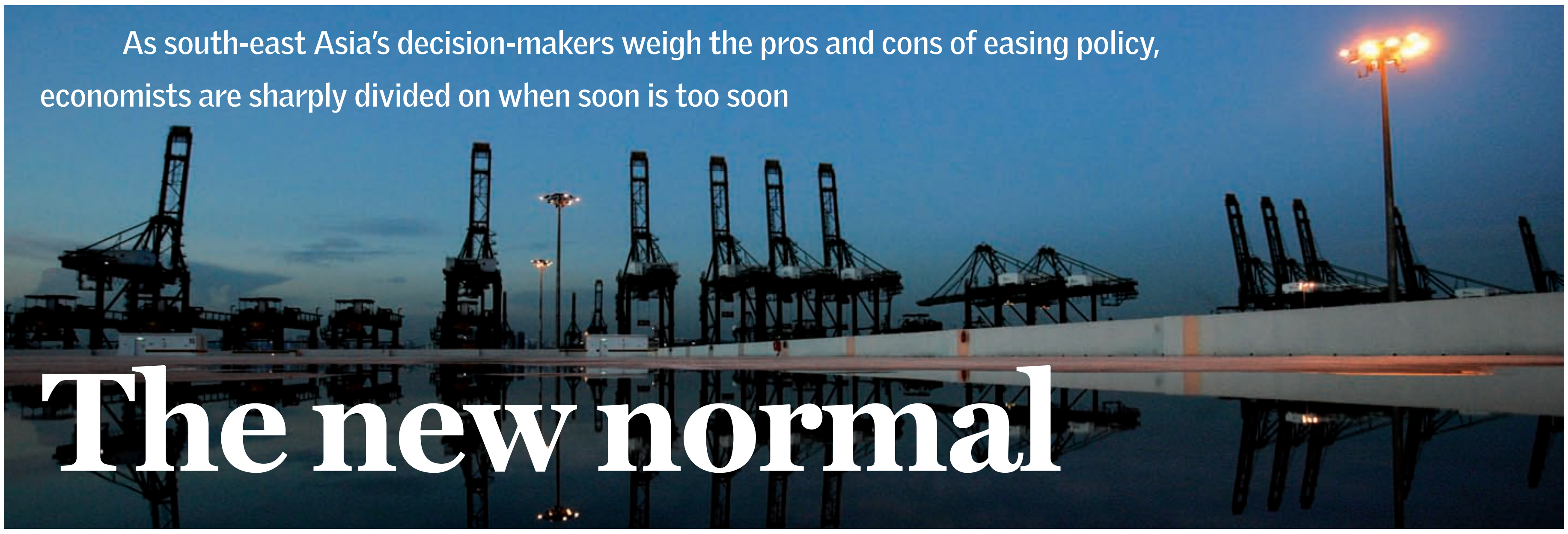

As south-east Asia's decision-makers weigh the pros and cons of easing policy, economists are sharply divided on when soon is too soon

# The new normal

Still sluggish
Idle cranes at the Port of Singapore Authority's Pasir Panjang container terminal

By Chris Wright

The global crisis struck Asia with a force that stunned a region that had thought itself, for a time, immune from the devastation in the West.

China's precipitous drop in output was accompanied by south-east Asia's own collapse in growth, as trade and capital flows dried up at the end of last year. In response, policy-makers eased policy fast, while rolling out a range of measures, including subsidies, transfers and widespread public investment.

A year later, growth has stabilized, supported by rising global demand, and easy fiscal and monetary conditions. "We see improvements," Zeti Akhtar Aziz, governor of Bank Negara Malaysia, the country's central bank, tells *Emerging Markets*. "The declines are moderating. If we compare quarter on quarter we see positive growth," she says. "For us, what is most encouraging is the improvement in domestic demand. It has benefited from the stimulus, but more importantly the continued access to financing has supported it."

Just as the slump in activity was concentrated in countries with high export dependency and large manufacturing sectors, so too the recovery, driven largely by exports and industrial production, with the region's economies expected to pick up in the coming quarters. "It's hard to know how much of the credit easing merely replaced lending that would have happened anyway," says UBS economist Edward Teather in Singapore.

