SPEECHES

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Making Globalised Financial Markets Work

Dinner Address
Pan Pacific Hotel, Kuala Lumpur
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by Dato' Dr Mohd Munir Abdul Majid
Chairman, Securities Commission, Malaysia

1. Ladies and gentlemen:

2. It gives me great pleasure to be given the opportunity to address you this evening. Before I begin in earnest however, allow me to extend my warmest congratulations to Dr Thillainathan and his team who have assembled a formidable set of speakers, each respected as an expert in his own right, and for identifying a theme which I am sure occupies a significant proportion of our thoughts as financial professionals within this region.

3. With your indulgence, I would like tonight to also put on my hat as the Chairman of the International Organisation of Securities Commissions' (IOSCO) Emerging Markets Committee (EMC) while sharing with you my thoughts on what I believe is perhaps the key to making globalised financial markets work.

4. As some of you may already know, the EMC's Working Group on Secondary Market Regulation has recently completed a report entitled the Causes, Effects and Regulatory Implications of Financial and Economic Turbulence in Emerging Markets. This document was released as an Interim Report of the EMC at the IOSCO annual conference held in Nairobi last month.[1]

5. This report identifies various factors-those domestic to the economies which were worst afflicted by the crisis and also those which were external to the economies concerned-to which the crisis now afflicting emerging markets world wide can be attributed. As for the domestic factors, it is now generally accepted that the 'poor fundamentals' of the emerging markets of East Asia cannot provide an adequate explication of the persistence and virulence of the financial tsunami that has rocked

the region, if not the world.

6. Even Professor Paul Krugman of the Massachusetts Institute of Technology, a long-time advocate of the 'fundamentals' view, has recently conceded in Washington that he was wrong on this front and that the East Asian crisis is proof that self-fulfilling financial panic plays a more significant role in explaining financial crises than was previously accepted.[2]

7. There is now a growing recognition that in addition to the role of financial panic, the external factors namely, the existing structure of the international financial architecture and the nature of international trading activity have contributed not an insignificant part to the outbreak and depth of the East Asian crisis. It is being questioned if unfettered market capitalism, which up till a year ago was the widely held orthodoxy is a sustainable means for the propagation of global prosperity.

8. It is against such a backdrop that I would like to highlight some of the key issues raised by the Interim Report of the EMC. Amongst other things, the report argued that the increasing integration and globalisation of financial markets and international financial activity have not been matched by a corresponding evolution in the thinking and practice of financial regulators.

9. In particular, the report notes that, over recent years, global financial activity has become increasingly complex and dynamic. This has resulted in, amongst other things, an evolving landscape that has seen the blurring of previously convenient distinctions between institutional arrangements and financial activities. As a consequence, the scope and nature of financial activities have in essence outgrown the traditional regulatory structures and jurisdictional boundaries that the international community has imposed upon them. Like a butterfly emerging out of its cocoon, international financial markets have metamorphosed, with the aid of advances in telecommunications and information systems, into something that the international community is ill prepared to deal with.

10. For example, the issue of systemic risk, long a domain of central bankers, has now been recognised to be one which requires also the attention of securities regulators. The East Asian crisis clearly demonstrated that financial systems of countries could not be practically dichotomised into banking systems and capital markets. The inextricable links between the two have meant that there is an increasing need for a holistic approach by both banking and securities regulators, and possibly even insurance regulators, to manage systemic concerns.

11. Other areas where market innovation and evolution have clearly outstripped existing regulation are that of international investors and trading activities across different asset markets. Certain groups of international investors that differ essentially only in legal form but not economic function are, under existing arrangements, subjected to differing regulatory standards. Similarly, it was also found that financial activities across different asset markets are accorded different regulatory treatment notwithstanding the fact that the same regulatory concerns, such as market integrity and systemic stability, are valid across all markets.

12. Consequently, regulators were stymied and frustrated in their attempts to monitor market activity and take the appropriate policy responses to correct any market failures. The heartbeat of financial regulators was perhaps best described by Mr Hans Tietmeyer, the President of Germany's Bundesbank, when, in relation to the recent Long-Term Capital Management (LTCM) debacle, he reflected, and I quote, "we need to examine whether the large hedge funds can continue to stay outside any surveillance".

13. These findings of the EMC Report in part reflect the orthodoxy prevailing in the regulatory community that has focused, rather asymmetrically if I may add, on the importance of protecting the suppliers of capital. The conventional thinking then was that atomistic suppliers of capital needed the assurance of integrity and equity in the market place to entrust their surplus capital to potentially productive ventures. As such, the onus of proof fell on the promoters-the users or demanders of capital-who had to embark on strict disclosure regimes to convince would be investors of their bona fide intentions.

14. However, it would appear that the advances in telecommunications and information systems coupled with financial innovation over the last three decades or so have rendered such orthodoxy increasingly obsolete or at least in dire need of a review. There appears now, in my opinion, to be a robust case for disclosure standards to be emphasised equally of suppliers of capital, not just with respect to users of capital alone. In particular, the argument is especially strong in the case of large sophisticated institutional investors who engage in significant cross-border activities as the amount of capital they manage is oft-times significant in relation to the size of many emerging market economies.

