Zeti Akhtar Aziz: Fifty years of central banking – stability and sustainability

Address by Dr Zeti Akhtar Aziz, Governor of the Central Bank of Malaysia, at the Ceremony for the 50th Anniversary of Bank Negara Malaysia: "50 Years of Central Banking – Stability and Sustainability", Kuala Lumpur, 8 February 2009.

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Bank Negara Malaysia opened its doors as a Central Bank on January 26, 1959, just over a year after Malaysia gained independence in August 1957, reflecting the importance that was being accorded by our founding fathers to the institution of Central Banking. At the very outset, the Central Bank was entrusted to provide leadership in performing the traditional Central Bank mandate of promoting monetary and financial stability. Equally important was the mandate to develop the domestic financial system – a financial system that would facilitate economic growth and development.

It is my very great honour to welcome distinguished guests that have come from different parts of the world to join us on this special occasion to commemorate the fiftieth anniversary of Bank Negara Malaysia. We also wish to express our appreciation to the Prime Minister of Malaysia for his presence as the guest of honour at this occasion.

Introduction

Allow me to share our experience during these fifty years and our aspirations moving forward. These five decades have been highly challenging but rewarding with many fulfilling outcomes and there were also lessons learned. While the country has experienced great prosperity during most of the period, our economic and financial progress has also been punctuated by episodes that have tested our resolve. Rising to address these challenges, the growth and economic transformation experienced in these fifty years have been achieved in an environment of macroeconomic and financial stability.

During the five decades, Malaysia has experienced an average annual growth that has exceeded 6 per cent and annual inflation that has been less than 3 per cent. The continued increase in incomes and the low and stable inflation have not only promoted a high rate of savings that has exceeded 30 per cent of GDP but it has also resulted in the financialisation of savings. This has allowed Malaysia to rely on domestic sources of funding to finance our growth and development during this period, thereby minimising our levels of external indebtedness.

Monetary stability

Being a highly open economy, the sources of monetary instability have generally emanated from external price shocks, which have occurred during periods of high commodity and energy prices, and to a lesser extent, from periods of excess demand and overheating conditions. There essentially have only been two episodes in our history in which overheating conditions have generated inflationary pressures; the major period being prior to the Asian financial crisis.

Since the 1990s, monetary policy has been further complicated by volatile capital flows. This was evident in several periods, the early nineties, the mid-nineties, and the outflows during 1997-1998, and in the current period following the de-leveraging by financial institutions in the advanced economies.

In the early days of the Bank, policy actions were focused on the management of liquidity in the financial system through the imposition of statutory and liquidity reserve requirements, and through prescription of interest rates and portfolio restrictions, including ceilings on lending. Further progress and sophistication in the financial sector, the deepening of the financial markets and the growing influence of capital flows, resulted in the reliance on interest rate and other market-based instruments for monetary policy. Further, with the increased role of expectations, greater clarity in policy signals became desirable. Thus in 2004, the New Interest Rate Framework was implemented, in which the Overnight Policy Rate became the new policy rate, thereby enhancing the efficiency of the monetary transmission mechanism. The new framework has also served as a catalyst for efficient pricing of financial products and services by banking institutions.

A key issue for monetary policy in an open economy like Malaysia has been in maintaining a flexible exchange rate and monetary independence in the face of increasingly large capital flows. To better manage surges in capital flows which have become more prevalent, the range of market-based instruments for monetary policy operations has been widened. The rise in intra-regional trade and investment flows has resulted in greater importance being accorded to stability of the exchange rate against regional currencies.

The monetary policy decision-making process at the Bank has also been redefined in which the governance for monetary policy is based on the Monetary Policy Committee to achieve a more optimal process for policy making. Monetary policy communication and increased transparency have also become highly important in this framework.

Thus, while the Central Bank's responsibility towards promoting monetary stability conducive to sustainable growth has remained unchanged since the inception of the Central Bank in 1959, the strategies, framework and instruments have evolved substantially to ensure its effectiveness in delivering the desired objective.

Financial sector development

A key focus of the Central Bank during these five decades has been institutional building, financial market development and putting in place the financial infrastructure. The evolution of the financial system has seen its transformation from a rudimentary financial system that was dominated by the banking sector to a highly diversified financial system, from a highly controlled financial system to greater market orientation, from a highly fragmented system to one that is more consolidated and rationalised, and to a financial system that is supported by an extensive legal regime and regulatory and supervisory framework, and a financial system that is more liberalised with stronger international linkages.

Part of the institutional building was the establishment of regulatory institutions that have clearly defined mandates. These institutions join us today in celebrating the long tradition of cooperation to meet the common purpose. Specialised development financial institutions were also established to promote access to financial services to sectors that are not being serviced by existing financial institutions. Financial inclusion, to ensure all economic activities and all segments of society have access to financial services, has been a key priority. Currently, about 80% of our population have some forms of banking accounts

Other financial infrastructure established by the Bank to support the intermediation process includes the comprehensive centrally coordinated credit information system at the national level which allows for better-informed credit decisions by financial institutions. In addition, the Credit Guarantee Corporation was established to provide support for small businesses. Cagamas, the national mortgage corporation, was established by the Central Bank to ensure a steady flow of funds to the housing industry and develop a secondary mortgage market.

