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Governor Tan Sri Ali Abul Hassan's Speech at the National Congress on Economic Recovery - "The Way Forward"

Speaker: Tan Sri Dato' Seri Ali Abul Hassan Sulaiman / Venue: Kuala Lumpur / Language: English /
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When the Asian crisis first broke out in July 1997, it was perceived as a localised problem that would dissipate in a couple of months. No one foresaw the magnitude and depth of the crisis, which is now into its second year and has since spread across Asia to Russia, South Africa and Latin America. As more and more countries succumbed to the contagion effects of the financial meltdown, the forecasts for the world economy have been repeatedly revised downward. The latest IMF forecasts call for world growth of 2%, or about half the rate projected a year ago. It suffices to say that the outlook for the global economy is not at all encouraging. Indeed, there does not appear to be any sign that stability will return to the global financial markets in the immediate future. A dramatic adverse development in any financial centre can set another round of depreciation in currencies of countries not only in that particular region, but throughout the other global financial markets.

In the face of all these risks and challenges, Malaysia had to act fast and decisively to protect its economy. Doing nothing would mean that Malaysia is leaving its destiny in the hands of others. In July 1998, the National Economic Action Council announced a comprehensive National Economic Recovery Plan to expedite economic recovery. The Plan focused on 6 key areas. The short-term aim was to stabilise the ringgit, restore market confidence and maintain financial stability. The Plan also outlined longer-term measures to promote structural reforms to strengthen the economic fundamentals, revitalise key sectors and persevere with the socio-economic priorities. To expedite economic recovery, Malaysia had to regain control of monetary policy and insulate itself from the adverse external developments, it is in this context that Bank Negara Malaysia introduced selective exchange controls on 1 September 1998.

The main objective of these controls is for Malaysia to regain monetary independence so that we will be able to introduce measures based on domestic conditions. Prior to the introduction of the selective exchange controls, our policies were essentially reactive to external developments and was based on the advice of the IMF. For example, when our economy recorded a negative growth of 1.8% during the first quarter of this year, it was clear that our economy needed to lower interest rates to spur economic activities. But this was not done by the officials responsible for monetary policy at that time. I guess there were two reasons for this. First these officials blindly believed in the IMF mantra that a high interest rate regime was good for Malaysia. Second, they were out to gain the confidence of the foreigners, ignoring the fact that confidence of the Malaysians was more important. They feared that lowering the interest rates would not impress the foreigners, and this may have resulted in the Ringgit depreciating further.

All that belongs to history now. We are now on the right course. The selective exchange controls introduced was a significant milestone of this change in policy. The new exchange control policy, of course, should not affect trade and business operations in Malaysia; neither should it affect long term investors nor the normal conduct of economic activity. The flow of direct foreign investment and repatriation of interest, profits and dividends continue to be guaranteed. The changes are directed at containing speculation of the ringgit and minimising the impact of short-term capital flows on the domestic economy. The regulation of currency carried by travellers, for instance, are not different from those applied in several other countries, including developed countries.

The most important measure to bring about financial and economic stability to the country is the elimination of the offshore ringgit market. The decision to disallow the transfer of funds between the external accounts, namely the ringgit accounts held by non-residents in the banks in Malaysia, has effectively stopped lending and borrowing of ringgit for currency trading and speculation. At the same time, net settlement of currency trades through the external accounts became no longer possible. As a result, ringgit trading overseas ceased to exist and the offshore ringgit market has now been eliminated. This move also facilitated the closing down of the CLOB market in Singapore through measures introduced in the securities market.

Once the offshore ringgit market has been removed, pressures on the currency were effectively removed. Consequently the Government was able to fix the exchange rate of the ringgit at 3.80 against the US dollar. The rate was chosen as it was the closing rate when the floating regime was dismantled. Hence it reflects

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closely market conditions and we believe to be in line with the true value of the ringgit. We are confident that the fixed rate of 3.80 against the US dollar is sustainable.

In order to ensure that stability in the exchange rate is preserved and the financial market is not subject to undue volatility, the Government has also decided to discourage short term flows by requiring that inflow of funds should remain in the country for at least one year. This one-year ruling applies to purchases of shares and securities as well as placement of deposits in the Malaysian banking system. However, profits and dividends generated on such inflows can be freely taken out of the country.

To complement the measures on capital control, other confidence-boosting policy initiatives had been implemented to improve the liquidity flows in the banking system, enhance the intermediation process, generate lending activities and ensure that viable businesses continue to receive financing. An important objective of these measures is to reduce the overall intermediation cost by reducing interest rates and releasing liquidity into the banking system. Towards this end, the intervention rate and statutory reserve requirement have been progressively reduced. Consequently the maximum BLR for the commercial banks have declined from 12% to 8.9% as at end-August 1998. To ensure that adequate credit will be made available to finance economic activities, Bank Negara has stipulated that banking institutions would be required to achieve a minimum loan growth of 8% by the end of 1998. The lower lending rates will help to spur economic activity, which in turn will improve the credit standing of business concerns.

