

Governor's Statement



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The Malaysian economy expanded by 6.3% in 2007, its fastest pace in three years. Growth was driven by robust domestic demand from both the private and public sectors. The stronger economic growth in a less favourable external environment has been on the account of the strength of domestic demand and the increasingly more diversified structure of our economy. With the structural transformation of the Malaysian economy during this recent decade, the services sector has now become the main driver of growth. As a result, new areas of growth have emerged. This diversification is also evident in the manufacturing sector and hence the export sector. This change in the pattern of trade has been reinforced by the further diversification of our export markets.

In 2008, the external environment is expected to deteriorate with the continued unfolding of the financial crisis that has erupted in the United States. With no signs of the crisis abating, there has been increased uncertainty and risk aversion in the financial markets. It is now expected that the economic slowdown in the crisis affected economies will be more pronounced and protracted than earlier anticipated. This is not only arising from the large scale liquidity strains and the consequent constraints on credit conditions, but also due to the impact of declining asset prices and higher inflation on consumer spending. While the extent of the impact of these developments on global growth is unclear, it has added to the existing uncertainty in the financial markets. It is likely for the significant volatility in the financial markets experienced in 2007 to extend into 2008.

The slower growth in some of the largest economies is likely to lead to a moderation in global trade. Trade among the Asian nations has, however, increased substantially. With the expansion in domestic demand in the Asian economies, the cumulative market in the region has increased significantly, thus increasing the prospects for mutually reinforcing intra-regional trade. Despite the region's strong inter-linkages to the global economy and to the international financial system, the dominance of domestic demand and the increasing regional economic integration have reduced the implications of external developments on the region. Thus, while the region is not being entirely insulated, there will occur some partial decoupling.

Malaysia enters this period of heightened global uncertainty from a strengthened position. The economy has been on a steady growth path averaging close to 6% in the past three years. The quality of the growth has also improved - becoming more balanced between domestic and external sources of growth, between private and public sector activity, and between the different economic sectors. There have also been significant payoffs from the development of the financial sector and the ongoing financial liberalisation. This has contributed to the more efficient functioning of the financial system and in supporting the growth process as well as its increased resilience in dealing with shocks. Against this background, the Malaysian economy is expected to sustain a growth of 5-6% in 2008.

Key in achieving this growth is sustained domestic demand. Rising incomes, strong labour market conditions and increased access to financing are expected to support continued consumption spending. Based on recent economic and financial indicators, strong domestic investment activity and foreign direct investment are expected to continue in 2008. With ample liquidity in the financial system, financing to support the increased activity is expected to continue. Public spending, including on projects under the Ninth Malaysia Plan and for the new economic corridors will reinforce the growth. Moreover, as a resource-based economy, the increase in commodity prices has generated high multiplier effects on the domestic economy. Strong employment and external balances, low indebtedness and a high rate of savings are additional macroeconomic fundamentals that have raised the level of resilience of the economy.

Even as the global economy shifts into slower growth, inflation is increasing in most countries due to the rising energy, commodity and food prices. In Malaysia, rising commodity prices have sharply increased the producer price index. These costs have not been passed on fully into consumer prices. The extent to which producer prices rise further and the extent to which these are passed on to consumers will determine the inflation trend in 2008 and into 2009. These inflationary pressures, however, are expected to be mitigated by a number of factors. The further slowing of global growth would to some extent ease the inflationary pressures and contain inflationary expectations. On the domestic front, capacity expansion and rising wages that are commensurate with productivity would also contain upward price pressures. Based on the assessment of these anticipated trends, the average headline inflation is expected to increase from 2% in 2007 to 2.5-3% in 2008.

Despite these inflation concerns in the global environment, most central banks have paused monetary tightening, while others have shifted to aggressive easing following the increased risk of a more pronounced economic slowdown. In Malaysia, the risks to inflation and to economic growth are assessed to be about in balance. Moreover, inflation has been largely due to rising costs rather than demand pressures. Given the nature of these inflationary pressures, significant efforts need to be directed by the private and public sectors to enhance efficiency levels and thus reduce costs. There remains tremendous potential within the system to further reduce the cost of doing business. Given the source of the inflationary pressures, when inflation is driven by global factors or supply shocks rather than domestic demand pressures, there are limits to what monetary policy can achieve. Over reliance on interest rates under these circumstances will result in an over adjustment of the economy. In this context, monetary policy will continue to carefully balance these considerations to ensure price stability in an environment of sustainable growth.

