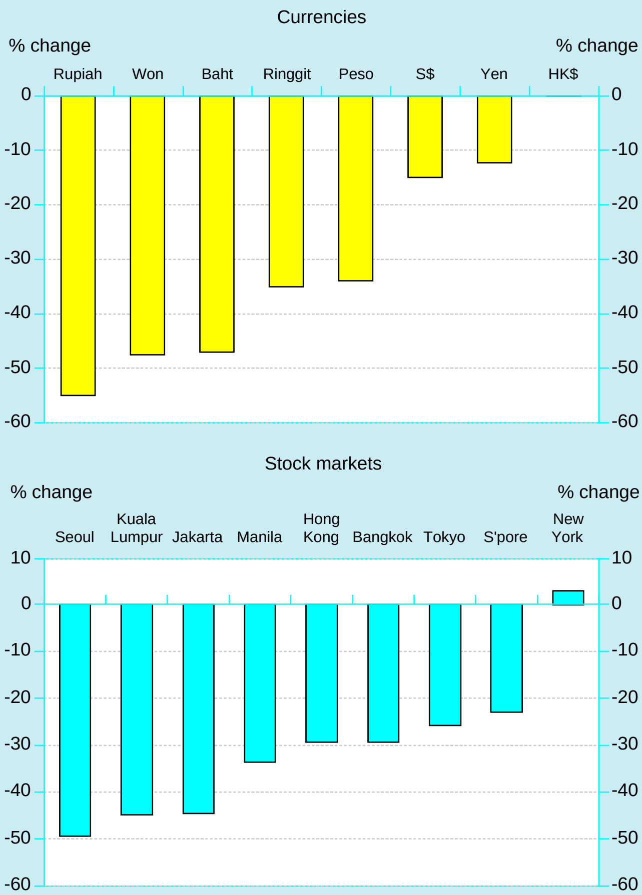
3 Outlook and Policy

International Environment

East Asian Financial Crisis

The East Asian financial crisis is expected to affect growth in world output and trade in 1998. The region's economies would be most affected by the crisis, as the prolonged uncertainty and the implementation of strong measures and structural changes to address existing macroeconomic imbalances take effect. In the short term, fiscal tightening and monetary restraint, and the restructuring of the economy and the corporate and financial sectors, can be expected to exert a dampening influence on growth prospects. However, these measures would pave the way for a more sustainable and broad-based growth over the medium term. Meanwhile, the effect of the crisis on the major industrial economies will vary, depending on their exposure to trade and investment in the region.

Graph 3.1
Performance of Selected Currencies and Stock Markets (30 June 1997 - 31 December 1997)



Prior to the crisis, the East Asian region had enjoyed several decades of strong economic performance, characterised by rapid export-driven growth, relatively low inflation, rising per capita incomes and reduced poverty. The favourable macroeconomic developments in the region attracted large capital inflows. While these inflows supported economic growth, they also contributed to an appreciation in asset prices and general optimism over the region's future prospects. Such flows were made possible by a trend of capital account liberalisation and greater foreign presence in the domestic banking and capital markets. Technological advancements in financial services amidst the globalisation of financial markets also facilitated countries in the region in mobilising foreign savings to finance domestic investments. Benefits of capital inflows accrued in cases where the capital-importing country could maintain sustainable growth with low inflation and a viable current account position. However, imbalances and weaknesses in a number of these countries began to emerge, making the region vulnerable to sudden reversals of these flows, with consequent destabilising effects on the exchange rate and the domestic economy.

Pressures on the regional currencies started with speculative attacks on the Thai baht in mid-May 1997 amidst market concerns over the impact of the export slowdown and the decline in asset prices. These developments heightened investors' perceptions of risks in other economies in the region in terms of the consequences of the export slowdown, asset price deflation and the servicing of high external debt. The consequent deterioration in market sentiment and the loss of investor confidence triggered a series of downward adjustments in regional currencies and sharp declines in the region's equity markets. The Thai baht, which was pegged to the United States dollar prior to the crisis, was floated on 2 July 1997, resulting in its immediate depreciation by about 10–15%. Subsequently, the Philippine peso and the Indonesian rupiah were also allowed to float more freely, while the Malaysian ringgit and Singapore dollar came under selling pressure. The instability in the currency markets was not confined to South-East Asia. The Korean won, the Hong Kong dollar and the Taiwan dollar in turn were subjected to selling pressures. While the Hong Kong dollar peg has remained, the Korean won and the Taiwan dollar depreciated against the United States dollar.

The main feature of the East Asian financial crisis was the severity of the contagion effects and the speed with which the crisis spread across the region. First, significant adjustments in one currency were almost instantly followed by adjustments in the other regional currencies. Second, pressures on the currency and equity markets reinforced each other. The depreciation of the domestic currency resulted in sharp falls in stock prices. The consequent capital outflows exerted further pressure on the exchange rate. Third, despite sharp increases in domestic interest rates, outflows continued, suggesting that investors were more concerned about fundamental weaknesses which existed in the economy. Fourth, the crisis triggered a loss of confidence in the financial system due to high exposure to external borrowing as well as the exposure of domestic financial institutions to properties and stocks and shares. Fifth, the crisis reflected mainly private sector excesses as most countries experienced fiscal surpluses. Finally, there was a spillover of the regional crisis onto the global financial markets, when it generated a global stock market decline in late October, and has since contributed to continued volatility in most equity markets.

Although there were no clear-cut causes of the crisis, there were several factors that triggered and prolonged the problem:

- Movements of the region's currencies against the United States dollar reflected to some extent the global realignments in exchange rates. The United States dollar had strengthened against the major currencies since the second half of 1995. Between the end of September 1995 and the end of 1997, the dollar had appreciated by 26% and 31% against the Deutsche Mark and the Japanese yen respectively.

- Macroeconomic imbalances associated mainly with large current account deficits due to the slowdown in export growth were perceived by the market as defining a build-up of risks and vulnerability to external shocks. Although the magnitude of these imbalances differed among the region's economies, collectively it undermined investor sentiment. Speculators in search of short-term gains aggravated the situation. While the current account deficits had narrowed in several of the East Asian countries, the perception of risks was associated mainly with the financing of these deficits. The East Asian economies relied heavily on foreign capital to finance the current account deficits. During the 1980s, capital inflows were predominantly long-term foreign direct investment. However, the composition changed by the mid-1990s, with a higher proportion in the form of short-term capital inflows, including private sector borrowing and portfolio investment.

- Perceptions of a loss of export competitiveness, after a prolonged period of real exchange rate appreciation, raised concerns on the ability of countries to service the higher external debt.

- Market sentiment was affected by concerns over the sustainability of the exchange rate levels given the regional economic slowdown and outflows of capital. This led to the perception that the region's currencies were generally overvalued.

- Liberalisation led to a large build-up of non-resident investment in the domestic financial markets. This made official reserves more vulnerable to capital outflows.

- As the crisis developed, concerns over vulnerability to external shocks were replaced by concerns over the stability of the region's banking systems. Financial systems in the region were viewed as fragile due to the high credit growth in recent years and the tendency for the allocation of credit to be skewed to non-tradeable and higher-risk sectors, particularly the property and equity markets. As interest rates were raised to contain inflation and discourage capital outflows, banking systems were viewed to have become more vulnerable to a deterioration of their asset quality. Although there were marked differences in the level of non-performing loans of countries in East Asia, the issue of banking sector vulnerability was generalised by the market as a common problem in the region.

The build-up of these vulnerabilities and the global exchange rate realignments against the United States dollar did not entirely explain the sharp correction in the region's currencies and equity prices over a relatively short time period and the speed of the contagion effects. The impact of the changes in market sentiment and investor confidence played a central role in magnifying the extent of currency depreciations and stock market declines. The rapid increase of foreign portfolio investment and international bank lending to East Asia, amidst the euphoria surrounding the region during the period of strong economic growth and booming asset markets, has also been a contributory factor. The excessive optimism and confidence led to an inadequate assessment of risks by international rating agencies, creditors and investors alike in view of the potential high rates of return from loans and investments. The inadequate risk assessment, despite the availability of information, was prompted by views that there were implicit guarantees by governments. The exchange rate stability that prevailed also encouraged capital inflows and the accumulation of private sector external debt, given the narrow spreads on loans. However, as adverse developments unravelled in some of the region's economies, the market began to reappraise the economic and financial situation, leading to the perception that there existed a common set of high risks in the region. The "herd mentality" that prompted the capital inflows into the region became apparent after the outbreak of the crisis, when equally massive reversals of capital flows occurred. According to an estimate by the International Monetary Fund (IMF), net private capital inflows into Asia in 1997 fell sharply to US$34.2 billion from US$101.2 billion in 1996, due mainly to the sharp decline in net portfolio investment and the net outflow of other investment (which included short-term and long-term lending). In addition, the lack of a pro-active role by the international community to facilitate the markets in differentiating the economic and financial conditions and developments among the region's economies accentuated the crisis. The financial market volatility was exacerbated by credit downgrades by international rating agencies, political uncertainties generating concerns over the commitment to undertake drastic policy measures and a reassessment of the region's short- to medium-term economic outlook and stability of the banking system. Confidence was further eroded by the emergence of debt repayment problems in several of the region's economies, which raised the concerns of debt defaults or moratoria.

During the initial stage of the crisis, the monetary and regulatory authorities attempted to stabilise their currencies by intervening in the foreign exchange markets, raising domestic interest rates and introducing selective administrative measures to curb speculation in the currency and equity markets. However, these measures proved insufficient to stem the selling pressures and stabilise the foreign exchange markets. At the same time, intervention in the foreign exchange markets became very costly as it resulted in the depletion of foreign exchange reserves. Similarly, raising domestic interest rates to support the local currencies had the perverse effect of exacerbating the current phase of economic downturn and contributing to the decline in equity prices in the region. Subsequently, since early July, the currencies were allowed to move in response to market forces.

Given the severity of the financial crisis, a more comprehensive solution was sought by policymakers. In this regard, the region's economies shifted their focus to improving the domestic economic fundamentals and enhancing the soundness of the banking system, while at the same time addressing the structural weaknesses in their economies. For several countries in the region, this effort was supported by international financial assistance packages to restore macroeconomic and financial market stability, and undertake reform and restructuring programmes, as well as to replenish their foreign exchange reserves to enable them to fulfil their short-term obligations. In July, the IMF approved the Philippines' request to extend the current Extended Fund Facility until end-year and to augment it by US$435 million. The Philippines had also indicated plans to seek another US$2.7 billion from the IMF as a precautionary stand-by arrangement and additional funds from the World Bank and the Asian Development Bank (ADB).

Thailand put in place a comprehensive adjustment programme in August 1997, in collaboration with the IMF. Financing of the US$17.2 billion programme was from multilateral and bilateral sources, including contributions from the IMF, the World Bank, the ADB and several Asia-Pacific countries, namely, Japan, Australia, Hong Kong, Special Administrative Region (SAR), China, Malaysia, Singapore, Indonesia, the People's Republic of China and Brunei Darussalam. After a brief period of political uncertainty, culminating in the establishment of a new Government and further pressures in the financial markets, the Thai authorities proceeded to introduce measures to achieve the targets as set out in the IMF programme. Fiscal consolidation measures involving cuts in public expenditure and increases in tax revenue were instituted, monetary policy was tightened and a floating exchange rate regime was maintained. Concrete steps were also taken to address weaknesses in the domestic banking sector, beginning with the suspension of 58 domestic finance companies facing bad loan problems. In a further step to rehabilitate the banking sector, a comprehensive financial reform programme was announced in October 1997. The key measures of the programme included the establishment of the Financial Restructuring Agency (FRA) and the Asset Management Corporation (AMC) to administer and facilitate the process of restructuring or closure of the suspended finance companies; establishment of a deposit insurance scheme to protect depositors; provision for majority foreign ownership of up to 100% in local financial institutions for a period of 10 years; recapitalisation of financial institutions and enhancement of the powers of the Bank of Thailand to restructure and replace the management of troubled commercial banks. On 8 December 1997, the FRA announced the closure of 56 of the 58 suspended finance companies in a sweeping reform of the banking sector, and the AMC proceeded to isolate the good assets from the bad assets of the closed finance companies to be transferred to healthy financial institutions. Meanwhile, the other financial institutions which remained in operation were ordered to comply with stricter regulations and disclosure rules. At end-January 1998, the Thai authorities removed the capital and foreign exchange controls that were imposed during the speculative attack on the Thai baht, reflecting increased confidence in the Thai baht.

