



GOVERNOR'S STATEMENT

As we enter 2012, the world economy is confronted with the challenge of managing a sustainable economic recovery in a highly challenging global environment. The international financial reforms and the required structural adjustments in several major economies will not only contribute towards increased uncertainty in the international financial markets but are likely to have negative near-term implications on overall global economic growth. While in these recent months there have been positive signs that conditions in the international financial markets and the major economies have improved, the fiscal austerity currently being undertaken, the ongoing deleveraging by both private and public sectors and the economic restructuring and its near-term resulting economic dislocation, can be expected to contain the potential of the recovery.

As a highly open economy, Malaysia is not insulated from these developments. Overall economic performance will be affected by the general weakness in external demand, while the high level of global liquidity would also lead to risks arising from the large cross-border capital flows and their implications on domestic financial markets and the economy. In this environment, the growth of the Malaysian economy has for some years now been increasingly underpinned by the strength in domestic demand. The solid foundations of the Malaysian economy have followed from a decade of conscious policies that were pursued, during a period of relative stability and growth, to restructure the economy and to reform and strengthen the financial system.

The structure of the economy has become significantly more diversified, with domestic demand currently becoming a significant driver of growth while the export structure has also diversified significantly with increasingly greater trade with emerging economies. The Malaysian financial system has also become more developed, competitive and resilient, through institutional building, financial infrastructure development, and progressive deregulation and liberalisation. The high level of savings, the low unemployment, the strong external position, the low level of external indebtedness and the high level of international reserves have also reinforced the strength of the domestic economy and its capacity to withstand the impact of destabilising external developments.

While this has provided the solid foundation to support our future growth, equally important is the role of macroeconomic policies. Since the onset of the global financial crisis, policy-makers across the world have been re-examining the appropriate macroeconomic policy framework, from monetary policy and fiscal sustainability to macroprudential policies to promote financial stability. Our approach in macroeconomic management has always been guided by the objective to be achieved and having the necessary powers and instruments to deliver the desired outcomes. Also important is

the efficient functioning of the financial system and thus the transmission mechanism for the policies. To be pre-emptive and anticipatory, the Bank has continued to strengthen our surveillance capabilities and our understanding of the operating environment and its attendant risks. Also important is having a long-term focus that extends beyond the business cycle, in particular with respect to the evolving developments and structural changes affecting the economy.

While the focus of monetary policy will continue to be preserving price stability in an environment of sustainable economic growth, an important consideration is to prevent the build-up of financial imbalances. While inflation during 2011 and in early 2012 has been on a moderating trend, the risk of higher commodity and energy prices cannot be ruled out. The potential risk for slower economic growth, however, also remains. While the degree of monetary accommodation was adjusted in 2011, to gradually increase interest rates from 2% to 3%, the stance of monetary policy remains accommodative. The normalisation of the interest rates was largely to prevent the build-up of financial imbalances. During the year, challenges also came from large and volatile capital flows. To manage the risks associated with the build-up of excess liquidity in the domestic financial system, sterilisation operations were reinforced by increases in the Statutory Reserve Requirement and the implementation of a wide range of macroprudential measures.

Fiscal policy also represents an important component of domestic macroeconomic policy. As with many parts of the world, the challenge is to achieve fiscal sustainability and to contain the fiscal deficit and public sector indebtedness while supporting growth of the domestic economy and facilitating the longer term economic transformation. In Malaysia, the trend has been for the gradual reduction of the fiscal imbalance. This gradual reduction process has been possible given the relatively lower level of indebtedness, in particular, the low level of external borrowing by the public sector. As the Government begins to reduce its role in the economy, the role of the private sector will become increasingly important. The role of Government in the economy will therefore change towards facilitating an enabling environment for private sector economic activity. While public expenditure has to be contained, the contribution to growth by the public sector can be through enhancing the efficiency and effectiveness of the public sector while also continuing to support socio-economic well-being and public sector investment that would enhance the growth potential of the economy.

Beyond the short and medium term, attention is also being given to economic transformation to sustain the relevance and competitiveness of the Malaysian economy. Malaysia's aspiration is to advance towards becoming a high-income, high value-added economy in this next decade, with growth that is underpinned by greater innovation, productivity and enhanced efficiency. In this regard, initiatives are already being undertaken to remove the constraints that may impede this economic transformation. Key initiatives to address this are in the areas of human capital development, developing a conducive and competitive business environment, and establishing the required physical infrastructure for a modern economy. Going forward, the Bank's Financial Sector Blueprint launched in late 2011, outlines the direction for the development of the financial sector during this next decade. In particular, it focuses on strengthening the effectiveness of financial intermediation in this new environment, in particular, in the new growth areas and to support the increased economic and financial linkages with the region and international economy.

