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WORLD BANK GROUP
INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT
INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
INTERNATIONAL CENTRE FOR SETTLEMENT OF INVESTMENT DISPUTES
MULTILATERAL INVESTMENT GUARANTEE AGENCY
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Statement by the Hon. **DATO' MUSTAPHA MOHAMED**,
Governor of the Bank and the Fund for **MALAYSIA**,
at the Joint Annual Discussion

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1. When we gathered here last year, the growth outlook for the crisis-affected East Asian economies was gloomy. Since then, economic conditions in these economies have improved markedly and there is greater optimism that the worst may finally be behind us. Reflecting this, there have been upward revisions in growth projections for East Asian economies. Similarly, prospects for world growth have also been revised upwards.

2. In September last year, Malaysia imposed selective exchange controls in order to prevent further internationalisation of our currency, the ringgit, and restore stability in the financial market. In the past one year we have used this window of opportunity to strengthen the fundamentals of the Malaysian economy. The banking and corporate sectors were restructured. We adopted an expansionary monetary and fiscal stance to prevent further contraction of the Malaysian economy.

3. Despite the severe criticism levelled at us when we first adopted selective exchange controls, the unorthodox measures have yielded positive results as they provided the stability required for recovery measures to be effective. What is perhaps most significant is that the economic recovery was achieved with minimal social costs to the most vulnerable segments of society. Unemployment remained low and poverty did not increase significantly. Our experience has shown that the standard IMF policy prescriptions introduced during the earlier part of the crisis did not work for Malaysia.

4. We are encouraged by the progress we have made so far. Our GDP grew by 4.1% in the second quarter after five consecutive quarters of negative growth. Malaysia's economic recovery reflects broad-based strength and is expected to be sustainable. Key monetary aggregates have improved and the multiplier effects of a more expansionary stance have begun to manifest themselves more strongly. Economic recovery was also stimulated by the strong export growth we have enjoyed for eight consecutive quarters. This followed the large monthly trade surpluses we have registered for twenty-one consecutive months since November 1997. At the same time, there has been a significant revival in private consumption. The fiscal stimulus package further reinforced the expansion in domestic activities. Meanwhile, Malaysia's balance of payments continues to be in substantial surplus and the external reserves position has improved significantly from 3.8 months of retained imports in August last year to 6.8 months at the end August or USD31.3 billion, four times larger than the nation's short-term external debt. The total external debt remained manageable at about 59% of GNP. Our debt-servicing ratio remains low at 6%.

5. The return of stability to the financial markets allowed Malaysia to liberalise the exchange controls within six months of its implementation. In February 1999, a graduated exit levy was introduced to allow funds to be repatriated freely. Subsequently

on September 21, the two-tier levy system was streamlined. The expiry of the 12-month holding period for portfolio funds on September 1, did not result in a major exodus of foreign funds.

6. At the onset of the crisis, the Malaysian banking system was at its strongest, with the RWCR at 12%, while NPLs were at a low of 3%. The financial sector was less affected by the crisis primarily because a sound and relatively well-developed financial infrastructure was already in place. This reflected the results of earlier comprehensive regulatory changes to restructure the financial system, following the recession in the mid-80s. Such measures included a new Banking and Financial Institutions Act, with stringent prudential regulations on connected lending. Over the last decade, continuous measures were implemented to keep in line with international banking standards. In addition, Malaysia had in place an adequate bankruptcy legislation and corporate governance structure.

7. During the crisis, Malaysia adopted a pre-emptive strategy to address emerging problems in the banking sector, well before they reached serious levels. The institutional framework was established early in the crisis to address the emerging problems of NPLs and recapitalisation of affected banking institutions. Because of the pre-emptive measures, Malaysia could effectively use the period of stability accorded by the selective exchange controls to accelerate the pace of financial and corporate restructuring, which helped to hasten the economic recovery process.

8. The asset management corporation, Danaharta, has made significant progress, with its initial acquisition phase completed six months ahead of its target. To date, Danaharta has acquired and managed a total of RM 39 billion worth of NPLs from the financial system. Of these, RM29 billion were from the banking system, accounting for 35% of total non-performing loans in the banking system. With the carve-out of NPLs by Danaharta, the net non-performing loans of the banking system has eased to 7.9% of total loans (RM29.7 billion) as at end-June 1999 based on the 6-month NPL classification period and (12%) on 3-months basis.

9. With the completion of the purchase of NPLs, Danaharta has embarked on its loan and management process and this is progressing well. Up to date, Danaharta has met with 1,732 borrowers with NPLs amounting to RM38 billion. Approximately 2% of these accounts have been regularised or fully settled, while 423 borrowers with loans of RM10.3 billion (representing 27% of total loans under management) have submitted their restructuring proposals. These proposals are at various stages of evaluation. In total, Danaharta has initiated recovery with 61% of the borrowers.

10. On asset disposal, Danaharta has conducted a restricted open tender on 5 July 1999 to dispose its foreign loan assets which comprise non-Ringgit loans and marketable securities extended to or issued by foreign companies amounting to USD142.82 million. The recovery rate on this loan was 55.3%.

11. At the same time, Malaysia has recapitalised 10 banking institutions. With the economic recovery, however, the capital position of some of the recapitalised banking institutions has improved and consequently, total investment by Danamodal, the special purpose vehicle set up to recapitalise financial institutions, had declined from RM6.2 billion to RM5.9 billion. This amount is significantly lower than the initial estimate made a year ago of RM16 billion needed to recapitalise banking institutions. With the capital injection from Danamodal, the risk-weighted capital ratio of these banking institutions have strengthened to 13.3% as at end-July from 9.9% as at end-September 1998.

