

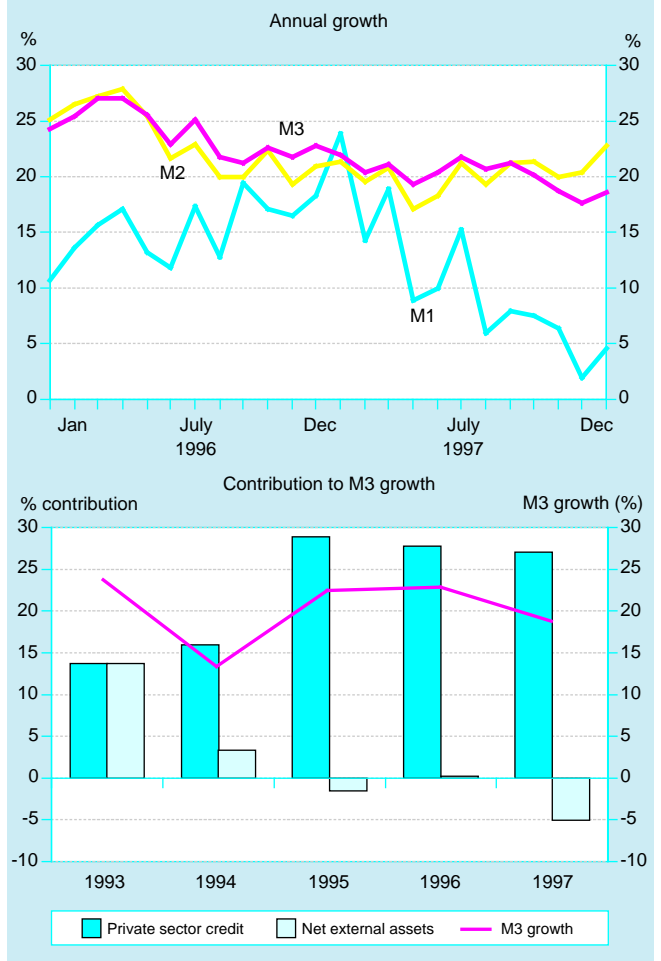
Monetary Developments

The progressive tightening of monetary policy during the course of 1997, complemented by selective prudential measures resulted in a moderation in the growth rates of all monetary aggregates by end-1997. Monetary developments, however, showed distinct trends in the early and latter parts of the year. In the first half-year, monetary aggregates moderated only slightly, in response to measures to address asset inflation. In the second half of 1997, monetary developments were influenced significantly by the policy responses on both the monetary and fiscal fronts to restore macroeconomic stability following turbulence in the financial markets in East Asia. The more pronounced tightening of monetary policy during this period was also to respond to rising inflationary pressures following the depreciation of the ringgit since July 1997. Liquidity conditions tightened considerably towards year-end as uncertainty and public concerns over the banking system resulted in distortions to the intermediation process and the smooth operation of the money market. These developments resulted in the rapid increase in effective lending rates. Several measures, including the reduction in the statutory reserve requirement (SRR) by 3.5% in 1998, alleviated this trend.

The strong growth in **money supply** in the first half of 1997 reflected the high credit growth which became the main focus of monetary policy in early 1997. As the credit growth emanated mainly from loans for the purchase of properties and shares, pre-emptive measures were implemented with effect from 1 April 1997 to facilitate adjustments of the exposure of the banking system to these sectors to more prudent limits. Subsequently, the annual growth rates of all monetary aggregates – M1, M2 and M3 – moderated but remained high, averaging 13.5%, 19% and 19.9% respectively during the first half of the year compared with the average of 15.1%, 23.2% and 23.8% respectively in 1996. The relatively slow response of loan growth to these measures reflected the continued drawdown of earlier loan commitments of the banking system.

The need for a more rapid moderation of monetary and credit growth became more urgent as expectations of inflationary pressures increased following the intensification of the currency crisis in East Asia. The high credit growth was also seen as a potential risk that could have adverse implications on financial stability. Monetary policy was, therefore, tightened further during the latter part of the year, through the firming of interest rates and adoption of further prudential measures. These were complemented by the requirements on banking institutions to draw up credit plans which were announced in October. Banking institutions were required to observe the limits as contained in their estimates for credit growth for the remaining part of 1997 and for 1998. As a result of these

Graph 2.1
Money Supply



measures, the annual growth of M1 and M3 slowed down substantially during the second half-year and ended the year significantly lower, at 4.6% and 18.5% respectively compared with 16.7% and 21.2% respectively at end-1996. Meanwhile, M2 remained high at 22.7% (19.8% at end-1996), reflecting the shift in deposits from finance companies to commercial banks. In absolute terms, M3 increased by RM61 billion during the year (RM57.8 billion during the previous year). The slower annual growth of M3 reflected mainly the moderation in demand for transaction balances, while growth in broad quasi-money was sustained during the year. There was also a notable shift in the preference of the private sector from transaction balances to interest-bearing deposits. Transaction balances accounted for only 4% of the increase in M3 (15% in 1996), following the higher interest rates and weak sentiments on the stock market.

Demand for transaction balances (currency holdings and demand deposits of the private sector) moderated significantly in 1997 to increase by only RM2.4 billion (RM7.7 billion in 1996). Except in January and December when there occurred strong expansion to meet cash requirements for the festive season, demand for transaction balances displayed a declining trend during the rest of the year. The largest decline was recorded in April, mainly as a result of the bearish sentiments in the Kuala Lumpur Stock Exchange (KLSE). The downward trend continued in the second half-year in response to the poor performance of the KLSE and the slowdown in economic activities, particularly in the last quarter of the year. At the same time, the private sector also optimised holdings of transaction balances as the opportunity cost of holding non-interest-bearing deposits became greater with the increases in interest rates.

As interest rates firmed significantly during the year, broad quasi-money (private sector holdings of fixed and savings deposits, negotiable instruments of deposit (NIDs) and repurchase agreements (repos) with the banking system (excluding interbank transactions)), expanded by RM58.6 billion or 21.8% (RM50 billion or 22.9% in 1996). The higher nominal interest rates amidst lower inflation rates meant higher real rates of return, thereby creating an incentive for the private sector to increase its holdings of interest-bearing deposits. However, the increase in quasi-money was dampened, to some extent, by the negative wealth effect arising from the marked decline in share prices, the consequent outflows of

portfolio capital and the overall moderation in growth of disposable incomes.

In terms of instruments, fixed deposits remained the largest component of broad quasi-money. A notable increase was also recorded in NIDs. The tight liquidity situation, particularly in the final quarter of the year, made borrowing in the interbank market relatively more expensive. The banking institutions, therefore, focused on sourcing funds through traditional instruments such as longer maturity fixed deposits and NIDs, in order to lock in funds for longer tenures and at lower cost. In an environment of tight liquidity, competition for funds among banking institutions intensified. Consequently, fixed deposits and NIDs rates were raised significantly, especially in the second half of 1997. Apart from the significantly higher returns from these instruments, the expansion in both instruments also reflected the shift in preference among the institutional and retail investors of the KLSE to less risky portfolios. During this period, savings rates were left virtually unchanged. The consequent higher differential between savings and fixed deposit rates caused savings deposits to decline significantly in 1997. The interest differentials between savings and 1-month fixed deposits of the commercial banks and finance companies widened to 4.6% and 4.8% respectively at the end of 1997 (3.1% and 2.3% respectively at end-1996).

In terms of determinants, claims on the private sector continued to be the main impetus to monetary expansion, contributing about 27.3% of M3 growth. As demand for credit remained strong throughout the year, claims on the private sector increased by RM90 billion or 25.2% (RM72.4 billion or 25.4% in 1996). Of the total increase, 89.7% was in the form of direct loans from the banking system, reflecting corporations' continued reliance on bank credit as a source of financing. Although the increase of RM88.3 billion in total loans and advances extended by the banking system was broad based, the bulk of the credit continued to be channelled to the broad property sector, for consumption purposes, for the purchase of securities and to the finance, insurance and business services sector. At the same time, a significant amount of loans was also channelled to the productive sectors, namely, the manufacturing sector, for general commerce, and transport and storage. While the pre-emptive prudential measures directed at containing credit for financing property and share transactions that were in effect from April did contain

further escalation in asset prices, it was noted that lending to the asset markets only slowed down moderately. Further measures were, therefore, required to slow down overall credit growth. The regional crisis since the middle of the year, which saw increased volatility in the stock and foreign exchange markets, increased the potential risks associated with lending to the asset markets. A more rapid slowdown in credit growth was also warranted at a time when inflationary pressures emanating from the weakening of the ringgit became more prevalent. Hence, prudential measures were further tightened with the implementation of voluntary credit plans in October, in order to reduce overall loan growth to a level that would be more consistent with the expansion in the real sector. As a result of the restraint exercised by banking institutions, the annual growth of total loans extended by the banking system moderated to 26.5% at the end of 1997 from a peak of 30.5% at the end of March. The slowdown in loan growth was particularly pronounced in November and December creating fears of a credit crunch. Banking institutions were, therefore, encouraged to allocate the limited resources to lending for productive purposes, and to accord priority to the manufacturing and services sectors, particularly to export-oriented industries. While credit growth moderated, it remained high exceeding the credit plan target of 25%. Loan approvals, however, decelerated towards the final quarter of 1997, auguring well for a further moderation of loan growth in 1998. During this period, the Government sector had a small expansionary impact on money supply of RM451 million.

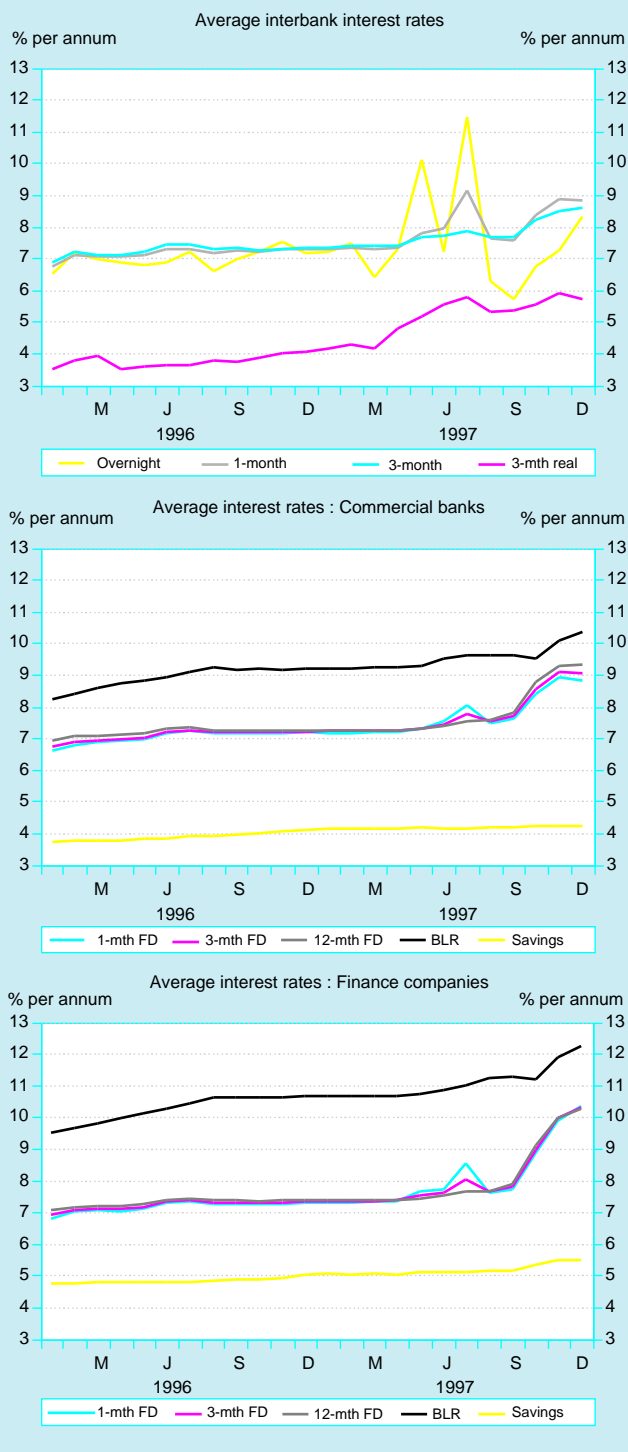
The expansionary influences of claims on the private sector and Government operations on money supply were partially offset by the contractionary influences of other determinants. External operations exerted a marked contractionary impact due to the significant decline in the country's net foreign assets of RM17.2 billion (RM1.5 billion in 1996). However, the impact of the fall in BNM's net external reserves of RM10.9 billion (RM6.2 billion in 1996) was moderated by an increase of RM6.3 billion in the net external liabilities of the banking system. The latter increased largely as a result of higher foreign interbank borrowings by the banking system. However, a significant amount of the borrowing was fully hedged by forward purchases of foreign currencies from domestic exporters and swap operations. The higher domestic interest rate vis-a-vis rates for the major foreign currencies created an incentive for some banks to source offshore ringgit funds through swaps with offshore banks.

