Tan Sri Dato' Dr Zeti Akhtar Aziz: Economic and monetary developments in Malaysia for 2001

Statement by Tan Sri Dato' Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the BNM 2001 Annual Report Press Conference, Kuala Lumpur, 20 March 2002.

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In the tradition of Bank Negara Malaysia, I have the pleasure to officially release the Bank Negara Malaysia Annual Report for the year 2001. The report releases the Bank's Annual Accounts for the year 2001, and provides an analysis of the economic and monetary developments in 2001, and gives the forecast for the Malaysian economy for year 2002.

The country's economic performance in 2001 was significantly influenced by the unprecedented external developments during the year that had widespread implications on the global economy. Being a highly open economy, Malaysia was affected by the weak external economic environment. The impact was compounded by the effects of September 11. Malaysia's strong economic fundamentals and the promotion of domestic sources of growth have however, reduced the impact of the external developments on the domestic economy. The strengthened macroeconomic fundamentals have also increased policy flexibility to implement pro-growth policies without creating imbalances in the domestic economy. With adequate domestic resources, stability in domestic financial markets and prompt pre-emptive actions, Malaysia has been able to weather this global economic slowdown to record a positive growth for the year at 0.4% and to contain unemployment at below 4%. This growth was sustained with a strengthened balance of payments position.

Macroeconomic policies during the year were focused on supporting domestic activities as the main driver of economic growth. Private consumption remained resilient despite the lower export earnings. National savings remained high at about 35% of GNP. Public sector investment increased by 15.5%, while consumption expenditure increased by 11.9%, mitigating the impact of the contraction in domestic private investment. The more diversified economic structure of the Malaysian economy also moderated the impact of the decline in external demand faced by the export-oriented industries. The weaker growth in the export-oriented manufacturing sector which contracted by -10.2% was mitigated by positive growth in all other sectors. Stronger growth in the domestic-oriented industries, which increased by 7.4% compensated for the shortfall from declining external demand. The agriculture and the mining sectors, which expanded by 2.5% and 0.2% respectively, accounted for 15.5% of GDP. Domestic-oriented industries in the manufacturing sector now accounts for more than one-quarter of total output. Domestic content in the services sector is now higher, at about 80%. The construction sector, which has high local content and multiplier effects, also performed better during the year. The pro-growth policies to stimulate domestic activities benefited in particular the services sector which sustained a growth of 4.9% in 2001. The expansion was broad-based, with strong increases recorded for intermediate services, particularly finance and insurance as well as communication sub-sectors. Strong expansion was also recorded in the final services group, particularly government services and utilities sub-sectors.

While the overall growth had moderated during the year, the overall balance of payments turned around to a surplus position of RM3.7 billion in 2001. While the current account surplus narrowed in 2001, the surplus remained large at RM27.4 billion or equivalent to 8.9% of GNP. This reflected a moderate decline in the trade account and an improvement in the income and services accounts.

As at end-2001, BNM's international reserves was higher at US$30.8 billion. Subsequently, reserves have increased further to US$32.6 billion as at 14 March 2002, sufficient to cover 5.5 months of retained imports and cover 5.3 times the short-term external debt. While the external debt increased during the year, the outstanding amount has remained low at 55.4% of GNP. The debt profile also remained sound with short-term debt accounting for only 13.7% of total debt.

In 2001, Malaysia's macroeconomic fundamentals continued to strengthen. Inflation moderated to 1.4%; international reserves continued its increasing trend, driven by sustained inflows of trade surplus and long-term capital flows; the overall fiscal position of the Federal Government improved; domestic savings remained high and the financial system strengthened significantly. These stronger fundamentals have increased the economy's resilience in the face of a more difficult external environment. The pegged exchange rate regime continued to be well supported by the fundamentals and facilitate international trade and investments during the year. The stability in the exchange rate also allowed for the effective implementation of pro-growth policies and the accelerated pace of banking and corporate restructuring.