Meanwhile, Indonesia sought assistance from the IMF on 8 October 1997. The IMF put together a financial support package totalling US$43 billion for Indonesia, comprising first line credits amounting to US$23 billion from the IMF, the World Bank, the ADB and a drawdown from Indonesia's own reserves, and "second line of defence" contributions of about US$20 billion from Singapore, the United States, Japan, Australia, Malaysia and Brunei Darussalam. The financial package was in support of a fiscal consolidation programme to achieve budget and current account surpluses in the medium term via cuts in Government expenditure and deferment of major infrastructure projects, tight monetary policy, and reform programmes to liberalise the domestic markets and external trade. Sixteen commercial banks were closed in a move towards consolidating the banking sector. Domestic conditions, however, hampered progress in meeting the conditions of the IMF package. The announcement of the 1998/99 Budget was perceived by the markets as contradicting the conditions of the package. In addition, mounting concerns over the external debt burden problem caused the rupiah to depreciate to an all-time low of US$1=Rupiah17,100 on 22 January 1998. In response to the worsening financial market conditions, the Government of Indonesia signed a letter of intent to reaffirm Indonesia's commitment to the conditions of the package. Subsequently, the 1998/99 Budget was revised to conform to the fiscal programme of the financial package, and non-essential infrastructure projects were postponed, while market-oriented reforms and deregulation were announced by the authorities. Further steps to rectify the financial sector problems were also undertaken by the Government, involving the establishment of the Indonesian Bank Restructuring Agency (IBRA) to consolidate and recapitalise weak financial institutions, the imposition of a tighter regulatory and supervisory framework, and guarantees on the banking system's domestic and external liabilities. Several merger proposals were also announced as part of the overall effort to consolidate the domestic banking sector. Meanwhile, in a move to address the external debt problem, the Government proposed a voluntary framework for a temporary freeze on external debt servicing by Indonesian debtors and the establishment of a committee to work out a new arrangement between lenders and borrowers.

In the case of Korea, the Government announced on 5 December 1997, that it had obtained international assistance amounting to US$58.4 billion to support its economic and financial stabilisation programme. Multilateral agencies, namely the IMF, the World Bank and the ADB, contributed a total of US$35 billion, while the remaining US$23.4 billion of bilateral contributions were pledged by Japan, the United States, the United Kingdom, France, Germany, Italy, Australia, Canada, Belgium, Netherlands, Sweden, Switzerland and New Zealand. The loan package for Korea was the largest ever arranged by the IMF. The measures prescribed by the conditions of the package were broadly similar to those for Thailand and Indonesia. The authorities were required to implement measures to ensure a budget surplus in the medium term, contain current account deficits and inflation as well as implement market-oriented structural reforms and liberalisation in the various sectors of the economy. The authorities were also required to rehabilitate and restructure the ailing banking sector, involving measures such as the closure of insolvent banks, adoption of strict banking regulations and supervision in accordance with international standards and relaxation of rules on foreign operations and ownership in the banking sector. In addition, the Government also took firm steps in dealing with the external debt. The effort began with the negotiation and agreement with international creditors in December 1997 to roll over short-term liabilities maturing at the end of 1997 and January 1998 to March 1998. Subsequent rounds of negotiations ended with a formal agreement on 29 January 1998 between the Government and international creditors to restructure Korea's short-term external debt through the exchange of US$24 billion short-term debt into new Government-guaranteed loans with extended maturities.

In dealing with the regional financial crisis, Malaysia implemented a self-initiated adjustment programme. The 1998 Budget contained policy measures to overcome the external shocks and weaknesses in the system. These involved measures to reduce the current account deficit, maintain fiscal discipline and improve the nation's resource position as well as to contain credit growth and strengthen the banking system. Subsequently, further measures were announced by the Government to reinforce and enhance the Budget measures. Several measures were introduced to strengthen the banking system (for details, refer to the Overview in Chapter 1).

The contagion effects of the regional currency crisis underscored the need for closer regional co-operation in stabilising the financial markets, preventing systemic risks and maintaining investor confidence. In this regard, the momentum towards a new mechanism for regional co-operation was initiated during a meeting of ASEAN Finance and Central Bank Deputies in Manila on 18–19 November, 1997. The meeting endorsed a proposal, subsequently referred to as the Manila Framework, which involved initiatives on four fronts: a mechanism for regional surveillance; technical assistance to enhance domestic financial systems and regulatory capabilities; measures to strengthen the IMF's capacity to respond quickly to a financial crisis; and a co-operative financing arrangement to supplement resources from the IMF and other international financial institutions.

The crisis in East Asia is unprecedented in terms of degree and extent. Given the region's increasing importance and integration with the global economy and international financial markets, the adverse consequences of the turmoil are expected to reach beyond the regional boundaries. Uncertainty remains with regards to the duration and the spread of the crisis, which could eventually alter the world economic and financial environment, and thus the short- to medium-term outlook for the world economy.

World Economic Outlook

In 1997, the overall macroeconomic conditions of the industrial countries improved, as reflected in a higher combined real GDP growth of 2.8%, amidst lower inflation of 2% and significant progress in reducing their fiscal deficits. Nevertheless, there was a marked cyclical divergence in the economic performance among the major industrial countries. Growth in the economies at the mature stage of expansion, namely the United States and the United Kingdom, strengthened in 1997, supported mainly by strong domestic demand. Meanwhile, the cyclical upturn in Europe and the depreciation of the Deutsche Mark resulted in an export-led recovery in Germany. In Japan, economic recovery faltered after the first quarter of 1997 due to the negative impact of the fiscal consolidation measures and the weak financial sector on domestic economic activity, which more than offset the stimulus from strong export growth. In the developing countries, real output growth moderated in 1997, with growth in the South-East Asian region being adversely affected by the sharp exchange rate and interest rate adjustments from the regional financial crisis.

The prospects for the international environment in 1998 continue to remain favourable although growth is expected to moderate. Real GDP of the **industrial countries** as a group is projected to grow more moderately by 2.4%, reflecting slower economic expansion in the United States and the United Kingdom, as well as continued weak growth in Japan. The stronger recovery in Germany would help sustain global economic growth. World trade is projected to expand at a slower pace of 6.2% (1997: 8.6%).

Real GDP growth in the United States is expected to slow down to a more sustainable pace of 2.4% in 1998 (1997: 3.8%). The moderation reflects the slower pace of domestic economic activity and weaker export growth, arising from a slowdown in external demand and the deterioration in export competitiveness following the appreciation of the

United States dollar. Although the economy could slow down on its own impetus and through the effects from the East Asian crisis, the slowdown is expected to be gradual as recent developments, such as continued high consumer and business confidence, the rally in the equity and bond markets and the decline in long-term interest rates, point to a strong growth momentum in the early part of the year. Alternatively, should domestic economic activity exhibit resilience to the dampening factors, inflationary expectations could emerge.

In Japan, growth is expected to remain sluggish at 1.1% in 1998 (1997: 1%). Export growth is expected to be affected by the deceleration in growth in East Asia, which accounts for more than 40% of Japan's total exports. Domestic economic activity is also expected to remain weak, with confidence and business sentiment being adversely affected by the restraint on public spending. In December 1997 and February 1998, the Japanese authorities introduced several measures aimed at reviving domestic economic activity. These measures included the introduction of the fiscal stimulus to boost private sector expenditure through the reduction in corporate tax and reinstatement of the special income tax allowance, provision to address the banking sector problems and the announcement of financial sector reform and liberalisation. Concerns that these measures might not be sufficient to bring about the desired effects of restoring consumer and business confidence and resolving the banking sector problem prompted the international community to call upon Japan to introduce a more substantive economic and financial package.

Germany is expected to sustain its economic recovery, with real output growth of 2.6% in 1998 (1997: 2.3%), boosted mainly by export growth amidst continuing expansion in the European Union (which accounted for more than half of Germany's exports) and a pick-up in business investment. Unemployment, however, remains high and could jeopardise the prospect of a sustained economic recovery by dampening private sector spending. Although the unemployment rate is expected to stabilise, it remains one of the highest in Europe (11.4%). High unemployment in Germany, and in Europe generally, amidst the current phase of economic expansion reflected structural impediments to the process of job creation. Therefore, labour market reform remains an issue. A more flexible and efficient labour market would enable Germany to benefit from the cyclical upturn.

Table 3.1
Industrial Countries: Key Economic Indicators

	Average 1990-94	1995	1996	1997*e*	1998*f*
	Annual change (%)				
Real GDP					
Industrial Countries	**1.8**	**2.2**	**2.5**	**2.8**	**2.4**
United States	1.8	2.0	2.8	3.8	2.4
Japan	2.2	1.5	3.9	1.0	1.1
Germany	2.9	1.8	1.4	2.3	2.6
United Kingdom	0.9	2.7	2.3	3.5	2.4
Consumer Prices					
Industrial Countries	**3.6**	**2.4**	**2.3**	**2.0**	**2.1**
United States	3.6	2.8	2.9	2.4	2.6
Japan	2.0	–0.1	0.1	1.7	0.8
Germany	3.7	1.8	1.5	1.8	2.3
United Kingdom[1]	5.0	2.8	2.9	2.7	2.7
	% of labour force				
Unemployment					
Industrial Countries	**7.4**	**7.7**	**7.7**	**7.5**	**7.4**
United States	6.6	5.6	5.4	5.0	5.2
Japan	2.4	3.1	3.3	3.4	3.3
Germany	7.6	9.4	10.3	11.5	11.4
United Kingdom	8.6	8.2	7.5	5.7	5.1
	US$ billion				
Current account					
Industrial Countries	**–25.2**	**+35.2**	**+21.5**	**+16.9**	**–45.8**
United States	–75.8	–129.1	–148.2	–177.5	–230.2
Japan	+97.4	+111.4	+65.8	+94.9	+98.9
Germany	–4.6	–23.6	–13.1	–8.2	–4.8
United Kingdom	–16.6	–5.8	–0.7	–2.0	–16.8

e Estimate
f Forecast
[1] Retail Price Index, excluding mortgage interest

Source: IMF World Economic Outlook, December 1997.

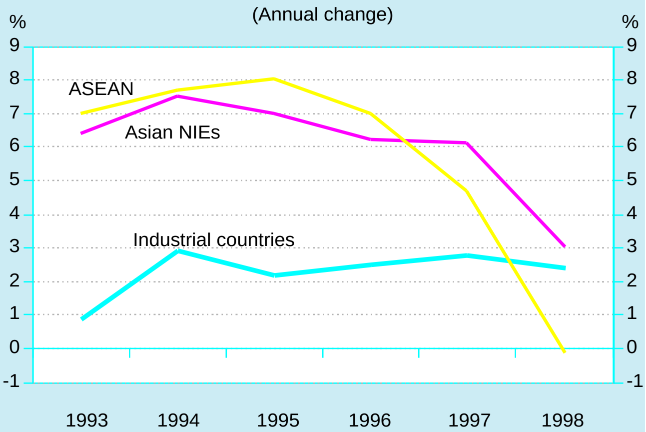
The outlook in the United Kingdom is for a slower growth of 2.4% in 1998 (1997: 3.5%), reflecting the dampening effects of tight monetary conditions. The increases in interest rates and the continuing process of fiscal consolidation would dampen expenditure. On the external front, exports of manufactures would be affected by both the increases in interest rates in 1997 as well as the appreciation of the pound sterling. The key issue is the extent to which the slowdown in domestic demand would ease inflationary pressures in the economy. Consumer spending and a buoyant services sector have been the key contributory factors in fuelling inflationary pressures and mitigating the favourable impact of the strong currency on import costs.