The large contractionary impact of RM12.2 billion, recorded in other influences, reflected mainly the higher paid-up capital and undistributed profits of the banking system.

The further tightening of monetary policy in 1997 reinforced the upward trend in **interest rates** that began in 1995. In the first four months of 1997, interbank rates remained firm as the tight stance of monetary policy was maintained to contain inflationary pressures arising from the strong credit growth. This was supported by several prudential measures introduced to contain credit growth to finance purchases of assets. Consequently, the 3-month interbank rate was traded in the range of 7.22–7.55% during the period. However, the relatively stable trend was disrupted by a sharp spike in interest rates in May and again in July, following speculative pressures on the ringgit as a result of the contagion effects of developments in the region. As liquidity contracted in an environment of increased volatility in the financial markets, the overnight and 3-month interbank rates rose sharply to peak at 18.75% and 8.62% respectively in mid-May. As the pressure on the ringgit subsided and liquidity improved, interbank rates subsequently drifted downwards with the 3-month interbank rate recording 7.51% at the end of May and remaining relatively unchanged in June. However, a second round of speculative activity on the ringgit occurred in July that caused an even sharper increase in interbank rates. On 10 July, the overnight and 3-month rates rose to 40% and 8.6% respectively from 7.5% and 7.9% the day before. On both occasions, there were temporary inversions in the term structure of interbank rates whereby the shorter term rates increased significantly to exceed the longer term rates. In contrast, the relative stability of longer term rates throughout the period reflected expectations that the tightness in the money market would be temporary. To maintain stability in the domestic money market and to insulate domestic interest rates from external developments, BNM introduced limits on non-commercial-related ringgit offer-side swap transactions with foreign customers on 4 August. Following this, interbank rates eased further and by mid-August, the 3-month interbank rate returned close to the levels prevailing prior to the emergence of excessive volatility in the currency market.

Interbank rates, however, were adjusted upwards progressively from mid-September until the end of the year as monetary policy was tightened further to pre-empt inflationary pressures arising from the

**Graph 2.2
Interest Rates**



ringgit depreciation and to maintain positive real rates of return on savings. The firming of interest rates was also due to tighter liquidity conditions in the banking system. The resource gap that emerged from the slower growth of deposits relative to strong demand for credit by the private sector, was reinforced by the net issue of Malaysian Government Securities amounting to RM2 billion in November. Hence, the loan-deposit ratio of the banking system increased from 92.7% in August to 95.8% in

November. Liquidity conditions, therefore, tightened in the last quarter. Smaller financial institutions faced higher borrowing cost due to a more selective lending practice in a market that had become segmented. As a result of the overall tighter liquidity and higher rates faced by smaller institutions, the 3-month interbank rate increased from 7.55% in mid-September to 8.3% at end-October, 8.5% at end-November, and eventually to 8.7% at end-December, the highest level recorded since 1986.

A notable development towards year-end were the distortions that emerged in the intermediation process, which affected the smooth functioning of the money market, following the increased uncertainty and tight liquidity conditions. As a result, smaller financial institutions faced considerable difficulty in obtaining interbank funds due to growing segmentation in the money market and the shift of deposits to the larger financial institutions. Subsequently, interest rates in the interbank market were generally higher. Arising from these developments, the term structure of interbank and lending rates was no longer reflective of market conditions. The shorter-end interbank rates reflected the exceptionally tight liquidity situation of a small number of banking institutions. The 1-week rate rose significantly from 6.66% in mid-September to 7.34% at end-October, 7.41% at end-November and to 14.94% at end-December. These developments resulted in a rapid increase in lending rates for loans priced on a cost-plus basis. To address these distortions, a package of monetary measures was introduced in February 1998, including the reduction of the SRR.

As domestic interbank rates rose progressively in Malaysia, the 3-month interbank interest rate differential with the United States widened by 103 basis points to 2.86 percentage points. In contrast, the interest differential with Singapore narrowed significantly by 181 basis points to 2.45 percentage points as the interbank rate in Singapore increased sharply during this period. Although the differential with the United States widened, it was significantly less than the average differential of 4.1 percentage points during the surge of capital inflows in 1992–93. Nevertheless, there was an inflow of funds in 1997, as reflected in the higher net external liabilities of the banking system. These inflows, however, did not have a destabilising impact on the banking system and the economy as a whole since a significant amount of the funds was for trade financing and was fully hedged.

Monetary Measures in 1997

Pre-emptive Prudential Measures in April 1997

With effect from 1 April 1997, Bank Negara Malaysia (BNM) implemented prudential measures to complement the overall policy of continued monetary restraint. Specifically, the objectives of the measures were to ensure that any downward trend in asset prices would not threaten the strength and stability of the financial institutions, and that available resources were channelled for productive activities. In addition, the measures were introduced following concerns over the strong increase in lending by financial institutions to less productive sectors. Lending to the broad property sector (comprising real estate, construction and housing) increased sharply by 29.9% in 1996. At the same time, loans granted for the purchase of stocks and shares and units of unit trust funds, including to holding and investment companies, rose strongly by 30.5%.

- **Credit facilities granted for the purchase of stocks and shares and units of unit trust funds:** With effect from 1 April 1997, ceilings of 15% of total outstanding loans for commercial banks and finance companies, and 30% for merchant banks were set for credit facilities secured by stocks and shares. These limits were defined to cover credit facilities granted for the purchase of stocks and shares and units of unit trust funds, including loans to holding and investment companies. Loans extended for the purchase of Amanah Saham Nasional, Amanah Saham Bumiputera, Amanah Wawasan 2020 and units of unit trust funds established by the state governments were exempted from the limits.
- **Credit facilities extended to financing of specified types of property:** Banking institutions were also required to observe a limit on credit facilities extended to the property sector (excluding houses and apartments costing RM150,000 and below, infrastructure projects and industrial buildings

and factories) of 20% of their total outstanding loans. The term “credit facilities” was defined to include all forms of lending, including the issue of guarantees, private debt securities and commercial papers.

Limit on Non-commercial Related Swap Transactions

Banks were required with effect from 4 August 1997, to observe a limit of US\$2 million on outstanding non-commercial related ringgit offer-side swap transactions with each foreign customer on a group basis. Banks that exceeded the limit were not allowed to transact in any further non-commercial related ringgit offer-side swaps with such foreign customers until the outstanding amount had been reduced to below the limit. Hedging requirements of foreigners for trade related and genuine portfolio and direct investments in Malaysia were not affected by this measure. The purpose of introducing this measure was to maintain stability in the domestic money market and to allow domestic interest rates to be more reflective of domestic conditions, and hence, promote an environment that was stable and more predictable for genuine investments.

Credit Plan

In the light of prevailing developments in the financial markets, the need to slow down the overall credit growth became more urgent and important, especially in reducing the leverage of the economy and curbing inflationary pressures. In this regard, in October 1997, banking institutions were requested to submit their credit plans for the remaining quarter of 1997 and for the year 1998. The credit plans were drawn up by the banking institutions based on the individual institution’s business strategy and their assessment of the opportunities and risks. Based on the projections submitted, the annual loan growth of the banking system as a whole would moderate to 25% by the end of 1997, 20% by

the end of the first quarter of 1998, and 15% by the end of 1998.

In the implementation of the credit plans, lending for productive and export-related manufacturing activities, the productive services sector, small- and medium-sized industries as well as low- and medium-cost housing, including end-financing for owner-occupied residential properties, was to be accorded priority.

Guidelines on Hire-Purchase Loans for Non-commercial Passenger Vehicles

Effective 20 October 1997, BNM tightened further the conditions on hire-purchase loans for the purchase of non-commercial passenger vehicles (both new and second-hand). Finance companies were only allowed to provide financing for up to 70% of the purchase price of the vehicles. In addition, the repayment period of these hire-purchase loans was restricted to not more than five years. The same conditions applied to the provision of block discounting for hire-purchase loans granted for the purchase of non-commercial passenger vehicles. This measure was introduced as part of an effort to strengthen existing prudential guidelines.

Guidelines on Lending to the Property Sector

In December 1997, BNM laid down guiding principles for banking institutions in extending loans to the property sector, as follows:

- (i) No credit facilities should be granted to property projects where construction had not started, including for the construction of low- and medium-cost residential properties costing RM150,000 and below;
- (ii) For property projects where construction had started, banking institutions should assess the viability of such projects under the changed economic conditions. Under strict selectivity, credit could be extended for the construction and purchase of residential properties costing RM150,000 and below. Other projects should preferably be deferred. Where such projects were

no longer viable under the changed economic conditions, banking institutions should review the projects and their financing; and

- (iii) Notwithstanding the above, banking institutions might continue to extend credit for the construction and extension of factories and industrial buildings which were needed to expand productive capacity.

With a more noticeable slowdown in overall credit growth, the Guidelines on lending to the property sector were modified on 26 January 1998, to exempt bridging loans and end-financing for the construction and purchase of houses and apartments costing RM150,000 and below.

Appointment of Principal Dealers

With effect from 1 January 1997, 16 new principal dealers (PDs) were appointed, comprising nine commercial banks, four merchant banks and three discount houses, for a one-year period. The PDs were required to bid for at least 10% of the instruments specified by BNM, to provide reasonable two-way price quotations, to keep and manage records separately and to provide information as required by BNM.

The PDs were granted several privileges such as eligibility to bid for instruments in the Scripless Securities Trading System (SSTS) at primary auctions, undertake repos of less than one-month maturity from non-interbank customers, and participate in money market auctions, as well as access to the Bank's discount window facility, and ability to net off 15% of the sales and purchases of specified instruments in the secondary market, whichever was lower, from the eligible liabilities (EL) base, up to a maximum of 1% of the EL base. The specified instruments comprised Malaysian Government Securities, Malaysian Treasury Bills, Bank Negara Bills, and any other instrument specified by BNM.

Monetary Measures Announced on 6 February 1998

On 6 February 1998, BNM announced the implementation of a number of monetary measures. The objectives of the measures were

to remove distortions in the intermediation process in providing financing to productive economic activities as well as to enhance the efficiency of the operations of the money market to allow interest rates to reflect underlying liquidity conditions. The measures were also aimed at reinforcing the fundamental thrust of policy to achieve the objectives of monetary and financial stability. The measures were as follows:

- **Streamlining the interest rate structure:** The interest rate structure was streamlined to reflect liquidity conditions in the market. Arising from recent developments, the term structures of interbank and lending rates were no longer reflective of prevailing market conditions. The shorter-end interbank rates mainly reflected the exceptionally tight liquidity situation of a small number of banking institutions. However, because of uncertainties, there was a tendency for lending rates to be based on these short-term rates on a cost-plus basis. To improve the flow of liquidity in the system, and therefore, generate a more orderly term

structure of interest rates that would better reflect the liquidity in the financial system, the 3-month BNM intervention rate was adjusted upwards to 11% from 10%.

- **Reduction in the Statutory Reserve Requirement:** With effect from 16 February 1998, the statutory reserve requirement (SRR) for all commercial banks, finance companies and merchant banks was reduced from 13.5% to 10% of their eligible liabilities. This was aimed at enhancing the efficiency of the intermediation process and not to provide additional liquidity to the system. BNM in effect neutralised the additional liquidity to the banking system following the reduction in the SRR by reducing its direct interbank lending, thereby slowing down base money growth.

BNM also emphasised that banking institutions should channel their resources to productive activities to support economic recovery, and to be more transparent in their loan pricing mechanisms and not charge excessively high lending rates on a cost-plus formula.