The Malaysian banking sector strengthened further and remained resilient to perform its intermediation function efficiently and effectively throughout 2001. The capital position of the banking system improved with the risk-weighted capital ratio increasing to 12.5% as at end-January 2002. Although non-performing loans had increased in 2002, it has remained at manageable levels. The net NPL ratio of the banking system stood at 8.4% as at end-January 2002, cushioned with a loan loss provision of 58.7% on the NPL amount or 146.5% if collateral are taken into consideration. The banking system continued to record profits in 2001 amounting to RM7.5 billion, which will further strengthen the capital position of the banking sector. In terms of potential risk to the banking sector, total outstanding loans in arrears have stabilised and continued to remain at manageable levels. Significant progress has been achieved in the financial restructuring undertaken by Danaharta and Danamodal. Progress in corporate debt and non-debt operational restructuring under the arrangement of the CDRC progressed at a more rapid pace in 2001 with the implementation of the new framework introduced in August. As part of debt restructuring, a number of large corporations have undertaken rigorous restructuring exercises in terms of management and ownership structure, and the disposal of non-core businesses and assets. The satisfactory progress of corporate debt restructuring under the new CDRC framework is expected to have a positive impact on the NPLs in the banking sector. The successful resolution of the larger CDRC cases has contributed towards reducing the NPL in the banking system. With the completion of the debt restructuring process under CDRC envisaged by July 2002, the asset quality of banking institutions can be expected to improve by approximately 3 percentage points.

The consolidation programme for the domestic banking institutions represents a major structural enhancement of the banking system. The successful completion of the consolidation and integration of the banking groups in 2001 has benefited the industry and the banking public. The merged banking groups are now more well capitalised to meet future calls for capital expenditure as well as undertake a wider scope of business activities. The operational business integration process and rationalisation exercise have been an important part of the merger to reduce duplication of resources and to attain higher levels of economies of scale and efficiency in the banking institutions.

The year 2001 marked a significant period for the Islamic banking industry. In terms of performance, the industry registered encouraging growth during the year. Total assets of the Islamic banking increased by 25.2%, amounting to RM58.9 billion as at end-2001 representing 8.2% of the overall banking system. In terms of profitability, significant growth was recorded with an increase in pre-tax profits by 69.9% to RM905.9 million during the year. Among the measures implemented in 2001 to further develop and strengthen the regulatory framework of the Islamic banking industry were the adoption of Risk Weighted Capital Ratio (RWCR) framework; the implementation of Rate of Return (ROR) framework; and the implementation of training and awareness programmes. In the area of research and training in Islamic banking and finance, an industry-owned institute named Islamic Banking and Finance Institute Malaysia (IBFIM) was established. IBFIM will become a one-stop centre for the purposes of education, training and research.

On the international front, significant progress was achieved on two initiatives, namely, the International Islamic Finance Market (IIFM) and the international standard-setting body. BNM participated actively in both initiatives. The standard-setting body, to be located in Malaysia, will focus on developing international best practices and prudential standards governing the supervision and regulation of Islamic financial institutions. These encouraging developments will contribute further to the overall development of the global Islamic financial system.

The insurance industry maintained a positive growth trend in premium income for the third consecutive year since the Asian crisis. Premium income grew by 12.4% in 2001 while the capitalisation of insurers strengthened further to RM4.9 billion as at the end of 2001. The increase in the minimum capital requirement to RM100 million, with effect from 30 September 2001, has been instrumental in advancing the consolidation of the industry. Since 1999, a total of eight mergers and acquisitions were completed. Seven other M&As involving 13 insurers are currently at various stages of implementation.

In 2001, macroeconomic policy was focused on managing the downside risks arising from the slowdown in the major economies. Macroeconomic policies were targeted at creating a positive and enabling environment for domestic demand to support growth. The strengthened economic fundamentals provided Malaysia the policy flexibility to implement pro-growth policies without creating imbalances in the economy.

