Governor's Statement

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The more optimistic global environment and stronger domestic economic conditions have enhanced Malaysia's prospects as we advance into 2004. The renewed strength of the recovery of the world economy is now supported by a more synchronised expansion of the major industrial economies and the strong growth in the Asian region. While economic and financial policies have been important in providing the stimulus to the improved overall growth performance, the increasing significance of the private sector in driving this growth has increased the prospects for the sustainability of these positive trends.

Strong domestic demand has been particularly evident in the Asian region, reflecting the increased role of the private sector in driving the growth. This strong growth in regional demand has provided a rapidly expanding market for Asian goods and services. The increased regional integration is, however, not only occurring as a result of the growth in intra-regional trade, but also in the form of financial flows, with intra-Asian investments gaining greater significance, resulting in a growing amount of the savings in Asia being reinvested in the region. As these trends become more pronounced, they would not only contribute towards greater regional integration but would also reinforce further the regional growth momentum. In addition, the growing demand from the Asian economies has also been increasingly supportive of the global recovery. Indeed, this trend would contribute towards reducing the external imbalances existing in the global economy and increase the prospects for a more balanced global growth.

The Malaysian economy in 2003 benefited from the more robust external demand and increased private sector activity in the domestic economy. A better-than-expected economic performance of 5.2% was recorded during the year. The growth momentum is projected to strengthen further in the region of 6 – 6.5% in 2004, with the private sector assuming the lead role as the engine of growth. Private consumption and investment activity are projected to be stronger, underpinned by improved economic and employment conditions and stronger balance sheets in both the corporate and financial sectors. Growth is expected to be stronger across almost all sectors of the economy, with the services and manufacturing sectors being the main drivers of growth. While the role of the Government in the economy remains important, the focus of policy has now shifted to providing an enabling environment, including enhancing the Government delivery system to reduce the cost of doing business, and to providing a stable and sound macroeconomic environment.

The underlying economic and financial fundamentals have continued to strengthen in the early part of 2004, according monetary policy the flexibility to remain supportive of private sector activity. This is reflected in the near absence of inflationary pressures in both the consumer and asset markets and excess capacity in the system, evident in the gap between actual and potential output. Price stability has also been reinforced by productivity improvements and further capacity expansion. In addition, as the globalisation process intensifies, there is increased access to goods and services at lower costs. Moreover, as the corporate sector performance improves, higher costs will not always translate into higher prices in this more competitive environment. The Government's fiscal prudence has also been a factor in reinforcing price stability. Against this environment, low interest rates can remain for some time to come.

In this stable environment, and with the much strengthened banking system and progress achieved in the development of the financial infrastructure, it is timely to transition to the new interest rate framework. The aim is to achieve greater efficiency in the operations of the financial markets and thus facilitate more effective pricing in the financial system as well as enhance the effectiveness of the monetary transmission mechanism. The window of opportunity will therefore be taken during this period when the current interest rate policy will remain unchanged. This will provide the market with the opportunity to adjust to the new monetary operating procedures to achieve the desired outcome of more efficient functioning financial markets and increased effectiveness of monetary policy.

Liquidity has remained ample in an environment of a strong external balance, a steady inflow of foreign direct investment and increased portfolio inflows. Sterilisation operations, however, have been conducted, taking into consideration the need to ensure adequate liquidity to support financing of the private sector-led growth, while at the same time, ensuring that this does not result in any risks to the financial system and to the economy. Important to this process is that the Central Bank has the instruments and the capacity to absorb this liquidity. The costs involved in these operations are essentially covered by the returns on the investment of the increased inflows. The Central Bank will absorb such immediate-term costs of monetary policy to ensure the stability and sustainability of our medium and long-term prospects. In the current environment, the net position has continued to remain positive. In managing the reserves, a well-diversified reserves portfolio is maintained. Major considerations taken into account are capital preservation and liquidity, while optimising returns. This has ensured a sound financial position for the Central Bank.