Following the upward movement in interbank rates, commercial banks and finance companies posted significantly higher fixed deposit rates and base lending rates (BLR) during the year. The increase in savings deposit rates was marginal. The stability in interbank rates in the early part of the year was translated into relatively stable fixed deposit rates in the first four months of 1997. However, in line with developments in the interbank market, there was a sustained inversion in the term structure of fixed deposit rates between May and July during which the shorter-term rates were higher than the longer-term rates. In August, as interbank rates reverted to levels more reflective of domestic conditions, the term structure of fixed deposit rates was once again upward sloping. Following further tightening of monetary policy and the firming of interbank rates since mid-September, borrowing from the interbank market became more expensive. As a result, there was intense competition for fixed deposits in the market, as reflected in the rapid increase in both short- and long-term fixed deposit rates since September. The average fixed deposit rates of commercial banks (1-month to 12-month) rose significantly in the last four months of 1997 by 135–177 basis points to 8.81–9.33% (7.18–7.26% at end-1996), while those of finance companies rose even faster, by 257–272 basis points to 10.23–

10.32% (7.28–7.36% at end-1996). The average 3-month fixed deposit rates of both commercial banks and finance companies began to exceed the 3-month interbank rate by mid-October. Expectations of continued tight liquidity were also reflected in the banking institutions' greater focus on attracting longer-term deposits. Consequently, the faster increase in longer-term rates caused a steepening of the term structure of fixed deposit rates of commercial banks, with the spread between the average 12-month and 1-month fixed deposit rates increasing from 10 basis points at end-August to 52 basis points at end-December. In spite of fixed deposit rates increasing significantly, the weighted average savings deposit rates remained relatively stable throughout 1997, increasing only marginally by 13 basis points to 4.23% for commercial banks and 47 basis points to 5.49% for finance companies.

Under the existing BLR framework, BLRs quoted by banking institutions are subject to a ceiling rate which is calculated based on the average 3-month interbank rate of the previous month, allowing for SRR cost, a fixed charge and also the reduction in funding cost due to zero-interest current account balances. In line with the higher 3-month interbank rate, for the year as a whole, the average BLR of

commercial banks and finance companies edged upwards by 115 and 157 basis points to 10.33% and 12.22% respectively. In view of the volatility in interbank rates in July due to developments in the regional currency markets, the BLR ceiling for August was temporarily capped at the July level. The move to contain fluctuations in the BLR was aimed at limiting the impact of external developments on the stability of domestic interest rates. The cap on BLR was subsequently removed and from September, the computation of the BLR ceiling reverted to the previous basis.

The average cost of deposits (ACD) of both commercial banks and finance companies increased in 1997 by 122 and 120 basis points to 6.52% and 8.28% respectively, consistent with the upward trend in deposit rates. While the BLRs of both institutions also increased in 1997, the subsequent effect on their respective average lending rates (ALR) was not symmetrical, with the ALR of commercial banks increasing more significantly by 139 basis points to 11.51%. In contrast, the ALR of finance companies increased more modestly by 23 basis points to 12.16%, as the bulk of their loans was in the form of fixed rate hire-purchase loans. As a result of these developments, the interest margin of commercial banks was relatively unchanged (increase of 17 basis points to 4.99%) while that of finance companies declined significantly (decline of 97 basis points to 3.88%).

Monetary Policy in 1997

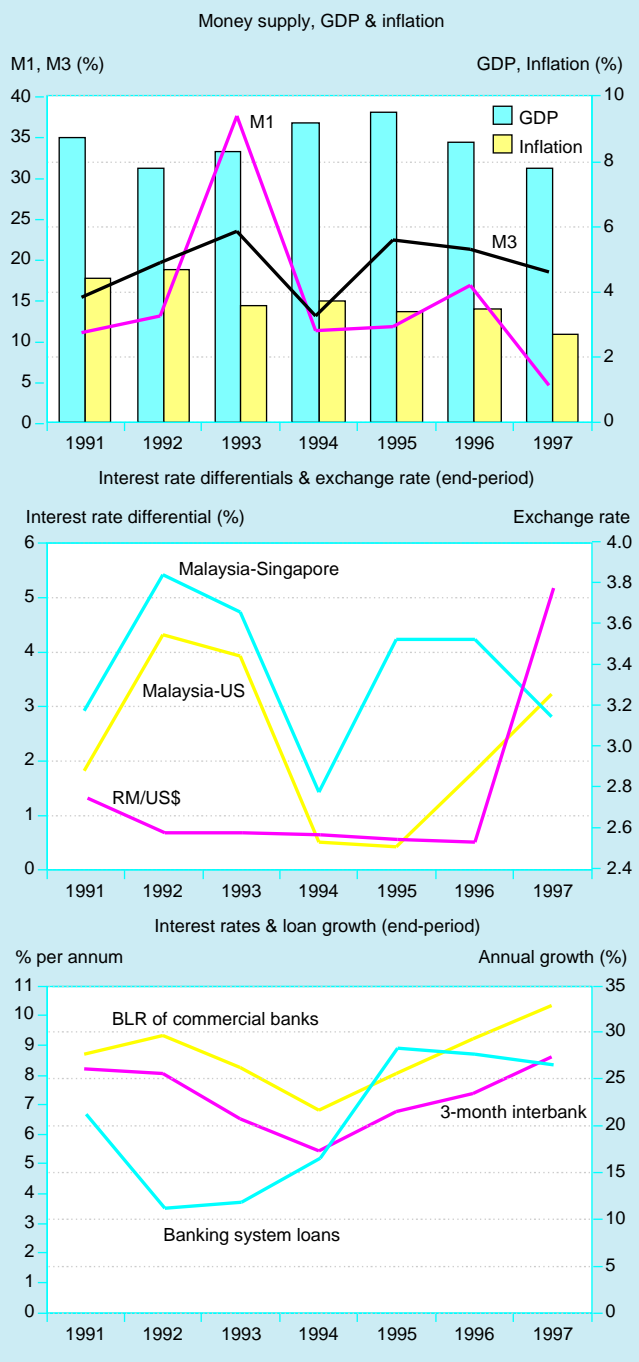
In the conduct of monetary policy in 1997, BNM faced the difficult task of maintaining domestic and external stability in the context of the unprecedented turbulence in the region's financial markets. The contagion impact and prolonged regional uncertainties, which accentuated the depreciation of the ringgit, aggravated inflationary pressures and adversely affected confidence, thereby increasing the complexity of monetary policy implementation.

While the implementation of monetary policy was unusually complex in 1997, its objectives remained unchanged. Price stability remained the primary objective of monetary policy. This became even more critical as the year progressed and the effects of the depreciation of the ringgit began to filter into domestic prices. Of importance, however, was to restore stability in the financial markets, not only enhance the efficient functioning of the intermediation

process and thereby facilitate business operations, but also to enhance the effectiveness of monetary policy. Under normal circumstances of stable financial markets amidst a low inflation environment, the ringgit is left to find its level under the flexible exchange rate regime.

Against this background, the implementation of monetary policy in 1997 should be analysed in two separate periods. In the first half of 1997, monetary policy focused mainly on asset inflation. In the period after July, monetary policy responses were

Graph 2.3



directed at restoring stability to overcome the disruptions to economic activities caused by uncertainties in the foreign exchange and stock markets. Towards year-end and in the early part of 1998, monetary policy focused on addressing the tight liquidity situation and inefficiencies in the intermediation process that had emerged in the banking system.

In early 1997, growth in the economy was expected to slow down further to about 8% for the year as a whole, compared with 8.6% in 1996. It was envisaged then that this moderation in economic growth, supported by a continuing firm monetary policy and supply side policies to increase capacity, would contain inflationary expectations and allow the economy to adjust to a more sustainable growth path. The threat of asset inflation was also expected to wane as several pre-emptive measures had been put in place since 1995. The increases in asset prices were driven mainly by the rapid increases in incomes and expectations of speculative windfall gains on the property and stock markets. These were evident in the rising prices of properties and excessive overvaluations of stock prices, particularly in the Second Board counter and during primary offers. Meanwhile, the increase in the Consumer Price Index had been contained by an appropriate mix of contractionary macroeconomic policies. The appreciation in the exchange rate also reinforced this trend. However, the wealth effects from the windfall gains in the asset markets resulted in rising domestic consumption, as reflected in rising imports of consumption goods and strong growth in car sales. If left unchecked, such a rapid growth in domestic spending, financed in part through credit, would increase the vulnerability of the banking system to any downward shift in demand, and if prolonged, could also contribute to inflationary pressures.

The focus of monetary policy was, therefore, to dampen the inflationary impulses emanating from these sources. The main objective of monetary policy was to slow down the overall credit growth to levels that were more reflective of the moderation in GDP growth as well as to encourage available resources into productive uses. The redirection of credit was important because the disproportionate concentration of loans in 1996 and 1997 to finance purchases of property and shares had tended to crowd out lending for more productive purposes, such as for expanding the manufacturing and services industries. Indeed, the annual credit growth for the purchase of properties and shares exceeded 29% and 30%

respectively. Bank lending to the broad property sector, and for consumption and for the purchase of stocks and shares accounted for nearly half of the increase in total loans in the first quarter of 1997. The proportion of total outstanding loans allocated to the property and share markets alone amounted to 43%. Even after excluding loans to meet social objectives and loans deemed as productive, namely loans for residential properties costing RM150,000 and below, infrastructure and industrial buildings and factories, the total outstanding loans of the banking system for property and shares exceeded 35%. At the same time, house prices in 1996 rose by 12.9%, while share prices on the Main and Second Boards of the KLSE rose by 24.4% and 93% respectively. While interest rates were raised during this period, lending to these sectors continued to increase as expected gains from asset price increases far exceeded the higher interest cost. The higher interest rates in turn were seen to be dampening investment in the productive sector in which excesses were not evident.

Interest rate increases were therefore reinforced with further prudential measures in the form of credit ceilings. These measures aimed to limit further exposure of the banking system to these sectors in order to minimise its vulnerability to any reversal in price movements in the asset markets. Effective 1 April 1997, banking institutions were not allowed to exceed 20% of their outstanding loans to the broad property sector and not more than 15% (30% in the case of merchant banks) for the purchase of shares. At the end of 1997, outstanding loans for property and shares subject to the guidelines accounted for 13.1% and 8.9% of total loans respectively. There were also indications that price pressures in the asset markets had moderated. The Bank also disseminated the latest available information on estimates of the supply of office and retail space in the market. The information on the potential over-supply situation together with the limits on credit had the effect of scaling down projects and the postponement of others. More importantly, these pre-emptive measures curtailed further increases in lending for financing of purchases of property and shares, thereby providing banking institutions with greater margins to withstand the subsequent declines in stock prices that followed the sharp ringgit depreciation towards the end of the year.

After the outbreak of the region's currency turmoil in July, the focus of monetary policy became much

broader and was aimed at restoring stability in the financial markets and addressing inefficiencies that had emerged in the financial markets and in the intermediation process. During this period, the Bank raised interest rates sharply to support the ringgit as it came under several bouts of speculative pressure. The speculative pressure on the ringgit was further exacerbated by the outflow of short-term foreign funds through divestment in the stock market. By the end of 1997, the ringgit had depreciated by more than 34% against the United States dollar. In the initial two weeks of the speculation in July, intervention in the foreign exchange markets absorbed a significant amount of liquidity from the banking system, which caused interest rates in the interbank market to rise to as high as 40% for overnight money. However, following the floatation of the Philippine peso on 11 July, it was recognised that the uncertainty in the currency markets would be prolonged. Given the prevailing circumstances, the Bank placed emphasis on restoring stability in the domestic financial markets in order to minimise the effects of currency speculative activities on the real sector. By mid-August, interest rates were reduced to levels just above the levels prior to the crisis. To insulate domestic interest rates from developments in the foreign exchange markets, effective from 4 August, banking institutions were required to observe a US\$2 million limit on outstanding non-commercial related ringgit offer-side swap transactions with each foreign customer. The 3-month interbank rate, which was the indicator rate of the Bank's monetary policy, remained relatively stable during August and September. Towards the end of September, the rate was adjusted upwards as inflationary expectations increased as the ringgit depreciated further to reach US\$1=RM3.40.

