Foreword

Malaysia entered the year 2000 with a stronger overall economic performance. While buoyant external demand strengthened the growth momentum, a more important development was that growth was also driven by domestic demand. Macroeconomic policies continued to provide a positive environment that was conducive for private sector economic activity. The fiscal stimulus, in the form of higher expenditure and tax incentives, together with accommodative financial policies provided a positive stimulus to consumption and investment demand. In addition, the rising levels of industrial production and capacity utilisation had paved the way for further expansion in private investment expenditure. The pegged exchange rate system ensured stability in market conditions, facilitating planning and investment decisions by the business community. Overall, business and consumer confidence strengthened with real GDP recording a high growth of 8.5% in 2000.

Economic fundamentals improved significantly during the year, with inflation contained below 2%, the current account in a strong surplus position, stable monetary and exchange rate conditions, high savings and a strengthened and more resilient banking sector. In 2000, the state of the banking system also improved significantly, as demonstrated by the improvements in asset quality, profitability and capitalisation. Loans from the banking system has been rising since February 2000, while non-performing loans stabilised at a low level. There was also a marked improvement in profitability, which exceeded pre-crisis levels, and the RWCR of the banking system remained strong at 12.4%.

Bank restructuring progressed to an advanced stage during the year. The consolidation of the banking sector had been one of the core strategies pursued by Bank Negara Malaysia to build a stronger and more resilient banking industry. By 31 December 2000, most banks had completed their merger exercise. Effectively, 94% of the total assets of the domestic banking sector was rationalised and consolidated. Except for one domestic banking group, all other merged banking groups had also met the new minimum capital funds requirements ahead of schedule. Of significance was that the merger exercise did not have an adverse impact on the lending activities of the banks. Financing of the private sector through the banking sector and through private debt securities increased by about 9% during the year.

In the banking sector, priority was also directed at capacity building, enhancing efficiency and promoting competition. In pursuit of these objectives, banks were required to upgrade their credit management skills and were also allowed to outsource their non-core activities and cross sell products within their banking groups. Given the importance of retaining and attracting skills into the banking industry, banks were given greater flexibility to reward employees based on productivity.

The year 2000 also marked the 10th year anniversary of Labuan as an International Offshore Financial Centre (IOFC). Significant progress had been achieved during the period, with expansion in the range of companies and activities undertaken. LOFSA had also been actively promoting Islamic banking and finance to make Labuan the centre for Islamic banking and takaful. In this respect, the establishment of the International Islamic Financial Market (IIFM) during the year represented a milestone for global Islamic banking in Malaysia. At the same time, the launch of the Labuan International Financial Exchange to provide for the listing and trading of a wide range of financial and non-financial products will further enhance the role of the Labuan IOFC as an international offshore exchange. The e-commerce gateway is another initiative made during the year that was aimed at providing an efficient platform for global access to products and services in Labuan. In addition, efforts are being made to expand the scope and breadth of the IOFC's products and services, including insurance and other support services as well as the overall development of Labuan.

Looking ahead, the magnitude and duration of the slowdown in the United States, the outlook for the Japanese economy and the developments in the international financial markets could all have significant global implications. Given its increasing global linkages, the Malaysian economy will be vulnerable to these external developments. Of particular concern is the implication of the slowdown in the United States on the electronics industry. While the growth of the electronics industry in Malaysia would indeed be affected by developments in the United States, the relatively well-diversified product mix and markets for the electronic industry would help to contain the risks. Overall, the adjustment policies over the years have contributed to a more diversified economic base that is more resilient to external shocks.

Against this background, economic growth in 2001 is estimated to moderate to a still strong pace of 5%. However, the strong fundamentals and the track record of previous prudent policies have accorded Malaysia sufficient policy flexibility to implement pro-growth policies to stimulate domestic demand and raise GDP growth in the year 2001 to closer to 6%. The current account in the balance of payments is expected to remain in surplus, while inflation will remain low and the savings rate will remain high.

