GOVERNOR'S STATEMENT

The world economy improved significantly in 2010. Particularly strong growth was recorded in the emerging economies with this trend being most pronounced in the Asian region. Generally this growth has been underpinned by strong domestic demand and the recovery in world trade. While the global growth momentum slowed in the second half of the year, economic growth in 2011 is expected to continue although at a more moderate pace. The slower world trade, and the implementation of policies to avoid risks to sustainable growth, have placed most emerging economies on a more steady growth path. The most pressing challenge for the world economy in 2010 has therefore been to promote a self-sustaining growth that is accompanied by job creation and macroeconomic stability.

In Malaysia, the economy expanded by 7.2% in 2010, with encouraging trends in private economic activity and continued improvements in employment conditions. Despite the more moderate global growth in 2011, Malaysia has the potential to sustain its underlying trend of steady economic growth. This will continue to be supported by sound macroeconomic fundamentals, continued access to financing in an environment of ample liquidity and a resilient financial sector. As a highly open economy, Malaysia will continue to be affected by the spillover effects of global developments. These will include the effects of developments and policies being pursued by the advanced economies, the geopolitical tensions in the Middle East and more recently, the tragic developments in Japan. Twelve years hence from the Asian financial crisis, Malaysia has built its capacity to cope with such challenges. The strengthening of our economic structure and the financial system, the enhancement of institutional arrangements and the improvement in our macroeconomic fundamentals have increased the resilience of our economy.

Two further global developments, the sharply higher global commodity and energy prices and the massive shifts in global liquidity, could also affect global growth prospects. These developments have been affected by supply disruptions due to geopolitical developments, weather conditions and the search for yield among investors in a low interest rate environment. The concern arising from these trends is that the higher commodity and energy prices could translate into higher inflation which in turn could unhinge inflationary expectations. In addition, the shifts in liquidity to emerging economies are also creating undue volatility in financial markets and excess liquidity conditions that could result in the formation of asset bubbles and other financial imbalances.

Despite the developments in the commodity markets, the consensus view at this stage is that economic activity would only be discernibly affected if the energy and commodity prices remained elevated for an extended period of time. The presence of stockpiles, better inventory management, the more efficient use of energy, and the better-anchored inflation expectations, all point to greater resilience to price shocks compared to the 1970s and 1980s. Nevertheless, different countries will be affected differently. Developing and emerging economies are likely to be more adversely affected given the greater weight of food and fuel in their consumption baskets. Commodity exporters will be less affected compared to commodity importers. The strength of the pass-through to domestic prices will also depend on factors such as domestic supply constraints, the efficiency of domestic distribution channels, the existence of subsidies and the fiscal capacity of governments to reduce the burden of higher prices.

In Malaysia, inflation was contained at 1.7% in 2010. The significant increases in global energy and commodity prices are expected however to translate into higher domestic food and fuel prices. In addressing this trend, Malaysia has adopted a more comprehensive approach that includes the implementation of a more gradual subsidy rationalisation, providing income support to the lower income groups, increasing food production and increasing efficiency in its distribution, and promoting greater energy efficiency by households and the industry. For monetary policy, this risk will need to be monitored and managed while taking into account that the consequent reduction in discretionary spending arising from the erosion of real income will also have a dampening effect on growth.

In early 2010, the Bank undertook steps to normalise the overnight policy rate, raising it in three steps to 2.75% as keeping interest rates too low for too long would result in its own risks that would undermine future growth. As we entered 2011, the risk of more modest growth remains, while the risk of higher inflation also needs to be managed. In this environment, monetary policy in 2011 has the flexibility to remain accommodative, although the degree of accommodation may need to be adjusted to ensure that economic growth in the medium term will not be damaged by higher inflation. Of importance is that the economy continues to remain on its current growth trajectory of a steady growth.

Managing the excess liquidity and its potential consequent effects on leverage, in particular by the household sector and also on the formation of bubbles in the asset markets has prompted a further strengthening of governance process to address these issues. A joint policy meeting of the Monetary Policy Committee and the Financial Stability Committee is periodically convened to deliberate on the appropriate policy responses in the event that these issues are raised in the respective committees. This is to ensure that policies will be consistent and coordinated. Also important is that there will not be over reliance on one set of measures that will result in over-adjustments.

A notable development in the current environment is the rising trend of household indebtedness and its potential to become an area of concern. While household indebtedness has increased, it has continued to be well-supported by strong financial buffers at the aggregate level. Income growth, the high rate of savings and the favourable employment conditions have supported the debt servicing capacity of households. Nevertheless, to avoid this becoming a risk, a comprehensive series of policies have been introduced during the course of the year. These include prudential policies applied in the residential property sector, new credit card measures and strengthened requirements for banks to adopt prudent and responsible lending practices. This was reinforced by increased financial education programmes including support arrangements to promote responsible borrowing by households. These pre-emptive measures, outcomes of the joint meetings, also aim to strengthen the resilience of the household sector.

A further policy challenge relates to the more volatile capital flows into the country. As with a number of other countries in the Asian region, Malaysia received large short-term capital flows since the second half of 2009. Overall, the capital flows have been manageable and have been well intermediated by the financial system. While the ringgit exchange rate has become more volatile against the major currencies, the foreign exchange market has remained orderly and the impact of these flows on domestic monetary conditions has not been destabilising. In addition, the substantial increase in liquidity in the banking system arising from these short-term flows has to a large extent been sterilised. The Bank also has at its disposal the instruments necessary to ensure that this excess liquidity does not lead to excessive risks in the financial system and the economy.

As part of the ongoing organisational development of the Bank, several advancements were achieved during the year. In particular, this included the operationalisation of the Central Bank of Malaysia Act 2009. In providing greater clarity of our mandate, the Act has significantly enhanced the role of the Board in providing its oversight on the operations of the Bank. In addition, the greater powers that the Act accords to the Bank is also accompanied by a more robust framework for governance and greater accountability. In addition to the existing Board Audit Committee, the Board Governance Committee and the Board Risk Committee were introduced during the year.

A further initiative in organisational development is the further strengthening of the performance-based culture at the Bank. This has continued to be a central pillar in the Bank's management of its staff and the remuneration and promotion framework. The Bank has also continued to build its human capital and strengthen its talent pipeline. In line with the demand for skills and specialised knowledge in this evolving economic and financial environment, the Bank has introduced specialist ladders and new job families for professionals that are supported by extensive tailored programmes to better equip our talent. Investment in technology was also a prime focus in 2010 with the further expansion and modernisation of the ICT infrastructure, including the operationalisation of the Bank's new Data Centre and the upgrading of our Recovery Centre.

The global financial and economic crisis and the challenges it has posed in the areas of the Bank's responsibilities have placed significant demands on our resources. On behalf of the Board I wish to express our appreciation and gratitude to all the staff of the Bank who have worked with great dedication and commitment to ensure that the Bank continues to serve the interest of the nation and to protect the longterm well-being of all citizens of this country. I am also grateful for the support and guidance of the Board of Directors, who are an integral part of the governance at the Bank. The Bank will continue to strive to achieve the highest standards of excellence in performing our responsibilities.

Zeti Akhtar Aziz
Governor
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