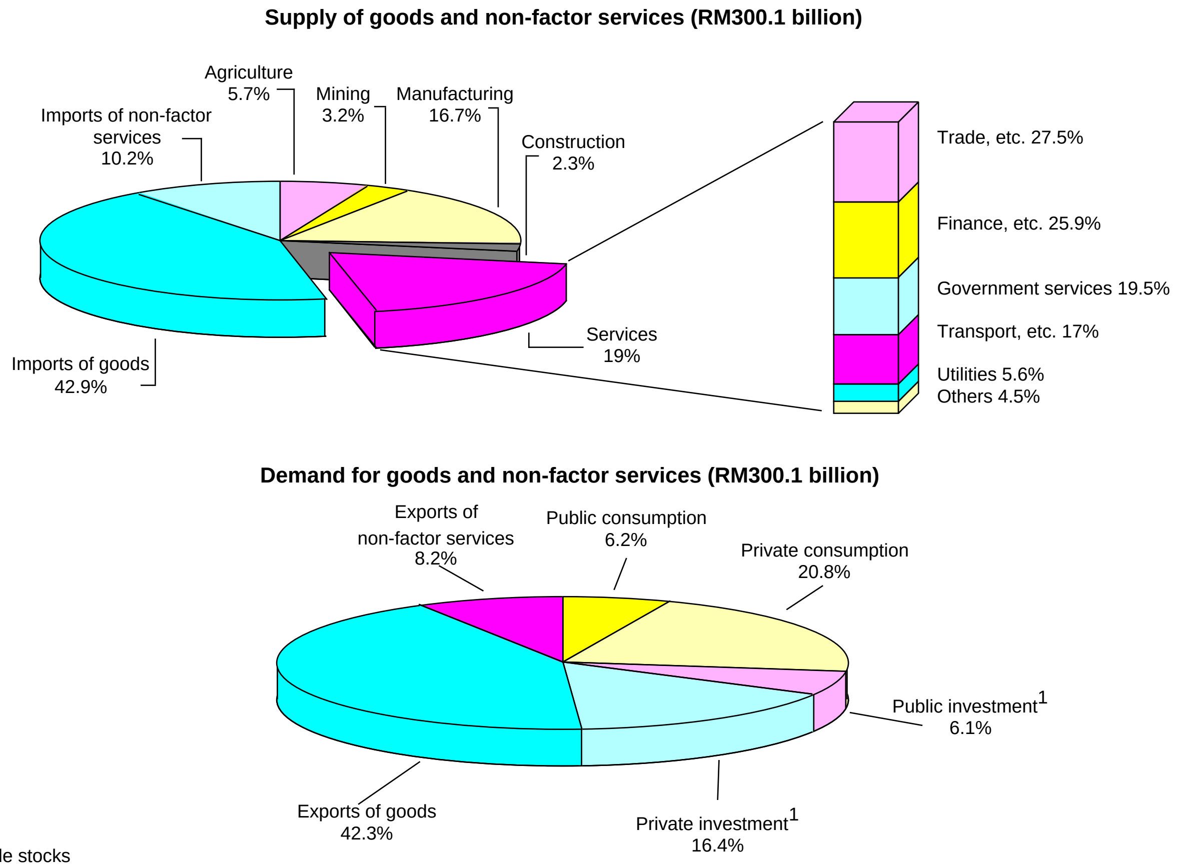
1 The Real Economy

Overview

The year 1997 began on an optimistic note for the Malaysian economy. Indeed, there was a strong sense of optimism that the adjustment measures that had been put in place to address existing economic imbalances would achieve a soft landing in terms of more sustainable growth with stability. In an environment of full employment and capacity constraints, there were a number of concerns over the adverse impact of rapid growth and excess demand pressures on the balance of payments and inflation; the disproportionate expansion in bank credit, particularly to finance the less productive sectors; and the intense competitive pressures on Malaysian exports from lower-cost producers. Remedial measures which had been introduced since 1995 had yielded positive results in terms of the significant improvement in the external balance as well as a moderation in the inflation rate in 1996. The announcement of prudential measures in early 1997 served to enhance market confidence that corrective measures were in place to reduce monetary and credit growth as well as to pre-empt any rise in asset inflation. Reflecting the positive market response to these measures, the ringgit exchange rate appreciated in terms of its composite as well as the United States dollar in the first half-year.

This optimism remained even as Malaysia was confronted with the initial contagion effects of speculative pressures on the Thai baht in early May. However, after July, the economic situation changed dramatically and deteriorated progressively as the

Graph 1.1: The Economy in 1997
(at 1978 Prices)



1 Include stocks

Table 1.1: Malaysia – Key Economic Indicators

	1995	1996	1997*p*	1998*f*
Population (million persons)	20.7	21.2	21.7	–
Labour force (million persons)	8.1	8.4	8.6	–
Employment (million persons)	7.9	8.2	8.4	–
Unemployment (as % of labour force)	2.8	2.5	2.7	–
NATIONAL PRODUCT (% change)				
Real GDP	9.5	8.6	7.8	2 – 3
(RM billion)	120.3	130.6	140.9	144.4
Agriculture, forestry and fishery	1.1	2.2	3.0	–1.8
Mining and quarrying	9.0	4.5	2.0	2.2
Manufacturing	14.5	12.2	12.5	6.0
Construction	17.3	14.2	10.6	–4.0
Services	9.4	9.7	7.9	2.7
Nominal GNP	15.1	14.3	10.6	6.2
(RM billion)	208.2	237.9	263.1	279.4
Real GNP	9.3	8.4	7.5	1.7
(RM billion)	113.6	123.1	132.3	134.6
Real aggregate domestic demand [1]	13.4	7.0	6.4	–4.7
Private expenditure [1]	15.4	9.0	6.3	–2.4
Consumption	9.4	6.0	4.7	1.0
Investment	25.3	13.4	8.3	–6.8
Public expenditure [1]	8.0	1.3	6.9	–11.6
Consumption	7.3	1.4	4.8	–11.4
Investment	8.7	1.1	9.2	–11.7
Gross national savings (as % of GNP)	35.2	38.5	40.0	40.7
BALANCE OF PAYMENTS (RM billion)				
Merchandise balance	0.1	10.2	11.1	27.6
Exports (f.o.b.)	179.5	193.1	218.7	298.8
Imports (f.o.b.)	179.4	183.0	207.6	271.2
Services balance	–19.4	–19.5	–20.8	–25.3
(as % of GNP)	(–9.3)	(–8.2)	(–7.9)	(–9.0)
Transfers, net	–2.5	–2.9	–3.7	–3.8
Current account balance	–21.8	–12.3	–13.4	–1.4
(as % of GNP)	(–10.5)	(–5.1)	(–5.1)	(–0.5)
Bank Negara Malaysia reserves, net	63.8	70.0	59.1[2]	–
(as months of retained imports)	(4.1)	(4.4)	(3.4)	–
PRICES (% change)				
CPI (1994=100)	3.4	3.5	2.7	7 – 8
PPI (1989=100)	3.9	2.3	2.7	12 – 13
Average wages in the manufacturing sector	6.1	9.6	7.0	–

Note: Figures may not necessarily add up due to rounding.

[1] Exclude stocks.

[2] The figure does not include an exchange revaluation gain of RM24.6 billion. Prior to 1997, the holdings in foreign assets were revalued once, at year-end. However, in 1997, the accounting policy of recognising the foreign exchange revaluation gain or loss was changed, whereby, the exchange gain from the revaluation of foreign assets and liabilities was not recognised in the Bank's books. Nevertheless, full provisions will be made for any losses. The US dollar equivalent of international reserves as at 31 December 1997 was US$21.7 billion.

p Preliminary

f Forecast

Table 1.2: Malaysia – Financial and Monetary Indicators

	1995	1996	1997*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	51.0	58.3	65.7
Operating expenditure	36.6	43.9	44.7
Development expenditure	12.5	12.6	14.4
Overall surplus	1.9	1.8	6.6
Overall surplus (% of GNP)	0.9	0.8	2.5
Total public sector development expenditure	29.8	30.8	40.6
Overall public sector surplus (% of GNP)	3.4	4.2	3.4
EXTERNAL DEBT			
Total debt (RM billion)	85.0	98.8	166.2
Medium & long-term debt	68.8	73.2	126.5
Short-term debt	16.2	25.7	39.7
Debt service ratio (% of exports of goods & services)			
Total debt	6.5	6.1	5.7
Medium & long-term debt	6.0	5.7	5.1

	Change in 1995		Change in 1996		Change in 1997	
	RM billion	%	RM billion	%	RM billion	%
MONEY AND BANKING						
Money supply M1	5.5	11.7	8.7	16.7	2.8	4.6
M2	38.5	24.0	39.3	19.8	54.0	22.7
M3	49.6	22.3	57.8	21.2	61.0	18.5
Banking system deposits	50.8	21.9	74.5	26.3	76.0	21.3
Banking system loans[1]	57.6	28.3	72.0	27.6	88.3	26.5
Manufacturing	11.5	30.7	4.6	9.5	9.8	18.3
Property sector	15.2	26.0	31.1	42.3	35.2	33.6
Finance, insurance and business services	9.0	39.4	0.8	2.4	3.4	10.5
Loan-deposit ratio (end of year)	89.0%		89.3%		92.7%	

	1995 %	1996 %	1997 %
Interest rates (end of year)			
3-month interbank	6.76	7.39	8.70
Commercial banks			
Average fixed deposits: 3-month	6.64	7.21	9.06
12-month	6.89	7.26	9.33
Average savings deposit	3.70	4.10	4.23
Finance companies			
Average fixed deposits: 3-month	6.79	7.32	10.32
12-month	6.98	7.36	10.25
Average savings deposit	4.70	5.02	5.49
Average base lending rate			
Commercial banks	8.03	9.18	10.33
Finance companies	9.38	10.65	12.22
Treasury bill rate (91 days)	5.92	6.39	6.76
20-year Government securities	7.43	7.45	7.70

	1995 %	1996 %	1997 %
Movement of Ringgit (end-period)			
Change against composite	0.4	2.6	– 31.4
Change against SDR	– 1.1	3.9	– 30.8
Change against US$	0.7	0.5	– 35.0

[1] Beginning December 1996, loans by sector are classified using a new statistical reporting format.
p Preliminary

regional financial crisis became more intense and widespread. The crisis dramatically undermined confidence in the region, changing the Malaysian setting from one of relative economic stability to a situation that was characterised by successive depreciation of the ringgit, major corrections in the equity market, generally weaker investor confidence and large outflows of non-resident short-term capital. These developments caused strains to emerge in the financial system. Notwithstanding its relatively strong economic fundamentals, the Malaysian economy has not been spared from the contagion effects of adverse developments in the region. This was manifested mainly through misperceptions of an apparent lack of commitment by the Malaysian authorities to pursue its adjustment policies. Such misperceptions created opportunities for speculators to capitalise on the situation for short-term gains. In the second half of 1997, macroeconomic policy management was further complicated by increased uncertainty in the region. As the financial crisis escalated, the depreciation of the ringgit and the decline in share prices reinforced each other, creating a vicious circle of exchange rate depreciation and falling stock prices. By the end of December, the ringgit had depreciated by as much as 35.1% against the United States dollar, while stock market prices fell by 44.8% from the end-June position.

Although the impact of the regional financial crisis on Malaysia in terms of the decline in the value of the ringgit and the stock market were severe, the significant improvement in macroeconomic and financial sector conditions just prior to the crisis has enabled Malaysia to have a greater degree of resilience to withstand the crisis. In addition, an important contributory factor to this resilience was the existence of a strong institutional framework for the financial system. Following the recession in 1985, the financial sector had undergone extensive restructuring with additional regulations based on internationally-accepted prudential standards. More importantly, the ability of the Malaysian economy to adjust to the regional financial crisis was a reflection of its strong economic fundamentals. Indeed, the financial turmoil occurred at a time when the Malaysian economy was at its strongest. Indications were that gross domestic product (GDP) growth, while still remaining strong for the first half-year, had now moderated to a more sustainable path. Inflation had moderated from a peak of 3.3% in December 1996 to as low as 2.1% in July 1997. Asset prices had also stabilised, with the Malaysian House Price Index registering a moderate increase of 6.1% in the first half of 1997, the lowest since 1993. Initial concerns of a prospective oversupply situation in selected property segments had also been alleviated, to some extent, by the deferment of several projects as the private sector adjusted to the situation as well as the limits placed on bank credit to selected property sectors. Deliberate policies to slow down less productive investments over the previous two years had resulted in a significant narrowing of the current account deficit in the balance of payments from 10.5% of gross national product (GNP) in 1995 to 5.1% in 1996. Both the total external debt (including short-term debt) and the debt service ratio remained low. The net international reserves of BNM stood at RM70.7 billion at end-June, sufficient to finance 4.3 months of retained imports. The Government's fiscal budget remained in surplus at 2.9% of GNP in the first half of 1997, while the national savings rate was maintained at 38.5% at end-1996. In addition to these strong fundamentals, policies were already in place to reduce bank credit and monetary growth through a further tightening of monetary policy. The banking sector also faced the challenges of the crisis from a position of strength. In terms of capital adequacy, the level of capitalisation had improved considerably during the past two years with the risk-weighted capital ratio (RWCR) of the banking institutions improving to 12% at end-June, lower non-performing loans of 3.6% of total loans and general provisions of 2%.

Towards the fourth quarter, however, the pressures of the regional crisis on the domestic economy intensified and its effects became more discernible. The steep depreciation of the exchange rate led to higher production costs, which were passed on to consumers in terms of higher retail prices. The ensuing environment of uncertainty and negative wealth effects dampened domestic demand. There were also large outflows of non-resident short-term capital following the continuous decline in stock prices. Consequently, GDP growth moderated to 6.9% in the fourth quarter from 7.4% in the third quarter and 8.5% in the first half of the year. On the strength of a strong first-half performance, GDP growth for 1997 as a whole expanded at a slower rate of 7.8% (8.6% in 1996). In line with the more moderate pace of growth, nominal GNP expanded by 10.6% compared with 14.3% in 1996.

The slower growth in **domestic demand** (excluding changes in stocks) contributed towards the moderate economic expansion in 1997, with real aggregate domestic demand increasing by 6.4% (7% in 1996). This reflected the effects of tighter macroeconomic

Macroeconomic Indicators for the First and Second Half of 1997

First Half

- GDP remained strong at 8.5%.
- CPI increase contained at 2.8%.
- Reserves level of RM70.7 billion at end-June; sufficient to cover 4.3 months of retained imports.
- Low external debt: 42.6% of GNP at end-June in terms of USD.
- Stable exchange rate: +0.2% against USD.
- Stock market performance weakened from second quarter: -13% in first half-year.
- Indications of improvement in BOP position.
- Investment sentiment was strong.
- Loan growth of banking system was 30.4% at end-June.
- Strong banking sector:
  - RWCR : 10.4%
  - NPL (6 months) : 3.6%
  - Loan loss provision (6 months) : 92% of NPL

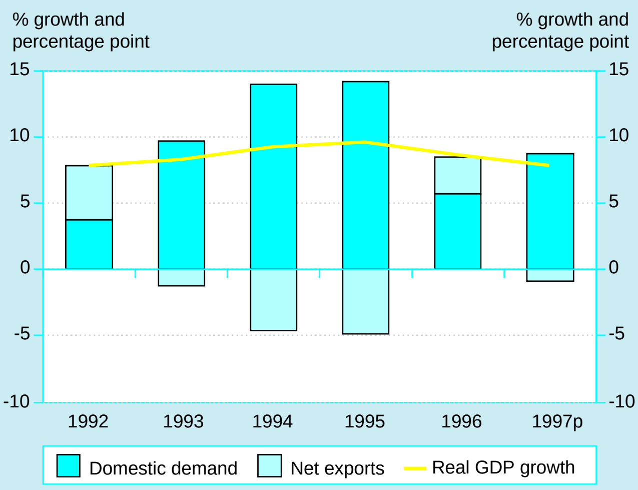
Second Half

- GDP moderated to 7.1%.
- CPI increase moderated to 2.5% but picked up slightly in December 1997 and to 4.4% in February 1998.
- Reserves moderated to RM59.1 billion at end-December 1997; sufficient to cover 3.4 months of retained imports.
- External debt increased to 45.6% of GNP in terms of USD.
- Sharp decline in exchange rate: -35.1% against USD.
- Sharp decline in stock market: -44.8%.
- Current account deficit stabilised at 5.1% of GNP.
- Weak market sentiment and confidence.
- Loan growth moderated to 26.5% at end-December.
- Banking position affected, but remained resilient:
  - RWCR : 10.6%
  - NPL (3 months) : 6.8%
  - Loan loss provision (3 months) : 54.5% of NPL

policies to curb excessive growth in aggregate demand in order to reduce the current account deficit. The moderation was largely on account of slower growth in private sector expenditure (6.3%) as public sector spending expanded at a faster pace (6.9%). The slower growth in private sector expenditure was due to more moderate increases in both consumption and investment, reflecting the negative wealth effects of declining share prices. Public sector expenditure, on the other hand, was higher, reflecting higher growth in both investment and consumption. The rise in public investment was due to increased capital outlays by the non-financial public enterprises (NFPEs), particularly in the oil and utility sectors, as well as the accelerated implementation of the Kuala Lumpur International Airport (KLIA) project.

On the **supply side**, the moderation in real GDP growth was attributed mainly to the slower expansion in the mining, services and construction sectors. Activity in the services and construction sectors were more adversely affected by the financial crisis. Growth continued to be supported by the faster pace of expansion in the manufacturing and agriculture sectors which remained resilient despite the financial turbulence. Growth in the manufacturing sector was sustained at 12.5%, reflecting mainly strong external demand for electronic components and parts, chemicals and chemical products, textiles and wearing apparel and off-estate processed products. The recovery in the electronics sector was stronger than expected. However, prices of selected memory chips remained depressed because of intense competition. Output of the electrical products industry declined due to increased competition and excess world-wide production. Meanwhile, output of the domestic-oriented industries continued to register double-digit growth (14.6%), underpinned by higher output of selected products, including chemicals and

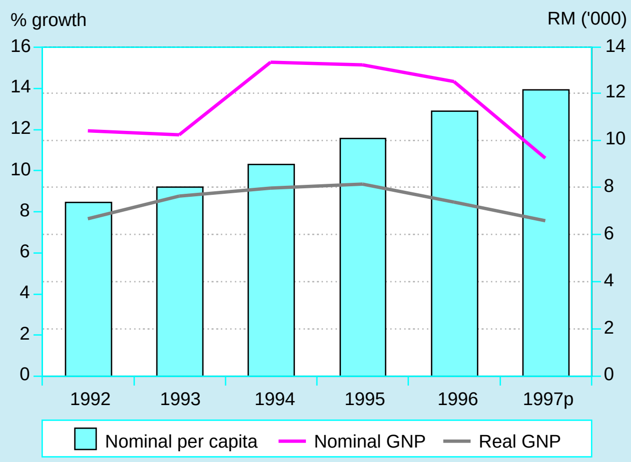
Graph 1.2
Contribution to GDP Growth: Domestic Demand and Net Exports



chemical products. The impact of the regional financial crisis on the export- and domestic-oriented industries was mixed. The export-oriented industries benefited from the improved competitiveness due to the ringgit depreciation but were adversely affected by a slowdown in regional demand towards year-end. However, the fall in the stock market and slower growth in the construction sector affected the domestic-oriented industries. On the whole, the manufacturing sector was less affected by the regional financial crisis for several reasons. Firstly, global demand remained strong, buoyed by sustained growth in the United States and the European markets. Secondly, the sector relied, to a large extent, on internal sources of funds to finance its investment and expansion plans, and was therefore less exposed to external indebtedness. Similarly, the agriculture sector was also less affected by the financial turbulence. A slightly better performance (3%) was recorded during the year, reflecting the continued increase in crude palm oil production and a turnaround in saw log output, which more than offset the lower output of rubber and cocoa. In contrast, activity in the mining sector moderated further, reflecting lower petroleum and tin production, although gas output remained strong during the year. Activity in the construction sector consolidated (10.6%), with all the three sub-sectors, namely, civil engineering, residential and non-residential construction recording strong growth, but at a slower pace than in 1996. Meanwhile, activity in the services sector remained strong (7.9%), with favourable performance in the finance, insurance, real estate and business services; transport, storage and communication; and utilities sub-sectors.

On the **external front**, the current account deficit in the balance of payments increased slightly to RM13.4 billion, about RM1.1 billion higher than the deficit recorded in 1996. As a proportion of GNP, however, the deficit remained at 5.1%. Following the depreciation of the ringgit, export growth increased at a faster rate relative to imports, culminating in a progressive improvement in the trade balance. With merchandise exports and imports growing at about the same level for the year as a whole, at 13.3% and 13.5% respectively, the merchandise surplus was moderately higher than the level recorded in 1996. However, gross exports in United States dollar terms registered only a small increase of 0.7%. The increase in export volume (5.2%) was offset, to a large extent, by a decline in prices. Keen competition in world markets led to a downward adjustment in the United States dollar prices of most manufactured goods. Meanwhile, the services deficit increased slightly to RM20.8 billion, but the ratio in terms of GNP declined to 7.9%, the lowest since 1973. The higher services deficit was mainly attributable to unforeseen developments in the second half of 1997. The most significant was the prolonged haze which severely affected tourist arrivals and related services receipts. In addition, the weaker ringgit led to higher costs of services payments, especially for investment income. In 1997, the deficit in the current account was fully financed by the large net inflow of long-term capital, particularly corporate investment. The surplus in the basic balance increased further to RM5.3 billion (RM1.3 billion in 1996). However, the short-term capital account recorded a large net outflow of RM14.2 billion, resulting in the overall balance of payments reverting to a deficit of RM10.9 billion, from a surplus of RM6.2 billion in 1996. Consequently, the net international reserves of the

Graph 1.3
GNP Growth



Bank declined to RM59.1 billion (US$21.7 billion) as at end-1997, sufficient to finance about 3.4 months of retained imports.

It is significant to note that Malaysia's main strength during the period of financial turbulence to a large extent, is the result of the relatively low level of **external debt**, which gave the country greater flexibility in dealing with the financial crisis. Total external debt (including short-term external debt) in United States dollar terms only increased moderately to 45.6% of GNP as at end-1997 (41.2% of GNP in 1996). The debt service ratio remained low at 5.7% (6.1% in 1996). The bulk of the external debt was in medium- and long-term maturities (76%), while the remaining 24% comprised short-term debt. The latter reflected the low reliance on short-term borrowing by the non-bank private sector, with the bulk of the loans being undertaken by the commercial banks, and was for the most part hedged. Furthermore, a large proportion of the external loans to the private sector was for the export-oriented sector, which had a natural hedge in the form of export receipts to service the external debt.

The increase in **consumer prices** was contained during the period of high growth due to the implementation of prudent macroeconomic policies, a liberal import regime and low inflation in industrial countries. Nevertheless, in early 1997, a combination of strong credit growth, tight labour market and capacity constraints gave rise to concerns over rising inflationary pressures. However, with continued monetary restraint and fiscal prudence complemented by various measures taken over the years to ensure price stability, consumer prices began to moderate after March and reached 2.1% in July, the lowest inflation rate since September 1990. In the second half-year, however, the consumer price index (CPI) rose slightly by 2.5% as the impact of the currency depreciation was translated into higher prices after a time lag of 3–6 months. Hence, for 1997 as a whole, the CPI registered an overall increase of 2.7%. During the first two months of 1998, the impact of the depreciation became more apparent, with the CPI rising at an average rate of 3.9%. The producer price index (PPI), however, was affected by the currency depreciation with a shorter time lag. After moderating significantly in the first half-year, it rose by 4.2% between July and December, resulting in an overall increase of 2.7% in 1997. In January 1998, the PPI increased further by 16% (17.2% for local production and 10.4% for imports).

An area of concern in the first half-year was the potential risk of asset price inflation on both the property and stock markets. The increase in asset prices in recent years had been attributable to the cumulative wealth effect over a prolonged period of rapid growth, accentuated by prospects of capital gains and availability of financing. Although several monetary and fiscal measures that were implemented since late 1995 had moderated price increases in the property sector, property prices in major towns continued to increase.

On the **employment front**, the labour market remained tight, although the unemployment rate increased slightly to 2.7% towards the end of the year. Shortages of workers were reported in the agriculture, manufacturing and services sectors despite the employment of foreign labour. A concern associated with the tight labour market was the increasing pressure on wages and lagging productivity growth. In 1997, average real wages in the manufacturing sector increased by 7%, compared with an increase in labour productivity of 5.7%. In view of the shortage of workers and rising wages, firms reviewed their strategies on the use of labour and stepped up human resource development, increased automation and moved towards high-technology industries. Towards year-end, there were some signs of easing pressures on the labour front, especially in the construction and selected services sectors. However, given the tight labour situation, the workers retrenched in selected industries were easily absorbed by other sectors which continued to experience shortages.

Macroeconomic policy management in 1997 had to address domestic issues as well as the rapid changes in the economic setting following the outbreak of the regional financial crisis. In the first half of 1997, the policy direction was focused on steering the economy towards a more sustainable growth path and on containing asset inflation. However, with the onset of the regional crisis since July, the focus of policy was to restore stability and confidence in the financial markets, while minimising any disruptions on the real economy.

In confronting the regional financial crisis, the Government had to adjust its policy accordingly in response to the uncertainties in the foreign exchange market and the deflation in asset prices. While it was recognised that policy adjustments were necessary to cope with the contagion, the magnitude and duration of the disruption was not immediately clear. Instituting overly harsh measures could precipitate a sharper than desired economic contraction that would, in turn, be very destabilising on the financial markets. Hence, attempts were made to stabilise the currency through intervention in the foreign exchange market. The consequent tightening of liquidity led to a significant increase in interest rates. However, as market pressures intensified with the floatation of the Philippine peso, the focus of policy was directed at the restoration of stability in the domestic financial market and to minimise the impact of external developments on the real sector. Consequently, by mid-August, interest rates were reduced to just above the crisis level. Nevertheless, it was recognised that rates had to remain sufficiently high to contain inflationary pressures. In early August, to limit speculators' access to the ringgit, the Bank introduced limits on outstanding non-commercial related ringgit offer-side swap transactions with foreign customers. This measure enabled interest rate policy to be based more on domestic considerations.

In the ensuing weeks, when both the ringgit and share prices were pushed to successive lows in a progressively volatile external environment, it became clear that there would be long-term repercussions on the economy. It was recognised that stronger macroeconomic adjustments were required. Studies of past currency crises showed that confidence was restored only after comprehensive reforms were implemented. Such programmes generally included economic and financial reforms, monetary and fiscal restraint, and greater flexibility in exchange and interest rate policies. In most cases, the economies of affected countries were found to recover faster than the financial markets. In other words, only when there was an economic recovery did the exchange rate strengthen. Accordingly, a set of austerity measures was announced in early September to further reduce the level of aggregate demand and contain the current account deficit. These measures included a 2% cut across the board in Government spending; rationalisation of the purchase of imported goods by public agencies, including the armed forces; and deferment of several large privatised projects. In addition, the implementation of new privatised projects would be assessed in terms of their macroeconomic impact and contribution to long-term growth. The overall strategy was to curb unnecessary imports and reduce strains on the balance of payments as well as on existing resources. These measures were reinforced with additional measures in the 1998 Budget in October 1997.

The regional instability persisted into the last two months of 1997, with the ringgit depreciating further. The depreciation did not bear any relationship to Malaysia's economic fundamentals. Instead, the movement of the ringgit was dictated increasingly by changes in market sentiment. Such sentiments fluctuated widely, based on perceived concerns that stresses in the economy, together with the apparent lack of transparency and uncertainty in market rules and governance, would adversely affect market players' short-term positions. As the crisis deepened towards year-end, such misperceptions and concerns also included the high leverage of corporations and its potential impact on the banking system, especially in an environment of rising interest rates, economic slowdown and possible asset deflation. During this period, therefore, the over-riding concern of policy was to restore stability to the financial markets and confidence in economic management. Malaysia is currently in a better position to manage a financial crisis, given that the turbulent years of the 1980s had led to continued efforts to strengthen the regulatory and supervisory framework of the banking industry.

When the regional instability continued into December, there was increased concern that the regional financial crisis could be more protracted than earlier anticipated, which would necessitate a stronger policy response. Consequently, on 5 December, the Malaysian Government announced a comprehensive package of policies to address the situation.

The 5 December package of policies was designed to complement the 1998 Budget measures and aimed to strengthen economic stability and instil confidence in the financial system. The measures took into account several underlying concerns on the economy and the financial system. These included the still high deficit in the balance of payments due mainly to the strong private sector investment in the 1990s to expand productive capacity as well as to improve infrastructure facilities. The rapid expansion of private sector activities had also led to the second concern of high credit growth, particularly to the property and stock markets. A related concern was the high private sector debt which accounted for 169% of GDP in 1997. Hence, it was observed that while the Government's finances were being managed prudently, there was a need to curb excesses in the private sector. Nevertheless, such a development needs to be viewed in its proper

Stabilisation Measures

To strengthen balance of payments, fiscal account and improve competitiveness

September
- Defer implementation of privatised large projects.
- Review public agencies' purchases of foreign goods.
- Assess new privatised projects in terms of their macroeconomic impact.
- Cutback in Federal Government expenditure by 2% in 1997.

1998 Budget (announced in October)
- Deferment of projects with total cost amounting to RM65.6 billion.
- Reduce corporate tax and petroleum income tax rate by 2% each.
- Tax exemption for selected exporting companies.
- Increase import duties on construction materials, consumer durables and motor vehicles.
- Promote services sector.
- Establish RM1 billion fund for small- and medium-scale industries.

5 December
- Reduce current account deficit (target 3% of GNP in 1998).
- Defer implementation of non-strategic and non-essential projects.
- Promote exports and tourism.
- Promote utilisation of domestic products.
- Stricter criteria for approvals of new reverse investment.
- Cutback in Federal Government expenditure by 18% in 1998.

To ensure monetary and financial stability

April
- Pre-emptive prudential measures to limit lending to the property sector and for the purchase of stocks and shares.

August
- Limits on non-commercial related ringgit offer-side swap transactions with foreign customers.
- Increase interest rates progressively (from mid-September).

1998 Budget (announced in October)
- Strengthen prudential standards:
  - Classify non-performing loans in arrears, from six to three months.
  - Greater financial disclosure by banking institutions.
  - Increase general provision to 1.5%.
- Introduce credit plan to limit loan growth to 15% by end-1998.
- Tighten rules on hire-purchase financing.

