Governor's Statement

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Robust growth of the Malaysian economy was sustained in 2004. Economic resilience also strengthened as the economic structure became increasingly more diversified and as the macroeconomic fundamentals continued to remain strong. The economy benefited significantly from the stronger domestic demand and high growth in external demand. Of significance was that growth was driven by private sector economic activity for the second consecutive year. Consumer and business confidence strengthened during the year to reinforce this trend.

Monetary policy continued to have a supportive role in the economy throughout 2004. While inflation edged up, it continued to remain within a tolerable range. Price increases have generally reflected one-off price adjustments that occurred during the year. The upward trend in prices has also been contained by the accelerated increase in private investment and the consequent expansion of capacity. In addition, some absorption of the price increases by producers mitigated the price increases. The focus of monetary policy has thus been to support the expansion in business investment activity to enhance the long-term growth potential of the Malaysian economy.

During 2004, Bank Negara Malaysia implemented a new interest rate framework to enhance the operational efficiency of monetary policy. Almost one year after its introduction, the new interest rate framework is operating well, with the overnight policy rate providing the signal to the market on the stance of monetary policy. The deregulation of pricing under the new interest rate framework has also acted as a catalyst for more efficient pricing in the financial system. Combined with the quarterly issue of the Monetary Policy Statement, the market is provided with regular information on the current and expected monetary conditions. The statement reflects the conclusion of the deliberations of the policy options considered by the Monetary Policy Committee in the Bank. Eight monetary policy meetings were held during the year.

Malaysia's inter-linkages with the global economy and the international financial system continued to strengthen in 2004. Trade with the rest of the world, and with the Asian region in particular, continued to be robust. Trade increased by 23.2% during the year, with trade with the Asian region now accounting for 60.2% of total trade. Malaysia has, for seven consecutive years now, recorded a significant current account surplus. This trend has been reinforced by a steady inflow of foreign direct investment. The investment flows have become increasingly more diversified, reflecting the new investment opportunities in the more diversified economy. The stronger position of Malaysian corporates has also resulted in higher Malaysian investments abroad. While portfolio flows were volatile during the year, overall, there was a net inflow. The cumulative inflows from trade, foreign direct investment and portfolio flows have contributed to a significant increase in the nation's international reserves.

To ensure stable financial markets, Bank Negara Malaysia has undertaken sterilisation operations to absorb the inflows to avoid conditions of excessive liquidity in the domestic financial system. The Central Bank continues to have at its disposal, instruments of monetary policy to undertake these sterilisation operations. While these operations entail a cost, the returns from the management of the reserves have exceeded these costs. The Central Bank, therefore, continues to have the capacity to absorb these inflows, and thereby maintain stability in the domestic financial markets and stability of the overall financial system.

Bank Negara Malaysia has taken the opportunity of this strengthened position to liberalise further the foreign exchange administration rules, effective April 2005. This is part of the continuous efforts to enhance the business environment and facilitate efficiency in transactions involving foreign exchange and to allow for better risk management of investments. This liberalisation is part of the on-going initiatives to reduce the cost of doing business and improve the efficiency of the regulatory delivery system. The changes allow for greater flexibility in hedging against currency risks and in the limits on maintaining foreign currency accounts, on domestic credit facilities to non-resident controlled companies and on investments abroad.

The liberalisation in 2004 permitting Multilateral Development Banks, Multilateral Financial Institutions and corporations to raise ringgit-denominated bonds has also increased foreign participation in the domestic capital market. The market has responded positively to these changes. Two multilateral development agencies have taken advantage of this initiative in 2004. The Asian Development Bank became the first foreign entity to issue ringgit-denominated bonds in November, followed by the International Finance Corporation, which became the first foreign entity to raise ringgit-denominated Islamic bonds.

Significant performance and development has also occurred in the financial sector in Malaysia. All segments of the financial sector strengthened in terms of improved capitalisation, quality of portfolios, profitability, soundness of financial positions and exposure to risks. Enhancements have also been made in the areas of corporate governance and risk management standards. Large investments were also made to strengthen internal systems and processes, improve delivery channels and acquire talent. Cumulatively, these enhancements have rendered the financial system to be more competitive. There has also been a narrowing in the gap in performance between domestic and foreign financial institutions.