On the exchange rate, the objective of our policy remains unchanged, that is, to achieve exchange rate stability, in particular, with our trading partners. As our trade with the region becomes increasingly significant, exchange rate stability in the region becomes increasingly important. At the very outset, when the pegged exchange rate arrangement was introduced almost six years ago, we have stated that we want an effective exchange rate mechanism that will efficiently facilitate international trade and investment. While there may be trade-offs, the benefits of the present system have far outweighed any costs. Consideration for an alternative system should only be made in the event of anticipated fundamental misalignment or structural change or if new regional arrangements can be evolved.

Extreme movements and high volatility in exchange rates have always been a concern, even to the major economies. For emerging market economies, the ramifications of such movements are even more pronounced and far-reaching. Recent pronouncements and pressures on Asian economies to adopt more flexible exchange rate regimes have been based on the view that adjustments in the exchange rate would correct structural imbalances in the global economy. It needs to be recognised that the comparative advantage that Asia possesses is not due to exchange rates but reflects other factors that have resulted in lower costs. Adjustments in exchange rates are therefore unlikely to correct such structural imbalances. In addition, whether exchange rate appreciation can address any signs of overheating needs to take into account the nature of the price pressures. In situations where the pressures are sectoral or localised, other measures, including prudential measures, may be more effective in addressing these developments. Indeed, the exchange rate should not be used for the purpose for which it may not be able to yield the desired results.

In strengthening our competitiveness, Malaysia has adopted a more comprehensive strategy, addressing all dimensions that will enhance competitiveness. This includes strategies to enhance labour quality and productivity, innovation, enterprise and the public delivery system, applied not only to the manufacturing sector but to all sectors of the economy. The strategy is essentially to assess costs on a more comprehensive basis. The strategy is towards achieving an enhanced overall cost competitiveness, leveraging on our low country risk, including the economic, social and political stability, reliable intellectual property protection framework, and our industrial maturity. Moving forward, efforts will therefore be focused on developing an efficient supply chain that is reinforced with local supporting industries, and on becoming more knowledge-based with the necessary skills and competencies.

An integral part of the strategy on competitiveness is to develop a robust Small and Medium-Scale Enterprises (SME) sector that will be able to contribute more significantly to the economy. Two years ago, Bank Negara Malaysia proposed a comprehensive framework for the development of SMEs to provide an enabling environment and to strengthen the infrastructure for SME development. The progress of the work achieved thus far will be deliberated by the National SME Development Council. The Council, which is being set up by the Government, will function as the highest policy-making body that will chart the future direction and strategies for SME development and ensure coordination and comprehensiveness of the policies.

As part of the efforts to enhance overall cost competitiveness, reduce country risks and sustain our position as a destination of choice for both local and foreign investors, a gradual liberalisation of rules and regulations will be undertaken by Bank Negara Malaysia to improve the delivery systems and reduce regulatory costs to business. Leveraging on technology to improve the surveillance system on capital flows has improved the ability to monitor the risks associated with these flows. This has therefore enabled the further deregulation and liberalisation of foreign exchange rules. In addition to the liberalisation in early 2003, further liberalisation of foreign exchange rules will take effect from 1 April 2004 to improve efficiency in the delivery system, while further reducing the cost of doing business.

In the development of the financial system, significant progress has been achieved during the first three years of the Financial Sector Master Plan. The efforts to evolve a more diversified financial structure that is complemented with the development of strengthened financial institutions have now yielded positive results. While the banking sector is still the main mobiliser and provider of financing, the more diversified financial infrastructure has increased the potential for new and alternative channels to mobilise savings as well as increased the alternative sources of financing. Financing from the capital market, in particular, the private bond market, specialised financial institutions and the insurance sector, have now become more significant. The provision of financial services to micro-enterprises has also been strengthened, while venture capital as an alternative form of financing has provided increased support to the new areas of growth that are more technology and knowledge intensive.

Significant progress has been achieved on institutional development and capacity building. The level of capitalisation, the capacity to lend to a wider range of activities, the level of operational efficiency, the level of skills, the more differentiated scope of business, the level of innovation, the standards of service quality and the risk management capacity have shown significant improvements. This is reflected, in particular, in the lower operating costs, the narrowing of margins, and the wider range of new products and services. These improvements are also reflected in the ability of the domestic institutions to maintain market shares in an environment of increased competition and narrowing margins.

