Governor's Statement

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The Malaysian economy achieved a steady growth in 2006 amidst an environment of moderating inflation. We entered the year with rising inflationary pressures, arising from record-high oil prices. While the policy rate was raised three times during the course of six months, monetary policy decisions carefully balanced the need to deal with the risks of inflation and the need to sustain a steady pace of economic growth.

With the increased flexibility of the economy, the more diversified economic structure, the improved macroeconomic fundamentals and the strengthened financial sector, the economy has emerged stronger and more resilient in 2006. While the external position remained strong, domestic private sector activity continued to drive the economic expansion. This trend was also reinforced by strong inflows of foreign direct investment. The manufacturing, services and the agriculture sectors continued to be the main engines of growth, while the mining and construction sectors experienced a recovery during the year.

Inflationary expectations were well anchored during the year. Despite rising inflation in the first half of the year, demand-induced inflation remained low and there was limited evidence of second-round effects from the supply-driven price shocks to headline consumer prices. Hence, following the increase in interest rates in late 2005 and early 2006, monetary policy remained unchanged for the remaining part of the year.

Malaysia continues to be a highly open economy in terms of the volume of trade and financial flows, and in terms of the foreign presence in our economy and financial system. In 2006, both exports and imports expanded at double-digit rates. Foreign direct investment in Malaysia also accounted for over one-quarter of investment. In addition, foreign financial institutions in the banking sector account for almost 30% of the market share while in the insurance, the foreign presence accounts for about 70%. Foreign participation in the capital market is also significant, with participation in the bond market now including non-residents who invest in papers as well as those issuing securities.

As a result of the high degree of integration with the global economy and the international financial system, global developments have significant effects on the domestic financial markets and economy. In addition, with the highly liberal exchange control policies, there have been large and volatile capital flows. Malaysia is therefore not insulated from external developments and contagion. Malaysia's ability to absorb this increased volatility has, however, been strengthened considerably. This increased resilience has been derived from the more diversified economic structure, the improved macroeconomic fundamentals, the strengthened financial system and the more developed financial markets.

While this growing resilience means that the country has the enhanced capacity to deal with shocks arising from unexpected external developments, the private sector will also need to actively manage their risks so as to be better positioned to benefit from the increased opportunities that the new environment accords. Strengthened corporate governance and risk management practices, reinforced by increased efficiency and greater innovation, will contribute to enhanced competitiveness and resilience. The accelerated development of the financial system has led to the emergence of new financial intermediaries, new financial instruments, more developed financial markets, and more liberalized exchange control rules. These progressive developments are aimed at meeting the changing requirements of the environment, facilitating flexibility in managing financial transactions and enhancing risk management by the private sector.

It has been almost two years since Malaysia transitioned to a more flexible exchange rate regime. The successful transition was the result of having in place a series of preconditions for its successful implementation. This includes a stronger and more dynamic banking sector; a deep and liquid bond market; strengthened macroeconomic fundamentals; sufficiently high level of reserves; and the liberalisation of the capital account commensurate with the capacity of the market to manage the risks. In addition, a surveillance mechanism has also been put in place to monitor capital flows given its increased influence in affecting exchange rate movements.

The developments in the ringgit foreign exchange market have generally been orderly, reflecting market conditions and the underlying fundamentals of the economy. The strength of the economy has essentially generated two-way flows that have contributed to the stability of the underlying trend in the exchange rate. The major part of the inflows is from export earnings, long-term investment activities and portfolio investments. The core of these flows is based firmly on sound fundamentals. The outflows have also generally reflected the strength of the economy that include the increased import demand, the repatriation of profits and dividends by foreign corporations and financial institutions, and the repayment and prepayment of external debt. In addition, an increasingly evident trend is the investment abroad by Malaysian companies. The outflows due to both the large foreign presence in Malaysia and the more internationally-oriented corporate sector have been substantial. In 2006, these outflows amounted to 5.3% of GDP and have, to some extent, offset the upward trend in the currency arising from the inflows.

The diversified financial structure and increasingly developed financial system have increased the potential for more effective intermediation by the financial sector. The ample liquidity situation, the strengthened capacity of the financial institutions and the greater depth and breadth of the capital market have supported the upward momentum in private investment activities. The household sector and the small- and medium-scale enterprises have also enjoyed substantial increase in access to financing. The investment banking institutions that commenced operations in 2006 are important capital market intermediaries that meet the new requirements of the corporate sector, while institutional arrangements for micro financing, which were introduced during the year, also enhanced access to financial services and financing for micro enterprises.

While the financial sector has been developed to become an important enabler of growth by facilitating the economic growth and transformation process, it is now emerging as a direct source of growth. The rapid development that has taken place in the financial services industry exemplifies this changing role. New areas of activity, including investment banking and Islamic finance, have experienced marked expansion. The finance, insurance, real estate and business sub-sector in the economy has become increasingly important to account for 15.5% of GDP, rising from 12.7% in 2000. This sub-sector also employs more than 770,000 persons compared to 500,200 in 2000. This significant growth has taken place despite the consolidation and rationalisation in the banking and insurance industries. The financial services industry has thus become an important engine of employment, income generation and thus growth of the economy.