Whatever the case, the mood in Asean (Association of South-East Asian Nations) has improved markedly in the second quarter. Consumer confidence has soared, reflecting an improving outlook for business, as well as stimulative policy settings. In Indonesia, the index of consumer confidence stands at 114.3, close to a decade high.

Now, several governments are signalling an end to fiscal and monetary expansion. And economists are puzzling over when the massive economic stimulus will be withdrawn from the system. "We all find ourselves pondering the risk" of economies' exit strategies from economic stimulus, says Teather.

The scale of the economic shock over the last 18 months should mean the removal of stimulus will be "tentative, cautious and halting", Teather says. But outside Malaysia, there is likely to be "some tentative removal of accommodation" starting in the second quarter of 2010 across the rest of the Asean economies.

Initially, policy-makers are likely to tread with caution. Hiking rates can incur real costs – including increased interest burdens for households and businesses – risking the delicate recovery of domestic economies. Questions remain whether the underlying financial health of businesses and households across the region is ready to sustain an increase in interest rates.

But as 2010 progresses, policy-makers are likely to rein in excess liquidity and tighten monetary conditions, Teather believes.

### LONG WAY HOME

Nevertheless, there is a long way to go before the region normalizes policy. As elsewhere in the world, Asean nations eased monetary and fiscal policy aggressively from the first quarter of 2009 – in Malaysia's case, for example, a 75 basis point cut in a single hit.

Singapore, Malaysia and Thailand eased most on the fiscal side, while Thailand and the Philippines relaxed monetary policy most substantially; Indonesia, which fared much better in the financial crisis because of the strength of domestic demand (gross exports account for only 30% of GDP and net exports barely 1%, compared to over 60% in Malaysia), eased policy least.

Asean economies also provided subsidized credit and increased government spending, and it appears to have worked, keeping some sem-

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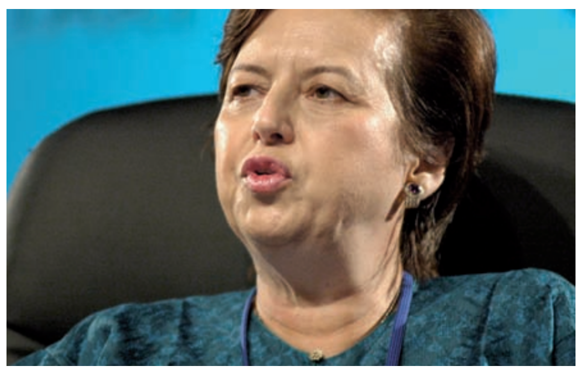
## Malaysia
# A test of strength

EMinterview



**Malaysia's central bank chief Zeti Akhtar Aziz is confident the banking sector is resilient enough to take on more foreign competition. But foreign banks want wider reaching licences before making the next move**

By Chris Wright

Malaysia's government and central bank believe its domestic banking sector is strong enough to stand up to foreign competition.

Since April, it has been taking the next steps in the liberalization of its financial sector, with new licences on offer, increased foreign equity limits, and more operational flexibility. Malaysia wants to liberalize in specific ways in order to serve its own needs, but it may find that foreign banks do not necessarily share its optimism.

"We put in place all the preconditions so that we would be able to benefit from liberalization, because liberalization should bring a mutual benefit to the entities that come here and to our own economy," says Zeti Akhtar Aziz, governor of Bank Negara Malaysia. She believes it will enhance international linkages for trade and investment; diversify the range of financial products and services available in Malaysia; and will bring technology and expertise.

There should be benefits to competition, pricing and arguably regional integration. "So far there has been significant integration in intra-regional trade and investment flows, but financial flows have been less significant," she says. "This liberalization hopes to [encourage] financial institutions from the region to operate in our domestic system."

Malaysia has already undergone a few rounds of liberalization since the Asian financial crisis, and today foreign institutions account for about 20% of total assets and 30% of lending market share. Liberalization has always been much more beneficial to Islamic institutions than conventional: in 2005 it handed out licences to three Gulf institutions (Kuwait Finance House, Al Rajhi and Asian Finance Bank) allowing them to set up 100% foreign-owned Islamic institutions with freedom

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## A test of strength *continued from page 28*

to do pretty much what they wanted, be it retail, commercial or capital markets.