Fiscal policy was expansionary to stimulate domestic economic activity. As the external environment became more adverse, the Government implemented a series of fiscal stimulus programmes in March, and again in September 2001. The fiscal deficit has, however, been kept at manageable levels to ensure long-term fiscal sustainability. Revenue performance was strong in 2001 resulting in a lower fiscal deficit at 5.5% of GDP, compared with earlier estimates of 6.5% of GDP.

While the 3-month Intervention Rate was maintained at 5.5% for the first nine months of the year, the low interest rates ensured that monetary conditions were conducive to reinforce other counter-cyclical measures to promote domestic activity. Following the events of September 11 and the heightened risks towards further weakness in the domestic economy, BNM reduced the Intervention Rate by 50 basis points to 5% on 20 September. Low and stable interest rates, ample liquidity and the low inflation rate contributed towards providing a positive domestic environment. In the low interest rate environment during the year, bank lending and financing via the bond market increased. Total financing through loans extended by the banking system and PDS issued by the private sector increased by RM33.5 billion or 6% in 2001. At the same time, financing to the small and medium enterprises (SMEs) was sustained.

The significant progress that was achieved in financial sector reform and restructuring in 2001 has enabled BNM to shift its focus from managing banking sector problems to the medium and longer-term issues of developing a more competitive and resilient banking sector. The Financial Sector Masterplan that was launched in March 2001 aims to provide the blueprint for the development of financial sector over the next ten years. To date, 9 out of the 119 recommendations under the FSMP have been fully implemented. In addition, 22 recommendations are being implemented on an on-going basis.

Outlook and Prospects for the Malaysian Economy in 2002

As we enter the year 2002, indications are that world trade is expected to recover to about 2.5% in 2002. Growth in the major industrial countries as a group is expected to stabilise at 1.1%, reflecting a stronger growth of 1.4% in the US economy.

Malaysia is well positioned to benefit from the emerging recovery in the global economy. Real GDP growth in the Malaysian economy is projected to recover to 3.5% in 2002. The projection is based on stronger growth in private consumption, a modest recovery in private investment, sustained public sector expenditure and moderate growth in exports.

Current domestic indicators suggest that the Malaysian economy is in the early stages of recovery. The index of leading indicators has shown positive growth for six consecutive months. Both the decline in exports and manufacturing production have also begun to moderate. While inflation is expected to edge up slightly, it is forecast to remain below the 2% level. On the domestic front, resilient domestic demand and the recovery in external demand is expected to result in a more broad-based and diversified growth. All sectors of the economy are forecast to show positive growth in 2002. More encouraging is that private investment is expected to recover in 2002 to register a positive growth of 1.2%. Specifically, capital investment in the manufacturing sector is expected to increase following a more strengthened global recovery in the second half of 2002. Foreign direct investment (FDI) is expected to show stronger growth in the year.

In 2002, the current account surplus is forecast to remain large at 7.9% of GNP. The financial account is expected to be supported by sustained inflows of long-term capital, including higher inflows of FDI. In view of the improved global economic conditions, FDI inflows are expected to be higher due to the projected inflows of equity from strategic alliances as well as inflows for expansion and new investment, in the manufacturing, services and oil and gas sectors.

In recent years, FDI has become more broad-based with higher investment in the services sector. In addition, foreign investments are not only through equity, but also at the management level, especially in sectors such as information and communication technology, telecommunications, ports and financial services sectors. Factors supporting higher inflows in 2002 include the further liberalisation of domestic regulations especially in the services and construction sectors; open and liberal trade regime; low cost of doing business; overall macroeconomic stability; high quality physical infrastructure; and efficient financial system. The Government emphasis on customizing incentives to meet the specific needs of industries and investors has also provided added stimulus.

