

Governor's Statement



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Economic expansion strengthened in 2005, driven by strong domestic demand and reinforced by the improvement in external demand. For the third successive year, the private sector has continued to be the main driver of growth. The improved growth performance in the second half of 2005 is expected to be sustained in 2006 as the external environment continues to improve and as domestic demand remains robust. The growth for 2006 is expected to be supported by a more broad-based expansion in all sectors of the economy. This will strengthen further the structure of the economy and its potential for sustained growth over the medium term.

A distinctive and important feature of the Malaysian economy is its high degree of flexibility. Malaysia's competitiveness has been derived from this high degree of flexibility. This economic flexibility has been important in mitigating the impact of external shocks and in sustaining Malaysia's growth performance for more than three decades. Going forward, the medium-term growth prospects for the domestic economy will thus hinge on measures to further strengthen this economic flexibility in this more challenging and competitive global economy. Therefore, the renewed emphasis on investments in human capital will be vital in enabling the work force to adjust and support Malaysia's transition toward higher value added activities and to new growth industries. This is vital to meet the increased demand for adequately qualified and highly skilled personnel. This will reinforce the ongoing efforts to identify new sources of growth to diversify the economic base and to enhance competitiveness of the economy. While the public sector is committed to providing the enabling environment for enhancing the flexibility of the economy, the private sector also has an important role in adjusting to the changes that are occurring in both the international and domestic fronts and in capturing the new opportunities that are emerging in this more dynamic environment.

A major challenge confronting the world economy in 2005 has been the sustained high energy prices during the year. While high and volatile energy prices continue to remain a risk, the world economy has, however, been better positioned to manage its economic consequences. Improved energy efficiency and the globalisation of production have contained its impact on the global economy. The pressure on prices has also been modest. For several economies, however, these trends have prompted increases in interest rates, particularly in countries where interest rates have been at exceptionally low levels. In Malaysia, notwithstanding the increase in prices in response to the rise in energy prices, the rate of inflation has remained within a manageable range. The growth in labour productivity and capacity expansion combined with increased competition have moderated the price increases. In 2006, the rate of inflation is expected to rise further before it moderates during the latter part of the year. The macroeconomic conditions, therefore, continue to remain favourable, providing a positive and stable environment conducive for the economy.

Macroeconomic policies will continue to remain supportive of the economy while financial conditions are expected to remain favourable. Policy initiatives will continue to focus on promoting high quality growth in an environment of macroeconomic stability. The Federal Government's overall financial position is expected to strengthen in 2006 as economic growth gains momentum. The Government will also continue its policy of fiscal sustainability with the financing from non-inflationary sources. Later this month, the Government will launch the Ninth Malaysia Plan, which will outline the strategies for strengthening the growth potential of the economy and enhancing national resilience over the Plan period, 2006-2010.

In 2005, monetary policy has continued to remain accommodative. As the risk of slower growth diminished in the second half of the year, the policy rate, which had remained at historical lows since the 1998 currency crisis, was raised twice, on 30 November 2005 and on 22 February 2006. The increase aimed to align the monetary conditions to the current economic environment. Going forward, monetary policy will respond appropriately to ensure sustainable growth in an environment of price stability. With interest rates still below neutral levels, monetary policy continues to remain supportive of the economy. The macroeconomic conditions are also supported by stable conditions in the assets markets. Malaysia's long record of strong growth performance in an environment of low inflation over several decades has provided a basis for anchoring inflationary expectations. In addition, the increased level of Central Bank communications on inflation and on the monetary policy process aims to promote a greater understanding on the conduct of monetary policy and to provide a further basis for anchoring expectations and thereby contributing towards achieving price stability.

Significant progress has been made in strengthening the role of the banking system and the capital market to intermediate funds, thereby enhancing their ability to support and facilitate the economic growth process. Indicators show increased financial strength and further gains in operational efficiency essentially reflect the payoffs from the earlier restructuring, consolidation and rationalisation. Portfolio quality has also improved with the non-performing loans ratio continuing its downward trend. The successful winding up of Pengurusan Danaharta Nasional Berhad in December 2005 marked the completion of the final chapter in the financial sector restructuring exercise undertaken to address the vulnerabilities that surfaced during the Asian currency crisis. As part of this restructuring process, there was also further strengthening in risk management and governance in the financial institutions during the year. This has also been reinforced by the introduction of a more dynamic prudential regulatory framework, supervisory oversight and surveillance.

