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INTERNATIONAL FINANCE CORPORATION
INTERNATIONAL DEVELOPMENT ASSOCIATION
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Statement by the Hon. **DATO' SHAFIE MOHD. SALLEH**,
Governor of the Fund and the Bank for **MALAYSIA**,
at the Joint Annual Discussion

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1. It is indeed heartening to see that global economic and financial conditions have improved markedly in the course of 2000. All the major regions of the world are expected to record increased growth in 2000. The crisis-affected East Asian economies in particular have made remarkable progress, and prospects in the near term look even more promising.

2. In tandem with these developments, the economic performance of the Malaysian economy has been good. Allow me to give an update of current developments in the country. The measures undertaken by Malaysia in dealing with the financial crisis consisted of an expansionary fiscal and monetary policy, adoption of a fixed exchange rate and selective exchange controls, and a longer-term program of restructuring of the corporate and financial sectors. As a result of these policies and strong external demand, Malaysia's GDP growth rebounded from a contraction of 7.5% in 1998 to record a strong positive growth of 5.8% in 1999, with overall strengthening of macroeconomic fundamentals. The strong rebound in economic activities in 1999 was achieved with low inflation and accompanied by a strengthening of the balance of payment position and a build-up of external reserves. External debt, which has traditionally been low, declined further.

3. We are indeed happy that the approach we have adopted continues to yield impressive rewards. In 2000, the Malaysian economy strengthened further. In the second quarter of 2000, real GDP recorded another strong performance of 8.8%, compared with 11.9% in the first quarter. Growth in the first half of 2000 is now estimated at 10.3% as against 1.8% in the first half of 1999. Growth was broad-based across both aggregate supply and demand. The strong external demand, the fiscal stimulus, and the positive domestic economic and financial environment continued to support growth. Further progress in banking reforms and corporate restructuring and the improved employment prospects strengthened domestic demand. Investment activities expanded further with a marked increase in real gross fixed capital formation both in terms of new investment as well as expansion of existing capacity to meet higher demand. Despite the strong economic expansion, inflation moderated further to only 1.5%. With expectations that strong external demand will be sustained and domestic demand will strengthen further, economic growth for the year as a whole is anticipated to be significantly higher than the earlier forecast of 5.8%.

4. The external sector remained strong in 2000. While the trade surplus has narrowed, it has remained large at RM 29 billion (US$ 7.7 billion), and has contributed to the increase in the international reserves of Bank Negara Malaysia to US$33 billion at end-August 2000. Reserves are sufficient to cover 5.4 months of retained imports and is 6.4 times the amount of short-term external debt.

5. The favorable performance of the real sector had contributed toward enhancing the health of the financial sector and facilitating efforts in restructuring the corporate sector. The banking system strengthened further with a risk weighted capital ratio (RWCR) of 12.8% and a net nonperforming loan (NPL) ratio of 6.4% as at end-June 2000. *Danaharta* (the asset management company set up to acquire NPLs and subsequently manage in order to maximise recovery on the acquired assets) has made further progress, particularly in rehabilitating and restructuring of viable loans. *Danaharta* has restructured and disposed a total of RM 31.5 billion of loans and assets with an average recovery rate of 73%. Capital injection by *Danamodal* (the special purpose vehicle set up to recapitalise banking institutions) in the banking sector also declined further following the repayment of loans, bringing the total capital injection to RM 4.9 billion as at end-June 2000 in five banking institutions. Similarly, the Corporate Debt Restructuring Committee (CDRC) has completed the restructuring of corporate debt in 27 cases involving debts totaling RM 23.6 billion as at end-July 2000.

6. Our strong belief in the appropriateness of the approach taken in dealing the economic crisis, even though it was discredited by many international agencies at that time, has spared us the worst of the economic crisis, such as widespread business failures, economic hardships, and social upheavals. We persisted with our approach despite dire predictions of total failure, because we believed that the special circumstances prevailing in our economy called for a different policy prescription and above all, that human cost and misery must be minimised. While our approach initially drew severe criticisms and predictions of doom, including from the IMF, the rapid recovery of the Malaysian economy from the severest recession in its history has proven that our policy approach has indeed been successful. It is gratifying to note, and we feel vindicated as well, that some of the measures we undertook, such as selective capital controls in dealing with the crisis has now gained position, recognition, and support from the international community including that of institutions such as the IMF and the World Bank.

7. Lately, however, there has been some debate on whether the Malaysian economy would have shown the same strong recovery with or without its selective exchange controls. For us, who have been managing the crisis and witnessing its destabilising effects across the region, we remain convinced that the Malaysian approach was not only appropriate, but also necessary to prevent further instability. Without the selective exchange controls, the economic recovery would not have occurred as speculation on the Malaysian ringgit was still active after the LTCM crisis, given the ease of access to Malaysian ringgit in offshore markets. More important, the Malaysian policy approach resulted in recovery at much lower cost, in both financial and social terms. Financially, the cost of restructuring the banking sector was less than 10% of GDP. The outturn in the

total cost of restructuring and fiscal stimulus in Malaysia was less than 15%, and 30% lower than earlier estimates. In social terms, Malaysia was also able to minimise the social costs of the crisis in terms of unemployment and poverty levels. As a result, the social fabric was not disrupted.

