF carries the mandate of promoting international dialogue, engagement and cooperation in the area of financial stability. It also aims to broaden the understanding on the external repercussions of policy action or inaction in a given country on other national financial systems, and in considering the merits for collective action. Whilst effective international cooperation requires a framework for shared commitments, important in this process is the recognition of the restraints of national autonomy given that financial regulation and intervention are subject to country-specific circumstances. This arrangement can contribute towards enhancing mutual understanding and prevent dilution of the commitment towards common objectives.

A concrete advancement in cooperation and collaboration that has paved the way for the development of yet another important international financial infrastructure is the establishment of the International Islamic Liquidity Management Corporation (IILM), in 2010. This landmark collaboration between 12 central banks and two multilateral development institutions represents a major breakthrough

in strengthening the liquidity arrangements for the international Islamic financial system. This liquidity infrastructure is vital for the efficient and well-functioning of the Islamic financial system. The creation of IILM with the mandate to issue Shariah compliant liquid instruments is an important step forward in promoting more efficient cross-border liquidity management by Islamic financial institutions. The IILM will also be well-equipped to serve as a platform of global engagement on liquidity management in the Islamic financial system and on addressing cross-border systemic liquidity issues.

Conclusion

Let me conclude my remarks. This decade has been a defining era in the evolution of Islamic finance. It has been characterized by rapid global expansion and increased internationalisation. Of importance is that these trends have been supported by significant actions taken to strengthen the foundations of the international Islamic financial system involving

the development of important international institutional arrangements and mechanisms. These tremendous achievements have been the outcome of strong cooperation and collaboration among the Central Banking community from both Islamic and non-Islamic countries.

Moving forward, it is essential for this strong cooperation to continue given the dynamic nature of the industry. In addition, the pace of internationalization can be expected to gain further momentum. As the international integration of Islamic finance intensifies, cross border financial flows and its associated challenges will also increase. This will call for an even greater degree of international cooperation and coordination. While this new decade beckons the prospect of immense opportunities in Islamic finance, our ability to realize this potential will be determined by the ability to recognize the shared responsibility it demands and to collectively advance forward the agenda of financial stability and resilience to achieve our ultimate goal of a shared prosperity.

**Langkawi International Dialogue 2011:
Innovative Financing for Transformation
Putrajaya, 19 June 2011**

Speech by

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The world is transforming. Our motivation for accelerating our own pace of transformation is to ensure that we will be able to effectively participate in this new economic and financial environment, and in the process, maximize our potential performance. Central to this is having a well functioning financial system and the right financial policies. The recent financial crisis in the developed world has shown that when things have gone wrong in the financial system, the consequences have been catastrophic. Instead of creating wealth - it destroys wealth, instead of generating employment - it results in job losses, instead of facilitating economic progress - it derails growth and development.

It is my great honour and pleasure to speak at this 2011 Langkawi International Dialogue on Innovative Financing for Transformation. The overarching objectives of economic transformation is surely to generate sustainable and balanced growth, to improve living standards, to create employment opportunities and to achieve a more inclusive development. This decade has however seen how innovative financing in several of the developed economies have fuelled excessive levels of leverage that have resulted in deeply indebted private and public sectors, which in turn have become highly destabilizing to their financial systems and to their economies. The challenge before us is how then should the financial system be developed and regulated so that these pitfalls will be avoided while at the same time remaining dynamic and innovative so that we can push our frontiers and gain the progress that we aspire.

While innovation remains essential to economic progress, it needs to be within the context of stronger governance and sound risk management practices. Positive innovation can make enormous contributions to economic performance. The financial system has to

deliver the essential financial services that would cater to the financial needs of all sectors of the economy - from households, small and medium enterprises, including to micro enterprises and to the corporate sector. The financial system also has to take into account the fundamental changes taking place in the global economy and the growing participation of emerging economies in the global economy. As we become more interlinked, financial systems also need to become more internationalized to facilitate and reinforce this trend.

