

**2010 Institute of International Finance (IIF) Annual Membership Meeting:
“South East Asia: Potential and Perspectives in the New Asia”
Washington D.C, 8 October 2010**

Luncheon Address by

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Generating growth and a long lasting recovery is the primary priority for the global economy in this aftermath of the recent crisis. The massive life support that was provided to avert a deep recession was to be temporary - to provide the opportunity to address the weakness in the system and to rebuild the capacity for a self-sustaining recovery. Recent indications are that this prospect has not been realised. The emerging world has however performed well with the potential to generate such a sustained recovery. These developments have drawn significant interest to the Asian emerging economies and on their changing role in the global economy and in the international financial system.

It is my honour and great pleasure to speak at this 2010 Institute of International Finance Annual Membership Meeting. My remarks today will focus on the challenges in managing such a sustained recovery with specific focus on the potential for emerging Asia to rise to these challenges in this new global economic and financial environment. The final part of my remarks will be on the changes taking place in the international financial environment from the perspective of emerging Asia.

As growth in the developed world slows, weighed down by structural factors, will the global environment of increasing interdependence then dampen the prospects for the Asian emerging economies? Asia comprises highly diverse economies. South East Asia, with a population of more than 500 million people is strategically located south of China and east of India, has been since the 13th century an important trading hub connecting Asia to the West. Being the most open economies in Asia, and perhaps in the world, we, therefore stand to be the most vulnerable to global developments.

While economic stimulus is vital for crisis containment, it will not, however, be sufficient to produce a self-sustaining recovery. The challenge is essentially the economic restructuring and transformation, the reform and rebuilding of the institutional capacity so as to remain effective in the new environment and to be well positioned to manage future shocks.

As emerging economies in Asia transition into this post crisis era, three important structural shifts are transforming the region. The first is the economic restructuring and the strategy to pursue more balanced sources of growth. This has involved significant shifts to new areas of comparative advantage and new areas of growth, and the greater emphasis on domestic demand as a driver of growth. While the export sector continues to be important, the pattern of trade has changed significantly with the growing importance of trade with emerging economies, in general, and with Asia, in particular.

Perhaps the most important factor that has for several decades sustained the economic success of the emerging Asian economies is its economic flexibility to adjust to the changing conditions in the global environment. This economic flexibility is supported by the high degree of labour and capital mobility within the national economies and the significant investment accorded to education and to infrastructure development. The region has also adopted a pragmatic approach to policy that is not constrained by rigid ideology. In this more recent decade, institutional development, extensive financial reforms, and the adoption of new business models have been an important part of this transformation process.

Several of the economies in emerging Asia's have transformed their production capacity in the manufacturing and services sector to meet

the changing demands of the global economy and the growing consumer market in Asia. Given the different stages of development and endowment of natural resources in the region, the emerging economies in Asia have also leveraged on their respective distinct comparative advantages. This has resulted in intra-regional division of labour and specialisation, and the capacity to undertake the entire spectrum of the supply chain for a wide range of products and services.

Part of the economic restructuring has also involved the greater emphasis on domestic demand as an important source of growth. This has involved significant increases in domestic private consumption and investment activities. Rising income levels and the presence of a young demographic structure with a high propensity to consume has resulted in a huge consumer market and the development of an extensive modern retail sector across the region. The potential sustainability of this trend is supported by the absence of inflationary trends, of large scale unemployment, or of high levels of indebtedness.

The second fundamental trend is the intensification of regional economic and financial integration. This has been facilitated by the ability to leverage on complementarities in the region arising from diversity and differences in comparative advantage. Intra-regional trade has been a major contributor to the recent recovery in Asia. Intra-regional investment flows have also gained momentum. Businesses in the region are increasingly leveraging on regional complementarities and taking advantage of the growing markets in the region through regional trade agreements to achieve the aspiration for ASEAN to become an Economic Community by 2015.

As high saving economies, it is recognized that there is an important need for a more efficient intermediation of the surplus funds in the region. This is to not only effectively channel these funds into productive investment opportunities in the region, but also to finance the massive development of infrastructure required by the region. As part of the increased regional financial integration, there is now increased regional presence and participation

in the domestic financial systems of the region. This phenomenon has been supported by the progressive financial liberalisation, the development of domestic financial markets, the greater use of domestic currency to facilitate bilateral trade activities and the development of the payments and settlement systems.

The economic and financial regional integration has also been reinforced by a higher level of regional 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, including in surveillance, crisis management, liquidity support arrangements, financial supervision and financial market development.

The approach in forging greater financial integration in Asia will be different from that adopted by Europe. The region does not have centralised institutions to coordinate financial integration but has leveraged on the existing intra-regional groupings and networks to forge greater cooperation and collaboration in areas of common interest. The region has its own monetary and financial stability committee that is supported by arrangements for regional surveillance to identify risks and vulnerabilities to the region. Also in place is an integrated crisis management framework that will be operationalised in the event of an imminent financial crisis in the region. Recently the region successfully organised two schemes for reserve pooling, the Asian Bond Fund and the ASEAN+3 Chiang Mai Multilateralised Swap arrangement as a liquidity support facility.