At the centre of the financial infrastructure is the payments infrastructure which has been enhanced and modernised over the years to achieve greater efficiency and reliability of the payments system. The payments landscape has evolved from one that was mainly paper-based to include a range of new electronic forms of payment. Internet banking which was not available in Malaysia as recent as 10 years ago is now widely used by the entire population of internet subscribers in the country. The acceleration of the nation's migration to the more efficient electronic payments continues to be an important agenda of the Central Bank.

Complementing institution building has also included the support given to the development of talent in the financial services industry. The growth of the financial sector cannot be achieved without adequate attention to the development of the professional requirements of the financial services industry.

In the recent two decades, a comprehensive Islamic financial system has also evolved in Malaysia, including the institutions, markets and supporting legal, regulatory and supervisory framework. The Islamic financial system now offers the full breadth and depth of Islamic financial services. Malaysia is the host to the secretariat for the Islamic Financial Services Board in Kuala Lumpur that sets the international regulatory and supervisory standards in Islamic finance.

Financial market development has also been central to building a robust financial system. The Central Bank's efforts in this direction have included establishing the institutions and the infrastructure to improve market efficiency of money, capital and foreign exchange markets. The Securities Commission, the domestic rating agencies, Cagamas and the Cooperative Commission were among the initiatives initiated by the Bank.

The development of a robust and vibrant foreign exchange market still remains an outstanding area of development. As a highly open economy, this market is a vital part of our financial system. The country exited from the Currency Board system in 1967 and introduced the ringgit (known as the Malaysian dollar then). The changeover was successful. It was a time when there was an absence of speculators. It was only in 1997-98 when the ringgit and other regional currencies came under speculative attack. The volume of foreign exchange transactions had become massive, far exceeding volume of trade and the normal financial flows. This resulted in exchange rate volatility during the Asian crisis that occurred wave after wave. Regional currencies continued to plummet during this period. After more than a year of this turmoil and uncertainty in the foreign exchange market, Malaysia implemented selective capital controls and de-internationalised the ringgit. This was instrumental in restoring stability in the market. It acted very much like a circuit breaker. Offshore trading of the ringgit, the major source for financing the speculative attacks, was effectively eliminated. Within a year, all the controls that were imposed were removed. More than 10 years later, the ringgit, however, still remains non-internationalised. An important precondition for the internationalisation is the development of a robust foreign exchange market in our financial system.

Financial stability

The events surrounding the current financial crisis has brought into sharp focus the role of central banks in financial stability. As these events continue to unfold with great uncertainty on the financial markets and broader economy, allow me to reflect on Bank Negara Malaysia's own role in financial stability.

In addition to its functions as the lender of last resort, Bank Negara Malaysia has also had the responsibility for the regulation of banking institutions. Since 1988, the Bank also assumed responsibility for the insurance industry and in 2002, the development financial institutions. The prudential regulatory and supervisory framework during these fifty years has undergone significant change. The prudential framework and supervisory approaches adopted by the Bank provided the flexibility to respond to the new developments and challenges that have confronted the financial sector. Several factors have guided the approach adopted by the Bank. The first is to recognise the limitations of the regulatory tools and instruments. Second, is the acceptance that change is required in the context of the changing environment, and the need to carefully assess the trade-offs that arise given the different stages of development within the financial sector. And finally, is the need to take into account the interlinkages within the financial system, and between financial systems across borders.

Guided by these parameters, the Bank has evolved a prudential framework which at the start comprised simple prudential rules that addressed capital, gearing, liquidity and portfolio restrictions, to the now more differentiated and principle-based regulations that reflect levels of risk taken by an institution. As a result, significantly greater flexibility is now accorded to institutions that are able to demonstrate sound governance practices and risk management capabilities. This flexibility has been accompanied by fundamental changes in the approach to supervision that has shifted from a predominantly compliance-based approach, to one that focuses on an assessment of the risk-taking activities of an institution and the effectiveness of the control functions that are in place within the institution to manage the risks. The supervisory tools have also been expanded to include more forward-looking assessments of the risks to financial stability, supported by more dynamic stress testing approaches and enhanced surveillance systems.

To a large extent, the preconditions for the shift to principle-based approach to regulation have been strengthened through capacity building measures that have been pursued in the period immediately following the Asian financial crisis. The development of the Financial Sector Masterplan which was released in 2001 is a blueprint not only for comprehensive financial sector reforms, but also provided the framework and strategies for the modernisation of our financial system.

The financial safety net was also strengthened with the introduction of a comprehensive deposit insurance system and the establishment of institutions to assist consumers in managing their debt and resolving disputes with financial institutions. These measures have contributed towards maintaining confidence in the financial system.

