



## Foreword

In early 1997, the fundamentals for Malaysia continued to remain strong as real GDP growth moderated to a more sustainable pace and the external imbalance narrowed. The broad strategy of the Government for the medium term had essentially focused on addressing structural weaknesses, with an investment strategy directed at export orientation and productivity improvement. Against this background, fiscal discipline was reinforced by monetary tightening to ensure overall macroeconomic stability. During this period, the supervisory framework in which the banking sector operated was tightened further to maintain a sound and resilient financial sector.

As the turmoil in the region unfolded, it imposed on economies the need to expedite and reinforce their adjustment policies. During the course of the year, policies in Malaysia were directed at further reducing the current account deficit in the balance of payments, increasing the fiscal surplus through significant cutbacks in public sector expenditure, reducing credit growth and containing inflationary expectations by tightening further monetary policy. To strengthen banking institutions, more stringent prudential standards were imposed on the recognition of non-performing loans (NPL) and provisioning, as well as requiring greater transparency on the financial positions of banking institutions. The authorities were, however, aware that the measures on their own would not lead to a complete restoration of investor confidence. Nevertheless, the measures would contribute to minimising the risks of destabilising contagion effects arising from developments in the regional and global financial markets. Of importance, the measures are aimed at building the foundation on which an early recovery could be achieved.

The economy expanded by 7.8% in 1997. This performance reflected mainly the underlying strength of the real economy where production was broad-based, with a strong export sector. Despite the onset of the regional financial crisis, growth in 1997 remained strong reflecting the structural adjustments that had been undertaken over the years. In particular, the banking sector was relatively resilient with NPL at a historical low. Policy that limited private sector foreign borrowings to those with foreign exchange earnings to service the debt helped to contain external debt at a manageable level. Short-term debt was also low, with the bulk of the debt already hedged. There was adequate domestic liquidity to support productive economic activities. The national savings rate remained high at 40% of GNP, while the country was at full employment.

The intensity of the contagion impact and the severe adjustments undertaken to restore confidence in the domestic financial markets are expected to have their full impact on the economy in 1998. While growth of the economy in 1998 will remain positive, it is expected to slow down to 2-3%. Growth is expected to be sustained by exports as domestic

demand is likely to decline due to lower consumption and investment. A positive development will be the dramatic improvement in the balance of payments position in 1998. The current account deficit is expected to narrow significantly to less than 1% of GNP, well below the target of 3% set under the Government's adjustment programme. Taking into account the impact of the depreciation of ringgit, inflation is forecast to double to a range of 7-8%. The inflationary pressure essentially reflects the direct and indirect impact of ringgit depreciation. The lower growth is also expected to result in a softening in the employment situation and unemployment could increase to 3.5%. However, a stronger recovery in exports and a positive response of the services sector to the depreciation could improve the growth prospects. Prospects for recovery will also depend on the restoration of stability in the financial markets.

In an environment of unprecedented depreciation of the ringgit, the commitment to tight monetary policy to contain inflation and to facilitate adjustments in the financial markets cannot be compromised. The objective of interest rate policy is to be pre-emptive in containing inflationary pressures and to help to restore investor confidence. The Bank will continue to exercise a judicious balance in managing monetary growth to contain inflationary expectations, while ensuring that the process of consolidating credit growth would not curtail productive investments. Of importance is that credit expansion is now already slowing down. A further encouraging trend is the higher proportion of credit being channelled to productive sectors. With the prospects for slower economic growth and higher NPL, some banking institutions have become more cautious in their lending operations, even for viable productive activities. While it is important to ensure that loan growth moderates to not more than 15% by end-1998, the Bank will continue to monitor the situation closely to ensure that banking institutions do not over-correct and deny access to bank financing for productive investments and activities. Such a situation could result in an adjustment in the economy that is more than warranted. The banking sector, therefore, has an important role in this adjustment process to ensure efficient intermediation in a difficult economic and financial environment.

Structural adjustments of the past have contributed to economic growth, strengthened the economic base and placed Malaysia in a stronger position to withstand the current financial turbulence. However, the turbulence has brought to the forefront, areas in which Malaysia is vulnerable to external shocks. Over the last decade, the international environment has changed dramatically. The emergence of a broader group of middle-income economies, all striving to expand through an export-oriented strategy, has altered the comparative advantage for Malaysian products. The Malaysian growth strategy, therefore, needs to adjust and adapt to these developments. In the real sector, while manufacturing activities would continue to lead growth, there is a need to develop strategies to enable the sector to meet global competition. The key electronics sub-sector is increasingly becoming more vulnerable to external competition. The linkages in this area to the development of the Multimedia Super Corridor would help to ensure that value added from the latter could be enhanced. There is a need to revitalise the agriculture sector to produce food competitively and to provide the raw materials needed to expand the resource-based industries. New growth areas are also required to promote a broad-based agriculture sector. Previous proposals to develop strong ancillary services to support the industrialisation drive are still relevant. Selected service industries where

import content is low and foreign exchange retention is high, such as tourism and education, require co-ordinated national strategies to realise their full growth potential.

