Governor's Statement

BANK NEGARA MALAYSIA

In 2001, the global environment experienced unprecedented events that had widespread implications on the world economy. While Malaysia was affected by these developments, earlier efforts to strengthen the economic base, secure sound macroeconomic fundamentals as well as restructure and reform the financial sector enhanced Malaysia's resilience in weathering the more difficult economic environment. Despite this more challenging environment, Malaysia has avoided a major economic downturn with growth for the year remaining in positive territory at 0.4% and unemployment being contained at below 4%.

Growth was driven by domestic economic activities. Concerted efforts since the financial crisis to promote domestic sources of growth and reduce vulnerabilities to external shocks have shown positive results. Private consumption remained resilient, and together with the strong growth in public sector expenditure, cushioned the adverse impact on the domestic economy of the weaker external sector and the contraction in domestic private investment. These developments contributed to positive growth in the domestic sectors of the economy, thus, mitigating the weaker growth in the export-oriented manufacturing industries.

During the year, the macroeconomic fundamentals have strengthened, with inflation remaining below 2% and the external balance remaining robust with international reserves having increased to more than US$30 billion. Strong macroeconomic fundamentals and strengthened corporate and banking sector balance sheets have made Malaysia well-positioned to tap the emerging global recovery to achieve stronger growth of 3.5% in 2002. Malaysia, nonetheless, is cognisant of the movement towards greater trade and financial liberalisation in the global market place, which would have an impact on Malaysia's economic performance. While nations attempt to ride out the current economic slowdown, they are continuing to strengthen the mechanisms for global integration. The vicissitudes of global competition and technology continue to feature the emergence of new competitors and the easing of protectionist barriers. As economies liberalise and adopt international practices, competition for investments will become more intense. Both foreign direct investments (FDI) and portfolio investments already have increased choices following the opening up of new markets, especially those with large domestic markets and low costs of operation.

The drive to sharpen the nation's competitive edge takes on added importance as we seek to sustain our growth prospects and raise our standard of living. Structural reforms to achieve the most efficient and effective utilisation of our resources have been intensified. Demand management has aimed not only to provide a positive macroeconomic environment but has also focused on structural developments that will improve the enabling environment for businesses. Supply-side policy measures have focused on capacity and institution building. These include raising the efficiency in the provision of public services, lowering the cost of inputs and reducing the cost of doing business. Efforts have also been put in place to raise the capacity of firms through strengthening the knowledge base, narrowing the skills gap in information and communications technology and enhancing technological capabilities. Dislocations arising from these adjustments have been minimal and business competitiveness has shown signs of improvement.

Malaysia has been a recipient of FDI over several decades, contributing to Malaysia's overall development in terms of growth, employment, foreign exchange earnings and transfer of technology. In recent years, FDI flows have become increasingly broad-based across all sectors, with the services sector now receiving a significant part of these flows. The steady inflow of FDI has continued in 2001, in response to the new opportunities that Malaysia offers. There is a distinct shift in the nature of the investments towards higher value-added investments in both the manufacturing and services sectors, which bring new technology and other expertise that contribute towards raising productivity. The Government continues to encourage FDI in all sectors of the economy with attractive incentive packages that are customised to the requirements of the specific industries and investors.

As an open trade-dependent economy, the stability of the exchange rate is important in facilitating international trade and investment. Wide swings in the exchange rate and prolonged periods of misalignment are highly destabilising. The pegged exchange rate regime in Malaysia has provided a stable environment for businesses to plan their investments and to undertake their operations. The stable exchange rate has facilitated a high volume of cross border trade and investment activity. The stability provided by the exchange rate has also allowed for the effective implementation of the pro-growth policies and for the accelerated pace of banking and corporate restructuring and reform. The regime has thus, functioned efficiently and continues to benefit Malaysia.

In the debate on the appropriate exchange rate regime, it needs to be recognised that these current more uncertain and turbulent times impose challenges and pressures on exchange rates, regardless of the exchange rate regime. No regime is insulated from the demands of the current global environment. The global experience has shown that when exchange rates have failed to perform their function, it was not due to the regime itself but due to the weaknesses in the economy and the financial system.

Three elements are important in ensuring that a regime continues to operate effectively. Firstly, it needs to be well supported by the domestic fundamentals. Malaysia's fundamentals have in fact strengthened during the course of the year and are important factors in ensuring the sustainability of the peg. Secondly, the economy needs to have the ability and strength to absorb the external volatility. In terms of external volatility, the strength of the economy, the strength of the banking sector, the strength of the corporate sector and that of the Government will give the country the ability to ride out the difficult period. It is our more diversified economy, enhanced mobility of labour and capital, the growing significance of the domestic economy and the strengthened banking sector that have provided Malaysia the increased resilience to external shocks. Also important is the ability and the flexibility for the authorities to respond with policies to address the situation. While such shocks will continue to affect us, they can be managed and their impact minimised.