With the increasing sophistication and dynamism of the financial services sector, the Bank has moved progressively to liberalise the financial services landscape. In particular, in new areas of growth including investment banking and Islamic banking and takaful, foreign equity limits have been raised. In the area of Islamic finance, three new Islamic banking licences were also issued to foreign players. This gradual but progressive liberalisation is not only aimed at promoting a competitive environment that ensures cost-effective pricing to benefit Malaysian consumers and businesses, but also to strengthen our trade and investment linkages with the rest of the world. The experience has also shown that the direct and indirect spillovers from the liberalisation would enhance growth, diversify activities and open new markets for Malaysia. For foreign investors, Malaysia has not only been a high profit centre, but has also provided a platform into the fast-growing East Asian region.

The Bank has also continued to review its foreign exchange administration rules and has progressively liberalised them with the aim of enhancing the efficiency of the delivery system, and providing greater potential for risk management by businesses, and thus enhancing Malaysia's overall competitiveness. In addition to reducing further the cost of doing business and facilitating a greater degree of risk management, the liberalisation announced in conjunction with this Report aims to contribute towards providing increased flexibility in undertaking foreign currency business, widening the investor base for ringgit assets and financial products, as well as enhancing business and capital market efficiency.

For the year 2007, the global economy is projected to expand by more than 4% despite some moderation in the US. This would be the fifth consecutive year the world economy has experienced strong growth. Despite some slowing in export growth, particularly in the first half of the year, the overall growth is expected to remain strong. The domestic economy is also expected to have an improved growth performance in the second half of the year. Domestic demand will be sustained as the improved consumer and business confidence translates into stronger private expenditure. Real GDP, in an environment of moderating inflation, is forecast to expand by 6%.

This stable macroeconomic and financial environment will be taken advantage of to shift resources to new areas of growth and also to shift to operating at higher levels of efficiency. A crucial component in achieving this is the accelerated shift to electronic means of payments. Studies conducted in countries where the migration to electronic payments has occurred show that the long-term savings from the adoption of these platforms more than offset the short-term costs of development and implementation. Transaction costs in an electronic payments system are between one-half to one-third of that of a paper-based system. In Malaysia's case, these costs are high, amounting to 1% of GDP per year. This level of savings would represent a significant stimulus to overall economic growth.

Malaysia's financial system, with the significant outreach by banks and adoption of basic electronic payments methods such as automated teller machine cards, is ready to adopt these more efficient systems widely. Indeed, it is possible for Malaysia to leapfrog to the latest electronic payments infrastructure, namely the more cost-effective and efficient internet- and mobile-based platforms. A precondition to successfully adopting these next-generation systems, however, is an expansion of the information infrastructure, in particular to have a significantly higher level of computer penetration and broadband coverage. While the cost of expanding the coverage may seem significant, the economic payoff from widespread broadband coverage will be great, far exceeding the cost savings arising from converting to electronic payments. The benefits that such access will also bring to the economy in terms of increased productivity, dissemination of information and capacity for more efficient communications will be tremendous. It will also allow business and financial transactions to take place more effectively and efficiently. This would subsequently lead to lower costs, higher quality and a higher standard of living.

While the global and economic outlook remains favourable, risks remain. In this context, continuous efforts will be directed to strengthen the resilience of the financial system and the economy to be able to absorb the shocks that might occur so as to minimize their implications on the domestic economy. This rapidly changing international environment has indeed altered the prospects and potential risks and challenges faced by the region. This has prompted a more coordinated approach to addressing common issues in the region. The aim for closer cooperation is not only to achieve greater regional macroeconomic and financial stability but also pave the way for achieving greater mutually-reinforcing growth. Regional cooperation is thus focused on strengthening the regional institutional arrangements and mechanisms in the areas of monitoring developments, enhancing capacity for risk management, financial market development and regional financial integration, crisis management and resolution and capacity building. The ultimate objective is to unleash the full potential of the region to achieve greater regional economic prosperity.

As part of the efforts to increase the internal ability of the Bank to manage a more challenging environment, the Bank has also continued to allocate significant attention to strengthening its organizational capacity so as to deliver the expected results. In 2006, the focus was on further improvements in the governance structure, talent management, learning and knowledge management as well as information and communication technology management. In particular, the realignment of the regulatory and supervisory functions under a more integrated approach was a major enhancement, to be better positioned to achieve financial stability and to drive the development of financial system. During the year, the Bank also made notable improvements to talent management. This included the establishment of new roles and competency requirements aligned to the Bank's strategic objectives. These initiatives mark a step in the continually evolving process to ensure that the Bank's talent management practices promote greater organizational clarity on roles and performance expectations across all levels. Leadership and knowledge management are also considered as critical components in internal capacity and capability development, and the Bank is increasingly collaborating with other central banks and other international learning providers to foster greater knowledge-sharing and understanding. The Bank will continue to accord utmost priority in its organizational development to enable it to carry out its mandate efficiently and effectively, in a sustainable manner.

Zeti Akhtar Aziz
Governor

21 March 2007