Although faced with a similar currency crisis, there were significant differences in the policy approach adopted by countries in the region. In Malaysia, it was decided early in the crisis that interest rates would not be raised for the sole purpose of supporting the ringgit. Under normal circumstances of isolated and limited currency pressures, raising interest rates to sharply higher levels and for a short duration would be effective in curtailing speculation against the exchange rate. It was assessed, however, that the speculative activities that engulfed the region in 1997 would persist over an extended period and that an interest rate policy on its own would not contribute to stabilising the currency market. The large foreign share of portfolio investment in the Malaysian stock market provided additional sources of the domestic currency, so that

the pressures on the equities and currency markets reinforced each other.

Investor concerns on the economic vulnerability of the region also meant that higher interest rates were unlikely to provide support for the currency. The pressures on ringgit exchange rates essentially reflected negative sentiment on the ringgit exchange rate. The outflows of capital that occurred involved mainly short-term foreign investment with some outflows of funds by Malaysians. Long-term direct foreign investment in Malaysia was for the main part unaffected. There was no evidence of significant outflows of resident funds, and deposits in the domestic banking system continued to increase at high rates. Economic fundamentals during this period remained favourable and activity in the export sector remained generally insulated from the currency turmoil. The loss of confidence occurred mainly among portfolio investors.

The uncertainties in the external sector made it even more critical for the Bank to ensure that its policies did not create further risks in the domestic economy. In the environment of a depreciated currency, exceptionally high interest rates for an extended period would add to the cost of doing business, dampen investment and constrain growth in the real sector. At the corporate level, this would affect export performance and income levels, and cause a greater contraction of excess demand than required to restore stability.

However, a firm interest rate environment was essential to contain inflationary expectations and to continue to promote a positive real rate of return to encourage savings. Moreover, it was felt that raising interest rates as a policy option could be effective only if implemented with a package of consistent macroeconomic policies to correct the imbalances in the economy. A comprehensive policy package was announced in early December to supplement the measures announced in the 1998 Budget, two months earlier. This policy package was aimed at addressing the imbalances in the economy as reflected in the current account deficit in the balance of payments, risks in the banking system, higher inflation due to the ringgit depreciation and high monetary growth.

With the adoption of a macroeconomic policy package in December, it was felt that higher interest

Box IV

Financial Volatility: The Challenge for Monetary Policy

Volatility refers to the short-term deviations around a long-term trend. Some degree of volatility is expected in financial markets as part of the normal process of “price discovery” that ensures financial resources are allocated in an efficient manner. However, when prices of financial assets become excessively volatile, the signals provided by these prices no longer convey the required information for markets to efficiently allocate financial resources amongst the many competing uses. This article looks at volatility in the two types of financial prices that are most relevant to monetary policy: volatility in the domestic price of money (interest rates) and volatility in the external price of money (exchange rates). It examines the causes of volatility in these prices and the challenges volatility poses for the conduct of monetary policy. Lastly, it looks at the role of monetary policy in mitigating excessive volatility and containing its adverse effects.

Interest Rate and Exchange Rate Volatility

As in the case of the price of any good, the exchange rate of a currency is determined by the conditions of demand and supply for that currency. For an open economy like Malaysia, the level of the exchange rate has important implications for the competitiveness of its exports and for domestic price inflation. Even more important is the need to avoid extreme volatility in the exchange rate, which would distort decision making in international transactions, particularly in trade and foreign investment.

Interest rates are the domestic price of money. They are a crucial element in determining the level of investment and real economic activity in a country. Of importance is the need to focus on real interest rates, i.e., nominal interest rates after excluding the inflation rate. As with the exchange rate, interest rates are determined by the relative magnitude of the demand and supply of liquidity.

What then causes exchange rate and interest rate volatility? In the case of exchange rates, the advent of floating rates in many of the world’s currencies in the 1970s augured in an era of greater volatility. Previously, under the Bretton Woods system, the values of most currencies were stabilised at agreed par values. The choice of an exchange rate regime will affect volatility. However, it is the economic fundamentals of a country that determines the long-run value of a currency. Economic fundamentals such as the inflation rate and the balance of payments, which have become more volatile in the 1980s and early 1990s, by themselves are sources of exchange rate volatility. More recently, increased cross-border flows which have been facilitated by the trend towards liberalisation of the capital account and the advancement in technology have also caused exchange rates to fluctuate.

As with exchange rates, volatility in interest rates can also reflect uncertainty in economic fundamentals. One of the most important of these variables is inflation, or rather, the public’s expectations of the future rate of inflation. The deregulation of interest rates and the removal of controls such as interest ceilings is another important factor leading to increased interest rate volatility. Higher volatility in interest rates could also result when the central bank changes its operating procedures in monetary policy. Targeting interest rates could result in less volatility in interest rates than would targeting money supply. This happened in the United States in the late-1970s and early-1980s. Similarly, unclear signals about the stance of monetary policy can generate uncertainty in the financial markets resulting in greater fluctuations in interest rate levels.

Malaysian Experience

Graph IV.1 presents the volatility of the average 3-month fixed deposit rate of the commercial banks and the RM/US\$ exchange rate. Volatility is measured as the standard deviation of monthly

percentage changes during each year in the case of exchange rates. Volatility in interest rates is measured as the standard deviation of the end-month interest rate during each year. Also indicated on the same chart are some of the major shocks to the economy that could have affected the volatility of financial prices.

Graph IV.1 shows that the contemporaneous correlation between the volatility of interest rates and the exchange rate is marginal. On average, volatility of interest rates is considerably lower than that for the exchange rate. This suggests that the exchange rate responds faster to shocks in the economy. This observation is evident by the sharp increases in volatility of the exchange rate during each of the periods of external shocks experienced in Malaysia's economic history.

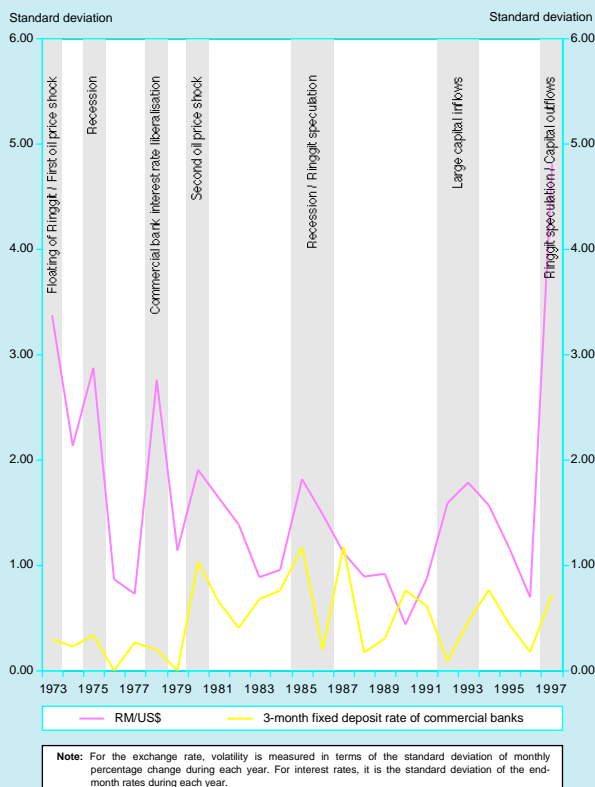
The exchange rate of the ringgit vis-a-vis the United States dollar was very volatile following the floating of the ringgit in June 1973. The commodity price shocks that occurred after the transition to a floating exchange rate regime only served to exaggerate this volatility. Apart from the two oil price shocks, economic recession and currency speculation were the other main shocks

influencing the volatility in the exchange rate of the ringgit against the United States dollar. In particular, the increase in volatility during the mid-1980s reflected the effects of several factors, the most important being the sharp deterioration in the terms of trade that triggered the recession. Speculative activity on the ringgit also contributed to the increased volatility.

Subsequently, volatility was on a declining trend and was lowest in 1990. Another period of exchange rate volatility occurred during 1992–94, following substantial capital inflows during the period. Attempts by BNM to neutralise the impact of the flows on the exchange rate and domestic liquidity did little to reduce the volatility. However, Graph IV.1 shows a sharp increase in volatility experienced during 1997. Such a level of volatility was unprecedented. As elaborated elsewhere in this Report, the movements in the exchange rate of the ringgit in 1997 were strongly influenced by the contagion effects of developments in the region, which resulted in a loss of investor confidence and large outflows of foreign short-term capital.

The assessment of the historical behaviour of interest rates in Malaysia is based on movements of deposit rates. Volatility of these rates was relatively low during the 1970s. During this period, deposit rates of the commercial banks were administratively set through consultations between the commercial banks and BNM. Consequently, interest rates were changed infrequently. Deposit rates were liberalised in 1978 with commercial banks free to set the deposit rates. Consequently, during most of the 1980s, interest rates were relatively volatile, reflecting the competitive pricing of deposits in response to changing liquidity conditions in the banking system. There was a brief respite in this volatility during 1986–87 when BNM introduced the pegged interest rate system. However, volatility increased again when the system was removed in 1987. The volatility in interest rates has persisted into the 1990s, although at a lower level than in the 1980s. Part of the reason for the lower volatility was the more aggressive management of surplus liquidity by BNM. The persistent excess liquidity situation required the Bank to use all instruments at its disposal to mop up surplus funds from the banking system. It also reflected the effect of the policy to allow banking institutions to move from the daily observation of the statutory reserve

Graph IV.1
Volatility of Interest Rates and Exchange Rate: 1973-1997



requirement and the minimum liquidity requirement to a system whereby the banking institutions fulfil these requirements based on a fortnightly average. This adjustment significantly reduced day-to-day volatility of short-term interest rates in the interbank money market. It is also notable that despite the unprecedented nature of the turbulence in the financial markets in 1997, the volatility of interest rates was not unusually high relative to the rest of the 1990s. This largely reflects BNM's policies designed to ensure that external developments do not destabilise the domestic sector.

Overall, the experience in Malaysia showed that as the country liberalised its interest rates and became more integrated with the international financial system, it also experienced greater volatility of both the exchange rate and interest rates. However, policy changes and improved management of liquidity allowed BNM to offset some of the volatility.

Financial Volatility and the Conduct of Monetary Policy

The volatility in financial prices has significant implications on the conduct of monetary policy. Higher flows and the consequent exchange rate volatility have occurred when investors estimate that such interest rate differentials would adequately compensate for the risks involved in investing in a foreign country, principally the risks of foreign exchange movements. Similarly, interest differentials would also encourage domestic residents, financial institutions and corporations to borrow from abroad. The recent financial crisis indicates the risk associated with such transactions not only for the borrowers but also for the financial system and the economy.

The liberalisation of the capital account and the resulting inflows and outflows of funds greatly complicate the process of monetary policy formulation. When such inflows are large, the natural tendency is for the exchange rate to appreciate. Should the flows reflect sentiments rather than underlying fundamentals, authorities may intervene to reduce the volatility of the exchange rate. In this situation, it would result in a higher growth of money supply and a build-up of excess liquidity within the banking system. Unless the monetary authorities sterilise these

injections of liquidity from their foreign exchange operations, by absorbing the excess funds through open market operations, the result will be a decline in interest rates with the subsequent effect of an increase in the growth of credit. The growth of credit can in turn feed demand-driven pressures on prices and work against the authorities' efforts to contain domestic inflation and maintain monetary stability.

When foreign funds flow out of the country, pressure on the exchange rate would occur in the opposite direction. In the absence of central bank intervention, the domestic currency will depreciate. The depreciation can lead to imported inflation. If BNM does intervene to stabilise the exchange rate, it would result in a drain on its foreign exchange reserves. Intervention in the foreign exchange market to support the currency would also result in a contraction of liquidity in the banking system. If not sterilised, this would result in significantly higher interest rates, which over a prolonged period would have adverse implications on economic activity.

Malaysia has for a long time maintained a relatively open capital account with liberal exchange controls. In the early 1990s, high interest rates to control inflation, a booming stock market, and an exchange rate that was expected to appreciate created a one-way bet for foreign investors. Large amounts of foreign funds flowed into the country in 1992 and 1993. The bulk of these short-term funds was invested in the Kuala Lumpur stock market, pushing its capitalisation to 375% of GDP at the end of 1993. Given the short-term nature of the funds, BNM intervention aimed to reduce the potentially destabilising implications of these funds. Exchange rates should appreciate in response to long term economic fundamentals such as large inflows of corporate investments. Inflows in 1992–93 were mainly short-term capital seeking arbitrage profits. Following policies to discourage such inflows, this trend reversed and there was a gradual outflow. In 1997, the reverse problem for monetary policy was experienced – a sudden tightening of liquidity and sharply higher interest rates following the outflow of funds by non-resident portfolio investors.