Inflation in the industrial countries as a group is expected to be marginally higher at 2.1% in 1998

(1997: 2%). Although cheaper imports from East Asia and soft commodity prices would contribute to keeping inflation in the industrial countries under control, inflationary pressures would emanate from higher wage increases in countries with tight labour markets and diminishing excess capacity in the economies that are recovering. In the United States, consumer prices are expected to rise by 2.6% (1997: 2.4%), reflecting tight labour market conditions and an increase in services inflation. Similarly, in the United Kingdom, the core inflation rate is expected to remain high at above the official target rate of 2.5% in 1998 (2.7%), despite the expectation of slower growth as wage pressures are anticipated from the continued tight labour market situation. Meanwhile, continued economic recovery and the effects of the weak Deutsche Mark on import costs are expected to raise inflation in Germany to 2.3% in 1998 (1997: 1.8%). In contrast, a lower inflation rate of 0.8% (1997: 1.7%) is projected in Japan, reflecting primarily the weakness in the domestic economy.

The volume of world trade is expected to expand more moderately by 6.2% in 1998 (1997: 8.6%), due primarily to the slowdown in economic growth in East Asia (including Japan), which accounts for about 25% of world trade. The current account balance of the industrial countries as a group is projected to revert to a deficit of US$45.8 billion in 1998. In the United States and the United Kingdom, the current account deficit is expected to widen substantially, following slower export growth relative to import growth. Meanwhile, Japan is likely to register a slightly higher current account surplus, following a large increase in 1997. In contrast, Germany's current account deficit is expected to narrow further to US$4.8 billion due to stronger export growth.

Graph 3.2
Real GDP Growth: Industrial Countries, Asian NIEs and ASEAN



Although some stability has been achieved in **East Asia** following the outbreak of the crisis in mid-1997, the outlook for the region is still uncertain. Nevertheless, the economic and financial disruptions arising from the crisis are projected to dampen the growth prospects of the member countries of the Association of South-East Asian Nations (ASEAN) and the Asian Newly Industrialised Economies (NIEs) in 1998. Domestic demand is likely to be adversely affected by both monetary and fiscal tightening, rising unemployment, structural reforms and negative wealth effects from the sharp declines in property and equity prices. As a result, economic activity in the ASEAN countries as a group is expected to be virtually stagnant (real GDP: -0.4% to 0.1%). Amongst the ASEAN countries, Thailand is expected to experience negative GDP growth of 3–3.5%, Indonesia's economy is projected to stagnate, while growth in the Philippines is expected to slow down to 2.4–3.5%. In all these countries, the main stimulus to growth will be the export sector, which is expected to benefit from the depreciation of their currencies. In the Asian NIEs, the combined output growth is expected to decelerate to 2.7–3.3%. While the Korean economy is projected to be virtually stagnant, a deceleration of growth is expected for Singapore and Hong Kong SAR, China. In contrast, Taiwan, ROC, which experienced minimal contagion from the crisis, is expected to continue to grow strongly, bolstered by strong export growth and higher public investment.

On the inflation front, the depreciation would result in a sharp increase in consumer prices in the ASEAN countries as a group to about 20.7–21% in 1998. Among the ASEAN countries, Indonesia and Thailand are projected to record the highest inflation rates of 40% and 11.6% respectively, due mainly to higher import prices, amidst supply shortages especially of food products and deregulation of the prices of utilities and other price-controlled items. Crop production is expected to be affected by adverse weather conditions. Meanwhile, price pressures are also expected to worsen in the Asian NIEs, where the average inflation rate is expected to double to 6.9%. In Korea, higher prices for imports and the increase in taxes could cause its inflation rate to rise above 10%.

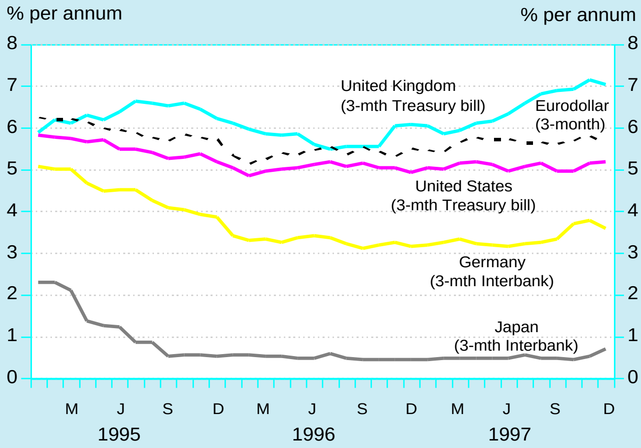
The structural adjustments in East Asia are expected to strengthen the prospects for a major improvement in their current account positions in 1998. Favourable developments include lower imports, particularly of capital goods, due to the cutbacks in spending on infrastructure projects and slower domestic consumption. At the same time, the depreciation in the currencies is expected to improve their overall export competitiveness. Among the Asian NIEs, the current account positions of Korea and Hong Kong SAR, China, are expected to improve further in 1998, due mainly to the improvement in the trade account. In particular, Korea's current account is expected to turn around to record a large surplus of US$10 billion in 1998. Given its service-based economy with a strong regional orientation, Singapore's external sector is expected to be affected by the slowdown in regional trade, mainly arising from lower services receipts from port and air transport-related activities, banking and tourism.

The risks to the growth forecasts are that any unfavourable political, social or economic development could trigger another round of instability in the region. If market sentiment worsens and the crisis is prolonged, the contagion effects would likely be more widespread, and may dampen further the global outlook. Against such developments, the ASEAN economies and the Asian NIEs may experience a sharper slowdown than currently envisaged, while the slowdown in the industrial countries would be more significant. Real output growth in several countries could be slower than projected in the event of a slowdown in export demand. Growth in these countries would be dependent on higher exports to offset the compression in domestic consumption and investment.

In the aftermath of the financial crisis, the main challenge for the economies in the East Asian region is to undertake the necessary adjustments in both the economic and financial sectors, in order to weather the adverse effects and to become more resilient to external shocks in the future. The success of the measures would depend on the speed and timing of the implementation and also on the international environment, particularly the growth performance and the import demand from the industrial countries. Of importance is the restoration of confidence in the financial system. A related issue is the external debt problems, which, if not resolved soon would further erode investor confidence. Meanwhile, for countries which are experiencing asset price deflation, the risk of a sharper decline in asset prices could exacerbate the projected economic slowdown in these economies.

Monetary policy in the major industrial countries remained unchanged during the first two months of 1998. For the remaining part of the year, the conduct of monetary policy is expected to be influenced by both domestic and external developments. In the United States, the issue is whether the East Asian crisis and the strong United States dollar would dampen growth and ease inflationary pressures in the economy, thus obviating the need for monetary tightening. On the other hand, the recent decline in long-term interest rates and its potential positive impact on interest rate-sensitive sectors, the rebound in the equity market and continued high consumer and business confidence could boost domestic demand. In view of the uncertainties about the net impact of these influences on growth and inflation, the Federal Reserve Board of the United States is expected to adopt a neutral stance in the near future. Meanwhile, in the United Kingdom, the February Inflation Report by the Bank of England warned of potential inflationary risks, arising from the tight labour market and the continued rally in the equity market, despite the projected moderation in output growth. Thus, the monetary authorities have not ruled out the possibility of another round of increases in interest rates. Short-term interest rates in Germany are expected to be increased to ensure maintenance of non-inflationary growth in the run-up to the establishment of the European Monetary Union (EMU). However, the high structural unemployment in Germany could dampen private sector expenditure, thereby affecting the economic recovery and hence may delay any monetary tightening in the near term. In Japan, monetary policy is expected to remain accommodative in 1998 to complement the fiscal stimulus measures and various economic and financial reforms to reinvigorate the domestic economy.

Graph 3.3
Industrial Countries : Short-Term Interest Rates



Box V

Implications of Recent Ringgit Depreciation on the Malaysian Economy

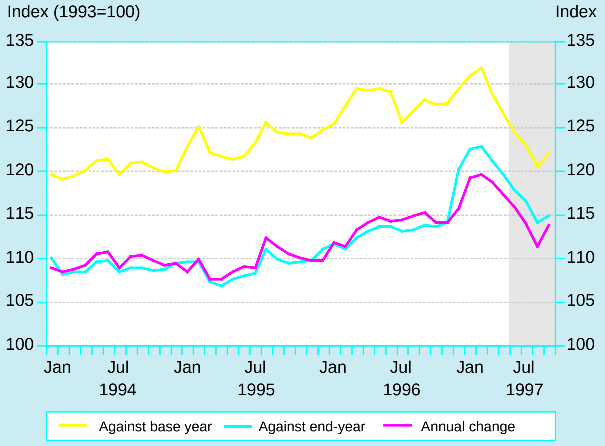
In 1997, the ringgit depreciated by 31.4% against the United States dollar and at mid-March 1998, it traded in the range of RM3.80-RM4.00 to the United States dollar. Since adopting the floating rate regime in 1975, the lowest rate recorded against the United States dollar was RM4.88 on 9 January 1998 and RM7.92 against the pound sterling on 7 January 1998. When the crisis started in July 1997, the ringgit was RM2.52 against the United States dollar and RM4.21 against the pound sterling. Depreciation of the domestic currency in such large magnitudes has serious implications on the economy, in particular, in the medium term. The impact of the depreciation on the economy is covered in this Article.

Signal of Impending Crisis

Prior to July 1997, there was some evidence of imbalances in the Malaysian economy in terms of a current account deficit, some asset inflation and high credit growth. Policies had been put in place to address these weaknesses and results had already emerged. More specifically, these imbalances were already being adjusted and were not so severe that by themselves they could precipitate a crisis. In other words, there were no "fundamental risks" of an impending crisis in terms of devaluation of the currency or a crisis in the financial markets. The "pre-episode" period of the financial crisis in South-East Asia (1994–96) witnessed evidence of favourable economic fundamentals in terms of steady inflows of foreign direct investment into Malaysia, build-up of international reserves and a stable ringgit. Furthermore, this period was not characterised by a sharp appreciation of the ringgit or a loss of international reserves. In addition, the net reserve ratio was high given ample international reserves and a low level of short-term debt. The relevant financial indicators that signal an impending banking stress (Kaminsky and Reinhart, 1996, Goldstein and Turner, 1996 and Demirguc-Kurt and Detragiache, 1997) were favourable for the Malaysian economy during the pre-episode period, notably stable money multiplier, low international interest rates, low inflation rate, stable exchange rate and a moderation in prices in the asset markets. Most noteworthy was an upward trend in the crisis index, that reflected an appreciation of the real effective exchange rate and build-up of international reserves (see Graph V.1). This favourable trend reflected a stable ratio of M2 to international reserves as well as the ringgit. Although there were some economic imbalances, the key variables also indicated the presence of relatively sound economic fundamentals which placed Malaysia in a less vulnerable position. Hence, while it is not unreasonable to expect contagion effects of the crisis, the contagion appeared to be greater and more widespread than expected. The extent of the contagion effect could be attributed to other developments in the country.

Policy measures have focused on reducing domestic absorption to alleviate the vulnerability of the current account as well as instituting both structural and financial reforms to minimise the effects of the "external shocks" to the economy. The medium term issues include measures to counter the erosion of external competitiveness, emphasis on productivity enhancement as a

Graph V.1
Crisis Index, 1994-1997



source of growth to complement expansion of capital formation and identification of new growth areas. With a weak ringgit, inflationary pressures and upward pressure on wages have been contained through consistent macroeconomic policies, including structural, fiscal and monetary measures reinforced by prudential measures to strengthen the banking system. Notwithstanding that the financial system entered the regional crisis from a relatively strong position, strengthening of the financial system has been necessary to limit the high costs of a potential failure of the banking system. More importantly, strengthening the banking system would ensure financial resilience in the wake of additional contagion effects of the regional financial crisis.

