Zeti Akhtar Aziz: The economic outlook for Malaysia in the aftermath of 11 September

Special luncheon address by Dr Zeti Akhtar Aziz, Governor of Bank Negara Malaysia, at the CFO Summit 2001 - The Economic Outlook in the Aftermath of 11 September, Kuala Lumpur, 8 November 2001.

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Ladies and Gentlemen,

Introduction

Even before the events of 11 September the global economy was already experiencing a slowdown in growth. Although there were emerging signs that the downturn was beginning to level off, the events of September 11, have increased the uncertainty of this prospect. The issue before us today is thus **to what extent these developments affected our own growth prospects?** To what extent can we mitigate the adverse implications on our domestic sector. And most of all, what can each of us do in the current environment to better weather the economic slowdown?

It is my pleasure to be here today to have this opportunity to share some thoughts with you on the implications of these developments on the Malaysian economy.

Current global economic environment

After a decade of rapid expansion, the US economy entered a period of cyclical slowdown beginning in mid-2000, with GDP growth in the US slowing sharply from 8.3% in the first quarter of 2000 to less than a half percent in the second quarter of 2001. Given that the US absorbs about one-fifth of world exports, the slowdown has had far reaching implications on world growth. The sharper than anticipated US slowdown before 11 September was due mainly to the adjustments in the technology sector leading to cyclical declines in business investment and the unwinding of inventories accumulated during the boom period. However, consumer spending, which accounts for two-thirds of GDP in the United States and activity in the housing sector generally was still holding up prior to 11 September. This trend was supported by interest rate reductions by 300 basis points between January and August 2001 and the tax rebates. In addition, adjustments in asset prices were seen relatively moderate.

While the events of 11 September has affected business and consumer confidence, we need to distinguish between the immediate term effects and the longer-term prospects for recovery and growth. On an industry-specific basis, the impact is visibly seen in the tourism and travel-related industries and in the insurance sector. In the immediate term, it can be expected that activity will be dampened and some scaling back of expenditure and activity will take place. The unemployment rate has also been seen to rise and the recently released National Association of Purchasing Managers (NAPM) index, a short-term leading indicator of the US economy, showed a significant decline. Nevertheless, the preliminary estimates of US third quarter GDP show that the decline was somewhat less than expected. This allows for some cautious optimism. The US automobile industry also recorded its largest ever monthly sales in October as consumers responded to promotions by auto companies, indicating that the events of 11 September have not entirely curbed consumers' propensity to spend. Furthermore, concerns for a sharp weakening in the US dollar have receded resulting in relative stability in the major exchange rates. Amidst these developments, there has however also been a simultaneous slowdown in the other major industrial economies resulting in downward revisions in the growth for Europe and Japan.

While these reports are hardly comforting, it is important to keep our assessments in perspective. The current external environment reflect reactions in the immediate aftermath of the attacks. Of importance will be how the consumers would behave in the coming months. The answer to this question is, in large part, still remains uncertain. Much depends on how households in the industrialised economies assess their near-term job and income prospects, and how these assessments evolve over time as events in global environment continue to unfold.

The final outcome would depend not only on analysis of the plethora of economic data before us, but also on the policies emerging in the US, Europe and also the regional economies. Of course, the main factor would be consumer and investor responses to these policy changes. In the US in particular, the Fed has eased monetary policy further immediately following 11 September, bringing interest rates to their lowest level since the 1960s. The US Congress has approved a series of fiscal packages, bringing the total fiscal spending to about 15% of GDP. The prompt and co-ordinated monetary policy response across the globe demonstrates the commitment to support global growth and avoid a tailspin reaction that could lead into recession. In this light, while further economic weakness could be expected in the near term, positive consumer responses to policy changes would point to more positive medium-term prospects.

Given these emerging indicators, there is a preponderance of views that the current economic slowdown would not be prolonged, that recovery can be expected to occur in the second half of 2002. Other positive factors relate to the sharp inventory adjustment that has taken place which will allow an upturn in demand to be promptly translated into higher production activities. At the same time, structural changes at the corporate level including world wide cost-cutting measures would provide the foundations for a sustained recovery in global growth.