As economic and financial systems in Asia continue to transform and as the region becomes more integrated and cohesive, this has not only enhanced the potential for the region to contribute to global growth but also enhanced the resilience of the region and thus its role in contributing to global financial stability. These trends support the global efforts by the various international groupings and multilateral agencies in the search for solutions to achieve global financial stability and sustainable growth.

The transition from G7 to G20 is recognised as a positive step forward that extends its

reach beyond the developed world. But the representation in G20 is by virtue of the size of the economy and not by representation of specific groups of countries. Its outreach and inclusiveness is therefore limited, and small and medium sized emerging economies are not part of this process. The G20 is, nevertheless, an important global forum for considering global issues and will have an important role in setting the direction for global policies. Earlier, the cohesiveness, the sense of purpose and urgency of the G20 did indeed contribute to restoring confidence in the global financial system and the coordinated policy stimulus was an important catalyst for the economic recovery. In recent months, however, the momentum for this coordinated actions have dissipated and there have been differing positions on several important issues. At the same time, a number of the major crisis affected countries have implemented their own financial reform plans. In view of the far reaching implications of any reform agenda, it is an important global responsibility to ensure that the reforms achieve their intended results and that this new phase of globalisation will result in a more inclusive international financial system that will allow for the effective participation in the global economy and international financial system regardless of size or stage of developments.

On the specific regulatory reforms to address the issues and problems that caused the crisis, of importance, is that the goal of such regulatory reform should not be overlooked - promoting financial stability is a means to an end and the ultimate goal is to achieve sustainable growth and development. Many have already highlighted the potential increased regulatory costs on intermediation and hence on economic activity. This is even more relevant in Asia where there is greater reliance on the banking sector for financing. The efforts undertaken to comprehensively assess the macroeconomic impact including by the IIF is highly relevant and will be important to the reform process.

A further concern and one that is less discussed is on the implementation of the regulatory reform. With greater capital mobility across borders, the stricter regulations could result in the migration of financial business to less regulated market segments, institutions or

financial centres. Important to this is the need for the development of the framework for cross border policy coordination and resolution. In Asia, efforts are underway to address these specific issues recognising that in this interconnected environment, the execution of remedial and containment measures will be highly complex and challenging. Focus is also being given to having enhanced surveillance and oversight that is complemented by a robust framework for governance, transparency and accountability.

Given the strong presence of international institutions in the Asian region, we have strong interest in the establishment of an effective cross border resolution mechanism so that any failure of such large and systemically important institutions with cross border representations can be dealt with effectively in an orderly manner. This will require cooperation and coordination across countries, taking into consideration their differing regulatory and legal systems.

A further priority in emerging Asia is the promotion of responsible market practices and consumer protection given the stage of development and level of financial literacy. There is significant scope for creating greater global momentum for improvements in regulatory standards on market practices.

Much work still remains ahead and would require resolve and commitment in this reform agenda. The more inclusive global process is critical to this effort and should be further deepened to truly reflect the global dimension of the financial system in this 21st century.

On the recent increasingly intense debate on the role of the exchange rate as the solution to the global imbalances, it needs to be recognised that the foreign exchange market is not like any other markets. With a daily transaction amounting up to USD4 trillion, it is the most liquid and dynamic market in the world. It is a market that is prone to excessive movements and overshooting. Any effort to engineer a significant exchange rate adjustment within a short period of time carries the risk of highly destabilising consequences. Global imbalances that have been built up

over several years need to be unwound by a combination of adjustments in demand, prices and exchange rates. Over reliance on the exchange rate to do the adjustment may not only not produce the desired result, but it also risks becoming a trigger factor to causing instability and future crisis.

The final development that I wish to say something on is the global development of Islamic finance and its increasing role in enhancing global economic and financial linkages particularly among emerging economies. Islamic finance is all about basic banking that is always supported by underlying economic activity. Its profit sharing feature provides for risk sharing and thus the necessary due diligence, disclosure and transparency, risk management and governance. The industry is also well supported by the regulatory and supervisory standards issued by the Islamic Financial Services Board (IFSB). While the focus

has been on keeping the regulation abreast with the developments in the financial system, emphasis is also given on the supervisory oversight, capacity building, and institutional and financial infrastructure development as part of the efforts to ensure financial stability. The most recent significant development was the establishment of the International Islamic Liquidity Management Corporation (IILM) that will issue highly rated short-term Islamic instruments to facilitate more efficient liquidity management of cross border investments.

The global challenges call for a collaborative approach to strengthen the prospects for a global recovery. The way forward is also to recognise the relative strengths of different parts of the world and the potential to leverage on these strengths. The transformation of Asia in this new environment offers the prospects for a greater shared responsibility towards a greater shared prosperity in the world.

**IMF-World Bank Annual Meetings:
“Islamic Finance: An Agenda for Balanced Growth and Development”
Washington D.C, 10 October 2010**

Luncheon Address by

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The growth and development agenda is now the primary priority for the world economy. In the advanced economies, the efforts to generate a long lasting recovery in the aftermath of this recent unprecedented global financial crisis is heavily weighed down by the need to address several structural challenges which will affect the strength of this recovery. In this new phase of globalisation, of greater economic and financial interdependence, the growth and development agenda for the emerging and developing world has therefore become even more challenging.