In the financial sector, the globalisation of international capital flows amidst the liberalisation of capital accounts has improved the intermediation of funds on a global scale. Malaysia, undoubtedly, has been able to enjoy rapid economic growth partly because of the strong foreign direct investment flows into the country, while the shorter-term foreign capital flows have added liquidity to the capital markets. Depending on their nature and scale, such flows have also been destabilising. However, economic isolation and capital controls are not an option for Malaysia. On the contrary, policies have been directed at increasing the resilience of the economy and the financial system to enhance the ability to adjust to these capital flows. In this regard, the appropriate mix of macroeconomic policies becomes important. Hence, policy has also focused on the promotion of transparency and the disclosure of information by corporations and financial institutions so that investors can make informed decisions. This would help to strengthen economic resilience. The disciplining power of the market would promote good corporate governance. However, this can only be expected to yield positive results under conditions of rational and efficient markets.

The focus of banking policy in recent years has been to consolidate the industry, an important building block in the further development of the financial system. At the same time, the favourable economic performance of recent years has contributed to strong asset quality and facilitated the build-up of capital and reserves to healthy levels. As a result, the capital and reserves of the banking industry have increased by RM35 billion over the last five years to RM47 billion at the end of 1997. The industry, therefore, entered the period of financial turmoil from a position of strength. While the banking sector is likely to experience the strains of a difficult environment, stress tests conducted by the Bank revealed that even under extreme conditions, only four banking institutions would need capital injection amounting to a total of RM2 billion, in order for them to comply with the minimum risk-weighted capital adequacy ratio of 8%. Even in these cases, the banking institutions would remain solvent. The parameters of the stress tests have incorporated a possible deterioration in property and share values, contingent losses of subsidiaries of banking institutions, including their overseas operations, and potential future provisioning for NPL. As part of the policy to consolidate the banking sector, merger initiatives have been intensified. Mergers among several banking institutions are now well underway. These are expected to result in the emergence of a core of large and stronger institutions.

The financial turbulence provided a further impetus to both the Bank and the industry to forge ahead with efforts to further strengthen the banking system in terms of sound banking practices, stronger prudential regulations, supervision and corporate governance, greater transparency, as well as further progress in institutional and market development. The trend will be for a further tightening in the areas of provisioning rules for sub-standard loans and off-balance sheet items. Although these measures may amplify the problems faced by some banking institutions, the adoption of more rigorous requirements will result in stronger balance sheets in the future. These measures will augur well for investor confidence and enhance the capacity of the banking institutions to contribute effectively to economic recovery.

The supervisory framework and standards will continue to be benchmarked against international standards and the best banking practices. Towards this end, supervisory requirements which are no longer relevant will be replaced or modified so that they are more effective and responsive to the changing environment. A new liquidity framework will also be introduced to provide the Bank with more effective means to assess the actual liquidity position of banking institutions. At the same time, the framework will provide the banking institutions with a more efficient mechanism to manage liquidity. The current capital adequacy framework will also be expanded to incorporate market risks. Banking institutions, on their part, would have to continually improve their internal governance, review the effectiveness of their risk management policies and practices and upgrade their skills.

In respect of financial market development, the creation of broad and deep markets with a spectrum of financial instruments and players would improve the management of risks in the financial system. At present, much of the credit extended is intermediated through the banking system. As a result, the risks associated with any cyclical downturn in the economy are concentrated in the banking system. Therefore, the development of alternative sources of funding and secondary markets for financial papers would allow for greater diversification of risks. These changes will enhance the capacity of the economy to assume risk in a more efficient manner in terms of lower cost, greater liquidity and the allocation of risk to those players that are better able to manage them. In this connection, significant progress has been achieved in the development of the private debt securities market in terms of developing the infrastructure and the issue of benchmark Khazanah bonds to assist pricing. Another important aspect of development is the presence of dynamic and progressive market players.

In developing the financial system, due consideration needs to be accorded to the critical success factors as well as their implications on the stability of the financial system. In this regard, a well co-ordinated and concerted effort would contribute to achieving the objective of developing a financial system that is more robust so that monetary and financial stability is preserved. The system would then become more market-oriented to support business activities and complement other sectors in making a greater contribution to GDP growth.

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