The crisis: a defining moment for the bank

In the 1990s, it became evident for emerging economies that new challenges to stability arising from the international dimensions of financial activity had emerged. In particular, highly volatile and potentially destabilising capital flows had become a dominant feature of the international financial environment. Strong economic fundamentals alone proved to be insufficient in containing instability in the domestic economy and financial system.

Many of us still vividly recall the Asian financial crisis of 1997-98 that significantly affected several of the countries in the region. What started as a currency crisis turned into a financial and economic crisis. During this period, the ringgit exchange rate depreciated by about 40% at the peak of the crisis; the stock market declined by almost 80%. While the Malaysian economy continued to expand in 1997, by 1998, conditions deteriorated significantly and the economy contracted by 7.5%. An extensive set of measures were implemented. This included a comprehensive restructuring programme for the financial and corporate sectors. While still at the early stage of the crisis, an asset management company was established to acquire and manage the non-performing loans of banking institutions. A special purpose vehicle to recapitalise the banking system and a Corporate Debt Restructuring Committee were also established to provide avenues for voluntary debt restructuring for businesses. Within six months of the implementation of these measures, the problems in the financial sector were addressed. This led to resumption in lending activities and the economy expanded by 6.1% in 1999. Notably, the stakes taken in the financial institutions were disposed back to the private sector with the costs of the exercise being more than covered.

The Bank's efforts to sustain stability did not end when the Asian financial crisis abated and economic recovery was firmly in place. The lesson that the foundations for resilience are built during good times was earnestly embraced. Therefore, once stability was restored, the Bank embarked on a comprehensive restructuring and reform of the financial sector. This included the consolidation of domestic financial institutions; the strengthening of corporate governance, risk management and the institutional capacity of domestic financial institutions; as well as the deepening of the bond market. These efforts have put the Malaysian financial system in a much stronger position to weather the current global financial crisis.

Regional cooperation

From the beginning, the Bank has had an active engagement in the region and was from the very beginning part of the SEACEN grouping which is the oldest and most inclusive regional grouping. Starting in 1967, SEACEN has been a valuable regional forum. While it is a group of highly diverse economies, this did not prevent it from being a cohesive grouping. The permanent secretariat of SEACEN resides in Kuala Lumpur since 1979. The Bank is also part of other groupings including EMEAP and the Asian Consultative Council (ACC) of the BIS. Collaborative efforts in surveillance, regional financial market development and sharing of information have been extensive. In Islamic finance, the Bank is a founding member of the Islamic Financial Services Board to promote and enhance the soundness and stability of the Islamic financial services industry.

Modernisation of the Central Bank

In the 50 years, the Central Bank has also been fundamentally transformed. At its inception, the Bank started with 57 people with four departments. The Bank has grown in strength to more than 2,600 staff to accommodate our expanded roles. The modernisation of the Bank has involved change to the legal framework, our organisational and governance structure, and the nature of human capital, to enable the Bank to become more effective in the changed environment.

As we advance forward into the future, the Bank will be confronted with increased challenges, and with many of the building blocks in place, the next phase of development of the Malaysia's financial sector will involve greater market liberalisation and internationalisation. These developments will intensify the demand for greater readiness, capacity and capability from the Bank to best serve the nation moving forward.

This year, the Bank is in the process of submitting to Parliament a new Central Banking Act. As the economic and financial landscape, both domestic and international, is now significantly different from 50 years ago, the proposed Act involves a holistic review of the Bank's mandate, governance, accountability and the present legislative framework to ensure that the Bank remains effective in performing its functions. The institutionalisation of the objectives and mandates of the Bank aims to provide greater clarity to the existing roles and functions of the Bank. The proposed Act will also provide the Bank with the necessary powers and instruments to perform the Bank's roles and functions effectively. The proposed Act will also institutionalise many of the practices that have been introduced in this recent decade which are deemed as critical in ensuring that the Central Bank has the necessary authority and state of readiness to face future challenges.

In concert with these, the new Act will further reinforce the existing governance framework with adequate mechanisms to ensure sufficient checks and balances are in place. The governance framework will further facilitate and enhance high quality decision-making in the Bank, institutionalising both existing and new procedures and processes to enhance accountability, professionalism and transparency. The strengthening of governance and accountability will form the prerequisite for the Bank to maintain our public legitimacy and autonomy, as well as to ensure the integrity of the Bank as a public institution in serving the nation's interests.

Conclusion

Bank Negara Malaysia's experience during these fifty years in preserving monetary and financial stability and in supporting the sustainability of economic development has seen many challenges. Throughout this journey, we remained focused on what needs to be achieved and the vision of where we want to be. Key to our effectiveness is the internal capacity of the Bank. At the heart of this are the people in the Bank. While the operating environment has changed significantly and the policy focus has evolved, the values that the Bank represents, of integrity, respect for diversity, professionalism and expertise, have been enduring and reinforced over time.

Finally, the Central Bank could not have been successful in achieving our objectives and policies if we did not have the support in our country – from the Government, the financial and business communities, and the people of the country – for their confidence and trust in us during these 50 years. The Bank, going forward, through our policy actions and in discharging our responsibilities, will continue to uphold this trust that has been placed upon us.