The global crisis has in fact demonstrated the pivotal role of an efficient functioning financial system towards achieving such a self-sustaining economic recovery. This has prompted an intensive collaborative effort by the international community to undertake wide ranging and far reaching financial reforms. This commitment is for a solution that will evolve a financial system that will best serve the real economy, a financial system that is sound and resilient and that is less vulnerable to financial crisis.

Islamic finance, as a rapidly growing form of financial intermediation, has demonstrated its resilience during the global financial crisis and has every potential to advance the growth and development agenda. It is my very great honour to be invited to speak at the Islamic Development Bank Group’s luncheon held in conjunction with the 2010 IMF-World Bank Annual Meetings here in Washington D.C. My remarks this afternoon will discuss the recent developments in the Islamic financial system and its role as an effective and competitive form of financial intermediation in the growth and development agenda. I will also discuss on the increasingly more important role of Islamic finance in strengthening international economic and financial linkages in the global economy,

particularly among the emerging and developing world thereby increasing the potential for achieving a greater shared progress and prosperity.

As a form of financial intermediation, Islamic finance incorporates several elements that guide the process of the mobilisation and allocation of funds to generate productive economic activity and inclusive development. Fundamental to Islamic finance is the requirement that financial transactions be accompanied by an underlying productive economic activity that will generate legitimate income and wealth. There is therefore, a close link between financial transactions and productive flows. Thus, the growth in Islamic financial assets is generally accompanied with growth of underlying activities that have economic value.

These important elements in Islamic finance enhance its ability to contribute to the growth and development agenda. Firstly, Islamic finance has been able to be dynamic to respond to the differentiated and requirements of consumers and business. In the early stage of its development, Islamic finance focused on meeting the demands for trade financing. Today, it offers the range of financial products and services from a highly diversified financial system that include the provision of innovative and high quality financial products and services such as consumer financing, wealth management and wide ranging products from the Takaful industry and the Islamic capital markets. It also has the capacity to promote project financing and long term structured products for the financing of large scale project and infrastructure development.

The second factor that has ensured the sustainability of Islamic finance is its ability to

remain a competitive form of financing. The competitiveness of Islamic finance is vital to enhance its role in the growth and development agenda and is derived from a number of fundamental reasons. Given that the Islamic financial instruments reflect the underlying economic activities and that such instruments inherently have the potential to provide tangible returns to the investors, it has therefore created significant demand on Shariah compliant financial products. In the current environment of great uncertainty, both investors and issuers are in search of financial products and services that require greater transparency and explicit risk management. Shariah principles, in this respect, prohibit excessive leverage and speculative financial activities and discourage excessive risks exposures.

The third aspect of the sustainability of Islamic finance is its resilience. The global financial crisis, unprecedented in modern history has brought to the forefront the wide ranging issues concerning soundness and stability of financial system. The regulatory reform and the reform of the international financial architecture is part of the efforts by the international community to address the many weaknesses that caused the crisis. In any reform exercise, however, of great importance is the clarity of the objectives to be achieved. It is recognised that financial stability is critical to ensure the sustainability of the intermediation function. The debate however has raised the issue on whether such stringent regulation might increase the costs of financial regulation and in turn affect the growth and development agenda.

In Islamic finance, financial stability has been addressed on three fronts. Firstly, Islamic finance has its own inherent inbuilt checks and balances. Its value proposition of profit and risk sharing requires the appropriate due diligence, disclosure and transparency. The features inherent in Islamic finance, therefore, emphasises the dimensions of governance and risk management. The role of the Shariah Board is to ensure all aspects of the business operations of Islamic institutions are in accordance with the Shariah principles. This therefore adds another level of oversight which inherently safeguards against irresponsible practices. This is particularly important in

ensuring that the rapid pace of innovation in the current environment contributes towards the real economy and the society.

The second factor that contributes towards strengthening the soundness of the Islamic financial system is the establishment of the Islamic Financial Services Board (IFSB) in 2002. This is an important international institution that sets the prudential standards for Islamic finance. This includes the standards for capital adequacy, risk management and corporate governance taking into account the specific risks inherent in Islamic finance. While the regulatory regime is keeping abreast with dramatic changes that have transformed the international economic and financial landscape, key for the Islamic financial service industry to thrive in this new environment is that its level of resilience has to be strengthened further.

Early this year, the IFSB Governing Board endorsed an independent report initiated by the IDB and IFSB which has proposed eight recommendations of which two of these recommendations are being implemented. The first is the establishment of the Islamic Financial Stability Forum (IFSF) as a platform to achieve the primary objective of building cross-border dialogue among regulators in efforts to promote financial stability, in the Islamic financial system. The objective of IFSF will be to facilitate better understanding of emerging developments in the Islamic financial system and their implications for national and global financial stability. The second is the development of a liquidity management infrastructure to facilitate cross border financial flows. This is a major breakthrough for Islamic finance. Not only does it address the issue of more efficient management of liquidity across borders but also it enhances competitiveness and addresses the issue of liquidity management in achieving financial stability.