The duration and depth of the crisis is expected to have an impact on all aspects of the economy. The most studied issue in international economic theory on the consequence of a devaluation of the domestic currency is the potential contraction of economic growth (Krugman and Taylor, 1978). The contraction of the economy is generally reflected in a decline in aggregate demand for goods and services as well as a deterioration in the trade account. Indeed, exports usually did not increase, while intermediate imports necessary for production would not decline, creating a possibility of slow growth and higher inflation. However, the economy would expand in situations in which exports are responsive to price changes,

Table V.I
Currency Crisis and Key Financial Indicators: 1994-97

Key Indicators	1994	1995	1996	1997
	Annual Change (%)			
Real GDP	9.2	9.5	8.6	7.8
Inflation rate	3.7	3.4	3.5	2.7
Gross exports	27.0	20.2	6.5	12.4
Gross imports	32.8	24.6	1.5	12.0
Total external debt	6.1	15.8	16.3	68.2
Short-term capital flows (RM billion)	–8.5	2.5	10.3	–14.2
Real effective exchange rate [1]	–3.5	–0.1	4.5	–24.5
Domestic credit expansion	16.5	28.3	27.6	26.5
Stock market capitalisation	17.9	11.2	42.6	–53.4
Ratio of private credit to nominal GDP (%)	116.0	130.2	143.0	161.4
Money multiplier (M3)	5.59	6.02	5.53	5.40
Reserves adequacy ratio (M3 to reserves)	3.3	4.3	4.7	6.6
3-month US LIBOR (%)	4.87	6.00	5.46	5.75

[1] Source: J.P. Morgan

and cases in which intermediate imports did not account for a significant share of imports. On the aggregate supply side, the contraction essentially reflects higher domestic cost of production due to costlier imported inputs and services, high nominal wages and financing cost. A higher cost of borrowing leads to an increase in the cost of financing working capital. This so-called "Cavallo effect" will cause a contraction of aggregate supply, which will then result in a "supply shock" to the economy and a "cost shock" for industries.

The pervasive effects of the ringgit's depreciation and the stock market declines on the domestic economy are expected to be more pronounced in 1998. Following policy measures to consolidate the economy, **real aggregate demand** is envisaged to decline particularly in the first half of 1998. **Private consumption** is envisaged to show a marginal increase in 1998, reflecting the negative wealth effects due to the decline in the capitalisation of the KLSE, measures to curb excessive spending, and promotion of national savings. Consumption would also be affected by the expected slower growth in real disposable income, and higher prices of imported goods. Private consumption is not expected to be affected by a potential redistribution of income from labour to capital. **Public consumption** is projected to decline sharply in 1998 in line with the Government's austerity drive.

The volatility of the ringgit, however, has made decisions to invest increasingly difficult. Theoretically, the pace of aggregate investment would be influenced by considerations such as the increase in prices for imported capital goods and high nominal wages. Furthermore, investors would also perceive that the market value of investment may be lower than its "replacement costs", reflecting the so-called Tobin Q theory of investment. This would discourage investment activity. In the wake of the higher nominal interest rates, it is expected that certain inefficient firms would exit from the market, and be replaced by efficient firms that would be able to accept higher costs of financing. An adverse result of this development could be the proliferation of riskier projects that are associated with higher expected returns. A combination of these factors together with the Government's austerity programme, is expected to result in a decline in real **private investment in** 1998.

The production and investment composition would also change in the wake of the ringgit's depreciation. Production activities by domestic-oriented industries could be discouraged, while those of export-oriented industries which receive "windfall" profits from exchange rate valuation gains would be encouraged to expand their activities. For the economy, too rapid a shift of resources over a short period could lead to misallocation and inefficiency of utilisation of resources. The higher nominal domestic value of a weaker ringgit would imply higher remuneration, and hence send out the wrong price signals.

The weak ringgit is envisaged to have a marginal impact on the demand for higher wages. In the labour market, some softening in the labour situation has begun to emerge, especially in the construction and services sectors. According to "Okun's Law" a moderation of real growth to 2–3% could generate potential unemployment in Malaysia of 3.5% in 1998 (1997: 2.7%).

A more important concern is the emergence of greater competition in the region as economies compete for market shares in similar products. Malaysia has some degree of comparative advantage in the export of higher value added and capital intensive goods. However, in the endeavour to increase supplies to the global market, Malaysia would face lower prices as an excess supply of products could emerge (problem of "aggregation" of products). A positive impact of the depreciation of the ringgit by over 30% is that it would provide flexibility for Malaysian exporters to "price to the market" by lowering export prices in United States dollars. This would be an advantage as long as the gains in export prices exceed the rise in import prices of intermediate inputs. The more significant depreciation of the ringgit vis-a-vis other global competitors could contribute to enhance competitiveness of Malaysian exports. For the gains from the weak ringgit to have longer-term benefits to the economy, the supply of exports must be elastic and along with it an enhancement of productivity. The depreciation of a currency to promote international competitiveness is not sustainable. In the long run, enhancement of international competitiveness for exports has to reflect structural and cyclical developments in productivity and demand and the financial market conditions, rather than a weak currency.

Empirical evidence from European economies in the early 1990s showed that a real depreciation that followed a nominal devaluation, led to a stronger external sector. Similarly, for Malaysia, the external sector has responded favourably to the depreciation of the ringgit with a recorded trade surplus of RM1.6 billion in the fourth quarter of 1997. A larger merchandise account is, therefore, envisaged for 1998. Indeed, the response in trade volume was favourable compared with the experience for other economies, whereby, only 50% of the adjustment in trade volume took place in the first three years. Preliminary empirical work on the trade balance response to the ringgit movements reveal that the trade balance is expected to improve for the first two quarters, and deteriorate from the third to the sixth quarters. Since the trade balance has responded favourably to the ringgit depreciation, the so-called J-curve phenomenon of a delayed response of trade to devaluation appeared to be irrelevant during the present crisis. The J-curve phenomenon is relevant to economies where exports are settled in domestic currencies and imports are in foreign currencies. About 70% of Malaysian exports are being settled in the United States dollar vis-a-vis 65% for imports, and hence providing a net valuation gain for the trade balance. Positive policy measures have been in place to reduce the import volume, through switching expenditure to domestic goods and the postponement of projects with high import content. Since the economy is investment driven, the

Table V.II
Implications on Key Macroeconomic Indicators: 1996-98

Key Indicators	1996	1997	1998
	Annual Change (%)		
Real GDP	8.6	7.8	2–3
Real aggregate domestic demand [1]	7.0	6.4	–4.7
Real aggregate consumption	4.9	4.8	–1.9
Real aggregate investment [1]	9.8	8.5	–8.1
Inflation rate	3.5	2.7	7–8
Federal Government Budget			
(% of GNP)	0.8	2.5	0.1
Balance of payments (RM billion)			
Gross export growth (%)	6.5	12.4	36.5
Gross import growth (%)	1.5	12.0	30.9
Merchandise account	10.2	11.1	27.6
Services account	–19.5	–20.8	–25.3
Current account	–12.3	–13.4	–1.4
(% of GNP)	–5.1	–5.1	–0.5
Long-term capital account	13.5	18.7	–
Overall balance of payments	6.2	–10.9	–
Net external reserves	70.0	59.1[2]	–

[1] Exclude stocks.
[2] The above figure does not include an exchange revaluation gain of RM24.6 billion.

postponement of large projects would have an immediate impact on the trade volume, especially in moderating the import growth for investment goods.

The larger surplus in the merchandise account is expected to more than offset the larger deficit of the services account resulting in a narrowing of the current account deficit to 0.5% of GNP in 1998 (1997: -5.1% of GNP). The narrowing of the current account deficit would reflect a depreciated real effective exchange rate, increased production of tradables and import-substitution of goods and services. In the wake of the crisis, inflows of private long-term capital are expected to slow down in 1998, albeit marginally on account of an uncertain outlook for the domestic economy. The basic balance, however, is expected to show a larger surplus, resulting in an improved overall balance of payments in 1998. As a result, the higher net external reserves (post-valuation) is expected to support about four months of retained imports.

The exchange rate valuation is estimated to increase the total external debt in ringgit terms to RM166.2 billion as at end-1997 (63.2% of GNP). The total outstanding external debt is estimated to increase to RM171.8 billion (61.4% of GNP) in 1998. The servicing of external debt is not expected to increase significantly in 1998 on account of the regular prepayment and refinancing exercise as well as productive use of external borrowing by the private sector. The longer debt maturity profile would mitigate the problem of large principal payments in the short term. Hence, prudent debt management and selected measures to influence debt flows have contributed to avert excessive indebtedness of the Malaysian economy. However, there would be incidences of higher foreign exchange obligations of certain corporations, resulting in some liquidity problems.

The present inflationary pressure differs from the experience of inflationary pressures in the 1970s and early 1980s. Inflation in the earlier periods reflected higher imported inflation as the sharp increase in oil prices led to inflation in industrial countries. In 1997 and 1998, the higher prices would reflect higher prices for imports due to the decline in the value of ringgit. Prospects are for an **inflation rate in the region of 7–8% in 1998**, after taking into account the stabilisation of the ringgit, incomplete pass-through of the depreciation and the deflationary trend in the economy. The estimated magnitude of the complete pass-through to domestic price is about 5–10%, based on the preliminary analysis that a 1% rate of depreciation of the ringgit would result in a 0.05% rise in the inflation rate. The incomplete pass-through of the depreciation of the ringgit on domestic prices is due to mitigating factors such as rigidity of contracts and nominal wages, and more importantly the presence of anti-inflation policy measures. Other contributory factors include product substitutability, market structure, and the absorption of prices by traders to maintain market share.

Inflationary pressure as a result of the depreciation of the ringgit is also restrained by the relatively low share of imported items (about 20%) in the Malaysian consumer price index. Imported goods and services are denominated mainly in United States dollars and determined by world prices. The balance is accounted for by non-traded goods (like property and domestic services) that would be determined by domestic supply and demand considerations as well as a secondary impact through higher domestic cost of production as a substantial share of intermediate inputs are imported. It is not expected that the supply of non-traded goods would be inelastic as to exert pressure on domestic prices. Except for the cost of working capital, inflationary pressure are also not expected to be exacerbated by increases in nominal wages and rents. The moderation in economic growth would have an adverse impact on employment and would make job security a more important consideration, thereby alleviating pressures for higher wages.

On the impact on asset markets, the pre-emptive monetary and fiscal measures taken since 1995 had alleviated the exposure of the banking industry to the property sector. Lending for speculative activities have also remained well within prudential limits. Pre-emptive prudential measures and a relatively sound regulatory framework meant that the banking system entered the crisis from a position of strength in terms of capitalisation, quality of portfolio, provisioning and overall profit performance and low ratio of non-performing loans. Nevertheless, the uncertainty in the macroeconomic environment, in particular the large depreciation of ringgit, higher interest rates and declines in equity prices are expected to exert some stress on the banking sector.