The classification policy on non-performing loans was also revised where the classification period for non-performing loans was lengthened from three to six months. This reclassification would provide borrowers with some breathing space to regularise their accounts. No borrower would like to have their loans classified as non-performing. Such classification has also at times deterred borrowers from repaying their loans as they get despondent from the NPL status. Now, borrowers would find it easier to service their loans and would continue to make payments to avoid the NPL classification. Therefore, banking institutions would also benefit as their non-performing loans would no longer balloon and their capital base would not be eroded due to higher provisioning levels. The requirement for banking institutions to automatically provide 20% specific provision for sub-standard loans have been removed. However, where a bank's provisions are not adequate to cover the NPLs, they will continue to provide the 20% specific provision. For the industry as a whole, the provisions are adequate at 150% of NPLs. We have not, however, changed the definition of bad loans as loans that are in arrears for more than 12 months would still be classified as bad.

The lengthening of the NPL classification period should not be seen as a relaxation in prudential standards. On the contrary, the redefinition of NPL, by allowing greater economic activities would strengthen the banking system, given that the health of the banking system is highly dependent on a strong and stable economic environment with vibrant business activities and a viable corporate sector.

What are the effects so far? With the BNM international reserves increasing by USD1.1 billion in September and deposits in external accounts increasing from RM9.1 billion as at end-August to RM12.7 billion as at 22 September, the measures have undoubtedly yielded positive results. In addition to the increase in international reserves deposits accounts, the Malaysian public deposited a total of RM1.7 billion currency notes back into the banking system in September this year. The non-performing loans of the banking system are also expected to reduce from RM66.8 billion to RM40.8 billion. In terms of percentage to outstanding loans, the NPL ratio would reduce from RM15.8% to 9.7%. The banking system is expected to make a profit of RM1.7 billion as a result of the recent measures from a loss-making position of about RM0.5 billion earlier. Car sales is increasing substantially. Housing constructions are gaining momentum. Generally, there is a strong "feel good factor" permeating in the economy now. The worst appears to be over. With improved business environment, banking institutions would now be more forthcoming in granting financing. To ensure that this happens, we have imposed a minimum annual loan growth target of 8% to be met by banking institutions by the end of this year. We are confident that the banking institutions can meet this target without forgoing financial discipline.

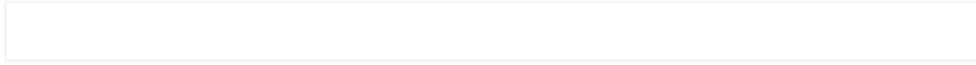
In this environment, Bank Negara can forge ahead with reform measures to further strengthen the banking system. This would mainly be achieved by using Danaharta and Danamodal. A rejuvenated economy supported by a strong banking sector will undoubtedly steer Malaysia back into the path of sustainable economic growth in the years ahead.

Ultimately, by ensuring that the intermediation process continues to function effectively and viable businesses continue to operate, we can generate enough economic activities to stimulate economic recovery. These economic activities would improve and build domestic confidence in our economy. By restoring domestic confidence, we believe that foreign confidence will eventually be regained. A strong and vibrant economy will also strengthen the banking system. In the final analysis, all stakeholders would benefit from the measures introduced to induce greater economic activities.

In conclusion, the imposition of the capital controls has now enabled the Government and Bank Negara Malaysia to pursue more aggressively policies and measures to put Malaysia on a firmer path towards economic recovery. We have reduced interest rates, injected greater liquidity into the banking system and enhanced the intermediation process. By fixing the ringgit-US dollar exchange rate, uncertainties with regard to the movement of our exchange rate have now been eliminated. With lower lending rates and greater certainty with regard to the direction of economy and exchange rate, viable businesses and projects can

continue to operate as their debt servicing burden are no longer at crippling levels. More importantly, their expansion plans, which have been put on hold following the outbreak of the crisis, can now proceed, thereby generating greater economic activities. The bad patch in our economy is about to end. We can see the light at the end of the tunnel.

Bank Negara Malaysia
6 October 1998



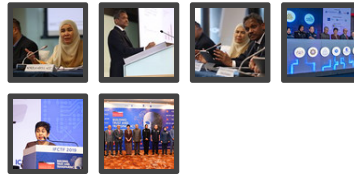
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As Malaysia's Central Bank, Bank Negara Malaysia promotes monetary stability and financial stability conducive to the sustainable growth of the Malaysian economy.

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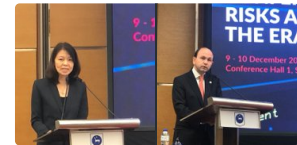
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