The supporting infrastructure has also been strengthened to reinforce this trend. These include the consumer education programme, the strengthening of the Credit Guarantee Corporation, the establishment of the International Centre for Leadership in Finance to develop world-class leaders in the financial services sector and the new Financial Mediation Bureau to be established this year. Work is also underway to develop a deposit insurance scheme that will add another layer to the consumer protection framework, representing a further building block in our financial infrastructure. Of significance is that it is designed to take into account the structure and conditions in our financial system and economy. The deposit insurance system will have a broader mandate that will integrate the financial restructuring processes and structure within its operations. The system will also be the first to provide for the protection of Islamic deposits in line with Shariah principles. These developments have also been complemented by improvements in the regulatory and supervisory framework to ensure the soundness and resilience of the financial system.

Access to financing to a wider range of activities in the private sector, in particular, to the SMEs, continues to improve. Outstanding loans to SMEs grew at an annual rate of 10% in 2003. Financing to the private sector and to the SMEs is expected to remain robust in 2004. Other measures that have supported this trend include the establishment of the Small Debt Resolution Committee, supported by Bank Negara Malaysia's SME Special Unit and continued availability of Bank Negara Malaysia's special funds that currently amount to RM5.6 billion. New avenues are also being developed to increase the SMEs' access to capital market funding.

As the financial sector evolves to meet the needs of increasingly sophisticated consumers, attention has been directed to ensure that basic banking facilities are widely available and that these facilities are offered at minimal costs to all segments of society. In addition, as banking consumers become more empowered by their awareness of financial products and facilities, they will exercise their rights and ability to select between products and services offered by different institutions. This, combined with the transparency requirements, will ensure that pricing is commensurate with the financial products and services. The competitive process is also expected to result in more competitive pricing of products and services and encourage greater innovation.

The insurance industry continued to perform an important role in supporting economic growth as a mobiliser of long-term funds and as a risk transfer mechanism. An important aspect in the development of the insurance industry is also the increasing socio-economic role of insurance in meeting the demand for healthcare financing support. This is being realised through the increasing provision of medical and health insurance products. As major institutional investors, insurers have an increasingly important role in the development of the capital markets. The insurance fund assets have increased significantly in 2003 to account for the largest share of the total fund assets of the industry. During the year, the framework governing insurance market practices, including claims handling practices, standards of product disclosure and dispute resolution mechanisms, were further strengthened to ensure greater consumer protection. A comprehensive consumer education programme was also launched to promote a larger role for consumer activism in the insurance business and practices and to ensure competitive prices to consumers.

The comprehensiveness of the Islamic financial system in Malaysia, in terms of both the pool of Islamic financial players as well as the broad spectrum of innovative Islamic financial products have enhanced the role of the Islamic financial system as a financial intermediary and enabler of economic growth. Further progress in the development and expansion of the Islamic financial system was achieved in 2003. Policy initiatives have focused on liberalising the domestic Islamic banking system, increasing the level of competition, and promoting financial innovation. Other measures were also directed towards strengthening and broadening the legal framework for Islamic banking and finance. On the global front, the Islamic Financial Services Board (IFSB) has drawn wide participation and has made significant progress in fulfilling its mandated role. The promulgation of standards on the capital adequacy and risk management is progressing rapidly and work on establishing standards for corporate governance has already been initiated. The year has also seen further Islamic-based issues accessing the international capital markets. Cumulatively, these developments have enhanced the role of Islamic finance as an integral component of the international financial system.

Bank Negara Malaysia has continued its developmental role during the year, over and above our core mandate of monetary and financial stability. This broader mandate is outlined in our Financial Sector Master Plan and essentially takes a holistic approach in the development and management of the financial system. While efforts to address areas of vulnerability and identifying emerging risks are important, these need to be complemented with efforts to build the financial infrastructure. Institutional and capacity building are necessary foundations for the financial system. It is in this context that the Central Bank drives the development of the financial sector.

Zeti Akhtar Aziz
Governor

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