5 December
- Promote good corporate governance:
  - Enhance disclosure of information of corporations.
  - Closer scrutiny for corporate restructuring.
- Ensure funds raised in the equity market are allocated to productive sectors.

February 1998
- BNM's 3-month intervention rate raised from 10% to 11%.
- Statutory reserve requirement (SRR) reduced by 3.5% of eligible liabilities to 10% to enhance efficiency and effectiveness of the intermediation process. SRR amount offset by reducing the Bank's lending to banking institutions by at least the same amount.

perspective. The increase in bank lending to the private sector was associated with the transformation of the economy from one in which the Government played a significant role to one where the private sector was the main engine of growth. This transformation resulted in a significant reduction in Government borrowing, while the share of the private sector in economic activity and in bank credit increased accordingly. Finally, market sentiments were also affected by a number of global and domestic developments, which were perceived to have an adverse impact on Malaysia's competitiveness. These included intense competition from the lower-cost producers in Asia, Latin America and Eastern Europe. The situation was further exacerbated by the sluggish world demand for semiconductors since the end of 1995, although there had been a rebound since May 1997. On the domestic front, there were also concerns that the increase in production costs arising from higher wage increases relative to productivity and increased utility and transportation costs would also undermine competitiveness. Notwithstanding these concerns, it should be noted that many measures had been taken by producers as well as the Government to improve competitiveness (for details, see Box Article VI on Malaysia's International Competitiveness). To address these concerns and reiterate the Government's commitment to adjust, the 5 December policy package was designed to complement the measures in the 1998 Budget. These measures were aimed at strengthening economic fundamentals and rebuilding investor confidence through maintaining fiscal discipline; strengthening the balance of payments position; strengthening the banking system; and enhancing corporate governance.

To strengthen the balance of payments position, efforts were directed toward a more rapid reduction in the current account deficit to 3% of GNP in 1998. Specific steps entailed a sharp cutback in Federal Government expenditure; deferment of selected projects, including privatised projects amounting to RM65.6 billion, as well as reverse investment, except for those that would have significant linkages with the domestic economy and earn foreign exchange. At the same time, efforts were intensified to promote exports, tourism and the usage of locally-produced goods. Meanwhile, continued attention was directed at reducing the cost of doing business in Malaysia. In the 1998 Budget, the corporate tax and the petroleum income tax were reduced by two percentage points each to 28% and 38% respectively.

Measures were instituted to further strengthen prudential standards of the banking system. These measures included the recognition of a loan as non-performing when its servicing had been in arrears for three months instead of six; increasing the minimum general provision from 1% to 1.5%; and greater disclosure in financial statements. Meanwhile, measures to reduce credit growth and exposure to the less productive sectors took the form of voluntary credit plans whereby the financial institutions undertook to reduce overall credit growth to 25% by the end of 1997, 20% by end-March 1998 and 15% by end-1998. Concurrently, banking institutions had to ensure that in allocating credit, priority would be accorded to borrowers engaged in productive and export-oriented activities. Measures were also taken to address the concerns on the high leverage of corporations. To complement credit measures introduced on bank lending, funds to be raised in the capital market were also subject to more stringent requirements.

Measures that were implemented to enhance corporate governance, accountability and high disclosure standards included closer scrutiny on corporate restructuring; and a requirement for companies to disseminate more timely and transparent information to investors. In line with this move, BNM also introduced changes in the format of its regular publications, aimed at providing more detailed and analytical information to the public.

The regional financial crisis has highlighted the importance of sound macroeconomic policies and a strong financial system as the best defence against volatility in capital flows. At the same time, the maintenance of consistent and transparent policies are vital to enhance investor confidence. While these elements would not completely insulate an economy from the contagion effects of external developments, they would increase its resilience in dealing with potential shocks. Recognising these considerations, Malaysia has undertaken appropriate policy adjustments to build upon the strengths while addressing any weaknesses in the economic and financial system. In the process, this would ensure that the Malaysian economy would be able to surmount the present difficulties, and become more resilient and stronger than before.

Sectoral Review

Output growth in the **manufacturing sector** was sustained at 12.5% in 1997. The performance of the manufacturing sector in the **first half** of the year was supported mainly by the better-than-expected recovery in the electronics industry and stronger growth in the chemical, paper products and off-estate processing industries. Hence, growth before the onset of the currency crisis in July was driven mainly by the improved performance of the export-oriented industries (12.2% and 4.7% in the first half of 1997 and 1996 respectively), supported by sustained strong growth in the domestic-oriented industries (15.2%; 17.9% in 1996). However, growth of the manufacturing sector in the **second half** of the year was affected by the financial turbulence in the region as well as structural adjustments in the construction sector. Although the financial turbulence resulted in an improvement in the competitiveness of some industries, on balance, the performance of the export-oriented industries was dampened by the slower growth in demand arising from the economic slowdown in the Asian region, which accounts for about one-third of Malaysia's exports of manufactures. The favourable impact of the depreciation of the ringgit in terms of improved competitiveness of the export-oriented industries as well as the stronger external demand for electronics and textiles were not sufficient to offset the lower growth in external and domestic demand for other products. Compared with 1996, growth in the manufacturing sector in the second half of the year consolidated (11.5%; 13.8% in the corresponding period of 1996), reflecting slower growth in both the export-oriented industries (8.8%; 11.7% in 1996) as well as the domestic-oriented industries (14%; 16% in 1996). Owing to poor external demand for electrical and wood products and the higher cost of inputs for the off-estate processing industries, growth in the export-oriented industries moderated in the second half of the year. On the other hand, growth of the domestic-oriented industries was affected more by the erosion of wealth due to developments in the stock market as well as structural adjustments in the construction sector which had caused growth of construction-related industries to moderate significantly to 7.2% in the second half of 1997 (23.7% in 1996). Despite the unfavourable development, the domestic-oriented industries continued to perform well at double-digit growth, riding on the back of strong growth in selected industries, especially the chemical, paper products and tobacco industries.

In 1997, production of **electrical machinery, apparatus, appliances and supplies**, which accounted for 33% of manufacturing output and two-thirds of total exports of manufactures, expanded strongly to grow by 13.7%. The stronger growth was stimulated mainly by improved global demand for semiconductors, particularly from the United States, Europe and the Asia-Pacific countries (excluding Japan). Arising from the oversupply of memory chips, world demand for semiconductors started to show signs of softening since the end of 1995 and worsened throughout 1996 and early 1997. However, since May 1997, world demand for semiconductors improved. Consequently, growth of the electronics industry surpassed its performance in 1996 to grow by 22.6%. Nevertheless, the recovery in demand was not accompanied by an increase in the price of memory chips. In contrast, the price of the industry benchmark 16MB memory chip plunged to a record low of US$2.50 per chip in December 1997, from a high of US$50 at the end of 1995, as a result of the intense competition among the manufacturers and the rapid process of upgrading to more powerful chips. Growth in this sub-sector was dampened by the moderation in output of disk drives. Increased competition and the consequent lower prices created a glut in the production capacity of disk drives world-wide, thus causing growth in the electronics industry to moderate from 23.8% in the first half of 1997 (6.2% in the corresponding period of 1996) to 20.8% in the last quarter of the year (22.2% in the fourth quarter of 1996). In addition, the economic downturn in the Asia-Pacific region also affected external demand, especially in November and December.

The strong recovery in the electronics industry was, however, offset to a certain extent by the electrical appliances sub-sector. Production declined by 1% due to intense competition and global excess supply of electrical products. In addition, the economic slowdown in the Asia-Pacific region also affected demand, particularly for audio-visual products and air-conditioners. This region accounted for about one-fourth (excluding Singapore) of Malaysian exports of electrical products.

Supported by higher production in the textile sub-sector, particularly the higher value added synthetic textiles, the **textiles and wearing apparel industry** expanded by 7.8% in the first half of 1997 (-0.9% in the corresponding period of 1996). The recovery in this sub-sector was dampened by the continued

Table 1.3
Growth in Manufacturing Production (1993=100)

	1995	1996	1997
	Annual change (%)		
Export-oriented Industry	**15.2**	**8.2**	**10.5**
Electrical machinery, apparatus, appliances and supplies	20.5	8.9	13.7
Radio and television sets	*22.4*	*5.9*	*–6.5*
Semiconductors	*21.7*	*12.6*	*22.6*
Cables and wires	*11.2*	*12.6*	*10.6*
Manuf. of office, computing and accounting machinery	*17.3*	*–2.4*	*9.1*
Manuf. of refrigerating, exhaust, ventilating and air-conditioning machinery	*16.9*	*–5.0*	*0.9*
(Electronics)	(21.7)	(12.6)	(22.6)
(Electrical)	(18.8)	(3.3)	(–1.0)
Textiles and wearing apparel	5.4	0.0	5.1
Wood and wood products	6.1	11.4	–1.7
Off-estate processing	5.1	10.3	10.3
Domestic-oriented Industry	**12.8**	**16.9**	**14.6**
Chemicals and chemical products	11.5	19.6	24.4
Construction-related products	11.7	21.2	11.3
Non-metallic mineral products	*10.9*	*24.5*	*9.9*
Basic iron & steel and non-ferrous metal	*12.8*	*17.1*	*13.2*
Transport equipment	36.2	22.3	14.2
Food products	7.3	4.4	3.8
Beverages	10.7	15.5	0.0
Tobacco products	2.0	7.5	19.9
Rubber products	13.1	11.1	3.4
Petroleum products	13.9	12.7	8.9
Fabricated metal products	9.1	23.1	12.0
Paper products	9.2	–4.8	12.8
Total	**14.2**	**12.3**	**12.5**

Source: Department of Statistics

decline in output of wearing apparel by 1.6% in the first half of 1997 (-3.5% in the same period of 1996) as competition in the international market remained intense. Output of the industry decelerated sharply to 2.5% in the second half of the year. The slowdown was due mainly to cutbacks in natural fibre spinning and weaving activities in response to the rising cost of imported cotton. Reflecting largely the cheaper cost of importing wearing apparel in the second half of the year because of the ringgit depreciation, overseas demand particularly from the United States and Europe (which accounted for about half of the industry's exports), helped to offset the slowdown in the textiles sub-sector. Therefore, for the year as a whole, the textiles and wearing apparel industry recovered to grow by 5.1% in 1997.

The sharp downturn in the property sector in the region resulted in a slowdown in construction activity in Japan, Korea and the People's Republic of China. In turn, this was reflected in lower overseas demand for Malaysian **wood and wood products**. Consequently, output of the industry moderated to 4.4% during the first half of the year (10.6% in the same period of 1996). As the financial crisis in the region spread in the second half of the year, growth in the wood and wood products industry deteriorated further to decline by 6.9%, so that production declined by 1.7% for the year as a whole. The lower output was due mainly to the continued deterioration in the sawn timber sub-sector which was hampered by the limited supply of logs as well as a sharp slowdown in the production of plywood and particle board.

Spurred by strong external demand for palm oil products, production in the **off-estate processing industry** surged strongly by 14.6% in the first half of 1997 (3.3% in the first half of 1996). However, growth moderated significantly to 3.2% in the fourth quarter of 1997 (20.2% in the same period of 1996) mainly because of the higher cost of production due to the increased cost of crude palm oil which was quoted in United States dollars. Indonesia's ban on exports of palm oil in the second half of 1997 also reinforced the upward pressure on the cost of crude palm oil. Although rubber is quoted in ringgit, output from rubber millers declined due to insufficient supply of raw materials. Despite the supply constraint of its raw material inputs, the off-estate processing industry still maintained growth at 10.3%, the same growth rate as recorded in 1996.

Notwithstanding the slowdown in the domestic economy, output of the domestic-oriented industries was sustained at a strong double-digit growth of 14.6%. Growth emanated mainly from the chemicals and chemical products, tobacco, rubber and paper products industries. These industries were less affected by the erosion of wealth in the stock market. The industries that were most affected were the **construction-related products industries** where output moderated sharply to 6% in the last quarter of the year (23% in the fourth quarter of 1996), from a high of 15.9% in the first half of 1997 (18.4% in the first half of 1996). Although growth in this group of industries slowed down significantly from 21.2% in 1996, it remained at a creditable level of 11.3% for 1997 as a whole. In the second half of the year, the industry was significantly affected by lower demand for construction-related materials as large projects were postponed, including development of higher cost residential houses. Reflecting the downturn in construction activity, growth of the non-metallic mineral products and iron and steel industries weakened to 9.9% and 13.2% respectively. The sharp slowdown, particularly in the last quarter of 1997, was due mainly to the scaling back of production in the cement and concrete products, hydraulic cement and primary iron and steel products industries.

After an impressive growth of 23.1% in 1996, growth in the **fabricated metal products industry** slowed down to 12%. This was due to the decline in the output of structural metal products arising from slower demand from the heavy and light engineering sub-sector, especially in the construction sector. Nevertheless, output from other sub-sectors, particularly tin and metal boxes, wire and wire products and brass, copper and aluminium, remained strong due to sustained domestic demand.

Production of **chemicals and chemical products** strengthened further to grow by 24.4%, attributed mainly to a strong increase in output in the industrial chemicals and plastic products sub-sectors. Strong domestic and external demand for industrial gases continued to support growth in the industrial chemicals sub-sector which had expanded its capacity in 1996. Meanwhile, the recovery in the electronics sector helped to boost the output of plastic-related packaging materials.

With the recovery in the electronics sector, there was a corresponding increase in demand for paper-based packaging materials, particularly in the second half of the year. Output of the **paper products industry** increased strongly by 16.5%, from 8.9% in the first half of 1997. Consequently, production for the whole year turned around to grow strongly by 12.8%. Growth was strong for inputs of packaging materials, particularly containers and boxes of paper and paperboard.

Despite the erosion of wealth, demand for new cars continued to remain strong in the first nine months of 1997. Sales of passenger cars and commercial vehicles declined drastically by 9.8% and 34.1% respectively in the last quarter of 1997 (increased by 22% and 26.7% respectively in the first nine months of 1997). Car sales declined towards the end of the year when BNM tightened the hire-purchase guidelines for the purchase of passenger cars by lowering the credit ceiling from 75% to 70% and shortening the repayment period

Table 1.4
Manufacturing Production: Selected Indicators

	1997	1996	1997
	Output	Annual change (%)	
Integrated circuits (million units)	12,552	-4.9	28.4
Semiconductors (million units)	7,432	10.1	41.9
Television sets ('000 units)	7,775	-5.9	-12.7
Room air-conditioners ('000 units)	2,114	-3.2	-28.9
Household refrigerators ('000 units)	250	-12.9	-2.7
Vehicles assembled ('000 units)	882	15.3	22.2
Passenger cars	*363*	*29.9*	*16.0*
Commercial vehicles	*95*	*41.1*	*20.3*
Motorcycles & scooters	*424*	*0.3*	*28.5*
Pneumatic tyres ('000 units)	13,754	7.5	12.5
Rubber gloves (million pairs)	8,919	13.1	4.8
Plywood ('000 cu.metre)	4,508	26.9	1.3
Veneer sheets ('000 cu.metre)	1,263	-7.0	-4.5
Liquefied petroleum gas ('000 tonnes)	1,353	5.8	-2.9
Kerosene & gasoline ('000 tonnes)	2,243	15.9	3.1
Diesel and gas oil ('000 tonnes)	6,792	6.9	7.4
Fuel oil ('000 tonnes)	3,153	21.1	12.8
Cement ('000 tonnes)	12,558	15.3	1.7
Iron and steel bars and rods ('000 tonnes)	3,377	23.1	11.5

Source: Department of Statistics

to not more than five years. In addition, demand was affected by the imposition of higher import duties and tight liquidity in the banking system. Despite these developments, the assembly of motor vehicles recorded a higher growth of 21.2% while the production of motor vehicle parts and accessories moderated to 0.3% in the fourth quarter of 1997 (16.7% and 8.7% respectively in the first nine months of 1997). The sharp moderation in production of motor vehicles only occurred in December when its growth slowed down to 13.5%, from 28.6% in November 1997. In addition, the assembly of motorcycles and scooters declined by 15.2% in the fourth quarter (an increase of 26% in the first nine months of 1997). Consequently, growth in the **transport equipment industry** as a group moderated sharply to 10.7% in the fourth quarter (15.5% in the first nine months of 1997), contributing to the sharp moderation in output to 14.2% for the year as a whole.

Boosted by higher external demand for rubber gloves and a weaker ringgit, output of the **rubber products industry** surged from virtual stagnation in the first half of the year to grow by 6.4% in the second half of 1997. Meanwhile, output of the tyre and tube industry remained relatively strong despite the softening demand in the car industry. Consequently, production of the industry for the year as a whole moderated to 3.4%. The industry continued to face competition, especially from Thailand and Indonesia, in the wake of the sharp depreciation of the region's currencies. At the same time, expansion of the industry was constrained by the limited supply of natural rubber in the country.

In tandem with the softening of the car market, demand for **petroleum products** also slowed down markedly to 6% in the fourth quarter, from 11.6% in the first half of 1997. For the year as a whole, growth of the industry moderated to 8.9%. Although the production of crude oil refineries remained strong, production of the other petroleum products, such as lubricating oil for motor vehicles and premixed asphalt for road construction purposes, decelerated sharply in tandem with the moderation in the transport equipment industry as well as the deferment of projects in the construction sector towards the end of the year.

Growth in the **food, beverages and tobacco products industries** as a group registered a slightly slower growth of 5.5% due mainly to the decline in output of the soft drinks, chocolate and sugar confectionery, large rice mills and other dairy food sub-sector. In contrast, the production of tobacco increased sharply by 19.9%. To summarise, the sustained strong growth of the manufacturing sector was boosted by higher growth in export-oriented industries (10.5%; 8.2% in 1996) which had supported strong growth in the domestic-oriented industries (14.6%; 16.9% in 1996) through inter-industry linkages.

The **1997 Bank Negara Malaysia Survey of Manufacturing Companies,** which covered 342 companies from a cross-section of all industrial groups, indicated that production in the manufacturing sector increased by 10.1%. Growth emanated mainly from the electronics, textiles, chemicals, transport equipment and basic metal industries. However, the increase was dampened by lower output in the wood and electrical products industries. On the external front, growth in export sales picked up strongly to grow by 11.2% in 1997 (3.5% in 1996), reflecting mainly higher exports of electronics, chemicals, transport equipment and fabricated metal products. The strong growth in export receipts reflected mainly the valuation gain due to the depreciation of the ringgit. In anticipation of higher demand, companies increased their capital investment, particularly in the transport equipment, electronics and off-estate processing industries. With the expansion in production capacity, the slowdown in production, especially towards the end of 1997, caused the average capacity utilisation of the manufacturing sector to decline from 82.2% in 1996 to 79% in 1997. For 1998, a majority of the companies indicated that the capital outlay would be reduced because they were pessimistic about the prospects for the manufacturing sector, particularly for the domestic-oriented industries, as they expected the economic downturn in the region and the volatility of the currency to continue. Growth would be export-led with production projected to slow down to 6.1%, while exports were expected to increase by 17.9% in 1998.

The impact of the depreciation of the ringgit differed among industries. Export-oriented industries in general benefited from the depreciation and increased their export receipts due to the valuation impact, as reported by 58% of the respondents. Another 10% of the respondents indicated a deterioration in export receipts, while 32% were not significantly affected. Export-oriented industries benefited more, as reflected in the improved export receipts for 64% of the companies in these industries compared with 51% of those in the domestic-oriented industries. The gain for exporters was not confined to mere valuation gains; 30% of the respondents reported a higher volume of exports while 57% reported maintaining the previous year’s export level. In the face of intense competition from the region, 33% of the respondents reported a downward adjustment in the United States dollar export price, while another 67% were able to maintain prices in foreign currency. A majority of the respondents, however, expected the export price in foreign currency to slide further in 1998.

The adverse impact of the currency depreciation was more severe on domestic sales as 35% of the respondents reported lower domestic sales turnover, while 44% were not affected. The decline in domestic sales was more significant in industries engaged in the construction-related materials and transport equipment industries which were also affected by the imposition of prudential limits on lending to the less productive sectors. In contrast, domestic sales for 21% of the respondents increased as customers substituted from imported items which had become more expensive. Nevertheless, 90% of the respondents reported a higher cost of production

Table 1.5
Impact of the Ringgit Depreciation on the Manufacturing Sector

	Sales		Export volume			Profit
	Export Sales	Domestic Sales	Export-oriented industries	Domestic-oriented industries	Total	Total
	% of respondents					
Higher	58	21	30	29	**30**	**37**
Lower	10	35	13	16	**14**	**56**
Same/No impact	32	44	57	55	**56**	**7**
Total	100	100	100	100	**100**	**100**

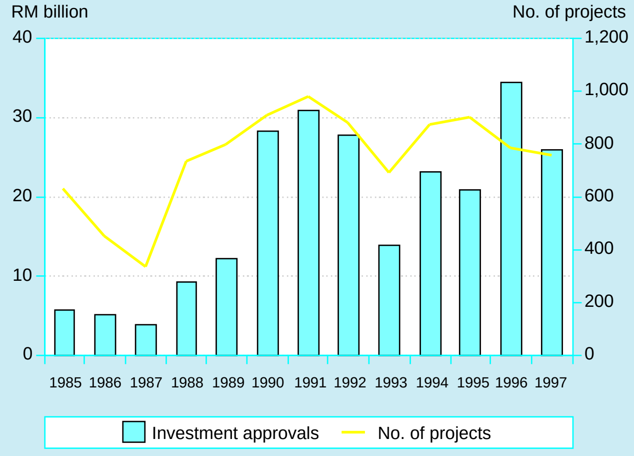
Source: Bank Negara Malaysia Survey of Manufacturing Companies, 1997.

due to the higher cost of imported components. This led to lower profits for 56% of the respondents, compared with 37% which achieved higher profits in 1997. Nevertheless, 91% of the respondents expected to continue to make profits in 1998. In the face of economic uncertainty and higher imported cost of capital items, 49% of the companies indicated that they would either scale down or postpone their investment, but 14% would increase investment plans while another 37% were not affected by exchange rate factors.

The problem of labour shortages persisted for the respondent companies, reflecting six consecutive years of full employment in the country. However, the tight labour market condition was expected to ease in view of the slower growth projected for 1998. In the meantime, the manufacturing firms had undertaken various short- and long-term measures to alleviate the labour problem. While one-third of the respondent companies provided training to improve productivity, 20% resorted to the employment of foreign workers and more than 20% had undertaken strategic adjustment through automation. Nevertheless, a slightly higher proportion of firms (39%) reported an increase in technical or skilled workers in 1997 (38% in 1996) and the share of unskilled workers declined marginally from 54% in 1996 to 53% in 1997.

The value of **investment** approved in the manufacturing sector by the Ministry of International Trade and Industry (MITI) in 1997 was high at RM25.8 billion, although lower than the record level of RM34.3 billion approved in 1996. Applications for investment also showed a similar trend, with the value of applications recording a decline of 20.6% to RM33.4 billion, from a high level of RM42.1 billion in 1996. Of the total investment approved, about 39% was contributed by five large projects, each with proposed capital investment exceeding RM1 billion. This implied a further shift towards higher value added and more capital-intensive investment, reflecting positive response to the provision of special fiscal and other incentives to promote high-technology industries. The level of investment applications and approvals remained high in the second half of 1997, indicating that investors in the real sector were confident of Malaysia's long-term growth prospects, despite the financial crisis. An analysis by industry indicated that the petroleum products (including petrochemicals) industry accounted for the largest share of 25.4% of total value of investment approved. The electrical and electronics industry was the next largest (24.1%), followed by basic metal products (14.6%), non-metallic mineral products (6.2%) and chemicals and chemical products (5.1%) industries. In terms of ownership, the share of domestic investors (56%) exceeded that of the foreign investors (44%). With Malaysia facing keen competition from low-cost producers, the focus in recent years was on the quality of investment, with emphasis on facilitating the manufacturing sector to shift towards higher value added and technology-driven activities with higher export orientation, lower import content and high inter-linkages. In this regard, foreign direct investment continued to play an important role as reflected by the significant foreign involvement in several industries, especially petroleum products (37.2% of foreign direct investment), electrical and electronic products (24.3%), chemicals and chemical products (6.5%), basic metal products (6.2%) and fabricated metal products (5.4%). The top five foreign

Graph 1.4
Malaysia : Investment Approvals



investors in 1997 were the United States (20% of foreign direct investment inflows in 1997), Japan (19%), Germany (16%), Taiwan, Republic of China (ROC) (12%) and Singapore (11%). These countries together accounted for 78% of total foreign direct investment approved.

The 1998 Budget contained several incentives to improve the competitiveness of the manufacturing sector by enhancing Malaysia's business and investment environment. Specifically, these incentives were aimed at further promoting private investment (both domestic and foreign) and increasing productivity, while reducing the cost of doing business. Several of the incentives would reinforce the benefits accruing to the export-oriented industries arising from a weaker ringgit. The major incentive provided was the reduction in the corporate income tax rate to 28% from 30%, with effect from assessment year 1998. At the same time, various other tax exemptions and allowances were provided to boost exports, while customs procedures would be simplified. For the manufacturing sector, companies exporting goods with value added of 30% were given exemption from income tax equivalent to 10% of the increase in export value and exemptions equivalent to 15% for the export of goods with value added of 50%. A special building allowance of 10% was provided on the expenditure incurred for the purchase or construction of warehouses which are used for export purposes.

To enhance the capacity of domestic manufacturing production for import substitution, the initial capital allowance for imported heavy machinery and the annual allowance were reduced to 10%, while the import duty rates were raised for construction materials, heavy machinery and equipment, selected consumer durables, cars and other vehicles. Several incentives were also introduced to support the Second Industrial Master Plan strategy to encourage the manufacturing sector to venture into other upstream and downstream activities along the value chain and to become more technology-oriented and knowledge driven. The reinvestment allowance was reviewed and restricted only to reinvestment that would result in increased productivity through automation and labour saving devices. To promote the use of Malaysian brand names, the expenditure incurred on local advertising was given a double deduction for income tax purposes, while research and development incentives were extended to companies carrying out designing or prototyping as separate activities. In addition, an allocation of RM270 million was also provided in the 1998 Budget to develop local technology and potential research and development that would be capable of assisting the industrialisation process and improving the quality and standard of locally-manufactured goods. In relation to financing, the Government established a RM1 billion fund with the objective of providing financing to the small- and medium-scale industries (SMIs) at lower cost, in order to promote exports and new growth industries (including high-technology industries).

The **construction** sector consolidated in 1997 with growth moderating to 10.6% (14.2% in 1996) following several measures adopted during the course of the year to pre-empt the development of a property bubble. Growth was generally broad-based, driven by continued strong construction activity in the residential and non-residential sub-sectors, as well as the expansion of large infrastructure and civil engineering projects. The civil engineering sub-sector expanded by 12.3% (15.7% in 1996), while growth of the residential and non-residential sub-sectors was more moderate at 10% and 8.1% respectively (13.2% and 12.4% respectively in 1996). Growth was particularly strong in the first three quarters of the year but slowed down to 6.8% in the last quarter of 1997 due to the deferment of some projects as well as tight liquidity conditions, which affected financing to the sector. The Bank also tightened prudential measures to curb excessive lending to specific types of property development. The consolidation of the construction sector was reflected in the moderate increase of 8.4% in the total value of property transactions in 1997 to RM53.1 billion (1996: 22.9% to RM49 billion), while the total number of transactions rose marginally by 1.8% to 275,328 (7.4% to 270,538 transactions in 1996).

Growth in the **civil engineering sub-sector** remained high in 1997 because construction of projects related to infrastructure facilities and capacity expansion peaked during the year. The bulk of the infrastructure projects was in the form of road and rail transport, airport and port facilities as well as power plants. In particular, the construction value of road projects was sharply higher in 1997. This included the on-going construction of the Second Link to Singapore, Shah Alam Expressway (Phase 2), North-South Central Link Expressway, the Middle Ring Road II in Kuala Lumpur, Elevated Highway, New Pantai Highway, Damansara-Puchong Highway and the upgrading of Sungai Besi Road, Cheras-Kajang Road and Kuala Lumpur-Karak Highway. At the same time, construction activity of rail transportation increased significantly due to the Light Rail Transit System, Kuala Lumpur Sentral Station, Express Rail Link and the Kuala Lumpur Monorail System. The construction of the Kuala Lumpur International Airport also gained momentum in order to meet the targeted opening date. Although the Government had announced the deferment of several projects in the 1998 Budget, the impact on the growth performance for the sector in 1997 was minimal as only one on-going project was affected, namely, the Bakun Hydroelectric Dam. In view of these developments, the civil engineering sub-sector continued to account for the largest share (48%) of value added in the construction sector.

The moderation in growth of the **non-residential sub-sector** to 8.1% in 1997 (12.4% in 1996) reflected the slower progress in the construction of several purpose-built office space buildings and shopping complexes, especially towards the last quarter of the year. The slowdown in this sub-sector was, however, offset by the relatively strong demand for commercial space emanating from new business activities and increased consumption as well as expansion in construction activity in the hotel industry. This strong growth was reflected in the total value of transactions for commercial buildings (comprising shop-houses and office buildings**)** which rose by 23.9%, while those for industrial property declined by 11.2% in 1997. At the same time, the number of transactions increased by 6.4% and 1.7% respectively, reflecting an increase in prices of the commercial property transacted while prices of industrial property declined. In the hotel industry, the number of new hotels increased by 9.5% or 122 new hotels with 27,832 rooms in 1997 (1996: 5.7%; 69 new hotels with 9,141 rooms). The significant increase in hotel capacity was partly in preparation for the XVI Commonwealth Games to be held in Kuala Lumpur in September 1998. Most of the new hotels were located in Kuala Lumpur (32 hotels with 8,229 rooms), followed by Selangor (17 hotels with 4,759 rooms) and Johor (14 hotels with 3,255 rooms). With the increased supply of rooms, the average occupancy rate for the nation as a whole declined to 58% in 1997 from 62% in 1996. However, the average occupancy rate of hotels in the Klang Valley remained high at 69% in 1997.