Therefore, capital account liberalisation and the resulting inflows and outflows of funds can result in greater volatility of the exchange rate.

Since a central bank in an open economy cannot simultaneously determine both the exchange rate and domestic interest rates, attempts to stabilise the exchange rate will transfer the volatility to domestic interest rates. Therein lies the challenge for monetary policy. A balance in judgement is required to limit the volatility in the exchange rate or in domestic interest rates. The initial response of BNM to the contagion pressures on the ringgit arising from the floating of the Thai baht was to intervene in the foreign exchange market to stabilise the exchange rate. However, the result of this intervention was much higher interest rates. The subsequent actions of BNM showed that it decided to accept the volatility in the foreign exchange market in order to maintain the stability of domestic interest rates. This was in contrast to the mid-1980s, when BNM had accepted short-term volatility in interest rates in order to stem speculative activity against the ringgit. In that instance, however, the speculative activities were of a shorter duration, and involved smaller amounts.

Managing Financial Volatility

The growing global integration of both the financial markets, as well as the real economy, results in higher volatility of financial prices as shocks in one market are quickly transmitted across borders. The current financial crisis in Asia demonstrates this phenomenon. It does not imply that volatility of interest and exchange rates due to external shocks should be avoided through economic isolation or capital controls. Rather, there is a general recognition that sound domestic economic management is an important element in reducing the risks associated with this volatility. The impact of policies in one country is even more relevant to other economies when market participants perceive similarities in the characteristics of these economies. Hence, regional co-operation and co-ordination of policies among such economies could reduce volatility in their financial markets. In addition, no one policy instrument can be relied on as a panacea for all financial ills. The Malaysian experience shows that monetary policy instruments can be more effective in moderating the effects of financial volatility on the banking system when complemented by other policies. In particular, such complementary policies include

a combination of fiscal, administrative and prudential measures.

Greater transparency in policy-making can also remove much of the uncertainty that is associated with private decision-making. A government that has clear objectives and shows a commitment to achieving those objectives earns credibility. In this context, the Malaysian Government has undertaken measures to increase the flow of information to the private sector. This aims to reduce misinterpretation regarding the priorities and policies of the Government. More transparent data will also ensure correct analysis in interpreting the signals about the direction of monetary policy.

In Malaysia, the intermediate target is the 3-month interbank rate, which is also the Bank's intervention rate. Currently, interest rates are on a rising trend due to tight liquidity and high demand for loans. Despite the exchange rate volatility, interest rates in Malaysia have remained relatively stable. The interest rate instrument is used to contain inflation. In the current circumstances, interest rates have not been used to influence the exchange rate of the ringgit. The authorities are committed to a flexible exchange rate regime that allows the exchange rate to move in response to market forces. However, the exchange rate should reflect the underlying fundamentals of the economy. Currently, the exchange rate is viewed as being undervalued. Therefore, intervention operations to restore stability to the currency remains an option.

To reduce the risks to the banking institutions arising from the volatility, BNM has imposed strict prudential requirements on the banking institutions in Malaysia. The observation of the risk-weighted capital requirement (RWCR) ensures that the banking institutions are adequately insulated against credit risk. Most banking institutions in Malaysia meet or exceed the Bank for International Settlements RWCR of 8%. The smaller less well-capitalised institutions have been actively encouraged by BNM to merge in order to increase their competitiveness as well as their resilience to adverse developments. Recent measures to increase general provisions and shorten the default period for classifying loans as non-performing from six to three months are also aimed at strengthening the balance

sheets of the banking institutions. Improved liquidity management and the incorporation into the RWCR of some measure of the vulnerability of different types of assets to interest rate volatility would further boost the resilience of banking institutions.

Volatility tends to be exaggerated in thin markets where even small transactions can cause prices to vary substantially. Therefore, efforts toward

developing deeper financial markets should result in greater stability of financial prices. A large and diverse base of financial institutions allows risks to be spread among many players. Institutions that are risk-averse can transfer these risks to those that have the capacity to manage them. The introduction of financial instruments such as futures and options provides the flexibility to hedge and manage the risks associated with the volatility of both the exchange rate and interest rate.

rates would have a greater role in restoring overall economic stability. During this period, the ringgit had depreciated by a greater degree for a more extended period, resulting in an increase in inflationary expectations. In this context, the 3-month interbank rate was raised from about 8.5% in November to 10% by end-January 1998.

The tighter liquidity situation resulted in an increase in the loan-deposit ratio of the banking system, which rose from 92.2% at end-June to 95.8% at end-November. This caused increased competition for funds, with the average fixed deposit rates of the commercial banks for one to 12-month maturities increasing by 127–195 basis points to 8.81–9.33% at end-December compared with their levels at end-June. There was also some shift in deposits from smaller institutions to larger institutions giving rise to higher interest rates as competition for deposits intensified. Following the Bank's assurances on the safety of all deposits in the banking system, this trend was halted. The banking institutions that faced the sudden withdrawal of deposits were provided with temporary funding from the Bank.

The tight liquidity situation and the consequent flight to quality led to distortions in the intermediation process, especially towards year-end. Faced with this scenario, the Bank injected liquidity through direct lending to banking institutions. These institutions were not facing solvency problems but rather a liquidity problem following uncertainty in the financial markets.

In an effort to restore market confidence in an environment of increased volatility in the financial markets, banking institutions were required in October to submit plans for their credit growth for the rest of the year and for 1998. Under the credit plans, overall credit growth for the banking system would moderate to 25% by the end of 1997, 20% by the end of March 1998 and 15% by the end of 1998. As the plans were drawn up in October, loan growth in the final quarter continued to be high following high drawdown of committed loans. By the end of December, total loans extended by the banking system grew at a slightly higher rate of 26.5%.

The policy to slow down loan growth however was not intended to curtail access to financing for productive investments. Viable productive projects

are expected to continue to receive financing. To ensure this, banking institutions were encouraged to focus their lending towards financing productive activities. To discourage further concentration of lending in the property sector, the Bank issued new guidelines in December 1997, whereby no new credit facilities were to be granted to property projects where construction had not started. In cases of projects already being implemented, the banking institutions were required to re-examine their viability in the changed economic environment. The guidelines emphasised that the banking institutions should continue to lend for the construction and extension of factories and industrial buildings needed to expand productive capacity. As an additional measure to ensure that credit would be available for productive activities, the Government has set up a special RM1 billion fund to provide financing to the small- and medium-scale industries.

To avoid deterioration of asset quality, a series of prudential measures were also announced in the Budget in October 1997. These measures included disclosure requirements on banks, including providing information to the public on their financial position, lending patterns, the level of non-performing loans, and provisioning against loan losses. To further allay concerns regarding the safety of deposits, a statement was issued by the Bank whereby the principal and interest earned on deposits placed with banking institutions were guaranteed by the Government.

Fiscal Operations and Policy

In the formulation of the 1997 Budget, the Federal Government targeted for an increase in the overall fiscal surplus to 1.6% of GNP in 1997, compared with the surplus of 0.8% of GNP achieved in 1996. The actual outturn of a fiscal surplus of 2.5% of GNP in 1997 exceeded expectations. The achievement of an overall surplus for the fifth consecutive year underscored the Government's commitment to the policy of fiscal prudence and financial discipline. This was part of the overall strategy to contain demand and inflationary pressures, with the broad aim of ensuring sustainable economic growth with price stability and external equilibrium over the long term. Achieving large budget surpluses was aimed at strengthening the foundation for macroeconomic stability and increasing national savings to strengthen the nation's economic resilience to meet future challenges. Following the emergence of the regional financial difficulties, fiscal policy

assumed a bigger role to address the economy's underlying vulnerabilities, especially the current account deficit and the national resource gap, and to restore macroeconomic stability and investor confidence.

The Government further tightened budgetary operations to bring about a more rapid downward adjustment in the current account deficit and to reduce inflationary pressures arising from the depreciation of the ringgit. Several fiscal measures were introduced in the third quarter of 1997 to manage the level of aggregate demand and to contain the current account deficit. These measures included an immediate 2% cut across the board in Government spending, the deferment of several large infrastructure projects (Bakun Hydroelectric project, the Kuala Lumpur Linear City, the Northern International Airport, Phase II of the Putrajaya project, the Hill Road project and the Straits of Malacca Malaysia-Indonesia Bridge) and a review of purchases of foreign goods by the public agencies, including the armed forces. The 1998 Budget announced in October 1997 was designed to further consolidate the public sector to further strengthen economic fundamentals and the nation's resilience to overcome external shocks. Additional projects were identified for deferment, including highway projects and the Light Rail Transit projects in Penang and Johor. Overall, the cost of projects deferred involved an estimated RM65.6 billion. In addition, the implementation of the privatisation programme would be more cautious and selective, and only projects that would expand productive capacity and enhance long-term growth prospects would be approved. The Budget also provided additional tax incentives to support the strategy of productivity-driven growth, enhance international competitiveness and further strengthen the balance of payments position. Among the key tax measures were a two percentage reduction in the corporate and petroleum income tax rates to 28% and 38% respectively to reduce the cost of doing business, tax incentives to boost exports and to expedite the pace of industries to shift to knowledge- and technology-intensive processes, as well as imposition of higher import duties on a number of goods to curb imports. In the wake of further regional uncertainties, the Government announced in December the implementation of a comprehensive package of policies, including further fiscal austerity measures involving an 18% reduction in the 1998 Budget allocation, to further strengthen the stabilisation process.

In the management of expenditure, public spending and investment were prioritised to maintain expenditure at a level consistent with the capacity to raise revenue and ensure that the public sector was not a source of inflationary pressures. In particular, the Government continued to exercise prudence and stringent controls on operating expenditure, including stricter accountability of expenditure by departments aimed at avoiding wastage and curtailing less productive spending, while continuing to provide improved public services and amenities to facilitate private sector activities. Further progress was made in streamlining the public sector through the wider use of office automation and information technology, organisational restructuring of Government departments, corporate restructuring of public enterprises, as well as the privatisation of public entities, projects and services. Furthermore, less essential projects were deferred. The Government continued to provide for essential expenditure to address supply constraints, raise productivity and enhance potential output. Higher investments were channelled towards infrastructure, education and training, and research and development, especially in science and technology. Priority was also accorded to socio-economic projects, especially agriculture and health, to eradicate poverty, reduce economic disparity and upgrade the quality of life.

Fiscal policy in 1997 was also aimed at maintaining a tax structure that would provide an environment that was conducive to private sector growth and investment, promote national savings and reduce inflationary pressures. The tax package implemented in 1997 was designed to achieve sustainable growth through enhanced productivity, and a strengthening of the balance of payments position through improving the services sector and increasing domestic production. Improved productivity was also strategic to the nation's effort in addressing a number of other challenges, especially to reduce inflationary pressures, maintain international competitiveness and overcome labour shortages. Several fiscal incentives were provided in the 1997 Budget to foster the strategy of productivity- and quality-driven growth. These measures included provision of the reinvestment allowance to encourage manufacturing and agriculture companies to reinvest in equipment which would significantly improve their productivity, as well as tax incentives to facilitate the shift to high technology, capital-intensive and information-based industries (especially in the Multimedia Super Corridor (MSC)), and enhance the value chain of the manufacturing sector to strengthen industrial linkages. Wide-ranging tax incentives and

exemptions were also introduced during the year to promote the services sector. Other fiscal measures included the withdrawal of duty exemptions on inputs used in the manufacturing sector and reimposition of import duties on heavy machinery to encourage domestic production and reduce the dependence on imported capital and intermediate goods. To control inflation and promote savings, the Government eliminated or reduced import duties and sales tax on a number of goods; exempted some inputs used by manufacturers of selected goods from sales tax to reduce production cost; and removed restrictions on relief for life insurance premiums. Incentives were also provided to enhance the effectiveness and efficiency of the financial markets to mobilise long-term savings to support the industrialisation drive.

The Government's commitment to prudent budgetary policies amidst favourable revenue performance arising from sustained economic growth contributed to another overall surplus position in the **consolidated public sector** in 1997. The surplus, however, was lower than in 1996 due largely to the higher development expenditure of the non-financial public enterprises (NFPEs).