The role of the financial system is essentially to effectively intermediate and to meaningfully mobilize funds including from across borders to be channeled to productive economic activity. Such intermediation must be firmly anchored and aligned to the objective of generating sustainable and balanced growth, raising the standards of living, creating employment and promoting development. With clarity in the role of the financial system and the importance of its link to the economy, the range of the financial solutions offered needs to meet these highly differentiated and changing requirements.

For the households, the financial system provides a means to optimally spread their income and consumption over their life cycle. Accumulating wealth via saving, investment and borrowing in the initial years, and de-accumulating of the wealth during the later years, such as through pension products and annuity schemes during retirement. This is particularly important as a population matures. The absence of these products will impose tremendous burdens to the government fiscal position and the overall standards of living.

The Malaysian experience has been to encourage diversity of financial product offerings to ensure that the needs of all segments of the

population are met. This includes, from having basic banking products at negligible cost for lower income groups, to the wider range of savings, investment and protection products for the middle income groups and for the higher income groups, wealth management and comprehensive advisory services.

In the area of financing, a key priority for any country is financing to promote home ownership. This is to meet an important basic need of society and to encourage wealth accumulation among households. Malaysia approached this by initially establishing Cagamas, a national mortgage corporation, which enables banks to source long-term funding to match long-term housing loans. The national mortgage corporation has continued to evolve to promote the secondary market for housing loans via securitization and mitigating risks in mortgage financing through the provision of mortgage insurance. A recent innovative arrangement introduced this year is the risk-sharing arrangements between the government and banks to provide opportunities for the lower income and younger segments of the population to own homes and thus accumulate wealth at an earlier age.

Another important form of wealth accumulation is the collective investment schemes such as unit trusts. The pooling of savings provides economies of scale, access to professional investment managers, as well as a diversified investment portfolio. In Malaysia, this was initially promoted through the establishment of government sponsored national savings scheme (Amanah Saham Nasional). Participation of the average household has now paved the way for the growth in the private unit trust industry. The formation of such national savings schemes has also contributed to the development of an institutional investor base in Malaysia that has been able to mobilize substantial volumes of savings. The mobilization of these funds provides the potential for funding of businesses and the corporate sector and for project financing including for infrastructure development.

As SMEs and micro enterprises form the majority of business enterprises in most countries, and as they contribute significantly

to GDP, employment and wealth creation, efficient access to finance is critical. The Malaysian experience to address this has been the establishment of the Credit Guarantee Corporation to assist viable SMEs with inadequate track record to access financing by providing guarantees and credit enhancements for SME financing. The credit evaluation is carried out by banks, and by the CGC. For countries where SME-credit evaluation skills are scarce, the centralisation of expertise using such an arrangement would be able to facilitate this as banks build their capacity. There have also been a wide range of innovative financial products and services to support this agenda.

A highly successful programme in Malaysia has been the RM2 billion SME Assistance Guarantee Scheme which was established in February 2009 to ensure that viable SMEs adversely impacted by the economic slowdown would have continued access to financing. Under this scheme, SMEs are able to obtain financing with an 80% guarantee cover provided by the Credit Guarantee Corporation. The cost of the guarantee was borne by the Central Bank. This scheme has assisted about 10,000 SMEs from all sectors of the economy in sustaining their businesses and preserving employment.

Venture capital and private equity funds are required to provide early stage financing for innovative SMEs. Due to the highly specialised focus of such funds, it is common for fund-of-funds to be established as a pooling mechanism for the purpose of risk diversification. However, the success of these forms of financing depend very much on the enabling environment in terms of availability of talent as well as deep and relatively well developed equity market for early stage investors to “exit”.

Finally, micro financing is important to provide access to funding for micro enterprises. There are now many highly innovative schemes to achieve outreach, including by mobile banking and agent banking. Critical to the success of such financing is pricing and accessibility. The world has seen different degrees of success of such financing. Critical to their success is the enabling environment of which equal attention has to be accorded. This includes the

institutional arrangements, the business model for such financing, the regulation and policies and the supervisory oversight. This will ensure its sustainability as a form of financing.