8. While Malaysia will continue to persevere with measures to strengthen the domestic economic and financial system to ensure sustainable growth and reduce its vulnerability to the risks of another crisis, our efforts alone would not be sufficient to guarantee that the Malaysian economy will be spared from external shocks. Sound domestic policies can be negated by adverse external developments. It is essential, therefore, that reform measures at the national level are complemented by global efforts to ensure greater stability in the world economic and financial system. Currently, the misalignment among the major currencies and the risks associated with overvaluations of U.S. equities could create risks for emerging markets. In this regard, closer policy coordination among the G-3 countries is essential to reduce the risks of an abrupt and disorderly adjustment in foreign exchange markets, and the adverse consequences on the global economy.

9. The IMF must also influence G-3 economic policies. For this to happen, the conduct of IMF surveillance must be more even-handed. Indeed, IMF surveillance must place emphasis on the major industrial economies, and not only on developing countries that are under IMF programmes. Surveillance would not be effective unless the IMF focuses more attention on developments in the major industrial countries, as they have systemic implications on the rest of the world.

10. There have been many studies and debates on measures to reform the international financial architecture (IFA). Current discussions on the IFA have tended to focus more on ideological rather than practical issues. The value of free and unregulated markets as reflected in free floating exchange rate regimes and free capital flows is constantly being reiterated. There is nothing wrong with this approach, and we do not dispute the merits of free market principles. We must, however, ensure that markets function efficiently. We have seen during the Asian crisis, the effects of the failure of free but inefficient markets which have destabilised world markets as well as misallocated resources and misaligned exchange rates.

11. Under the present situation, the global financial system clearly does not provide a level playing field, as large players can overwhelm small markets. Reforms, therefore, are needed to ensure that as small emerging markets liberalise capital account transactions, such liberalisation will not result in unstable markets arising from excessive foreign exchange speculation by owners and managers of capital. The current period of relative calm in the financial markets should not detract the international community from expediting IFA reforms to promote more responsible behaviour by the private sector. Private market participants have an equal role with governments in effecting good practices that contribute toward maintaining efficient and stable markets.

12. Many developing countries are already responding to the challenges of globalization by strengthening their economic and financial systems, liberalizing their markets, and disengaging their governments from many economic activities. Many have also embraced the adoption of codes and standards and good market practices as set out by the developed countries. However, the unevenness of the starting point and the backlog of deprivation and inequity of the past decades are significantly constraining the developing world in benefiting from the gains of globalization. In fact, rapid globalization and integration is paradoxically widening the economic and social gap between rich and poor nations. In our eagerness to liberalise our market, it is therefore, critical for us to reduce this globalization divide such that benefits of globalization are equitably distributed. Some "management" of globalisation is required to maximise its benefits. We cannot accept that globalisation must be pursued at any cost. The new IFA should seek to manage globalisation to ensure efficient markets, but with equitable rules applied to both the owners of capital and the host countries where these capital are being invested. The rules should accord equal emphasis to how owners of capital can maximise profits as well as how host economies can safeguard their domestic interests.

13. The overall objective of globalization should then be directed at bringing additional benefits to all concerned with adequate systems in place to protect those who are likely to be adversely affected by global developments. Effective participation of all parties - that is from both the developed and developing countries - is necessary if policies related to globalization are to be accepted globally. A one-sided approach in this matter, with the domination of the developed countries, would not lead to a global system that is acceptable to all, nor would it meet global objectives for mankind.

14. While countries need to continue with reforms, at the international level, reforms are also of paramount importance. Specifically, I wish to draw your attention to the need to impose some form of direct regulation on highly leveraged institutions and hedge funds to ensure stability in the global financial system. Unfortunately, IFA reforms in terms of actions by market participants to promote more efficient and stable market conditions remain limited, particularly on the important issue concerning activities of over-the-counter (OTC) derivatives and other trades of highly leveraged institutions (HLIs) and hedge funds. The recent IMF Capital Markets Report showed that OTC derivatives market transactions had US$3 trillion in credit exposures at the end of 1999. This amount is the same value of global trade in goods. Hence, even if there is some control in bank lending to HLIs, the volume of funds available to them remains large relative to the size of the foreign exchange and capital markets of emerging economies. The reluctance to accept the damaging role of HLIs in the Asian crisis is again reflective of the belief among developed economies in the supremacy of the free market system. The concern that large HLIs can dominate or manipulate markets, especially in smaller economies, is a very valid and serious one. We fail to see why developed countries are so protective of these institutions. The issue is not that these institutions cannot exist. Rather, they should be subject to prudential regulations like other financial institutions and take responsibility for ensuring stability in financial markets.

15. In the absence of action by the international community to address the risks associated with globalisation in a comprehensive manner, individual countries will need to fend for themselves or look toward regional cooperative efforts. In Asia, efforts are under way to promote a regional self-help and support mechanism that could respond quickly to avert or deal with a possible crisis in the future. A regional financing mechanism modeled to complement and supplement the role of the IMF to support any regional currency under attack but with a regional bias and flexible procedures could be one of the approaches that could be considered by countries in the region. We have suggested the setting up of the Asian Monetary Fund (AMF) to provide funds to member countries with more flexibility and less stringent conditions with a view to ensuring a more speedy and timely response. We will continue with our efforts to make such a regional self help and support a reality.

