Central Banker Extraordinaire

From the peg and hot money to the competitiveness of Malaysian banks, central bank governor Tan Sri Zeti Akhtar Aziz takes them in her stride.

By Gurmeet Kaur

A TYPICAL day of Tan Sri Zeti Akhtar Aziz sees her sifting through at least a hundred memos, each ranging from one to five pages. As governor of the country's central bank, Bank Negara Malaysia (BNM), Zeti is naturally tapped for a myriad of issues and has seen a steady stream of visitors to her office on the fringes of Lake Garden, Kuala Lumpur for the last five years. She is often called upon to explain the country's approach to central banking and to discuss the reforms taking place in the banking sector and the economy.

Zeti says the last five years have been 'extremely eventful in terms of development in the economy and financial system'. This year, the central bank hopes to put in place the financial infrastructure that would increase further the effectiveness of the financial system. 'Introducing investment banking, new structures for Islamic finance, deposit insurance, financing to smaller businesses, and strengthening the cooperative movement are some of the plans that will be introduced during the course of the year,' she says.

Here, Zeti addresses some current issues facing Malaysia's economy and the financial sector. Some excerpts:

THE RINGGIT PEG

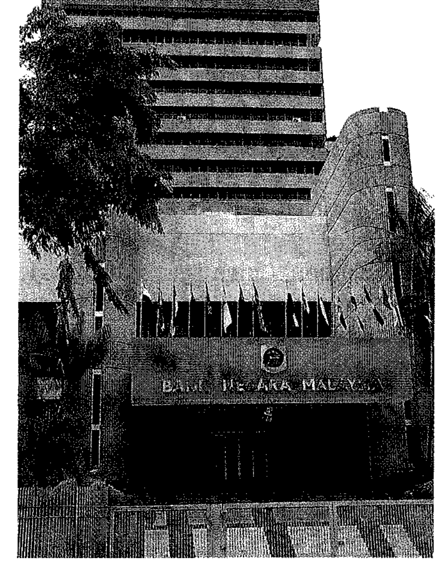
Does BNM still hold the view that any re-assessment of the peg will take place if the ringgit's misalignment reaches the critical 20%?

The pegged exchange rate has been in place for more than six years now. It has withstood extreme swings in the major currencies and has continued to function effectively. An important lesson from this is that the currency regime should not be bound to short term nominal exchange rate movements of other currencies.

The environment will continue to be dynamic and constantly changing. Any decision on our pegged exchange rate regime will be based on the longer-term interest of the nation and should not be tied to short-term market movements, or policy decisions in other countries, or bound to any specific nominal exchange rate levels of any other currencies.

What options would BNM likely take: a re-peg, total de-peg or a shift to a managed float system?

We have studied in detail all the possible exchange rate systems and are fully aware of their respective implications. If a change becomes necessary, we will assess the situation at the time and we will choose a regime that has the best ability to maintain a fair and relatively stable value for the ringgit. It will be a regime that will best serve Malaysia's interest. Currently, the regime in place best achieves that purpose.



Large amounts of 'hot money' have been coming into the market ahead of speculation of a review of the peg. Our reserves have increased significantly.

A large part of our capital inflows is from export earnings. Malaysia has a very strong surplus in the current account as exporters bring back their export earnings. This has significantly increased the reserves.

There has also been a strong inflow of foreign direct investment. They continue to find Malaysia attractive; we have strong economic performance, stable macro-economic environment and a sound and stable financial system. These have been supported by the well-developed physical infrastructure. We also have a low cost of doing business.

Over and above this, we have the portfolio flows, reason being Malaysia is looked at as attractive. Not all portfolio funds, however, constitute hot money; some of these are strategic investments and stay in Malaysia for a reasonable period of time. Portfolio funds make up about 30-40% of the inflows, and only part of this could be hot money.

BNM has been effectively sterilising these inflows to neutralise their implications on domestic monetary conditions. While there is a cost in these sterilisation operations, it has been offset by the income from managing our reserves. Our investments are in the major currencies, namely in euro, yen, sterling, Australian and Canadian dollars and in some Scandinavian countries. These investments yield an income that has been in excess of our cost.

