Foreword

In 1998, Bank Negara Malaysia was confronted with the most difficult and challenging year in managing the financial system and the economy. The Asian financial crisis led to changes in the Bank's monetary and exchange rate policies that triggered widespread debate and concerns on policy responses to the crisis. The Bank and the Malaysian authorities would, however, be judged by the results these measures bring as the year 1999 unfolds.

Although there was general consensus that the economic fundamentals and banking supervisory standards in Malaysia were much stronger, real output declined sharply by 6.7% in 1998. The crisis also had resulted in the deterioration of regional demand by such an unforeseen magnitude that conventional fiscal and monetary policies to address the external current account deficit and inflation resulted in an over-adjustment of the economy. The tight fiscal and monetary policies adopted in late 1997 and early 1998 caused aggregate demand to fall more sharply than anticipated which then led to a curtailment of business and commercial activities and an increase in non-performing loans (NPLs). When the demand in East Asia collapsed, export performance was affected which in turn had consequences on overall growth. In the face of all these risks, Malaysia had to act quickly and decisively to protect its economy. In July 1998, the National Economic Action Council announced a comprehensive National Economic Recovery Plan to bring about stability and expedite economic recovery.

A priority of policy was to ensure that the payments system and the intermediation function continued to operate efficiently without interruption. This was crucial to maintain confidence and to ensure that economic activity did not grind to a halt. The guarantee by the Government for deposits placed with the banking institutions was issued in late 1997. This was an important decision that provided the necessary stability for the effective implementation of policies and reforms aimed at addressing the potential deterioration in asset quality and capital strength of banking institutions, in an environment of regional financial market turmoil that did not seem to abate. It was recognised very early on that it was important to put in place appropriate mechanisms to deal with potential banking sector problems to contain its severity and to ensure market confidence. In January 1998, the merger programme for finance companies was announced, based on market principles, to consolidate and strengthen the industry as this segment was the most vulnerable to the adverse effects of the economic downturn. This was reinforced with the establishment of Pengurusan Danaharta Nasional Berhad (Danaharta) in June, followed by Danamodal Nasional Berhad (Danamodal) and the Corporate Debt Restructuring Committee (CDRC) in August.

Stability in Malaysia was also threatened by the growing internationalisation of the ringgit. In this environment, the traditional policies would not guarantee stability in the domestic market. External risks threatened to erode the gains achieved under earlier policies and result in further contraction of the economy. If not addressed, further loss of incomes could threaten the social fabric. A sense of social responsibility to the general public prompted Malaysia to consider other viable policy options to protect Malaysians from further economic hardship. Given the lack of response from the international community to address inherent weaknesses in the international monetary system, the Malaysian authorities moved on 1 September 1998 to impose the selective exchange controls to prevent the internationalisation of the ringgit. The controls were selective, aimed at achieving specific objectives, and designed not to affect foreign direct investment, while the current account remained fully convertible.

The authorities have taken full advantage of the period of stability accorded by the controls to ensure an economic recovery. Contrary to market expectations that the controls would delay economic reforms, the restructuring of the financial and the corporate sectors has been accelerated. Danaharta has acquired and managed NPLs from the banking institutions amounting to RM15.1 billion, equivalent to about 20% of total NPLs in the banking system. Including NPLs acquired from the other financial institutions, total NPLs acquired and managed amounted to RM21.7 billion. Danamodal has injected RM6.15 billion into 10 institutions. Of the 10, seven have signed Definitive Agreements to convert Exchangeable Subordinated Capital Loans into permanent Tier-1 and/or Tier-2 capital. Of the 48 applications received involving RM22.7 billion of debt, the CDRC has successfully implemented debt restructuring schemes for two companies. In addition, the CDRC had recently announced the restructuring proposal for one of the largest conglomerates involving debts of RM8.4 billion. These schemes have been achieved without the involvement of any Government funds. The restructuring process will continue to be accelerated. By end-June 1999, Danaharta would have completed the acquisition process and Danamodal would have completed the recapitalisation of those banking institutions whose shareholders are unable to inject the required capital. The progress to date and the acceleration of the restructuring process augur well for the ability of the banking system to respond effectively to support the recovery process during the course of 1999.

Following these developments, consumer confidence has been revived. While investor sentiment remains cautious given the uncertain regional and global outlook, it has not worsened. There are indications that the trough in the growth cycle had been reached in the third quarter of 1998 and prospects are for a gradual recovery in 1999. The balance of payments and the external reserves position have strengthened. Higher loan approvals do not indicate pressures of a credit crunch. Inflation continues to moderate and the fiscal deficit is manageable, funded mainly by the high domestic savings. Greater stability in terms of the foreign exchange and stock markets and the financial system has encouraged a steady revival in consumer and investor confidence. These pre-conditions should support a positive growth in 1999.