Another important segment of businesses is the corporate sector. Established corporates will require efficient sources of financing for expansion as well as advisory services to maximise enterprise value. A deep and liquid bond market with good information flow and modern infrastructure will allow for efficient pricing of corporate issuances - from short term commercial papers to support liquidity and working capital, to longer term bonds for project financing. Treasury services are also important to manage the funds of larger corporations to achieve higher returns as well as access to risk management and hedging instruments to manage foreign exchange, commodity price and other forms of market risk.

As economies develop, governments will need to increasingly shift from being a driver of growth towards having a facilitating role and to promote the private sector as the driver of growth. Malaysia has leveraged on the comparative advantage of the public and private sectors through Public Private Partnerships for infrastructure projects. The objective is to optimise on the cost efficiency and sustainability of the financing model, so as to enhance the financial viability of the infrastructure project. This is achieved as risks are transferred to parties that can best manage those risks. Hence, the public sector can provide the regulatory risk guarantees and incentives to ensure adequate demand, whilst the private sector will raise financing as well as technical expertise. This model was successfully implemented for the biggest highway concessionaire in Malaysia. PLUS operates and maintains 973km of expressways in Peninsular Malaysia, stretching from the border of Thailand to Singapore and linking all major cities on the west coast of Peninsular Malaysia.

Financing for infrastructure development is equally important as this has implications on the fiscal position. To structure the most competitive and efficient financing for each stage of the infrastructure project schedule, several options can be considered - including

direct funding from the budget, the issuance of long-term Government bonds, the issuance of long-term Government-guaranteed bonds, the securitization of works completed, and the issuance of long-term bonds backed by the Government's undertaking to make deferred payments. The actual funding mix adopted needs to be based on the Government's fiscal position and on economic conditions. By adopting a mix of strategies over the overall duration of the project, the Government can optimise on the funding costs.

Another major area of financing that has been a challenge both in the developed and emerging economies is for health care. The structure of healthcare provision requires a balanced socialised element to avoid both the market failure of a largely privately driven system (e.g. as experienced in US) and the inefficiencies of fully public systems (e.g. several European countries). Social health insurance schemes based on earnings contributions is a means by which such funding sources can become a complementary source of funding to public sector. Such an institutional arrangement should provide high quality basic healthcare for the population whilst private health insurance can have a complementary role in providing higher level care for those that have the means to absorb these costs.

In developing a financial sector that will deliver innovative financing for economic transformation throughout the different phases of development requires several supporting elements. These include:

- a. Having strong financial institutions that are resilient to withstand the economic cycle;
- b. Establishment of a credit information system;
- c. Development of a domestic bond market for financing large investments for both the public and private sectors. This includes the necessary infrastructure to facilitate the functioning of the bond market;
- d. Having the talent pool in the financial services industry;
- e. Financial literacy has to be advanced aggressively;
- f. Effective structure to ensure sufficient supervisory oversight to ensure soundness and stability of the financial system;

- g. Mechanism for resolution of debt problems including for public and private sector;
- h. Potential to leverage on technology. This in particular enhances distribution channel and outreach;
- i. Consumer protection framework needs to be in place; and
- j. Surveillance mechanism needs to be in place.

Finally, I would like to discuss the importance of Islamic finance as an important mode for financing economic transformation. Islamic finance requires financial transactions to be supported by an underlying productive economic activity that will generate legitimate income and wealth. This gives rise to a close link between financial transactions and productive flows. Therefore, the growth in Islamic financial assets is generally in line with the growth of underlying economic activities, thereby ensuring that the financial system is always grounded to the real economy. Other inherent features arising from risk sharing also contribute to the stability and integrity of Islamic finance. Thus, Islamic finance, embraced in its entirety, is supportive of sustainable economic growth.