BNM thus has the capacity to continue to manage these inflows. We expect the capacity to undertake these sterilisation operations would be further enhanced as interest rates abroad increase.

THE ECONOMY

Malaysia's growth outlook is expected to slow down this year. What is BNM's assessment of the outlook for 2005?

Economic prospects in 2005 remain favourable. While there are some signs that global economic growth may be slowing, the overall assessment at this juncture is for world growth to remain strong. On the domestic front, the underlying economic conditions remain solid. The growth performance of the domestic economy will continue to be supported by strong consumption demand and sustained investment activity. Malaysia's export performance will also benefit from continued regional growth and the growth in the non-traditional markets.

How do you assess business confidence in Malaysia? How much of this confidence is riding on the United States economy?

Business confidence has been strengthening since 2003. This is reflected by the steady increase in investment that has taken place for more than six quarters since the third quarter of 2003. This increase in private investment has been supported by strong domestic and external demand. During this period, there has also been a strong demand for funds by companies from both the banking system and the capital markets. Indeed, capital expenditure of public-listed companies shows growth in investment increased strongly in 2004. This momentum is expected to be sustained into 2005.

How is Malaysia's trade structure evolving? How much will Malaysia's economic fortunes be affected by China's economic health?

Malaysia's trade structure is becoming more diversified. Although manufactured goods account for the main part of Malaysia's exports, accounting for about 80%, changes have occurred in the composition of the manufactured exports. Resource-based manufactured exports have now become more important and within the non-resource-based sector, the share of electrical goods has declined. This has been due largely to the relocation of the production of lower-end products to other low-labour cost economies.

The share of high-end manufactured goods, such as electronic components, metal and optical and scientific equipment exports, have in turn increased. Efforts more recently have aimed at promoting capital-intensive and high value-added investments into industries associated with the higher-end electronics and semiconductor cluster.

Excluding Japan, East Asia now accounts for 45% of total Malaysian trade, compared to 36% in 1995. The growth in trade has stemmed largely from strong growth in trade with Asean and China. In particular, the bilateral trade between Malaysia and China has been increasingly strongly. China is now our fourth largest trading partner, accounting for about 8% of Malaysia's total trade, compared to only 2.4% in 1995. Malaysia's exports to China are well diversified, comprising both manufactured goods and commodity products.

In addition, China is an increasingly important tourism market. Malaysia received more than half a million visitors from China in 2004, an almost five-fold increase from 1995. There continues to be significant complementarities between China and Malaysia. Going forward, there is potential for both countries to continue to explore new opportunities.

COVER STORY

What is the direction of our monetary policy going forward?

Monetary policy is currently supportive of the economy. In this low interest rate environment, the financial sector has been important in facilitating strong private consumption and investment demand. Going forward, Malaysia continues to have the flexibility of maintaining the rates at these present low levels given that inflation is still at relatively low levels.

Inflation is creeping in via a rising import bill as a result of our weakening ringgit. What is BNM's measure to contain this rising inflation?

Inflation has now edged up from 1.2% in 2003 to 2.1% at end-2004. While we expect further increases in inflation over the medium term, it is expected to remain within the tolerable range. Important to note is that the increase in inflation has been due mainly to one-off price adjustments and not to demand-induced inflationary pressures. In addition, imported inflation is not significant. Interest rate policy will therefore continue to be supportive of growth.

A rise in interest rate would encourage more hot money taking advantage of the inconsistency between rising domestic rates and an undervalued currency. How would BNM address this?

Interest rate differentials have been in Malaysia's favour for several years now and it has not been the cause of speculative flows. It is only when major currencies have moved to extreme levels that we have seen some of these speculative flows. The inflow have, however, been manageable.

On the ringgit, our assessment is that it is not fundamentally undervalued. As interest rates abroad rise, we expect that global foreign exchange markets will stabilise. Currently, we have the capacity to sterilise the flows and neutralise their impact on our financial markets. These sterilisation operations will continue so as to avoid excessive liquidity in our financial system and its destabilising implications.

BANKING, INSURANCE AND OTHERS

Will BNM consider prodding a second round of banking mergers considering that the timeline to the liberalisation of the industry is nearing?

