Zeti Akhtar Aziz: Facing Malaysia's current economic challenges

Speech by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia (Bank Negara Malaysia), at the Invest Malaysia 2015 "Facing Malaysia's Current Economic Challenges", Kuala Lumpur, 23 April 2015.

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It gives me great pleasure to be here at Invest Malaysia 2015. This event takes place at a time of major transformative change in the world, in the region and in our country. These changes include the world becoming more inter-connected, integrated and interdependent within and across countries. It also reflects the significant shifts in demographic structures occurring in major parts of the world and the marked transformation in the international financial landscape following the international regulatory reforms prompted by the recent Global Financial Crisis. Slower but nevertheless equally far-reaching are the changes in the institutional arrangements that are altering international and regional circumstances. A further fundamental change is the greater reliance on unprecedented and unconventional monetary policy responses that has brought us into uncharted territory. And finally, the world is also being transformed by the more significant cross-border financial, information and talent flows.

My remarks today will touch on three key areas: the current challenges confronting the global and domestic economy in this new environment; the intrinsic strengths of the Malaysian economy that will enable us to navigate through these more challenging times; and finally on the new changing profile of Malaysia's investment landscape and what it means for the prospects of our economy.

Key challenges and prospect for the world and domestic economy

We meet today at the time when the international economic and financial environment has become immensely more challenging. To a large extent, this has been due to the significantly higher degree of uncertainty that has prevailed on several fronts in the world today. Firstly, is the uncertainty about the prospects for global growth in the aftermath of the Global Financial Crisis. The persistence of this uncertainty is now having its implication on sentiment and confidence. Secondly, are the conditions in the commodity and financial markets that have become more volatile. The massive shifts in global liquidity are precipitating volatile capital flows with its immense implications on the asset and foreign exchange markets.

Thirdly, is the increased uncertainty prevailing in the policy environment in the global economy in terms of the extent and timing of policy changes. In particular, is the uncertainty with respect to the timing of the exit from the highly accommodative policies and the implications of the divergent monetary policy stance that are being pursued in the major economies. Fourthly, is the uncertainty related to the implementation of the structural reforms to address the structural rigidities and deficiencies that surfaced during the Global Financial Crisis. Fifth and finally, are also considerable geopolitical uncertainties prevailing in the world today. Cumulatively, these developments have compounded the uncertainties surrounding the global economy.

In this environment of great uncertainty, a more moderate recovery of the global economy has been projected for 2015. The most pressing challenge, therefore for the global economy, is to generate an economic recovery that is balanced and sustainable. Although the growth momentum has improved in a number of major economies, the growth has thus far been modest. In addition, weaknesses in several major economies continue to point to a global economy that remains vulnerable to downside risks. While the growth performance in most emerging economies is projected to moderate, collectively emerging market economies remain an important driver of growth of the world economy. A less robust external sector, slower domestic demand and specific domestic factors are amongst the reasons for this growth performance. In Asia, the growth for 2015 is projected to be sustained at 6.4%, while growth in the ASEAN-5 is projected to be in the region of 5%.

A further phenomenon affecting the global economic performance is the significant decline in global oil prices. While this has partially offset the weaker-than-expected growth momentum in some of the advanced countries, it has, in different degrees, adversely affected the oil exporting economies resulting in divergent growth performance across and within regions. Overall, however, the global economy is expected to benefit from the lower oil prices. A further recent development is the consequences of the unprecedented and divergent monetary policies being pursued in the major economies which have now resulted in significant policy spillovers to other parts of the world. Against this backdrop, the financial markets are therefore expected to remain in a state of heightened volatility during this year.

Given the degree of openness of the Malaysian economy and the financial system, we are of course affected by these global developments. These effects, however, need to be seen from the perspective of our underlying conditions. Malaysia is affected by these external developments through trade and capital flows. The diversified structure of our economy and of our exports has reduced the impact of the effects of the plummeting oil prices on the economy. While the current account of the balance of payments is expected to narrow, it is projected to remain in surplus. The global shifts in liquidity have caused sizeable outflows from emerging economies, including Malaysia, resulting in volatility in our financial markets and depreciations in our currencies. Despite these developments, after a stellar performance in 2014, the economy is projected to remain on a steady growth trajectory with an economic growth being in the region of 4.5 – 5.5% in 2015 with the growth mainly being driven by domestic demand.

Solid macro economic fundamentals

Building the foundations and resilience is the best line of defense to deal with the spillovers from external developments and on future shocks. Malaysia has, over several decades demonstrated time and time again, the ability to emerge from commodity price shocks, financial crisis and spill overs from disruptions generated from other parts of the world. While Malaysia will always be affected by such external developments, the strategy has been to have the flexibility to absorb and adjust and the strength to rapidly rebound. While each crisis or setback has been different, there are several common features that have allowed Malaysia to rapidly recover from such shocks.