Bank Negara Malaysia's Survey on Office Space in the Klang Valley showed that a total of 21 purpose-built office buildings with a net lettable area of 639,375 square metres were completed in 1997. A significant portion (34%) of the space completed is in Tower 1 of the KLCC with a net lettable area of 218,000 square metres, and is fully occupied by PETRONAS. The average occupancy rate in the office space market at end-1997 declined only marginally to 95% from 97% in 1996 due to the late completion of several buildings, which were originally scheduled to enter the market in 1997. The void was mainly in the older buildings as tenants relocated to newer buildings that offered more and better facilities. Nevertheless, choice buildings located in the Golden Triangle continued

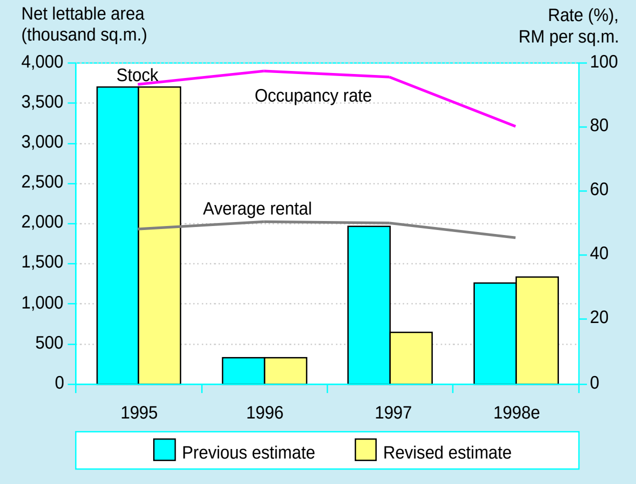
Table 1.6
Supply of Office Space and Condominiums in the Klang Valley

	Office space		Condominiums		
	No. of projects	Area in sq. metres	No. of projects	No. of units	Area in sq. metres
1983	11	159,840	5	782	81,698
1984	12	342,899	4	561	60,065
1985	28	747,757	9	1,240	204,638
1986	11	304,780	2	460	70,857
1987	10	244,069	6	1,143	175,975
1988	4	43,255	4	936	95,771
1989	2	45,628	4	682	64,248
1990	0	0	8	1,221	139,386
1991	6	57,470	13	2,576	266,252
1992	7	95,296	21	3,346	380,897
1993	12	232,693	26	5,013	565,439
1994	15	350,951	40	8,507	973,202
1995	20	451,119	52	14,241	1,576,297
1996	16	321,629	35	8,342	1,022,444
1997	21	639,375	25	7,530	864,057
1998*e*	42	1,320,135	47	14,791	1,719,577
Total	**217**	**5,356,896**	**301**	**71,371**	**8,260,803**

e Estimate

Source: Survey by Bank Negara Malaysia

Graph 1.5
Supply of Purpose-Built Office Space in the Klang Valley

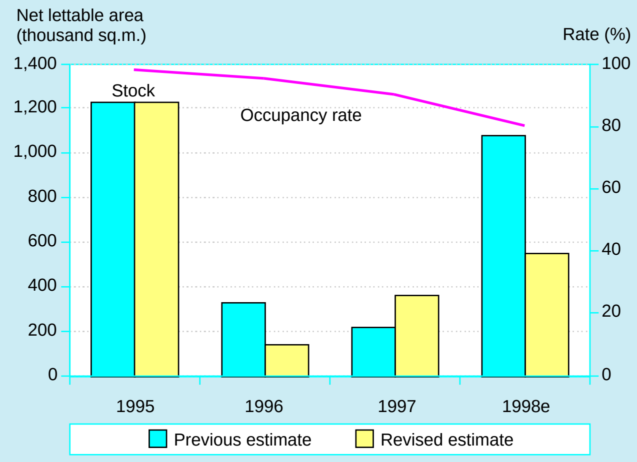


to enjoy full occupancy. The average monthly rental declined marginally by 1.3% from RM50.45 per square metre (RM4.70 per square foot) at the end of 1996 to RM49.75 per square metre (RM4.60 per square foot) at the end of 1997. Certain prime buildings located outside the Golden Triangle were rented out at premium rates similar to buildings in the Golden Triangle due to enhanced accessibility. In addition, prime office buildings located in the Golden Triangle, Central Business District and Damansara in Kuala Lumpur as well as in certain locations of Petaling Jaya were estimated to enjoy full occupancy with stable rentals as the increase in supply in these localities had been rather limited. In view of the new supply, demand for older buildings located in less popular areas in the suburbs of the Klang Valley moderated. However, following curbs on financing for such buildings, the estimates on supply coming on-stream in 1997 and 1998 have been revised substantially downwards.

Based on the 1997 Property Market Report, the stock of retail space in commercial complexes in the Klang Valley increased by 26.6% from 1.4 million square metres in 1996 to 1.7 million square metres in 1997. In addition, a total of 1.4 million square metres (representing 83.4% of the existing stock) of retail space were at various stages of construction in 1997. The Bank's Survey indicates that a total of 549,000 square metres of retail space would enter the market in 1998, instead of an earlier estimate of 1.1 million square metres. Recognising the potential for excess supply, several developers have rescheduled the completion of projects so that the large increase in supply anticipated earlier would probably be moderated.

Value added in the **residential sub-sector** rose by 10% in 1997 in response to the sustained strong demand for housing, particularly landed property. Consequently, the number of houses completed in 1997 increased to 132,562 units, accounting for 16.6% of the 800,000 housing units targeted for completion during the Seventh Malaysia Plan period. In addition, the number of houses approved by the Ministry of Housing and Local Government for construction by private developers in Peninsular Malaysia rose significantly by 63% to 188,400 units (115,540 in 1996). Of the total number of houses approved for construction, 46.9% were high-cost units, 28% medium-cost and 25.1% low-cost units. In the case of flats and condominium units priced above RM100,000, the number approved by the Ministry increased significantly by 82.1% to 29,925 units in 1997 from 16,437 units in 1996. Reflecting strong construction starts, new sales and advertising permits for residential and shop-houses in Peninsular Malaysia issued by the Ministry increased by 18.9% to 867 in 1997. The Bank's Survey on the construction of condominiums in the Klang Valley showed that a total of 25 condominium projects comprising 7,530 apartment units with a total built-up area of 864,000 square metres were completed in 1997 (35 projects comprising 8,342 units with one million square metres in 1996). In response to the sustained strong demand for residential housing, the total value of residential property transactions in 1997 rose by 15.2% to RM21.6 billion (1996: 18.6% to RM18.8 billion), while the total number of transactions increased by 3.3% to 175,682 units (1996: 8.3% to 170,007 units). Transactions were particularly buoyant in the first half of 1997 when expectations of capital gains on property fuelled demand. Towards year-end,

Graph 1.6
Supply of Retail Space in the Klang Valley



financing constraints and the loss of wealth due to the financial crisis caused transaction volume to decelerate markedly.

Although construction activity for residential property remained buoyant, the demand for traditional landed housing consistently exceeded supply, particularly in the major towns. The shortage of housing supply was attributed partly to the scarcity of suitable land for housing in preferred locations, the long time taken for land conversion as well as increased demand from an increasingly affluent population and from migrants who had moved to the major towns in search of better economic opportunities. In view of the strong underlying demand and interest in property investment (partly due to anticipation of speculative gains), **house prices continued to increase in 1997** but at a more moderate rate. The National House Price Index for the first half of 1997 showed an increase of 6.1% compared with an increase of 12.9% for the whole of 1996. Prices for terrace houses increased by 11.2% (10.2% in 1996), followed by detached houses (10.4%; 14.1% in 1996) and semi-detached houses (8.5%; 8.1% in 1996). However, the increase in house prices was most evident in the case of landed residential properties in Kuala Lumpur, Selangor and Pulau Pinang. In Kuala Lumpur, prices for semi-detached and detached houses rose by 22.2% and 16.9% respectively in the first half of 1997. In Selangor, prices for detached houses rose by 17.6% while semi-detached houses in Pulau Pinang increased by 13.6%. In contrast, prices for high-rise units declined by 4.6% due mainly to a 5.9% decline in prices for high-rise units in Kuala Lumpur. The Maybank-Rating Agency Malaysia (RAM) Property Index, which is based on landed residential property prices in the Klang Valley, showed that house prices consolidated during the third quarter of 1997. After registering double-digit growth since 1994, the rise in the Index moderated from 10.6% in the first half of the year to 8.1% in the third quarter (third quarter of 1996: 12.7%). Prices of double storey terrace houses experienced the slowest growth of 6.4% while prices of single storey terrace houses grew by 9.7%. Meanwhile, prices of semi-detached houses continued to record double-digit growth, albeit slower at 12.9% (third quarter of 1996: 15.6%).

The increase in house prices moderated following implementation of several measures during the year to discourage speculative activities and to contain pressure of escalation in property prices. These included the measure by the Bank to limit the credit exposure of the financial institutions to the broad property sector effective April 1997. In addition, expectation of a strong increase in supply following a significant rise in approvals for housing projects also contributed to the slowdown in the rate of price increases. The guidelines by the National Land Council on acquisition of properties by foreigners, which were revised effective 23 June 1995, also had some dampening effect on sentiment in the property sector in 1997. It reduced foreign purchases of residential property, especially condominiums. The total number and value of residential property acquired by foreigners declined further to 479 units and RM215.6 million respectively in 1997 (1,521 units valued at RM488.5 million in 1996). Properties that were adversely affected were condominiums, which declined by 73.1% in terms of number of units and 63.2% in terms of value. The proportion of foreign share of the total transacted value for residential property declined significantly from a peak of about 10% during the 1993–95 period to 2.6% in 1996 and 1% in 1997. However, in the case of non-residential property, foreign purchases of commercial property declined by nine units or 4.6% to 186 units (195 units at RM213.8 million in 1996), but the value continued to increase by RM112.4 million or 52% to RM326.2 million. To promote foreign interest in the property market, the RM100,000 levy on foreign purchases imposed in 1995 was removed effective 28 August 1997. In addition, the 1998 Budget made provisions for the reduction of the Real Property Gains Tax to 5% for disposal of property after the fifth year as well as the relaxation of guidelines on foreign ownership of properties. Foreigners were also allowed to buy two condominium units, with the foreign quota increased from 30% to 50%.

Reflecting the performance of the construction sector in 1997, production of major construction-related materials expanded further. During the year, production of cement and concrete, iron and steel, and construction-related products increased by 21.3%, 7.8% and 11.3% respectively, while sales of cement and concrete products rose by 23%, plywood, hardboard and particle board by 8.1%, and structural clay products by 40%. However, sales of iron and steel declined by 3.4%. Despite the higher output of construction-related materials, prices of several major building materials continued to increase during the year, thus exerting pressure on property prices. The average price of glass sheet increased by 15.9%, paints by 13%, mosaic floor tiles by 11.8%, glazed wall tiles by 10.5% and sand by 7.8%. As cement remained a controlled item, its price was maintained at the ceiling rate of RM10.35 per 50 kilogramme bag of ordinary portland cement in Peninsular Malaysia, while mild steel round bars and high tensile deformed bars were still priced within the ceiling prices of RM1,189 per metric tonne and RM1,229 per metric tonne respectively. However, prices of two items which are mainly used in civil engineering works, namely, fuel oil and bitumen, increased significantly by 33% and 29.7% respectively in the last quarter of 1997 following higher import cost from a weaker ringgit.

Demand for construction workers in 1997 remained high, exerting further pressure on wages. The **average daily wages** for skilled and semi-skilled foreign workers rose further by 15% and 7.7% respectively in 1997, while wages for unskilled foreign workers declined by 2.6% (0%, 5.4% and 6.5% respectively in 1996). However, the average daily wage for local construction workers increased marginally by about 2.9% for all three categories of workers after having increased substantially in 1996 (22.5% for skilled, 13.5% for semi-skilled and 7.4% for unskilled workers). Nevertheless, wages of local workers were higher by 25–43% compared with their foreign counterparts. In 1997, **total employment in the construction sector** continued to expand by 5.4% to 765,000 persons (9.1% of total national employment), of which 30% were foreign workers. In reality, the share of foreign construction workers was higher as the number of illegal workers was not included in the statistics. The Bank's Survey findings indicated that in the case of the civil engineering sub-sector, about 60% of the construction workers (both legal and illegal) were foreigners.

It is estimated that although the gross local content for infrastructure projects is about 64% of the total project value, the net local content is lower at 48%. Imports of building materials and heavy machinery and equipment for the construction sector (such as tower cranes, forklifts, crane lorries and concrete mixer lorries) accounted for 3.8% of total imports, while imports of iron and steel accounted for 3.9% in 1997. In terms of value, imports of intermediate goods for construction amounted to RM5.2 billion, a decrease of 3.5% compared with RM5.4 billion in 1996. To discourage unnecessary imports, the import of heavy machinery for the construction sector was made subject to approval of the Ministry of International Trade and Industry. Approval would be given provided the machinery was not available locally. In addition, the import duty on crane lorries and concrete mixer lorries was increased from 35% to 50%, while the import duty on construction materials such as tiles, marble, iron and steel was increased to between 10% to 30% (from between 5% to 25%).

Despite continued monetary restraint in 1997, demand in the property sector remained high. The total value of loans (excluding loans sold to Cagamas) extended by the banking system to the broad property sector, comprising residential, non-residential, real estate and construction, increased further by 32.5% or RM29.6 billion to RM102.6 billion in 1997. Such loans accounted for 35.8% of total loans extended during the year. However, total loans extended to the broad property sector, including loans sold to Cagamas, accounted for 39.9% of total loans extended in 1997. Of the total housing loans extended in 1997, 52.4% were housing mortgage loans purchased by Cagamas. During the year, new mortgage loans purchased by Cagamas increased further by 41.2% to RM5.6 billion (RM4.7 billion in 1996). The purchase of housing loans by Cagamas accelerated in the fourth quarter as the liquidity situation tightened further. Loan growth for properties covered under the BNM Guidelines effective April 1997 moderated. By the end of December, the exposure of the banking system to the property loans subject to the guideline was 13.1% as against 14% at the end of June.

Loans by housing credit institutions for residential houses amounted to RM48.1 billion, an increase of 9.7% over 1996. The banking system provided RM29.4 billion. This included financing of owner-occupied houses costing RM100,000 or less. As at end-1997, the commercial banks and finance companies had made firm commitments to finance 94,568 and 41,002 of these units respectively. Other than the banking system, the other major housing credit institutions, comprising the Treasury Housing Loans Division, the Malaysian Building Society Berhad, the Borneo Housing Mortgage Finance Berhad, Sabah Credit Corporation, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional, also extended loans to the housing sector. The total value of housing loans extended by these institutions as a group amounted to RM18.7 billion as at end-1997, representing an increase of 4.8% or RM852.3 million compared with 1996.

Reflecting continued efforts to promote house ownership, especially for the lower income group, a total of 33 projects involving 90,904 units were approved under the **Low-Cost Housing Revolving Development Fund (LCHRDF)** as at end-1997. Of the total units approved, 46% (42,195 units) were for low-cost housing and 34% (31,208 units) for medium-cost housing. During the year, the disbursement of funds under the LCHRDF increased by 33.1% to RM874.1 million (RM656.6 million in 1996). In the case of the **RM600 million Housing Fund for Hardcore Poor**, 31 projects involving the construction of 15,511 low-cost houses, valued at RM644.6 million were approved as at end-1997. In addition, a total of RM52.7 million was withdrawn from the 1997 allocation of RM54 million under the **Public Low-Cost Housing Scheme** for the construction of low-cost houses, while for the **Special Site and Services Scheme**, a total of RM1.9 million was withdrawn from the 1997 allocation of RM2 million for the construction of core houses or the provision of land for those earning less than RM500 per month. Under the **RM500 million Fund to Accelerate the Construction of Low-Cost Housing,** a total of RM379.1 million was approved for the construction of 21,499 units of low-cost houses in 58 projects as at end-1997.

The output growth of the **agriculture, forestry and fishery** sector rose by 3% in 1997 (2.2% in 1996). Output growth expanded in the first three quarters and then moderated significantly in the fourth quarter. Overall, the improved performance was due to the continued increase in the production of crude palm oil by 8.1% and the turnaround in saw log production to 4.3%. In contrast, rubber output declined further by 10.4% in 1997, reflecting mainly the low prices which led to the continued decline in planted area, as well as labour constraints. Cocoa production was also lower, declining further by 10.7%, as the prolonged dry weather, particularly towards the second half of the year, had affected fruit setting. Consequently, the share of the agriculture, forestry and fishery sector in the GDP remained at 12.1% in 1997. In terms of gross exports, its share was 10.5% (11.4% in 1996) and in terms of employment, it accounted for 15.2% (16.8% in 1996).

1997 was an exceptional year for **crude palm oil** production, which reached a new record of 9.1 million tonnes. The sharp increase was attributed to the biological yield cycle, which peaked in September and October 1997. In addition, new mature areas increased further by 3.9% to 2.4 million hectares at the end of 1997. Higher output was also attributable to the improvement in the oil extraction rate (OER) from 18.97% to 19.03%. Despite increasing competition from other producing countries, Malaysia remained the largest producer of palm oil, contributing about 52% of the world supply, followed by Indonesia with a share of 28.6%. Although overseas demand remained strong, the level of stocks of palm oil as at end-1997 increased to 0.96 million tonnes, compared with 0.79 million tonnes as at the end of last year, reflecting higher production relative to exports.

Table 1.7
Agriculture: Production

	1996	1997*p*	1996	1997*p*
	'000 tonnes		Annual change (%)	
Rubber	1,083	970	-0.6	-10.4
Saw logs[1]	30,426	31,731	-3.8	4.3
Crude palm oil	8,386	9,062	7.4	8.1
Fish	1,237	1,261	-0.3	1.9
Cocoa	120	107	-8.7	-10.7

[1] Expressed in thousand cubic metres.
p Preliminary

Source: Department of Statistics
PORLA
Forestry Departments (Peninsular Malaysia, Sabah & Sarawak)
Malaysia Cocoa Board
Department of Fisheries Malaysia

On a regional basis, output of crude palm oil in Sabah and Sarawak continued to record an impressive growth, reflecting a further increase in mature area. In Sabah, production rose by 24.6% to 2.1 million tonnes, accounting for 23.4% of the national production, while in Sarawak, output increased by 20.4% to 331,540 tonnes. Meanwhile, output from Peninsular Malaysia increased by 3.1% to 6.6 million tonnes, with its share of the total national production being reduced further to 72.9%, compared with 76.4% in 1996.

During the year, the total area under oil palm cultivation increased by 3.4% to 2.8 million hectares, of which almost 88% or 2.4 million hectares were mature area. Peninsular Malaysia remained the major contributor to the palm oil sector, contributing 73% of the total mature area. Although the area under oil palm cultivation in Sabah increased significantly by 8.5%, its share of total mature area increased slightly to 22.7%. In Sarawak, planted area rose by 3.6%, with its share remaining relatively small at 4.3%. In terms of ownership, private estates accounted for the largest share of 52.3% of the total oil palm

Table 1.8
Oil Palm: Area, Production and Yield

	1996	1997*p*	1996	1997*p*
			Annual change (%)	
Area ('000 hectares)				
Planted	2,692	2,785	6.0	3.4
Mature	2,353	2,446	4.9	3.9
Production ('000 tonnes)	8,386	9,062	7.4	8.1
Yield (tonnes/mature hectare)	3.55	3.63	1.4	2.3

p Preliminary

Source: Department of Statistics
PORLA

cultivated area or 1.5 million hectares. These were followed by organised smallholder schemes under the Federal Land Development Authority (FELDA), Federal Land Consolidation and Rehabilitation Authority (FELCRA) and the Rubber Industry Smallholders Development Authority (RISDA) which accounted for 30% or 831,619 hectares. The schemes under the States and independent smallholders accounted for the remaining share of 17.7% or 497,292 hectares.

In 1997, an additional 25 new palm oil mill licences were issued by the Palm Oil Registration and Licensing Authority (PORLA). With the opening up of large areas of land for oil palm plantations, Sabah received the largest number of licences for new mills (21) during the year, bringing the total number of mills approved in the State to 96. On the other hand, only three licences were granted for Peninsular Malaysia and one licence for Sarawak. Meanwhile, the number of mills in operation increased further to 306, with an aggregate capacity to process 55.8 million tonnes of fresh fruit bunches annually. By region, there were 239 mills operating in Peninsular Malaysia, 56 in Sabah and 11 in Sarawak. Following the seasonal trend in palm oil production, the average rate of capacity utilisation of the mills increased to 96.3% in the second half of the year, from 80.3% during the first half of the year. For the year as a whole, the average rate of capacity utilisation improved to 88.3%, from 86.2% in 1996, in response to higher production of palm oil during the year.

Consistent with higher production, domestic processing of crude palm oil increased further by 8.4% to 8.9 million tonnes in 1997. During the year, the Malaysian Industrial Development Authority (MIDA) approved three new refineries. At the same time, seven licences were cancelled for refineries that were no longer in operation. As a result, the total number of refineries approved as at end-1997 declined to 67, compared with 71 in 1996. Meanwhile, the total number of refineries in operation increased to 44, with an annual capacity to refine 11.6 million tonnes of crude palm oil and crude palm kernel oil. Although the OER improved slightly to 19.03% in 1997, this was still lower than the record level of 19.87% achieved in 1988. This was due to the indiscriminate collection of ripe and unripe oil palm fruit by harvesters, and labour shortages. The latter was particularly acute in the oil palm estates, thereby resulting in a lower harvest as many loose fruits were left uncollected.

Natural rubber production continued to decline for the third consecutive year, with the production level declining significantly by 10.4% to 970,266 tonnes, a level not seen since 1965 when total production had fallen to 916,940 tonnes. The decline in rubber production during the year was due mainly to a prolonged period of low rubber prices. During the first half of the year, rubber prices fell in response to increased supplies from Indonesia.

Table 1.9
World Elastomer: Production and Consumption

	1997*e*		1996	1997*e*
	'000 tonnes	% share	Annual change (%)	
Production	16,267	100.0	4.6	1.2
Natural rubber	6,240	38.4	7.8	-1.6
Thailand	1,946	12.0	9.6	-1.6
Indonesia	1,552	9.5	5.2	0.6
Malaysia	980	6.0	-0.6	-9.4
India	507	3.1	8.0	-6.2
People's Republic of China	444	2.7	19.4	3.3
Sri Lanka	109	0.7	6.1	-2.8
Nigeria	91	0.6	-2.2	-0.4
Other	611	3.8	22.4	8.4
Synthetic rubber	10,027	61.1	2.6	2.9
Consumption	16,747	100.0	2.6	6.8
Natural rubber	6,573	39.3	2.2	7.2
Synthetic rubber	10,173	60.7	2.8	6.5
Deficit(-)/surplus(+)	-480			

e Estimate

Source: Department of Statistics
International Rubber Study Group

News of a major strike by Goodyear workers in April also affected market sentiment. During the second half of the year, rubber prices remained weak. As rubber was traded in ringgit, it did not benefit from the depreciation of the ringgit. The low prices further dampened tapping activities that were already affected by the continued decline in the total area under rubber cultivation. In Peninsular Malaysia (which accounted for 80% of the total area under rubber), the cultivated area declined further by 1.9% to 1,314,900 hectares, following the continued conversion of rubber land to other more lucrative crops and economic activities. Labour constraints as well as widespread heavy rain and consequent floods contributed further to the decline in tapping and collection activities, resulting in a considerable drop in productivity. Notwithstanding the continued decline in the production of local natural rubber, Malaysia is still a net exporter of the commodity, ranking third after Thailand and Indonesia.

On a regional basis, output from Peninsular Malaysia, which accounted for 96.4% of the total rubber production, declined by 9.6% to 935,804 tonnes. Production by both the smallholders and estates declined further by 10.6% and 9.4% respectively. Similarly, rubber production in Sabah and Sarawak also recorded a significant decline of 16.2% and 55.8% respectively. Lower local production of rubber had, to some extent, caused a shortage of domestic latex, a major raw material in the manufacture of rubber gloves. Presently, Malaysia is the world's largest producer of examination gloves. To meet the demand by domestic manufacturers, imports of rubber, mainly latex (40% of the imported rubber), increased by 59.5% to 431,491 tonnes, two-thirds of which were sourced from Thailand.

Table 1.10
Rubber: Area, Production and Yield

	Estates		Smallholdings	
	1996	1997*p*	1996	1997*p*
	'000 hectares			
Planted area	232	226	1,435	1,418
Replanting	7	7	56	46
Newplanting	8	8	103	106
Production ('000 tonnes)	238	215	845	755
Yield (kg./mature ha.)	1,079	984	791	688

p Preliminary

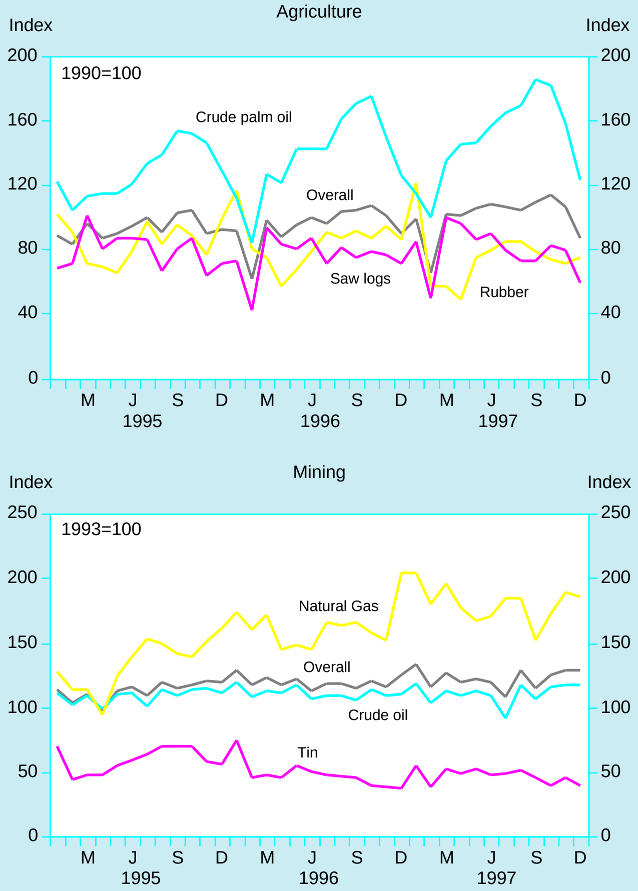
Source: Department of Statistics
Malaysian Rubber Research and Development Board
Department of Agriculture, Sarawak
Sabah Rubber Fund Board

During the year, RISDA allocated a total of RM211 million to finance replanting projects and another RM2.5 million for the rehabilitation programme to assist smallholders with difficulties in their previous replanting projects. The replanting projects involved a total of 21,632 hectares of rubber land, while the rehabilitation programme covered 1,595 hectares. This programme is aimed at ensuring that smallholders who currently contribute 78% of the country's rubber production continue to play a significant role in the rubber sector.

Production of **saw logs** turned around to increase by 4.3% to 31.7 million cubic metres in 1997. The increase in saw log production was mainly due to higher production from Sarawak and Sabah, while Peninsular Malaysia recorded a decline. Output from Sarawak, which accounted for 53% of the total saw log production, increased by 2.8% to 16.8 million cubic metres. The higher production was also due to logging in the agroconversion area as well as in the Bakun Hydroelectric project. However, heavy and thick haze during August and September led to lower production in the second half of the year, as harvesting operations were halted due to poor visibility. Saw log production from Sabah, which accounted for 21.7% of the national saw log production, increased by 21.8% to 6.87 million cubic metres. This was due entirely to the late submission of the previous year's production data, which amounted to 2.9 million cubic metres. Excluding the backlog, saw log production in Sabah declined further by almost 30%. This reflected the depletion of logging areas and the expiry of small logging licences as well as the declining number of active logging licences. Furthermore, in compliance with the Government's target of sustainable forest management by the year 2000, no new logging licences were issued during the year. On the other hand, saw log production in Peninsular Malaysia, which contributed 25.3% of the national production, declined by 4.5% to 8.04 million cubic metres following a reduction in the logging area as well as in compliance with quotas set by the state authorities under the sustainable forest policy.

The production of **cocoa** continued its downtrend in 1997 for the seventh consecutive year. Although

Graph 1.7
Production Indices



cocoa prices in local currency improved strongly during the second half of the year following the ringgit's depreciation, production of cocoa beans declined significantly by 10.7% to 107,176 tonnes, the lowest since its peak production level in 1990. Total production for the year as a whole was affected by the prolonged dry weather in Sabah which affected the fruit setting for the second season, which normally contributed two-thirds of the annual production. At the same time, while there was no conversion of other crop areas into cocoa, about 8,000 hectares of cocoa area were felled and converted to other profitable ventures, especially oil palm. The conversion was actively carried out by the estates in Sabah, which accounted for 84.8% of the total felling, followed by Peninsular Malaysia (13.4%) and the balance in Sarawak. Cocoa output was also affected by rising labour cost which formed a significant portion of the local cost of production, and escalation in the prices of agricultural inputs. With the lower production of cocoa beans, the domestic cocoa processing industry had to import cocoa, particularly from Indonesia. Nevertheless, with favourable weather conditions and as more of the rehabilitated areas reached maturity, productivity in the cocoa sector is expected to improve in the near future.

In 1997, the production of the **fishing** industry turned around to increase by 1.9% to 1,260,088 tonnes. The improved performance in fish production was due mainly to the 2.9% increase in marine fisheries, which accounted for 92% of total fish production. This included inshore fisheries with a total production of 1,023,376 tonnes, while deep sea fishing produced 135,528 tonnes. Total production from aquaculture, however, declined by 7.9% to 101,184 tonnes. Although the total supply of fish increased during the year, it was insufficient for local consumption (per capita consumption of fish is estimated at about 39 kilogrammes in 1997). As a result, the importation of fish increased further by 2.9% to 245,810 tonnes, the bulk of which was from Thailand.

Value added in the **mining** sector moderated further to 2% in 1997, compared with 4.5% in 1996. The slower growth reflected mainly the decline in crude oil production, the first decline since 1993. At the same time, the production of tin decelerated further, attributed mainly to the depletion of tin reserves despite an increase in local tin prices following the ringgit depreciation in the second half of the year. In tandem with the slowdown in construction activities, growth in the quarrying sub-sector moderated to 10.6%. Meanwhile, the production of natural gas remained strong, spurred by continued domestic and international demand. With the slower growth in the mining sector, its share of GDP declined to 6.8% (7.2% in 1996), while its contribution to employment remained stable at 0.5%. Nevertheless, in terms of exports, the share of the mining sector in total export earnings was higher at 7% (6.6% in 1996), reflecting mainly valuation gains from the ringgit depreciation.