The latest liberalization keeps that bias very much intact. The new licences come in two stages, with up to six to be granted this year and a further three in 2011. Of this year's haul, four are Islamic, two for Islamic banking licences and two for family takaful players. The two conventional commercial banking licences on offer this year are for foreign players who can bring in "specialized expertise to address gaps in the financial sector and spur the development of targeted economic sectors"; it's not until 2011 that the much more widely coveted broad commercial banking licences for "world-class banks that can offer significant value propositions to Malaysia" will be offered.

Equally, the increases in foreign equity limits are also tilted towards Islamic institutions. Domestic Islamic banks can accept 70% of their equity being held by foreigners. A 70% limit is also being applied to several areas on the conventional side, but again in more specific areas: investment banks and insurance companies (including takaful) rather than full-service banks.

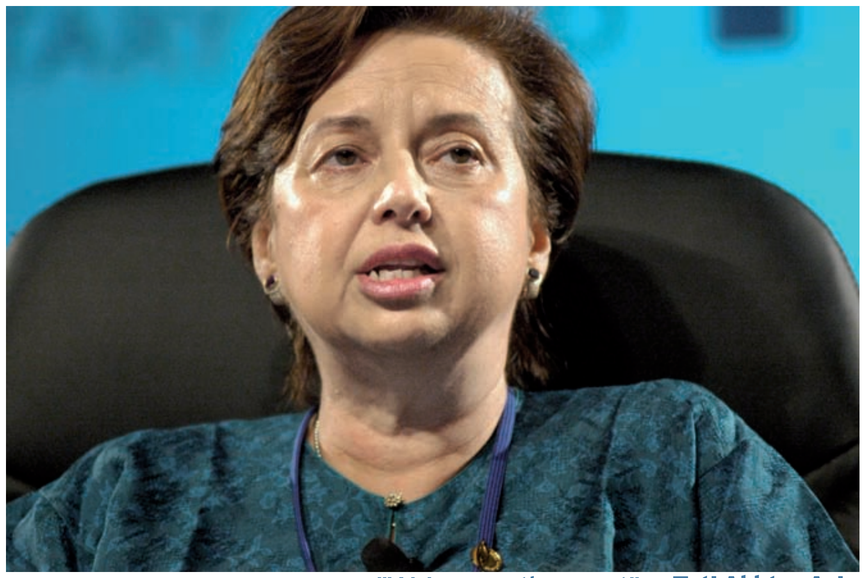
Some interesting points come out of this. On the conventional side, the 2009 licences may be so specific they end up not attracting anyone. *Emerging Markets* interviewed Zeti in September, less than eight weeks before the October 31 deadline to submit bids for the 2009 licences; at that point, she said firm bids had been lodged for the Islamic licences but not for the conventional ones. "For the specialized licences, they are engaging in discussions because they are not quite sure they can qualify," she says.

But what does specialization mean anyway? "We see some gaps that still exist in our financial system, so in terms of finance for certain sectors of the economy like technology and agriculture, we are looking to see whether we can draw in expertise," she says. "That need not be the only area, but they have to have a proven track record of strength in those areas."

### ENTHUSIASM

Foreign banks active in Kuala Lumpur have widespread enthusiasm for the wider-reaching 2011 licences but not for these specialized licences, and there is some doubt both domestically and internationally about whether they will ever be awarded. There's a difference, it seems, between Malaysia's hopes for foreign participation and the way foreigners want to participate. "There's just nothing in those [specialized] licences for us," says one foreign banker. "We are much more interested in the 2011 licences that will let us do things properly."

On the Islamic side, there are some curiosities too. The new Islamic banking licences, which can be 100% foreign-owned, have become known as "mega-Islamic" licences locally, because they require that the new banks have paid-up capital of $1 billion. That's setting the bar pretty high: by contrast, the new family takaful licences require only RM100 million ($29 million). Why so high?



"We've seen the worst" —Zeti Akhtar Aziz

"Because we already have quite a number of Islamic financial institutions, but they are all quite small in size," Zeti says. That's fine for domestic retail and financing businesses, she says, and there is already widespread foreign involvement in the sukuk markets. What she wants is international.

"In order to see the increase in international activity, you would need the kind of capitalization to be able to conduct international business that would originate out of Malaysia – capitalization in terms of technology, human talent and expertise," she says.