Thirdly, competitiveness needs to be achieved through efficiency and productivity gains rather than relying on currency depreciation. As a matter of policy, Malaysia does not rely on the exchange rate to gain competitive advantage. The Malaysian economy has sufficient flexibility to undertake adjustments in all sectors of the economy to remain competitive under these changing circumstances. True competitiveness will be derived not from exchange rate flexibility but more from increasing efficiency, innovation, marketing strategies and providing quality products and services.

Monetary policy will continue to build on gains from the cumulative monetary easing, initiated since 1998, to ensure that the economic recovery process becomes well entrenched. A priority of policy is also to ensure that the pegged exchange rate is well supported by the underlying economic fundamentals. With low inflation and stronger economic fundamentals, Malaysia has the ability to exercise greater policy flexibility to preserve longer-term sustainability and stability.

The strengthened banking system, low interest rates and ample liquidity continued to support the bank intermediation process. Financing to the private sector has been forthcoming, which is evident not only in terms of the increased lending activity but also in terms of financing via the bond market. The greater access to the bond market has enabled corporations to undertake restructuring exercises and allowed greater flexibility in the management of their funding risks. This, in turn, has allowed parallel reforms to take place simultaneously at both the corporate and bank levels. At the same time, financing to the small and medium enterprises (SMEs) has been sustained.

Malaysia remains committed to strengthening the domestic corporate and financial infrastructure. Significant progress has been achieved in financial restructuring undertaken by Danaharta and Danamodal. Progress in corporate debt and non-debt operational restructuring under the arrangement of the Corporate Debt Restructuring Committee (CDRC) progressed at a more rapid pace in 2001 with the implementation of the new framework introduced in August. As part of debt restructuring, a number of large corporations have undertaken rigorous restructuring exercises in terms of management and ownership structure, and the disposal of non-core businesses and assets. Most of the restructuring has been market driven. The Government has been involved in the restructuring of a selected number of companies with a high degree of social and national interests. The successful resolution of the large CDRC cases has contributed towards reducing the NPL in the banking system.

The private sector plays a vital role in the Malaysian economy. While considerable attention has been directed towards strengthening the corporate sector, another area in which special focus is being given is to provide an enabling environment for the development and growth of the SMEs. SMEs are important in providing the linkages between the various sub-sectors within the economy. The SMEs represent a potential source of dynamism and driving force in the economy, having greater agility to adjust and adapt to the changing environment, thereby allowing for further diversification of the economic base. SMEs also represent indigenous enterprises that have the potential to grow and evolve into larger and listed companies with the potential to become regional or global players. To realise this potential, a holistic approach for their development is required. Bank Negara Malaysia has conducted a survey on SMEs through the banking system. It is hoped that this database will form the basis for a comprehensive framework for the development of SMEs across all sectors. The strategy will need to focus on providing the enabling business environment to not only address the issue of access to financing but also to enhance their technological capabilities, access to training, access to advisory services, marketing channels and other enabling infrastructure. This is to enhance their productive efficiency and effectiveness, encouraging production of high quality, differentiated and high value-added products that meet world standards.

Amidst a more challenging economic environment, the banking sector has remained strong and resilient in 2001. The positive results achieved through the restructuring process and enhancements to the regulatory and supervisory framework and process have minimised the impact of the economic slowdown on the banking system. The banking system recorded a pre-tax profit of RM7.5 billion with significant increases in loan disbursements. The significant progress that was achieved in financial reform and restructuring in 2001 has allowed for the focus of attention to now shift from dealing with banking sector problems to the medium and long-term issues on developing a more competitive and resilient banking sector.

The consolidation programme for the domestic banking institutions represents a major structural enhancement to the banking system. The successful completion of the consolidation and integration of banking groups in 2001 has benefited the industry and the banking public. The consolidation process during the year has placed the banking sector on a stronger footing. Customers now have a wider access to banking services and are able to enjoy seamless services from the merged institutions. The merged banking groups are now more well-capitalised to meet future calls for capital expenditure as well as undertake a wider scope of business activities. The operational business integration processes and rationalisation exercises have been an important part of the merger to reduce duplication of resources and to attain higher levels of economies of scale and efficiency in the banking institutions. Strategies of the banking institutions are now directed towards establishing themselves as key players in the financial sector.