In 1997, the production of crude petroleum including condensates, declined marginally by 0.5% to 714,209 barrels per day (bpd). Crude petroleum output was significantly higher in the fourth quarter of the year, following the Government's decision to increase production. However, this was not sufficient to offset the lower production recorded in the earlier quarters. Consequently, for the year as a whole, excluding condensates, crude petroleum production was lower, at 629,297 bpd (645,664 bpd in 1996). Meanwhile, output of condensates increased to 84,912 bpd (70,046 bpd in 1996), in view of higher production of natural gas. On a regional basis, output from Peninsular Malaysia recorded an increase of 3.2% to 429,012 bpd, to account for the largest share of 60.1%. Similarly, output from Sabah increased significantly by 29.2% to 62,474 bpd, with a share of 8.7%. In contrast, Sarawak registered a decline of 12.2% to 222,723 bpd or 31.2% of the total national output mainly due to an unplanned shutdown at Baram Delta Operation (BDO). As at the end of 1997, the total number of oilfields in production increased to 34, with one new oilfield in Peninsular Malaysia. Consequently, Peninsular Malaysia has 14 oilfields, while Sarawak and Sabah have 13 and 7 respectively. In the upstream sector, nine production sharing contracts were signed in 1997, of which two were in Sarawak, four in Sabah, and three in Peninsular Malaysia. In addition, one oilfield located offshore at Terengganu was discovered.

In response to the continued demand from local and international markets, net natural gas production increased strongly by 12.8% to 3,846 million standard cubic feet per day. This reflected the strong external demand for liquefied natural gas (LNG) from traditional buyers. During the year, the volume of LNG exported to Japan, Korea and Taiwan, ROC, increased significantly by 18.6% to 15.3 million tonnes. On the domestic front, demand for natural gas expanded further, emanating mainly from the Peninsular Gas Utilisation (PGU) and MLNG projects as well as other gas-based industries. During the year, the construction of Sectors 2 and 3 of the PGU III project was completed as scheduled. This involved the construction of 265 kilometres of main pipelines from Sitiawan, Perak to Pauh, Perlis to supply gas to PETRONAS Fertiliser (Kedah) Sdn. Bhd. in Gurun, Kulim High Tech Park and the Independent Power Producer (IPP) operated by Teknologi Tenaga Perlis in Kuala Sg. Baru.

Table 1.11
Mining: Production

	1996	1997*p*	1996	1997*p*
	'000 tonnes		Annual change (%)	
Tin-in-concentrates[1]	5,174	5,060	-19.2	-2.2
Crude oil[2]	715,710	714,209	1.8	-0.5
Bauxite	219	279	19.0	27.4
Iron-ore	325	228	60.9	-29.8
Copper	87	81	0.0	-6.9
Natural gas[3]	3,402	3,746	21.4	12.8

[1] Expressed in tonnes
[2] Expressed in barrels per day
[3] Expressed in mmscfd
p Preliminary

Source: Department of Mines
PETRONAS

Meanwhile, 10 gas fields were in production in 1997, with five each in Peninsular Malaysia and Sarawak. A gas field located offshore at Terengganu, was discovered.

The production of tin-in-concentrates continued to record a decline for the eighth consecutive year since 1990. Despite a significant increase in local prices, particularly in the second half of the year, the output of tin-in-concentrates declined further by 2.2% to 5,060 tonnes. Although production from dredging, panning and retreatment increased during the year, it was offset by the decline from other modes of mining such as gravel pump, open cast and underground which, as a group, accounted for 61.4% of the total output. Overall, the lower production was due to the reduction of mines in operation to 34 at end-1997, from 35 in 1996. In 1997, Malaysia remained the seventh largest producer of tin in the world.

Despite the decline in production, total domestic consumption of tin metal increased by 9.4% to 6,562 tonnes, reflecting higher demand from domestic tin-based industries. Utilisation of tin metal by the solder industry, which accounted for more than one-half (53.2%) of total domestic consumption, increased marginally by 1% to 3,490 tonnes, supported by strong demand in the electronics industry. Similarly, demand for tin by the tin plate industry also recorded an increase of 4.8% to 903 tonnes, making the industry the second largest consumer with a share of 13.8%. This was followed by the pewter industry, with demand increasing strongly by 18.6% to account for a share of 11.9% of total demand. Reflecting the continued decline in domestic production, the local smelters continued to import foreign tin-in-concentrates for their smelting operations in 1997, mainly from Peru, Australia, Portugal, South Africa and Bolivia. As a result, Malaysia has become a net importer of tin.

Following a strong growth of 8.4% in the first three-quarters of 1997, the performance of the **services** sector showed signs of being adversely affected by the financial market turbulence. In the last quarter of 1997, the value added for the services sector grew by 6.4%, the lowest quarterly growth since 1988. Consequently, growth for the year as a whole moderated to 7.9%, marginally higher than the GDP growth of 7.8%. Following the trend in recent years, growth continued to be led by intermediate services, while the final services sub-sector grew at a more moderate pace. Despite the slower growth, the services sector remained the largest sector in the economy, with a share of 44.8% of GDP. The services sector also accounted for the largest share of employment (47.5%).

During the year, **intermediate services** comprising transport, storage and communications; and finance, insurance, real estate and business services provided the main impetus to growth, expanding by 10.1%. Strong growth was recorded in all sub-sectors, especially in the first three quarters of the year. Growth in the **finance, insurance, real estate and business services** sub-sector remained strong at 10.2%, although marginally lower than the average annual growth of 10.8% during the period 1991-95. This increased the sub-sector's share in real GDP and the services sector to 11.6% and 25.9% respectively. The higher value added in this sub-sector reflected the strong credit expansion by the banking sector, particularly in the first half of 1997 when credit expanded by RM46.5 billion, before moderating to RM36.1 billion in the second half of 1997. The performance of this sub-sector was dampened by the decline in prices and significant moderation in the volume of shares traded on the Kuala Lumpur Stock Exchange, particularly towards the end of 1997. Value added in the finance sub-sector was also affected by the slower growth in the insurance industry as evident by lower estimates in premium income collection of 13.7% in 1997 (20% in 1996).

Notwithstanding the slower growth in the last quarter of 1997, value added in the **transport, storage and communications** sub-sector continued to record a high growth of 10%, to account for 7.6% of GDP in 1997. The stronger growth was attributed mainly to the increase in transport activities to support the increase in the volume of domestic and international trade. Growth was stronger in the first half-year at 11.8%, but slowed down in the second half to 8.3% as the financial crisis adversely affected trade. However, for the year as a whole, three major industries under this sub-sector, namely, rail, air transportation and shipping, recorded higher growth. In the rail transportation services, notable progress was achieved in commuter train services. Passenger revenue of the commuter train services increased significantly in 1997, following the increased frequency of Keretapi Tanah Melayu Berhad commuter trips and the introduction of the Light Rail Transit within the Kuala Lumpur city centre at the end of 1996. In terms of air transport, Malaysia Airlines increased its capacity by expanding its fleet as well as augmenting its flight frequency to more destinations. The transport sub-sector also benefited from the continued buoyancy of the shipping industry. This was reflected in the increase in the acquisition of ships and tankers by the local shipping industry as well as strong performance in local port services. In 1997, at least 25 ships and tankers, valued at RM2.2 billion were purchased by several major shipping companies. Local port facilities and services also expanded further following vigorous efforts by the Government to enhance the role of Malaysian ports in serving its international trade. Currently, approximately 35% of Malaysia's international trade still goes overland via Singapore, while 80% of the total container volume from Penang and 40% from Port Klang are feedered via Singapore. To promote the development of Port Klang as a prime transhipment and regional load centre and to encourage value added transhipment activities, the Government has gazetted the North, South and West Ports as Free Commercial Zones. This complemented an earlier measure in 1993 when the cabotage policy was relaxed to allow foreign ships to provide feeder cargo services from Penang Port

Table 1.12
Growth in the Services Sector in 1978 Prices

	1996	1997*p*	1996	1997*p*
	Annual change (%)		% share of GDP	
Services	**9.7**	**7.9**	**44.8**	**44.8**
Intermediate services	12.6	10.1	18.8	19.2
Transport, storage and communications	9.8	10.0	7.4	7.6
Finance, insurance, real estate and business services[1]	14.6	10.2	11.3	11.6
Final services	7.6	6.3	26.0	25.6
Electricity, gas and water	12.0	13.5	2.4	2.5
Wholesale and retail trade, hotels and restaurants	9.3	7.5	12.4	12.3
Government services[2]	4.2	3.3	9.1	8.7
Other services[3]	8.4	5.1	2.1	2.0

[1] Includes imputed rent from owner-occupied dwellings.
[2] Includes general public services (general public administration, external affairs and public order and safety), defence, health, education and others.
[3] Includes community, social and personal services, product of private non-profit services to households and domestic services of households.
p Preliminary

Source: Department of Statistics and Bank Negara Malaysia.

Box I

Potential Output in Malaysia

In the 1995 Annual Report, the Bank raised concerns over the sustainability of the strong economic growth over a long period as strains began to emerge in the form of supply bottlenecks that were manifested through labour shortages as well as infrastructure constraints. While macroeconomic management enabled consumer prices to remain under control, the current account deficit widened considerably. These developments in an environment in which the rapid pace of industrialisation and the buoyancy of demand had exceeded the underlying expansion of supply capacity has brought to the forefront, the significance of the concept of **potential output**. The concept of potential output and the implied output gap is defined as that level of output in the economy at which there are no inflationary pressures or external imbalances. Nevertheless, operating at close to potential output or the supply capacity could increase inflationary pressures.

Two possible approaches have been used to measure potential output and thereby ascertain whether the economy is operating at above supply capacity. Firstly, a production function of the economy can be specified and then solved for some equilibrium rates of factor utilisation to estimate potential output. This method, however, assumes that there exists a stable long-run relationship between output and the factors of production. The second approach attempts to create some form of "trend" or "underlying" output based on the assumption that deviations from this equilibrium level of growth will eventually correct themselves. The advantage of the latter approach is the ability to take account of structural developments and changes in relationships over time. The "trend" approach is particularly useful when data is insufficient or unreliable. However, this method is unable to provide more than simple insights.

This Article estimates potential output based on a relatively simple production function approach, utilising a single equation. The following production function was used:

$$Y_t = f(KCU_t, L_t)$$

where KCU represents the utilised level of capital stock (that is, capital stock multiplied by the average level of capital utilisation) and L represents the labour force in employment. From this relationship, the KCU and L were substituted with K and L* to derive the potential output. K represents full utilisation of available capital and L* represents the potential employment, that is, the labour force in employment that is consistent with the "natural" or "long-run" rate of unemployment[1].

In the absence of reliable quarterly estimates of capital stock, annual data were used. Output was defined as real gross domestic product (GDP) at purchasers' value while capital stock estimates were based on estimates made by the World Bank and extended using the perpetual inventory method[2]. Capital utilisation rates were based on capital utilisation in the manufacturing sector as captured in the various Bank Negara Malaysia surveys of that sector. Labour was defined as the number of workers in paid employment.

A number of interesting features emerged from the estimation results. The absolute value of the error-correction factor indicated a stable long-run relationship. However, the estimate of the long-run elasticity of labour appeared to be unusually large while that of capital was small. This seemed to imply increasing returns to scale and poor utilisation of capital although the Wald Co-efficient Restriction Test did not verify this hypothesis.

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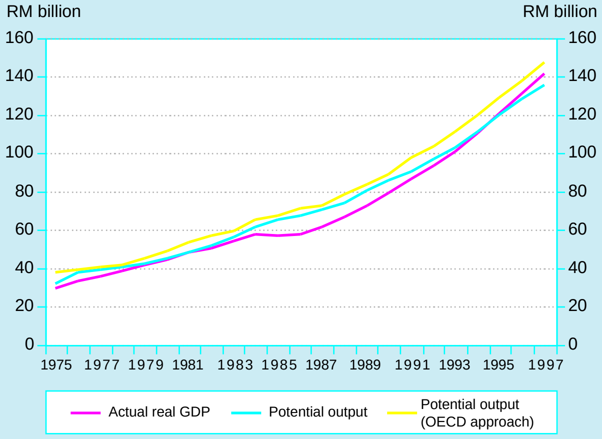
[1] In this case, the "natural" or "long-run" unemployment rate is not an explicitly defined Non-Accelerating Inflation Rate of Unemployment (NAIRU) but is a rate of unemployment that has been cyclically adjusted. Assuming that the economy operates at the NAIRU over the course of the cycle, then the cyclical natural rate should be approximately the same as the NAIRU.

[2] Explicitly the perpetual inventory method can be written as $K_t = K_{t-1}(1-\delta)+I_t$ where K represents capital stock, I represents investment and δ the depreciation rate. Real gross fixed capital formation was used as the proxy for I and δ was set as 7.2%, the average scrapping rate used by the World Bank.

A possible reason that the estimates differed from theoretically predicted values could be the continuous structural changes in the Malaysian economy over the last 27 years. As the economy has moved towards greater capital intensity, the single equation approach may have underestimated the true level of capital elasticity, especially between 1988 and 1997. Secondly, the estimates of capital stock may have to be refined to take into account investment in “productive” capital, namely, plant and machinery and “less productive” capital, which would encompass most forms of infrastructure. The significant share of investment in infrastructure over the last decade could account for the low impact of some of the capital building on the economy.

The results of this study showed that the growth of potential output for the Malaysian economy during the period 1970–97 averaged 6.9% as compared with the actual output growth of 7.4%. However, it would be too simplistic to conclude from such a simple comparison that the economy was operating above its supply capacity. This simple model merely takes into account two factors of growth and does not incorporate productivity and human capital gains in the 27-year period of the sample. Under these circumstances, the underlying growth of potential output would be underestimated. In the earlier period between 1970 and 1987, the economy expanded at a slower rate of 6.27% compared with an average annual growth in potential output of 6.89%. However, from 1988 to 1996, actual growth was faster at 8.86% compared with potential output growth of 6.94%. In 1997, however, growth in the economy moderated to 7.8%.

Graph I.1
Real GDP: Actual versus Potential



A further measure of potential strains on the economy is the output gap, defined as the difference between actual and potential output. When actual output is above potential – output gap is positive – inflationary pressures would be expected to increase. During the period 1970–97, the gap averaged -5.49% as a proportion of potential GDP, indicating spare capacity in the economy for most of the period. However, this gap had continuously narrowed from -14.18% in 1986 until 1995 when actual growth was in tandem with supply capacity. Between 1988 and 1996, the gap averaged -4.33% of potential output but narrowed to average -2.63% between 1990 and 1996. This indicates that continuous high growth since 1988 had increased the pressure on the country’s supply of resources and the average inflation rate had increased from 3.53% to 3.78% over the same two periods. In the period 1990–95, the negative potential output gap had narrowed, suggesting the need for vigilance against possible dangers of inflation. After 1995, the output gap became positive but inflation remained low with the adoption of an anti-inflation package, including monetary restraint, fiscal prudence and stricter enforcement of administrative measures.

To further test the robustness of the estimates, the natural rate of unemployment was re-estimated based on the method employed by the OECD in its estimation of potential output. This yielded the following results. Firstly, the estimate of the natural rate of unemployment using this method tracked the simple trend estimate closely. Secondly, the average growth of potential output was actually lower at 6.50% compared with 6.85% under the production function approach. Thirdly, the trend of the gap for both methods was similar, with the gap narrowing between 1988 and 1995 as well as the requisite widening during the two recessions in the mid-1970s and the mid-1980s. However, the size of the gap was much larger using the OECD approach. On average, the gap was -10.74% of GDP. Taking the period between 1988 and 1996, the gap only narrowed slightly to -9.94%. Between 1990–95, the gap was -8.69%. However, in the later years, the growth in potential GDP was higher at 7.5%, indicating that the economy had moved on to a higher plane.

Earlier studies include the Coe and McDermott study, which estimated the trend in GDP. The authors estimated the underlying GDP growth as 8.6% for Malaysia for the period 1990–94. Although a non-parametric trend approach was used, the underlying growth of potential output would have taken into account structural changes in the economy during that period, thereby allowing for higher growth potential.

The approaches in the above study have used de-trended series with no explicit behavioural assumptions. The results have essentially been similar as far as trends are concerned (that is, the underlying growth of potential output as well as the narrowing output gap) and the difference has been one of magnitude with the OECD approach giving larger values of potential output. The critical issue therefore seems to be the definition of the natural rate. However, shortcomings in the data do not allow for an appropriate behavioural relationship to generate a price (or wage)-consistent NAIRU. Nevertheless, all models seem to provide similar insights.

The above study needs, however, to be refined further to deal with the problem of estimating “natural unemployment” and technical change. Malaysia can be said to have a high rate of technical change (as reflected in the large co-efficient of the slope dummy in the model) as a result of convergence or “catching up”. This implies that the production frontier is not “well behaved” in a mathematical sense, that is, that relationships are liable to change over time and do so often. Finally, additional factors such as human capital, which have not been taken into account, could well push the frontier up, reducing the contribution of the “cyclical” factor. Furthermore, annual data for this period are clearly not sufficient to model these relationships with any degree of confidence and hence, the focus would be on developing credible quarterly estimates of capital stock. Such an effort would not only provide an improved indication of the underlying strength of the economy but it would also provide valuable insights into the efficiency of investment undertaken as well as the actual progress made towards achieving higher value-added growth.

to Port Klang. In addition, the electronic data interchange system was introduced and customs procedures and documentation for re-exports as well as the port tariff structure were reviewed with the aim of improving efficiency. Latest estimates for five major ports in Malaysia showed that cargo handled by these ports increased significantly by about 11.5% to 137.4 million freightweight tonnes (f.w.t.) in 1997 (123.2 million f.w.t. in 1996). Container throughput of these ports also increased significantly by about 16.7% to 2.8 million twenty-foot equivalent units (TEUs). In the communications sub-sector, the performance of telecommunications services was also encouraging in 1997. During the year, applications for new telephone lines grew by 12%, with the number of business subscribers increasing by 13.1% to reach 1.2 million, while residential subscribers increased by 11.5% to 3.1 million.

The financial crisis in the second half of 1997 had a marked impact on the growth of the **final services** group, which moderated to 6.3%. In particular, growth in wholesale and retail trade, other services and government services moderated. This was offset to some extent by the strong increase in the utilities sub-sector. Wholesale and retail trade was affected by the loss of wealth arising from the decline in stock prices. Provision of government services moderated due to deliberate policies to contain expenditure in 1997. With the moderation in income growth during the second half of 1997, value added in the **wholesale and retail trade, hotels and restaurants** sub-sector moderated to 7.5% in 1997. In the first half of the year, this sector recorded a growth of 8% before moderating to 7% in the second half of 1997. The moderation reflected a slowdown in private consumption as indicated by the slower increase in service tax collection and the moderation in revenue of wholesale and retail trade. In 1997, service tax collections moderated to 19.8% compared with 21.2% in 1996. Likewise, the sales value of domestic-oriented industries, one of the indicators for the wholesale and retail trade sub-sector, moderated to increase by 14.4% in 1997, from a growth of 19.6% in 1996. The slowdown in this sub-sector was aggravated further by the slowdown in the hotel and restaurants industry as a result of the decline in tourist arrivals, mainly because of the haze condition during the months of July-October 1997. Consequently, the occupancy rates of hotels dropped from a norm of 60-65% to as low as 30-50% for some hotels in the Kuala Lumpur Golden Triangle area. Nevertheless, the wholesale and retail, hotel and restaurants industry retained its dominance in the services sector to account for the largest share of 12.3% of GDP.

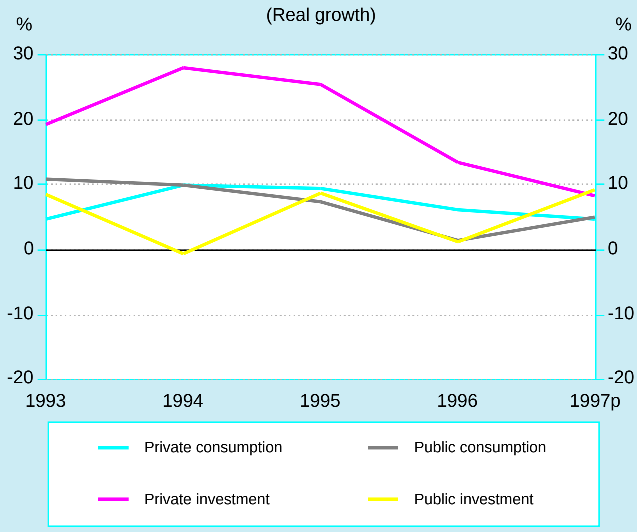
Growth in the **Government services** sub-sector moderated to 3.3% in 1997 (4.2% in 1996) resulting in a decline in its share of GDP to 8.7% from 9.1% in the previous year. The moderation was in line with the Government's efforts to rightsize the civil service and the role of the Government in the economy. Nevertheles, the Government continued to provide improved public services and amenities to facilitate private sector activities.

In tandem with the continued strong demand by the industrial and commercial sectors as well as by households, value added in the **utilities** sub-sector, comprising electricity, gas and water, grew strongly by 13.5%. Higher growth in this sub-sector was due entirely to stronger growth (15%) recorded in the first half of 1997, compared with a growth of 12% in the second half of the year. Supply of electricity as reflected in the Industrial Production Index (1993=100) expanded by 14.2% in 1997, compared with 12.8% in 1996. The electricity consumed by the industrial sector accounted for a major share of electricity consumption with the rest distributed among commercial (27.3%), domestic (16.3%) and public lighting (0.7%). The growth of this sub-sector was also driven by the strong expansion in capacity generation. Approximately 1,400 megawatts of new capacity came onstream in 1997. The biggest project was the Segari Energy Venture plant in Lumut (with a total capacity of 652 megawatts), followed by the Pergau project (600 megawatts), Melaka (110 megawatts) and Sungai Piah (55 megawatts). To date, the Government has issued approvals and licences to a total of 15 Independent Power Producers (IPPs) with a total capacity approaching 10,000 megawatts by the next century, excluding other new entrants and variants such as co-generation plants to serve specific buildings or installations. On the other hand, growth in water consumption, another component of the utilities sub-sector, was moderate, increasing by an annual rate of 3% to 8,000 million litres per day in 1997, the same growth as recorded in 1996. Overall, production capacity of water in 1997 was 9,800 million litres per day, an increase of 1% compared with a growth of 2% in 1996.

Domestic Demand Conditions

Aggregate domestic demand (excluding changes in stocks) increased at a more moderate pace in 1997. The slower increase reflected the further tightening of macroeconomic policies during the year in order to consolidate the reduction in demand pressures achieved in 1996 and to strengthen economic fundamentals following the emergence of the regional financial difficulties. The slower economic growth and the unprecedented decline in the value of the ringgit and share prices contributed to the softening in domestic demand particularly in the latter part of the year. In current prices, total domestic expenditure increased by 9%, slower than the growth of 9.9% in 1996. In real terms, the increase was 6.4% compared with 7% over the same period. The slower increase in demand was due to a deceleration in the growth in private sector expenditure as a result of a more moderate increase in both private consumption and investment. Public sector expenditure expanded at a faster pace, due mainly to higher investment by the non-financial public enterprises.

Graph 1.8
Domestic Demand Aggregates



Overall, consumption spending which constituted about 57% of total domestic demand, was sustained at an annual growth of 4.8% in real terms (4.9% in 1996). Public consumption increased moderately by 4.8% while private consumption spending grew at a slower rate of 4.7% (1.4% and 6% respectively in 1996). The moderate increase in **public consumption** was due to higher outlays on supplies and services to ensure the smooth running of the Government machinery and to provide improved public services and amenities. The moderation in **private consumption** reflected largely the impact of measures implemented to discourage excessive consumption and promote savings. These measures included the launching of the National Savings Campaign in December 1996 to encourage voluntary savings, and the imposition, in October 1997, of more stringent guidelines on hire-purchase loans for the purchase of non-commercial passenger vehicles and higher import duties on consumer durables and motor vehicles to curb imports. The negative wealth effect resulting from the weak performance of the stock market, slower income growth and lower tourist arrivals as a result of negative reports on the haze situation also dampened overall private consumer spending. At the same time, uncertainty on the short-term growth prospects and employment outlook due to the financial crisis also led to increased caution in consumer spending.

A number of major consumption indicators showed a moderation in the growth of private consumer spending. Although sales of passenger cars increased in 1997, the 12.3% growth was about one-half the increase recorded in 1996 (22.8%). In particular, sales of passenger cars, especially the luxury and higher capacity cars, were sharply lower in the last two months of the year as a result of higher import duties imposed in the 1998 Budget. The growth in loans extended by the banking institutions for consumption credit moderated to 29% at end-December, while sales tax collection increased slightly to 12.7%. Imports of consumption goods increased by only 1.3% in terms of the United States dollar, although it recorded a stronger growth in ringgit terms (12.4%) due to the depreciation of the currency. Similarly, the Business Expectations Survey of the Department of Statistics showed that revenue from wholesale and retail trade grew by 7.6% in 1997, compared with 9.1% a year ago. The sharp decline in the stock market indicators resulted in a negative wealth effect, contributing significantly to the moderation in private consumption.

Gross investment in nominal terms increased at a marginally slower rate of 11.2% in 1997 compared with 12.1% in 1996, due to a slight moderation in private investment growth. **Private investment** increased by 11% to RM85.5 billion (15.8% in 1996). The continued expansion was underpinned by higher investment in the productive sectors, in particular the manufacturing and the oil and gas sectors, while investment in the services sector increased at a slower rate. The investment sentiment remained strong in 1997 but was dampened somewhat towards the end of the year following increased uncertainties in the regional financial markets. The moderation in the rate of investment towards the latter part of the year reflected a slowdown in the rate of investments in the construction, finance, insurance and business and energy sub-sectors arising from the deferment of projects as well as the scaling down of some on-going projects which were considered less essential.

The positive investor sentiment was reflected in a number of private investment indicators. Loans extended by the banking system to both the manufacturing and broad property sectors registered a strong growth of 18.3% and 32.5% respectively in 1997. Similarly, imports of capital goods recorded a larger increase of 6.9% in terms of the United States dollar (-0.2% in 1996). However, while the value of manufacturing investment approved by the Ministry of International Trade and Industry (MITI) in 1997 was high at RM25.8 billion, it represented a 24.8% decline from the record level of RM34.3 billion approved in 1996. The decline was due largely to lower approvals of big projects (10 big projects worth RM13 billion, compared with 15 projects worth RM19.5 billion in 1996). The investment approvals continue to indicate an increasing shift towards greater automation and capital intensive production processes in the manufacturing sector.

In terms of sectoral composition of private investment, preliminary estimates showed that investment in the services sector expanded at a more moderate pace of 16.2% in 1997 (23.3% in 1996), to account for about one-third (RM29.1 billion) of total private investment. The sustained high investment in this sector reflected higher capital outlay in the transport sub-sector, due mainly to the expansion programmes in the airline and shipping industries and the on-going implementation of several rail projects. However, capital expenditure in the energy sub-sector was lower following the completion of several independent power plant projects as well as the deferment of the Bakun project. The development of the first phase of the Putrajaya and Cyberjaya townships and other strategic projects underpinned investment in the finance, insurance and business sub-sector. Following a reassessment of the supply expected to come on stream, investment in this sector moderated, in particular, in investments for office space and retail outlets in shopping malls. Capital outlay in the manufacturing sector increased further in 1997, by 12.2% to RM22.7 billion, accounting for a share of 27% of total private investment. The sustained strong manufacturing investment reflected the implementation of the large number of investment projects approved by MITI in recent years. Investment was estimated to be highest in the electrical and electronic products industry, representing mainly capital outlay for the production of computer motherboards, hard disk media and silicon wafers. Investments totalling RM12.4 billion were approved by MITI during 1994–97 for the establishment of wafer projects, in response to the provision of special fiscal and other incentives to promote high technology industries, especially those producing wafer fabrication products for the semi-conductor industry. Most of these projects are expected to come into production by 1999–2000. A large part of the investment in the chemical and chemical products industry reflected the on-going implementation of several large petrochemical projects in Kertih, Gebeng and Pasir Gudang. Meanwhile, investment in the basic metal products industry and the non-metallic mineral products industry also remained high. Reflecting continued demand for residential housing and on-going construction of privatised roads and other civil engineering projects, particularly in the Klang Valley, investment in the construction sector remained strong, amounting to RM9.5 billion or a share of 11% of total private investment. Capital investment in the agriculture and mining sectors amounted to RM2.7 billion and RM2.2 billion respectively or a share of 3% each.

Table 1.13
Private Investment by Sector[1]

	1995	1996	1997
	RM billion		
Private investment	66.6	77.1	85.5
Of which:	% share		
Manufacturing	27.2	26.3	26.5
Construction	9.7	10.4	11.1
Services	30.5	32.5	34.1

[1] Estimates

In terms of sources of investment, foreign direct investment remained important. In 1997, net inflows of foreign direct investment were sustained at RM19.2 billion, compared with RM19.4 billion in 1996. The non-oil private sector accounted for 93% of these inflows, particularly for investment in the manufacturing sector.

Public investment increased at a faster pace of 11.9% in 1997 (3.2% in 1996), due to significantly higher capital expenditure by the non-financial public enterprises (NFPEs), especially PETRONAS, Tenaga

Nasional Berhad (TNB), Telekom Malaysia Berhad and the Kuala Lumpur International Airport (KLIA), and a moderate increase in capital outlay by the general government. PETRONAS increased both its upstream and downstream investment during the year, which included the expansion of the gas processing plant, the completion of the Malacca Refinery Centre and expansion of gas transmission lines. Capital investment by TNB was mainly to expand and upgrade its power generation capacity, and its distribution and transmission networks to meet the demand for electricity by the commercial and industrial users. Higher capital spending by Telekom was mainly for the expansion and upgrade of the intemational and local networks, as well as investment in telecommunications infrastructure for the Multimedia Super Corridor projects and cellular infrastructure. The strong increase in investment for the KLIA project during the year reflected an acceleration in implementation to complete the construction of the first phase of the project in 1997. Meanwhile, higher investment by the general government was mainly to improve infrastructure facilities, expand the capacity of existing educational institutions such as polytechnics, technical schools and institutions of higher learning, and on health facilities and rural development.

Growth in **gross national savings (GNS)** rose at a more moderate rate of 15% following very rapid growth in 1996 (24.8%), reflecting the slower growth in nominal income. However, in terms of GNP, the share of GNS increased slightly to 40% from 38.5% in 1996, as a result of the slower growth in consumption. Malaysia's GNS continues to be very high by international standards. Meanwhile, growth in gross domestic capital formation increased further by 14.4% to account for 45.1% of GNP (43.6% of GNP in 1996), which led to a marginal increase in the savings-investment gap to RM13.4 billion (RM12.3 billion in 1996). The current account deficit of the balance of payments, however, stabilised at 5.1% of GNP. The national resource gap was more than adequately financed by the large net inflows of long-term capital, particularly foreign direct investment.