IMPLICATIONS OF RINGGIT DEPRECIATION

Economic Growth

Contractionary Effect
- higher prices of imported inputs
- wage increase offset by job security
- increased cost of working capital
- some retrenchment of workers

Expansionary Effect
- improved trade and current account balance
- lower wage pressures

Increased International Competitiveness
- " hysterisis in exports": adjustment of US$ export prices
- depreciation of real effective exchange rate
- face challenge from collective depreciation of East Asian currencies and higher cost of production at full employment

Domestic Prices
- valuation effect from imports
- partial pass-through with time lag
- industry -wide adjustment
- erosion of competitiveness of exports
- surge in prices upon recovery

Banking System
- higher interest rates
- system remained sound reflecting past structural adjustments
- deterioration in asset quality affected a few institutions but they remained solvent

Aggregate Demand

Lower Consumption
- negative wealth effects
- higher external debt
- higher imported inflation
- redistribution of income

Lower Investment
- uncertainty and risks
- costlier imported capital goods
- disparate investment incentives
- perception of low market value: Tobin Q theory
- Government's austerity drive

External Balance
- improved trade and current account
- expected favourable terms of trade
- expansion in export volume
- J-curve not relevant

Capital Flows
- perception of risks
- implications on capital formation
- cheaper RM will encourage FDIs

Asset Market
- pre-emptive measures have alleviated an asset bubble
- decline in share prices. Loss in market capitalisation
- moderation in prices of property

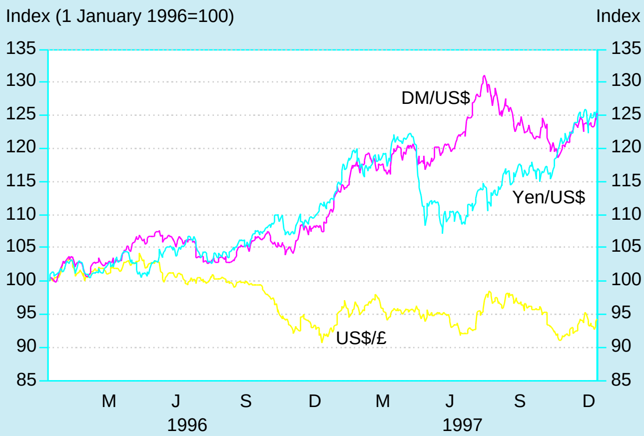
Aggregate Supply

Rising cost of production: Cost Shocks
- higher price of services inputs
- higher price of intermediate inputs
- higher cost of working capital
- encourage domestic production: import substitution

Higher External Debt in RM terms
- valuation effect
- composition of debt matters
- debt position sustainable
- low share of short-term debt

In the **foreign exchange** markets, the United States dollar continued to strengthen against the major currencies during the most part of January. It appreciated against the Deutsche Mark to a high of US$1=DM1.8438 on 20 January 1998 following concerns over the stability of the EMU and the persistent high unemployment in Germany, which dampened market expectations of interest rate increases in the near term. Against the yen, the dollar appreciated to reach a five and a half year high of US$1=¥134.40 on 7 January 1998 amidst indications of continued strong domestic economic activity in the United States and a pessimistic economic outlook in Japan. The new wave of selling pressures in the East Asian financial markets during the period also contributed to the strengthening of the dollar. The dollar gains were subsequently reversed, particularly against the yen, when it declined to a low of US$1=¥122.45 on 12 February 1998, as sentiments on the yen improved on expectations of a new fiscal stimulus package in Japan. However, the recovery in yen was short-lived as the dollar rebounded to above US$1=¥127.00 level on 20 February 1998, when the measures announced by the Japanese Government fell short of market anticipations of an increase in public spending or tax cuts. Meanwhile, the pound sterling was traded in the range of £1=US$1.61–1.67 during the first two months of 1998, after closing at £1=US$1.6475 on 31 December 1997, amidst uncertainties over the direction of monetary policy. For the remaining part of 1998, movements of the major currencies are expected to be influenced by a number of factors, namely, the relative strength of the major industrial economies amidst the expected slowdown in world output growth, movements in interest rate differentials, developments in East Asia and assessment on the stability of the EMU following the decision on which countries would qualify for the membership of the Union in mid-1998.

Graph 3.4
Movement of the US Dollar against Major Currencies



Malaysian Economy in 1998

The Malaysian economy ended 1997 on a weaker note as the regional financial crisis began to take effect on domestic economic activities. The full impact of the crisis on the domestic economy is expected to be felt in the first half of 1998, before recovering in the second half of the year. This will result in overall growth for the year to slow down and some increase in unemployment. While inflationary pressure, arising mainly from higher import costs due to the depreciation of the ringgit are expected to increase in 1998, indications are that the balance of payments position of the country will improve significantly. The Government is cognisant of these developments and appropriate adjustment measures have been introduced to maintain financial stability and business confidence as well as to minimise the impact of the crisis on the economy. These measures are essential to ensure an early recovery and sustainable growth over the medium term. In the immediate term, however, these adjustment measures, particularly the fiscal cutback, deferment of several large projects and reduction in credit growth to the less productive sectors, would contribute to a contraction in domestic demand in an environment of continued uncertainty in the region. The measures, however, would result in a significant improvement in the balance of payments position as well as greater efficiency in the allocation of resources towards higher value added activities. Overall, based on conservative assumptions, real GDP growth is expected to slow down to about 2–3%, after a decade of rapid growth.

Notwithstanding the slowdown in growth, the latest assessment is that growth will remain positive in the first half of 1998 with stronger growth taking place in the second half of the year. This projection is premised on prospective developments in the international and regional environment, as well as developments in the domestic economy in the context of the Government's macroeconomic adjustment programme. The implementation of the adjustment measures introduced in December 1997 as well as emerging signs of restoration of regional financial stability have had a positive effect in restoring investor confidence. On the domestic front, the measures were aimed at strengthening the balance of payments and the banking system and enhancing corporate governance in order to reduce the nation's vulnerability to external shocks. Other positive developments have been the stronger-than-projected export growth especially of electronics, and some recovery in the equity market. Should this trend strengthen, the prospects for growth could be higher. Despite these favourable developments, a number of risks remain. They include the possibility of a sharper-than-expected moderation in world growth and trade; a more prolonged regional crisis and increased uncertainty in the performance of capital flows; more intense competition; slower growth in regional trade; and the uncertain outlook for exports of electronic and electrical goods. Other risks revolve around a prolonged weakening of investor sentiment as well as a sharper-than-projected softening in consumption demand in the event of weaker consumer confidence. Recognising these risks, the Government announced a comprehensive economic package in March 1998. The package aims to limit the severity of the adjustment, maintain a positive growth for the economy and set the stage for an early recovery. More importantly, the package aims to allay concerns on the health of the banking system by outlining broad-based pre-emptive measures to further strengthen the banking system.

Notwithstanding its potentially adverse implications, the slowdown in economic growth provides an opportunity for consolidation and review. The prospects of a decline in construction activity in 1998 will allow the market time to clear the surplus office and retail space, and high-end apartment buildings after several years of over-investment. Such a correction will contribute to a better balance in demand and supply in the construction sector and more sustainable growth in the medium term. Nevertheless, the manufacturing and services sectors will continue to provide the main impetus to overall growth in 1998, supported by sustained output in the mining sector. Output in the agriculture sector is expected to decline.

Prospects are for output growth in the **manufacturing sector** to expand at a more moderate pace of 6% in 1998. The export-oriented industries would benefit from the ringgit depreciation and recent measures to enhance productivity. They are expected to expand further (5.5%; 10.5% in 1997), with sustained world demand for electronic goods, including semiconductors and electronic equipment and parts. Despite intense competition in selected items, particularly electronic chips, the demand for electronic components and parts is expected to remain favourable because of the increase in new uses for these items in non-personal computer devices, including high-end digital consumer electrical goods, multimedia equipment and automobiles. In the case of disk drives, expectations are for a recovery in demand in the second half of 1998. In contrast, the performance of the electrical products industry is expected to remain weak due to sluggish external demand for audio-visual products and air-conditioners, amidst global oversupply and excess capacity. Meanwhile, output of the domestic-oriented industries is expected to record a slower growth of 6.2% (14.6% in 1997) due to lower output of construction-related products and transport equipment industries. However, strong growth is expected in the chemicals and chemical products industry. On the whole, the manufacturing sector is expected to expand at a more rapid pace than the overall economy, raising further its share of GDP to 36.9% in 1998.

Growth in the **agriculture sector** is expected to decline by 1.8% in 1998 (+3% in 1997), reflecting lower output of palm oil and saw logs which would more than offset the higher production of rubber and cocoa. The output of palm oil is expected to be lower because of tree stress following strong growth in 1997. Similarly, saw log production is expected to decline sharply during the year in line with the sustainable forest management policy as well as weak demand from traditional buyers, including Japan, Taiwan, Republic of China (ROC) and Korea. In contrast, rubber output is expected to recover in 1998, following three years of decline, due to increased domestic demand. Value added in the mining sector is expected to be sustained (2.2%; 2% in 1997) with a turnaround in crude oil production reflecting the Government's policy to increase production and strong gas output. Tin production is envisaged to decline further.

Following the consolidation of the **construction sector** in 1997, activity in the sector is expected to decline by 4% in 1998. This would reflect mainly the projected decline in both the civil engineering and non-residential sub-sectors. Activity in the residential sub-sector, on the other hand, is expected to remain strong (4%), amidst continued strong demand for low- and medium-cost houses, which would more than offset the subdued demand for high-cost properties. The Ministry of Housing and Local Government will give priority to assist developers to convert high-cost housing units to more affordable units priced below RM150,000. In addition, the financial institutions will continue to ensure that financing is available at reasonable cost for housing projects, particularly those priced below RM150,000. However, activity in the civil engineering sub-sector is expected to decline by 10%, with the completion of several projects in 1997, and the deferment of several large and less strategic projects. Similarly, in the non-residential sub-sector, growth is expected to decline by 1.7%, as most projects are near completion and no new projects have been launched. Nevertheless, the development of the Multimedia Super Corridor as well as the on-going activity in the construction of office space, which is expected to be taken up largely by the services sector, could mitigate the decline. The 1997 BNM Survey of Office Space in Kuala Lumpur and Selangor Darul Ehsan showed that a total of 86 office buildings are at various stages of construction and are expected to supply an additional 3.2 million square metres of office space upon completion in the period 1998-2000. It is envisaged that the market for office space will be highly competitive, with wider choices and potentially lower rentals. There would be increased opportunities for foreign participation in the property market in 1998, in the light of the lifting of the RM100,000 levy, and the relaxation of rules to allow foreign participation of up to 50% (from 30%) in a project.

The **services sector** would expand further, albeit at a more moderate pace (2.7%; 7.9% in 1997) because of slower domestic demand. All the sub-sectors are expected to record slower growth, including the utilities; transport, storage and communication; wholesale and retail trade, hotels and restaurants; and finance, insurance, real estate and business services. The moderation in activity in the transport sub-sector is premised on slower growth in trade, especially within the Asia-Pacific region. In line with this trend, major transport operators are expecting more moderate revenue growth for 1998. Meanwhile, the decline in economic activity would imply lower growth in demand for new telephone lines for the telecommunications industry. Lower disposable income, coupled with the negative wealth effect of the stock market, would also moderate growth in the wholesale and retail trade, hotels and restaurants sub-sector, while the consolidation of banking activities would be translated into slower value added growth in the finance sub-sector. The services sector is, however, expected to benefit from the Commonwealth Games to be held in September 1998.

Over the last 10 years, domestic demand had consistently made a strong contribution to overall growth in the Malaysian economy. In 1998, however, the full impact of asset deflation and higher cost of imports and domestic prices as well as the fiscal austerity programme to achieve macroeconomic stability will adversely affect domestic demand in the immediate term. Aggregate domestic demand in real terms is therefore expected to decline. The main impetus to growth will emanate from net exports.

Real aggregate **domestic demand** (excluding changes in stocks) is expected to decline by 4.7% (+6.4% in 1997), reflecting a sharp decline of 11.6% in public sector expenditure and lower private spending (-2.4%). Private consumption is expected to record a deceleration in growth, while private investment is projected to decline. The forecast of a marginal growth of 1% in private consumption in real terms reflects expectations of more cautious consumer sentiment in the wake of lower real incomes and the uncertain employment situation, as well as the adverse wealth effects of the decline in stock prices. In nominal terms, however, private consumption would register a growth of 8.6%, compared with 7.6% in 1997, due to the price effect. Private investment is expected to decline by 6.8% in real terms, but increase by 0.5% in nominal terms. On a sectoral basis, investment in the construction sector is expected to moderate as the sector adjusts to the reprioritisation of bank credit as well as the deferment of several large projects. Investment in the utility sector is expected to decline with the completion of power projects as well as deferment of a hydroelectric project. Investment in the manufacturing sector is expected to increase at a more moderate pace. Indications are that the depreciation of the ringgit is unlikely to result in a major change in the investment plans of existing foreign companies and multinationals, although investment prospects could be dampened if the regional crisis is protracted. Investment in the manufacturing sector will largely be concentrated in the electrical and electronics, chemicals and chemical products and basic metals industries, reflecting the increasing shift towards higher technology and capital-intensive industries. Similarly, investment in the oil and gas and transportation sectors is also expected to be higher, with the latter reflecting additional investments by the airline companies. Overall, the Government remains committed to promote productive investment. In the 1998 Budget, several measures were also introduced to further reduce the cost of doing business and strengthen competitiveness. These included a 2% reduction each in corporate income tax to 28% and in petroleum income tax to 38%, as well as the establishment of a

RM1 billion fund to provide financial support for the small- and medium-scale industries.