Ladies and Gentlemen,

Weathering the slowdown

Being a highly open economy, Malaysia will continue to be affected by external developments. While we may not be able to directly reduce the impact of these developments on our external sector we can compensate for them by encouraging domestic activity. On the domestic front, Malaysia has over the years has built strong foundations that places us in a position to weather this current slowdown. The events of 11 September have not altered our positive economic fundamentals and our foundations. This will continue to provide businesses with the platform to sustain their activity.

Firstly, structural adjustments undertaken over the recent decades and the more recent measures taken since the crisis have resulted in a **more diversified and productive economic** base that is more resilient to external shocks. The recent strong performance of the services sector and positive growth in the agriculture and mining sectors in the first half of this year contributed to mitigating to some extent the decline in electronics exports. For the services sector the domestic content is high and several services sub-sectors are not linked to the manufacturing sector. These sectors continue to respond positively to domestic policies. Even within the manufacturing sector, domestic-oriented industries contribute about one-third of the total output of the sector. These sectors have benefited from the fiscal stimulus package and the low interest rate environment.

Second, the Government's **fiscal position remains strong**, with outstanding debt being contained at 37% of GDP and the debt service to GDP ratio of 2.8%. The increased fiscal deficit has been financed from non-inflationary sources. Expenditure allocations have also been targeted to projects with immediate and high spin-off effects.

Third, **inflationary pressures are contained**, thus allowing monetary policy to remain accommodative. Our track record of low and stable inflation has also encouraged capital formation through a high savings rate.

Fourth, the **current account surpluses** continue to remain large thereby lending strength to the balance of payments. The current account of the balance of payments is expected to register a surplus of 7.9% of GNP in 2001. The decline in exports has been offset by corresponding reduction in imports as well as payments in services. This surplus is expected to continue to serve as a buffer to finance volatility in short-term flows.

Fifth, our **external reserves have continued its rising trend and are ample and unencumbered**. The external reserves level have now breached the end-2000 level. The figures for 31 October shows the reserve level is now US$30.2 billion. This reserve position is adequate to finance 4.9 months of retained imports and 6.3 times the short-term external debt.

Sixth, our **external debt levels are low**, reducing our vulnerability to the current slowdown in external demand. Total external debt was equal to 49.5% of GNP as at end-June, significantly lower than the peak of 64% recorded at end-1997. The overall debt service ratio is also low at only 5%, even with the slower export growth. In addition, the short-term debt component is low, accounting for 11% of total external debt and 18% of external reserves holdings, giving Malaysia one of the most favourable positions among regional economies.

Seventh, the **Malaysian banking sector** has been strengthened and is more resilient following the recent restructuring and consolidation that has been achieved. This is reflected by the higher capitalisation ratios, improved profitability and asset quality. The strong RWCR of 12.5% (end-September) and core capital ratio of 10.6% provides adequate cushion to absorb increases of NPLs from the economic slowdown. The latest stress tests indicate that the RWCR of the banking system is expected to remain well above the BIS minimum of 8% in view of the strong capitalisation of the banking institutions. Also domestic private debt to GDP has declined from the peak of 152% in 1998 to current level of 133% mid-2001.

Eighth, while we have seen an increase in retrenchment in the labour market, **unemployment levels remain low**. Of importance is that the educated labour force has the mobility to adapt to a changing environment. Efforts are focused on upgrading the quality of the education system. While some labour dislocation can be expected, efforts are being directed to encourage redeployment to alternate activities.

Ninth, our **physical infrastructure** is one of the best developed in the Asian region, facilitating production, trade and communication.

Tenth, the **political stability and institutional arrangements in place** allow for rapid, effective and co-ordinated decision making to deal with ongoing developments. It allows for prompt response and strategic planning in managing the management of the economy. Accelerated corporate restructuring involving some of the largest corporations in the country is also underway with increased attention being focussed on enhancing corporate governance.