The remaining recommendations involve strengthening further the institutional arrangements and financial infrastructure for Islamic finance. This includes extending the parameters for prudential standards to other segments of the industry to avoid migration to less regulated sectors. The IFSB is also now mandated to set the prudential standards for Takaful and capital markets.

The second remaining recommendation is strengthening of the safety net mechanisms which are compatible with Shariah principles, such as lender of the last resort facilities and emergency financing mechanism and deposit insurance. In the current regulatory reform by the international community, there is yet to be a consensus on the resolution framework. For Islamic finance, the efforts will be in parallel not only for resolutions of problem institutions within jurisdictions but also across borders.

The third relates to the accounting, auditing and disclosure standards to enhance financial reporting and allow for effective monitoring and assessment of Islamic financial institutions. The fourth relates to macro prudential surveillance framework to support prudential regulation which cannot always effectively deal with system wide stress. The fifth relates to strengthening the rating process and finally the sixth, relates to the capacity building and talent development so that the industry and the regulators are well equipped to deal with the issues and challenges in the new environment.

In the search for permanent solutions to put the financial system on a solid foundation, an issue that has been frequently highlighted is that this may result in higher financial intermediation costs that will have a disproportionate impact on economic activity. This is particularly relevant to emerging and developing economies. For Islamic finance, to avoid the over reliance on regulation to achieve financial stability, the strategy has been for the regulatory framework to be complemented with building the institutional capacity, relying on other policies including macro prudential measures, strengthening surveillance and an enhanced effectiveness of supervisory oversight.

Another more recent important development in Islamic finance is the increased significance of its international dimension driven by extensive interest and demand from different parts of the world, the internationalization of Islamic finance is shaping new global patterns of financial and trade flows. It is also facilitated by progressive liberalization of emerging economies in this recent decade. There is now increased presence of Islamic financial institutions beyond their domestic borders

and increased foreign participation in Islamic domestic financial markets. Correspondingly, the internationalisation process reflects the more inclusive global financial integration as it facilitates financing of international trade and cross border investment activities among the emerging and developing world. The wave of internationalisation in Islamic finance which continued unabated despite the recent global crisis has contributed to stronger investment and financial flows between Asia and the Middle East, generating mutually reinforcing growth prospects for both regions. This has in particular contributed to the deepening of financial and economic ties between Asia and the Middle East, which harnesses the complementarities in these dynamic growth regions to promote trade, direct investment and finance.

It has therefore becoming an important channel for fostering international financial linkages and in so doing is contributing to more balanced growth and development. The internationalization of Islamic finance has therefore not only allowed for further diversification of risks, it has also contributed to more efficient allocation of funds across borders from centres with surplus funds to regions with investment opportunities.

The importance of Islamic finance in strengthening financial linkages is evident in particular with the emergence of sukuk instruments to prominence as an attractive new asset class for investors and a competitive form of financing for businesses. The global sukuk market currently stands at almost US\$130 billion, with an average growth rate of about 40 percent annually. Having now become the most vibrant segment in Islamic finance, the sukuk market has evolved into a truly international market, generating significant cross-border flows as funds are being raised from beyond domestic financial markets.

As observed from the Malaysian experience, whilst sukuk has now become the preferred financing and capital raising option for the government and local corporations, our market has also seen a significant amount of participation and continued rising interest from foreign companies and multilateral institutions. Our sukuk market has also attracted investors

from across the globe. The recent issuance of Malaysia's USD1.25 billion sovereign sukuk in May this year was 6 times oversubscribed with a wide investor base from Asia, the Middle East, Europe, and the U.S, despite the prevailing volatile market conditions.

Conclusion

Let me now conclude. As we pursue with stronger vigour the agenda of balanced growth

and development, we have the potential to leverage on the increased role of Islamic finance in contributing to the global growth and global financial stability agenda. In addition, it can also be leveraged upon to foster greater financial flows across borders to contribute towards our agenda of enhancing a mutually reinforcing growth and the development agenda to achieve global aspiration of a self-sustaining, balanced and long lasting economic progress and development.

**World Congress of Accountants (WCOA):
“Islamic Finance: Strengthening the Global Financial Market”
Kuala Lumpur, 10 November 2010**

Keynote Address by

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Restoring stability in financial markets, resuming the efficient functioning of financial systems and reigniting a sustainable economic recovery are the pressing priorities in the current global environment. As financial markets across jurisdictions become more connected, and as economies become more inter-linked, the resulting increased interdependence has however rendered the search for solutions to be even more challenging.

While the extensive international response involving massive stimulus measures have contained the extent of the global crisis, it has however, not been sufficient to produce a self-sustaining long lasting economic growth. Over and above the regulatory reforms are the required restructuring, resolution and the other financial and economic reforms to address the crisis related and structural issues that are still confronting the world economy. These prevailing conditions can therefore be expected to result in an extended period of increased uncertainty.