In the public sector, growth in savings increased markedly by 18.8% in 1997, reflecting better revenue performance as well as prudent fiscal discipline. With higher growth in public savings compared with public investment, the overall public sector resource balance improved significantly to a surplus of RM15 billion (RM11.8 billion in 1996). Private sector savings, on the other hand, slowed down to 12.1% in 1997 (27.7% in 1996). Given the more rapid growth of private investment (14.1%) vis-a-vis private savings, the private sector recorded a larger resource gap of RM28.4 billion (RM24 billion in 1996).

In an effort to promote a higher rate of domestic savings to meet the country's rising investment needs, the Government launched a nation-wide savings promotion campaign on 16 December 1996. The main objective of the campaign is to create public awareness on the importance of financial and non-financial savings. In the current economic environment following the sharp depreciation of the ringgit, the promotion of both forms of savings has become even more relevant and urgent. Non-financial savings essentially relates to prudent spending habits, conserving, economising and avoiding wastage, as well as more efficient consumption behaviour leading to surplus income, which could be saved.

In the initial phase of the savings promotion campaign, the strategy was to create public awareness on the importance of financial and non-financial savings and the spectrum of financial savings products offered by the financial institutions. Toward this end, BNM in co-operation with the financial institutions circulated two pamphlets which were made available to the public, namely, "The Importance of Savings" and "Financial Savings Products in Malaysia".

The savings promotion campaign is aimed at three main target groups, namely, students, workers and women. The campaign for school children was launched on 4 March 1997, with the aim of inculcating the savings habit among students and to encourage them to save for their future education. For this purpose, the financial institutions launched several new products under the Education Savings Scheme (ESS), in particular, savings for future education by students as well as long-term savings for education by parents/ guardians. These savings schemes offered several attractive features, including higher interest rates, with a minimum rate of 5%, and an initial minimum deposit of only RM1. At the end of December 1997, 30 commercial banks including Bank Islam, 3 non-bank financial institutions, 35 finance companies and 17 insurance companies participated in these schemes.

In addition, an “Adoption of School Programme” was introduced in April 1997. This programme is aimed at providing an opportunity for closer ties between financial institutions and students and to cultivate a positive savings habit among students. Financial institutions were urged to play a leading role in educating students to deposit their money with the financial system. Under this programme, government-aided primary and secondary schools were adopted by at least one financial institution. At the end of December 1997, 8,473 schools had been adopted by 85 financial institutions. Various activities were organised under this programme, including visits to banks, lectures and talks on the importance of savings, the role and functions of financial institutions and the introduction of financial savings products. The financial institutions were also encouraged to assist students to set up savings clubs in schools. Financial institutions are required to submit quarterly progress reports to BNM on these activities. At the end of December 1997, the financial institutions had mobilised a total of RM95.2 million in deposits from 238,690 student account holders, visited about 4,620 schools and helped establish 370 savings clubs.

Workers represent the largest potential source of voluntary savings. To promote the savings habit among workers, the “Savings Promotion Campaign among Workers” was launched on 3 May 1997, in conjunction with the Labour Day celebrations. After the launch, follow-up savings activities for workers were carried out at the factory level, aimed at encouraging them to save for specific purposes, especially for their children’s education, purchase of houses, fixed assets and consumer durables as well as for emergencies, health care and retirement.

As part of an on-going programme to facilitate the smooth implementation of the savings promotion campaign, representatives from the various committees and financial institutions involved in the campaign were invited to a three-day seminar on the “Japanese Experience in the Promotion of Savings” at BNM on 5–7 May 1997, as well as a one-day seminar at BNM on 26 August 1997. The latter was convened to explain the overall strategy of the national savings campaign to government agencies as well as financial institutions that were involved in the campaign.

The management of household expenses is an important element in the savings campaign. As housewives play an important role in managing household accounts, the savings campaign for the women’s group was focused on enhancing awareness on non-financial savings through conservation and avoidance of excesses as well as via proper budgeting and planning. The women’s savings campaign was launched on 24 October 1997, with the theme of “The Promotion of Non-financial Savings – Economising and Conserving”. A training programme on household financial management was conducted for 30 women leaders from various women’s organisations. After completing the programme, the women leaders returned to their respective home states and conducted similar seminars at the state and district levels.

While the first phase of the savings promotion campaign focused on enhancing awareness on the importance of savings, the second phase of the campaign in 1998 will emphasise activities relating to planning and budgeting for the immediate term as well as for the future. The aim is to encourage people to plan for the future, particularly for children’s education, marriage, housing, purchase of fixed assets and consumer durables, health care and retirement. Efforts will be directed at increasing public awareness about the benefits of planning and the financial commitments that are required to meet one’s plans for the immediate and long term. In this connection, activities will emphasise the importance of proper prioritisation, including the postponement of present consumption, in order to achieve a higher standard of living in the future. The long-term objective is to eventually change the consumption habits of Malaysians in terms of achieving a proper balance between savings and consumption.

To achieve the objective of encouraging life-time planning and budgeting, a guidebook on planning and budgeting will be distributed to the two main target groups, namely, workers and women. These publications provide guidance in identifying one’s goals and the financial requirements of achieving such goals. In addition, a “Household Account Book” will be introduced in 1998 to encourage the maintenance of proper records on household expenditure. The Education Savings Committee intends to introduce a “Pocket Money Account Book” in 1998 to assist students in monitoring their spending habits and to educate them to save the balances from their pocket money.

In the light of the current economic conditions, the need to increase public awareness on the importance of savings, to economise and spend prudently has become even more urgent. The strategy of the savings promotion campaign in 1998 will continue to be directed towards changing spending habits, with a view to economising and conserving resources. As the public learns to restrain and prioritise their spending habits in accordance with the changing economic environment and save their surplus income for the future, this will indirectly assist in containing inflationary pressures and promoting price stability in the country. The increase in savings will also provide additional funds to finance productive investment. The support of all Malaysians is essential for the success of the savings campaign which, in turn, will enhance the nation's economic prospects over the medium and longer term.

External Sector

Overall, the depreciation of the ringgit exerted some positive impact on the outcome of the **balance of payments** for 1997. Although the current account deficit increased moderately by RM1.1 billion to RM13.4 billion, the deficit stabilised at 5.1% of GNP and was lower than the level forecast at the beginning of 1997. The favourable impact from the ringgit depreciation was most evident in the better-than-expected performance of the trade account. The merchandise surplus was RM933 million higher than the level recorded in 1996. There was a significant improvement in the basic balance, comprising the current account and long-term capital account, to RM5.3 billion. This surplus showed that unlike in 1994 and 1995, the long-term capital inflows were more than sufficient to finance the current account deficit. Hence, the decline in international reserves in 1997 was primarily due to a large outflow of short-term capital, including intervention to support the ringgit exchange rate, estimated at RM14.2 billion. Overall, the higher surplus in the basic balance was not adequate to offset the net outflow of capital, resulting in the overall balance of payments reverting to a deficit of RM10.9 billion in 1997, from a surplus of RM6.2 billion in 1996. As at end-1997, net external reserves stood at RM59.1 billion or US$21.7 billion, sufficient to finance 3.4 months of retained imports.

Of significance was that the regional currency crisis did not result in a contraction in long-term capital inflows. The sudden and large depreciation

Table 1.14
Balance of Payments

Item	1997*e* +	1997*e* -	1997*e* Net
	RM million		
Merchandise balance (f.o.b.)	**218,734**	**207,646**	**11,087**
Balance on services	**49,834**	**70,624**	**-20,790**
Freight & insurance	3,216	12,165	-8,949
Other transportation	6,592	4,184	2,408
Travel & education	10,524	6,698	3,826
Investment income	6,767	20,291	-13,524
Government transactions n.i.e.	309	374	-65
Other services	22,426	26,912	-4,486
Balance on goods and services	**268,568**	**278,270**	**-9,703**
Unrequited transfers	2,255	5,952	-3,697
Balance on current account	**270,823**	**284,222**	**-13,400**
Official long-term capital			4,805
Federal Government	462	2,143	-1,681
Market loans	–	697	-697
Project loans	462	1,446	-984
Suppliers' credit	–	–	–
Non-financial public enterprises	9,526	3,046	6,480
Other assets and liabilities			6
Private long-term capital			13,900
Balance on long-term capital			18,705
Basic balance			**5,305**
Private short-term capital (net)			-14,229
Errors and omissions			-1,968
Overall balance (surplus +/ deficit -)			**-10,892**
Allocation of Special Drawing Rights			–
IMF resources			–
Net change in international reserves of Bank Negara Malaysia (increase - / decrease +)			10,892
Special Drawing Rights			-51
IMF reserve position			116
Gold and foreign exchange			10,827
Bank Negara Malaysia international reserves, net [1]			**59,123**

[1] The figure does not include an exchange revaluation gain of RM24.6 billion. Prior to 1997, holdings in foreign assets were revalued once, at year-end. However, in 1997, the accounting policy of recognising the foreign exchange revaluation gain or loss was changed, whereby, the exchange gain from the revaluation of foreign assets and liabilities was not recognised in the Bank's books. Nevertheless, full provisions will be made for any losses. The US dollar equivalent of international reserves as at 31 December 1997 was US$21.7 billion.

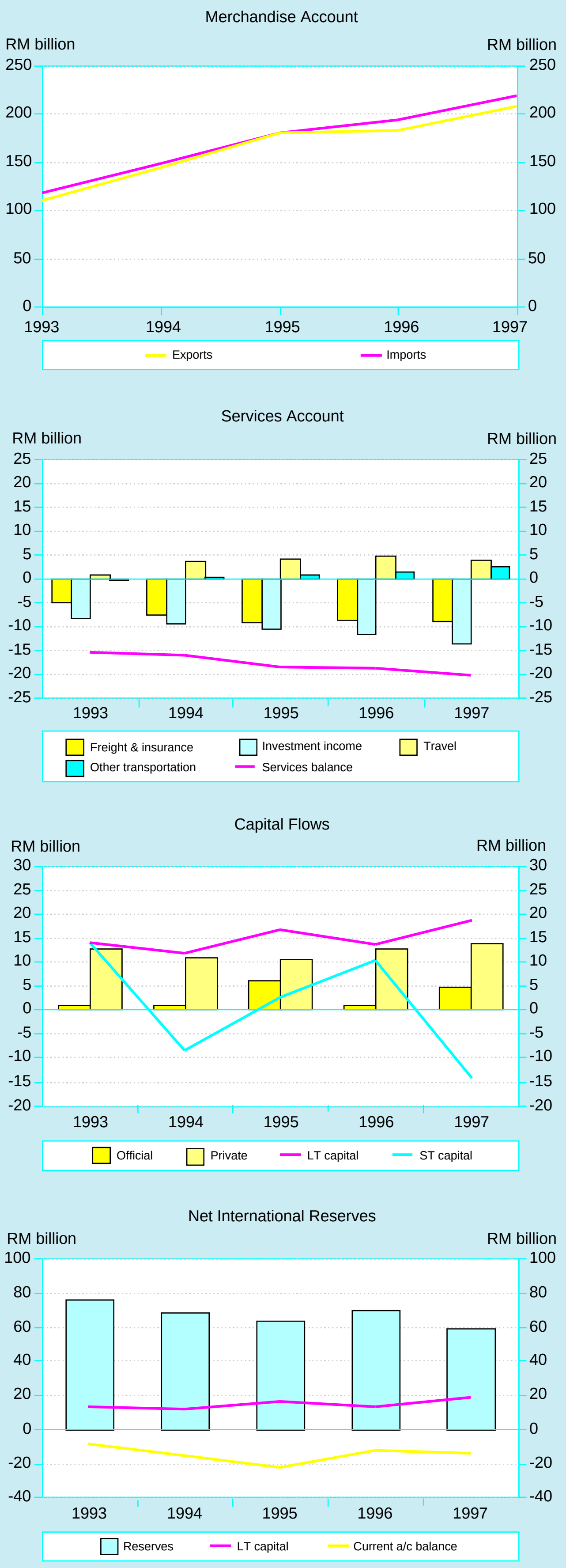
e Estimate

Source : Bank Negara Malaysia and Department of Statistics of the ringgit also did not cause a major disruption to annual servicing of interest and repayments by borrowers. The distinguishing development was that the currency crisis prompted the public and private sectors to postpone planned prepayments and refinancing of external loans scheduled for the second half-year, while some overseas investments were also deferred. Nevertheless, in the face of the depreciation of the ringgit and market concerns over the sustainability of the current account deficit, the strengthening of the balance of payments took on a sense of urgency. Hence, one of the critical elements of the policy packages introduced in the second half of 1997 was to contain excess demand via an appropriate mix of monetary and fiscal policies. The policies were aimed at addressing both short-term cyclical issues as well as accelerating the implementation of structural adjustment programmes already in place.

In 1997, the performance of the **merchandise account** was better than expected. The surplus of RM11.1 billion was RM933 million higher than the level registered in 1996. Reflecting the adjustment measures to reduce imports of lumpy investment goods, exports expanded faster than imports in the second half-year. Reflecting mainly the valuation gains from the depreciation of the ringgit, annual growth in merchandise exports accelerated to 23.3% in the second half-year, from 2.7% in the first half-year. Annual import growth also showed a similar trend, but the pick up in growth was less pronounced. Imports rose by 21% in the second half-year, from 5.7% in the first half-year. For the year as a whole, both exports and imports rose by about the same rate (13.3% and 13.5% respectively) to exceed the RM200 billion level for the first time in 1997. However, exports and imports in United States dollar terms recorded marginal increases of 0.7% and 0.8% respectively, as expansion in volume was offset to a large extent by the decline in the United States dollar prices of Malaysian exports.

The developments in the trade sector indicated clearly that Malaysia is in the transitional stage of moving away from labour intensive industries where Malaysia is losing competitiveness, to industries producing higher-end products. In the transitional stage, the corporations will be experiencing a period of consolidation. The depreciation in the ringgit has given an impetus for these companies in transition to consolidate and to adapt speedily via productivity improvements, to a changing competitive environment. The corporations in the manufacturing

Graph 1.9
Malaysia: Balance of Payments



sector are fully aware that the authorities would not be adopting a weak ringgit policy to maintain competitive strength.

Export earnings in the second half of 1997 improved significantly to increase by 22.5%, compared with only 1.9% in the first half-year. The expansion in export receipts was particularly strong from September to end-year, when growth accelerated from 12.8% in August to exceed 30% in the final quarter. This coincided with the period of sharp depreciation of ringgit exchange rates, from RM3.20 to the United States dollar in September to RM3.89 in December. However, the slower growth in the first half-year caused overall export receipts to expand by only 12.4% for 1997 as a whole (6.5% in 1996). All main categories of exports recorded higher growth during the year. However, in United States dollar terms, export growth was quite marginal, at 0.7% (6.2% in 1996), as the increase in export volume was offset by price declines. Keen competition arising from the larger exchange rate depreciation in countries in the region enabled overseas buyers to demand downward adjustments in United States dollar export prices.

The impact of the depreciation of the ringgit differed among sectors and between industries. In the commodities sector, export performance was constrained by supply bottlenecks so that the sector could not take full advantage of the ringgit depreciation. In the manufacturing sector, exchange rate factors helped to improve the competitive position of some industries. However, the ability of most industries to expand output to take advantage of the weaker currency was fairly limited owing to bottlenecks such as labour constraints and production levels having approached full capacity. Nevertheless, total export volume expanded by 6.6% (compared with 10.6% in 1996) and was more than sufficient to offset the decline in United States dollar export prices of 5.1%.

Exports of **manufactured goods** expanded by 12.9% in 1997 (1996: 7.6%) to RM178.9 billion, due mainly to improved demand for semiconductors and electronic components and parts, chemicals and chemical products, metal products and optical and scientific equipment. While the depreciation of the ringgit helped to enhance competitiveness in most industries, the higher export receipts reflected mainly exchange rate valuation gains. On the demand side, volume growth was constrained by the downturn in the Asia-Pacific region which accounted for about one-third of Malaysia’s export market. On the supply side, most industries were already operating at about 80% capacity utilisation so that there was little room for further expansion. The labour market in this sector also remained tight in 1997, inhibiting output. In addition, the increased competition within the region prompted most industries to grant price discounts. Competitive price discounts towards year-end resulted in exports valued in the United States dollar to decline by 2.5% in the final quarter of 1997 (4Q 1996: -2%), although most firms were able to maintain their pace of volume growth. Consequently, exports of manufactures in United States dollar terms rose marginally by 1.1% in 1997 (1996: 7.3%). During the first half of 1997, exports of manufactures valued in United States dollars rose by 1.7% (first half of 1996: 16.1%) and picked up further to grow by 3.5% in the third quarter (third quarter of 1996: 1.8%).

Exports of electronic goods picked up strongly to expand by 25% to RM80.8 billion in 1997 (1996: 13.8%). The growth was due largely to expansion in the export of semiconductors (15.8%; 6.2% in 1996) and electronic equipment and parts (36%; 24.6% in 1996). Although the export of semiconductors had declined marginally in the first half of the year, growth accelerated in the second half of the year in line with the recovery of the global market since May 1997. Demand was particularly strong in the United States, Europe and Asia-Pacific (excluding Japan) markets. Meanwhile, the growth in exports of electronic components and parts was attributable to favourable global developments in the internet, telecommunication and multimedia industry and increased usage of electronic components in higher-end consumer electrical products such as digital television, heavy industries and the transport equipment industry. Total exports of electronic equipment and parts were, however, dampened slightly at the end of the year with emerging signs of oversupply and aggressive pricing in the world market for hard disk drives. Nevertheless, the impact on Malaysian electronic exports was minimal as hard disk drives accounted for less than 5% of total exports of electronics.

Strong external demand for oleochemicals, resins and plastic products from the United States, Japan, Singapore and Hong Kong, Special Administrative Region (SAR), China, led to a marked increase in exports of chemicals and chemical products to 21.6% from only 7.7% in 1996. This industry benefited from the stronger-than-expected recovery in the electronics industry. Growth was particularly strong in the final quarter of the year when export growth in United States dollar terms was almost double its rate in the corresponding period of 1996. With the depreciation of the ringgit, the metal products industry became more competitive with sustained demand from Singapore, Japan and Hong Kong SAR, China. Consequently, export growth of metal products turned around from -11.7% in the first half of the year to increase by 41.5% in the second half of 1997. Meanwhile, stronger external demand from the United States, Hong Kong SAR, China and Europe underpinned the high export growth of optical and scientific equipment, which experienced significantly higher growth in the second half of the year, both in terms of United States dollars as well as in ringgit terms.

Growth in the exports of the remaining industries was more moderate. Exports of rubber products expanded by 11.4% (1996: 9.7%) as stronger orders from the United States and Europe had sustained external demand for surgical and examination gloves which more than compensated for the reduction in tyre exports. The exports of the textile, clothing and footwear industry picked up to 8.8% (1996: 6.8%), reflecting mainly the valuation gains of the currency

Table 1.15
Gross Exports

	1997				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Manufacturing sector	**178,858**	**12.9**	**80.8**	**63,717**	**1.1**
Of which:					
Electronics, electrical machinery and appliances	118,958	14.1	53.7	42,368	2.2
Electronics	80,773	25.0	36.5	28,691	11.7
Semiconductor	*40,801*	*15.8*	*18.4*	*14,519*	*3.6*
Electronic equipment & parts	*39,972*	*36.0*	*18.1*	*14,172*	*21.3*
Electrical machinery & appliances	38,185	-3.7	17.2	13,677	-13.3
Consumer electrical products	*17,755*	*-11.0*	*8.0*	*6,364*	*-19.8*
Industrial & commercial electrical products	*11,935*	*13.8*	*5.4*	*4,275*	*2.5*
Electrical industrial machinery and equipment	*7,764*	*-9.4*	*3.5*	*2,780*	*-18.4*
Household electrical appliances	*731*	*11.1*	*0.3*	*257*	-1.7
Textiles, clothing and footwear	7,575	8.8	3.4	2,696	-2.6
Chemicals & chemical products	8,189	21.6	3.7	2,922	9.1
Wood products	6,492	6.6	2.9	2,325	-4.0
Manufactures of metal	5,655	13.0	2.6	2,012	1.2
Transport equipment	4,904	7.9	2.2	1,766	-2.2
Rubber products	3,994	11.4	1.8	1,420	-0.4
Agricultural sector	**23,191**	**3.3**	**10.5**	**8,292**	**-7.1**
Of which:					
Rubber	2,971	-15.4	1.3	1,056	-24.3
Saw logs	2,346	2.8	1.1	834	-8.1
Sawn timber	2,781	-10.9	1.3	989	-20.3
Palm oil	10,810	14.6	4.9	3,843	2.4
Minerals	**15,413**	**18.3**	**7.0**	**5,513**	**6.5**
Of which:					
Tin	479	-10.1	0.2	170	-19.6
Crude oil	7,069	-2.0	3.2	2,513	-12.3
LNG	6,752	42.3	3.0	2,400	27.3
Other	**3,950**	**28.2**	**1.7**	**1,396**	**13.9**
Total	**221,413**	**12.4**	**100.0**	**78,917**	**0.7**

Source: Bank Negara Malaysia and Department of Statistics depreciation and stronger growth in the first half of the year. Improved demand was recorded for high quality textiles, including synthetic textiles and knitting materials from the United States, Japan and Europe. Despite registering a strong growth of 22% in the first quarter arising mainly from strong demand by Japan for plywood and particle board, growth in the exports of wood and wood products slowed down in the following two quarters and moderated to 6.6% for the year as a whole. This was due mainly to stronger competition from South American producers as well as the slowdown in demand from Japan, the People's Republic of China and Korea. Moderate growth was also registered in the exports of several other manufactured goods, including non-metallic mineral products (5.7%), paper and pulp products (7%) as well as petroleum products (2.4%). On the other hand, the depreciation of the ringgit caused a turnaround in exports of transport equipment which expanded by 42.3% in the second half of the year, from a decline of 13.3% in the first half of 1997, resulting in 7.9% growth for the year as a whole (1996: -13.5%).

The only two industries which recorded a contraction in export receipts were electrical goods, and toys and sporting goods. The sluggish external demand for audio-visual products and air conditioners, which had begun in the last quarter of 1996, continued into 1997. Despite the valuation gains in the last quarter of 1997, exports of electrical goods declined by 3.7% as the global oversupply triggered a price war, which was exacerbated by the rapid rate of product innovation common to the industry. In the case of toys and sporting goods, the intense competition from low-cost producers together with the regional turmoil in the second half of the year had depressed the market.

The **commodity** sector experienced favourable export performance in 1997. Export earnings from the sector increased by 8.8% to **RM38.6 billion** (+1.5% to RM35.5 billion a year ago), following the increase in export prices in ringgit terms (6.5%) due to the valuation gains. Export volume, however, recorded a marginal decline of 0.3% during the year. The valuation gains, however, were dampened by the decline in the United States dollar prices for most of the major commodities. Nevertheless, since most of Malaysia's export commodities, except rubber, were traded in United States dollars, the depreciation of the ringgit against the United States dollar resulted in higher prices in local currency terms and hence, higher export earnings.

Exports of **agriculture** commodities turned around to increase by 3.3% to RM23.2 billion in 1997 (-7.2% or RM22.4 billion in 1996). The increase was largely due to significant growth in the exports of palm oil and saw logs, which more than offset the decline in exports of rubber, sawn timber and cocoa. Reflecting the strong external demand in the face of generally tight global supply of vegetable oils and fats, the export volume of palm oil increased by 3.9% in 1997. Despite a marginal decline in the United States dollar price of 1.4%, prices in ringgit terms rose by 10.3% following the ringgit depreciation, particularly during the second half of the year. Consequently, export earnings of palm oil increased strongly by 14.6% in 1997 to RM10.8 billion, representing the single largest export earner for the commodity sector. Although the export volume of saw logs declined by 8.4%, export earnings increased by 2.8% because of price increases. The United States dollar prices for saw logs rose by 0.4% during the year (equivalent to an increase of 12.3% in ringgit terms). Meanwhile, export earnings from sawn timber and cocoa continued to decline by 10.9% and 17.1% respectively, due mainly to the significant decline in export volume. Export earnings from rubber continued with their declining trend, falling further by 15.4% in 1997 to RM3 billion. The lower earnings, despite an increase in export volume of 3.9%, were due mainly to lower prices (-18.5%) arising from poor demand amidst ample supplies in the international markets. As rubber prices were quoted in ringgit, the subsequent lower United States dollar prices prompted an increase in demand from traditional buyers.

Export earnings from the **mining** sector increased markedly by 18.3% to RM15.4 billion in 1997 (+20.8% or RM13 billion in 1996), reflecting a significant increase in the export of liquefied natural gas (LNG), which accounted for almost 44% of total export earnings from minerals. The export volume of LNG increased by 18.6%, in response to strong demand from Japan, Korea and Taiwan, Republic of China (ROC). Likewise, the United States dollar prices of LNG increased further by 7.3% in 1997 to US$156.8 per tonne. Reflecting the valuation gains from the ringgit depreciation, the export unit value of LNG in ringgit terms increased significantly by 20% to RM441 per tonne. Meanwhile, the export unit value of crude petroleum declined by 3.4% to US$20.83 per barrel, in line with the trend in world crude oil prices. Strong global demand following the severe winter season in the northern hemisphere supported high oil prices during the first half-year. Prices started to moderate in the second half, especially towards the end of the year, in response to increased supply following the sale of Iraqi oil under the "oil-for-food" exchange programme. The announcement by OPEC countries in December to increase the quota for crude oil production by 10% exerted further downward pressure on prices. Nevertheless, the exchange rate valuation gains resulted in a marked increase of 8% in the export unit value for Malaysian crude to RM445.3 per tonne. The export volume of crude oil, however, declined by 9.3%, due to increasing demand for domestic consumption as well as lower imports by the traditional buyers. Consequently, gross export earnings from crude oil declined marginally by 2% in 1997 to RM7.1 billion.

The stronger growth in **gross imports** of 12% to RM221 billion in 1997 (1.5% in 1996) reflected mainly an increase in import volume of 10.2%. Import prices also rose, albeit at a slower rate of 3% (-0.5% in 1996). Imports in United States dollar terms, however, recorded only a marginal increase of 0.8% in 1997 (1.1% in 1996). The stronger increase in imports by 5.4% in the first half-year reflected the stronger domestic activities during this period. There was a sharp reversal in the second half-year when imports in United States dollar terms declined by 3.6%, in line with the moderation in aggregate domestic demand. Investment and intermediate goods continued to account for a significant share of 85% of total imports in 1997.

By economic classification, **imports of investment goods** valued in United States dollars recorded the strongest growth (6.9%). The strong growth recorded

Table 1.16
Gross Imports by Economic Function

	1997*p*				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Consumption goods	31,584	12.4	14.3	11,314	1.3
Food	6,144	9.5	2.8	2,191	–1.7
Beverages and tobacco	634	15.7	0.3	224	3.0
Consumer durables	5,954	16.7	2.7	2,150	6.0
Other	18,852	12.0	8.5	6,749	0.8
Investment goods	93,864	19.0	42.5	33,527	6.9
Machinery	23,854	10.3	10.8	8,514	–0.9
Transport equipment	13,801	46.2	6.2	4,995	33.3
Metal products	13,669	17.1	6.2	4,855	4.6
Other	42,540	17.6	19.3	15,163	5.5
Intermediate goods	94,180	5.6	42.6	33,697	–4.9
For manufacturing	79,203	5.0	35.8	28,332	–5.5
Of which:					
Electronic parts	45,765	8.1	20.7	16,279	–3.3
CKD parts	4,751	5.9	2.1	1,706	–4.4
Chemicals	6,489	17.1	2.9	2,321	5.3
Textiles	1,581	–12.2	0.7	568	–20.6
For construction	5,215	–3.5	2.4	1,876	–12.7
For agriculture	2,267	13.2	1.0	814	2.2
Crude petroleum	473	1.7	0.2	169	–8.7
Other	7,022	20.2	3.2	2,506	7.9
Imports for re-exports	1,364	21.8	0.6	491	10.1
Tin ore	402	–5.7	0.2	145	–14.4
Natural rubber	962	38.6	0.4	346	25.2
Total	**220,992**	**12.0**	**100.0**	**79,029**	**0.8**

p Preliminary

Source: Bank Negara Malaysia and Department of Statistics reflected mainly the resumption of the capacity expansion programme by the national airline and the increase in the number of ships purchased by domestic shipping companies. Lumpy imports almost doubled in 1997 to US$2.7 billion from US$1.5 billion in 1996. As the bulk of the lumpy items was purchased in the first half-year, imports of investment goods rose at a higher annual rate of 11.1% in the first half-year, compared with 2.9% in the second half-year. Of significance, imports of investment goods for general investment activities moderated in 1997 in line with the slower growth in aggregate investment demand. Imports of machinery declined by 0.9% in terms of the United States dollar, particularly due to a significant decline in imports of generators, following the completion of the capacity expansion programme in the utilities sector.

Imports of intermediate goods declined by 4.9%, valued in United States dollars due to several developments affecting the performances of major sub-sectors within the manufacturing sector, particularly electronic and electrical products, motor vehicles and textile products industries. Imports of electronic components and parts, which accounted for 49% of the total import of intermediate goods, declined in United States dollar terms by 3.3%. This decline was due entirely to lower unit value as growth in import volume remained positive in line with the expansion in production in the electronic and electrical machinery industry. In 1997, prices of electronic components continued to decline in the first half-year due to an excess supply situation globally. The decline in prices, however, moderated since May following the strengthening of demand for semiconductors. Reflecting this trend, imports of electronic components and parts recorded a lower decline of 2.7% in the second half of 1997, compared with 3.8% in the first half-year. Imports of completely-knocked-down parts for the motor vehicle industry was the other major component of intermediate goods to record a decline (-4.4%) in United States dollar terms. Higher interest rates and tighter credit conditions, including the tightening of conditions on hire-purchase for passenger cars, led to a significant slackening in the demand for completely-knocked-down parts for the motor vehicle industry. As a result, imports of completely-knocked-down parts which virtually stagnated in the first half-year declined markedly by 8.5% in the second half-year. Imports of textiles also declined significantly by 20.6%. This decline was due to lower external demand for natural fibre and weaving products. In contrast, imports of chemical inputs for the chemical industry recorded a positive growth of 5.3% as strong external demand for chemical products, particularly oleochemicals, resin and plastic products, provided the main impetus to the growth of this industry. Other imports of intermediate goods which registered negative growth rates were imports for the construction sector (-12.7%), reflecting moderation in activities in the sector towards year-end, and crude petroleum (-8.7%), reflecting mainly a decline in prices.