The general government's consolidated position, comprising the Federal Government, 13 state governments, statutory bodies and local governments, recorded a much larger current account surplus of RM27.9 billion or 10.6% of GNP in 1997 (8.6% of GNP in 1996). The strong performance was due to both a large increase in revenue collection and a sharp deceleration in operating expenditure. Following a strong growth of 21.9% in 1996, operating expenditure increased only marginally, by 0.4% in 1997. This essentially reflected the tight budgetary control on expenditure, especially on less productive spending, partly in response to the announcement in September of an immediate 2% cut in expenditure. Increased outlays were channelled mainly to improve the quality of public services and amenities. The large surplus was generated mainly by the Federal Government and to a lesser extent, the state governments. As in previous years, the statutory bodies remained in deficit, attributable to their narrow revenue base. With several major public enterprises sustaining good performances during the year, the NFPEs as a group also maintained a large operating surplus of RM21.7 billion or 8.3% of GNP. In aggregate, the consolidated public sector recorded a large surplus of RM49.6 billion or 18.9% of GNP in 1997. This was significantly larger than the surplus of 17.1% of GNP achieved in 1996.

Public sector development spending expanded significantly in 1997, largely due to investments in infrastructure to expand productive capacity to support economic growth as well as to meet the socio-economic objectives of the nation. Both the general government and NFPEs contributed to the expansion in expenditure. In particular, the development outlay of the NFPEs escalated sharply (43%) in 1997, to account for a larger share of 55% of the total public sector development expenditure. Several of the public enterprises, especially Petroliaam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB), Telekom Malaysia Berhad, Keretapi Tanah Melayu Berhad and Malaysian International Shipping Corporation Berhad continued to undertake expansion projects and modernisation programmes during the year. A sizeable share of the expenditure was also for investment overseas, especially by PETRONAS and Telekom, to complement their domestic activities. In the public sector, expenditure was mainly directed at several large infrastructure and related projects under construction, including the Kuala Lumpur International Airport, Putrajaya and the Light Rail Transit Systems. Meanwhile, higher capital expenditure of the general government was also for human resource development and infrastructure projects. In aggregate, public sector development expenditure expanded by 31.7% in 1997, compared with 3.4% a year ago. As a result, the overall surplus of the consolidated public sector was slightly

Table 2.1
Consolidated Public Sector Finance

	1996	1997 ^p	1998 ^r
	RM million		
General government ¹			
Revenue	70,912	78,549	68,468
Operating expenditure	50,463	50,647	44,204
Current surplus of general government	20,449	27,902	24,264
Current surplus of NFPEs ²	20,348	21,747	21,732
Public sector current surplus (% of GNP)	40,797 17.1	49,649 18.9	45,996 16.5
Net development expenditure	30,818	40,588	37,448
General government	15,306	18,407	16,490
NFPEs	15,512	22,181	20,958
Overall surplus (% of GNP)	9,979 4.2	9,061 3.4	8,548 3.1

¹ Refers to general government, comprising Federal and state governments, statutory authorities and local governments.

² Refers to 28 NFPEs in 1996 and 1997 respectively.

^p Preliminary

^r Revised based on 5 December 1997 announcement.

Source: Ministry of Finance, state governments and non-financial public enterprises.

lower at RM9.1 billion or 3.4% of GNP in 1997, compared with 4.2% of GNP in 1996.

The financial position of the **Federal Government** strengthened in 1997. Fiscal discipline and tight controls on expenditure amidst favourable revenue performance resulted in an overall budget surplus for the fifth consecutive year. The current account surplus increased to RM21 billion or 8% of GNP (6.1% of GNP in 1996) and the overall surplus to RM6.6 billion or 2.5% of GNP (0.8% of GNP in 1996).

Federal **revenue** expanded further by 12.8% to reach RM65.7 billion or 25% of GNP. The strong revenue collection in 1997 stemmed from the continued growth of the economy, the improved tax collection machinery coupled with a large positive contribution from petroleum-based revenue. Benefiting from higher petroleum prices and production in 1996 (the tax base for 1997), petroleum-based revenue accounted for nearly one-quarter of the increase in total revenue collection during the year. In addition, several tax measures introduced in the 1997 Budget were estimated to have generated net additional revenue of RM321 million in 1997, compared with revenue foregone of RM437 million in 1996. The currency crisis in the latter part of the year had a marginal impact on revenue in 1997, given that collection of direct taxes, the largest component of Federal revenue, was based on the corporate performance in the previous year. However, indirect tax collections were somewhat affected, especially in the last two months of 1997. While collection from export duties benefited due to gains in export value in ringgit terms, receipts from import and excise duties declined in November-December due to slower aggregate demand arising from measures instituted to curb imports and excessive consumption.

In aggregate, the favourable revenue performance was contributed by all three broad categories of revenue, particularly receipts from direct taxes. **Tax revenue** maintained its strong growth momentum in 1997, due in part to measures to broaden the tax base and the more efficient tax collection machinery. As a result, the Government's tax effort, that is, the ratio of tax receipts to GNP improved to 20.4% (19.9% in 1996). Receipts from **direct taxes** recorded a stronger double-digit growth for the eighth consecutive year to account for a higher share of total revenue (46%), although the increase was

Table 2.2
Federal Government Finance

	1996	1997 ^p	1998 ^r
	RM million		
Revenue	58,280	65,736	55,924
Operating expenditure	43,865	44,665	38,899
Current surplus (% of GNP)	14,415 6.1	21,071 8.0	17,025 6.1
Development expenditure	12,600	14,445	12,967
<i>Gross development expenditure</i>	<i>14,628</i>	<i>15,750</i>	<i>14,267</i>
<i>Less Repayments</i>	<i>2,028</i>	<i>1,305</i>	<i>1,300</i>
Overall surplus (% of GNP)	1,815 0.8	6,626 2.5	4,058 1.4
<i>Sources of financing</i> ¹			
Net domestic borrowing	1,291	-2,048	-
<i>Gross borrowing</i>	<i>6,000</i>	<i>3,000</i>	-
<i>Less Repayments</i>	<i>4,709</i>	<i>5,048</i>	-
Net foreign borrowing	-2,177	-1,681	-
<i>Gross borrowing</i>	<i>749</i>	<i>462</i>	-
<i>Less Repayments</i>	<i>2,926</i>	<i>2,143</i>	-
Special receipts	475	91	-
Realisable assets ² and adjustments	-1,404	-2,988	-
Total	-1,815	-6,626	-

¹ Data for 1998 are not given.

² Includes changes in Government's Trust Fund balances. An increase in the accumulated realisable assets is indicated by a minus (-) sign.

^p Preliminary

^r Revised based on 5 December 1997 announcement.

Source: Ministry of Finance

moderated to some extent by a number of concessions implemented in the 1997 Budget to enhance productivity and international competitiveness as well as to strengthen the services sector. These fiscal measures included a review of reinvestment allowance, tax incentives (investment tax allowance or pioneer status) for selected tourism projects and information-based industries in the MSC, tax incentives for promoting industrial linkages and acquiring proprietary rights, and a concessionary tax rate for the local fund management industry. While these fiscal measures could result in some immediate revenue loss, it is expected to contribute to additional revenue in the future through expansion of economic activities and growth. Receipts from petroleum income tax recorded an exceptionally large increase (75%) in 1997. Collections from corporate income tax, the single largest contributor of revenue (25%), remained buoyant, while receipts

from personal income tax were also higher. Overall, the improved income tax collection reflected higher profits, business earnings and incomes in 1996, as well as the increasing number of taxpayers included in the tax base. The Inland Revenue Board (IRB) is estimated to register 150,000 new taxpayers in 1997. In addition, concerted efforts were made by IRB to further strengthen the tax collection machinery, expand the tax base and raise the tax compliance rate through stricter enforcement to reduce tax evasion and tax avoidance. These measures were successful in generating an additional RM282 million in back taxes in 1997. Collection from stamp duties stabilised at the previous year's level, with higher values in property transactions being offset by the sharply lower value of shares

traded on the Kuala Lumpur Stock Exchange. The contribution from other components of direct taxes, including real property gains tax, increased in 1997.

Revenue from **indirect taxes** increased at a more moderate pace in 1997, in tandem with the slightly slower rate of increase in domestic demand. Collections from this source were affected, especially in the last two months of the year, following the measures imposed on import demand, including the higher rates of import duty on construction materials, consumer durables and motor vehicles introduced in the 1998 Budget. Receipts from most major components of indirect taxes moderated during the year. Receipts from export duties were sustained at the previous year's level, with the gains in collection from petroleum export duties (97% of total export duties) arising from the depreciation of the ringgit, largely offset by the decline in petroleum prices and export volume.

Growth in receipts from import duties moderated in 1997 consonant with the deceleration in import volume. The abolition or reduction of import duties on a number of goods in the 1997 and 1998 Budgets to reduce inflationary pressures and reduce excessive protection on domestic industries also contributed to the slower collection. The increase in revenue from indirect taxes was underpinned by the reimposition of duties on heavy machinery and the withdrawal of exemptions on spares, consumables and components used in manufacturing and certain hotel equipment in the 1997 Budget. This was estimated to raise additional revenue of RM326 million. However, the increase in duties on petroleum and, in particular, on motor vehicles slowed down sharply (4.4%; 26.8% in 1996) as a result of a reduction in demand for vehicles towards the end of the year in response to the tightening of financing facilities and the substantial increase in import duty rates on motor vehicles introduced in October 1997. Receipts from excise duties were similarly affected, with sharply lower collections from petroleum and petroleum products, and a smaller increase in duties from motor vehicles. Collection from sales tax remained buoyant despite the exemption of sales tax on inputs of selected domestic manufactured goods to reduce production costs. The increase was largely on account of stronger growth in receipts from sales tax on imported goods, partly due to the ringgit impact. Receipts from service tax benefited from the imposition of a service tax on credit cards. However,

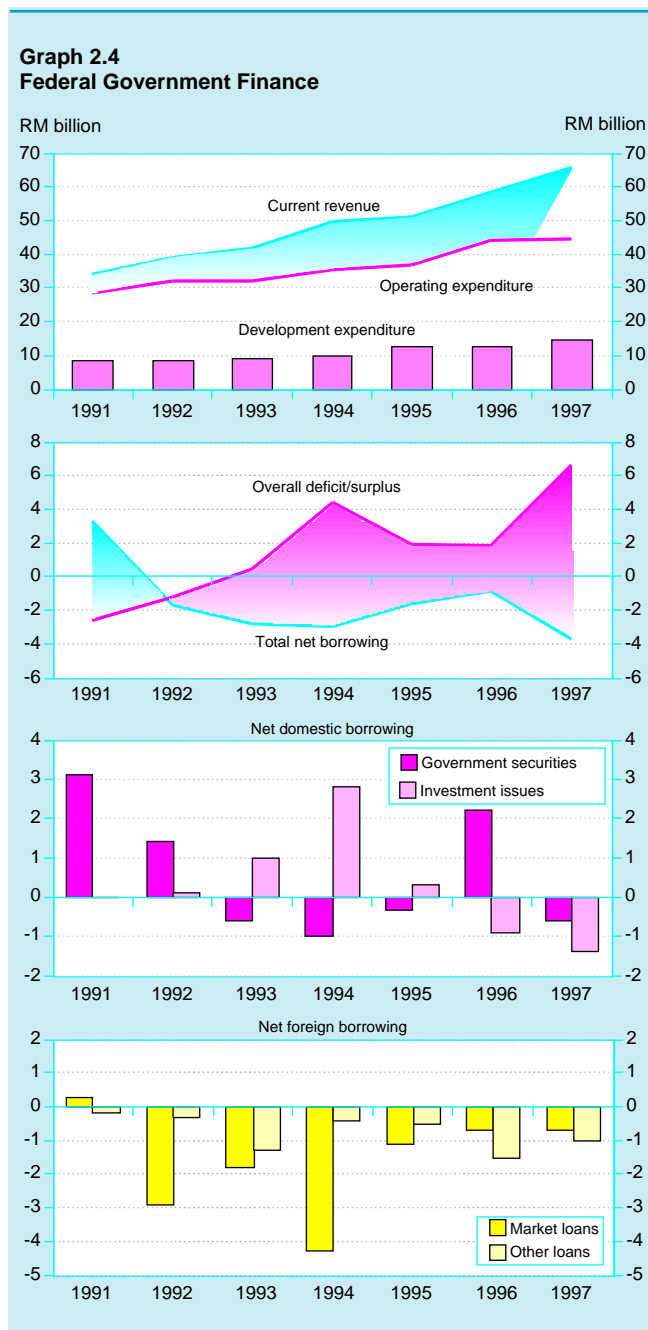


Table 2.3
Federal Government Revenue

	1996	1997 ^p	1996	1997 ^p
	RM million		Annual change (%)	
Tax revenue	47,272	53,627	13.4	13.4
Direct taxes	25,851	30,432	13.9	17.7
Income tax	22,661	27,121	12.3	19.7
Corporate	14,166	16,688	21.0	17.8
Petroleum	2,203	3,861	0.8	75.3
Personal	6,172	6,429	-0.5	4.2
Co-operative	120	143	34.8	19.2
Stamp duties	2,708	2,714	23.5	0.2
Other	482	597	48.8	23.9
Indirect taxes	21,421	23,195	12.9	8.3
Export duties	1,041	1,053	22.2	1.2
Import duties	6,132	6,524	9.1	6.4
Excise duties	5,790	6,054	9.7	4.6
Sales tax	5,473	6,167	12.4	12.7
Service tax	1,231	1,475	21.2	19.8
Other	1,754	1,922	31.7	9.6
Non-tax revenue and receipts	11,008	12,109	18.6	10.0
Total	58,280	65,736	14.4	12.8

^p Preliminary

Source: Ministry of Finance

receipts were partially offset by service tax exemptions given for the export of professional services and for approved companies undertaking research and development.

