

Governor's Statement



BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The broad-based growth achieved in 2002 has further enhanced the resilience of the Malaysian economy. The underlying trend has been for a more balanced growth, with a greater balance between domestic and external sources of growth, between the role of the private and public sectors, and between the performance of the various sectors of the economy. The broad-based and more balanced growth has also contributed towards strengthening the resilience of the economy through a more diversified economic structure, while also extending the benefits of growth to become more widespread across all segments of the economy.

In 2002, the global economy continued to be affected by uncertainties and underlying structural weaknesses. While the global economic recovery in 2002 has been slow and uneven across countries, developments in Asia, however, were more positive. On balance, the regional economies benefited from the global recovery in the electronics sector and from increased intra-regional trade. Indeed, the increased significance of intra-regional trade has created new dynamic and self-reinforcing forces of endogenous growth in the region. While the Malaysian economy was affected by these external developments, policy in 2002 was directed towards sustaining domestic demand and promoting domestic sources of growth, thereby contributing towards the more balanced growth.

The positive results from the macroeconomic policy initiatives that have been taken were reflected in the more robust expansion in consumption activity and the recovery in private sector investment experienced in 2002. The policies have also fostered a further strengthening of the financial and economic fundamentals. These improved macroeconomic fundamentals are indeed a source of strength, rendering Malaysia greater resilience to potential destabilising external developments. It has also allowed the focus of policy to shift towards the long-term strategies to further diversify the economy and to enhance the competitiveness of the Malaysian economy.

While the underlying trend of the economy remains positive, the outlook for 2003 is weighed down by the increasingly more adverse external environment. So long as geopolitical tensions persist, the outlook will be dampened by downside risks impinging on global growth. The risks from geopolitical developments can be expected to result in high costs, not only to the countries directly involved, but also to the world economy. While co-ordinated global and regional policy responses will contribute towards containing the implications of the downside risks, global growth is likely to be slower than earlier expectations. Despite these developments, most forecasts for the Asian region are for the pace of growth in 2002 to be sustained into 2003. Against this background, the underlying trend is for the Malaysian economy to expand by 4.5%. The sustainability of growth will depend on the ability to shift towards an increasingly domestic-led economic growth, underpinned by the continued strong growth in private consumption and private investment activity.

Macroeconomic policies have contributed towards sustaining the recovery process achieved in 2002, against an environment of improved fundamentals. While the public sector has had a major role in effectively reducing the amplitude of the economic cycle, it cannot, however, be expected to remain the driver of future growth. The role of fiscal policy has increasingly shifted towards providing an enabling environment for private sector-led growth. Thus, while fiscal policy in 2002 was expansionary to provide a counter-cyclical stimulus to demand, a more important objective of the fiscal measures was to enhance the long-term productive capacity of the economy. Fiscal policy during the year was supported by strong revenue performance. Nevertheless, Malaysia remains committed to fiscal prudence to preserve the long-term sustainability and flexibility of fiscal policy. Therefore, while consolidation has become necessary, fiscal policy measures with greater orientation towards enhancing supply and production responses will continue to have an effective role in promoting private sector-led economic growth.

Against the prevailing uncertain environment in 2003, monetary policy will remain accommodative. While monetary policy continues to have the flexibility to respond to changing monetary and economic conditions, policies to promote private sector activity need to extend beyond macroeconomic policies. Malaysia has at its disposal a wide range of policy measures for this purpose. This includes supply-side policies to facilitate private sector activity, to reduce the cost of doing business, to open new opportunities for the private sector and to increase the efficiency of the public sector in facilitating the growth process. The focus of policy is therefore for a broader growth strategy that would promote the private sector as the engine of growth, promote new sources of growth and enhance the overall competitiveness of the economy.

As part of the effort to promote endogenous sources of growth and to further strengthen the prospects for broad-based growth, Bank Negara Malaysia has produced a report on a proposed comprehensive framework for the development of small and medium-scale enterprises (SMEs). This is aimed at strengthening the necessary infrastructure for SME development, building the capacity of the SMEs and improving their access to financing, and thereby enhancing the SME contribution to growth in the domestic economy. An Inter-Ministry Steering Committee has been formed to take this initiative forward. Bank Negara Malaysia will work closely with the Government Ministries and Agencies involved in SME development, as well as with the private sector to secure the maximum results in enhancing the potential of the SME contribution to the economy.