Public sector expenditure is expected to decline in 1998 (-11.6%) due to lower public investment and consumption (-11.7% and -11.4% respectively in real terms; and -4.8% and -9.2% respectively in nominal terms). This reflects mainly the fiscal austerity package announced on 5 December 1997, involving a cut in both current and development expenditure. The deferment or scaling down of some projects by the NFPEs as well as the completion of the first phase of the KLIA will also contribute to the decline in public investment.

The fiscal austerity package is aimed at addressing existing economic imbalances as well as ensuring a balanced Federal Government budget in 1998 in the face of an anticipated decline in revenue following the economic slowdown. The current account position of the Federal Government is expected to record a surplus of 5.4% of GNP. This surplus would be sufficient to finance the projected increase in development expenditure to provide for higher outlays on health, education, housing and poverty reduction projects to mitigate the adverse effects of the economic adjustment on the poorer segments of the population. Notwithstanding the projected increase in allocation for such facilities, the Federal Government is expected to achieve a small overall surplus of RM336 million or 0.1% of GNP in 1998. In the event that the outturn in revenue performance is better than anticipated, continued fiscal discipline would enable a larger overall surplus to be realised. Similarly, the consolidated public sector financial position is expected to remain in surplus, as total expenditure will also be reduced in line with total available resources.

The overall **balance of payments** is expected to improve significantly in 1998, with a large surplus in the merchandise account and a reduced current account deficit. Reflecting the positive impact of the weaker ringgit on the export sector, the contraction in import volume arising from the fiscal measures and the postponement of non-critical projects with large import content, the current account deficit is projected to narrow substantially to RM1.4 billion or 0.5% of GNP (-RM13.4 billion or -5.1% of GNP in 1997). This is well below the Government's target of 3% of GNP. The surplus in the merchandise account is anticipated to increase markedly to RM27.6 billion (RM11.1 billion in 1997), due mainly to a more rapid expansion in merchandise exports (36.6%) relative to imports (30.6%). However, the weaker ringgit is expected to lead to higher net payments on freight and insurance as well as investment income. Consequently, the services deficit is expected to deteriorate further to RM25.3 billion. It is important to note that the large net payments of investment income reflect more an accounting entry as part of these profits and dividends earned by foreign investors are retained in Malaysia. Indeed, a large proportion of these funds is reinvested in the country and shown as inflows of long-term capital, so that a large segment of the current account has been generally self-financing. In the capital account, the net inflow of long-term capital is expected to moderate to RM10.7 billion, mainly on account of a lower surplus in the long-term official capital account. Net inflows of private long-term capital in ringgit terms are anticipated to moderate, but remain relatively high at RM10 billion, about the same levels recorded in 1994-95. Meanwhile, net external borrowings of the NFPEs are expected to decline to RM1 billion (RM6.5 billion in 1997). The latter essentially reflects the lower drawdown of external loans by the NFPEs and higher repayments due to the weaker ringgit. As in previous years, the Federal Government is expected to make net repayments (-RM0.3 billion). Given these developments, the basic balance would record a larger surplus of RM9.3 billion in 1998.

The prices of most major **commodities** are projected to be higher in 1998, with the overall commodity export unit value index increasing sharply by 20.8%. To a large extent, the increase is mainly attributable to the exchange rate revaluation gains on major commodities which are traded in United States dollars (except for rubber which is traded in ringgit). Hence, prices of most major commodities are expected to register significant increases in ringgit terms. Palm oil prices are expected to remain strong at US$500 per tonne. In the case of saw logs and sawn timber, prices are expected to be lower in United States dollar terms, as demand for these commodities in the Asia-Pacific region is expected to be adversely affected by the regional crisis. Meanwhile, crude oil prices are expected to moderate to US$16 per barrel (US$20.8 per barrel in 1997), reflecting the oversupply situation following the resumption of Iraqi oil exports under the "oil for food" exchange programme and the announcement by OPEC countries to increase by 10% the quota for crude oil production. At the same time, demand would be weaker in view of the financial crisis in the Asian region. Similarly, rubber prices are also expected to remain weak due to the ample supply in the world market amidst poor demand. In aggregate, total export earnings from primary commodities are projected to decline in United States dollar terms due to the decline in both export price and volume. These mitigated to some extent the revaluation gains, with total export earnings in ringgit terms projected to increase by 20.9% to RM46.7 billion, to account for 15.4% of gross exports.

Meanwhile, **exports of manufactured goods** are projected to increase sharply by 39.6% to RM249.7 billion and are expected to continue to be the leading source of export earnings with a projected share of about 82.6% of total exports. Whilst the depreciation of the ringgit helped to enhance competitiveness in most manufacturing industries, the higher export receipts would mainly reflect exchange rate valuation gains. In volume terms, manufactured exports are expected to increase by 4.4%. The manufacturing export items which are expected to record strong growth in volume terms in 1998 include electronic components and parts, chemical products and rubber products. In the case of the electronics sector, the expected strong performance would reflect the continued higher demand from the United States and Europe arising from the increased usage of electronic components in higher-end consumer products, and heavy and transport equipment industries. It was observed that keen competition arising from the exchange rate depreciation in countries in the Asia-Pacific region had prompted exporters to provide discounts in United States dollar prices in the last quarter of 1997. However, over-reliance on the exchange rate to strengthen export competitiveness would not be sustainable over the long term. Rather, the emphasis has to be on reducing the cost of production and enhancing productivity. In this regard, there is a need to accelerate the implementation of the Second Industrial Master Plan to promote more technology-intensive industries as well as to intensify the strategic shift towards the manufacture of high value added products.

Growth in **gross imports** is expected to increase by 30.9% to RM289.2 billion, mainly reflecting exchange rate revaluation effects. In volume terms, gross imports are envisaged to decline by 5% in 1998. The cutback in Government expenditure and the deferment of a number of projects as part of the policy package to strengthen the balance of payments position would contribute towards reducing import volume during the year. In particular, imports of “large items” in 1998 would be lower (RM6.3 billion; RM7.5 billion in 1997) despite the revaluation effect. The bulk of these lumpy imports would comprise mainly imports of aircraft and ships, and machinery and equipment for the oil and gas industry. Reflecting the sustained growth in the manufacturing sector, the import volume of intermediate goods is expected to increase, albeit marginally, while import volume of investment and consumption goods is expected to decline.

The outstanding medium- and long-term **external debt** of the nation is expected to expand at a moderate rate of 4.4% to RM132.1 billion in 1998 because of lower recourse to external borrowings by both the public and private sectors. In the wake of the weaker ringgit, the private sector is expected to defer new investment projects both at home and abroad, thereby reducing their requirements for funds. Consequently, the debt/GNP ratio is expected to improve to 47.3% (48.1% in 1997). Nevertheless, with the expected higher repayments in ringgit terms, the debt service ratio will increase to 7%, from 5.1% in 1997. Based on the assumption that the short-term external debt remains unchanged at end-1997 level, the outstanding external debt, including short-term debt, is expected to total RM171.8 billion or 61.5% of GNP in 1998.

Malaysia has enjoyed relatively low inflation rates during the last decade of high growth. While the impact of the depreciation on the consumer price index has been moderate until late 1997, it is expected to intensify in 1998. Indeed, the pass-through effects of the depreciation of the ringgit on domestic prices are expected to increase progressively in 1998. Taking into account both the direct and indirect impact of the ringgit depreciation, **inflation** is expected to increase to about 7–8%. This forecast has taken into consideration several factors that would mitigate inflationary pressures in 1998. These include reduced demand pressures with the projected slower pace of growth and the substitution of imports with cheaper alternative sources. Producers and traders have also tended to absorb part of the price increases arising from the depreciation in order to maintain market share in an environment of moderating consumption demand. Another contributory factor is the influence of administrative measures, including price regulation for essential goods for the low-income group. The Government is committed to the achievement of price stability as a matter of high priority. This is to ensure that inflation would not erode real income, wealth and the competitiveness of the country. A combination of tight monetary and fiscal policy is already in place to contain inflationary pressures. At the same time, administrative measures to improve the flow of information on the prices of consumer goods and to curb unfair trade practices would be stepped up during the year to ensure reasonable prices.

In line with the moderation in domestic economic activity, a weaker **employment** situation is likely to emerge in 1998. It is envisaged that retrenchments could arise in the construction-related industries and also in the manufacturing and services sectors as companies undertake restructuring exercises to reduce costs in the face of a decline in market demand or following completion of existing projects. In the context of slower economic growth, these adjustments could lead to an increase in the overall unemployment rate. However, the agriculture sector, especially the plantations, would continue to face shortages of workers. Selected manufacturing firms have also indicated a shortage of production workers. The mixed picture suggests the need for a redeployment of workers across industries and sectors. This would mitigate a further rise in unemployment. It would also help to moderate the pressure for wage increases in 1998.

The regional financial instability and the economic adjustment measures that it has entailed would inevitably lead to some disruptions to the domestic economy. While these will pose challenges that would need to be addressed, they also provide opportunities for a consolidation and review of the future direction of the economy. The crisis has brought into focus the need to re-examine the country's economic development plans and strategies. It provides a timely opportunity to assess the weaknesses and vulnerabilities of the economy, and to implement remedial measures. The regional crisis has also demonstrated the need to expedite on-going efforts to transform the structure of the economy and further develop the financial system to support new growth strategies and to better cope with the changing dynamics of the global economy. Malaysia has been fortunate in that the structural adjustments of the past two decades have contributed to rapid economic growth, strengthened the economic base and placed Malaysia in a stronger position to face the crisis. Nevertheless, the severe contagion effects demonstrate that there are several weaknesses in the domestic economy and the financial system that rendered Malaysia vulnerable to external shocks. These include the relatively large current account deficits in the past few years, the strong credit growth, and excessive demand pressures, in addition to risks in the asset markets. Expectations that economic growth will slow down significantly in 1998 have also raised concerns about the quality of bank assets. In this context, the immediate objective of public policy in 1998 is to preserve economic and financial stability and restore business confidence. The Government is fully committed to a policy of fiscal austerity and monetary restraint to address existing imbalances and ensure a speedy recovery. In particular, efforts to strengthen the financial system have also been expedited, in addition to ensuring that productive sectors continue to have access to bank credit at reasonable cost.

With rising inflationary pressures, **monetary policy** would need to remain tight in 1998 in order to mitigate the effects of the currency depreciation on domestic prices. The implementation of the credit plans of the financial institutions will be monitored closely to curb excessive growth in bank credit, particularly for less productive purposes. Given the prospects of slower economic growth and the need to manage the quality of bank assets, the financial industry would have to accord high priority to efforts to strengthen the evaluation of credit as well as to channel bank credit to productive sectors. This is important to ensure that growth in monetary aggregates is consistent with the underlying developments in the real economy. The Bank is monitoring the situation closely to ensure that productive investments are not denied access to bank financing at reasonable cost.

To enhance the efficiency and effectiveness in the **mobilisation and allocation of the country's scarce resources** towards achieving the over-riding objective of sustaining non-inflationary growth, several measures have been put in place to enhance the intermediary role of the private debt securities market to complement the banking system and the equity market in providing financing support for the economy. At the same time, parallel development in the financial market infrastructure has aimed to enhance the safety and efficiency of financial transactions. A combination of all these efforts would help to preserve financial stability, a prerequisite in maintaining market confidence and the promotion of greater private sector initiatives.