15. I would argue, that economic agents that tap the international capital market, as much as agents who choose to supply capital to such a market, have inalienable rights to an efficient, stable and fair market environment. As such, in so far as

promoters of securities are required to disclose information, so too should large cross-border and cross-market investors and others who engage in largely similar activities be required to provide relevant disclosures.

16. The rationale behind this, in my mind, stems simply from an extension of the asymmetrical information argument which has been used to justify the hitherto prevailing orthodoxy. That is, given that promoters of securities have always been held to have more information about the true viability of their projects, strict disclosure regimes would alleviate this informational asymmetry. Conversely, one may argue that the increasing scale of investors and the sophistication of international trading activities are such that the informational landscape may now be tilted, undesirably, in their favour given that they-large sophisticated investors- now also have the added advantage of actually influencing, at least indirectly, the outcome of the said investment opportunities.

17. The months following the East Asian crisis saw opinion and editorial pages filled with obituaries of the Asian model and calls for greater transparency within these economies. In fact, some even went so far as to single out the lack of transparency as one of, if not, the cause of the crisis. While it is not in dispute that a lower level of transparency in the emerging markets relative to industrialised economies did indeed contribute to the evolution of the crisis, singling it out as the or a major cause of the crisis leads, as one commentator puts it, to the commission of the post hoc, ergo propter hoc sin.[3] Explanations of the crisis must, by the dictates of logic, be reconcilable with the successes of these economies prior to the crisis. Otherwise, we would simply be drawing spurious causal links between coincidental factors which happened to be present prior to the crisis.

18. The weight of evidence and the force of logic lead one to question such assertions when one recalls that even notably transparent industrialised economies such as Finland, Norway and Sweden were not spared financial crises in the recent past. In addition, there were also economies, which were significantly more opaque than the worst afflicted economies of East Asia which were left relatively untouched by the financial contagion.

19. As such, while I agree that full and complete disclosure on the corporate side will provide for greater transparency in investment activity, there must also be a similar need to remove some of the opacity which exists in respect of certain categories of international investors.

20. Moving on to Washington, ladies and gentlemen:

21. I am sure that you have been following as keenly as I have the hive of activity over the past two weekends. While I must concede that the Clinton-Lewinsky affair makes for interesting reading, I am actually referring to the back-to-back meetings of the G7, the G22 and IMF/World Bank Annual Meetings.

22. Firstly, let me say that I am very glad that the global community now acknowledges the urgency of the situation which we face. The IMF's Managing Director, Mr Michel Camdessus, in his remarks at the Closing Joint Session of the Annual Meetings on 8 October 1998 noted that, and I quote, "it is clear that we face a systemic crisis". With global concern, I believe that the probability of much-needed concerted action to deal with a regional crisis that has become global in scope and scale has increased significantly.

23. Nevertheless, I continue to have some concerns over the pace at which the global community is moving. The G7 for example, stopped short of calling for concerted interest rate cuts and said that it would only 'explore' Clinton's so-called 'anti-contagion' plan which essentially allows for the extension of loans to countries which are fundamentally sound but may be susceptible to financial contagion. Global markets-a useful, though not infallible, evaluator of policy-reacted to the G7's action by registering significant declines the next trading day immediately following the meeting.

24. Another pleasing development arising from the meetings was the G22 report on the International Financial Architecture which recommended that consideration be given to compiling and publishing data on the exposures of investment banks, hedge funds and other institutional investors. This, in my mind, appears to be a step in the right direction as I interpret it as one of the few initial hints of acknowledgement by the international regulatory community that there remains a significant blackhole on their radar screens.

25. As for the matter of capital controls, there now appears to be more rational debate and less dogma on the issue. The IMF has now conceded that in some circumstances they may be appropriate. I am sure that most of you would have read Mr Stanley Fischer's piece in a recent issue of The Economist where he concedes that capital controls can indeed provide an economy with short-term respite from external pressures.[4]

26. His caution over the long-term costs imposed by such controls is neither new nor unknown. As was recently noted, Malaysia's imposition of exchange controls only came after a clear recognition that our first preference-internationally agreed preconditions and safeguards against the destabilising effects of large capital movements-was not forthcoming. Mr Fischer himself recognised this when he noted that, and I quote, "we should … recognise that the lure of isolation from the international system will increase unless market turbulence settles".

27. From the recent tone of proceedings at the G7, G22, IMF and World Bank meetings in Washington, I would venture to surmise that there is a gradual recognition, albeit grudgingly in certain quarters, that in order to make globalised financial markets work, the clarion call for greater transparency must also envelope that of international investors who are able to take positions of up to 50 times their capital base.

28. Despite vociferous arguments put forth by the both our Prime Minister and the Financial Secretary of Hong Kong, neither could bring the point home as effectively as the LTCM debacle. While it is not yet game, set and match, I believe that there is increasing acceptance by the global community that the existing architecture of the international financial system clearly facilitates behaviour by individual agents whose private cost is far outweighed by the social cost to entire system. In my mind, this can be the only justification for the Federal Reserve's recent swift action to bail out and intervene so directly in the LTCM affair.