Growth in **imports of consumption goods** valued in United States dollars stabilised at 1.3% in 1997. Imports of consumer durables and other consumption goods registered positive growth rates of 6% and 0.8% respectively. However, imports of food items declined by 1.7% (+14.6% in 1996). This decline in value reflected the decline in demand for non-essential food items.

The double-digit growth in exports and imports led to a 12.2% expansion in Malaysia’s **total trade** (3.9% in 1996) to RM442 billion or 168.2% of GNP in 1997 from RM394 billion or 165.7% of GNP in 1996. The United States displaced Japan to become Malaysia’s largest trading partner in 1997, accounting for 17.7% of total trade, followed by Japan (17.2%) and Singapore (16.6%). These three countries together accounted for 51.5% of total trade in 1997. In terms of **export destination**, Singapore remained the largest export market. The United States and Japan retained their positions as the second and third largest export markets respectively. In terms of **import origin**, Japan continued to be the largest source of imports (21.9%), followed by the United States (16.8%) and Singapore (13.1%). In terms of **bilateral trade balances**, Malaysia continued to record trade deficits with other major trading partners such as Japan, Korea and Taiwan, ROC. A notable development was that Malaysia's trade balance with Thailand, Indonesia and Germany deteriorated attributable to some import substitution from higher cost suppliers to countries whose currencies either depreciated much more than the ringgit (Thailand and Indonesia) or against which the ringgit recorded a lower depreciation (Germany). Large trade surpluses continued to be recorded with Singapore, Hong Kong SAR, China, the Netherlands, the United States, the United Kingdom and India. Larger trade surpluses recorded with Singapore and the Netherlands reflected higher exports to these transhipment centres.

Table 1.17
Direction of External Trade

	1997*p*				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	
ASEAN countries	60,725	27.4	44,960	20.3	15,765
Singapore	44,356	20.0	29,004	13.1	15,352
Thailand	7,930	3.6	8,683	3.9	–752
Indonesia	3,464	1.6	4,114	1.9	–650
Philippines	3,302	1.5	2,635	1.2	666
Brunei Darussalam	764	0.3	67	…	696
Vietnam	910	0.4	457	0.2	453
European Union	31,944	14.4	31,224	14.1	719
United Kingdom	7,298	3.3	5,797	2.6	1,501
Germany	6,366	2.9	9,697	4.4	–3,331
Netherlands	8,701	3.9	2,167	1.0	6,534
Other	9,579	4.3	13,564	6.1	–3,985
United States	41,122	18.6	37,049	16.8	4,073
Japan	27,798	12.6	48,506	21.9	–20,708
Hong Kong SAR, China	12,179	5.5	5,404	2.4	6,774
Taiwan, ROC	9,633	4.4	10,599	4.8	–967
Korea	7,096	3.2	11,324	5.1	–4,228
People's Republic of China	5,258	2.4	6,254	2.8	–997
Australia	3,797	1.7	5,473	2.5	–1,676
India	3,306	1.5	2,135	1.0	1,171
West Asia	4,216	1.9	1,698	0.8	2,518
Rest of the world	14,340	6.5	16,363	7.4	–2,023
Total	**221,413**	**100.0**	**220,992**	**100.0**	**421**

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Source: Bank Negara Malaysia and Department of Statistics

The improvement in the merchandise surplus in 1997 was offset by the higher deficit in the **services account** and higher outflows on the **transfers account**. In 1997, the transfers account increased by RM761 million to RM3.7 billion, reflecting mainly the increase in remittances by foreign workers. The higher services deficit was attributable to unforeseen developments in the second half of 1997. The most significant was the prolonged haze which severely reduced tourist arrivals, and affected passenger fare receipts. Consequently, growth in services receipts moderated from 21.4% recorded in 1996 to 14.7%. Overall, reduced imports of selected services following the moderation in domestic demand in the second half of the year and the growth in services receipts due to the structural adjustment measures was offset by higher cost due to the depreciation of the ringgit. Hence, the lower growth in output in 1997 was not reflected in a lower deficit for the year. In United States dollar terms, however, the services deficit declined by US$349 million to US$7.4 billion. The improvement was most visible for the freight, other transportation and consultancy services accounts. The services deficit in terms of GNP declined to 7.9%, the lowest ratio recorded since 1973, reflecting the positive results from the structural adjustment policies undertaken to strengthen the services sector of the economy.

In 1997, the performance of the tourism industry was affected particularly by the prolonged haze in the South-East Asian region. The net surplus in the **travel account** declined by almost RM1 billion to RM3.8 billion, the first decline since 1991. The decline in tourist arrivals by 13% to 6.2 million more than offset the increase in average per capita expenditure of 8.2%. Average per capita expenditure rose during the year as per diem expenditure of tourists increased by 9.6%, while the length of stay of tourists per visit stood at 5.3 days (1996: 5.4 days). The number of excursionist arrivals also declined by 8.1%. Consequently, the combined earnings from various categories of travellers, namely tourists (who stayed more than one day), excursionists (day travellers) and transit passengers,

Box II

Management of the External Sector in the 1990s

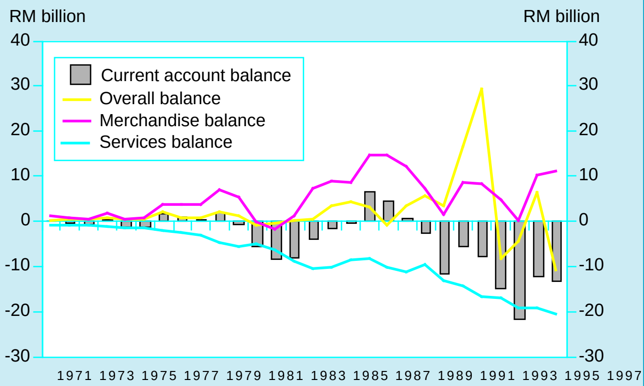
Prior to 1980, Malaysia had not experienced prolonged periods of current account deficit. The first period of sustained current account deficit occurred in 1980–86, when the deficit in terms of GNP averaged 6.5% (Graph II.1). Following voluntary structural adjustment policies undertaken by the Government, the deficit turned around to record surpluses in the period 1987–89. This phase of policy adjustments led to further transformation of the Malaysian economy to one in which the manufacturing sector dominated and in which the private sector played an increasingly significant role. The current account deficit re-emerged during the period 1990–97, averaging 6.2% of GNP. The deficit in 1995 reached 10.5% of GNP. This raised considerable concern that the imbalances were attributable to excessive domestic demand in relation to the productive capacity of the economy and to distortions in the price levels resulting in the shift of resources away from the productive sectors to the less productive sectors. The purpose of this Article is to review the factors contributing to Malaysia's current account deficit in the 1990s and to draw broad implications for the medium–term prospects. In order to assess the situation, it is necessary to identify and distinguish the nature of the current account imbalance, the macroeconomic conditions prevailing and the means by which the current account imbalance has been financed.

Nature of the Imbalance

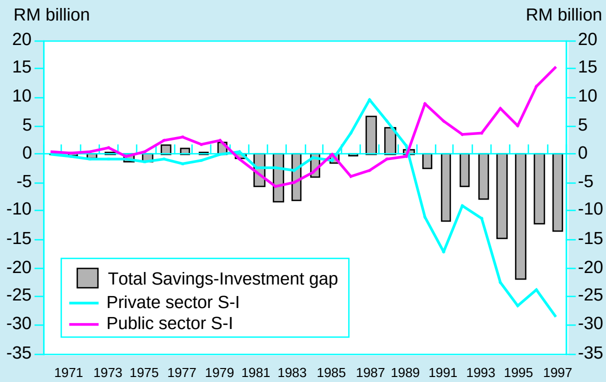
Domestic demand was investment driven

The performance of key macroeconomic indicators for the period 1990–96 showed that the developments in the external sector have essentially been associated with strong investment activities. In terms of the savings-investment gap, the current account deficit in the balance of payments reflected the faster growth of investment relative to savings. By international standards, investment and savings in terms of GNP for Malaysia were high during this period, averaging at about 40% and 34% respectively. The shortfall in savings over investment was largely confined to the private sector (Graph II.2). The public sector savings-investment gap has been in surplus since 1990. Of significance, the overall balance of the Federal Government has been in surplus since 1993 (Graph II.3).

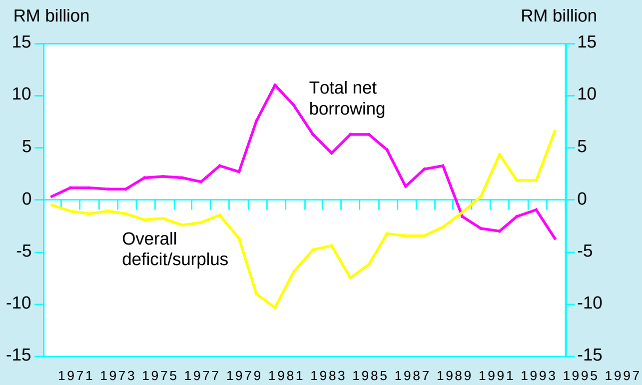
Graph II.1
Balance of Payments



Graph II.2
Savings-Investment Gap

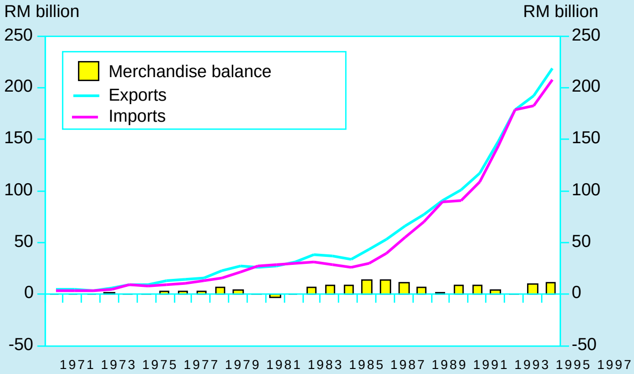


Graph II.3
Federal Government Finance



The allocation of investment is also important for assessing the nature of the current account deficit. The strong performance in exports in the 1990s (Graph II.4) indicated that the bulk of the resources, particularly foreign savings, were channelled to the more productive sectors of the economy. Guided by the need to increase competitiveness and raise industrial efficiency, greater emphasis was placed in the 1990s on the balanced development of the manufacturing and services sectors. The pressure to enhance competitiveness, which is increasingly determined by the availability of adequate infrastructure facilities, expertise, knowledge and networking, called for efforts to strengthen both the goods and services sectors, particularly in the transport, communication and utilities sub-sectors. Consequently, capital outlays, in both manufacturing and services sectors increased strongly during this period. The high rate of investment and high import requirements of these two leading sectors led to stronger growth in imports of goods and services. In the period 1990–96, imports for the construction sector were also high coinciding with the rapid growth in this sector (14.6%). Investments channelled to the construction sector accounted for 14.3% of total private investment, while loans from the banking system to this sector grew at an average annual rate of 22.4% to account for 8.4% of total loans outstanding as at end–1996. Overall, a double-digit growth rate of 16.5% was recorded for gross exports of goods in the period 1990–96, while gross imports of goods increased at a faster rate of 18.3%. As resources were channelled mainly to the non-resource based manufacturing sector, imports of investment goods and intermediate goods accounted for more than 80% of the total import bill. The share of

Graph II.4
Merchandise Account

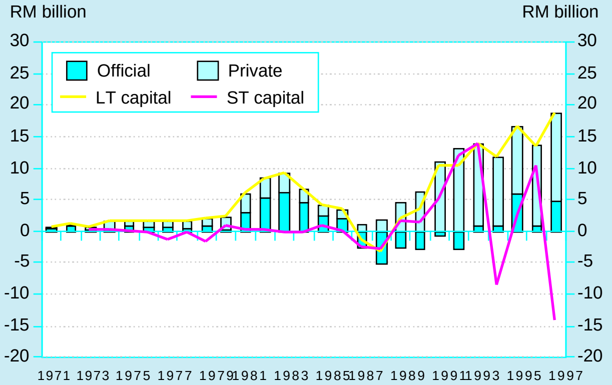


consumption goods, however, declined from 16.4% in 1990 to 14.2% in 1996. In the services account, the deficit worsened in absolute terms, but policy measures taken to strengthen the services account led to faster growth in receipts (21%) than payments (16%).

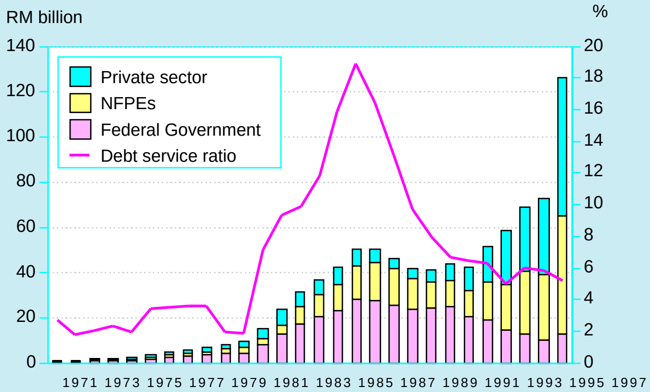
Meanwhile, dependence of non-resource based industries on imported inputs and labour scarcity prompted the Government to move to promote higher value added and high technology-oriented industries. The broad strategy that was put in place was to promote exports of high value added products, expand and diversify overseas markets, improve domestic linkages to reduce the import content of exports and to increase international competitiveness. In this regard, a key strategy of the new Industrial Master Plan (IMP) 1996–2000 is to strengthen the inter-industry linkages through the cluster approach to complement the Vendor Development Programme. The objective is to maximise foreign exchange retention in the country by shifting from assembly-intensive type of manufacturing to higher value added products, encompassing the entire value chain of manufacturing production and other complementary aspects, including research and development, design, distribution and marketing activities. Similarly, in the services sector, policies were also implemented at sub-sector levels to enhance complementary linkages. The IMP has placed priority on the development of the services sector as a major catalyst for growth, as well as a potential source of export growth. Prior to the IMP, selected services sub-sectors, such as education, tourism and consultancy services, were identified for aggressive promotion in an effort to reduce the services deficit. The efforts on this front have now begun to yield positive results. The services deficit in recent years has been contained at less than 10% of GNP (previous peak: 14.6% in 1984). Excluding the net outflow of investment income, the bulk of which are reinvested, the services deficit improved from 7.8% of GNP in 1980 to 3.3% in 1996 and 2.8% in 1997.

The emphasis on providing a stable medium- and long-term macroeconomic environment has enabled Malaysia to attract long-term capital inflows to finance the current account deficit (Graph II.5). Foreign direct investment inflows contributed significantly to the surpluses in the long-term capital account since 1989, the bulk of which was

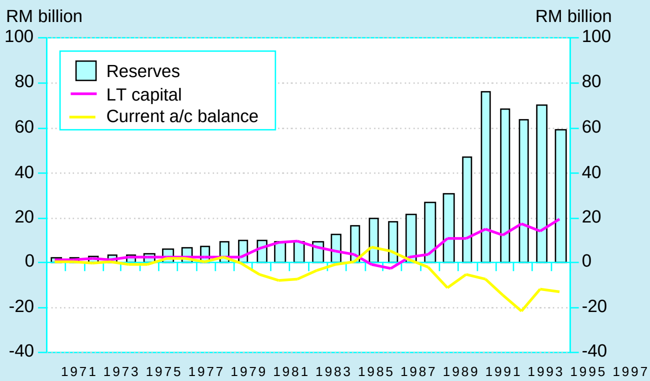
Graph II.5
Capital Flows



Graph II.6
Medium and Long-Term External Debt



Graph II.7
External Reserves



concentrated mainly in the oil and manufacturing sectors. By type of flows, equity flows became important primarily as a result of the relaxation in the foreign ownership requirement in the manufacturing sector. With respect to external borrowings, active debt management by both the public and private sectors in the 1990s has contained the growth of external debt and debt servicing, avoiding bunching of payments as well as reduced Malaysia's exposure to interest and exchange rate fluctuations. The medium- and long-term external debt to GNP ratio fell to 30.5% as at end-June 1997, prior to the financial crisis, from a peak of 75.6% in 1986. As the bulk of the external loans were also channelled to the productive sectors of the economy, the debt service ratio at 5.1% in 1997 has remained low by international standards (previous peak: 18.9% in 1986, Graph II.6). External loans are prohibited for the financing of property development or for the purchase of shares in the country.

Reflecting the dependence on longer-term funds to finance the current account deficit, the basic balance (current account plus long-term capital inflows) has been in surplus for most years. The negative balance in 1994–95 was due to several factors, including the wider current account deficit in 1995 due mainly to the import of several large items during the year, in particular aircraft, in addition to the higher repayments of external debt by the Government as well as the strong outflows in the form of overseas investment by Malaysian-owned companies. Over the period 1990–97, international reserves were sufficient to finance more than three months of retained imports (Graph II.7).

Current Account Deficit, Inflation and Exchange Rate

Inflation pressures remained subdued, ringgit was relatively stable

Inflation, as measured by the consumer price index, was contained below 5% during the period under review due to a combination of factors. In addition to monetary restraint since 1989 and fiscal discipline, the growth in domestic demand had to a significant extent been accommodated by higher imports. Of relevance, growth in imports of investment and intermediate goods was high in the period 1990–96. Imports of investment goods recorded the sharpest annual growth (21%), followed by intermediate goods (18%) and consumption goods (15%). Food imports, which accounted for about 20% of total consumption goods, rose at an average annual rate of 10%.

As the basic balance of the balance of payments remained at near balance position, fluctuations in the exchange rate of the ringgit were associated with movements in short-term capital, which complicated monetary management in Malaysia. Nevertheless, the ringgit in general was not viewed as an overvalued currency. On the contrary, the general perception prior to the currency crisis was that it was undervalued, given the underlying economic fundamentals.

Future Direction

Overall, the authorities envisaged that the current account would remain in deficit during the Seventh Malaysia Plan. The deficit, nevertheless, has improved significantly since 1995, from 10.5% of GNP in 1995 to 5.1% in 1996–97. The recent pressures on exchange rates has increased the urgency for a more rapid adjustment in the current account balance. The expansion and implementation of projects have been critically reviewed. Some projects have been postponed indefinitely, while the strategic projects are being sequenced to prevent bunching of imports. In the immediate term, the deferment of large non-critical projects is expected to yield positive results in reducing the deficit. For 1998, the current account deficit is expected to decline to 0.5% of GNP, well below the 3% target set by the Government. The measures introduced in late 1997 were also aimed at strengthening the competitiveness and resilience of industries to cope with the more challenging environment, the details of which are outlined in the Overview in Chapter 1. All structural adjustment policy measures that have already been in place since the early 1990s would be reinforced to strengthen the balance of payments position. Generally, Malaysia has set specific policy prescriptions to address each of the issues to ensure that the medium term balance of payments position remains viable. Significant progress has also been made to improve data and information in terms of coverage and timeliness of data dissemination to promote greater public understanding of developments in its economic and financial environment to facilitate well informed decision making by the markets.

declined by RM740 million to RM10.5 billion. On the payments front, the economic uncertainty and the higher cost of travelling during the latter part of the year deterred somewhat the number of Malaysians travelling abroad. Expenditure on this item stabilised at RM4.2 billion, about the same level as in 1996. Outflows for pilgrimage rose moderately by 1.3% to RM156 million. Meanwhile, payments for education abroad increased further by 8.7% to RM2.4 billion, due in part to the higher cost of education as a result of the weaker ringgit.

After recording a decline of 5.6% in 1996, net **freight and insurance** payments abroad increased by 5% to RM8.9 billion. Despite the generally lower freight rates, gross outflows on freight and insurance increased by 7.1%, due to the weaker ringgit and the higher import volume. Gross payments were moderated by the increase in freight and insurance earnings by 13.6%, reflecting mainly the expansion in the carrying capacity of the domestic shipping companies. In terms of United States dollars, net payments declined by US$206 million. The share of the freight and insurance account in the services deficit remained virtually unchanged at about 43%.

Net **investment income** payments rose further by RM1.8 billion to RM13.5 billion in 1997. The interest income account reverted to a deficit of RM1.5 billion due to the increase in outstanding external debt, as well as the higher cost of servicing following the weaker ringgit. As a result of higher recourse to foreign loans by the non-financial public enterprises (NFPEs) and the private sector, interest payments by these sectors exceeded the RM4 billion level in 1997. Meanwhile, the profits and dividends accrued to non-residents remained high at RM13.9 billion. Consequently, net investment income outflows remained the largest contributor to the services deficit, with its share rising to 65% in 1997, from 60% in 1996.

The **other transportation** component (consisting of passenger fares; charter fees; and port and airport-related activities, such as stevedoring, bunkers and port and airport disbursements) improved further to record a higher net surplus of RM2.4 billion (RM1.5 billion in 1996). Gross receipts rose by 21.8% to RM6.6 billion, reflecting mainly higher earnings on passenger fares by the national airline and higher receipts for port-related activities. Increased frequencies of flights by the national airline to existing destinations and commencement of services to new destinations were facilitated by the expansion in fleet size and the conclusion of code-sharing arrangements with other airlines. Nevertheless, receipts for passenger fares would have been higher if not for the adverse developments affecting the tourism industry. Port-related activities, particularly port disbursements, stevedoring and sales from bunker fuel also drew higher receipts in 1997 following continued efforts to promote Port Klang as a premier port in Malaysia. The Government's efforts to make Port Klang a hub port also showed encouraging success with transhipment volume increasing by 42.6% in 1997. Meanwhile, gross payments for other transportation rose by 6.8% to RM4.2 billion. Higher outflows in other transportation account were due in part to the weaker ringgit.

Net payments for **other services** declined by RM1 billion to RM4.5 billion (RM5.5 billion in 1996). The improvement in the other services account reflected the completion of some of the big projects, particularly in the civil engineering sector. As a result, the share of the other services deficit to overall deficit declined markedly to 22% in 1997 (28% in 1996).

The long-term **capital account** strengthened in 1997, while the short-term capital account recorded a deficit. This reflected the large reversal of portfolio investment. Net inflow of long-term funds increased during the year to an unprecedented level of RM18.7 billion, with net inflows of official and private long-term capital of RM4.8 billion and RM13.9 billion respectively.

The higher net inflow of RM4.8 billion in the **official long-term capital account** was due mainly to lower net repayment by the Federal Government as well as lower repayments and prepayments by the NFPEs. Gross foreign borrowing by the Federal Government declined by RM287 million to RM462 million. These borrowings were in the form of project loans to finance development expenditure in the public sector. Reflecting the strong financial position of the Federal Government, no new external market loan was raised in 1997. The Government continued its prepayment programme in 1997, amounting to RM911 million which was undertaken entirely in the first half-year. With repayments and prepayments during the year of RM2.1 billion, the Federal Government registered a net outflow of RM1.7 billion for the sixth consecutive year. In the second half-year, the Federal Government postponed the prepayment of three market loans equivalent to RM491 million in ringgit terms.

In 1997, net external borrowings by the NFPEs increased substantially to RM6.5 billion, from RM2.8 billion in 1996. Although gross borrowings declined in the second half-year, they remained high at RM9.5 billion for the year as a whole. This reflected drawdowns mainly by Telekom Malaysia Berhad, Tenaga Nasional Berhad and PETRONAS to finance their domestic capital expenditure, overseas investment as well as prepayments and refinancing of more expensive loans. With the weakening of the ringgit, some prepayments of the more expensive loans scheduled for the second half-year were postponed. Consequently, prepayments of external loans in 1997 declined to RM421 million, from RM1.3 billion in 1996.

In the **private sector**, the net inflow of long-term capital increased by RM1.1 billion to RM13.9 billion due to the combined effects of some valuation gains arising from the weaker ringgit and lower overseas investment by Malaysian-owned companies. **Net inflow of inward investment** continued to remain strong at RM19.2 billion (1996: RM19.4 billion). As in previous years, the bulk of the inflows of foreign direct investment was primarily channelled to the manufacturing (83%) and oil and gas (7%) sectors. Retained earnings by the existing companies accounted for 54% of the net inflow of inward investment, followed by external loans (24%) and equity (22%). External loans, mainly from parent and associated companies, increased in 1997 attributed to the high rate of investment in the first half of 1997 and the valuation effects of the weaker ringgit in the second half-year. The volume of external borrowings in United States dollar terms declined in the second half-year. The slowdown in approval in manufacturing investment in 1997 did not cause a slowdown in actual inflows during the year. New inflows of equity in the manufacturing sector remained strong because of exceptionally large approvals of manufacturing projects in the 1994–96 period. Foreign equity investment approved in 1997 by the Ministry of International Trade and Industry (MITI) was lower (RM3.6 billion) when compared with the exceptionally high approvals in 1996 (RM6.2 billion). A total of 12 large projects (capital investment of RM500 million and above) with foreign equity amounting to RM3.6 billion were approved in 1996. Excluding these large projects in 1996, the amounts approved for 1997 would have exhibited a normal trend. Despite the currency crisis, long-term investors continued to view Malaysia as a favourable investment destination. In the second half of 1997, six big projects with foreign participation were approved by MITI. The proposed foreign equity in these projects amounted to RM1.1 billion or 54% of the total equity. The data on foreign investment approved for manufacturing projects in 1997 showed that the United States was the leading investor, followed by Japan, Germany, Taiwan, ROC, Singapore and Korea. These six countries accounted for 84% of the proposed foreign investment in approved manufacturing projects. Within the oil and gas sector, the United States and the Netherlands continued to remain the major foreign investors, followed by Japan and Taiwan, ROC.

Overseas investment by Malaysian-owned companies, which had risen rapidly since 1991, declined in 1997. The uncertainty in the region prompted investors to defer implementation of some overseas projects. Hence, net overseas investment (including retained earnings overseas) declined to RM8.4 billion in 1997 (1996: RM10.5 billion). Gross outflows of RM5.5 billion which were stronger in the first half-year, moderated to RM4.4 billion in the second half-year. In line with the slackening trend in overseas investment in the second half-year, net external borrowings by Malaysian-owned companies moderated to RM3.1 billion in 1997 (1996: RM3.9 billion). The major recipient countries of overseas investment in 1997 were the United States (24%), Singapore (19%), Hong Kong SAR, China (9%), Indonesia and the United Kingdom (6% each). Investment in the United States was largely concentrated in the high value added sub-sectors in the services and manufacturing sectors. This move by Malaysian companies indicates the corporate strategy towards acquiring technical know-how via participation on a joint venture basis with firms in developed countries.

The short-term capital account recorded a large net outflow of RM14.2 billion in 1997 in the wake of the currency turmoil in the region. The bulk of the net outflow of funds in 1997 was due to liquidation of portfolio investment as well as intervention to support the ringgit exchange rate. While there was some increase in the placement of funds abroad by residents, such outflows were offset by the withdrawals from abroad, as residents took advantage of the weaker ringgit to make foreign exchange gains. During the year, net external liabilities of the commercial banks increased to RM7.7 billion. The tight liquidity conditions in the second half-year and lower interest rates abroad prompted some institutions to source offshore ringgit funds through swap operations with offshore banks. A significant portion of these higher liabilities was fully hedged by forward purchases of foreign currencies from domestic exporters.

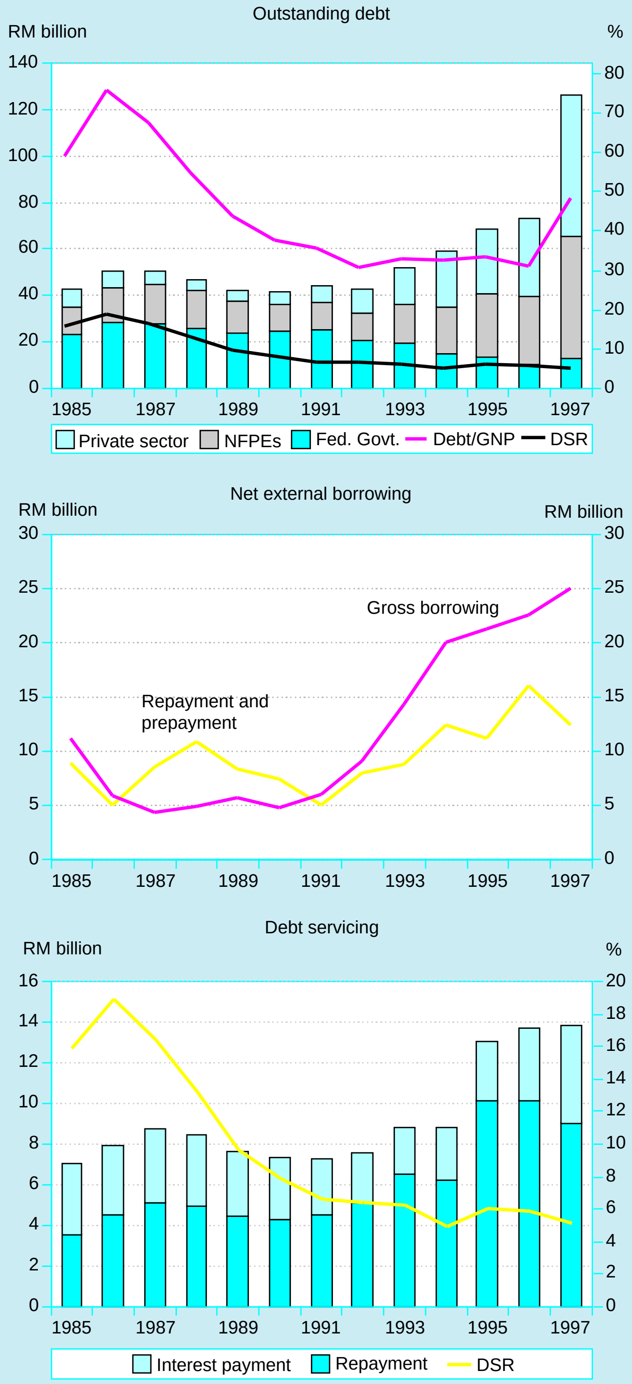
The overall debt situation remained manageable in 1997, reflecting prudent **external debt** management strategies adopted since 1987. The adverse impact on debt servicing was not significant as the bulk of Malaysia's external loans had maturity periods of four to twenty years. Short-term debt accounted for only 24% of total debt, of which commercial banks accounted for 80% of total short-term debt. Given that the external loans of the private sector were channelled mainly to export-oriented industries, these companies in general had a natural hedge from export receipts to cover any significant increase in debt servicing. Among the NFPEs which were significant borrowers from overseas markets, PETRONAS had substantial earnings in foreign currencies, while utility companies had strong financial standing in the international markets. As a result, these companies continued to have access to funding, despite the tightening in credit terms in the international capital markets.