Islamic finance offers an extensive range of innovative financial products and services from consumer financing, asset and wealth

management to Islamic insurance and capital markets. The sukuk market has become a highly competitive fundraising option for large scale projects and infrastructure development. With an annual growth rate of 40 percent, sukuk instruments are fast emerging as an attractive new asset class for investors, while evolving to become a preferred financing and capital raising option for issuers. In Malaysia, the sukuk market now accounts for more than fifty percent of our bond market, drawing the participation of not only our own corporates but also a wide range of international corporations and multilateral agencies. In Malaysia, a comprehensive Islamic financial system operates in parallel to the conventional financial system. This is now internationalized to enhance our interlinkages with other emerging economies and traditional markets.

The emerging economies will be the key drivers of economic transformation over the next decades, both within and across borders resulting in a more integrated global economy. It is therefore imperative that efforts are increased in ensuring collaboration and sharing of experience for the common good. The Langkawi International Dialogue continues to be an important platform for such exchanges and it is a great honour for me to have this opportunity to be here today.

**Official Monetary and Financial Institutions Forum (OMFIF)
World Banking Summit:
“Looking into the Crystal Ball: The New International Balance of Economic and
Financial Power and its Implications”
London, 30 June 2011**

Speech by

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We live in the most extraordinary of times. A major global transformation is taking place at an unprecedented scale and speed. The pervasive nature of this transformative change is the result of several mutually reinforcing global shifts – an economic shift, financial shift and monetary shift. The ramifications of these significant structural shifts will have widespread and far reaching implications. It will result in a realignment of the global economic and financial landscape, a realignment that will not be transitory but a structural transformation that will be of historical significance that will reshape the world.

It is my great pleasure to be here in London to speak at this OMFIF World Banking Summit. My remarks today will focus on the three global – and interconnected – structural shifts; the economic, financial and monetary shifts that are unfolding. While the world is currently confronted with wide-ranging challenges – sustaining growth that is accompanied by job creation, ensuring effective and efficient functioning financial systems, reining in rising inflation, dealing with fiscal imbalances and excessive indebtedness and living with volatile and destabilising cross border financial flows – it is also important to recognise the significance of these underlying shifts that are reshaping the future global landscape.

Economic Shift

The **economic shift** is resulting from the cumulative shifts in global consumption, investment and trade. For more than two centuries, the centre of global economic power has been with nations with less than twenty per cent of the world populationⁱ. But in these

recent two decades, the concurrent rise of the emerging economies is contributing towards a major realignment of the global landscape. Furthermore, this process has been further accelerated by the recent global financial crisis that is resulting in a global recovery that is uneven, with slow and fragile recovery in the developed world and robust and stronger growth in the emerging world.

The concurrent rise of the emerging economies is shifting the economic centre of the world towards a global environment in which the economic power is more dispersed – into a world that will become increasingly multi-polar. While the economic growth has been most visible in Asia, strong growth has in fact been experienced in most of the emerging world in this recent decade. The emerging economies today collectively contribute almost three-quarters of global growth, while their share of global economic output is projected to account for almost 60% of total world output by 2030ⁱⁱ.

Rising incomes, growing employment opportunities and the conscious policies to promote domestic demand is increasingly shifting the locus of global consumption from the advanced to the emerging economies. The emerging economies are already – on the average – adding 125 million people into the global middle class each year, equivalent to more than twice the population of the United Kingdom. This will about double the global middle class population to 3.2 billion by the conclusion of this decadeⁱⁱⁱ. Highly visible are the new consumer retail centres that are emerging in Asia, the Middle East and Latin America. By 2020, Asia alone is projected to comprise more than 50% of the global middle

class population, accounting for more than 40% of global consumption^{iv}. This is reinforced by a demographic structure that indicates a relatively young population with a relatively higher propensity to consume.

Other measures that have enhanced the potential for increased consumption are the social safety nets that are being put in place including for health and education, the improvements in public transportation, the institutional arrangements that are reducing the need for precautionary savings that involve the development of pension funds and insurance. And finally, the development of the domestic financial system has ensured the continued access to financing.

This geographical shift of global consumers is also transforming the patterns of international trade. As final demand increasingly originates from Asia, the Middle East and Latin America, the final destination of exports is also increasingly gravitating to the emerging economies. The direction of trade is therefore expected to shift as advanced economies will increasingly be exporting to the emerging economies. This in turn will contribute to the unwinding of the global imbalances and potentially even reversing the global balance of payments position.

