Foreword

The Malaysian economy and financial sector turned around in 1999. Confidence was restored as evident in the rise in domestic consumer and investor activity; the rebound in stock market activity; the narrowing of credit spreads on Malaysian bonds; and the return of portfolio inflows into Malaysia. Significant progress has also been made in the financial sector, particularly in terms of the restructuring and merger of banking institutions. The risk-weighted capital ratio of the banking system has improved considerably as the banking system returned to profitability in 1999. The formation of the ten domestic banking groups arising from the current merger programme will further strengthen the banking industry to meet greater challenges in the future.

At the corporate level, there has been a trend towards deleveraging, while significant progress has also been achieved in the restructuring of corporate debt. This has enabled companies to better manage their funding risks and reduce their vulnerability to abrupt changes in interest rates. The greater efficiency in the use of resources (particularly imported capital goods) and the divestment of non-core activities have allowed companies to concentrate in industries in which the competitive edge is enhanced, niche markets tapped while at the same time reduce potential strains on the nation's balance of payments.

The economic recovery in Malaysia has been significant in many ways. The introduction of the selective exchange control policy was of paramount importance in restoring stability to the economy. At the same time, it provided flexibility for the Government to implement the appropriate monetary and fiscal policies to accelerate economic recovery. The speed and magnitude of the recovery have surpassed even the most optimistic market expectations. In the management of the crisis, Malaysia had consciously incorporated the social agenda into its recovery programme, to minimise social costs and dislocations. In the process, this has not only protected the social fabric of Malaysia but also ensured stable conditions to preserve investments and incomes of individuals and enterprises including foreign investors. In addition, an active debt management policy ensured that the external borrowings of the country were contained at manageable levels, which made Malaysia less vulnerable to exchange and interest rate developments abroad. Furthermore, Malaysia's recovery programme ensured that the private sector absorbed the costs of restructuring so that the impact on the public sector finances has been reduced. As a result, the burden of financing the adjustment to be borne by future generations will be minimised.

As the Malaysian recovery gathered momentum in the course of 1999, the international community, including the IMF, has acknowledged that there is no standard prescription to crisis management, given the diverse stage of development, structure, and circumstances of each economy. In an environment of highly destabilising and unrestrained capital flows, the

Malaysian approach to crisis management is a viable option that has produced results. In this context, the experience of East Asia has highlighted the need to address the adverse consequences of unregulated capital flows, examine the role of large market players and introduce greater accountability in the practices in financial centres offshore.

The experience of Malaysia during the crisis has made Malaysians more aware of the vulnerabilities confronting the economy. Far from being complacent, there is general awareness of the need to actively embark on efforts to seek new approaches to achieve greater heights of economic success and a better standard of living for all Malaysians. We need to position ourselves to promote sustainable growth under the new environment where technology, skills and innovation are the main drivers to enhance efficiency and competitiveness in this more globalised environment. In this regard, the Government has already embarked on a long-term strategy of accelerating the transformation of the economy towards a knowledge-based economy and growth in new areas which would be based on information, communication and technology. This requires a co-ordinated approach in engineering the transformation of the Malaysian economy into the next phase of economic development.

In the real sector, Malaysia has made a head start in infrastructure investments in information technology. Malaysia is now embarking on the next step to raise potential output by emphasising on increases in efficiency of capital investments. The narrowing of the output gap continues to be an issue of concern, due to the less than optimal complementarities between labour, skills and technology. Increasing investment alone to expand the output gap is insufficient, and could result in a further funding mismatch given the stage of development of the capital market at this juncture. Growth in the medium term would, therefore, need to be productivity-driven. Greater emphasis will be placed on skills development. In this regard, the Eighth Malaysia Plan (2001-2005) will represent an important framework to review Malaysia's strategies to chart the next phase of industrialisation and economic development.

In the financial sector, the challenge is to promote a dynamic and innovative financial system that has the capacity and ability to support the country's economic transformation. Of importance is the need to develop alternative financing mechanisms such as venture capital financing, "business angel" investment and "specialist seed capital" firms to support high-risk investment. It is also important to ensure that all players understand fully, and possess the necessary skills to deal with, the new risks involved and have in place internal controls and effective risk management systems. The establishment of the Malaysian Exchange of Securities Dealing & Automated Quotation Berhad, marks an important milestone in providing alternative financing avenues for growth and technology companies, and serving as an exit mechanism for venture capital companies. Equally important is the development of instruments that enable economic agents to better manage risks and allow the risks to be borne by those most able to manage these risks.

