GOVERNOR'S STATEMENT

The year 2014 marks a year of transition for the world economy. As the recovery in the major advanced economies is sustained, the prolonged period of monetary accommodation will shift towards normalisation. While the structural adjustments and institutional changes being implemented will also contribute towards strengthening the growth process, challenges remain in managing this period of transition so as not to undermine the recovery. The emerging economies, in particular in Asia, have been resilient during this period of prolonged global slowdown, and will benefit from the global recovery. Most emerging economies have continued with the reforms to strengthen the medium-term growth outlook, while addressing the areas of vulnerabilities.

While the normalisation of monetary conditions in the advanced economies will be positive for the world economy given that it reflects improved economic conditions, this has been followed by heightened volatility in the international financial markets. During this period, the emerging economies have experienced sharp reversals of capital flows. The policy spillovers and contagion effects are potential risks confronting the emerging economies in this year of transition. The emerging economies have been affected by these developments in varying degrees. The earlier reforms and a broader policy toolkit have, however, allowed most emerging economies to more effectively manage these highly uncertain and volatile conditions.

Economic conditions in Malaysia have also continued to improve, and the Malaysian economy is expected to remain on a steady growth path going into 2014 and 2015. While the economy will continue to benefit from the gradual global recovery, the private sector-led domestic demand remains the key driver of growth. The economy has benefitted from the earlier reforms and initiatives introduced, which have provided a conducive environment for private investment. Projected to register its fifth consecutive year of strong growth, the broad-based capital spending across the economic sectors and geographical areas reflects the ongoing efforts to transition towards becoming a higher value-added economy. The household sector has also remained resilient. Private consumption activity is supported by the sustained income growth and stable labour market conditions.

As a highly open economy and an increasingly more liberalised financial system, Malaysia is significantly affected by external developments. Despite the increased capital flow volatility during the recent months, the domestic financial markets have remained orderly, and financial intermediation has not experienced any disruptions. This is largely from the payoffs from the decade of reforms to develop a more resilient domestic financial system. Additionally, the high level of international reserves, the low level of external indebtedness and the balance of payments current account surplus continue to reinforce the strength of the Malaysian economy and its capacity to cope with external shocks. Beyond the prevailing short-term volatility, structural adjustments and economic transformation efforts currently being implemented will strengthen the fundamentals and growth prospects over the medium term.

In the domestic economy, the focus has been on the management of a number of key challenges to strengthen the potential for the sustainability of our medium-term growth prospects. Following rising costs, the domestic economy is entering a period of higher prices. Inflation in 2014 and 2015 is projected to be above its historical average, and to be between 3-4%. The revisions to a number of administered prices, higher domestic cost factors and the implementation of the Goods and Services Tax (GST) in 2015, are taking place at a time of modest global commodity prices, moderate domestic demand pressures and anchored inflationary expectations. These price adjustments are, therefore, expected to have a transitory effect on inflation. The impact of these adjustments is projected to diminish over time, and inflation is expected to stabilise in the region of its long-term average of 3%. The continued productivity enhancements and efficiency improvements by businesses will contribute towards containing the pass-through of the higher costs to consumers.

As the Government proceeds with its ongoing plans to contain the fiscal deficit and the level of public sector indebtedness, the challenge is to achieve these fiscal sustainability efforts while remaining supportive of growth. These fiscal reforms are essential to strengthen the overall resilience of the economy, and to increase the fiscal space to manage future unanticipated shocks. The fiscal consolidation process has, for the main part, been implemented gradually to minimise its potential adverse implications on the economy, with some supporting pro-growth measures to avoid disruptions in economic activity and dislocations to the vulnerable segments of society. The improved revenue position and the more efficient public sector spending will increase the potential for the development of a more comprehensive social protection system and further investments in infrastructure development in Malaysia.