To further diversify sources of financing in the economy, several initiatives were also taken to enhance further the role of the bond market in the financial system, in particular the private debt securities market. These included measures to enhance the liquidity of the market and to promote a more effective price discovery process and thereby enhance the efficiency of the market. The private debt securities market now accounts for 52% of GDP exceeding the significance of the government debt market, as it becomes an increasingly more important source of financing for the corporate sector.

With the strengthening of the economic and financial resilience, the opportunity was taken to further deregulate and liberalise the domestic environment to promote greater flexibility and efficiency in the economy. A major policy initiative in this direction was the shift in the exchange rate regime to a managed float in July 2005. The adoption of the new regime was to better position Malaysia to respond to the structural changes taking place in the regional and international environment. In the context of this shift, there was no change in the monetary policy framework and the conduct of monetary policy. Under the new regime, the exchange rate will reflect Malaysia's economic fundamentals and developments in the exchange rates of the currencies of Malaysia's trading partners. The regime also accords greater leverage for Malaysia to respond to external shocks. In operating under this regime the Central Bank does not target any particular level of the exchange rate, and intervenes only to smoothen exchange rate volatility, in particular, when large short-term capital flows create excessive movements in the exchange rate. While the developments in the

exchange rate are an important consideration in the setting of monetary policy, it is important to emphasise that the Central Bank does not use the exchange rate as an instrument to achieve monetary policy objectives. The orderly transition to the new regime has been positive for the economy.

The financial sector continued to be progressively transformed during the year following the rationalisation among existing institutions, the introduction of new institutions and the strengthening of the international dimension in the financial system. The rationalisation efforts through the phasing out of traditional players such as finance companies and discount houses have resulted in the emergence of new specialised institutions. The consolidation of the retail banking business into a single entity with the merger of finance companies and commercial banks is now complete. The merger of merchant banks, stockbroking companies and discount houses currently being undertaken will see the emergence of investment banking in the financial landscape. These rationalisations aim to increase the capacity of the financial system to meet more effectively and efficiently the new changing and differentiated requirements of the economy. The consumer protection framework was also strengthened with the establishment of the deposit insurance corporation, which is now fully operational.

There has also been greater regional and international integration of the financial system. New licences have been issued to foreign Islamic financial institutions of which one institution has already commenced operations. In addition, the potential for foreign participation in the investment banks and in the Islamic subsidiaries have been raised to 49%. A number of domestic players have also increased their presence in foreign markets. To-date, our banking sector has representations in twenty countries. As part of the process of facilitating increased international integration, the liberalisation of the foreign exchange administration rules in April 2005 has allowed for greater flexibility and efficiency in foreign exchange transactions, as well as higher foreign participation in the issue of ringgit-denominated papers in the domestic bond market. This has contributed to further enhancing our economic and financial inter-linkages with other parts of the world.

During the year, aggregate spending by the household sector has continued to be robust. While this has been supported by increases in income, the banking sector has also provided increased financing to the sector. In order to sustain the contribution to growth by the household sector, new institutional arrangements have been put in place to ensure that the expansion is commensurate with the capacity of the sector to absorb the higher level of indebtedness. As part of these efforts, a Credit Counselling and Debt Management Agency is being established as a pre-emptive measure to address issues relating to household financial commitments, to essentially provide financial counselling and loan restructuring for the household sector.

Other key policy initiatives in 2005 included ensuring that all segments of the economy have access to financing. The development of a more inclusive financial system is an important element that needs to be taken into account in the development of the domestic financial system. The focus on financial inclusion ensures that institutional mechanisms are in place in the formal credit market to facilitate access to credit by micro enterprises, small and medium scale businesses, and the lower income groups. The aim is to bring these target groups into the economic mainstream, reduce poverty and promote a

more balanced growth. The strengthening of the institutional arrangements that include specialised development financial institutions, micro financing institutions and cooperatives has been instrumental in promoting financial inclusion.