Non-tax revenue increased moderately in 1997. Collections from licences and permits remained buoyant with substantially higher receipts from the levy on foreign workers following stricter enforcement by the authorities, as well as higher collections from road tax and petroleum royalty. Service fees also recorded an increase, while investment income receipts stabilised despite the further divestment of Government-owned companies. Non-revenue receipts, which included refunds of expenditure, receipts from Government agencies and revenue from the Federal territories, were marginally higher during the year.

Total **Federal Government expenditure** increased by a modest 4.7% in 1997, as budgetary policy during the year continued to be one of consolidation in order to achieve a larger fiscal surplus. Several measures taken in the third quarter also contributed to containing the increase in expenditure. **Operating expenditure** increased by 1.8% to RM44.6 billion

(19.9% in 1996), reflecting continued stringent controls on expenditure to avoid wastage and to curtail less essential spending. Increased efficiency and effectiveness of the government administrative machinery as a result of the wider use of office automation and information technology also assisted in containing the growth in operating costs. The total wage bill, the largest component of operating expenditure (34%), was 7.7% lower than the 1996 expenditure level which included the payment of arrears arising from the salary adjustment for civil servants. In addition, only part of the one month bonus payment to civil servants (up to a maximum of RM500) was made in 1997, with the balance to be paid out in 1998. The reduced wage bill also reflected the policy to rightsize and rationalise the civil service through the privatisation of public services and projects as well as organisational restructuring and consolidation of departments. However, new recruitment continued in the essential services, especially in the health and education sectors. Meanwhile, pension payments increased moderately, reflecting the increased number of pensioners and the annual contribution to the Pensions Trust Fund.

Expenditure on supplies and services was higher, largely for maintenance and enhancing the quality and efficiency of public services. Transfer payments increased moderately, due to larger grants and transfers provided to the state governments and other government agencies for development and maintenance purposes, increased subsidy payments, especially on petroleum products and the paddy fertiliser scheme to assist the lower income consumers, a launching grant to the Higher Education

Table 2.4
Federal Government Operating Expenditure by Object

	1996	1997 ^p	1996	1997 ^p
	RM million		% share	
Emolument ¹	16,282	15,024	37.1	33.6
Supplies and services	5,673	6,363	12.9	14.2
Asset acquisition	874	905	2.0	2.0
Public debt charges	6,795	6,425	15.5	14.4
Pensions and gratuities	3,509	3,638	8.0	8.1
Other grants and transfers ²	9,449	10,273	21.5	23.1
Other expenditure	1,283	2,037	3.0	4.6
Total	43,865	44,665	100.0	100.0

¹ Includes statutory bodies.

² Includes grants and transfers to state governments as well as public agencies and enterprises.

^p Preliminary

Source: Ministry of Finance

Fund to assist students facing financial constraints and higher allocation for the Fund for Food. The reduction in the size of the Government domestic debt contributed to the decline in public debt service payments in 1997. Both domestic and foreign interest payments were lower during the year. The impact of the ringgit depreciation on the interest payment burden was insignificant in 1997, largely due to the low external indebtedness of the Federal Government. Debt servicing, however, remained the second largest component of operating expenditure, although its share declined to 14.4%.

Gross development expenditure rose moderately by 7.7% to RM15.8 billion, mainly on projects to expand the productive base of the economy and alleviate supply constraints. The increase in expenditure was contained through further privatisation and some deferment of the less essential projects. The emphasis of development expenditure continued to focus on the expansion of infrastructure, upgrading the quality of the workforce through human resource development, and broadening and deepening the research, science and technology base. Priority was also accorded to achieving the socio-economic objectives of the country, especially to eradicate poverty and improve the quality of life of the rural population as well as to provide housing for the low- and medium-income groups.

In terms of sectoral distribution, economic services remained the largest component of total development expenditure, although its share declined to 49% due in large part to the on-going programme to privatise new projects, especially the major infrastructure projects. Disbursements on the transport sub-sector was maintained at about the previous year's level, comprising mainly investments on transportation networks to facilitate the flow of goods and passenger traffic to support the industrialisation process and to overcome traffic congestion in the major towns. The major share of the expenditure was for the construction and improvement of Federal roads, and support loans for the development of the rail system, including the light rail transit system projects, and the purchase of rolling stocks for the commuter train system. Priority was also accorded to the development and expansion of ports and airports to strengthen their capacity and efficiency in handling the increasing volume of international and regional trade and passenger traffic. In terms of expenditure on trade and industry, attention continued to focus on industrial development,

Table 2.5
Federal Government Development Expenditure by Sector

	1996	1997 ^p	1996	1997 ^p
	RM million		% share	
Defence and security	2,438	2,314	16.7	14.7
Economic services	7,693	7,800	52.6	49.5
Agriculture and rural development	1,182	1,105	8.1	7.0
Commerce and industry	1,212	1,286	8.3	8.2
Transport	4,530	4,536	31.0	28.8
Public utilities	733	837	5.0	5.3
Other	36	36	0.2	0.2
Social services	3,984	4,919	27.2	31.2
Education	2,091	2,521	14.3	16.0
Health	459	449	3.1	2.9
Housing	501	735	3.4	4.7
Other	933	1,214	6.4	7.6
General administration	513	717	3.5	4.6
Total	14,628	15,750	100.0	100.0
<i>p</i> Preliminary				
Source: Ministry of Finance				

research and development, promotion of small- and medium-scale industries and tourism projects. A large portion of the expenditure was also channelled to developing technology infrastructure and to programmes to strengthen the technological base of the economy. As part of the continuing effort to reduce the poverty rate to 5.5% by the year 2000 and raise the standard of living of the rural population, expenditure on agriculture and rural development, including land development, and investment to improve rural roads, water supply and electrification programmes remained high.

Capital outlay on the social services sector recorded a large increase of 23.5% in 1997, raising its share to 31% of total development expenditure. Expenditure on education and training increased significantly by 20.6% to absorb the second largest share of development expenditure (16%). The expenditure was mainly for the construction and upgrade of polytechnics, vocational and technical schools and industrial training institutes, the upgrading of educational facilities, including implementation of the computer education programme. The development of institutions of higher learning, including the development of University Malaysia Sabah, also absorbed a larger share of the expenditure. Expenditure on housing was also higher, largely on low- and medium-cost housing projects and

housing programmes for the armed forces, police force, customs and immigration officers and teachers in rural areas. The outlay on social and community services included expenditure on projects to conserve the environment and a larger contribution for the development of facilities for the Commonwealth Games in 1998. Investment to provide better quality health care services was mainly on the construction and upgrading of hospitals and health clinics and on the purchase of medical facilities and equipment, including equipping rural health clinics to serve as nerve centres for primary health care services. However, spending on this sector was marginally lower, reflecting the privatisation of support services such as clinical waste management, engineering facilities and biomedical engineering maintenance. Outlays on defence and internal security were mainly for the modernisation of the armed forces and the police force, as well as the construction of training centres. Expenditure for general administration was higher, largely for the construction of office buildings, including the development of the new administrative centre at Putrajaya, and the introduction of electronic government.

The large fiscal surplus recorded in 1997 provided the resources for the Federal Government to further reduce its domestic borrowing while continuing with its external loan prepayment programme. Concomitantly, there was a large build-up in the Government's accumulated financial assets which contributed to increasing national resources to fund development and growth. As a result, **total net borrowing** of the Federal Government remained negative for the sixth consecutive year, with another large net repayment of RM3.7 billion. The total debt position of the Federal Government was, however, marginally higher due to an increase in the foreign debt in ringgit terms following the depreciation of the ringgit. Total debt increased by 0.3% to RM89.9 billion at the end of 1997. In terms of percentage of GNP, it declined further to 34%, from 38% at the end of 1996.

The favourable revenue position permitted the Government to review and subsequently reduce its planned **domestic borrowing** programme during the year. As in the previous year, the Government's domestic borrowing was mainly to accommodate market demand for Malaysian Government Securities (MGS). Gross funds raised through MGS was reduced to RM3 billion, one-half the amount raised in 1996. Hence, for the first time, there

Table 2.6
Public Debt of Federal Government

	Annual change		At end 1997 ^p
	1996	1997 ^p	
Nominal value in RM million			
Domestic debt	1,173	-2,243	76,968
Treasury bills	0	0	4,320
Investment issues	-900	-1,400	2,750
Government securities	2,191	-648	66,262
Treasury Housing Loans Fund	-118	-195	3,636
External debt	-2,860	2,480	12,951
Market loans	-1,072	1,312	6,472
Project loans	-1,788	1,168	6,479
Total	-1,687	237	89,919
^p Preliminary			
Source: Ministry of Finance			

was a net repayment of domestic loans as maturing MGS and Government Investment Issues (GII) totalling RM5 billion exceeded new issues. Similarly, no new funds were raised through GII or Treasury bills (TB) during the year, while the Treasury Housing Loans Fund continued to record a small net repayment of loans. Consequently, the total domestic debt of the Federal Government declined by 2.8% to RM77 billion at the end of 1997, thereby accounting for a smaller share of 86% of the total outstanding debt of the Federal Government.

In 1997, the Government floated two issues of MGS worth RM1 billion and RM2 billion respectively by way of tender through the principal dealers. The issues were for maturity of five and ten years. Again, longer-dated MGS were not offered to the long-term institutional investors such as the social security institutions. After adjusting for loan redemptions, total MGS outstanding declined by 1% to RM66.3 billion at the end of 1997 and accounted for 86% of the total domestic debt outstanding. In terms of the ownership structure of **MGS holders**, the social security and insurance institutions maintained their dominant position, although their share of the total outstanding MGS declined to 67%. This reflected mainly the maturity of MGS held by the Employees Provident Fund (EPF), the Social Security Organisation (SOCSO) and insurance companies. This development reflected the recent policy move to liberalise the investment guidelines of these institutions to allow them to further diversify to non-Government securities assets such as private debt securities and

equity. Nevertheless, the EPF remained the single largest institutional investor in 1997, holding a slightly lower share of 56% of the total MGS. The new issues of MGS during the year were absorbed mainly by the banking institutions to meet their statutory liquidity requirements following the maturity of Bank Negara Bills of RM6 billion, which is an alternative instrument held to comply with their liquid asset requirement. Consequently, their shareholding in MGS increased further to 20%. The remaining MGS was held mainly by the public enterprises, the non-bank financial institutions and foreign investors.

The balance of the domestic debt was in the form of TB (6%), the Treasury Housing Loans Fund (5%) and GII (3%). There was a significant shift in the profile of **holders of TB** in 1997. The traditional holders, namely, the banking institutions, doubled their holdings to RM3.9 billion, to meet their statutory liquidity requirements. Hence, it regained its position as the major investor to account for 90% of the total TB outstanding. The demand was offset by net liquidations by the insurance companies, which reduced their holdings significantly to only 7% after a large increase of their shareholding to 56% in 1996. The composition of **GII by holder** also indicated an increase in the holdings of the banking institutions participating in the Interest-free Banking Scheme, to account for a larger share of 37% of the total GII outstanding. In contrast, the traditional holders, comprising the Islamic financial institutions, such as Bank Islam, Syarikat Takaful and the Pilgrims Fund Board, further reduced their holdings due to the increased availability of other higher-yielding instruments based on Islamic principles such as Islamic bonds. Meanwhile, BNM's holdings of GII was reduced to 58%, reflecting the large net redemptions of loans during the year. The main lenders to the **Treasury Housing Loans Fund** were Cagamas Berhad, the EPF, the National Savings Bank and the commercial banks.