Monetary policy is also presented with the challenge of volatile capital flows. Heightened uncertainty has also resulted in an increase in the amplitude of the volatility of capital flows. For most of the period, there has been continued two way flows that have contributed to reducing the degree of the volatility. Inflows of export earnings, foreign direct investment and portfolio funds are offset by increases in payments for imports as well as repatriation of profits and dividends by multinationals and investments abroad by residents. There are however bouts of massive inflows as well as reversals triggered for the most part by profit taking or specific events. The financial instruments at the disposal of the Central Bank and the strong level of reserves have provided the Central Bank with the capacity to manage these extreme flows to ensure the orderly functioning of the foreign exchange market.

The recent volatility in the global and domestic financial markets has emphasized the importance of the efforts that have been undertaken to strengthen and deepen the domestic financial markets. In particular, significant efforts and resources were channeled for the development of the bond and foreign exchange markets. The Bank has continued in 2007, to undertake further sequenced and gradual liberalisation of the foreign exchange rules based on careful consideration of the preconditions and state of readiness of the financial system to manage the risks and benefits to the economy. This liberalisation has contributed to the development of the domestic financial markets including the foreign exchange market. The liberalisation has also had positive economic payoffs through the reduction in the cost of doing business and the creation of new business opportunities. Similarly, the pace of development of the bond market has also accelerated. As a percentage of GDP, the Malaysian bond market is now the largest in the ASEAN region and, excluding Japan, is the second largest in Asia after South Korea. Efforts to position Malaysia as an international Islamic financial hub has also yielded positive results. In 2007, the issuances of sukuk (Islamic securities) rose by 161% to account for 63% of total private debt securities issued. Malaysia accounts for 69% of the total global sukuk issuances. This trend has gained further momentum in early 2008 despite the uncertainties in the global financial markets.

In the region, the Bank continues to actively participate in efforts to strengthen regional cooperation among regional central banks. Priority is being given to the regional surveillance agenda and putting in place an integrated regional crisis management framework that may be activated in the

event of an imminent crisis. As part of the implementation of the recommendations in the roadmap for cooperation among the EMEAP central banks, the Monetary and Financial Stability Committee has been established and will work towards a more structured surveillance and crisis management for the region. This is a tremendous step forward for the region's financial cooperation and integration. In 2007, the Bank has established a new Central Banking Services Unit to facilitate the efficient management of our interface with other Central Banks that involves two-way sharing of knowledge, experience and training.

During the year, the Bank's macro and micro surveillance capabilities were significantly strengthened. This includes enhancing the surveillance tools and the evaluations and assessments of the implications. With the greater uncertainties, stress-testing based on alternative scenario is increasingly being adopted to facilitate early preemptive action. From the experience of the Asian financial crisis, the resolution requires three important elements. Firstly, the approach adopted needs to be comprehensive, addressing both macro and micro developments. Secondly, it needs to be implemented at the early stage of the crisis, and thirdly, it needs to be accompanied by an extensive communication strategy to restore confidence and stability. Surveillance is key to supporting this process.

During the year, the Bank has intensified efforts to modernise and strengthen organisational capacity of the institution. Several departments were restructured during the year including that of the financial stability sector to achieve a more consistent regulatory and supervisory regime across all different components of the financial sector. It has also supported a more integrated approach to regulatory reforms and surveillance and has enabled a more efficient allocation of supervisory resources within the Bank.

A business plan for 2008 has also been drawn for the first time to set out the focus and priorities for the year, not only for achieving the core mandate of monetary and financial stability but also of the development of the financial sector. Finally, continued focus will be given to talent management and investment in human capital. Following the successful implementation of a performance-based highly-differentiated compensation system, the focus is on career management, succession planning and leadership development. The Bank will also continue to invest heavily in staff training in 2008 with the equivalent of 12% of total salaries being spent on learning.

In 2009, Bank Negara Malaysia will celebrate its 50th Anniversary. It is an important milestone in the nation's monetary and financial history. Since its establishment, the Bank has served the interest of the nation and sought to create a stable monetary environment while at the same time, promoting a modern and efficient financial system. Significant strides forward have been made in these 50 years, but the journey continues. With growing globalisation, the Malaysian economy and financial system will continue to evolve. This changing environment will undoubtedly bring new challenges. A major task this year will also be to amend our Central Banking Act to take into account the major changes that have occurred and transformed the environment we are operating in. This is to ensure that the Central Bank continues to effectively perform its responsibilities going forward over the next 50 years.

Finally, I would like to thank all staff and colleagues at Bank Negara Malaysia for the hard work and unwavering commitment during the year. I also thank our Board of Directors for their guidance and for their support to the Bank.



Zeti Akhtar Aziz
Governor

26 March 2008