In such a period of extraordinary challenges and uncertainties, Islamic finance has continued its global expansion and development. In addition, this recent decade has seen the increased internationalisation of Islamic finance. It is my great pleasure to join you today at this World Congress of Accountants to speak at this session on Islamic Finance and its introduction in the global financial markets. My remarks this morning will discuss the potential role of Islamic finance in the international financial system as it becomes increasingly internationalised and its role in strengthening international financial and economic linkages in the global economy. Of importance to this trend are both the inherent features of Islamic finance and the financial infrastructure development that have

contributed to its resilience and sustainability and thus its positive role in the international financial system.

The Islamic finance model

As a form of financial intermediation, Islamic finance incorporates several elements that guide the process of the mobilisation and allocation of funds. The Shariah injunctions fundamentally require that the financial transactions in Islamic finance be accompanied 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 accompanied with growth of underlying activities that have economic value.

Islamic finance also has its own inherent inbuilt checks and balances that address the issues in financial stability. Its value proposition of profit and risk sharing requires the appropriate due diligence, disclosure and transparency. The features inherent in Islamic finance, thus, emphasise the importance of governance and risk management. The contracts entered into therefore demands high standards of disclosure and transparency, which in turn, reinforces market discipline and minimises informational asymmetries. A further layer of oversight that acts as a safeguard against irresponsible practices is the Shariah board in the respective individual financial institutions that has an important role in ensuring that the business operations of Islamic financial institutions are in accordance with the Shariah principles. Thus, Islamic finance, embraced in its entirety, supports responsible and sustainable innovation that contributes towards the real economy and to society.

These important elements in Islamic finance provide the foundations on which it contributes to growth and development and towards preserving financial stability. Despite the turmoil and uncertainties in the global financial system, Islamic finance has demonstrated its resilience and its continued global expansion during this period. Expanding at an average annual rate of 20%, Islamic finance represents one of the fastest growing segments in the financial industry. The Islamic financial services industry is now approximated to be worth more than US\$1 trillion.

Of importance is that Islamic finance has also been able to respond to the changing demands of consumers and businesses by providing the range of differentiated products and services. Today, Islamic finance offers an extensive spectrum of innovative and high quality financial products and services that include consumer financing, asset and wealth management and products from the Islamic insurance industry and capital markets. Islamic finance has also demonstrated its capacity to undertake project financing with the sukuk market becoming a highly competitive fundraising option for large scale projects and infrastructure development.

Today, in Malaysia, we have developed a comprehensive Islamic financial system that operates in parallel with the conventional financial system. The Islamic banking system in Malaysia currently accounts for 20 percent of our banking system while the sukuk market accounts for more than 50 percent of the bond market that is now 98% of GDP. Following the liberalisation initiatives in this decade, there is greater foreign institutional presence and substantial foreign participation in Malaysia's Islamic financial system. Of significance is that the participation from multinational corporations and international financial institutions from both the Muslim and non-Muslim countries. The Islamic financial system in Malaysia is also well supported by a robust regulatory and supervisory regime, legal and Shariah framework, and payment and settlement systems that are also important in supporting its sustainability.

Islamic finance: Strengthening international economic and financial linkages

The internationalisation of Islamic finance has in a large part been facilitated by increased liberalisation initiated in this decade and by the further development of the international Islamic financial infrastructure. This trend has prompted Islamic financial institutions to venture beyond their domestic borders. Today, there are more than 600 Islamic financial institutions that operate in more than 75 countries. Similarly, the liberalisation of the Islamic financial markets has resulted in increased foreign participation to raise funds in these markets. This participation also includes institutional investors that have surplus funds for investment. This wave of internationalisation of Islamic finance has continued unabated despite the challenging global economic environment. In financing trade and investment activities, it has influenced new global patterns of trade and financial flows. In particular, it has strengthened financial and economic ties between Asia and the Middle East. In strengthening international financial linkages between nations, it reflects its potential for the diversification of risks and for the efficient allocation of resources across borders.

The fastest growing segment of the Islamic financial system is the sukuk market which has become a significant platform upon which international financial and economic inter-linkages are being fostered. Sukuk instruments are fast emerging as an attractive new asset class for investors while becoming a preferred financing and capital raising option for issuers. Growing at an average annual rate of about 40 percent, the global sukuk market has demonstrated its ability to effectively intermediate funds across borders, allocating surplus funds from one part of the world to productive investment opportunities in other parts of the world. Today, the sukuk market has become a truly global product, generating significant cross-border financial flows.

In tandem with the rapid internationalisation of Islamic finance, this decade has also seen the increased emphasis that has been given to the development of the international Islamic financial infrastructure relating to financial stability. The Islamic Financial Services Board (IFSB) was established in 2002 as the international prudential standard setting body for the Islamic finance industry. With only nine regulators as members when it was established, the IFSB now has membership of more than fifty regulators from both Muslim and non-Muslim countries. In considering risks that are specific to Islamic finance, the IFSB has introduced standards for capital adequacy, risk management and corporate governance as part of the regulatory regime to strengthen the resilience of Islamic financial institutions. The work of the IFSB has not only contributed to the orderly global expansion of Islamic finance, but has also contributed towards achieving a cohesive cross-border regulatory framework and international best practices for the Islamic financial system.