The challenge for macroeconomic management is to sustain the confidence and commitment of the private sector. It would not be prudent to allow negative expectations to gather momentum and become self-fulfilling. There will be close monitoring of evolving trends to take further pre-emptive measures if trends indicate a substantive change in outlook. The ability to exercise flexibility to stimulate domestic demand is of key importance.

As early as October 2000, it was recognised that there would be a slowdown in the US economy. The Government's fiscal programme for 2001, presented to Parliament in October 2000, provided for a further expansion in expenditure. The planned fiscal deficit is 5.1% of GNP. Increasing the fiscal impulse would not create risks given that the Government debt and debt servicing are low. Furthermore, the restructuring of the banking system has now been successfully completed. The cost of restructuring was significantly lower than expected and the current consolidation of the banking sector is not likely to have any impact on the budget.

In the current environment, the monetary policy stance in 2001 will remain accommodative to support economic growth. While some price increases are expected for the remainder of the year, any increase in inflation this year is expected to be contained. This is because price levels are starting from a very low base and there is excess capacity in some sectors while capacity expansion has taken place in the areas where capacity utilisation is high. Inflation in the industrial countries are also expected to be relatively subdued despite the oil price increase. Hence, inflation in 2001 is expected to be contained at or below 2%. There is, therefore, policy flexibility to promote domestic demand to achieve a growth rate which is closer to potential output.

Policy strategies adopted during the past decade have deepened and widened the industrial base and enhanced the development of the services sector as a second engine of growth. There was rapid expansion and modernisation of physical infrastructure and support services. Going forward, the economic strategies will, however, focus beyond physical infrastructure management. In the new globalised environment, it is recognised that the dynamics of competition has changed. Competition is no longer based on access to traditional factors of production but, increasingly, on productivity, innovation and exploitation of knowledge and skills. Knowledge has become the new source of competitive edge and value creation. In order for Malaysia to face challenges as well as reap benefits from these developments to achieve an industrialised nation status, the strategy going forward will be to tap the vast opportunities provided by the new environment to make the quantum leap into the next stage of development.

The timing of this change is emerging at a time when the country is moving into a new development phase under the Third Outline Perspective Plan (OPP 3) and the Eighth Malaysia Plan (8MP). These Plans, to be launched in April 2001, will provide the policy framework which outlines the strategies for the next phase of Malaysia's economic development. An important policy component is to increase the knowledge content of the economy by moving up the value chain to transform Malaysia into a knowledge-based economy. In this respect, a Masterplan for the transition towards a knowledge-driven economy will be launched in 2001 to outline the strategic shifts that can contribute to the enhancement of knowledge which can increase the production capacity in all sectors in the economy. At the same time, the strategy will also seek to promote technology-based activities. The next ten years will witness human resource enhancement and intensive research and technology development, important prerequisites for enhancing market competitiveness at the international level, in terms of both price and quality.

Within the new framework for the economy, Bank Negara Malaysia has also taken steps to stay "ahead of the curve" to develop a strategy for the financial sector to become more competitive, innovative and technology-driven. The structure of the financial system needs to evolve to serve the increasingly demanding, complex and more diversified economy, and the expansion into new areas of activity, including technology and service activities. The optimal financial structure that will meet the special requirements for Malaysia are embodied in the Financial Sector Masterplan which was launched on 1 March 2001. The Plan provides the blueprint for the development of the financial sector in the next ten years. The recommendations in the Plan are aimed at developing a competitive and dynamic domestic financial system that will be resilient to the challenges of the new and more globalised environment.

For Malaysia, its strength lies in the real economic sector and the primary role of the financial sector will continue to be as an enabler of economic growth and development. Hence, the objective for the financial sector for an emerging economy such as Malaysia is not necessarily similar to those systems that aim to develop as an international financial centre, independent of developments in the real sector. While Malaysia remains committed to moving towards greater market orientation and international integration, the approach taken will be to first enhance domestic capacity to develop a core of strong domestic institutions capable of supporting the real sector and to build the necessary domestic financial infrastructure. The recommendations in the Financial Masterplan, therefore, will be implemented in three phases - phase one which is envisaged to span about three years, will focus on enhancing domestic capacity and capability, before proceeding to the second phase in the following three to four years with the introduction of an increasingly more competitive environment. Subsequently, in the third phase, the financial sector should move towards greater international integration, allowing for new players in the market.