Despite a more difficult external environment, these solid foundations have remained intact and will continue to provide Malaysia the ability to ride out this current phase of slowdown while ensuring our long-term growth prospects. More specifically, it will provide us with the **agility** to adapt, adjust and respond to changes in economic conditions, changes in comparative advantage and changes in opportunities that the current environment accords. The track record has shown that over the decades the economy has been able to shift to new areas of growth with changing opportunities and changes in comparative advantage. Prudent policies pursued and careful economic management have also accorded us with a high degree of **flexibility** in policy options in responding to the new challenges that have emerged. Our resilience is on account of the combination of our strong foundations, and the high degree of agility and flexibility of policy to respond to this difficult period thereby enhancing our ability to weather the current slowdown.

Ladies and Gentlemen,

Of importances is therefore to **look beyond the immediate term**. Our history shows that the economic downturns in 1985, in 1998 and in the current period have been externally driven. As a highly open economy we will continue to be vulnerable to external developments. In these periods of adverse external conditions, domestic policy responses have however, been successful in restoring growth. The strategy adopted has been to be pre-emptive and to front load the policy initiatives. In addition, these efforts have generally been supported by further efforts to strengthen the economic base further and the restructuring and reform of the financial system. Despite the severity of the 1998 contraction, Malaysia recovered within a year with strengthened economic fundamentals. All this was possible given the strong foundations of our economy and financial system. All too often this has been taken for granted.

In the current period, the focus of policy is on promoting domestic sources of growth. It has so far allowed us to mitigate to some extent the adverse effects on the slowdown in the export-oriented manufacturing sector. In the first half-year, we saw positive growth recorded in the agriculture and mining sectors, construction sector as well as domestic-market oriented manufacturing industries. Going forward, pro-growth policies are targeted at improving consumer disposable income, increasing expenditure skills enhancement and improving infrastructure. The impact of these policies together with low interest rates would continue to filter into the domestic economy. Should global demand strengthen, Malaysia will be well positioned to see a strengthening in the second half of the next year.

The Government has therefore directed policy measures to strengthen domestic sources of growth. The expected impact of the US economic slowdown was already built into the fiscal stimulus package contained in the 2001 Budget and now in the 2002 Budget. Projects identified under the fiscal stimulus include those with high spill-over effects, low import content and short gestation period. Hence, higher allocations have been given to social services, education, training, low cost housing and health services.

In early 2001, amidst signs that the slowdown in the US economy was more severe than earlier expectations, further measures were taken in March 2001. The measures included an **additional fiscal stimulus of RM3 billion** and reduction in employees' share of EPF contributions by 2% for one year are aimed at promoting consumer spending and overall economic activity.

Following the heightened uncertainty after the events of 11 September, an **additional stimulus package amounting to RM4.3 billion was announced prior to the Budget 2002**. This early announcement was aimed at providing enough lead time for higher expenditure to sustain growth. The focus of allocations has also been also skewed towards small projects for which funds would be promptly be disbursed.

Most recently, the **Budget 2002** presented to Parliament in October reinforced the strategy to diversify further the economic structure by increasing the significance of domestic sources of growth. The Budget included measures to further promote economic activity through increasing domestic demand while strengthening the private sector's resilience and competitiveness. In addition, to higher development expenditure, the focus of Budget 2002 was directed at raising disposable incomes via tax cuts and bonuses as a more direct measure to stimulate private consumption. Other fiscal measures and allowances were also aimed at providing further incentives to businesses.