While further banking mergers are encouraged, BNM has always maintained that any future consolidation will be driven by the market. BNM will continue to provide support and facilitate any merger exercises that would result in greater synergy and stronger banking institutions. In the current environment, however, the focus is on further enhancement of capacity and capability in terms of elevating the level of efficiency of banking institutions, their effectiveness in meeting the needs of the economy, the quality of their service and to ensure the resilience and stability of the banking system.

As they stand, can Malaysian banks compete with their foreign counterparts?

The performance of domestic banking institutions is becoming increasingly comparable with foreign banks. The capacity of the domestic banks has strengthened in terms of capitalisation and profitability. At the end of November, the return on average assets of top domestic banks was higher than foreign banks at 2.4%. Top domestic banks are also managing their costs better than foreign banks with lower cost-to-income ratio. The gap to foreign banks in productivity levels and asset quality is also closing.

There have also been strong enhancements in the area of corporate governance and risk management standards in the domestic banks. All this has increased the potential of the banks to be competitive. This is also demonstrated by the fact that domestic banking institutions have been able to maintain their market share. At the end of 2004, domestic banking institutions controlled 76% of the banking system's total assets and 78.9% of gross loans. The liberalisation measures introduced thus far has therefore not led to an erosion of the market share of domestic banking institutions.

Will BNM enforce Section 46 of Bafia, which limits ownership to 10% for individuals and up to 20% for corporates?

It is clearly stated in our Financial Sector Master Plan that shareholding of banking institutions should be by corporate and institutional investors. This is aimed at ensuring that banking institutions have strong and capable shareholders that will drive performance improvements. Enforcement of the shareholding limit on existing shareholders is, however, being implemented gradually to minimise any potential destabilising effects on the financial sector. A reasonable time period is given for the rationalisation of the shareholding to comply with these requirements.

What is the development with the mergers of general insurance companies?

As at Dec 31, 2004, 16 mergers and acquisitions involving 29 insurers have been completed. All 29 insurers involved were in the general insurance business. The number of direct insurers in the industry has thus been correspondingly reduced to 42 from 58 in 1999, with companies carrying on general business accounting for 35 of the total number.

As competitive pressures continue to intensify, further consolidation in the general insurance sector can be expected. However, the pace of the consolidation, and ultimately the number of players in the market, will be determined by the market.

Are there too many Islamic banking licences?

Malaysia recently issued Islamic banking licences to three new foreign players. The move is following the rapid progress that has been achieved in the development of the Islamic banking industry. This prompted BNM to bring forward the liberalisation programme originally scheduled for 2007.

It is envisaged that the presence of the foreign players in the Islamic banking industry will enhance the diversity and depth of the players in our financial system. It will also accelerate the global integration of the domestic Islamic banking system and will strengthen economic and financial linkages between Malaysia and the Middle East.

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In the case of the establishment of Islamic subsidiaries by the conventional banks participating in the Islamic banking scheme, the move should not be looked at as a proliferation of Islamic banking licences. The exercise essentially involves the migration of the existing Islamic banking business from the window basis that currently resides in the conventional bank to a legal Islamic banking entity that is to be regulated under the Islamic Banking Act (IBA).

This exercise will also promote greater strategic focus for the Islamic subsidiaries in carrying out their Islamic banking business. It will also enable the operations to leverage on the group infrastructure including the branch network and support functions. This will allow for greater cost efficiency and for the benefits of group synergies to be reaped.

What is the progress made in implementing the Financial Sector Master Plan?

The implementation is on track and as scheduled. Under the Financial Sector Master Plan, the recommendations and projects are to be implemented in three phases over a 10-year period. In the initial phase of implementation, efforts have been focused on enhancing the capability and capacity of domestic banking institutions. These efforts are now being continued with further initiatives to develop the financial infrastructure and to further strengthen the regulatory and supervisory framework as well as to enhance the consumer protection framework.

For the most part, the financial infrastructure and the foundations for strong performance have been well established, especially for the domestic banks. We are now entering the second phase of the plan, during which initiatives will be taken to gradually deregulate and liberalise the system further to bring increased benefits to the economy. mb