The merger programme among financial institutions is an initial step towards enhancing domestic capacity. The creation of larger institutions is envisaged to result in increased capacity and, at the same time, the synergy derived from the merged entities will allow the provision of broader range of products and services. Larger institutions would have more resources to invest in technology and to take advantage of the economies of scale.

In the area of regulation, the Bank will move towards providing a more flexible regulatory framework that encourages new ventures and innovation while ensuring prudence and customer protection. Regulation will be market-driven based on good corporate governance and best market practices. Similarly, the supervisory framework will be strengthened to ensure continuous surveillance of market developments and evaluation of trade-offs between encouraging innovation and maintaining stability. The approach would emphasise the assessment of the adequacy of risk management systems and controls and identify weaknesses before they impact the financial performance and soundness of the banking institutions. By the third quarter of 2001, Bank Negara Malaysia will implement a more comprehensive Central Credit Bureau that will provide information to financial institutions to facilitate comprehensive credit evaluation on the total exposure of an applicant.

In the current changing economic environment, it is important to ensure that the Small and Medium Scale Enterprises (SMEs) and the agriculture sector will have increased access to financing at reasonable costs. These sectors are of strategic importance in promoting linkages in the economy and are targeted as more important growth sectors. BNM is also working towards enhancing efficient financing schemes for SMEs that would enable them to make the necessary investments to increase productivity in their existing operations and exploit new growth areas. In the agriculture sector, BNM has been working with the Ministry of Agriculture and the banking institutions to address the issue of availability of credit to finance activities in the sector. BNM is also in consultations with the insurance industry to develop insurance coverage schemes and services required for the sector. As a further step towards enhancing the role of development financial institutions (DFIs), a new regulatory framework for DFIs is also being put in place. The new regulatory framework aims to streamline the operations and regulation of DFIs through a single supervisory authority.

Plans have also been formulated to position Malaysia as the regional Islamic financial centre with the Islamic banking and takaful industry playing a more significant role in the financial system. This will be augmented by efforts to position Labuan IOFC to play a lead role in global Islamic banking and finance activities. The Bank had already established a new department, the Islamic Banking and Takaful Department in 2000, to intensify efforts to promote and develop Islamic banking and takaful business in Malaysia.

The capital market will also evolve into an important source of financing for the economy. The Capital Market Masterplan, launched on 22 February 2001, provides the framework for the development of the Malaysian capital market in the new decade. Efforts will be directed at increasing the competitiveness of the Malaysian capital market and at providing an effective mechanism for the mobilisation of funds to meet the growing needs of the economy. In order to achieve the vision, several initiatives have been proposed, aimed at enhancing the efficiency of market institutions, promoting supporting services and establishing Malaysia as an international Islamic capital market centre.

To safeguard the soundness of its operations and policies, the Bank has also implemented a risk management framework that constantly reviews and deals with the risks of the processes for the formulation of sound and effective policies and to ensure safe and efficient operations. As part of this process, the Bank has devoted significant effort and resources in enhancing the infrastructure for a formal and integrated risk management that is relevant to the current internal and external situation. In early 2000, the Bank also embarked on structured activities towards transforming into a knowledge-based organisation to enhance efficiency, effectiveness and performance. Technology and organisational infrastructure was put in place to facilitate this process, in particular, to ensure real time connectivity within the organisation and the outside world and to institute the appropriate organisational structure and practices for this purpose.

The year 2001 will be an important benchmark in the progress of Malaysia's economic development. A strong foundation has been laid for the economy to move forward to meet the challenges of the new environment. This, together with the various plans outlining the strategies for the next decade will present vast opportunities for wealth creation in both the traditional and new growth areas. The private sector can contribute to the success by responding positively to these initiatives.

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