The question has often been raised concerns the sustainability of the fiscal deficit and its potential for long-term risks to the economy. Previous prudent policies has accorded the Government the flexibility for this expansionary policy. The deficits has been financed from non-inflationary sources and the high rate of domestic savings has enabled access to such financing without crowding out the private sector. Prudent policies have also kept debt levels low. Debt levels, in particular the external debt position remains low. This continues to be an important strength of the Malaysian economy. Secondly, excess liquidity in the domestic money market and strong demand for Government securities means that new issues can be raised at low interest cost. The debt servicing would therefore not be a burden to future generations. Thirdly, the expenditure is well-targeted and has high potential to achieve the desired objectives. And finally, the plan is for a consolidation of the nation's fiscal position with a reduced deficit in the year 2002 with a balanced position envisaged during the period of the Eight Malaysia Plan.

On the monetary front, the strategy has been to front load the monetary measures to provide a positive environment for the private sector. During the recent period, the already historically low lending rates have been effective in stimulating domestic demand both in terms of rising loans for residential property, passenger cars and consumer durables and for investments in the manufacturing and services sector. Interest rates were not raised with the growth in 1999 and when growth was exceptionally strong in 2000. Monetary policy during this period continued to be directed to support domestic activity in an environment of low inflation.

Following the increased uncertainty after the events of 11 September, the **3-month intervention rate was reduced by 50 basis points** to 5% on 20 September to support domestic economic activities in the light of heightened potential for a more rapid economic slowdown. Currently, lending rates in Malaysia are now among the lowest in the region. In addition, specific measures have also been undertaken to increase volume and access to financing by SMEs. All these measures have contributed to positive growth in bank lending.

While addressing short-term developments, policy also continues to focus on long-term areas to strengthen further our foundations in the financial sector. With the successful completion of the consolidation of the banking sector, it became necessary to address the remaining overhang of corporate leverage. In this context, a series of **aggressive measures has been taken to expedite the process of resolving the outstanding corporate debt of large corporations**. Important changes has been implemented in the management and implementation of this corporate sector restructuring.

Similarly, the implementation of new rules with regard to **corporate governance** has also ensured improvement in standards and practices in the corporate sector. The Malaysian Code of Corporate Governance has been implemented and various changes have been effected to the Securities Commission Act 1993 and to the KLSE Listing Requirements to strengthen the regulatory and statutory framework for corporate governance.

These developments in the economy and financial markets serve the ultimate goal to create an economy that is responsive to change and resilient to external shocks thereby increasing our prospects for long-term growth.

Conclusion

Ladies and Gentlemen,

Malaysia has a track record of ensuring that the economic environment is supportive of business activities. Policies that have been implemented have demonstrated our commitment to preserve the value of both domestic and foreign investments in Malaysia. While our foundations have provided us with the agility to adjust, and the flexibility of policy to respond the resilience to weather the current slowdown, it is recognised that we need to continue to strengthen our economic structure need to continue with determined perseverance so as to enable us to effectively manage external shocks without weakening our economic foundation.

While all these may provide some assurance, this will by no means ensure the desired results. The reactions and responses by the business and consumers are vital to the success of these policies. This requires an ability for a more balanced approach and distinguishing the longer-term economic prospects that are not biased by short-term concerns from the immediate term conditions. Within the context of domestic conditions, business must also be aware of global developments and the more competitive external environment. In this regard, we need to strive to increase efficiency and productivity to enhance our own competitiveness. Despite the current weaker conditions, businesses should not hold back making the strategic investments to ensure that they are well-positioned to benefit from an upturn when it occurs. Any hindrances to further progress should be eliminated and new business segments for growth should be sought out. Research and development expenditure should continue as this will be an important true sustainable source of competitive advantage in the global economy. An integral part of this strategy is the need for enhanced training and upgrading of human resources.

Bankers, in the meantime, should not overreact to the weaker short-term environment, and should continue to provide access to financing for viable projects to support the growth process. A more constructive approach needs to be taken by the financial institutions to assist borrowers, on their own initiative, to reschedule and restructure the loans of viable borrowers. Finally, consumers should spend productively and contribute to sustain domestic demand.

To conclude, the Government has acted swiftly to the global slowdown and the recent events in the US. The Government has done its part. It is therefore the private sector response that will be the key determining element in how Malaysia will weather the current challenging environment.