29. While central bankers and policy makers of some developing markets may feel vindicated, it is clear now that neither the industrialised nor the developing world has the moral high ground. We have all been laid low by our own complacency in believing that we could allow two of the basest of human instincts greed and fear to govern and, in the midst of the present crisis, to grip our markets.

30. Ladies and gentlemen:

31. Finally, I would like to take this opportunity before I close to make some comments on the recent policy initiatives by the Malaysian government. Some have labelled our recent imposition of exchange controls as regressive and reminiscent of the 'bad old days' of trade and investment barriers and isolationism. Others have suggested that the Malaysian economy is reverting towards an autarkic state. All of these cannot be further from the truth.

32. Firstly, the government has repeatedly stated that these controls are a means to an end, although they will not be removed until stability returns to financial markets and an appropriate global regulatory framework is in place. This point was repeated ad nauseam in Washington two weeks ago. Our Second Minister of Finance, Yang Berhormat Dato' Mustapa Mohamed, belaboured the point that this option was not our policy of choice and that our first preference was and continues to be internationally agreed preconditions and safeguards against destabilising effects of large capital movements over short periods of time. Unfortunately, it was clear to the Malaysian government in late August, even as it is clear to us now after the Washington meetings, that the prospects for an early international consensus to restore stability will not be forthcoming in the near future. We were left with no choice. We had to protect the economy. We could not allow social and political stability to be eroded and undermined.

33. However, Malaysia is not in anyway withdrawing from the international financial community or abandoning faith in the market mechanism. We are still actively engaged in international fora such as the G22 grouping, the APEC forum, IOSCO and others where we actively seek to promote reforms to the international financial system that ensure a truly level playing field for all participants. Similarly, no self-respecting economist can and would describe the Malaysian economy as a command economy. The market mechanism is still the best mechanism for resource allocation. But any economist in command of his subject matter would be the first to concede that the conditions under which such allocations are Pareto optimal are demanding to say the least and in most instances unlikely to prevail without some form of government intervention.

34. We are not, as some believe us to be, a xenophobic nation that is averse or hostile to all things foreign. On the contrary, we welcome all foreign direct investment and embrace the indisputable benefits of international trade with minimal impediments. Most prospective investors are pleasantly surprised to find that we have a highly motivated and educated English-speaking workforce that is not unexposed to western norms, that the extensive range of incentives to attract foreign direct investments have not been changed and that, in some instances, restrictions on foreign ownership have even been significantly relaxed. Upon further inquiry, these investors are often more surprised to learn that the recent exchange restrictions notwithstanding, the general convertibility of current account transactions; the free flows of foreign direct investment; and free repatriation of interest, profits and dividends and commissions, are all guaranteed by the government of Malaysia. Long-time foreign investors in Malaysia would be among the first to provide testimony that the government of Malaysia is a firm believer in private sector led economic development and market-driven policies.

35. Finally, the Malaysian technocracy and bureaucracy is not oozing with ignoramus policy makers dwelling in a Shangri-La of their own construct. We concede that as with any public sector machinery in the world, we have our fair share of inefficiencies and excesses. But we are fully cognisant of the fact that in addition to governing, we face the Herculean task of nation-building, of galvanising a diverse group of peoples and of harnessing their energies towards a better and brighter future together. I realise that this may be difficult for some of you here to appreciate but that simply means that you are far more fortunate than we are as you have already successfully charted that stage in your country's developmental process. But for us, it is but the beginning of our journey.

36. We have acknowledged that these are indeed challenging times for the Malaysian economy and the Malaysian people. We are cognisant of the much needed reforms. These new controls have never been intended, nor will they ever be intended, as substitutes for sound macroeconomic and financial policies. They were specifically designed to provide us with breathing space to ensure that the on-going structural adjustments could continue unmolested by external developments and exchange rate volatility.

37. Ladies and gentlemen:

38. In recent months, it has become fashionable once again to quote that bon vivant, John Maynard Keynes. As such, in keeping with fashion, let me quote one of the more memorable passages from his monumental piece, The General Theory of Employment, Interest and Money:[5]

I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants and politicians and even agitators apply to current events are not likely to be the newest. But soon or late, it is ideas, not vested interests, which are dangerous for good or evil.

39. Keynes recognised that it is really the power of ideas more so than that of vested interests that shapes the mind of policy makers. Columbia University's Professor Jagdish Bhagwati alludes to the so-called Wall Street-Treasury complex as a driving force behind the push for capital account liberalisation, but I suspect that Wall

Street intellects, as with the rest of us, are simply but a few of the million petals being carried by the stream of ideas.[6]

40. I, for one, am persuaded that the actions of the international community over the last one-and-half years have been driven more by an unquestioning faith in the idea of free market capitalism than an objective and rational analysis of the situation that has confronted us. Fortunately, recent indications appear to suggest that the international community has begun to unshackle itself from this dogma and shake off its apathy. It must now rise to the occasion.

41. Ladies and gentlemen:

42. May I bid you good evening, bon appetit and thank you.