Table 1.18
Outstanding External Debt

	1996		1997*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**98,836**	**38,968**	**166,228**	**42,678**
Medium & long-term debt	*73,181*	*28,863*	*126,508*	*32,480*
Short-term debt[1]	*25,655*	*10,105*	*39,720*	*10,198*
As % of GNP				
Total debt	41.5	41.2	63.2	45.6
Medium & long-term debt	30.8	30.5	48.1	34.7
As % of exports of goods and services				
Total debt	41.8	41.4	61.9	44.7
Medium & long-term debt	30.9	30.7	47.1	34.0
Debt service ratio (%)				
Total debt	6.1	6.1	5.7	5.7
Medium & long-term debt	5.7	5.7	5.1	5.1

[1] Refers to bank and non-bank private sector short-term debt.
p Preliminary

Graph 1.10
Medium and Long-Term External Debt



External borrowings of medium- and long-term loans of the NFPEs and the private sector registered a larger net inflow of RM14.3 billion in 1997 compared with RM8.7 billion in 1996. The drawdown of loans by these two categories of borrowers were utilised not only to finance their investment, both at home and abroad, but also to refinance selectively the more expensive loans. Nevertheless, following the outbreak of the currency crisis in mid-1997, there was a noticeable moderation in the drawdown of loans by the NFPEs and the private sector in the second half-year. The Federal Government recorded a net outflow of RM1.7 billion. Reflecting these developments, the medium- and long-term external debt in United States dollar terms increased by 12.5% to US$32.5 billion (1996: US$28.9 billion). Short-term debt, comprising mainly the external borrowings of the commercial banks and short-term debt of the private sector, increased by 54.8% to RM39.7 billion, bringing the total debt outstanding to RM166.2 billion, an increase of 68.2% compared with the level as at end-1996. In United States dollar terms, total external debt increased moderately by 9.5% to US$42.7 billion (US$39 billion in 1996). Consequently, the ratio of total external debt to GNP increased in United States dollar terms to 45.6% from 41.2% in 1996. Likewise, the ratio of medium- and long-term debt to GNP increased to 34.7% in United States dollar terms from 30.5% in 1996. In ringgit terms, the ratio of medium- and long-term debt rose from 30.8% in 1996 to 48.1% in 1997.

Total **debt servicing** payments, comprising principal repayments and interest payments for medium- and long-term debt in 1997 increased marginally by 1.9% to RM13.8 billion. Nevertheless, the debt service ratio (ratio of debt servicing to export of goods and services) declined to 5.1% in 1997 (1996: 5.7%) due to the stronger expansion in exports of goods and services (13.5%), particularly in the second half-year. Increased recourse to external borrowing by the NFPEs and the private sector in recent years had led to higher interest payments. However, principal repayments declined by 9% during the year.

In terms of currency composition, debts denominated in the United States dollar continued to dominate the currency profile of the nation's medium- and long-term debt. The share of United States dollar-denominated debt rose by four percentage points to 76% of total debt outstanding at the end of 1997. The share of yen denominated debt declined marginally to 15% (1996: 16%) due to the prepayments of yen loans by the public sector. The share of external debt denominated in other international currencies, including the French franc, Singapore dollar, Deutsche Mark and pound sterling declined from 12% to 9%, due to prepayments of several loans as well as maturity of loans denominated in European currencies during the year.

Public sector external debt: The Federal Government continued its active debt management strategy to contain the size of its external debt and its future debt servicing. Prepayment of external loans and restraint on new external borrowing remained an integral part of the Federal Government's debt policy in 1997. In the first half of the year, two Swiss franc market loans amounting to SF225 million or RM424 million were redeemed. The Federal Government also took advantage of the cheaper yen in the early part of the year to prepay four yen loans (two market loans and two project loans) amounting to RM911 million. Apart from the prepayments, about 13 project loans were fully repaid during the year. In aggregate, repayment of external loans by the Federal Government totalled RM2.1 billion in 1997 (1996: RM2.9 billion). Gross external borrowing was limited to drawdown of project loans. The Federal Government did not raise any external market loan in 1997. This was the third time since 1992 that the Government had not raised loans from the international capital market. Despite the large net repayment of loans, the outstanding external debt of the Federal Government increased in ringgit terms. For the first time since 1992, the external debt of the Federal Government rose by 23.7% to RM12.9 billion at the end of 1997 due to an exchange revaluation loss of RM4.2 billion. Nevertheless, the Government's prudent approach to debt management since 1987 helped to minimise exchange rate losses from the adverse movement in ringgit in 1997.

In the first half-year, NFPEs actively sourced funds from abroad to take advantage of the lower international interest rates and the availability of long-term debt at fine margins to finance their investment and expansion programmes, as well as to refinance and prepay some of the more expensive loans. Gross borrowing of the NFPEs increased by 17.2% to RM9.5 billion. The substantial drawdown of loans were made by Tenaga, PETRONAS and Telekom which together accounted for 74% of total external borrowing by the NFPEs. Meanwhile, the repayments of NFPEs declined by 42.4% to RM3 billion (1996: RM5.3 billion) due mainly to the decline in planned prepayment and refinancing of loans to RM1.6 billion against RM3.8 billion in 1996. Coupled with the

Box III

External Debt Management

Recent events in Asia once again demonstrate that high growth rates and strong export performance cannot insulate economies from risks associated with large external debt positions. A high external debt position exposes a country to external shocks, which can not only threaten financial stability but also undermine the economic growth prospects. Malaysia has long recognised the adverse consequences of unsustainable debt levels, with the lessons drawn from the recession in the mid-1980s. Since then, Malaysia has adopted a conservative approach to foreign debt management and kept its external debt at relatively low levels. However, the recent depreciation of exchange rates to unprecedented levels in East Asia has had a cataclysmic impact on external debt obligations and strongly undermined the financial stability of regional economies. In this regard, the lower external debt level of Malaysia has strengthened the country's capacity to face the challenges associated with the regional financial turmoil.

Malaysia's total medium- and long-term external debt of US$32.5 billion at end-1997 (34.7% of GNP in US dollar terms and 48% of GNP in ringgit terms) is low by international standards. In large part, this was due to the low external indebtedness of the Federal Government. Including the short-term external debt of both the banks and non-bank private sector, Malaysia's external debt amounted to US$42.7 billion or 45.6% of GNP (63.2% in ringgit terms), while its debt service ratio was 5.7% in 1997(6.1 % in 1996). Short-term debt accounted for 24% of total external debt, reflecting the low reliance on short-term borrowing by the non-bank private sector. The bulk of the short-term debt was borrowing by the commercial banks, and for the most part was fully hedged against contracts with their exporting clients.

With the weakening of the ringgit as a result of the regional financial turmoil, the debt in ringgit terms has increased significantly. However the policy of limiting private sector external loans to corporations and individuals with foreign exchange earnings has enabled Malaysia to meet its external obligations from export earnings. At the exchange rate of US$1=RM3.895 at end-1997, the total debt in ringgit terms increased to RM166.2 billion from RM114.3 billion at end-June 1997 (US$1=RM2.52). However, the short-term debt remained small, at about 24% of total debt. Total short-term debt of the banks and non-bank private sector amounted to RM39.7 billion, substantially lower than Bank Negara Malaysia's (BNM) reserves of RM83.7 billion (reserves of RM59.1 billion plus exchange rate revaluation gain of RM24.6 billion. In BNM's published accounts, external reserves of RM59 billion at end-1997 are not revalued to reflect the year-end exchange rates). The short-term debts are mainly in the form of revolving credits, inter-company credits through inter-company loans and commercial bank net external liabilities. The net liabilities of banks, which form the bulk of short-term loans, are related to their normal trade financing activities and are fully hedged. More than half of the external borrowing of the banks is covered through forward contracts with exporters.

As at end-December 1997, total external debt that is due in 1998, inclusive of all short-term debt and medium- and long-term debt with remaining maturity of less than one year, would amount to RM57.7 billion or US$14.4 billion. This amount is well below the ringgit equivalent of reserves of RM83.7 billion. While a substantial part of external loans due in 1998 are hedged, some corporations are likely to experience liquidity problems resulting from the magnitude of the currency depreciation. To address these problems, many of these borrowers intend to restructure their debts, including the option to roll over existing loans or to extend the repayment period.

The current exposure of the country reflects a deliberate policy to contain total medium- and long-term external debt in the region of 30–35% of nominal GNP. At end-June 1997, this ratio was 30.5%. The country's policy on active debt management has enabled Malaysia to meet this objective without impinging the ability of the private sector to obtain loans from foreign sources at favourable rates. In addition, the regular prepayment and refinancing exercises have kept debt levels low, while the refinancing programmes have improved the debt maturity profile of the country. The bulk of Malaysia's medium- and long-term debt are loans with remaining maturities of between four and twenty years (55%).

In practice, Malaysia's external debt management strategy is guided by the following objectives:

- To ensure adequate financing for productive investment activities and a level of borrowing consistent with maintaining sustainable growth with low inflation, monetary stability and external stability; and

- To maintain a stream of external debt service payments consistent with the economy's debt servicing capacity over the medium-term.

As a matter of policy, the Government exercises prudence in its recourse to external borrowing and relies mainly on non-inflationary domestic borrowing as well as current budget surpluses to fund its development programmes. In recent years, the Federal Government raised foreign loans mainly to maintain market presence and to refinance loans on more favourable terms. Notwithstanding these considerations, external loans are generally raised only if the funds are to be utilised for productive purposes. In the case of private sector borrowing, the Bank's approval is required for such borrowing to finance productive activities and strategic projects, and for investments that would generate sufficient foreign exchange receipts to service the debt. Companies are not permitted to raise external borrowing to finance the purchase of properties in the country. Foreign investors in the country can borrow funds, especially on a long-term basis from their offshore shareholders or related companies overseas. These loans, however, need to be obtained on reasonable terms. Corporations are also encouraged to raise loans with longer maturities, while short-term borrowing is closely monitored.

These stringent criteria are applied in approving external borrowings in order to achieve the following objectives:

- Contain the size of the national external debt within prudential limits to reduce the vulnerability to adverse movements in global foreign exchange and interest rates;

- Ensure the ability of companies to meet their external debt obligations and to contain the country's total debt servicing within sustainable levels to avoid any potential debt servicing problems; and

- Maintain Malaysia's favourable international credit standing and investment-grade rating of the external debt in order to ensure continued long-term access to financing from the international financial markets and low future borrowing costs.

Over the past decade, the Government had selectively prepaid its more expensive external loans to contain the external debt at a manageable level and to reduce the debt servicing burden. The non-financial public enterprises (NFPEs) and the private enterprises were also encouraged to prepay their external debt. The Federal Government prepaid a total of RM16.5 billion of its debt during the period 1987–97, while the private sector and the NFPEs prepaid RM11.2 billion of their loans. At the same time, the Government closely monitored developments for opportunities to obtain new foreign loans on more favourable terms to refinance existing debt. In total, the public sector refinanced about RM10.9 billion of the debt over the same period. The active refinancing programme helped to lengthen the maturity structure of the debt profile, smoothen the bunching of repayments and lower interest costs.

Malaysia had been successful in maintaining a high credit rating in the international markets through careful management of its "presence" in individual markets and through the judicious use of different market instruments. The public and private sectors were encouraged to diversify their borrowing in terms of currencies, debt instruments and creditors in order to spread risks, achieve a longer maturity profile and gain wider access to capital markets. Traditionally, bank loans and syndicated loans, including Eurodollar loans, were the major instruments in the Government's borrowing programme. Concomitantly, Malaysia also floated fixed rate bonds in Japan and in the various European markets. In the 1980s, the Government shifted to the issuance of Floating Rate Notes (FRN) with longer maturities. Following its successful entry into the Eurobond market, the Government floated its first Yankee bond issue in 1990, establishing its presence in the United States capital market. This paved the way for Malaysian corporations, especially PETRONAS, Tenaga Nasional Berhad (TNB) and Telekom to issue Yankee bonds with long maturities. Indeed, TNB was successful in launching a 100-year bond, while PETRONAS raised a large Global Bond of US$1.9 billion. Several companies undertaking infrastructure projects also issued bonds in the various capital markets. The issue of convertible bonds, including Euro-convertible bonds, increased in the 1990s. It was initiated with the launch of the sovereign Euro-Exchangeable Bond, exchangeable for equity, at the option of the bondholders, in a public enterprise. Commercial bank borrowing and syndicated loans were the major borrowing instruments of private corporations. These were supplemented by loans from parent companies or associated companies and suppliers credit. The Government also received loans from multilateral institutions, such as the World Bank and Asian Development Bank, official development assistance from Japan (loans with long maturities and concessionary interest rates) and bilateral loans.

The rules governing external borrowings by both the private and public sectors are rather stringent. The Federal Constitution provides the legal framework, within which the Government can undertake borrowing from both domestic and external sources. Operations involving Government debt are subject to Parliamentary approval, as it is the Parliament which sets a ceiling on the overall external debt level of the Federal Government. The state governments, local authorities and statutory bodies are not authorised to borrow, except with the approval of the Federal Government. Private sector borrowing is governed by the Exchange Control Regulations administered by BNM. The Bank imposes strict prudential rules, and approval is required for all foreign currency borrowings exceeding the equivalent of RM5 million by Malaysian companies (including non-financial public enterprises). Taken together, the regulations governing foreign borrowing provide an important check on the amount of foreign loans that can be contracted by both the public and private sectors.

There is also a strong institutional framework for monitoring the national external debt level. The debt monitoring system enables the authorities to know the overall debt level, the structure of the debt as well as the servicing obligations of both the public and private sectors. The Ministry of Finance and the Office of the Accountant-General are responsible for maintaining all information necessary to monitor the commitments, disbursements, terms, currencies, principal repayment and interest payment schedules, creditors and end-uses of the loan proceeds of all public sector loans, including NFPE loans guaranteed by the Government. Quarterly reports on the status of the guaranteed loans must be submitted to the Ministry of Finance. BNM is responsible for monitoring and maintaining similar information on private sector and other NFPE loans. Companies are required to submit quarterly reports on their external debt position. Short-term borrowing is also closely monitored by the Bank. Data on external debt and debt servicing, including projections of debt servicing over the medium term, are compiled on a regular basis.

currency revaluation losses of RM17 billion, the external debt of NFPEs increased significantly by 79.4% to RM52.5 billion (1996: RM29.2 billion).

Private sector external debt: As in the case of the NFPEs, the private sector also took advantage of the lower cost of borrowing as well as the easy access to long-term funds from international markets, especially in the first half of the year. Corporations also raised loans through the issuance of bonds, including Euroconvertible bonds, albeit at a lower level compared with 1996. A large number of loans continued to be sourced from the Labuan International Offshore Financial Centre, while non-resident controlled companies continued to receive long-term loans from their offshore shareholders, parent companies and associated companies. External borrowing of the private sector increased by 10.2% to RM15 billion in 1997. The external borrowings during the year were mainly undertaken by export-oriented companies as well as companies undertaking overseas investments. The proceeds were used to finance the purchase of raw materials, machinery, expansion of plants, and factories, overseas investments as well as to refinance some of the expensive loans. The repayments, however, declined by 7% partly due to lower prepayments and refinancing and deferment of repayments by some companies, particularly non-resident controlled companies to their parent companies or associated companies abroad. Together with the large exchange revaluation loss of RM19.8 billion, private sector external debt outstanding increased significantly by 82.5% to RM61 billion at end-1997. Their share of the total medium- and long-term external debt increased from 45.7% to 48.3%, making the private sector the single largest category of borrowers in 1997.

The **gross international reserves** held by the Bank, comprising gold, foreign exchange, reserve position with the International Monetary Fund (IMF) and holdings of Special Drawing Rights (SDRs) declined by RM10.9 billion to RM59,133 million at the end of 1997. After taking into consideration the external liabilities of the Bank of RM10 million, the net international reserves of the Bank stood at RM59,123 million at end-1997.

Prior to 1997, holdings in foreign assets were revalued once, at year-end. However, in 1997, the accounting policy of recognising the foreign exchange revaluation gain or loss was changed, whereby, the exchange gain from the revaluation of foreign assets and liabilities was not recognised in the Bank's books. Nevertheless, full provisions will be made for any losses. In 1997, the gains from revaluation of external reserves amounted to RM24.6 billion. The United States dollar equivalent of gross reserves was US$21.7 billion at end-1997, a level sufficient to finance 3.4 months of retained imports. In SDR terms, the international reserves held by the Bank amounted to SDR16.1 billion.

Table 1.19
Net International Reserves

	As at end		
	1995	1996	1997
	RM million		
SDR holdings	391.0	427.7	478.9
IMF reserves position	1,723.3	1,738.2	1,622.0
Gold and foreign exchange	61,655.2	67,848.7	57,021.9
Net reserves	**63,769.5**	**70,014.6**	**59,122.8**

During the year, net holdings of **gold and foreign exchange** declined by RM10.8 billion to RM57 billion at the end of 1997. The decline in foreign exchange holdings reflected mainly the intervention operations in the second half of 1997 following pressures on regional currencies. For the year as a whole, net outflow of short-term capital was estimated at RM14.2 billion.

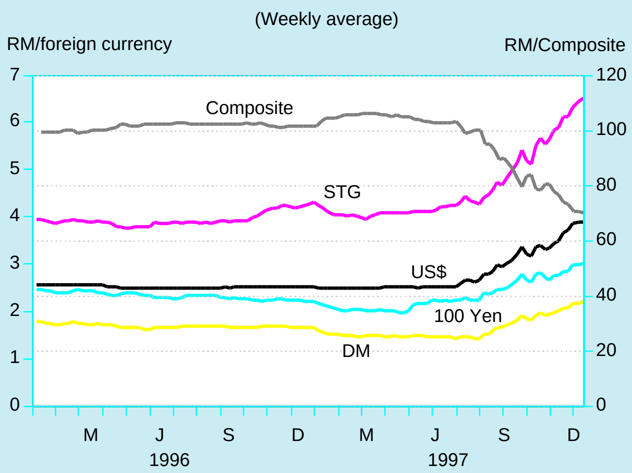
Holdings of reserves in the form of **SDR** increased by RM51 million during the year to RM479 million at the end of 1997. The increase was mainly on account of the receipts of remuneration from the IMF arising from Malaysia's net creditor position with the Fund which more than offset the charges incurred for holding SDRs below the allocated level. Malaysia was not included in the quarterly SDR Designation Plans of the Fund in 1997, under which countries were required to provide convertible foreign currency in exchange for SDRs upon request.

The **reserve position of Malaysia with the IMF** defined in terms of SDR, reflected transactions with the Fund during the year. In 1997, this component of external reserves declined by RM116 million to RM1.6 billion or the equivalent of SDR445 million. The decrease reflected mainly the repurchase of

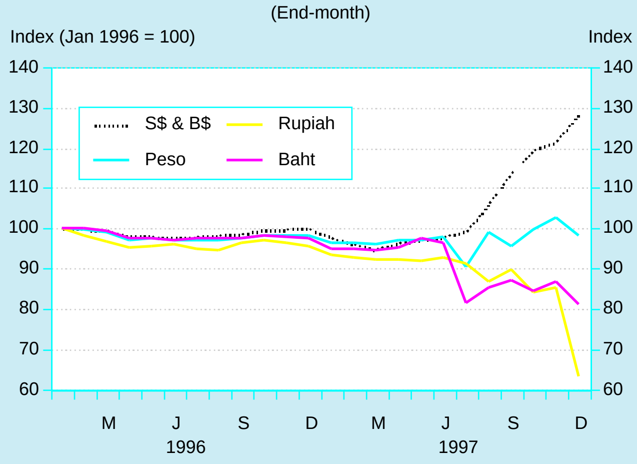
SDR34 million (RM116 million) under the Operational Budget of the IMF. The obligation to purchase the ringgit was intended by the IMF to facilitate the use of the ringgit by the Fund to meet withdrawals of funds by member countries. The obligation to repurchase would arise whenever a country which had drawn ringgit from the IMF subsequently made repayments. Purchases of ringgit from the IMF by a member country would result in an increase in the Bank's reserve position, while repurchase of the ringgit by a member would result in a decrease in the Bank's reserve position. Under the last quarterly Operational Budget for 1996, which covered the period December 1996 to February 1997, Malaysia was obliged to make purchases of SDR7 million and repurchases of SDR17 million. During this quarter, Malaysia repurchased ringgit from the Fund for a total of SDR15 million (RM50 million). Malaysia was included in the quarterly Operational Budget for the periods March to May and June to August 1997, under which Malaysia was obliged to make purchases of SDR24 million and repurchases of SDR41 million. During this period, Malaysia repurchased ringgit from the Fund for a total of SDR19 million (RM66 million) arising from repayments made to the Fund by three other members. Consequently, total repurchases for the year as a whole amounted to SDR34 million or equivalent to RM116 million. No purchases were made in 1997.

The overall objective of foreign reserve management of the Bank is to manage the foreign assets with the aim to optimise returns subject to safety and sufficient liquidity. The foreign assets are held in the form of cash or invested in allowable

Graph 1.11
Exchange Rate of the Malaysian Ringgit against Major Currencies



Graph 1.12
Exchange Rate of the Malaysian Ringgit against ASEAN Currencies



financial instruments in foreign government and supranational bonds and gold. The concern for safety encompasses the aspect of preservation of value while applying the concept of diversification to reduce portfolio volatility and meeting the investment guidelines of the Bank. **The Bank ensures adequate supply of liquidity to meet its obligations and has not entered into any forward transactions in its investment operations.** Subject to the constraint of minimising risk while maintaining sufficient liquidity, investment strategies are structured so as to optimise returns.

The movement in the **ringgit** in 1997 was influenced by international, regional and domestic developments. Several distinct phases could be observed during the year. During the first quarter, the ringgit steadily appreciated influenced largely by domestic developments. Against a background of a strengthening United States dollar, the currency experienced bouts of pressure in the second quarter, particularly in May and June, following developments in Thailand. During this period, the ringgit's volatility, as measured by the standard deviation, declined to 0.01 on a monthly basis from 0.02 in 1996. During the second half of the year, the ringgit experienced further increased volatility arising from both domestic and regional developments. In the second half of 1997, the volatility as measured by the standard deviation on a monthly basis increased to 0.09. While the ringgit depreciated significantly during this period, its volatility also increased in comparison to historical levels, although this was not significant when compared with the wider short-term fluctuations experienced by major currencies in recent years.

For 1997 as a whole, the ringgit recorded a depreciation of 31.4% against the composite basket of currencies of Malaysia's major trading partners. The depreciation of the ringgit was pronounced against all major currencies, ranging between 25–35%. Against the United States dollar, the ringgit depreciated by 35%. During the previous bouts of ringgit weakness experienced since the floating of the ringgit in 1975, the annual rate of depreciation of the ringgit against the United States dollar had not exceeded 10%. Against the pound sterling, the ringgit depreciated by 33.7%. The pound sterling was supported by strong output growth in the United Kingdom buoyed by strong private sector spending, aggressive monetary tightening to pre-empt inflation and safe haven buying of the currency during a period of uncertainty over the European Monetary Union. The relatively moderate decline of the ringgit against the Japanese yen by 27.3% reflected mainly the weakening of the yen against the United States dollar in the wake of the weak economic activity and financial sector problems in Japan.

The decline in the ringgit to levels observed in 1997 did not reflect the underlying fundamentals of the economy. With the increasingly greater integration of financial markets, the contagion effects of developments in the region were transmitted quickly to Malaysia. A track record of relative macroeconomic stability and progressive policy tightening was not sufficient to insulate Malaysia from these contagion effects. The market perception of emerging risks in the Malaysian financial system and economic outlook resulted in the contagion effects on Malaysia being much more severe, leading to a significant downward adjustment of the currency. Consequently, speculative activity during the period of uncertainty also increased the extent of the adjustments in the equity markets. For Malaysia, the relatively optimistic views early in the year and market perception that the ringgit was undervalued, were replaced by greater pessimism as the year progressed. As the regional currency crisis escalated, expectations played an increasingly significant role in determining the direction of the exchange rate. The situation was exacerbated by the thin volume of transactions. The decline in ringgit in the final quarter of 1997 reflected weak market sentiment, influenced by regional developments and market perception that the financial system would be adversely affected by the fall in stock value and the potential decline in property prices as well as expectations of higher interest rates.

Throughout the crisis, the exchange rate policy of Malaysia essentially remained unchanged. Since Malaysia adopted a floating exchange rate regime in 1975, no targets were set for the ringgit exchange rate level. The large and unpredictable changes in ringgit exchange rates in 1997 presented a major concern for macroeconomic stability. The significant misalignment of the exchange rates would ultimately, if allowed to remain for an extended period of time, result in economic distortions and a misallocation of resources. Measures adopted during this period were therefore aimed at restoring confidence and stability in the markets. In particular, correction of macroeconomic imbalances would allow the ringgit rate to reflect economic fundamentals. During the final quarter, the Government put in place a package of macroeconomic stabilisation measures. These measures centred on the further tightening of monetary policy, maintaining fiscal prudence, restoring external balance through the deferment of a number of large non-critical projects and the strengthening of the financial system. The measures were aimed at adjusting the economy to the changing economic conditions, including reducing the risks of adverse external developments on the Malaysian economy and the financial system.

With the adoption of the December measures, the basis was firmly in place for the exchange rate to adjust to reflect domestic economic fundamentals. Of importance was also the need to maintain domestic investor confidence. The highly disruptive and destabilising trends in the foreign exchange market, if prolonged, could be highly destabilising to an open economy. In this regard, intervention operations have always remained an option for the Bank.

The ringgit began the year on a bullish note, strengthening to the range of US$1=RM2.47–2.50 in the first quarter of 1997 due to enhanced prospects for Malaysia to achieve a more sustainable pace of growth, amidst price and external sector stability over the medium term. In the first quarter of 1997, the release of real output growth data for 1996 showed a moderation to a more sustainable level at 8.6% in 1996 (9.5% in 1995) and the trade balance improved significantly. In April, however, the ringgit depreciated against the United States dollar in the wake of the outflow of short-term capital following the consolidation of the stock market and increase in interest rates in the United States on 25 March 1997. In mid-May, the ringgit came under pressure, triggered by developments in Thailand. The ringgit, however, recovered to an intra-day high of US$1=RM2.4795 on 16 May and thereafter stabilised within the range of US$1=RM2.4900–2.5250 up to end-June.

In the second half of 1997, the strengthening of the United States dollar and pound sterling in international foreign exchange markets and the escalation of the regional financial crisis set the stage for the depreciation of the ringgit to unprecedented levels. On the international front, the United States dollar and the pound sterling strengthened significantly due to strong growth in their domestic economies, moderate growth of the European economies and stagnation in the Japanese economy. The appreciation of the United States dollar against major currencies was supported by expectations of high returns in the stock markets with the Dow Jones consistently exceeding the 7000 level. This was reinforced by receding expectations of an interest rate hike amidst moderating inflation. These developments resulted in a shift in strategy by international fund managers to increase the proportion of their investments in the United States and the United Kingdom and to reduce their investments to this region, including Malaysia. The outflow of funds from the region to markets in the United States and the United Kingdom contributed to the capital rally in these countries and the strengthening of their currencies. Against these developments, regional currencies, including the ringgit, would have adjusted downwards just based on the performance of the United States dollar alone. This trend, however, was made more pronounced by regional developments triggered by events in Thailand. In the aftermath of the floatation of the Thai baht on 2 July, the contagion effects caused South-East Asian currencies to depreciate significantly.

Amidst the sudden and adverse change in investor sentiment against the regional currencies, speculative activity in ringgit intensified, culminating in a sharp correction in both the equity and currency markets. In August 1997, the ringgit weakened against the United States dollar to breach the previous low of US$1=RM2.7945 recorded on 4 July 1991. The ringgit touched US$1=RM2.7995 on 19 August 1997. Besides the liquidation of securities in the equity market, ringgit funds for speculative activities were raised from the offshore ringgit market and via swap transactions (offer-side) with domestic banks. The increased demand for ringgit for speculative activity was met with sharp increases in domestic interbank interest rates in July. The overnight and three-month rates rose sharply to 40% and 8.6% respectively on 10 July. In an effort to separate the impact of external developments on the domestic markets, the Bank also introduced a limit on non-commercial related offer-side swap transactions with foreign customers on 4 August 1997. Each bank was required to observe a limit of US$2 million outstanding on non-commercial related ringgit offer-side swap transactions with each foreign customer. The measure was to facilitate lower domestic interest rates that were more reflective of domestic conditions without the consequential result of allowing access to low cost ringgit to fund speculation.

Adverse market reaction to a series of events in the last four months of 1997 and early 1998, both at home and abroad, pushed the currency to successive lows until it reached an intra-day low of US$1=RM3.9300 on 15 December 1997 and subsequently US$1=RM4.8800 on 7 January 1998. On the international front, the contagion impact spread in October 1997 to the Hong Kong dollar, Taiwan dollar, and across the globe, causing a sharp fall in stock prices in New York, Hong Kong SAR, China, South-East Asia, Latin America, Europe, Australia and New Zealand. Regional developments, particularly the liquidity crisis in Indonesia and problems of the Korean financial system, exerted a stronger influence. On the domestic front, the weak investor confidence was attributable to United Engineers Malaysia Berhad's purchase of shares of its parent company, Renong Berhad, and the imposition of trading restrictions by the Kuala Lumpur Stock Exchange on five stock broking companies. Consequently, the ringgit traded at

Table 1.20
Movement of the Ringgit

	RM to 1 unit of foreign currency[1]				Annual change (%)	
	1996	1997			1996	1997
	End Dec.	End Dec.	Low	High		
Composite	101.67	69.70	69.58	106.00	+2.6	-31.4
SDR	3.6350	5.2539	3.3939	5.2715	+3.9	-30.8
US$	2.5279	3.8883	2.4717	3.8900	+0.5	-35.0
S$	1.8066	2.3200	1.7121	2.3454	-0.6	-22.1
100 Yen	2.1755	2.9921	1.9737	3.0294	+13.5	-27.3
Pound sterling	4.2747	6.4449	3.9353	6.5276	-8.1	-33.7
Deutsche Mark	1.6256	2.1729	1.3989	2.1958	+8.7	-25.2
Swiss franc	1.8746	2.6742	1.6641	2.7174	+17.5	-29.9

[1] Based on the average of buying and selling rates at noon in the Interbank Foreign Exchange Market in Kuala Lumpur

US$1=RM3.8883 at end-1997, a depreciation of 35% from the end-1996 level. The ringgit touched a record low of US$1=RM4.8800 on 7 January, before recovering to an intra-day high of US$1=RM3.3500 on 11 February 1998. A combination of factors, including Government commitment to accelerate implementation of measures to restore stability as well as favourable developments in the region, particularly the restructuring of short-term Korean debts, the moves to address Indonesia's corporate debt and the abolition of the two-tier exchange rate system in Thailand, contributed to the firmer trend in regional currencies, including the ringgit.