The Government, on its part, will continue to maintain a proactive approach in the development of the financial system to create a competitive, strong and resilient financial sector. The authorities will remain vigilant and take the necessary measures to continually strengthen the financial system and maintain financial stability. For the further development of the financial sector, progress is well underway to formulate the master plans for the financial system and the capital market, and the National Bond Market Committee is providing the impetus for the development of the bond market. In addition to providing the means for raising funds in a more effective manner, these initiatives will also help to chart the strategic positioning and future direction of the financial system so that the Malaysian financial institutions can effectively position themselves to face the challenges as the operating environment becomes increasingly liberalised and globalised. The accelerated pace of financial reforms underlines Malaysia's firm commitment to enhance the competitiveness of the sector. In formulating the framework for the financial sector, however, an important consideration is the proper sequencing between capacity building and reforms in the financial sector. The recent crisis has underscored the importance of proper sequencing in liberalising the financial markets to ensure that the associated risks are maintained at a prudent and manageable level. Such an approach is essential to ensure that Malaysia enjoys the full benefits of globalisation.

The financial reforms will also ensure that Malaysia has a core of strong and forward looking domestic financial institutions that can excel in a changing global environment through capacity building efforts with the enhancements of the necessary skills and technology base. In this regard, the recent consolidation exercise of the domestic banking institutions into ten banking groups represents an important step to transform the financial sector towards meeting the new challenges as well as the objective of supporting sustainable economic growth. Banking institutions that are well-capitalised would be able to enjoy economies of scale, while allowing them to have greater investment in information technology to remain competitive and efficient. At the same time, Bank Negara has also embarked on measures to encourage the consolidation of the insurance industry through mergers and acquisitions among insurers.

Measures to develop a more resilient corporate and banking sector have also been intensified through reforms to address areas of vulnerabilities as well as potential risks. Greater emphasis has been placed to improve corporate governance, enhance asset-liability management of corporations and banking institutions; and to avoid the problem of funding mismatch. While the overall leverage of the economy has been relatively stable and funded mainly by domestic bank borrowings, the maturity mismatch of some companies, have rendered such companies (and consequently banks) vulnerable to a sudden change in liquidity conditions, as experienced during the height of the crisis. As plans to implement a more stringent liquidity management framework and a comprehensive stringent capitalisation requirement for banking institutions come on stream, and a prudent asset-liability management strategy is put in place, the corporate and banking sectors will be well placed to absorb any eventuality or shocks.

The Government recognises that an important pre-requisite in encouraging the private sector to seek new opportunities is the creation of an environment of certainty and stability. Towards this end, the Government will continue to pursue stability-oriented macroeconomic policies. Balanced and consistent macroeconomic policy will be emphasised to ensure that current policies to revive economic activity will not lead to undesirable developments such as renewed inflationary pressures or external imbalances in the medium term. It is only under an environment of stability that the broader goals of public policy have the best chance of being realised. The Government will remain prudent in managing its fiscal policy, with emphasis on the quality and efficiency of public spending. While the conduct of monetary policy will continue to complement the fiscal policy stance, Bank Negara will remain vigilant against any signs of incipient inflationary pressures. A major priority of policy will be to ensure that the large inflows of capital within a fixed exchange rate regime and the increase in bank lending will not be a source of instability that could result in asset price inflation and, ultimately, inflationary pressures. An important consideration will be to ensure consistency between the exchange rate regime and the underlying macroeconomic policy framework.

While Malaysia and other crisis-affected countries have expedited the necessary economic and financial restructuring, the threat to stability posed by the unregulated financial flows, however, remains. Although international discussions have been proceeding on in numerous fora over the past two years, there is still no clear prospect of any concrete fundamental change taking place in the foreseeable future to implement reforms to strengthen the international financial architecture, and in re-defining the role of the international financial institutions. Under the current circumstances, small, open economies such as Malaysia, will remain vulnerable to market excesses and tendencies, which would create undue volatility and destabilising consequences on fundamentally sound economies. The Government remains committed to the market system and to a mutually beneficial engagement in the global economy. However, in the absence of global solution against volatile capital flows, individual countries will trend towards maintaining safeguards and toward strengthening regional integration.

A shared global growth is the key to enhance the prospects for long-term economic prosperity in this age of globalisation. Malaysia, on its part, will continue with its economic and financial reforms to ensure that its efforts to achieve sustainable growth in an environment of stable prices are well within its reach without creating unnecessary imbalances.

29 March 2000 ***Tan Sri Dato' Seri Ali Abul Hassan bin Sulaiman***
Governor