Trade between the emerging economies is also increasing substantially. Not only will there be greater intra-regional trade within Asia, but trade between the various regions of the emerging world, in particular, between Asia and the Middle East and Latin America is also gaining importance. As the emerging economies transform from being global producers to becoming global consumers, the concentration of trade will also shift from comprising of intermediate manufactured inputs to that of final consumer goods. Indeed, these shifts in trade patterns are taking place. While world trade has expanded by almost four-fold, trade among the emerging economies has increased by more than ten times^v. Within the more recent decade, Asia has emerged as the largest trading partner for the Middle East, accounting for more than half of the total trade in the Middle East.

Alongside these profound changes is also the secular shift in investment flows into the emerging economies. Initial investment flows to the emerging world were prompted by the presence of resources, labour supply, the lower costs of doing business and the growing scale of the domestic market. These factors have produced vast investment opportunities in the emerging economies. In particular, in this recent two decades there has been a massive shift in the manufacturing capacity from the advanced economies to the emerging economies.

More recently however is the investment flows into the emerging economies originating from the emerging economies themselves. Today, more than one third of foreign direct investments (FDI) into the emerging economies originate from the emerging economies, and this share can be expected to increase further^{vi}. As firms in the emerging economies grow in size and strength, they can be expected to expand their operations to beyond their domestic borders to the region and other parts of the world, thus creating a new generation of global multinational companies. Importantly, the increasing regionalisation and internationalisation of such firms will not only provide capital to the other emerging economies, but also talent and expertise. Recent statistics indicate that the number of emerging market companies in the Fortune 500 have more than doubled in the recent four years^{vii}. The strengthening of trade links among the emerging economies also reinforces this cross-border corporate investment into the emerging economies.

This change in the direction of capital flows – from the advanced into the emerging economies, and among the emerging economies themselves – will contribute to reinforcing the growth potential of the emerging economies, and thus this global economic shift towards the emerging economies. Additionally, the increasing allocation of capital towards productive investment opportunities in emerging economies will contribute to the global rebalancing process, and thus towards achieving a more balanced global economy.

Financial Shift

Let me now turn to a more recent shift that is taking place in the global environment – the financial shift. As the world economy becomes more globalised and as economic activity and production becomes globally more dispersed, the distribution of financial centres will also become increasingly more dispersed. International financial centres are currently still dominated by financial centres in the developed world. There is still a high level of geographical concentration of financial centres that are dominated by cities in the advanced world. The global financial system is also characterised by a network of financial institutions that originate from such financial centres – mainly from the United States, Europe and Japan – that have presence in different parts of the world. Their international presence is largely to serve their clients that have international businesses and to finance international trade.

The future is likely to see the distribution of financial centres become more dispersed. Increasingly, new centres of financial activities will emerge to serve the new growth centres in the emerging economies and the new businesses that have operations in their respective regions and other parts of the world. This will also promote greater interlinkages between financial systems, especially among the emerging economies. This trend will be reinforced by the changes in the pattern of international trade and cross border investment activities to and among the emerging economies.

In addition, several features that are prevailing in most emerging economies will prompt greater intra-regional financial intermediation. Firstly, is the relatively higher savings rate in most emerging economies. This provides opportunities for more effective mobilisation of savings within and between regions to be efficiently channelled to productive investment opportunities across and between regions. Regions with surplus funds such as the Middle East have the opportunity to channel these funds to other regions that have investment opportunities. Secondly, is the trend for deregulation and financial reform that allows for greater flexibility and predictability in the

functioning of the financial system. Thirdly, is the trend towards greater liberalisation – both in terms of elimination of barriers to entry and that of capital account restrictions. These developments have been reinforced by the development of financial markets in emerging economies. These trends have cumulatively prompted greater regionalisation and internationalisation of financial systems in the emerging economies.