Changes in the exchange rate level have pervasive effects on prices, external trade, external debt servicing, interest rates, output and employment. Although the full impact of the depreciation of ringgit will be more evident in 1998, some favourable developments were seen in the sectors producing "tradeable goods" in the second half of 1997. The manufacturing and plantation sectors showed strong export growth performance. Overall, export growth accelerated since July 1997 and the trade balance improved progressively. Of significance, gross exports grew by 22.5% in the second half of the year compared with gross import growth of 19.6%. While the export performance reflected mainly higher receipts due to the depreciation, there was also an increase in export volume.

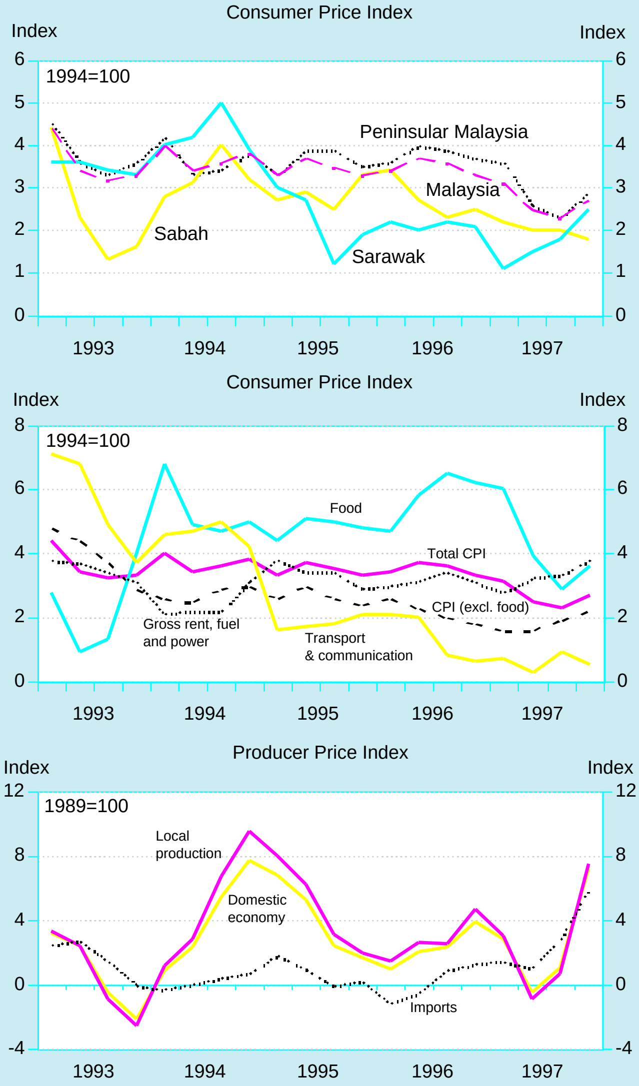
The impact of the depreciation on external debt servicing was not as severe, as Malaysia's external debt, including short-term debt, is relatively low. Arising from the ringgit's depreciation, the external debt in ringgit terms increased from RM114 billion as at end-June 1997 (US$44.9 billion) to RM166 billion as at end-1997 (US$42.5 billion). This included short, medium and long-term debt, with short-term debt accounting for 24% of total debt. The relatively lower debt position was due to deliberate policies maintained over several years. As a result, private sector external borrowings was allowed mainly to fund export-oriented industries. Given that the bulk of the external loans of the private sector was channelled mainly to export-oriented sectors, these companies had a natural hedge from export receipts to cover the significant increase in debt servicing. Hence, recourse to external reserves to meet obligations due in 1998 remains manageable (for details, please refer to Box Article III on External Debt Management).

Of concern is the impact of the depreciation of the ringgit on consumer prices. A 10% depreciation is estimated to result in a 1% increase in consumer prices. Theoretically, therefore, the inflation rate is likely to increase to 7–8% in 1998. In this context, monetary and fiscal policies will remain tight to contain the inflationary pressures. Other mitigating factors to moderate inflationary pressure include lower aggregate demand, traders absorbing higher exchange rate costs in order to maintain market shares and substitution of imports from cheaper sources.

Prices and Employment

While prices moderated in 1997, the rate of **inflation** showed a significant rising trend in early 1998. Similar to experiences in other countries, the

Graph 1.13
Prices Indices : Average Annual Rate of Change



impact of the ringgit depreciation was reflected within a relative short lag on the Producer Price Index (PPI, 1989=100), while its pass-through impact on the Consumer Price Index (CPI, 1994=100) was evident only with a longer time lag. Producer prices rose sharply in the fourth quarter (7.2% in the fourth quarter from 1%, -0.5% and 2.8% in the third, second and first quarters respectively) at the time the depreciation of ringgit against the United States dollar was also most significant for 1997 (35% at end-December compared with 20.9% at end-September and 4.1% at end-July). Consumer prices, however, showed a stronger increase in early 1998, following the depreciation of the ringgit since mid-1997. CPI growth rates remained relatively low at 2.5% in the second half-year, from 2.8% in the first half of 1997. During the first two months of 1998, the CPI rose at an average rate of 3.9%.

This phenomenon reflected two factors. Firstly, the pass-through effect of higher import prices was filtered down to the domestic price level with a time lag. Secondly, the increase in consumer prices had been on a downward trend in 1997. At the start of the financial crisis in July 1997, the CPI rate was 2.1%, the lowest level since September 1990. In addition to the lagged effects, the marginal initial impact of the depreciation on domestic prices was also due to market imperfections, influences of the price-setting mechanisms, and the relatively lower share of imported goods in the CPI basket. Furthermore, the actual impact of the ringgit depreciation on the CPI could also be mitigated by several factors, including the substitution of imports for locally produced goods as well as cheaper alternative sources. As costs increase due to the ringgit depreciation, this would reduce demand and assist in the adjustment process to moderate excesses within the economy, while producers and traders would also absorb part of the price increase in order to maintain market share.

In 1997, inflation, as measured by the CPI, increased at a slower rate of 2.7%, compared with 3.5% in 1996, the lowest rate of inflation since 1990. The moderate increase in the prices of food, and transport and communication, had a particularly strong effect on the CPI. Excluding the food sub-group, the adjusted CPI rose more moderately by 1.8%, compared with 2.3% in 1996. The low rate of consumer price inflation was, in part, due to the slower growth of the economy following monetary policy tightening that contributed to moderate demand pressures.

Table 1.21
Price Indices for Malaysia

	Weights	1996	1997
		Annual change (%)	
Consumer Price Index (1994=100)	100.0	3.5	2.7
Of which:			
Food	34.9	5.7	4.1
Beverages and tobacco	3.6	2.2	1.3
Clothing and footwear	3.6	-0.7	-0.5
Gross rent, fuel and power	21.1	3.2	3.2
Furniture, furnishings and household equipment	5.6	1.1	0.1
Medical care and health expenses	1.9	3.7	3.6
Transport and communication	17.9	1.4	0.6
Recreation, entertainment, education and cultural services	5.8	3.3	0.4
Miscellaneous goods and services	5.6	2.5	4.6
Peninsular Malaysia CPI	100.0	3.8	2.8
Sabah CPI	100.0	2.8	2.0
Sarawak CPI	100.0	2.2	1.7
Producer Price Index (1989=100)	100.0	2.3	2.7
Of which:			
Local production	79.3	2.8	2.5
Imports	20.7	0.1	2.8
House Price Index (1990=100)		12.9	6.1[1]
Of which:			
Klang Valley		15.7	4.6
Johor Bahru		14.3	3.1
Penang Island		4.3	5.2

[1] January-June.
Source: Department of Statistics
Department of Valuation and Property Services

Concomitantly, measures to ease supply constraints and promote savings as well as strict enforcement of administrative measures to curb excessive profiteering also contributed to the moderation in the inflation rate. In addition, stable import prices in the first half-year, reflecting lower world prices of food and beverages and the appreciation of ringgit, as well as the reduction or abolition of import duties on a wide range of goods in recent years, in particular, foodstuff, also contributed to moderate price pressures. On a regional basis, the CPI for Peninsular Malaysia, Sabah and Sarawak also moderated to 2.8%, 2%, and 1.7% respectively in 1997.

The bulk of the 1997 price increases came in the early part of the year, emanating from seasonally high food prices as well as the increase in toll charges; city bus, taxi and airline fares; and electricity tariff rates. In addition, the higher cost of production arising from higher utility charges and transportation costs as well as higher wages was also reflected in the CPI. Price increases eased after March to its lowest level of 2.1% in July. However, the impact of ringgit depreciation was partly reflected in the CPI since October, mainly due to higher import prices in the food; gross rent, fuel and power; and miscellaneous goods and services sub-groups, which together accounted for more than one-half of the imported items in the CPI basket. Consequently, prices edged upwards to 2.9% in December.

The CPI for food (accounting for 34.9% in the overall CPI basket) rose by 4.1% in 1997 (5.7% in 1996), due mainly to slower price increases for food consumed at home (3.7%; 6% in 1996), while prices of food consumed away from home continued to record a large increase of 5.3%. Of significance were the more moderate increases in the prices of fish, meat, fruit and vegetables due to the availability of a larger supply through higher imports and domestic production, as well as the slower price increases for rice, bread and other cereals as a result of lower prices for flour. In March 1997, flour prices which were administered by the Government were reduced by 9.1% to reflect lower world prices. However, to reflect the higher cost of imports arising from the depreciation of the ringgit since July, the Government approved an increase in the ceiling price of two essential items, namely, cooking oil and chicken from mid-December 1997. This was followed by an increase in prices of another three administered items, namely, flour, sugar, and milk effective 1 February 1998. These items account for 4% of the weight in the CPI basket. Among the non-food sub-groups, price increases for gross rent, fuel and power; and medical care and health expenses remained high. Similarly, miscellaneous goods and services also recorded higher prices, largely due to higher import prices of jewellery, watches, and personal goods in the fourth quarter. Slower price increases were registered for all other sub-groups, in particular prices for transport and communication, partly due to slower increases in the prices of petrol and motor oil during the year.

Although the CPI is generally used as a measure of inflation, it may not indicate all the changes that affect the cost of living, as consumers respond to price changes and new choices. The differences between the CPI and the cost of living, often referred to as measurement biases, are mainly caused by substitution bias, quality bias, and “new goods” bias. Substitution bias arises as consumers substitute cheaper products for more expensive ones and as consumers move away from a more expensive retail outlet towards a cheaper outlet. Quality bias arises because the quality of goods and services may change over time but the price index fails to capture this, thereby, overstating or understating changes in the cost of living. Meanwhile, new products are introduced over time while the production of existing products in the basket may be discontinued. Removing an existing product from the basket and replacing it with a new one will result in a measurement bias as the two products are unlikely to be identical. These biases have a cumulative effect on the overall CPI. Inflationary expectations have also begun to build up as producers and suppliers adjust to higher import costs by requesting for price increases, including prices of goods administered by the Government. The Consumer Sentiments Survey conducted by the Malaysian Institute of Economic Research (MIER) in the fourth quarter of 1997, indicated that more than 83% of the households surveyed were expecting prices to increase in the next six months, compared with only 79% of the respondents in the third quarter.

The PPI, which measures prices of both intermediate and final goods charged by domestic producers and paid by importers in the country, rose by 2.7% in 1997, compared with 2.3% in 1996. The deterioration was due to increases in both import prices and domestic production costs in the second half-year. Unlike consumer prices, the impact of the depreciation of ringgit on producer prices is more immediate and direct. The producer prices for imports surged from an annual rate of 1.1% in June to a high of 8.3% in December, reflecting costlier imports of machinery and transport equipment; food and live animals; chemicals and related products; and manufactured goods. Similarly, the PPI for domestic production rose to 9% in December due to an escalation in prices of animal and vegetable oils and fats (44%); and mineral fuel, lubricants, and related materials (11.5%). On the other hand, prices of crude materials continued to decline as a result of lower prices of rubber and timber. Excluding these three major sub-groups, the PPI rose by 1.7%, compared with 2.2% in the previous year.

While the prices of goods as measured by the CPI remained relatively stable, asset prices particularly stock prices continued to increase. Higher prices of properties and excessive overvaluation of stock prices, evident in 1996, spilled over into 1997. The Bank continued with its policy of monetary restraint to contain asset inflation risks. The Bank instituted further prudential pre-emptive measures in April 1997 to limit overall bank exposure to the broad property sector and for share financing. As a result, property prices stabilised with the increase in the National House Price Index moderating to 6.1% in the first half of 1997, the lowest increase since 1993. However, the onset of the regional financial crisis led to a sharp correction in stock prices, which fell by more than 50% from the end-March level. There were also signs that property prices had begun to ease. While residential and industrial property prices had stabilised in 1997, there were signs of an easing in prices in some segments of the property market, particularly office and retail space, and high-end condominiums.

A combination of strong credit growth, buoyant demand, capacity constraints and cost pressures emanating from higher utility and transportation charges and higher wages also gave rise to concern over inflationary risks in early 1997. Hence, macroeconomic policies continued to firmly focus on maintaining price stability in 1997. These were reinforced by continued fiscal prudence and further supported by administrative measures to improve distribution and curb profiteering. With food prices accounting for more than one-half of the increase in the overall CPI, concerted efforts were made to increase food production activities and to improve the marketing and distribution system. The 1997 Budget allocated RM1.7 billion to develop the agriculture, fisheries and livestock sector, while the allocation for the Fund for Food was increased twice during the year to RM700 million. Among the programmes implemented during the year was the launching of the Fishermen's Initiative Fund to help traditional fishermen obtain interest free loans to finance their fishing activities. This Budget also provided an allocation for programmes to combat inflation, including the "Zero Inflation Campaign", price monitoring of 75 essential items for the lower income group and stricter enforcement to curb unethical business practices and profiteering. Import duties and sales tax were reduced or abolished for a number of goods, including foodstuff, paper and printing industry products. The list was extended further to include medication, canned food and selected electrical items in the 1998 Budget. To reduce cost push inflationary pressures, the manufacturers of selected non-taxable goods were allowed to obtain raw materials and components free from sales tax. Meanwhile, several savings promotion campaigns were launched in 1997 to promote voluntary savings amongst the targeted groups, mainly the school children, workers and women, as well as to nurture a more cost-conscious society. These added a further dimension to the overall policy to contain inflation.

In addition, to keep imported inflation in check, more conscious efforts were taken to procure imports from cheaper sources as well as to increase local substitutes. Concomitantly, the Government intensified enforcement of administrative measures to curb profiteering and unjustified price increases that usually occur when the exchange rate depreciates. The Ministry of Domestic Trade and Consumer Affairs conducted a total of 543,626 "Ops Sedar" and took action on 6,709 traders throughout the year. The Ministry plans to launch a special campaign on "Buy Malaysian Products" in 1998. At the same time, to break the expectation-inflation link, the Government announced it will establish benchmark data on prices of both essential and non-essential goods to improve the flow of information on prices of consumer goods. This would be part of an action plan for stabilisation of supply and prices for essential goods, and to curb hoarding and smuggling. Following the rise in the crude palm oil prices, the Government reintroduced the Cooking Oil Stabilisation Scheme in December 1997, whereby the Government agreed to fix the price of palm olein at RM1,700 per metric tonne.

Continued tight labour market conditions and good corporate profits, particularly in the first half of 1997, exerted further upward pressures on **wages**. The real average wage in the manufacturing sector increased by 7% in 1997, albeit at a slower rate than the 9.6% recorded in 1996. The upward pressure on wages was reflected in the three-year collective wage agreements concluded within the private sector during 1997. However, wage increases under collective agreements apply only to 2% of the total workforce in the country. The weighted average wage increased by 13.1% in 1997, compared with 10.3% in 1996. The increase in wage rates was higher in all sectors, except the agriculture and mining sectors. Of significance, wages increased strongly in both the electricity and services sectors, by 18.1% and 14.1% respectively, compared with 6.4% and 7.6% respectively in the previous year. The wage agreements concluded in the manufacturing sector during the year also indicated that the weighted average wage rose at a faster rate of 15%, compared with 13% in 1996. However, this trend was not reflective of wage trends for the manufacturing sector as a whole, as less than 10% of the companies were involved in the collective agreements concluded in 1997. Wages in the transport and commercial sectors also recorded double-digit increases of 10% and 11.8% respectively. In contrast, both the agriculture and mining sectors recorded slower wage increases of 10.2% and 7.7% respectively. As in the previous year, no collective wage agreement was concluded in the construction sector.

During the year, the number of collective wage agreements concluded in the private sector totalled 412, involving 130,035 workers or only 2% of the workforce. A total of 241 agreements involving 63,381 workers were concluded in the manufacturing sector while in the agriculture sector, 18 agreements were concluded involving 35,982 workers. In the services sector, 11,973 workers were involved in the 44 agreements signed in this sector. In tandem with their contribution to the overall GDP and total employment, these three sectors accounted for 86% of the number of workers in the country.

An analysis of wage trends and labour productivity in 1997 provided grounds for concern. Estimates showed that the increase in real labour productivity of 5.7% in 1997 continued to lag behind the growth of real average wages in the manufacturing sector of 7%. The average increase during the previous two-year period, 1995–96, was 7.9% for wages and 6.2% for labour productivity. The overall labour productivity growth for the economy as a whole was also on a downward trend. Growth in labour productivity, as measured by the ratio of GDP to total employment increased at a slower rate of 5.1% in 1997, compared with 5.3% in 1996 and 1995 respectively. The slower rate of growth in labour productivity reflected in part the impact of slower demand, particularly during the second half of 1997, resulting in companies producing below the optimum productive capacity. Although the Government had adopted the guidelines for a productivity-linked wage reform system in August 1996, implementation of the policy by the private sector is still slow. A progressive move to productivity-wage setting arrangements would help the economy avoid being trapped in a cost-push inflation situation as trade unions often use the CPI as a yardstick in negotiations of collective wage agreements.

In 1997, the Government continued to focus on the strategic shift to productivity-driven growth to optimise the utilisation of capital and human resources to achieve sustainable growth, to overcome labour shortages and contain wage-cost inflation in order to maintain the country's export competitiveness. Several fiscal incentives were provided in the 1997 and 1998 Budgets to enhance productivity. These measures included the provision of reinvestment allowance to encourage companies to reinvest in automation and labour-saving devices which would contribute to significant improvements in productivity; fiscal and other incentives to facilitate the shift to high technology, capital intensive and information based industries; incentives for research and development; and incentives to increase the value chain of manufacturing processes to strengthen industrial linkages. Concomitantly, the Government provided an allocation of RM721.4 million for the Technology Development Action Plan and for research programmes under Intensification of Research in Priority Areas (IRPA) and Microelectronic Institute of Malaysia (MIMOS) to encourage more productivity-related and research and development activities to increase the efficiency and effectiveness of industries. At the same time, the NPC three-year *National Productivity Enhancement Campaign* added a further dimension to accelerating the transformation of the economy towards productivity-driven growth.

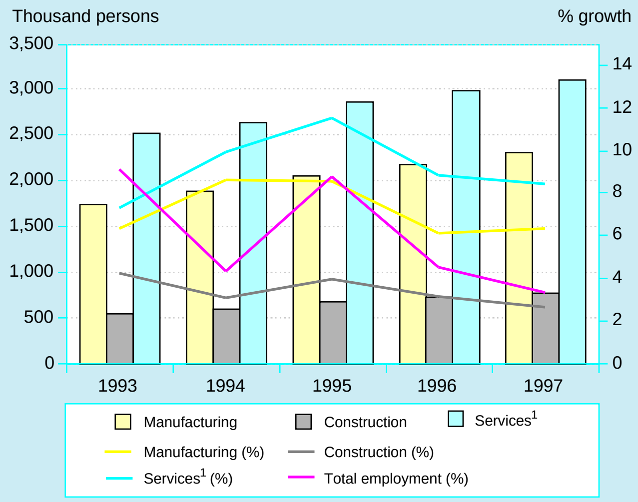
In 1997, the number of strikes declined to five cases involving a total of 812 workers, compared with eight cases involving 935 workers in 1996, an indication of a further improvement in industrial relations in the country. Four sectors, namely, the manufacturing, agriculture, transport and commercial sectors, faced strike actions during the year. In the manufacturing sector, two cases of strike actions involving 598 workers were recorded, compared with three cases involving 572 workers in 1996. The agriculture sector faced only one incident of a strike involving 151 workers compared with five cases involving 363 workers in the previous year. A total of 63 workers were involved in strike actions in the other two sectors. The strike actions were due to refusal to enter into collective bargaining; dispute over terms and conditions of employment; and disputes over other issues. Consequently, the strikes resulted in a loss of 2,396 man-days during the year, compared with 2,423 man-days in 1996.

The number of industrial disputes fell to 463 cases in 1997, compared with 552 cases in 1996. However, the number of workers involved in the disputes more than doubled to 139,187 workers from 66,915 workers in the previous year. The bulk of the cases arose from disputes over terms and conditions of employment (223 cases) and deadlock in the process of collective bargaining (112 cases). On a sectoral basis, the number of industrial disputes in the manufacturing sector declined to 182 cases involving 43,170 workers, from 209 cases involving 46,624 workers in 1996. Most of the other major sectors of the economy also recorded a lower number of industrial disputes. However, the number of industrial disputes in the transport sector rose markedly to 130 cases involving 70,342 workers compared with only 3,759 workers in 1996.

The **employment** situation remained tight in 1997, although it eased somewhat towards the end of the year, especially in the construction and selected services sub-sectors due to the deferment of projects as well as the scaling down of some on-going projects which were considered less essential. The economy operated at full employment for the sixth consecutive year, although the unemployment rate increased slightly to 2.7% compared with 2.5% in 1996. Total employment increased at an estimated rate of 2.6% or 214,000 persons to 8.4 million in 1997, while the labour force grew by 2.8% or 235,000 persons to 8.6 million. The number of registered job-seekers rose to 23,760 persons at the end of the year from 22,420 persons at the beginning of the year, reflecting slightly easier labour market conditions towards the end of the year.

On a sectoral basis, the **services sector** accounted for the major share of new jobs (48%),

Graph 1.14
Employment by Sector



[1]Exclude Government services

followed by the manufacturing (28%) and the agriculture (15%) sectors. With the continued expansion of the services sector, the level of employment in the sector grew by 2.6% to four million persons in 1997. The wholesale and retail trade, hotels and restaurants sub-sector remained the major source of employment. Employment in this sub-sector rose by 0.6% during the year, accounting for 16.5% of total employment. In the transport, storage and communications sub-sector, employment rose by 4.6%, while employment in the finance, insurance, real estate and business services sub-sector increased by 4.7%. These two sub-sectors accounted for a combined share of 10.2% of total employment. Reflecting on-going privatisation and continued efforts to rightsize the public sector, growth in employment in the public services sub-sector increased marginally by 0.3% during the year to 880,000 persons or 10.5% of total employment.

Employment in the **manufacturing sector** rose by 6.3% or 138,000 persons to 2.3 million persons, reflecting the sustained expansion in manufacturing activities during the year. Statistics released by the Ministry of International Trade and Industry (MITI) on approved manufacturing investment indicated that the capital investment per employee was slightly lower at RM361,408 in 1997 compared with RM372,800 in 1996. In contrast, total employment in the **agriculture sector** continued to decline by 4.9% to 1.3 million persons during the year. Labour shortages in this sector were further exacerbated by the continuous outflow of labour to other sectors, apparently attracted by better terms and working conditions. Employment in the **construction sector** rose at a slower rate of 5.4% to 765,000 persons in 1997, representing a share of 9.1% of total employment. In the **mining and quarrying sector**, employment stabilised at 43,000 persons, accounting for less than 1% of total employment.

The problem of labour shortages and their adverse implications on efficiency and cost of production continued to persist in 1997. This was exacerbated by the short supply of skilled labour as industries continued to shift into higher value added products and more knowledge-based and technology intensive processes. In the immediate term, the labour-intensive industries have continued to rely on foreign workers. Available data showed that there were 1.14 million registered foreign workers in 1997, while the total number of foreign workers currently employed reached an estimated 1.7 million. The majority of the foreign workers were from Indonesia (65%), Bangladesh (22%), and the Philippines (7%). On a sectoral basis, one-half of the total foreign workers were employed in the productive sectors, namely, the manufacturing (27%) and plantation (23%) sectors, while the balance were in construction (24%), services (13%), and domestic services (12%). The Bank Negara Malaysia Annual Survey of Companies in the Manufacturing Sector for 1997 showed that the recruitment of foreign workers in the manufacturing sector declined by 7.5% in 1997, while employment of local workers declined by only 0.7%. This was due to the tightening of the policy on the employment of unskilled foreign labour in 1997 to expedite efforts to reduce the dependence on labour-intensive production processes and for industries to undertake strategic adjustments in moving towards labour-saving production technology and to high value added and high-technology industries. There were also increasing concerns over the social implications arising from the prolonged reliance on the employment of a large pool of foreign workers and on the need to ensure that employers give priority to hiring local labour, especially in the context of slower economic growth and a weakening of the domestic labour market. Since 10 July 1996, the Government stopped approving new entry permits for foreign workers in the construction, services and plantation sectors. This was extended in August 1997 to include a freeze on recruitment of foreigners in all sectors. In January 1998, the levy on foreign workers (excluding workers in the estate sector and househelpers) was increased to RM1,500 per annum from RM1,200 per annum.

To meet the demand for skilled workers, in particular, manpower with technical skills, the Government further relaxed conditions governing the employment of foreign expatriates and other skilled manpower. Recruitment was allowed based on the needs of companies, especially in sectors actively promoted by the Government, such as companies in the Multimedia Super Corridor (MSC), approved International Procurement Centres and companies producing selected wafer fabrication products. However, the employment of skilled foreign workers was also a temporary measure, with the longer term strategy being to enhance and upgrade skills as well as to increase overall efficiency and productivity. In the 1997 Budget, RM13.2 billion was allocated for human resource development. This was complemented by a package of fiscal incentives to encourage greater automation and more capital-intensive production processes to increase efficiency. These incentives included a tax exemption of 50% on gross income received by foreign lecturers teaching in selected fields (including science, engineering and information technology) in approved educational and training institutions. The tax incentives given to MSC companies were extended to multimedia faculties in institutions of learning in the 1998 Budget.

Greater emphasis continued to be accorded to industrial and skills training in 1997. The Government also proposed to set up a Design Technology Centre and a Flexible Manufacturing Centre to train skilled manpower in the field of design and use of robotic technology which would contribute towards encouraging production at the higher end of the value added chain. The new intake of trainees in the existing nine Industrial Training Institutes increased further by 17.4% to 2,892 participants, while the number of instructors trained by the Centre for Instructors and Advanced Skill Training rose to 3,391 persons. In addition, output from the existing bilateral training centres, namely, the German Malaysia Institute (GMI), Malaysia-French Institute (MFI) and British Malaysia Institute (BMI) which aim to provide skilled workers to selected strategic industries, increased to 559 persons in 1997. During the 7MP period, the Government planned to set up another four bilateral training centres, including the Malaysian Institute of Chemical Engineering Technology, Malaysia Aviation Institute of Technology, Malaysian Automotive Engineering Institute of Technology and Malaysian Institute of Ship Building Technology. It is interesting to note that a World Bank study on *Enterprise Training, Technology and Productivity in Malaysia* on 2,200 manufacturing firms in 1994-95 found that formal training helped to improve productivity at the firm level. Firms that provided training, on average, were about 32% more productive than firms that provided no training. The productivity effects were enhanced when new technologies acquired through licensing were complemented with training.

The Human Resource Development Fund (HRDF), which was established since 1993, has to date assisted companies in retraining and upgrading the skills of a total of 1.7 million employees. As at end-1997, a total levy of RM494 million was collected, of which RM459 million was allocated for training. During 1997, three additional schemes were introduced to further upgrade workers' skills and to retrain workers. These involved the purchase of personal computers to train workers in branch offices; 100%

financial support for employers to retrain and upgrade the skills of workers, particularly among the rural under-employed workers; and an apprenticeship scheme for tools and die machining. As at the end of 1997, a total of 5,883 employers were registered with the Human Resource Development Council (HRDC), of which 80% were from the manufacturing sector and the rest from the services sector. In the 1998 Budget, the HRDF scheme was extended to other sectors, particularly in the energy, education and consultancy fields, to promote sufficiently skilled manpower.

In the face of a slowdown in domestic economic activity, it is expected that the domestic labour market will weaken. During 1997, official estimates indicated that the number of workers retrenched increased to 18,863 workers, compared with 7,773 workers in 1996. The retrenchments were attributed to a drop in demand and increased competition (51%); restructuring of companies (32%); and increased automation and technology (10%). In terms of sectoral distribution, the retrenchments were from the manufacturing sector (82%), particularly the electronics industry (42%), and the transport sector (8%). The balance was from the agriculture, mining, construction and services sectors. In terms of job category, the majority of workers retrenched were production workers (46%), followed by semi-skilled workers (15%), and general workers (10%). The balance were skilled workers, professional and technical workers and clerical staff. The Government monitored the situation closely and implemented various measures to address the problem. In early 1998, the Government established a Tripartite Committee on Retrenchment of Workers and introduced a mandatory requirement for employers to inform the Director-General of Labour Department one month ahead of any retrenchment exercise. The Ministry also set up a mechanism at the local level to register the retrenched workers and to assist them in finding alternative jobs. A programme to improve labour mobility was also introduced to assist in retraining and the redeployment of excess labour to economic sectors which continued to face labour shortages such as the manufacturing, agriculture and services sectors. A Workers' Retraining Programme will be implemented in March 1998 with an initial allocation of RM2.2 million. In order to reduce the financial burden, employers were given a temporary exemption from paying the levy to the HRDF for six months, while RM66 million was recredited to the employers' account, to be utilised to retrain their staff.