The year 2002 saw significant progress on several fronts in the financial sector. The significant advances made in the restructuring efforts, the institutional development, the development in the financial infrastructure and the enactment of new legislation have all contributed towards strengthening the foundations of the financial sector and the emergence of an increasingly

resilient financial sector. The restructuring process has not only addressed weaknesses and preserved the stability of the financial system, but has also enhanced the effectiveness and efficiency of the system. The institutional arrangements established in 1998, namely, Danaharta, Danamodal and the Corporate Debt Restructuring Committee (CDRC) have now essentially achieved their objectives and are near completion of their operations. The Corporate Debt Restructuring Committee was wound down in August, while Danaharta and Danamodal have commenced scaling back their operations. The year also saw the successful completion of the consolidation of the domestic banking institutions into ten banking groups.

With strengthened balance sheets, efforts in the banking sector have continued to shift towards addressing more critical issues to enhance institutional capacity and effectiveness so as to ensure long-term competitiveness and relevance. Resources have, therefore, been devoted towards enhancing core competencies, in particular, the risk management capabilities. While putting in place the building blocks is necessary for enhancement, the need to narrow gaps calls for alternatives to the incremental approach to performance improvement. Increasingly, with shareholders' activism becoming a key driver to growth and performance, emphasis on management of shareholder value and enhancing services to consumers would become a differentiating element in banking. The immediate challenge for financial institutions would be to align the risk culture and the need for shareholder value maximisation that also considers community interests towards achieving long-term sustainability. In achieving this, there needs to be a balance between the institutional objectives and the broader objectives of nation building.

An important prerequisite for the development of an efficient, dynamic and competitive financial sector is the quality of skills and calibre of management in the sector. Highly skilled managers are needed to maximise the opportunities presented by the evolving financial landscape. To achieve this objective, Bank Negara Malaysia is in the final stage of establishing a Financial Services Institute to provide a focused and co-ordinated approach towards enhancing development of senior management in the financial sector. Through strategic alliances with renowned international business schools and institutions of higher education, the Institute will provide strategic management courses as well as specialised programmes in the financial services industry. It is envisaged that the Institute will serve as a regional centre of excellence devoted to enhancing the quality of human capital of the domestic and regional financial industries.

As the financial infrastructure becomes more diversified, non-bank sources of financing have increased in importance. While the banking industry continues to be the main source of financing, the year saw increased financing through the capital market, in particular, from the debt securities market, the development financial institutions and venture capital. Within the banking sector, there has also been a distinct change in the pattern of lending activities. During the year, the low interest rate environment has supported stronger growth in lending

activity. Lending has increased to both the household and the business sectors, in particular, to the small and medium-scale enterprises. There has also been increased diversification of lending activity across economic sectors by the banking system.

While priority has been given to strengthening the financial infrastructure, to improve access to funds to a broader segment of the business community in the new growth sectors and to the small and medium-scale enterprises, of equal importance is the need to meet the financing requirements of the micro-enterprises. A structured and comprehensive formal financial infrastructure needs to be developed to ensure improved access to financing for micro-enterprises and thereby enhance access to financing for a broader spectrum of the economy. The aim is to ensure that the micro-enterprises and the informal sectors of the economy have access to the range of financial services. The approach taken will be to strengthen the existing financial infrastructure and to introduce new institutional arrangements with the objective of further enhancing the financial infrastructure to reach all segments of society on a sustainable basis.

The year saw significant strides forward in the growth and development of Islamic banking and finance. The accelerated expansion of Islamic financial activity has increased its relative significance to account for 9% of our banking system. New products and services continue to emerge while gains were also made in enhancing the competitiveness of Islamic financial products. These developments are actively complemented by the role of the Labuan International Offshore Financial Centre to develop a niche in Islamic finance for Malaysia. Given the progress that has been achieved, the time line for liberalisation of the industry to foreign Islamic banking players can now be brought forward to not only increase the potential for expansion but also to bring about greater international integration. The year 2002 also marked a number of significant milestones in the global development of Islamic banking and finance. The establishment of the Islamic Financial Services Board (IFSB) in Kuala Lumpur in November 2002 was the culmination of a two-year effort that has put in place the organisational infrastructure that will contribute towards ensuring the soundness and stability of the Islamic financial system as well as to pave the way for its global integration in the international financial system. The inaugural issuance of the US\$600 million Islamic sukuk in the international markets by the Malaysian Government in June 2002 marked another significant development of the Islamic international financial market. These developments, onshore and offshore, have placed Malaysia on the world financial map.