During the year, measures continued to be undertaken by the Bank to liberalise the foreign exchange administration rules to allow for better management of the foreign exchange transactions by the private sector in an environment of increasing economic and financial linkages with other parts of the world. The liberalisation is also aimed at lowering costs of such transactions and strengthening the competitiveness of our economy. Going forward, there will be accelerated efforts to develop the foreign exchange market and the payments infrastructure to allow for multicurrency settlements. In this environment of highly volatile capital flows, the Malaysian money, bond, equity, and foreign exchange markets have demonstrated their capacity to intermediate these flows and their ability to support the larger two-way real and financial flows from and to other parts of the world.

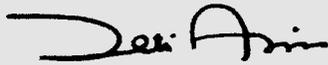
The year 2011 also saw further advancement in the efforts towards greater regional financial integration. A major motivation for this is to achieve a more effective intermediation of surplus funds from the region to productive investments in the region. For the ASEAN region, the ASEAN Financial Integration Framework is being introduced with the aim of accelerating the financial integration process and strengthening the platform for its interface with other parts of the world. During this period of relative stability and growth in the ASEAN region, the opportunity is also being taken to strengthen the regional arrangements for financial stability. The Bank is committed to and is active in participating in these endeavours. The Bank has participated in the bilateral arrangements initiated by EMEAP central banks to promote more efficient cross-border liquidity management. These cross-border collateral arrangements are also supported by active regional surveillance efforts that are reinforced by the work on developing an integrated crisis management framework for the region.

On organisational matters, the Bank has entered its third phase of organisational transformation in this decade. Changes have been made to the governance structure and practices and to human capital management and development. This has been reinforced by a new compensation framework and internal corporate administration structure. Cumulatively, this has aimed to strengthen the effectiveness, efficiency and cohesiveness of the Bank. The Central Bank Act 2009, which continued to be operationalised during the year, gives greater focus on governance and accountability in the Bank. In 2011, the role of the Board was enhanced to provide further oversight, in particular, on risk management by the Bank, on the utilisation of resources in the delivery of our mandates, and having in place the necessary control measures and the Business Continuity Plan so as to ensure the state of readiness of the Bank for the different eventualities.

The greater clarity of the mandates in the Act has also reinforced the implementation of the three-year Business Plan of the Bank which was concluded in 2011. The plan has provided strategic focus and a benchmark against which to assess the Bank's achievements during this period. The new Business Plan 2012 – 2014, which was introduced early this year, sets the goals, outcomes and reporting structures. In the management of human capital, a new framework is being introduced to recognise role specialisations through job families and differentiated rewards. Targeted development will complement the current development framework to accelerate readiness of talent in the Bank. Equally important in the Bank is the corporate culture and values that we uphold. This year we have upgraded the Code of Conduct and introduced the new Code of Ethics, given the significantly changing and more complex environment in which the Bank operates in. In the currency function of the Bank, a particularly significant event this year will be the introduction of the new currency notes

and coins with leading edge security features. In 2011, Sasana Kijang, our new building was launched as a centre to promote greater regional and international collaboration in the field of central banking and finance. The building also houses the Bank's Art Gallery and Numismatic Museum.

In essence, amidst an increasingly challenging and changing environment, organisational effectiveness is key to ensuring the Bank's ability to fulfil our responsibilities at the highest level of excellence. Having a cohesive workforce that is dedicated to performance has been a vital part of the achievements of the Bank. On behalf of the Board, I wish to express our appreciation to all the staff of the Bank for their hard work, dedication and commitment to ensure that the Bank continues to serve the best interests of the nation. I am also grateful for the support of the Board of Directors, who are an integral part of the governance of the Bank. Going forward, the Bank will continue to strive to achieve the highest standards of excellence in fulfilling our responsibilities and to uphold the trust that has been placed on us.

A handwritten signature in black ink, appearing to read 'Zeti Akhtar Aziz', with a stylized, cursive script.

Zeti Akhtar Aziz
Governor
21 March 2012