Economic, Monetary and Financial Management in 2002

The immediate policy concern in 2002 is to ensure that recovery of the Malaysian economy gathers momentum and that any downside risks are minimised. Given Malaysia's strengthened fundamentals, Malaysia is well positioned to tap the emerging global recovery.

Macroeconomic measures have provided a positive environment that contributes to improving the enabling environment for businesses. Malaysia macroeconomic policies are essentially already in place. The focus of policy is therefore on supply side measures to enhance Malaysia's competitive advantage. Emphasis is therefore on policies to accelerate further structural adjustments.

Supply side measures aim to address the issues of enhancing efficiency and productivity to reduce the cost of business operations in Malaysia. Improving efficiency requires strengthening institutional infrastructure as well as more specific measures that contribute to increasing efficiency of public services, lowering cost of inputs to be in line with international prices, raising education and skill levels and enhancing use of information technology to widen technical capacities. These measures would essentially reduce operational costs and improve the nation's competitiveness.

In this more uncertain environment a stable exchange rate is a major competitive advantage. For an open trade-dependent economy, stability in the exchange rates accords significant advantage in enhancing trade and investment opportunities. By eliminating wide swings in the exchange rates, the pegged exchange rate regime has provided a stable environment for businesses to plan their investments and to undertake their operations. At the same time, stability of the exchange rate also provides an environment that facilitates continuous structural reform to improve Malaysia's competitive position. It is through long-term structural adjustments rather than frequent adjustments in the exchange rate that a country can build a strong business foundation, improve efficiency and create the enabling environment that encourage competition and innovation.

As a small open economy, Malaysia does not have influence over the external factors that affect the economy. However, by working on strengthening domestic economic fundamentals, Malaysia will be in a stronger position to manage and mitigate the impact of the volatility in the external sector. Three elements are important in ensuring that an exchange rate regime continues to operate effectively. First, it needs to be well supported by the domestic fundamentals. Second, there must be flexibility in domestic markets to enable the economy to adjust and absorb the impact from external volatility. Third, increased competitiveness is achieved through efficiency and productivity gains rather than relying on currency depreciation.

In respect to the conditions prevailing in Malaysia, Malaysia's strong economic fundamentals, with low rate of inflation, strong external balance, low level of foreign debt, strong reserves levels and strengthened banking sector have provided strong support for the pegged exchange rate regime. Malaysia also has sufficient flexibility to undertake adjustments on all sectors of the economy to remain competitive. The diversified economic structure, the enhanced mobility of capital and labour has also provided Malaysia with increased resilience to weather external shocks. Malaysia also had the flexibility of policy to respond to the circumstances. In all cases, when an exchange rate regime has failed, it was not due to the regime itself, but due to the weaknesses in the economy and the financial system.

Having undergone significant transformation and emerging with a much strengthened set of fundamentals, the Malaysian and regional economies are better able to absorb the volatility in the exchange rates. Countries are also more cognizant of the costs of currency depreciation, particularly on confidence.

As an example, comparing the response of regional currencies during the two episodes of yen depreciation, one in the early part of 2001 and the other towards the end of 2001 and early 2002, it is clear that the response of regional exchange rates was significantly more muted during the most recent episode. The experience has shown that periods during which many of the countries in the region had experienced significant declines in their exchange rates, it was difficult to find clear evidence of a relationship between the degree of depreciation of the exchange rate and the growth in exports. The exchange rate has not been a dominant influence in determining export performance. More important, it is the overall competitiveness of the economy that will ensure sustained export performance. Current conditions favour monetary policy in 2002 to remain accommodative, reinforcing the continuing counter-cyclical policies. Monetary policy will build on the gains from the cumulative monetary easing initiated since 1998, to ensure that the economic recovery process becomes well entrenched. Emphasis will be placed on creating an environment of stability and predictability to facilitate investment decisions. With low inflation and stronger economic fundamentals, Malaysia has the ability to exercise greater policy flexibility to preserve longer-term sustainability and stability.