The regional financial crisis has highlighted the urgent need to **strengthen and consolidate the financial sector** in order to minimise its vulnerability to external shocks and avoid the risk of price misalignments. The policy focus would be to create financial institutions which have the commitment, capacity and ability to gear up to a higher level of competitiveness and efficiency as well as to meet the changing needs of the economy in the face of globalisation and pressures for liberalisation. Amidst these developments, the improvement of risk assessment or management is given priority. In this context, due emphasis is placed on prudential conduct and financial transparency as well as integrity to ensure that the interests of investors are safeguarded and confidence in the market place is enhanced. This would require vigilance on the part of both the participants and the relevant regulatory authorities to anticipate and pre-empt potential problems that may emerge.

In the immediate term, the focus of policy is to contain inflationary expectations and address existing economic weaknesses to facilitate economic recovery. The continued volatility in the foreign exchange markets, uncertain and unpredictable regional developments, including the pervasive impact of non-economic events on investor confidence would constrain the prospects for a quick recovery. While the economic adjustment and stabilisation package already in place should be allowed to take their course, additional policies cannot be ruled out, given the prevailing uncertainties. Concomitantly, the implementation of on-going adjustment efforts to correct existing imbalances would need to avoid an over adjustment. Additional measures may therefore be necessary to mitigate the adverse impact of an over adjustment, particularly on the lower-income groups. A budgetary allocation for a social safety net to provide for health and education services would be necessary. The focus of activities in such an eventuality would be to undertake selected projects that will serve as new engines of growth to facilitate a speedy revival in domestic economic activity. Such projects would include those that could be speedily implemented, possess high multiplier effects and strong inter-sectoral linkages, as well as utilise domestic raw materials and services, with minimal import content.

The regional financial crisis is likely to lead to a softening of the domestic labour market. Although any increase in the **unemployment** rate is expected to be small, it will still need to be managed effectively to reduce the burden, particularly on the lower-income groups. Efforts to mitigate the unemployment situation would need to include measures to improve labour market flexibility and mobility, including retraining of retrenched workers. While the Government would continue to accord priority to improve overall human resource development, the role of the private sector is crucial in ensuring that the retraining programmes are relevant to the needs of the respective industries.

While the immediate priority of public policy would be to restore confidence and stability, the longer-term challenges confronting the management of the economy would be to reassess development strategies to attain a **sustainable balance of payments position**, and to foster a productivity-driven growth. Overall, another round of economic restructuring is required for the economy to adjust to the changing international environment. The emergence of a broader group of middle-income economies, all striving to expand through an export-oriented strategy has altered the competitive advantage of many Malaysian products. The Malaysian growth strategy would need to adjust and adapt to these developments. In the real sector, while manufacturing activities would continue to lead the growth process, there is a need to develop new market niches to enable the sector to cope with the challenges of intense global competition. The key electronics sub-sector is increasingly becoming more vulnerable to external competition. The development of effective linkages in this area with the development of the Multimedia Super Corridor would ensure that value added from the latter could be enhanced. There is also a need to revitalise the agriculture sector to regain Malaysia's natural comparative advantage in this area, and provide the raw materials needed to expand the resource-based industries. New growth areas are also required to stimulate a broad-based economy. On-going measures to develop a strong ancillary services industry to support the industrialisation process are still relevant. Selected service industries, where import content is low and foreign exchange retention is high, such as tourism and education, require a well co-ordinated national strategy to realise their full growth potential.

In the wake of the regional financial crisis, considerable attention has been given to reduce the current account deficit in the balance of payments, which reached a high of 10.5% of GNP in 1995. The situation is expected to improve considerably to 0.5% of GNP in 1998, following the implementation of the adjustment measures. This improvement in the current account deficit will be achieved through both improved export performance and a decline in import volume. The completion of expansion programmes and infrastructure facilities as well as the deferment of selected projects would lead to a reduction in imports of capital goods. At the same time, the moderation in domestic demand would result in lower imports of consumption goods. While a decline in import volume is necessary to facilitate a more sustainable balance of payments position in the immediate term, a better balance in policy direction is required in the medium to long term, with the focus on increasing export earnings further to strengthen the external sector. The strategy for further improvement in the balance of payments position will focus on the promotion of exports through strengthening international competitiveness; increasing local content to alleviate the dependence on imports of intermediate goods; and encouraging long-term capital inflows into high value added industries to enhance the future export and growth potential. Amongst the many measures that have already been put in place to increase Malaysia's export competitiveness are initiatives to increase the value chain of the manufacturing process. Moves are also in the pipeline to accelerate the use of technology, including information technology, and to strengthen Malaysia's research and development capabilities. Details of other measures to increase competitiveness are discussed in Box Article VI on Malaysia's International Competitiveness.

Meanwhile, the traditional deficit in the services account indicates that much remains to be done to develop Malaysia's **services sector** to provide more comprehensive and efficient services to meet the increasing needs of the business sector. The services deficit reflects the significant increases in freight and insurance payments as well as higher outflows of profits and dividends from increased profitability of foreign investments. The weaknesses in the services sector are well recognised and there has been an intensification of efforts to enhance the development of the services sector. This sector has the potential to become a new growth area for the economy both in terms of increasing value added and strengthening of the export base. The tourism industry, in particular, is a major source of foreign exchange earnings in Malaysia. The basic infrastructure such as transportation and a wide range of hotels and tourism attractions are already in place. Further intensification of measures to promote tourism could contribute toward the reduction in the services deficit. There is also scope for the development of the private education industry, which will not only reduce education payments abroad, but also generate foreign exchange earnings. Legislative and other changes have been made to facilitate the establishment of private universities and colleges in Malaysia. The current situation offers opportunities to promote Malaysia as a regional centre for education.

As the country moves towards an industrialised nation status, more emphasis needs to be placed on fostering **productivity-driven growth** as opposed to an investment-driven growth. Measures are already in place to develop a more conducive environment that nurtures productivity-driven growth. These include the introduction of various incentives to encourage industries to move towards greater automation and higher technology activities as well as to shift the value chain of the manufacturing processes up to a higher plane. In addition, a SMI Fund of RM1 billion was recently established to assist small- and medium-scale industries to enhance their productivity. These measures are being reinforced with other strategic moves, including efforts to enhance the efficiency and capacity of the services sector to play a more pivotal role in contributing towards higher productivity in the economy. In particular, the development of the financial services sub-sector is being intensified to further enhance its efficiency in the mobilisation of investment in the economy. The development of the Multimedia Super Corridor is another area that is being pursued actively to facilitate the development of information technology and increase productivity. At the same time, it is recognised that the key to productivity and technology-driven growth lies with the development of a highly trained and skilled labour force that can effectively engage in technological innovation, and research and development. Additional measures have been introduced to further upgrade the development of human resources. In the 1998 Budget, additional allocations were provided for education and human resource development, with a view to producing a critical mass of individuals with multiple and diverse skills.

The regional financial crisis has highlighted many implications for Malaysia. On a more positive side, the crisis has provided the nation with the opportunity to consolidate its industries as well as reassess its long-term development strategies. In the process, this will enable Malaysia to place itself in a stronger position to compete in the new global environment.

Monetary Policy in 1998

Growth in the Malaysian economy is forecast to moderate significantly to 2–3% in 1998. This moderation in growth reflects the uncertain regional and international outlook that has continued into 1998 as well as the implications of the adjustment measures on the domestic economy. Although the growth of the Malaysian economy is expected to moderate in 1998, the risks of inflation remain high following the significant depreciation of the ringgit since mid-1997. In this environment, monetary policy will remain tight. Indeed, the maintenance of a tight monetary policy stance is an integral part of the economic stabilisation policy package that was implemented in 1997. This is essential to restore macroeconomic stability and thereby promote stability in the domestic financial markets. The primary focus of monetary policy in 1998 will, therefore, continue to be directed at containing any rise in inflation, in particular, inflationary expectations that may be generated by the increase in import prices following the ringgit depreciation. At the same time, prevailing uncertainties in the external environment require that monetary policy remains flexible to respond to changes in the economic environment during the course of the year. The need for flexibility is particularly important as the conduct of monetary policy in 1998 will be complicated by several elements in the external environment, notably the magnitude and duration of the regional financial crisis and the prospective course of United States monetary policy amidst concerns about the sustainability of the equity markets in the United States as well as the developments in Japan. Under these circumstances, while the focus of monetary policy will be on containing any build-up of price pressures, its implementation will be in co-ordination with other macroeconomic, structural and prudential measures to achieve the desired macroeconomic and financial stability. It will not be the intention of policy to create an over adjustment or correction of the economy.

On the domestic front, the conduct of monetary policy will also be influenced by several factors including the severity of the "pass-through" effect of the depreciation on domestic prices, as well as the need to encourage the allocation of resources to the more productive sectors. Notwithstanding the emerging strength of the current account position in the balance of payments, uncertainties remain on the net flows of short-term capital. While the most important consideration in the conduct of monetary policy in 1998 will be the need to address potential inflationary pressures, of equal importance is the need to ensure the efficiency of the functioning of the money market as well as the intermediation process. The restoration of investor confidence is not only premised on reducing price and demand pressures and re-establishing macroeconomic stability but also on ensuring access to financing by the productive sectors through an efficient intermediation process by the banking sector. To achieve macroeconomic stability, the formulation of policy will need to be based on an appropriate sharing of the burden of macroeconomic adjustment between monetary policy and fiscal policy. The maintenance of confidence in economic management makes it imperative to recognise this balance and the relative roles of monetary policy and fiscal policy as well as to ensure the efficient allocation of resources, based on market principles.

Measures that were implemented in 1997 and in early 1998 to moderate the strong credit and monetary growth have begun to show positive results. At the end of January 1998, credit growth moderated to 23.4% from the high rate of 28.6% in October 1997, while growth in M3 slowed down significantly to 16%. Given the uncertain economic environment and the need for monetary restraint to contain inflationary pressures, the moderation in credit growth will be monitored closely, to ensure that it is consistent with the projected growth of output. Based on the forecast of real GDP growth of 2–3% in 1998 and significantly higher inflation of 7–8%, the moderation in credit growth at the current pace will allow for an expansion of the monetary aggregates that is more consistent with output growth. However, in an environment of slowing economic growth, the credit growth has, in fact, moderated at a much faster pace than expected as a result of an uneven expansion in credit growth among the banking institutions. These developments, if allowed to persist can precipitate a credit crunch. BNM recognises that an effective allocation of resources to productive activities is a crucial element of public policy during a period of a slowdown in economic growth. Consequently, the need to maintain a tight monetary policy to fight inflation needs to be reinforced with appropriate policy adjustments to ensure an efficient functioning of the intermediation process.

On the inflation front, current indicators are that the sharper increases in prices that are emerging in early 1998 are caused entirely by the depreciation in the ringgit exchange rate. The rise in consumer prices reflect mainly the higher cost of imports, as evidence indicates that a significant moderation in consumption demand has already taken place since the last quarter of 1997. During the course of 1998, it is expected that aggregate demand will remain subdued and this will help to moderate the pressures on prices during the year. Furthermore, the economic slowdown, increase in unemployment and consequent concerns about job security will contribute to moderating pressures on wage increases. In 1998, the risk of a re-emergence of asset inflation is also unlikely and the erosion of wealth (following the decline in the equity market) will continue to dampen growth in consumption demand. All these factors will moderate inflationary expectations and the likelihood of demand-driven pressures on prices. However, in the immediate future, monetary policy will remain tight to dampen any rise in inflationary expectations and to facilitate adjustments in the economy when the regional financial crisis comes to pass.

The reduction of the statutory reserve requirement (SRR) from 13.5% to 10%, effective 16 February, does not represent a more accommodative policy. The objective of the measure was to enhance the intermediation process and increase the efficiency of the transmission mechanism of monetary policy through the banking system. The liquidity released to the banking system by the reduction in the SRR was more than offset by the withdrawal of funds of RM15.7 billion from the banking system. At the same time, the Bank's 3-month intervention rate in the interbank market was also raised from 10% to 11%. Given the less flexible nature of the SRR as an instrument of monetary policy, it is not used to address short-term fluctuations in liquidity. Instead, such changes in the SRR are only undertaken when there is a fundamental shift in the liquidity conditions of the banking system. There were some distortions in the intermediation process towards year-end due to the increased uncertainty, tight liquidity conditions and the consequent flight to quality of deposits. Consequently, smaller institutions faced a liquidity problem. The reduction in the SRR in February reflected the need to address this fundamental shift in the liquidity situation by facilitating the flow of liquidity to the banking system.