In this more complex and challenging environment, the focus of attention of the appropriate policy mix by the Bank has been on preserving macroeconomic and financial stability, while also addressing the risks arising from the build-up of destabilising financial imbalances, and at the same time, supporting an inclusive growth. While monetary policy is an important policy lever, the Bank has also relied on a range of policy tools to achieve these objectives. The focus of monetary policy remains on preserving price stability in an environment of sustainable growth. However, also embedded within the considerations for the policy is to ensure that the interest rate setting does not result in widespread financial distortions or excessive risk-taking behaviour in the economy. For sector-specific risks of financial imbalances, a specifically more targeted approach, in the form of macroprudential and microprudential measures, has been implemented. While this broader policy toolkit has been relied upon, these measures are not a substitute for the monetary policy stance that is consistent with the prospective economic and financial conditions in the country.

During the year, initiatives were also continuously undertaken to further enhance the structure of the financial system, to facilitate more effective intermediation and to improve the risk management practices. In the further development of the bond market, the issuance of notes with a 30-year maturity period by the Government strengthens the depth of our bond market, and provides a benchmark for long-term project financing by the private sector. Another important development that is set to come into effect in 2015 is the introduction of a new reference rate, the Base Rate, for the pricing of floating-rate bank loans, to replace the Base Lending Rate that has been in place for more than 30 years. This enhancement to the interest rate framework aims to increase the relevance of the reference rate to the financial sector, improve the pricing mechanism that is more market-based, and at the same time, ensure greater transparency for households and businesses.

As financial integration in the region deepens, central bank cooperation to enhance collective resilience has also been strengthened further during the year. The cooperation has been strengthened in the area of cross-border surveillance, and in the development of an integrated crisis management framework to address pre-emptively threats to regional macroeconomic and financial stability. Financial resources available for crisis management have been, and will continue to be, enlarged through cross-border collateral arrangements and new bilateral swap arrangements. The Chiang Mai Initiative Multilateralisation (CMIM) is also being enhanced to strengthen the regional financial safety net. Cumulatively, these initiatives advance and strengthen the institutional arrangements and mechanisms, as part of the overall regional financial architecture to support regional stability.

During the year, the Bank established the Bank Negara Malaysia Representative Office in Beijing. This marks a significant milestone for the Bank. As the third overseas representative office after London and New York, it serves as an important liaison point with China's regulators and financial market participants to support a deeper understanding of the country's economic and financial developments.

In the Bank, efforts continued in enhancing organisational capacity to ensure that the Bank continues to remain effective in delivering our mandates. Equally important is that we are in a state of readiness to deal with future eventualities. Ongoing investments in talent management practices, over the years, have contributed to strengthening our institutional resilience. During the year, more structured programmes have been introduced to accelerate the time to competence, while more targeted leadership development programmes were provided for the mission critical positions. Guided by the Bank's business planning and enhanced risk management practices, the clear focus on strategic outcomes and awareness of potential risk areas ensure that mitigating and contingency measures have been put in place to facilitate the management of these risks and unexpected developments. Rigorous financial and operational management further supports the effective allocation of resources, and the management of multiple demands with varying priorities. During the year, our engagement and interface with partner institutions, including across borders, was also strengthened further, with several formal arrangements entered into to enhance greater collaboration efforts.

Going forward, the international and domestic environment will continue to place significant demands on the capacity and capability of the Bank. The continued readiness and effectiveness of the Bank in fulfilling our responsibilities will require a cohesive workforce that is dedicated to performance and strong collaboration with our institutional partners. On behalf of the Board and the management, I wish to express our appreciation to all staff of the Bank for their commitment and professionalism to ensure that the Bank continues to serve the best interests of the nation. I am also grateful for the unwavering support and guidance of the Board of Directors, who is an integral part of the governance at the Bank. The Bank will continue to strive towards achieving the highest standards of excellence in fulfilling our responsibilities and upholding the trust that is placed upon us.

Zeti Akhtar Aziz
Governor
19 March 2014