For each respective major shock confronting our economy, Malaysia has registered V-shaped recoveries. This has essentially reflected the flexibility of the economy to adjust and the early and comprehensive policy response. The ensuing periods were often marked by structural reforms and institutional development that were designed to rebuild the fundamentals of the economy, address the weaknesses and vulnerabilities and to forge new areas of growth. This has, decade after decade, resulted in vital changes in our economic structure, from being export-led to now being predominantly domestic demand-driven, and from being over-reliant on specific sectors to having a more diversified economic structure with the manufacturing and services sectors having now transitioned to higher value added activities.

In essence, the structure of the economy has now become significantly more diversified in terms of sources of growth. While the export sector remains an integral component of our economy, domestic demand has now become the key driver of growth, anchored by strong private sector activity that now accounts for 70% of GDP. Underpinning the robust domestic demand is the sustained consumption spending and the revival of investment activity by the private sector. On the external balance, the more diversified exports and markets has allowed the balance of payments position to remain sound. Thus, despite the fall in commodity prices, the trade and current account is expected to remain positive, sustained by manufactured exports while the financial account is expected to adjust in an orderly manner.

During this same period, the financial sector restructuring, rationalisation and reforms, the institutional development, the strengthening of the regulatory, supervisory and legal framework and the development of the domestic financial markets have also diversified the financial sector and has enhanced its ability to disperse external shocks throughout the system. In particular, the financial reforms also involved the transition to greater market orientation and more liberalised financial system which has allowed for greater flexibility to adjust to the effects of shifts in global liquidity. The now deep and robust financial system is also underpinned by high levels of capitalisation and sufficient levels of liquidity. This has ensured that financial intermediation continues to be effective in providing support to economic activity.

It is therefore not the recent policies nor the new measures that have placed Malaysia on a stronger position to manage the external challenges. Rather it is the economic restructuring and financial reforms and development undertaken during the recent two decades and the building of several layers of buffers that has allowed us to weather the current challenging operating environment.

Further solid fundamentals include the relatively low rate of inflation, the low levels of unemployment, the high rate of savings and the manageable levels of external debt with the majority of debt in medium- to long-term tenures and with more than 40% of the external debt being denominated in ringgit. This, together with the ample international reserves, accords the economy with the policy flexibility to manage external risks. The combination of these factors will cumulatively enable a more effective policy response to mitigate the impact of any external shocks on domestic demand. While monetary policy has remained accommodative and access to financing has been enhanced, wide-ranging measures including macro prudential and tax measures have been implemented to rein in excessive leverage and excessive risk-taking to ensure growth is achieved without compromising our future prospects.

Malaysia's new investment landscape

As Malaysia progresses, so has the nature and profile of our investments. Compared to the 1990s, the current investment landscape is driven by the private sector, is geographically and sectorally more diverse, and is focused on high value-added activities and new growth areas.

Since 2010, Malaysia has experienced an investment renaissance and continues to benefit from a long-standing track record of being a profit centre for large multinational companies. Malaysia continues to be a recipient of foreign direct investment (FDI). This is also reinforced by a high level of capital spending undertaken by Malaysian companies. Regional economic corridors established has also expanded and transformed the Malaysian investment landscape to be more geographically diverse and extending the development throughout Malaysia.

The emergence of new growth areas in Malaysia such as renewable energy (e.g. solar) and semiconductors in fast-growing segments such as automotive, medical devices and telecommunications, has enabled Malaysia to be plugged into the global supply chain. Investment in the manufacturing sector has moved towards higher value-added activities, shifting from basic production and assembly to producing goods which have advance applications such as in the automotive and healthcare sectors.

As a country which is strategically located within close radius of two of the most populous economies in the world, China and India, Malaysia is centrally located in Asia, more broadly, and in ASEAN, in particular. With the conception of the ASEAN Economic Community (AEC), companies would benefit from the stronger economic inter linkages through greater cross border liberalisation and increased intra-ASEAN trade. Firms in this region will gain greater market access to 630 million people that are generating economic region that is worth USD2.4 trillion.

The increasing importance of Asia in the global economy has raised international interest to better understand Asia – the economies, businesses and the people that comprise the region. On that note, I would like to mention that Bank Negara Malaysia has entered into a collaboration agreement with the Massachusetts Institute of Technology Sloan School of Management (MIT Sloan) to establish the Asia School of Business (ASB) in Kuala Lumpur. ASB is envisioned to be a premier business school that develops transformative and principled leaders that will contribute to a better future and the advancement of the emerging world.

Conclusion

Let me conclude my remarks. We are now experiencing a phase of modest growth in the global economy, in an environment that is characterised by heightened uncertainty and volatile financial markets. The Malaysian economy has withstood these challenging times, supported by our strong initial conditions and early and comprehensive policy responses. The intrinsic strength of the economy, reinforced with policies to encourage greater investments that would serve to ensure greater economic sustainability for the future. Finally, active regionalisation is an important strategy for Asia to enhance regional economic prosperity. Malaysia actively participates in the efforts to strengthen linkages within the ASEAN community and to creating opportunities to foster greater economic integration. These efforts will place ASEAN on a path to realising its economic potential and enable the region to collectively prosper.