Important progress was made in 2005 to expedite the development of SMEs in the economy. Efforts have focussed on strengthening the supporting infrastructure for SME development, the introduction of capacity building measures and in enhancing the access to financing. As the Secretariat to the National SME Development Council, the Bank was actively involved in developing the National SME Development Blueprint for 2006. The blueprint outlines the Government's objectives, targets and strategies, including the action plans and programmes for 2006 to accelerate the development of SMEs. An important milestone was the launch of the SMEinfo Portal, a one-stop online information gateway to provide comprehensive information to SMEs on access to financing, Government support facilities and training and development programmes for SMEs. The Portal also serves as a platform for SMEs' networking and marketing activities. During the year, SME access to financing continued to receive priority. In addition to the establishment of the SME Bank, banking institutions have launched two new trade finance products to encourage greater SME participation in the export market. Following increased access to financing from the banking sector, SME loans now account for 43% of business loans.

Significant progress was achieved in both the Islamic banking and takaful sectors in 2005. At the same time, developmental efforts in Islamic finance have also been intensified to position Malaysia as an international Islamic financial hub. These efforts have been directed towards institutional development, enhancing the domestic financial infrastructure, strengthening the Shariah and legal infrastructure, and promoting greater international integration. The year also witnessed the introduction of new foreign players and the transformation of the Islamic windows in conventional banks to Islamic subsidiaries. In addition, the Bank further strengthened the regulation and supervision of takaful intermediaries.

In line with the considerable progress made in the Islamic banking and takaful sectors, the Islamic capital market also recorded impressive developments in terms of higher issuances of Islamic papers and the introduction of innovations, which have contributed to broaden and deepen the domestic Islamic capital market. Moving forward, efforts to enhance Malaysia's position as an international Islamic financial hub will be strengthened with the establishment of the International Centre for Education in Islamic Finance (INCEIF) which will commence operations in March 2006. This represents the investment in human capital which is vital for the development of the Islamic financial services industry. INCEIF will serve as an international centre of educational excellence in Islamic finance, specialising in developing professionals and specialists in Islamic finance. Such talents are much needed to sustain market competitiveness and meet the future challenges of the Islamic financial industry. The Bank has established an endowment fund of RM500 million to support this initiative.

The payment system represents an important pillar of the overall financial system and the Bank continued to accord priority in strengthening the efficiency, reliability and security in the payment system. Continued efforts have been directed at developing and improving the major payment system infrastructure to ensure its robustness and to mitigate any systemic risks to the financial system and

the wider economy. Initiatives have also been made to encourage the migration from paper-based payments to electronic payments to increase efficiency and reduce costs. Improvements in the payment systems operated by the Bank included the establishment of a “payment versus payment” mechanism to reduce inter-bank foreign exchange settlement risks and the introduction of a cheque truncation system to reduce the physical handling of cheques and its related costs. To enhance the security of payment cards, banking institutions have also successfully completed the installation of chip-based terminals in 2005, making Malaysia the first in the region to complete a national chip migration exercise. Moving forward, intensive efforts will be made to promote debit cards as an alternative and more cost-effective means of payment. Efforts have also been intensified to increase public awareness on the various payment channels, products and innovations. The agenda is essentially to increase the use of electronic payments through initiating changes in the infrastructure and processes, enhancing accessibility and facilitating the right incentive structure to encourage the active use of electronic payments.

The Bank has always accorded priority to organisational development to ensure that the Central Bank continually enhances its capacity to manage the new challenges emerging in this ever-changing environment. In addition to increased investments in staff development, changes were made in organisational structure, as well as the introduction of ICT enhancements to raise the level of connectivity, enhance access to information and to strengthen networking. Other initiatives include the adoption of a performance-based culture and further efforts toward becoming a Knowledge-Based Organisation. Attention was also given to work and space management to enhance efficiency, security and the effectiveness of the functioning of the Bank. During the year, work commenced on the construction of the Financial Services Resource Centre. Upon completion, it is envisaged that it will become a centre of excellence for knowledge and learning, to support the requirements of the Bank, as well as the South-East Asian Central Banks (SEACEN) Research and Training Centre, and the Islamic Financial Services Board (IFSB). The Centre will also house the Bank’s Knowledge Management Centre, Financial Museum and Art Gallery. Given the challenging environment in which the Bank operates, these initiatives aim to ensure that the Bank delivers the expected results with the highest level of competence and professionalism.



Zeti Akhtar Aziz
Governor

22 March 2006