These trends will also be reinforced by the rapid growth and expansion of emerging market financial institutions that are increasingly operating beyond their national borders. Financial institutions from the emerging economies have grown significantly in size and strength over the recent decade, accounting now for almost half the worldwide financial industry market value. In fact, the world's two largest banks by assets are today held by emerging market financial institutions. Not only have financial institutions gained presence by way of establishing subsidiaries or branches in new jurisdictions, but there has also been increased cross border mergers and acquisitions. This trend has further facilitated cross border financial intermediation and has enhanced the economic interlinkages between emerging economies. With the development of the domestic financial markets and as these markets are internationalised, it enhances the interconnectedness of these markets and hence the potential of facilitating the optimal and efficient allocation of resources between economies. It will result in some part of the high savings within the region to be recycled into, investment activities in the region.

Another key trend in the international financial landscape is the internationalisation of Islamic finance and its role in contributing to supporting overall global economic growth and global financial stability. This recent decade has seen the expansion of Islamic finance as a competitive form of financial intermediation. With the internationalisation of Islamic finance, it will also enhance the economic interlinkages not only in Asia and the Middle East, but also with the rest of the world. While the regulatory framework for Islamic finance has been well established at the international level, there has also been meaningful progress in the

harmonisation of Shariah interpretations and the establishment of a mechanism for managing cross border liquidity. An area that has been identified for further work is on the development of a cross border crisis management framework. As evident in recent trends, the internationalisation of Islamic finance is facilitating the strengthening of trade and investment ties – especially between Asia and the Middle East, and thus deepening the economic and financial inter-linkages between the two dynamic growth regions.

Monetary Shift

The third global shift taking place is in the international monetary system. As the share of emerging economies in the global economy increases and as our participation in cross border transactions in trade and investment increases, the role of emerging economies in the international monetary system will also increase. The issue before us is how will the international financial system evolve amidst the global economic and financial shifts that are taking place. Will there be a corresponding shift in the international financial system?

When the Euro emerged as an international reserve currency, it was thought that three international reserve currencies would prevail in the international financial system – the US dollar, the Euro and the Japanese Yen. Given the degree of the internationalisation of the US dollar, the significant size and liquidity of its financial markets, the US dollar has dominated as an international reserve currency in the international financial system. Going forward, it is those currencies that can effectively perform as a medium of exchange for cross border transactions for trade and investment that will emerge as an international reserve currency. Three scenarios have been extensively discussed by the international community. Firstly, a single currency dominates; second, multi-currencies exist as international reserve currencies; and third, the emergence of a global currency such as the SDR. Key is the relative stability of the currency and its ability to withstand destabilising developments.

Prior to the sovereign debt crisis in Europe and the financial crisis in Japan, there was

ready acceptance of the Euro and the Yen as important reserve currencies. The recent developments in Europe should be viewed as a temporary setback. Following the resolution and restoration of stability, the trend of its role as an international reserve currency can be expected to resume. In addition, the emergence of China as a significant participant in the international financial system will enhance the prospects of the Renminbi as a reserve currency. China is already the largest trading partners to many countries. There are already settlements in Renminbi for bilateral trade. Increasingly, Central Banks and Sovereign Wealth Funds are also already investing in Renminbi denominated assets. This trend can be expected to increase.

The third scenario that has been discussed is the emergence of a global currency. The smaller emerging and developing economies that participate in international trade may consider the case for a global currency that represents a composite of a basket of currencies compelling. Being a composite of currencies, it would provide greater relative stability, a risk that a single currency is not able to avoid. Trade earnings would thus avoid being diminished by volatile currency movements.

The transition to any new monetary order will however be gradual given that the financial infrastructure and pre-conditions that need to be in place will need time. Historical experiences have shown that inertia exists in the internationalisation of currencies. As such, the internationalisation of the euro and Chinese renminbi as complementary reserve currencies to the US dollar can be expected to proceed gradually, with even occasional reversals towards the US dollar during periods of heightened risk aversion. Among the important pre-conditions is the strengthening of the depth and liquidity of the foreign exchange and other financial markets, to withstand the transition process as we transition into a multi-polar international reserve system.