During this year, two new initiatives have been introduced to further strengthen the international financial infrastructure in Islamic finance and to promote the sound and efficient functioning of its financial markets. The first is the establishment of the Islamic Financial Stability Forum (IFSF) that serves as a platform for cross-border engagement among regulators to discuss efforts to achieve financial stability in the Islamic financial system. The forum aims to promote better understanding of the developments in the Islamic financial system and their implications for national and global financial stability.

The second major breakthrough for Islamic finance is the establishment of the International Islamic Liquidity Management Corporation (IILM) in October this year - a liquidity management infrastructure for Islamic financial institutions. It represents a concrete collaboration and commitment by twelve regulatory authorities to establish a mechanism for more efficient management of liquidity across borders, and to address the issue of liquidity management in achieving financial stability. Cumulatively, these efforts serve to contribute towards the continued resilience of the global Islamic financial system.

Addressing the financial reporting issues in Islamic finance

As the Islamic finance industry continues to grow and expand beyond domestic boundaries, the role and support of the accounting profession and standards setters will become more important. Applying the existing accounting frameworks and conventions to Islamic financial institutions may prove to be more challenging given the unique features of Islamic financial transactions such as the equity based and profit sharing contracts. In addition, given the risk sharing features of these contracts, it may raise the case for a higher level of transparency for users to better understand and be better positioned to assess the underlying risks and their likely financial impact.

More broadly, there are the questions on whether the current international accounting framework adequately addresses the different Islamic financial transactions, structures and business models which are continuing to evolve as the industry develops and matures. There are differences in views on how conventional accounting concepts, such as reporting based on substance over form, and cash flow discounting principles, can be applied to Islamic financial transactions. There is therefore a need for greater understanding on these issues to further evolve solutions that would improve the value of the financial reporting.

Harmonisation of financial reporting standards in Islamic finance

An important development that has accompanied the internationalisation of Islamic finance is the effort to enhance the cross-border comparability of Islamic financial transactions. In this area, the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) has made contributions towards improving the measurement approaches for Islamic transactions and the overall quality of financial statements. There has also been greater cooperation at the regional level through the recently formed Asian-Oceanian Standard-setters Group (OSG) to examine the technical issues in financial reporting of Islamic finance. The efforts by AAOIFI and OSG represent important contributions to current efforts to evolve

an accounting framework that is appropriate and that will support further the global development of Islamic finance. It is important that the standards setting bodies such as the IASB is engaged in this process to complement, and to leverage on the current global efforts to converge international accounting frameworks.

Conclusion

Allow me to now conclude. The internationalisation of Islamic finance pushes forward the new frontier that brings with it tremendous potential to become a further means by which cross border financial flows are intermediated between economies from different parts of the world. Islamic finance, as an increasingly important component of the international financial system can be leveraged upon to facilitate surplus funds to be

intermediated to economies that present new opportunities. As Islamic finance continues to gain global acceptance, strengthening the accounting reporting, auditing and disclosure standards are very much a vital part of this process.

As we enter this new phase of globalisation in which Islamic finance is very much a part of, the cumulative efforts of the standard setters, the regulators and the industry will raise the potential to address the many challenges before us. We need to leverage on the respective areas of strengths and address the weaknesses with unrelenting perseverance. While a more connected world may bring with it new vulnerabilities, I do believe it also brings with it new prospects for new opportunities, new relationships and new hope for a greater shared prosperity.

**Svein Gjedrem Colloquium -
“Role of Central Banks in Emerging Economies”
Norway 18 November 2010**

by

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Introduction

Central Banks continue to be challenged with changing demands as the environment before us is rapidly being transformed. These fundamental and pronounced changes have prompted calls for a review of the role of Central Banks in the financial system and in the economy. Frequently, such calls have been precipitated during a financial crisis, as was the case during the Asian financial crisis and more recently during this current global financial crisis. However, such institutional reforms undertaken in periods of exceptional conditions risks influencing the nature and direction of the reforms. While the reforms following a crisis may address the immediate term demands, of equal importance is the medium and the longer term implications of the reforms. Perhaps, an important lesson for Central Banks is that such reinvention and modernisation should be undertaken during the good times so that we will not be subjected to such changes during the worst of times. In essence, in such a dynamic environment, Central Banks need to continue to adjust and evolve to remain relevant and, thus, useful.

It is my great honour to be invited to speak at the Norges Bank Colloquium held in honour of Governor Svein Gjedrem. Let me take this opportunity to congratulate Governor Gjedrem for the achievements of the Bank under this leadership during his twelve year terms in office. My remarks today will focus on the role of Central Banks from the perspective of emerging economies and more specifically in the context of Central Banking in Asia as we confront the challenges in this rapidly changing global economic and financial environment.

Central Bank Mandates

While there is no unique blueprint for the design of the institutional arrangements for a Central Bank, of importance is that it needs to be relevant to our own circumstances. But of importance is that there is clarity on the mandate, the governance framework and the areas of accountability of the Central Bank. And that needs to be supported by the empowering legislation to ensure that the Central Bank has at its disposal the capabilities to deliver the mandate.