Export performance has improved significantly in recent months, rising by 12% in United States dollar terms. However, production has lagged, with the manufacturing sector still contracting in January 1999. This is largely due to the high inventories that were built up in the first half of 1998. Indicators, however, point towards a progressive easing of excess capacity in the near term, which will enable production growth to respond with some lag.

In the uncertain global environment, Malaysia cannot depend on export demand alone to lead the economic recovery. Hence, in 1999, the counter-cyclical fiscal policy would continue. Of importance is the need for the full implementation of projects financed by the fiscal deficit of 6% of GNP. Monetary policy will continue to be accommodative in 1999. Interest rate policy will continue to depend on domestic developments, in particular the efforts to contain inflation and to provide adequate incentives to promote deposit mobilisation to finance new lending. The Bank will also continue to persevere with its efforts to encourage banking institutions to respond and support the reform and recovery process.

The funding of the fiscal deficit and the restructuring of the financial sector has remained manageable. The fiscal deficit will be financed by both domestic and foreign funds, with sources for the latter comprising mainly borrowings from multilateral and bilateral sources. Financing for the recapitalisation of the banking institutions and the acquisition of NPLs has mainly been drawn from the excess liquidity in the banking system that has been generated by the current account surplus and the high savings rate. The contingent liability of the Government has also remained manageable. A significant part of the bond issues that had been taken up by the banking institutions did not require Government guarantee.

Although the high savings and the current account surplus will provide adequate sources of funds in the economy, Malaysia continues to welcome foreign direct investment. The level of foreign participation in the Malaysian economy has always remained high, particularly in the manufacturing, oil and gas sectors. In the financial services sector, the foreign share in the banking sector is more than 30%, and in the insurance sector, the foreign share of life insurance premiums is more than 70%, and for general insurance premiums, more than 30%. In attracting foreign players into the financial system, consideration will be given to the role they can play to make the sector more dynamic and competitive. In the meantime, the focus of policy will be to strengthen the Malaysian-owned financial institutions in terms of capacity and capability so that they would be ready to compete in a more liberalised environment. Foreign banking institutions have and will continue to play an important role in supporting Malaysia’s economic development and in sharing both its prosperity and difficult times.

While the current emphasis is to expedite the resolution of the NPL problem, the banking sector must also be developed to meet the challenges of the globalised financial markets. Hence, efforts would be directed towards developing an early warning system to better anticipate future shocks, promoting a competitive banking sector that would support future growth as well as increase its own contribution to this growth. Emphasis is also being given to accelerating the development of the bond market to reduce the concentration of risks in the banking sector. A master plan is being charted that would identify the steps and policy direction to develop the banking industry in the next decade. While Danaharta and Danamodal are instrumental in addressing the sources of systemic risk in the banking system, a more holistic approach is also being adopted to instil greater discipline, promote a change in management culture and, more importantly, inculcate sound risk management practices in the banking institutions. These measures will be reinforced with more intensive and regular supervision of banking institutions by Bank Negara Malaysia with emphasis on early detection of potential areas of vulnerabilities and the implementation of timely corrective actions. In addition, a programme is being launched to upgrade the technical expertise of regulators and supervisors to keep abreast of developments in the financial markets.

In the real sector, additional measures at the micro level to accelerate recovery will be introduced. To reduce the over dependence on just a few export-oriented industries and in order to contain the vulnerability to external shocks, new areas of growth with high economic linkages with the rest of the economy, low import content and high value added should be more actively encouraged and promoted. These include resource-based industries and selected services sectors, such as education, port services, recreation and tourism. Existing infrastructure would enable Malaysia through a concerted promotion effort to increase tourist arrivals in 1999. Similarly, efforts to expedite corporate debt restructuring would enable affected companies to remain viable and contribute towards reviving other related businesses. While growth in GDP in the longer term would require continued increases in investment, the past build-up in capital formation and slow growth in external demand would also require increases in domestic consumption. The private sector, therefore, needs to respond favourably to measures to promote consumption of domestic goods in order to ensure recovery in 1999.

Malaysia's experience has shown that policies must be flexible and proactive rather than rigid and reactive. In being flexible, however, it is equally important to take cognisance of the long-term objectives of policies. As has been demonstrated by the recent regional financial turmoil, adjustment efforts by individual economies alone are not sufficient to address the challenges of an increasingly integrated global financial market place. The international community has also a role to play in strengthening the global financial system to ensure responsible behaviour by both governments and markets. Malaysia will continue to support the efforts to develop a new global financial architecture. A new framework that allows better management of volatility of short-term capital flows, including regulating the activities of hedge funds and the work of international rating agencies, and safeguards for liberalisation of capital account transactions would provide the requisite requirement for countries like Malaysia to revert to liberal policies on portfolio flows. Malaysia remains committed to the market mechanism and liberalisation.

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Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman
Governor