16. Efforts to ensure orderly and stable conditions in the international financial system must also include measures for substantive and meaningful reforms in the operations of international financial institutions. The IMF, in particular, needs to enhance its own transparency and accountability, just as it insists that member countries be transparent and accountable for their policies. There is a need for the IMF to get back to basics, to focus on its core functions, and to avoid being too intrusive in its relations with its members The IMF should also resist the temptation to overload its lending programmes with issues that are not relevant to the problem at hand. In this regard, we look forward to the first report of the Independent Evaluation Office on a review of IMF operations.

17. To the extent that crises will continue to happen, the IMF must also strengthen its capacity to engage actively in the effective management and resolution of crises. This should be part and parcel of a comprehensive review of the existing IMF financial facilities, in conjunction with a review of the role and functions of the IMF. While unduly prolonged use of IMF resources should be discouraged, proposals designed to make access to IMF resources more difficult and punitive could be counterproductive to the health of the international monetary system. The IMF should not deny countries access to much needed financial resources for economic and financial adjustments. Reforms of the IMF should also include a revamp of the programme design, to be more attuned to local conditions, especially the capacity of the countries concerned to implement the programme and meet the conditionality.

18. The recent crisis has highlighted the dangers and implications of inappropriate IMF policy recommendations. The failure of the IMF to make correct prescriptions has led to the collapse of domestic economies in some countries and set back decades of development efforts and progress. Malaysia had emphasised repeatedly that the IMF needs to strengthen its diagnostic capabilities and resist the tendency to adopt a "one-size fits all" approach or the "father-knows-best" attitude. In this regard, we are encouraged by the new Managing Director's commitment to listen to the views of the members and to work more closely with other international financial institutions to ensure that IMF policy recommendations suit country-specific circumstances.

19. To date, proposals for IFA reforms have tended to focus on ensuring that countries become more transparent, adhere to international standards and codes, and adopt better risk management policies. Such measures are supposed to enable markets to make better-informed decisions and reduce a country's vulnerability to unexpected shocks. In this context, we fully support many of the initiatives under way to encourage countries to adopt the international standards and codes. I must also add, however, that the plethora of these standards, codes, and principles are overwhelming and highly demanding of manpower and financial resources, as well as time. They also have a potential to become overly intrusive vis-à-vis national authorities. Moreover, we need to ensure that the observance of these standards and codes, many of which are at the experimental stage and voluntary in nature, do not prematurely become part of IMF conditionality. It is also important that whatever codes are developed, they are applied equally to all member countries, including industrial countries.

20. At the same time, a review of IMF quotas is important to ensure that the IMF decision-making process is more inclusive and better reflects members' relative economic and financial strength in the world economy. As the IMF quota formulae were last modified in 1982–83, a revamp is long overdue, in view of the rapid changes in the world economy. Since then, many developing economies have expanded significantly and are able and willing to contribute more to IMF resources, and should therefore have a proportionate share in the decision-making process.

21. We welcome the new initiatives by the World Bank and the IMF relating to the intensification of work on social sector issues. In this regard, the recently developed proposals by the Bank and the Fund to strengthen the link between debt relief under the Initiative for Heavily Indebted Poor Countries (HIPC) and poverty reduction, and to judiciously blend policies of poverty alleviation with structural adjustment and other reform, are especially noteworthy. We hope that the necessary financing for the enhanced HIPC Initiative will be forthcoming and that the funding embodies genuine additions and will not be obtained at the expense of non-HIPC developing countries. We must not lose sight of the debt problems of low income non-HIPC countries.

22. Some progress has been made in involving the private sector in resolving financial crises. As was evident, private sector lenders and borrowers have been heavily involved in these recent crisis episodes. It must also be noted that, the official sector has had to bear a disproportionate burden in resolving the crises. The sums involved have been so large that the requirements have exceeded the availability of financing from official sources. The Fund could, therefore, help to catalyze private sector participation. In devising a framework for this, there is a need to ensure that obligations of the private sector of the industrial countries do not involve sacrifices by the developing country official creditors. The role of creditors should be accurately reflected, since there is evidence of imprudent lending in the run-up to recent crises. There is a strong risk of moral hazard unless there is significant penalty on imprudent lending practices by private creditors. I note that various proposals have been made to increase private sector

involvement in crisis resolution. However, the lack of practical implementation of these proposals in involving the private sector remains a main stumbling block in pursuing further this effort. It is, therefore, imperative that a framework that allows for effective implementation be designed.

23. In concluding, let me reiterate that defining the new IFA is a matter of urgency. The international community has been dragging its feet far too long. There is a need to achieve progress in several core areas in the reform process and in this context the regulation of highly leveraged institutions and hedge funds is important. And finally, work has to begin on how to operationalise the various proposals that are emerging. There has been continuous debate on various issues but with little discussion on their implementation.