Central Banks in emerging economies generally have a broader mandate beyond the traditional mandates of monetary and financial stability. Even within these traditional mandates, the role of Central Banks have varied considerably. In the mandate of monetary stability, it has ranged from having the narrow mandate of price stability to the mandate where price stability is the primary role of the Central Bank while due consideration is also given to economic and employment objectives. While for some the mandates are clearly hierarchical, for others, the multiple mandates involve assessments of the trade-offs.

The Central Bank mandate of financial stability is less clearly defined particularly in circumstances in which the supervisory function does not reside in the Central Bank. The majority of Central Banks in emerging economies in Asia, however, has the responsibility of the supervisory function although for three of the region’s major economies - Japan, China and Korea, this function resides in a separate agency. Even for Central Banks that has the responsibility of the supervisory function, the specific outcomes to be achieved are less clearly defined compared

to the mandate for price stability. In Malaysia, our new Central Bank Act of 2009 has defined this mandate in terms of the risks to financial stability - that is, the risk of the disruption to financial intermediation, the risk of disruption to the orderly functioning of financial markets and the risk of loss of confidence in the financial system.

Common to most Central Banks in emerging economies is the mandate to develop the financial system. Given the stage of development of financial systems in emerging economies, this is an important mandate not only to enhance the financial intermediation process in the economy but also for the purposes of facilitating the mandate of monetary and financial stability. This mandate has involved institutional building, financial market development and the strengthening of the financial infrastructure including that of the payment systems and the legislative framework.

The decade of financial reforms and financial sector development that followed the Asia financial crisis have resulted in more developed and resilient financial systems that is now better able to intermediate the more volatile financial flows and to withstand shocks to the system. During the recent global financial crisis, most emerging economies in Asia did not experience any disruptions to the financial intermediation process and credit flows continued uninterrupted providing important support to economic activity. It also allowed the financial markets to facilitate the transmission of policies to support the economic recovery.

This developmental role is also significant in contributing towards preserving financial stability. The development of the domestic financial markets and the development of a more diversified financial system has reduced the risk of over concentration on the banking system, a feature that was prevalent during the Asian financial crisis. The introduction of new institutional arrangements has also been aimed at keeping abreast with innovation, the advancement in technology and the intensification of globalisation. It has also allowed for the adoption of a more balanced approach towards regulation in which it is complemented by the newly developed

mechanisms for surveillance including across borders, strengthened supervisory oversight and institutional arrangements for resolution.

Central Banks and Financial Markets

A more recently much discussed mandate is the role of the Central Bank in ensuring the orderly functioning of financial markets. Orderly functioning financial markets are vital not only for the efficient allocation of financial resources in the economy but it is also essential for the transmission of the monetary policy and for preserving financial stability. While competitive forces are expected to result in efficient and optimal outcomes, Central Banks in emerging economies have had the important role of balancing between the market forces and intervention with the objective of ensuring the orderly functioning of the financial markets. It needs to be recognised that several important preconditions need to be in place to generate equilibrium prices that reflect the underlying fundamentals. This includes the institutional and market infrastructure, the incentive structure, the rules of the game and the level of financial literacy that recognise and understand the market signals. When these elements are still yet to be fully developed in many emerging economies, it increases the risk to instability. Thus, as a result of the stage of development of such markets, or its size or prevailing market imperfections, emerging economies have tended to be more vulnerable to greater volatility and circumstances in which markets do not self-equilibrate. The recent global financial crisis has shown that such dislocations have occurred even in developed financial systems. Institutional structures and rules that become deficient and less relevant heighten the risk for such unstable market conditions. Experience has also shown that such market dislocations have severe and far reaching adverse implications on the overall economy.

For the effectiveness of such interventions, however, there needs to be clarity in the objectives to be achieved by such Central Bank presence and the results that are expected to be delivered. Of importance, there needs to be the recognition of the temporary nature of such interventions and the challenge of efficiently unwinding such presence when the objectives

are achieved. There is also the need to manage the risks of unintended consequences of such direct Central Bank interventions. Such risks could include the potential for circumvention, or the gravitation to other markets not protected by such intervention. There could also be potential costs associated with such interventions, not only the current costs, but also the cost to future generations.

While the pace of deregulation and liberalisation may differ across emerging economies, there is a discernable distinct shift to greater market orientation in this recent decade. These reform efforts have been reinforced by efforts to develop the financial markets and financial infrastructure. Within this framework, the nature of intervention has been in the form of direct presence in the financial markets, the setting of rules and regulation, and in the resolution of problem financial institutions. Such interventions were evident during the Asian financial crisis in the late 1990s to restore stability in the financial markets. This in turn created conditions for the resumption of the financial intermediation process. While the efficient functioning of the financial system was vital for the economic recovery in Asia, more important was the comprehensive set of policies that produced the recovery. Within a year of the introduction of the pro-growth measures, most of the crisis affected economies experienced a strong recovery.