Global Governance

As the emerging economies increasingly take centre-stage in the global economic and financial landscape, emerging economies need to be accorded with greater representation and

responsibility in the global governance process. Whilst the transition from the G7 to the G20 is recognised as a positive step forward that extends beyond the advanced economies, representation in the G20 remains limited by virtue of size of economies and not by the groups of countries. Importantly, small and medium-sized economies need to be a part of this global governance process and in the setting of international standards which have to sufficiently take into account the impact on the emerging economies.

Increasingly, regional blocs are undertaking their own surveillance and establishing facilities and mechanisms to safeguard stability. This does not diminish the role of existing international multilateral financial institutions. These efforts should be encouraged. The comparative advantage of the regional blocs should be leveraged upon to achieve the common agenda.

The higher degree of interconnectedness in the global economic, financial and monetary landscape also means that the global agenda for growth and financial stability is a shared responsibility. As the world is confronted with global challenges, there will be a greater need

for global solutions and global accountability. Policies can no longer be on only national considerations. The new global governance architecture will also need to take into consideration this greater interdependency of economies and the need to achieve greater international cooperation and coordination.

Conclusion

Allow me to conclude. The concurrent rise of the emerging economies is fundamentally transforming the global landscape. These developments that are unfolding, are having immense implications to the world. While we are currently in a period of transition, faced with the need to manage many major challenges, it is important to recognise the underlying structural shifts that are reshaping the world. As we head towards this 'new normal' that is being reinforced by a world in which there is greater economic and financial interconnectedness, it will necessitate a greater balance in global governance, as well as an intensification in global cooperation and coordination. The common agenda is to achieve a new world that is more balanced, more stable and more sustainable.

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- i OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - ii OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - iii OECD, The Emerging Middle Class in Developing Countries (January 2010)
 - iv OECD, The Emerging Middle Class in Developing Countries (January 2010)
 - v OECD, Perspectives on Global Development 2010: Shifting Wealth (June 2010)
 - vi World Bank, Global Development Horizons 2011: Multipolarity – The New Global Economy (May 2011)
 - vii McKinsey Quarterly, The Great Rebalancing (June 2010)

CALENDAR OF EVENTS April – Jun 2011

20 April 2011

The Bank announced the reappointment of Dr. Zeti Akhtar Aziz as the Governor of Bank Negara Malaysia for another term of 5 years effective 1 May 2011. Dr Zeti has held the position of the Governor of the Bank since May 2000.

25 April 2011

The Bank and the People's Bank of China signed an agreement on the establishment of a representative office by the Bank in Beijing. The establishment of this representative office will further strengthen the bilateral cooperation between the two central banks. The office will also serve as an important liaison point with China's regulators and market players as well as to facilitate the conduct of market research on China's economic and financial developments. The Beijing representative office is the third overseas representative office established by the Bank, in addition to its offices in London and New York.

3 May 2011

The Bank announced measures to ensure that all motorists will obtain access to motor cover. Members of the public can obtain motor cover from all general insurers and their branches as well as at Pos Malaysia outlets nationwide. All general insurers are committed to provide motor cover to all motorists including those "displaced vehicles" comprising private vehicles exceeding 10 years old and motorcycles currently underwritten by the Malaysian Motor Insurance Pool. In ensuring the rights of consumers are protected, the Bank also prohibits insurers from compelling their customers to purchase non-motor products as a condition for the sale of a motor cover.

5 May 2011

At its third meeting for 2011, the Bank's Monetary Policy Committee (MPC) decided to raise the Overnight Policy Rate (OPR) by 25 basis points to 3.00%. With the assessment for the Malaysian economy to remain firmly on a steady growth path, the MPC decided to adjust the degree of monetary accommodation. At the new level, the monetary policy continued to remain supportive of economic growth. The Bank also announced the increase in the Statutory Reserve Requirement (SRR) Ratio from 2.00% to 3.00% effective 16 May 2011, as a pre-emptive measure to manage the significant build-up of liquidity which may result in financial imbalances and create risks to financial stability.