The year 2001 marked a significant period for the Islamic banking industry. The encouraging achievement by the industry was a manifestation of the collective efforts of BNM and the industry to realise the potential of the Islamic banking industry in meeting the economic and financial needs of the country. During the year, several of the specific measures in the Financial Sector Masterplan (FSMP) to elevate the performance of the Islamic banking industry were implemented. Today, Islamic banking has proven to be one of the effective financial intermediation channels and has captured an 8.2% market share of the total banking assets. Moving forward, enhancing the institutional capacity of Islamic banking institutions through the envisaged “bank within a bank” concept would not only provide the strategic focus and autonomy, but also achieve the economies of scale, critical mass as well as cost efficiency for the Islamic banking players. On the international front, significant progress was achieved on the two initiatives namely, the International Islamic Finance Market (IIFM) and the international standard-setting body. BNM has participated actively in both initiatives. The IIFM creates a platform for Islamic financial institutions to manage their liquidity as well as facilitate the trading of Islamic capital market instruments. The standard-setting body, to be located in Malaysia, will focus on issuing international best practices governing the supervision and regulation of Islamic financial institutions. These encouraging developments will contribute further to the overall development of the global Islamic financial system.

Bank Negara Malaysia will continue to play an active role in developing the financial sector to be an important enabler of the economic transformation and growth process in Malaysia. Considerable progress has been achieved in the implementation of the FSMP, notably in the areas of enhancing institutional efficiency and competitiveness as well as promoting consumer awareness through a structured consumer education programme. Several banking institutions also moved to offer a broad range of financial services through new distribution channels. This will become increasingly important in securing the competitive edge in the new global environment. New prudential policies were also introduced to enhance risk management practices and corporate governance. The thrust of the banking policies in the coming year will continue to place emphasis on enhancing the capacity of banking institutions, further strengthening the regulatory framework while providing a conducive environment for banking institutions to become more efficient and competitive.

Despite the less favourable environment in 2001, the insurance industry recorded strong growth of 12.4% in premium income. The strengthened capitalisation of the industry since 30 September 2001 has built greater financial resilience among insurers, a key factor in advancing the consolidation of the industry through mergers and acquisitions. Eight M&As have been completed and seven others involving 13 insurers are currently in progress. Going forward, the insurance industry has the potential for a quantum leap in growth, given the low penetration rate and rising incomes. This growth potential is being realised through initiatives under Phase I of the FSMP, which aims at building capacity and efficiency as well as strengthening consumer protection. In the takaful industry, the growth momentum was maintained in the year 2001 with the combined takaful funds reaching RM2.4 billion or 4.6% (2000:2.6%) of the total assets of the insurance funds.

Development financial institutions (DFIs) are expected to continue to play an important role in promoting the development of identified priority sectors in the economy. With the enactment of the Development Financial Institutions Act 2002, a new regulatory and supervisory framework came into force for the DFIs. Bank Negara Malaysia has been empowered to administer the Act. The future focus would be on building the overall financial and structural capacity of DFIs in meeting their mandated roles. Prudential regulations that will improve the management of assets and liabilities, corporate governance as well as risk management practices of DFIs will be introduced to enhance the soundness of their operations and practices.

Efforts are also being directed at improving the efficiency and reliability of the payment system, while keeping abreast with technological developments. In this respect, a National Payments Advisory Council has been established in 2001, with membership including expertise from the Bank of Japan and the Hong Kong Monetary Authority, to formulate developmental policies related to infrastructure needs, new technology and standards on payment systems.

As the process of globalisation intensifies, regional economies have become increasingly inter-dependent and integrated. Being highly open economies, the region has in the recent years been confronted with global economic and financial uncertainty with periodic episodes of turbulence which have tested regional policy makers. In such an environment, national policies alone, while vital and necessary, would not be sufficient to secure the regional financial stability and prosperity we aspire to achieve. Regional co-operation and solidarity can serve as an important anchor during turbulent periods of uncertainty. Critical first steps have been made in strengthening regional financing facilities to promote mutual assistance in maintaining financial stability. Work is also underway to develop an effective regional surveillance mechanism to complement and support the regional financing facilities. Looking forward, the priority would be on the development of regional markets, including a regional bond market to better serve the needs of all regional economies. Closer co-operative efforts in the standardisation of systems and documentation procedures, would also contribute to enhance greater inter-regional financial and economic activity. Effective co-operation in these areas will augment the foundations for translating the tremendous potential that this region possesses for future growth and prosperity.

Although Malaysia has made significant strides on several fronts, much still needs to be done and new challenges are emerging. The challenge to achieve sustainable growth and prosperity requires looking beyond the immediate term, beyond our own immediate interests and beyond our own boundaries. While immediate concerns need to be addressed to preserve confidence and stability, the core of sustainable development is derived from the institutional strength and the fundamental structures and foundations. It is efforts directed towards these goals that will yield the broad-based high quality growth that we aim to achieve.

Zeti Akhtar Aziz
Governor

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