In strengthening the resilience and competitive position of banking institutions, BNM will continue to further strengthen the regulatory and supervisory framework. The objective is to provide a conducive environment for banking institutions to be more efficient through innovation and competition amongst players in the financial market. The challenge is to manage the trade-offs between encouraging innovation in the financial system and preserving overall financial stability. Towards this end, a total of 14 recommendations under the FSMP, involving 36 projects, are targeted to be fully implemented in 2002. These projects relate to building the capacity and enhancing the efficiency of financial institutions as well as the development of consumer education and protection.

Policy measures for the insurance industry in 2002 will continue to focus on promoting incentives for improved performance, encouraging the adoption of best practices and strengthening consumer protection. Towards this end, 10 recommendations under the FSMP involving 13 projects are targeted to be fully implemented in 2002. The recommendations include the introduction of independent financial advisers (IFAs) and the adoption of 'best advice' practices in the sale of life insurance products that will enable Malaysian consumers to obtain professional independent advice on their financial options. Given the right strategic focus, there is tremendous potential for future growth in the life insurance sector, particularly in products and services that provide for retirement needs, capital accumulation and long-term care. Given the right strategic focus, there is tremendous potential for future growth in the life insurance sector, particularly in products and services that provide for retirement needs, capital accumulation and long-term care.

To achieve sustainable growth, there is a need for insurers to intensify research and development efforts to provide consumers with a broader range of innovative and competitively-priced products. Furthermore, there is a need to establish and continuously strengthen minimum underwriting standards and controls, particularly in new lines of business. This is to ensure that business is underwritten on sound and prudent insurance principles. Finally, insurers need to adopt prudent pricing policies and investment strategies that are properly matched with insurers' long-term financial commitments as illustrated to policyholders. Malaysia remains committed to strengthening the domestic corporate and financial infrastructure. The corporate sector is expected to continue to restructure to enhance competitiveness, to be in a stronger and better position to support economic growth. At the same time, while a number of large corporations have undertaken rigorous restructuring exercises, focus will also be channelled on SME development in 2002. The SMEs are important in providing the linkages between the various subsectors within the economy and represent a potential source of dynamism and driving force. SMEs also represent indigenous enterprises with potential to grow and evolve into larger and listed companies, with the potential to become regional or global players. For the SMEs, the focus of its development will be placed in creating an enabling business environment that is not confined only to providing access to financing to the SMEs, but also to efforts towards enhancing their technological capabilities, provide training and access to advisory services, as well as channels to market their products and services. The formulation of a comprehensive framework for the development of SMEs will be based on a survey of SMEs conducted by BNM through the banking system.

As part of the effort to strengthen the economy's institutional structure further, a new legislation, the Development Financial Institutions Act 2002 (DFI Act), has been enacted and came into force in February 2002. The new Act empowers BNM to enforce the various provisions of the Act and to date 6 DFIs have been placed under the purview of the Act. DFIs, as a component of the financial sector will continue to play an important role in the socio-economic development of the country, in particular, in providing financing facilities to certain targeted sectors of the economy. Strategies are, therefore, formulated to promote the development of efficient and effective DFIs. The ultimate objective for the DFIs is to achieve their mandated functions at minimum cost to the Government. Moving forward, the focus will be on strengthening the overall financial and structural capacity as well as improving the operational efficiency of the DFIs.

Bank Negara Malaysia's financial position in 2001, has been examined and certified by the Auditor General. Total assets of BNM rose to RM149.7 billion as at end 2001 (RM148.9 billion at end-2000). The major increase in assets is attributed to an increase in international reserves. BNM's international reserves increased to RM117.2 billion (US$30.8 billion) as at end-2001. BNM registered a net profit of RM0.7 billion in 2001 for the financial year ended 31 December 2001. BNM declared a dividend of RM0.5 billion to the Government for the year 2001.