12 May 2011

In her speech at the 8th Islamic Financial Services Board (IFSB) Summit in Luxembourg entitled "Financial Stability: Regional and Global Cooperation", Governor Dr. Zeti highlighted that as Islamic finance becomes more internationalised, there is a need to develop a cross-border financial stability framework to further strengthen the resilience of Islamic financial system and to address cross-border challenges. She added that collaboration among supervisory authorities of Islamic financial institutions is vital to ensure the success of this initiative. In addition, Governor also proposed the establishment of an integrated framework of macro surveillance for Islamic finance activities, including efforts such as the IFSB's global database of Islamic finance statistics, which would help to identify and mitigate the emerging risks in the Islamic financial system across jurisdictions.

18 May 2011

The Bank announced that Malaysia has sustained its economic growth momentum in the first quarter of 2011 by registering a growth of 4.6%, led by expansion in domestic demand and higher private sector spending. On the supply side, all major economic sectors recorded positive growth led by strong growth in the manufacturing and services sectors, with the exception of the primary commodity sectors namely agriculture and mining. The headline inflation rate increased by 2.8% in the first quarter attributed mainly to higher global commodity and food prices.

On the same day, the Bank also announced the liberalisation of foreign exchange administration rules on direct investments abroad, inter-company loans and foreign currency trade financing with effect from 1 June 2011. Resident companies that meet the prudential requirements are now permitted to undertake any amount of direct investment abroad to support the expansion of their operations. They are also permitted to borrow any amount in ringgit or foreign currency from their resident and non-resident non-bank related companies to further enhance the efficient management of financial resources within a corporate group and to provide greater flexibility on sources of competitive financing. In addition, the RM5 million limit previously imposed on foreign currency trade financing obtained by residents from non-residents will no longer be applicable. In this regard, residents may obtain foreign currency borrowing, including foreign currency trade financing, up to the prevailing aggregate limit of RM100 million for companies on a corporate group basis and RM10 million for individuals. The liberalisation is part of the efforts to continuously increase business efficiency and enhance competitiveness of the economy.

23 May 2011

The Bank announced that a new series of Malaysian banknotes and coins will be issued for circulation in early 2012, an exercise that is undertaken periodically every twelve years. The theme of the design of the new currency series will include features that are distinctively Malaysia. It will also be enhanced with new security elements in line with the latest advancements in technology for currency notes. As part of the efforts to increase public awareness on the new currency series, the Bank will issue the commemorative coins set for the third series and unveil the new fourth series banknotes design in the third quarter of 2011.

15 June 2011

The Bank awarded a new international Islamic bank licence to Elaf Bank B.S.C (c) (Elaf Bank) of Bahrain to conduct a wide array of Islamic banking business in international currencies other than Malaysian ringgit. Elaf Bank's presence will further strengthen the economic and financial linkages between Malaysia and Bahrain and contribute further to the development of the Islamic financial system in Malaysia.

19 June 2011

At the Langkawi International Dialogue 2011 in Putrajaya, Governor Dr. Zeti delivered a speech entitled "Innovative Financing for Transformation". She highlighted that financial system has to deliver essential financial services that would cater to the financial needs of all sectors of the economy – from households, small and medium enterprises including micro enterprises and to the corporate sector. She also shared Malaysia's experience in developing a financial sector that would deliver innovative financing for economic transformation.

20 June 2011

The Bank announced the introduction of a new Islamic monetary instrument, the Bank Negara Monetary Notes-Istithmar (BNMN-Istithmar). The issuance of BNMN-Istithmar is based on the Istithmar (investment) concept which refers to portfolio investments into a combined structure of sale and lease-back of assets (Ijarah) and commodity mark-up sale transaction (Murabahah). The main objective of issuing BNMN-Istithmar is to increase efficiency and flexibility of liquidity management in the Islamic money market by expanding the Shariah concept used in the Bank's Islamic monetary instruments. BNMN-Istithmar will contribute towards expanding investment instruments and the investor base as well as promote greater liquidity in the Islamic money market.