For the banking system, the opportunity was taken to encourage expansion in activities in the domestic economy, in particular in the new growth areas; and for those institutions with the capacity, to venture beyond domestic borders. In the domestic economy, there has been a significant shift in financing activities to small businesses, which now account for 40% of loans to the business sector. Lending to the household sector also increased. A wider range of products, including those delivered through electronic channels, also came on-stream. Attention continued to be focused on preserving financial stability including strengthening prudential regulation and surveillance over financial conglomerates as well as operations undertaken beyond domestic borders.

The year also saw further progress in streamlining the legal and regulatory infrastructure in Islamic finance. A more structured legal and Shariah governance framework and a more conducive tax environment were introduced, resulting in neutrality of treatment between Islamic and conventional financial products. A further significant development is the transformation of the `Islamic Window' in conventional banks into Islamic subsidiaries. This transition will allow for the Islamic subsidiary to leverage on the group infrastructure, including the branch network and support functions, to maximise cost efficiency and to reap the benefits of group synergies. Several domestic banking groups are in the midst of strategically participating in this transformation process. The year also saw the liberalisation of the Islamic banking industry with the issue of new Islamic banking licences for three foreign-owned Islamic banks to operate in Malaysia. It is expected that this move will not only spur the development of Islamic finance in Malaysia but would enhance Malaysia's economic and financial linkages with the rest of the world. Cumulatively, these series of developments are also expected to not only enhance the global integration of the domestic Islamic financial system but also increase Malaysia's potential as an International Islamic financial centre.

The Malaysian economy enters the year 2005 from a position of strength. The economic prospects for 2005 will continue to be favourable. The underlying conditions of the domestic economy continue to remain strong, with robust private consumption and investment activity. While there are signs of slower global growth, there is uncertainty relating to the extent to which specific developments may moderate growth. In particular, these include the impact of higher oil prices, the extent to which interest rates will be raised and the depth and duration of the electronic downturn. Despite these emerging trends, domestic economic growth in 2005 is projected to be sustained at 5 – 6%. This growth forecast takes into account the potential uncertainties related to the global developments. The more modest the impact of these developments on global growth, the more supportive will be external demand on the growth prospects of the domestic economy. While these uncertainties prevail in the external environment, the strong domestic demand projected for the year enhances the underlying potential for the favourable growth prospects in 2005.

The favourable global environment in 2004 has, however, masked the risks to world growth arising from the structural imbalances prevailing. The stronger global growth performance in 2004 has not provided a sense of urgency to address directly the risks associated with these imbalances. In a less favourable environment, the risk of disruptions, disorderly adjustments and instability would be heightened. Moreover, such disorderly adjustments could also occur if there is over-dependence on exchange rate adjustments to address these imbalances. Exchange rates may be only part of the solution. The issue of competitiveness, however, requires more than just adjustments in exchange rates. Ultimately these structural imbalances would have to be addressed by the countries where these imbalances exist. The long-term solution is for a rebalancing of demand across the world to eventually reduce the prevailing imbalances. With rising income levels across Asia, there is tremendous potential for this to be part of the adjustment process.

The excessive focus on exchange rates as corrective mechanisms for these imbalances has led to speculative capital inflows, particularly into the Asian economies. Exchange rate flexibility in response to these flows would result in significant exchange rate volatility and would not reflect the prevailing underlying fundamentals. Such adjustments also face the risk of shifts in the opposite direction should a reversal in the flows occur. Malaysia has therefore consistently maintained that, in the present environment, the exchange rate regime in place best serves the nation's interests. Developments in the region and in the international environment will continue to be closely monitored, with assessments made on the implications on the efficient functioning of the mechanism in place. The basis for any change would therefore be made on long-term structural considerations and not short-term movements in capital flows or transient shifts in exchange rate expectations.

With the foundations for strong performance in the financial sector now being firmly achieved in the first phase of the Financial Sector Masterplan, the transition into the second phase of the Masterplan can now be made. In the year 2005, the focus of attention will continue to be to develop and strengthen the framework to enhance access to financing, particularly to meet the new requirements of the economy; to enhance competition and hence efficiency; and to strengthen the infrastructure for consumer protection. While the banking sector is encouraged to provide access to new areas of growth, non-banking institutions, including specialised financial institutions and the cooperative sector, will be developed to have an increasingly more important role.

