Keynote Address by YB Dato' Mustapa bin Mohamed At the Malaysian Capital Market Summit 10 August 1999

Distinguished Guests,

Ladies and Gentlemen,

I am pleased to be here this morning to share with you some of my thoughts on the need to revitalise the capital market in a concerted effort to strengthen and sustain national economic recovery. I would like to thank the Securities Commission and ASLI for giving me this opportunity to address you and for taking the initiative to organise this Summit, which to my mind is timely - timely because for the past two years we have been preoccupied with the challenge of minimising the adverse consequences of the financial crisis and now that the economic recovery is gaining momentum, we can focus on ensuring that the recovery is sustained and position ourselves to meet the challenges of the new millenium.

In discussing the need to revitalise the capital market to sustain economic recovery, allow me to begin with a quick flashback on the initial conditions prevailing in the Malaysian economy and financial system prior to the crisis. You will recall that Malaysia's strong macroeconomic fundamentals had set it apart from other crisis-affected economies in the region. At the end of 1996, real GDP was growing at about 8%. The Government was enjoying its fourth year of fiscal surpluses and the external debt was generally low, at about 40 per cent of GNP. The current account of the balance of payments had narrowed from a deficit of 10 percent to 5 percent of GNP. Inflation was at its lowest, at 2.1 percent and unemployment was similarly low at 2.6 percent.

On the financial front, the banking system was strong and sound as reflected in the strong capitalisation and high asset quality of the banks. Our banks adhered to strict international prudential standards. However, despite the stronger initial conditions that prevailed as compared with other regional economies, there existed some vulnerabilities in the economy to external shocks and financial market turbulence. These weaknesses included high credit growth which exposed the banking system's fragility to corporate financial distress, inflated asset prices and oversupply in some sectors of the economy. Although the implications of the financial crisis contagion on the economy were limited initially, strains on the corporate and banking sector became increasingly felt as the crisis persisted into the second and third quarters. By end-August, the ringgit had depreciated 40 per cent against the U.S. dollar and share prices had declined 49 per cent. Meanwhile, the real sectors of the economy contracted sharply as economic activities decelerated with the easing of demand. The swift and deep changes in the economic environment called for appropriate and timely responses to contain the deflationary spiral before it escalated further.

Amidst these deteriorating circumstances, the Government adopted a comprehensive and forward-looking approach in dealing with the situation. As is usually the case, policies were formulated, taking into account the likely developments and anticipated risks. The approach, as always, was one of pragmatism. To address the worsening of economic conditions which translated into cash flow difficulties in the business sector, which in turn caused non-performing loans (NPL) to increase, thereby eroding bank capitalisation, steps were quickly taken to address the potential banking sector problems to contain its severity and ensure market confidence. As external conditions did not allow an easing of monetary policy, aggressive measures were taken to lower the statutory reserve ratio to reduce the cost of funds and ease lending rates. Distortions in loan intermediation were removed to allow the banking system to play its role more effectively in the market to lend support to economic recovery. This objective was met through a strategy to address the NPL problem and emerging weaknesses in some banking institutions.

As the crisis persisted, the ringgit continued to come under tremendous speculative pressure which limited the ability to conduct an independent monetary policy based on domestic considerations. The decision to break with conventional economic wisdom has paid off with the return of a more stable and conducive environment for economic recovery and a revival of both investor and consumer confidence in recent months.

What has our encounter with dealing with the crisis taught us, and how can the economy, in particular the capital market, build its resilience to future crises, thereby ensuring sustainable growth in the future? We have undoubtedly learnt many harsh lessons from the crisis, as an economy, a business enterprise or an investor. As an economy, we cannot afford not to take stock of our vulnerabilities and go back to business as usual now that the economic recovery is well on its way. This is because we cannot completely rule out instability or turmoil, in the international economy. Although we have pushed ahead aggressively at the international level, be it APEC, Commonwealth, ASEAN or on a bilateral basis for controls to be instituted to regulate international financial markets and we are encouraged by some of the developments, the fact is that we are still vulnerable and will continue to be for a long time. Be it such, we must take heed of the need to continue the process of taking stock, reforming and strengthening to enhance on resilience in meeting future challenges.

Allow me now to share some of my thoughts about the capital market and its role in sustaining growth. The capital market, as we know, has and will continue to play an important role in facilitating and supporting economic growth and transformation. It has been a major source of funds for the industrialisation process and capital market financing has increased significantly, especially since 1990 to account for 35 percent of total financing in 1996, just before the crisis. Although this is not high, it is a vast improvement from the 10 percent achieved during the 1980-85 period. The growth enjoyed by the capital market reflects primarily the structural adjustments undertaken by the Government in the last economic slowdown in the mid-1980's to consolidate its financial position and enhance the role of the private sector as an engine of growth. The shift in policy led to an increase in the volume of papers issued by the private sector and a concomitant decline in Government papers. The subsequent implementation of the privatisation programme provided a further impetus to the growth in private sector securities.