More recently, the global financial crisis has seen several rounds of wide ranging direct market interventions to restore the smooth functioning of these markets. Described as actions taken in the most extraordinary and exceptional circumstances, it demonstrates that this phenomenon of severe market dislocations has the potential to occur even in the most developed of the financial systems. As these massive interventions continue, primarily in the public and private securities markets, the concern is on its potential consequences on other parts of the world, in particular, to the emerging world. In the now more interconnected and interdependent world, these actions are already creating significant shifts in capital flows. Important for

the emerging world is the ability to intermediate such surges in capital flows and to manage the risks associated with such liquidity inflows and its potential to undermine the current recovery.

A further element that has frequently been underestimated is the role of behaviour which has had a major influence on the dynamics of the financial markets. Extreme forms of such behaviour are evident in asset and foreign exchange markets. While the former is prone to boom and bust, the latter is prone to overshooting. While several emerging economies have successfully relied on macro prudential measures to contain the formation of such asset bubbles, the foreign exchange market is not like any other market. With a daily transaction amounting to USD4 trillion, it is the most liquid and dynamic market in the world. The role of sentiment and expectations has resulted in a market that is frequently prone to excessive movements and overshooting. As highly open economies, disruptions and disequilibrium in the foreign exchange market have far reaching consequences in the real economy. Intervention operations to maintain orderly market conditions reinforced by sterilisation operations have aimed at ensuring liquidity in the market and at ensuring that the market conditions reflect the underlying economic fundamentals. Similar to the presence in other financial markets, this is to ensure the sustainability of the efficient functioning of the market.

Central Banks and Crisis Containment and Management

The world going forward is likely to continue to be affected by financial crisis. History has shown that there have been more than a hundred distinct banking crises in this recent two decades. The prospect of surviving such a crisis is not only about building resilience but also having the capacity to manage it. Central Banks have a critical role in crisis containment and management, in particular, to provide liquidity, to restore the efficient functioning of financial markets, to lead resolution programmes and to restore confidence to the financial system.

Given that the Central Bank is the lender of the last resort, the Central Bank is in the front line of actions to restore stability. Regardless of the institutional arrangements for the supervision function, - of whether it is based on an integrated model or a model that is organised along sectoral lines, effective coordination is vital to effectively safeguard financial stability. Established arrangement for coordination avoids a piecemeal approach by any individual agency in the system and ensures a comprehensive response to the crisis. Greater coordination across agencies also allows for prompt actions to be taken.

Elements for crisis management have largely been put in place in several of the emerging economies in Asia. This has included a framework for rigorous surveillance for the early detection of risks and vulnerabilities, the range of policy instruments to address the build-up of risks, the governance and accountability framework as well as the coordination framework. Regardless of whether the supervisory responsibility resides at the Central Bank, the role of the Central Bank in surveillance for macro-economic management, and its direct contact with the financial markets in its money market and reserve management operations can be leveraged upon to support the financial stability mandate. This allows for a more comprehensive response in containing and managing the crisis.

In Asia, as regional financial integration intensifies, there has been greater regional cooperation and collaboration. During the Asian financial crisis, the management of the crisis was by the individual economies. As the challenges become more complex, standalone actions may not achieve the desired outcomes. Moreover, the perceived best solution for one country may have unintended consequences for collective stability. Asia has, thus, come together collectively to conduct regional surveillance with concrete steps to establish financial support networks, to develop regional financial markets and payment systems. Such collaboration also provides a collective voice and representation and the potential to be heard in the sphere of global policy formulation.

Modernisation of the Central Bank

As central banks advance forward into the future of great uncertainty, the challenge of the new environment demands new institutional capability for the central banks to remain effective in delivering our mandates. Central Banks also need to undertake its own transformation and modernization. Such institutional capability enhancement may involve changes in the institutional arrangements, organizational and governance structures and practices, the empowering legislation and the talent required. Such organisational development would thus require continual reinvention to adjust to the new realities of the changing environment.

In most emerging economies, the largest concentration of talent resides in the Central Bank. In this new environment, this talent needs to have new capabilities to deal with complex issues from different perspectives that are no longer based on functional boundaries. While this involves horizontal collaboration across the organization, it also requires management of relationships including with the government while retaining the independence of the organization. This would require institutionalizing the channels for information flows, governance structures and clarity of accountabilities as well as the mechanisms for dealing with disputes. Cumulatively, this would provide for a constructive relationship while preserving the independence of the Central Bank.

An essential element in Central Banking that is paramount in an environment of great uncertainty is having a well-developed communication strategy. Unlike the mature evolution of communication strategy in the conduct of monetary policy, Central Banks' communication with respect to financial stability is still very much in its early stage of development. Indeed, the recent crisis has clearly surfaced the need for Central Banks and policy makers to design communication strategy that balances the objective of providing information to the market and the public, while achieving an optimal outcome of enhanced financial stability.

Conclusion

Allow me to conclude. The rapidly changing global economic and financial environment will continue to exert much demands on the Central Banks. While extensive modernization and transformation of Central Banks can be implemented at the national level, the increasingly interconnected and interdependent

world demands a greater emphasis on global perspectives and considerations. The greater interface at the international level has involved enhanced engagement to concrete collaborative actions. The common objective is surely for an inclusive participation in the international financial system that will facilitate the common agenda for a self-sustaining global growth and development. Thank you for your attention.