It has been announced that a bank for small and medium enterprises (SMEs) will be established to complement the role of the banking sector in providing financial services to this segment. The SME bank will also provide non-financial services to SMEs, including nurturing SMEs and creating an entrepreneurial community. Other activities envisaged for the SME bank include providing guarantees to loans granted by banking institutions, facilitating securitisation, providing credit ratings and preparing business reports on SMEs. The role of the cooperative sector in providing financing to micro-enterprises will also be strengthened to enhance access to financing to this sector. A cooperative commission initiated by Bank Negara Malaysia is being established to support this objective. The cooperative commission will have the supervisory oversight of the cooperative sector including taking on a developmental role.

The second phase of the Masterplan will entail the further deregulation and liberalisation of the financial system in general and in the banking system in particular. As part of this process existing foreign banks will be accorded greater operational flexibility so that they can better serve the needs of the growing economy. With this move, foreign banks will, however, need to become more integrated with the domestic economy. A further development in 2005 will be the establishment of a deposit insurance corporation as part of the efforts to strengthen the consumer protection framework and to promote financial stability.

The Malaysian financial landscape will continue to be redefined with the setting up of investment banks. This move essentially transforms merchant banks, stock broking companies and discount houses within the same banking group into investment banks. This rationalisation will contribute towards a more dynamic financial system, with a greater ability to compete effectively in the domestic and international markets. Their integration will not only contribute to enhancing efficiency and effectiveness, but also strengthen the potential to capitalise on expanded business opportunities. These new investment banks will be jointly regulated by Bank Negara Malaysia and the Securities Commission. The permissible foreign equity participation for investment banks is also increased from 30% to 49%, as part of the effort to strengthen global linkages and enhance the transfer of specialised skills and expertise.

A challenge towards increasing efficiency levels in the financial system is in improving the use of electronic payment delivery channels and settlement instruments. Bank Negara Malaysia's policies and initiatives in the payments systems in 2004 have essentially been aimed at creating an enabling environment to promote the migration to electronic payments from a predominantly paper-based system. There has been a general reduction in the ratio of currency in circulation to GDP from 7.5% to 7.2% and the value of cheques to GDP from 320% to 303% during the year. As part of the measures to enhance the efficiency and safety of the payments systems, the banking industry in Malaysia has taken the lead in the Asia-Pacific region to combat card fraud by investing in a chip-based infrastructure for payment cards. Moving forward, the focus will be on promoting greater efficiency and risk reduction improvements in domestic and cross-border payments, as well as harmonising standards and the functionalities of electronic payment channels across sectors, including the Government agencies. Emphasis will also be given on enhancing the consumer protection framework in payment-related services so as to provide a conducive environment for the large-scale adoption of electronic payment instruments by the general public.

Regional economic and financial co-operation strengthened during the year, with emphasis on promoting greater intra-regional trade and investment. Initiatives were also taken in the area of economic surveillance, the monitoring of cross-border linkages including capital flows, combating money laundering and terrorist financing and the building of stronger financial systems and markets among the countries in the region. Steps have been taken to enhance regional financing and swap arrangements. In addition to the liberalisation of the domestic bond market to allow for the issuance of papers denominated in domestic currency by multilateral institutions, being part of the Asian Bond Market Initiative, a second Asian Bond Fund has also been launched. While the first Fund only invested in US dollar-denominated bonds, the second Fund is for investment in domestic currency bonds issued by sovereign and quasi-sovereign entities in regional markets. This new initiative is also aimed at supporting the overall efforts to develop domestic bond markets in the regional economies.

The world continues to change in economic, financial and geopolitical terms. It continues to present increased uncertainties, greater interdependence, more intense competition, and continues to test our ability to rise to emerging challenges. Indeed, our ability to survive and succeed in this environment very much depends on our level of tolerance, our ability to adjust, the extent to which we are able to effectively and efficiently manage our resources and the flexibility of policy to respond to these changing conditions. All this will also depend on the strength and structure of our economy, the degree of mobility of our resources, and the efficiency and soundness of our financial system. Therefore, our policy initiatives are towards meeting these objectives.

Zeti Akhtar Aziz
Governor

23 March 2005