The prepayment of external loans and restraint on new external borrowing remained an integral part of the Government's debt policy in 1997. Consequently, net **external borrowing** of the Federal Government continued to decline for the sixth consecutive year, recording an outflow of RM1.7 billion in 1997. Gross external borrowing was limited to drawdowns on project loans. During the year, Malaysia signed one project loan agreement with the Asian Development Bank (US\$26.3 million) to finance the Klang River Basin Environmental Improvement and Flood Mitigation project. The

Table 2.7
Holdings of Federal Government Domestic Debt

	1996	1997 ^p	1996	1997 ^p
	Nominal value in RM million		% share	
Treasury bills	4,320	4,320	100.0	100.0
Insurance companies	2,431	304	56.3	7.0
Banking sector	1,849	3,879	42.8	89.8
Other	40	137	0.9	3.2
Government Investment Issues	4,150	2,750	100.0	100.0
Insurance companies	63	119	1.5	4.3
Banking sector	3,878	2,610	93.4	94.9
<i>of which:</i>				
<i>Bank Negara Malaysia</i>	2,938	1,588	70.8	57.7
<i>Commercial banks</i>	611	930	14.7	33.8
Other	209	21	5.1	0.8
Malaysian Government Securities	66,910	66,262	100.0	100.0
Social security and insurance institutions	46,402	44,332	69.4	66.9
<i>of which:</i>				
<i>Employees Provident Fund</i>	38,743	37,055	57.9	55.9
<i>Insurance companies</i>	5,447	5,279	8.1	8.0
Banking sector	11,541	13,196	17.2	19.9
Other	8,967	8,734	13.4	13.2

^p Preliminary

Federal Government also took advantage of the weaker yen in the early part of the year to prepay two market loans and two loans from the Overseas Economic Co-operation Fund of Japan in addition to the maturing of two market loans. However, the recent significant depreciation of the ringgit led to an increase in the external debt in ringgit terms. For the first time in five years, the external debt of the Federal Government rose by 23.7% to RM12.9 billion at the end of 1997.

Based on preliminary estimates, the consolidated financial position of the 13 **state governments** remained in surplus in 1997, for the fifth consecutive year. Reflecting efforts to contain increases in operating expenditure in line with revenue growth, the consolidated current account of the state governments recorded a larger surplus of RM4.6 billion in 1997. Almost all the states achieved surpluses in their current accounts, in line with the objective of raising public sector savings to finance development expenditure. However, with some states recording deficits in their overall balance, the consolidated position showed a smaller overall surplus of RM529 million. The surplus position together with Federal Government loans led to an increase of RM1.2 billion in the accumulated financial assets of the state governments.

The consolidated state **revenue** rose by 1.4% to RM9.6 billion in 1997, on account of higher receipts from both state sources and contributions from Federal grants and transfers. The higher revenue receipts from state sources were mainly from direct taxes, especially forest taxes, which remained the single largest source of state revenue (20%). However, receipts from indirect taxes were lower. Non-tax revenue also declined, largely due to lower receipts from commercial undertakings and the absence of privatisation proceeds. Investment income and payment of petroleum and gas royalty to Sabah, Sarawak and Terengganu Darul Iman were higher during the year. The receipts from Federal sources were aimed at assisting the states in providing infrastructure and other essential amenities to improve the quality of life and to support the industrialisation process.

The total expenditure of the state governments as a group increased at a more moderate rate of 6.3% in 1997, after recording double-digit growth in the preceding two years. Reflecting tighter control on consumption spending, the **operating expenditure** of the state governments increased marginally by 0.7% to RM5 billion (18.9% in 1996). Emoluments, the single largest component of operating expenditure,

was lower than the 1996 level which included the payment of salary arrears. The higher expenditure was mainly on maintenance, as well as to provide better facilities and improve the efficiency of state services and administration. **Net development expenditure** increased by 14% to RM4.1 billion (3.8% in 1996), to expand the infrastructure and amenities required to support the high level of industrial development and urbanisation in the states. Most of the states increased their capital expenditure, reflecting their increasing role in the nation's development process. The major share of the outlay was channelled to the economic sector, especially infrastructure (roads, bridges and public amenities), industrial and commercial investments and agriculture and rural development. The balance was for investment in the social services sector, including housing and social and community programmes.

Preliminary estimates of the consolidated position of 28 **non-financial public enterprises** (NFPEs) indicated that the overall financial position of the NFPEs as a group remained in surplus in 1997. However, the surplus was lower than the surplus achieved in 1996 due to the strong increase in capital expenditure by several major public enterprises, mainly to finance capacity expansion. Several NFPEs continued to rationalise their operations during the year, including increasing capacity utilisation by diversifying into upstream and downstream products to improve quality, efficiency and productivity. During the year, TNB completed a corporate restructuring exercise to strengthen performance and consolidate its activities in order to enhance efficiency, as well as optimise utilisation of its assets and human resources. Meanwhile, Telekom Malaysia Berhad also undertook a voluntary redundancy programme to rightsize its workforce. PETRONAS acquired 29.3% shareholding in Malaysian International Shipping Corporation (MISC) to complement and strengthen the operations of both enterprises.

The consolidated revenue of the NFPEs expanded further by 7.2% to reach RM62 billion in 1997, supported by the expansion in business and other activities amidst sustained economic growth. A review of the electricity tariff rates, returns from investments, and gains from overseas operations also contributed to the higher revenue receipts. The depreciation of the ringgit also contributed to higher export earnings of several enterprises during the latter part of the year. Reflecting tight fiscal discipline

	1996	1997 ^p	1998 ^f
	RM million		
Revenue	9,494	9,624	8,739
<i>State sources</i>	7,974	8,023	7,283
<i>Federal grants and transfers</i>	1,520	1,601	1,456
Expenditure	4,955	4,988	4,408
Current surplus	4,539	4,636	4,331
Development expenditure (net)	3,605	4,107	3,612
<i>Gross development expenditure</i>	4,137	4,433	3,923
<i>Less: Loan repayment</i>	532	326	311
Overall surplus	934	529	719
<i>Sources of financing</i>			
Federal loans	544	678	700
Realisable assets ¹	-1,478	-1,207	-1,419
Total	-934	-529	-719

¹ An increase in the accumulated realisable assets is indicated by a minus (-) sign.
^p Preliminary
^f Forecast

Source: State governments

as well as the restructuring exercises undertaken by some public enterprises to improve productivity and efficiency, operating expenditure rose more moderately by 7.2% to RM39.7 billion. The higher spending reflected the increased cost of business expansion and higher labour and supply costs, including higher import costs due to the weaker ringgit in the latter part of the year. Debt servicing payments, especially the foreign interest servicing burden, increased in 1997 due to the accumulation of a larger debt and the implications of the depreciation of the ringgit.

The operating surplus of the NFPEs as a group was maintained at a high level of RM22.3 billion or 8.5% of GNP in 1997 (8.7% of GNP in 1996). The large surplus was contributed mainly by the major NFPEs, notably PETRONAS, TNB, Telekom and MISC. A small number of enterprises continued to experience losses in 1997.

During the year, several major public enterprises continued to undertake large capacity expansion and modernisation programmes, mainly on infrastructure and utility projects, as well as investment in the oil and gas and manufacturing sectors. The NFPEs also diversified their investment to include acquisition of companies related to their core activities as well as overseas ventures, especially in emerging economies. These developments contributed to a significant increase in the capital spending of the NFPEs, by 43% to RM22.2 billion in 1997 (13.8% in 1996). PETRONAS, TNB, Telekom and MISC accounted for the major share of total capital expenditure during the year. In particular, capital investment by

PETRONAS expanded in both upstream and downstream activities. A substantial portion was invested in the gas sector, including the construction of two new gas processing plants (GPP 5 and 6), and the completion of the Peninsular Gas Utilisation project (PGU III); the completion of the Malacca Refinery Centre; and investment in several petrochemical projects as well as PETRONAS Institute of Technology. Overseas investment activities also expanded during the year. Investments by TNB included outlays to expand the power generating capacity and upgrade the transmission and distribution networks to meet the rapid growth in demand for electricity by the commercial and industrial sectors. Major projects underway included the construction of Phases III and IV of the Port Klang Sultan Salahuddin Abdul Aziz Power Station, the construction of two initial phases of the 500kv transmission line network, the construction and installation of gas turbines at the various load centres as well as the rehabilitation and conversion works at several power stations. Other projects included the development of the electricity infrastructure for Putrajaya and the MSC projects and the construction of phase II of the TNB University complex. Other investments included power projects overseas, including those undertaken in Bosnia and Pakistan.

A major part of the expenditure of Telekom was for the expansion and upgrading of the international and local networks, as well as investment in telecommunication infrastructure for the MSC projects. Telekom continued to diversify its investments to overseas emerging economies. MISC maintained its long-term fleet expansion programme in 1997 to enhance its capacity to handle the growing volume of international trade. Keretapi Tanah Melayu Berhad continued to enhance the quality and efficiency of rail services as an alternative commuter transport system. The projects included the purchase of 44 additional electric multiple units for the electric commuter train service.

With these large capital investments, the consolidated overall account of the NFPEs as a group recorded a lower surplus of RM86 million or less than 0.1% of GNP in 1997 (2.2% of GNP in 1996). These capital outlays were financed by internally generated funds as well as recourse to domestic and external borrowing. In 1997, the outstanding external debt of the public enterprises increased to RM52.5 billion, to account for 41% of the nation's medium- and long-term external debt.

Table 2.9
Consolidated NFPEs Finance¹

	1995	1996	1997 ^p
	RM million		
Revenue	48,682	57,794	61,956
Expenditure	32,343	37,032	39,689
Current surplus (% of GNP)	16,339 7.9	20,762 8.7	22,267 8.5
Development expenditure	13,630	15,512	22,181
Overall surplus (% of GNP)	2,709 1.3	5,250 2.2	86 -

¹ Refers to 32 NFPEs in 1995, 28 in 1996 and 1997 respectively.
^p Preliminary

Source: Ministry of Finance, Economic Planning Unit and non-financial public enterprises.

This increase reflected the increase in borrowing as well as the increase due to the depreciation of the ringgit. However, the external debt position of the NFPEs remained manageable as most of the loans were utilised to fund productive investments, including overseas investments, which were expected to strengthen the performance of the NFPEs as well as generate additional revenue to service the debt. The expenditure, investment activities and borrowings of the NFPEs were closely monitored by the Federal Government to ensure that the activities were consistent with the Government's policy of fiscal prudence and financial discipline.

In 1997, the Government continued with the privatisation programme as part of public policy to consolidate the public sector while increasing private sector participation to meet the country's need for capital investments. During the year, two government agencies, namely, Federal Land Consolidation and Rehabilitation Authority (FELCRA) and the Maritime Academy were corporatised. Another 15 existing and new projects were privatised, mainly involving infrastructure and construction projects. Major privatised projects included several highways such

as the Dedicated Kuala Lumpur-Sepang Highway, Western Traffic Dispersal System, Assam Jawa-Taman Rimba Templer Highway and Kajang-Seremban Highway. One state entity, namely, PASDEC was divested through listing in the Kuala Lumpur Stock Exchange. Following the emergence of the regional financial crisis, the Government announced the deferment of a number of large privatised projects, including the Bakun Hydroelectric project, the Kuala Lumpur Linear City, the Northern International Airport, Phase II of the Putrajaya project and Light Rail Transit Systems in Penang and Johor. In addition, the privatisation programme would now be more selective. New privatised projects would be assessed critically in terms of their macroeconomic implications, especially on the balance of payments position. Only projects with low import content, which would contribute to expanding productive capacity and improve the long-term growth prospects would be approved. On-going construction projects which were not strategic were deferred. For large infrastructure projects that have been approved, the implementation would be staggered and the emphasis would be placed on the usage of domestic inputs and on projects that would generate export earnings.