12. The Corporate Debt Restructuring Committee (CDRC) has made good progress in its debt restructuring exercise for the larger debts. Currently, CDRC is in the process of working out the restructuring schemes of 39 applications involving debts worth RM20.9 billion, whilst the debt restructuring schemes for 10 applications have been completed and are at various stages of implementation. In addition, restructuring of corporations is also being implemented by merchant banks and Danaharta in the process of managing the NPLs.

13. While we are heartened by the progress we have achieved thus far, we are mindful that sound domestic policies alone are not enough. Adverse external factors can negate good domestic policies. It is for this reason that reform of the international financial architecture is of great urgency to reduce the impact or avert future crises.

14. The globalisation of financial markets has been the outcome of concerted efforts to free trade in goods and services. The greater liberalisation of trade flows has created much wealth to exporting countries. This has resulted in owners of this wealth seeking to maximise returns on their capital. Unfortunately, the absence of prudential rules to guide the “profit-maximising” behaviour of owners of capital has significantly negated much of the benefits of free capital flows. In the case of trade, the push towards free trade was matched by adequate rules on market opening measures and procedures for dispute settlement. In contrast, the push to liberalise capital movements has not been matched by a parallel move to develop rules to safeguard economies from the adverse consequences of market excesses.

15. In the absence of rules to manage capital flows, small emerging market economies have become extremely vulnerable to volatility. The global financial system clearly does not provide a level playing field, as large players can effectively corner and manipulate small markets with impunity. In our view, reforms are needed to safeguard the interests of small emerging markets so that they will not be subjected to predatory tendencies of large market players.

16. It should also be noted that in spite of the best institutional framework, small countries can be completely overwhelmed by a liberalised capital account framework. Without a parallel institution at the international level, countries may be forced to resort to more inward-looking policies in order to protect incomes and employment.

17. The recent G-7 initiatives, particularly the establishment of the Financial Stability Forum and its working groups, represent an important step forward. However, given the restrictive nature of this forum, the concerns and interests of small emerging market economies have not been adequately addressed. This is further aggravated by the exclusion of smaller economies in the G-20 which was set up over the weekend. None of the ASEAN countries has been included although their economies are open and well integrated into the global financial system and have been the major victims of the crisis. We urge for an expanded membership in the FSF and the G-20 to ensure greater acceptance and ownership of the recommendations of both these fora.

18. Current efforts on the new architecture need to consider options for some form of indirect and direct regulation of highly leveraged institutions, in addition to measures to enhance transparency of their operations. Given the increasingly important role of the private sector in the global economy, a more balanced approach to the issue of transparency and disclosure by both the public and private sectors is essential. On-going efforts to promote greater transparency of Government operations must be complemented by a mechanism to strengthen surveillance and transparency of private sector market participants that are of systemic importance to guard against market failure. Consideration of the issues associated with managing volatile capital flows should include both debt as well as non-debt related flows. Lest we forget, let me remind that the Asian crisis was largely due to the non-debt creating capital flows by the private sector.

19. In addition to extending disclosure requirements to the private sector, we also need a global mechanism to supervise the international financial markets. Such a global regulator would ensure the orderly functioning of the international capital markets and compliance with measures to inhibit cross-border manipulative activities in financial markets and design rules against the cornering of financial markets, circuit breakers, and appropriate international standards for financial institutions.

20. The experience in the last two years indicate that small countries are most vulnerable to liberalisation. It is our view that they should not be coerced into accepting capital account liberalisation at any cost. Instead, they should be allowed to liberalise at a pace commensurate with their stage of development. Liberalisation of the capital account should not be part of Fund conditionality. Malaysia believes a more productive approach is to create a conducive environment, which would serve as an incentive for countries to liberalise their capital accounts. This requires stable financial markets that would make it "safe" for countries to open their capital accounts.

21. In our view, any expansion of the IMF's jurisdiction over the capital account should await the outcome of discussions in various international fora on reform of the international financial architecture. The issue of IMF jurisdiction over capital movements can be revisited at a future date. At this juncture, the priority should be ensuring a sustainable recovery in the crisis-affected countries and on reforming the architecture of the international financial system to restore stability and order in global financial transactions.

22. While prospects for recovery have improved, indicators showed that global poverty continues to worsen. Extreme poverty as measured by the proportion of the population living on less than $1 a day has been increasing over the years and progress in meeting the goals that have been set for poverty reduction and elimination has been limited. Against this background, Malaysia believes that the international community, including the World Bank and the IMF, need to reexamine current strategies and policies on poverty redressal.

23. In this regard, we welcome the on-going efforts to modify the ESAF-HIPC initiatives through the simplification of its conditionalities as well as enhancing its accessibility to more heavily indebted poor countries. While Malaysia believes that countries should settle their debt obligations, this new ESAF-HIPC initiative would provide breathing space for them to use their limited resources to undertake social spending to reduce poverty levels.

24. In concluding, let me reiterate the importance of addressing issues of liberalisation and globalisation and their impact on small open economies. Given the vulnerability of these economies to the risks arising from globalisation, we need to move forward aggressively to achieve better progress in reforming the international financial architecture. In this, the voice of developing countries that are most vulnerable to destabilising capital flows, is important. In pushing for liberalisation and globalisation, let us not forget the adverse implications of such a policy on small economies. We do not want globalisation and liberalisation to further aggravate the sufferings of smaller developing economies. We urge the international community to be mindful of the adverse consequences that globalisation and liberalisation may have on these economies whose success in providing a better life for their citizens have fallen far short of expectations. Let us redirect our efforts to eliminate poverty and humanise globalisation.

Thank you.