In the insurance sector, the focus has been on consolidating the capacity-building initiatives already taken thus far to provide a strong foundation for continued stability in the industry in the more competitive environment. Efforts to this end include enhancing prudential risk management standards for the insurance industry, preparing consumers for the more diversified financial landscape and strengthening the consumer protection framework.

The development of a risk-based capital framework for insurers is aimed at ensuring that insurers continue to remain fundamentally sound under changing business conditions, and at the same time, strengthen incentives for insurers to manage their risks adequately. This would be supported by an enhanced surveillance infrastructure that features improved technological capabilities and a more rigorous supervisory intervention process. On the consumer front, avenues available for consumers to seek redress are being expanded, in addition to the measures to promote greater disclosure and transparency in insurance business practices.

As part of the effort to strengthen the regulatory framework, measures were also directed towards further developing the legal framework, with the enactment of the Development Financial Institutions Act 2002 (DFIA) and the Anti-Money Laundering Act 2001 (AMLA). With the enactment of the DFIA, six development financial institutions have been brought under the supervision of the Central Bank. Given that development financial institutions have been established to achieve specific national objectives, efforts were directed at strengthening the institutions to meet these objectives. The AMLA came into effect in January 2002 with Bank Negara Malaysia being identified as the enforcement agency. This legislation reinforces Malaysia's commitment to the global combat against money laundering, financing of terrorism and serious crimes. The Act has also paved the way for international co-operative activities that would contribute towards preserving the overall integrity of the financial system.

In mid-2003, legislation on the payment systems is expected to be enacted to provide the mandate for Bank Negara Malaysia to effectively oversee and facilitate greater development of the payment system. The payment systems in Malaysia continue to evolve with the introduction of new technology, and in tandem with the increasing use of electronic payment channels by consumers and corporations. Several innovative delivery channels have been introduced that leverage on the use of electronic payment modes, including Internet banking and wireless banking, thus increasing the potential for greater economic efficiency. Bank Negara Malaysia has accorded priority to the development and adoption of a more secure and effective payment media. In particular, the adoption of the chip technology in the payment cards and the network infrastructure, sets the stage for better security and expandability of the payment industry. As part of this process, consumer awareness and market transparency are being further enhanced. Consumer awareness and education is also being intensified to increase understanding of the benefits and the inherent risks in the payment industry. These developments underscore the changing financial landscape for the payment industry that, over the long run, shall contribute towards better optimisation of economic resources for the country.

In moving towards a more liberalised and competitive financial sector, measures have been taken to enhance the consumer protection framework as well as to develop more active consumerism. As part of this process, the conceptual framework and overall strategy as well as the design features for the setting up of a deposit insurance scheme were crystallised

during 2002. Similar efforts have been initiated to develop a structured 10-year consumer education programme that commenced in early 2003. The implementation of the new framework that comprises a strengthened institutional framework for consumer redress as well as enhanced institutional and product transparency so as to improve consumers' financial literacy would continue to be an area of focus in future. This would be complemented with the development of a service quality index for the industry as part of the industry-wide benchmarking exercise.

Malaysia was also actively involved in strengthening international and regional co-operation. Given the uncertain global environment, regional surveillance processes provided an important avenue for countries to exchange views on developments affecting the region and share experiences on different policy options and undertake vulnerability assessments of areas of common concern. Important progress was made to further enhance regional surveillance in the context of the ASEAN Plus 3, including a review of the modalities to strengthen the effectiveness of the surveillance process. Regional financial co-operation under the Chiang Mai Initiative was further strengthened with the signing of additional Bilateral Swap Arrangements, including those between Malaysia and Korea and the People's Republic of China. Important steps were also underway to develop the regional bond market and establish a regional bond fund to promote closer financial integration in Asia.

The environment in which the Central Bank operates has changed dramatically. To remain at the forefront in dealing with the new challenges that we are faced with, there has been an on-going review of our strategic orientation and key priorities. In particular, while monetary and financial stability continue to be the main responsibility of the Bank, the developmental role of the Central Bank in driving the evolution of the broader financial system extends beyond those under the direct purview of the Central Bank. In this connection, the role of the Central Bank has included the review of existing infrastructure, development of new institutional arrangements and the provision of general institutional and policy support.

In this regard, with the vision and objectives defined, the approach adopted has been consultative and collaborative. The development of the financial system is the result of the combined efforts of the regulators, the Government, the industry and the market participants. In so doing, the common goals can be realised for the ultimate advantage of the nation.



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Governor

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