She says there are firm submissions for those licences already, and it's intriguing to ponder who they might be. The most obvious Middle Eastern institutions, Al Rajhi and Kuwait Finance House, are already present; of the multinationals, HSBC and Standard Chartered are already licensed, and while Citi Islamic does not have a licence on the scale of a new one, this seems an unlikely time for it to be putting large amounts of capital to work. It may be that an already-present player wants to upgrade to this symbolically more dramatic licence; otherwise, it's puzzling to predict who else will come in. Either way, though, it's highly unusual for any country to lower barriers in the middle of a global financial crisis, and there is clear confidence in the timing: as other banking systems fall, Malaysia believes it is strong enough to face the foreigners. "Our banking sector continues to be resilient," Zeti says. "We've seen the worst."

# The new normal *continued from page 28*

"Monetary and exchange rate policies across Asia will remain defensive over the next year" —Cem Karacadag

blance of business confidence afloat. Zeti says Malaysia has continued to experience loan growth, has no large-scale unemployment, low inflation, and is also assisted by rising commodity prices. "In addition, exports decline has moderated."

### TIGHTEN UP

Policy-makers could act to curb spending as they refocus on fiscal sustainability. Indonesia, the Philippines and Thailand have already put out estimates for the balance of government finances in 2010. They project a smaller deficit than in 2009, which suggests less stimulus. Malaysia has not been so specific, but analysts say it is heading in the same direction.

But concerns over excess liquidity and asset price inflation are also on the rise. Chinese authorities have already moved to rein in credit expansion and withdraw liquidity. Economists believe others may follow suit, using a range of tools including open market operations, FX forward intervention, reserve requirements, lending guidelines and hikes in stamp duties.

"As always, central bankers' decisions will be driven by their policy goals" – a combination of trying to maximize employment in the economy, preserve the value of money and keep stability in the financial system, notes Teather.

### NOT SO FAST

Still, others argue that Asian monetary conditions outside of China are accommodative, but rightly so for the foreseeable future.

"It has become fashionable to argue that Asia's monetary conditions are too loose and that too much domestic liquidity is creating asset price bubbles," says Cem Karacadag, an economist at Credit Suisse in Singapore. "The entire region is being painted with a China brush, which does not wholly apply."

Adds Karacadag: "Domestic and external demand are still fragile and money and credit growth are still sluggish. Central banks are certainly not printing money because of foreign exchange inflows."

It is neither obvious nor inevitable that liquidity in Asia will spill into the real economy or asset markets, says Karacadag. Instead, property prices have surged in places like Hong Kong and Singapore on the back of sentiment, not liquidity. Moreover, capital inflows have hardly returned, he adds. "All told, we think monetary and exchange rate policies across Asia will remain defensive over the next year," he says.

Data out of Europe and the US are encouraging but still uncertain; exports and industrial production in Asia, while improved, are below previous peaks; capacity utilization is low so it will be a while before investment demand recovers.

"Central banks certainly don't want to tighten policy through currency appreciation, given that export sectors are the weak spot in their economies." He adds: "Put yourself in the shoes of policy-makers."

Even so, Karacadag has been upgrading his real GDP forecasts across Asia; where recently he was calling -3.9% in 2009 and 4.4% for 2010 in Singapore, he now expects -2.4% and 5.7% respectively. He also expects import demand in G–3 economies to climb in the next few quarters, helping Asian exports.

But these improvements are not reason enough for central banks to start tightening in the near future, he says.

### LONGER TERM

Meanwhile, central bankers, while navigating their way out of the crisis, are also starting to think again about the longer term. "Our concern is mainly structural," says Zeti. "We want to make the economic transformation towards a higher-performing economy, towards new areas of growth, higher value-added activity, where we have a higher level of productivity and efficiency, and a more innovative industrial and services sector."

Malaysia's banks have transformed themselves since the 1990s into useful agents for corporate finance, alongside the development of the bond market, she says. "Now they need to transition to be able to provide financing for the services sector, for knowledge-based activities."

"The challenge for us is to have the skills to transform ourselves to that next level of economic performance and development."

Transforming economies is no mean feat, but it's at least encouraging that just a year on from a near-collapse of the global economy, central bankers can now talk in such terms. EM