In developing the capital market, the Government has undertaken comprehensive measures to strengthen, broaden and deepen the market to enhance its intermediary role in financing economic activities. These measures concentrated on the establishment of appropriate institutions to accelerate capital market development. The Securities Commission was set up as the sole regulatory body for the capital market. To spearhead the development of the bond market, a national mortgage corporation (CAGAMAS) was set up followed by the establishment of two rating agencies for corporate debt issues. More recently, the establishment of MME and KLOFFE and their subsequent merger to form the Monetary Exchange of Malaysia provides the opportunity to trade in a wide range of financial instruments, allowing companies to manage their risk exposures in a more efficient and cost effective manner. To increase market access to a wider range of borrowers, smaller capitalised companies were allowed to tap funds from the Second Board while the establishment of MESDAQ provides a new avenue for high-technology capital and skill-intensive companies with no track record to raise funds. Steps have also been instituted to enlarge the supply of domestic funds in the capital market in the liberalisation of guidelines to selected institutional investors, in particular the Employees Provident Fund. Meanwhile, the trading and settlement structure has been upgraded with the implementation of various systems, including the Central Depository System and SPEEDS. There has also been significant progress in expanding the range of financial products available in the market, compared to that available in the early 1980s. In addition, the regulatory and prudential framework was being continually reviewed to ensure better disclosure standards and transparency of transactions.

Despite the significant development of the capital market prior to the crisis, you must agree with me that much more needs to be done to further strengthen, broaden and deepen the capital market. The recent crisis highlighted the absence of a well-balanced financial system which contributed to exacerbating the adverse consequences of the crisis. The economy was overdependent on the banking sector for financing which exposed it to a higher degree of liquidity and systemic risk and this made it more vulnerable to internal and external shocks. As the bond market was relatively underdeveloped, economic activities were mostly funded through bank credit. As a result, risks in the economy, particularly credit risks were heavily concentrated in the banking sector. This is unlike the situation in many developed countries where bond issuance, represents more than 90% of their Gross Domestic Product (GDP). In Malaysia, bond issuance represented only 54% of GDP as at end 1997. As a result, long-term project financing requirements were met by short-term borrowings, which in turn exposed the corporate sector to large funding mismatches. These circumstances led a large number of corporate borrowers to face problems in the crisis due to the structure of their funding rather than their financial viability per se.

The further development of the domestic bond market will also allow corporations improved access to a larger number of debt instruments to enhance the management of their liabilities. One of many issues we are looking at is developing an active secondary bond market in government securities to enable it to play a role in pricing credit risks. At the same time, we will also study the securitisation of other kinds of debt to assist the further development of an active and vibrant private debt securities market to complement the more matured market in equities and Government securities. In addition, we are looking at ways to further develop the domestic capacity of the fund management industry to allow for the more efficient management of funds and risks.

Aside from our efforts to further develop the private debt securities market to ensure more balanced funding of economic activities, we have to look seriously at the need to ensure financial integrity of the capital market to limit any potential contagion effects and reduce systemic risks. The crisis has, in some ways been a blessing to us because it has brought to the fore, issues relating to the need to strengthen the regulatory framework and enhance corporate governance which are cornerstones for enhancing investor confidence and sustained long-term growth of the capital market. I am encouraged by the proactive stance adopted by the Securities Commission, KLSE and Bank Negara Malaysia in addressing the shortcomings revealed by the crisis. Much has been done, to date to raise the standards of capital market institutions, including those in the insurance industry and much more can be done, not just by the regulators but by market participants themselves.

The move towards front line regulation where market institutions self regulate the primary and secondary markets in areas of operational details requires the full commitment of industry participants. In sustaining the long-term and continued growth of the capital market, industry players will have no choice but to accept the challenge of employing higher standards of management and best practices or else be left behind as other regional markets move ahead. The Government remains fully committed to ensuring that the measures we have in place to enhance financial integrity are implemented and complied with, as we cannot afford to let up on the pace of reform in this increasingly competitive environment. Recent moves by the Securities Commission to deal severely with errant market participants is an indication of the seriousness with which we are pursuing the issue of integrity of the markets in our bid to ensure the sustained growth of our market and institutions. However, at the end of the day, market participants, institutions and intermediaries must themselves see the benefits of employing best practices as only best practices can protect and insulate them from the vagaries of an increasingly demanding and competitive environment in the years ahead.

I should perhaps also add that in facing the challenges of liberalisation and globalisation, there is a need for further consolidation of market intermediaries to ensure that economies of scale and scope are realised and enjoyed. The move towards consolidation is a worldwide move as the competition for offering products at the lowest possible costs is intensifying in the bid to attract more investors. Your ability to survive will therefore hinge on how successful you are in facing the increased competition to effectively meet the challenges arising from new market entrants and alternative trading platforms. In this connection, you have my assurances that the Government will lend support to the industry by facilitating the process although it will not be our intention to interfere with commercial decisions. As you are aware, the Securities Commission recently announced its intention to introduce a Capital Market Masterplan to prioritise immediate needs and provide direction for the long-term growth of the capital market to enable Malaysia to face the challenges associated with the competition ahead. With the benefit of such a Masterplan, I have no doubt that you will be able to decide for yourselves how best to take advantage of the opportunities ahead while preparing to face the impending challenges.

In concluding, I would like to assure you that the Government will continue to ensure sound macroeconomic management to sustain the current economic growth momentum and support the continued growth of the capital market. Thus far, we are encouraged by the current trends in key economic indicators in the economy. The economy is looking good and poised for a return to the growth rates we have become accustomed to in the past. You have witnessed the return of stability and confidence to the financial markets in recent months which has been translated into visible signs of recovery in the real economy.

I hope my remarks and thoughts about the need to revitalise and keep the momentum of reform currently taking place in the capital market going in order to sustain national economic recovery have been useful. I urge you to support Government efforts to sustain the national economic recovery by meeting some of the challenges currently facing your industries in a positive and committed way. On our part, we will continue to push for reforms to the international framework architecture to ensure the orderly functioning of world capital markets and a conducive environment for the continued growth of your industries and the growth of the Malaysian economy.

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