While monetary policy will continue to focus on reducing inflation, the tightening of fiscal policy complements such efforts by ensuring that the public sector does not aggravate demand pressures. The co-ordination of monetary and fiscal policies underscores the Government's commitment to its adjustment programme to address existing imbalances. At the same time, the appropriate fiscal-monetary policy mix will avoid placing undue pressures on the use of monetary policy to achieve price stability. In the absence of an appropriate balance between fiscal policy and monetary policy in the adjustment process, the burden of adjustment will fall unduly on monetary policy. This could lead to higher-than-optimal interest rates, which could have negative implications on the domestic economy and financial system. Of importance is that the expected real rate of return on savings will remain positive.

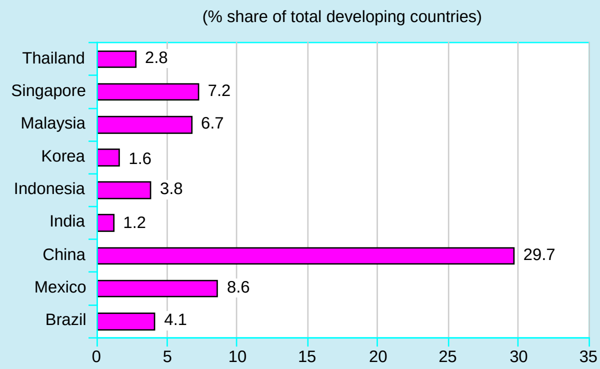
In the current environment where the regional financial crisis has imposed significant pressures on the domestic financial system, the role of monetary policy to maintain as well as to further strengthen the resilience and stability of Malaysian financial institutions assumes critical importance. This is essential to minimise the vulnerability of the financial system to external shocks as well as to further develop the banking system to meet the changing needs of the Malaysian economy as it adapts to a more competitive and integrated global environment. The co-ordination of monetary, prudential and institutional policies assumes renewed significance as the Bank focuses its policies on ensuring that banking institutions remain strong and viable, as well as become more efficient. In its conduct of monetary policy, the Bank will continue to ensure that it optimises the use of available instruments so that financial intermediation can be undertaken more efficiently and at the lowest possible cost. Structural impediments that hindered the effective transmission of monetary policy and the issue of market segmentation will continue to be resolved during the course of 1998. Among the measures that will need to be considered are those aimed at ensuring that the policy signals on the stance of monetary policy are effectively transmitted to the markets. In this regard, the Bank has initiated work to develop and strengthen the financial system through the development of more market-oriented policy instruments. Monetary management will be directed towards a sharper focus on interest rates as the intermediate target, increased flexibility in the use of the various monetary policy instruments, more flexible liquidity management, improved policy signals and the development of additional indicators of monetary conditions. It is recognised that a more market-oriented financial system will require a substantial broadening and deepening of financial markets. This will not only allow for a greater degree of securitisation and reduce the reliance on banking intermediation, but also facilitate the development of

Box VI

Malaysia's International Competitiveness

The ultimate measurement of a nation's competitiveness is its ability to effectively sell goods and services in the international market and at the same time, attract substantial foreign investment. Over the last decade, growth in Malaysia has been largely export driven, supported by large inflows of foreign direct investment. During the last few years, the international competitive position among countries has changed significantly. Competition for foreign savings as well as export markets have become increasingly more intense due to both domestic and external factors. On the domestic front, rapid economic growth over an extended period has exerted pressures on the availability of resources, with strains emerging on several fronts, notably the balance of payments and the labour market. On the external front, liberalisation in many developing countries has resulted in the emergence of new competitors, particularly the lower-cost producing countries. This development has altered Malaysia's relative comparative advantage. Technology and the globalisation of financial markets and production centres have also created new challenges for countries to maintain or gain comparative advantage in international trade. In this environment, Malaysia needs to engineer its growth strategies, and structural adjustments could be necessary to remain competitive.

Graph VI.1
Foreign Direct Investment to Selected Countries, 1991-96



Source: World Investment Report, 1997

Present State of International Competitiveness

Based on several studies undertaken by international organisations, Malaysia has been rated favourably in terms of overall competitiveness

Table VI.1
The Non-OECD Scoreboard

Overall ranking	Competitiveness ranking			
	1990	1993	1996	1997
1	Singapore	Singapore	Singapore	Singapore
2	Taiwan, ROC	Hong Kong SAR, China	Hong Kong SAR, China	Hong Kong SAR, China
3	Hong Kong SAR, China	Taiwan, ROC	Chile	**Malaysia**
4	Korea	**Malaysia**	Taiwan, ROC	Taiwan, ROC
5	**Malaysia**	Chile	**Malaysia**	Chile
6	Thailand	Korea	Israel	Israel
7	Mexico	Thailand	People's Republic of China	People's Republic of China
8	Indonesia	Mexico	Thailand	Argentina
9	Brazil	Venezuela	Philippines	Thailand
10	India	Indonesia	Argentina	Philippines

Source: World Competitiveness Report, various issues

Table VI.2
Malaysia's Ranking: Eight Factors of Competitiveness[1]

Factors		1994	1995	1996	1997
Domestic economy	Macroeconomic evaluation	4	4	7	2
Internationalisation	Extent of participation in international trade and investment flows	18	23	16	17
Government	Conduciveness of government policies to competitiveness	4	4	4	4
Finance	Performance of capital market and quality of financial services	20	21	19	19
Infrastructure	The extent to which resources and systems are adequate to serve businesses	20	21	22	27
Management	Management of enterprises in an innovative, profitable and responsible manner	12	23	15	17
Science & technology	Scientific and technological capacity	26	30	29	25
People	Availability and qualifications of human resources	29	33	34	33

[1] The World Competitiveness Yearbook analyses competitiveness of 46 countries. The country showing the best performance is ranked as first and the worst performance is ranked as last.

Source: World Competitiveness Report, various issues

as well as in attracting foreign investment. The World Competitiveness Report, 1997, published by the International Institute for Management Development (IMD), ranked Malaysia 17 out of 46 developed and developing countries (improving from 23 in 1996) in the world competitiveness ranking. Among the non-OECD countries, Malaysia was ranked as the third most competitive nation after Singapore and Hong Kong, Special Administrative Region (SAR),China.In another study conducted by the World Economic Forum (WEF) in 1997, Malaysia was ranked ninth out of 53 countries, ahead of Japan, Germany and Korea.

The World Competitiveness Report focused on eight major factors to assess competitiveness, namely, domestic economy, internationalisation, Government, finance, infrastructure, management, science and technology, and people. Malaysia's favourable ratings were due to the ability to sustain high economic growth over a protracted period with price stability, reflecting the policies to attract foreign direct investment and provide a conducive environment for business activities. The nation's growth expanded by 8.5% per annum during the period 1991–97, exceeding the average growth of developing countries as a group (6.1% per annum) and the ASEAN region (6.9% per annum excluding Vietnam). An important factor that has enabled Malaysia to achieve high growth is its competitive edge in attracting large inflows of foreign direct investment. Based on investments approved by the Ministry of International Trade and Industry (MITI), foreign direct investment surged to RM78.7 billion during the period 1991–96, compared with RM35.9 billion during the period 1985–90. Malaysia accounted for 28.8% of total foreign direct investment flows to ASEAN countries during the period 1991–96 and 6.7% of flows to developing countries. The nation's competitive position was also relatively favourable in the export sector, particularly for exports of manufactured goods. Indeed, Malaysia accounted for a rising share of 1.5% of the world's total exports at end-1996 from 0.6% at end-1970.

A key element that has underpinned the country's competitive edge has been the track record of

Table VI.3
Comparison on Stability of Currencies[1]

Period	(%)				
	RM	S$	Stg	DM	Yen
1973-92	7	11	18	20	28
1986-92	3	10	8	12	11
1991-96	4	9	8	7	13

[1] Refers to coefficient of variation of the average rate against the US dollar.

consistent macroeconomic policies which had contributed to stable financial conditions. Indeed, consistent monetary and fiscal policies have enabled Malaysia to maintain a low inflation rate and thus, ensure monetary stability. During the period 1980–96, consumer prices increased at an average rate of 3.7% per annum, compared with 9.2% in Indonesia, 7.6% in Korea and 5.5% in Thailand. The exchange rate had also been relatively stable before 1997, which facilitated the smooth conduct and settlement of international trade and investment. Calculations using the coefficient of variation of the average ringgit/US dollar rate indicate that the ringgit was one of the most stable currencies during the period 1973–96. In terms of the Real Effective Exchange Rate (REER), the index showed that Malaysia was less competitive than Indonesia, Thailand and Korea during the period 1992–96. However, this did not lead to a significant loss of competitiveness as actual competitiveness depends more on productivity gains and other factors that are not captured by the REER index. More importantly, overall international competitiveness entails not just pricing considerations but also non-price factors. For example, in the recent period of volatility, the REER does not serve as a good indicator of competitiveness. In such a situation, non-price factors such as confidence, the relative stability of macroeconomic conditions, reliability of services and availability of credit become more important to facilitate trade and investment, rather than the rate of depreciation of the currency.

Table VI.4
Financial and Real Sectors' Performance

	1979-87	1988-97
	(Average growth in %)	
Nominal GDP	8.9	13.3
International trade	11.8	19.3
Total assets of banking system	13.1	50.1
Net funds raised in the capital market (RM billion)	45.6	167.7

Malaysia's competitiveness has also been supported, to some extent, by productivity and quality improvement. Based on productivity measurement (ratio of real gross domestic product (GDP) to total employment), Malaysian workers compare favourably with selected newly industrialised economies (NIEs). This is evident in the productivity growth which rose by an average annual rate of 5.3% during the period 1990–96 (the increase in Korea, Taiwan and Singapore was 4.9%; 4.9%; and 7.4% respectively). Improvements in productivity were more pronounced in the manufacturing sector, with the increase in productivity in this sector exceeding the overall productivity growth. Malaysia has now reached a stage in its economic development where the enhancement of productivity and quality in its goods and services are the major determinants of the nation's future prospects.

Table VI.5
Competitiveness of the Banking Sector: Selected Countries

	Ranking							
	Malaysia	**Singapore**	**Indonesia**	**Thailand**	**Korea**	**Chile**	**Argentina**	**Mexico**
The policy of the Central Bank	6	3	21	22	43	20	18	40
Size of banks ranked by assets (1995)	22	28	17	15	10	38	34	22
Bank savings, 1994 [1] (US$ per capita)	26	4	38	29	28	34	31	30
Banking sector assets (as percent of GDP, 1995)	11	8	34	17	30	26	45	43
Interest rate spread, 1996 (lending rate minus deposit rate)	3	11	38	30	2	18	19	28
Legal regulation of financial institution	19	1	37	32	45	21	27	40

[1] Only include bank savings in the form of fixed-term deposits, savings books and savings deposit accounts.

Source: World Competitiveness Report, 1997

Table VI.6
Inter-Country Comparison: Cost of Doing Business

	Malaysia	Thailand	Indonesia	Singapore	Korea
1992-96			(%)		
Average lending rate [1]	9.5	12.1	19.7	6.0	11.9
Producer Price Index [2]	2.8	3.3	6.7	-1.8	2.8
Consumer Price Index	3.8	4.9	8.6	2.1	5.3
Corporate tax rate [3]	28	30	30	26	16 – 28
Power rate (Sen/KWH) [4]	22.17	21.41	-	22.26	17.64

[1] For Singapore and Korea, it refers to prime lending rate, while for Thailand, it refers to minimum loan rate.
[2] For Indonesia, Singapore and Thailand refer to wholesale price index.
[3] For Korea, corporate tax rate is 16% for income up to 100 million won and 28% for income exceeding this amount.
[4] Based on electricity tariff rates charged by selected power companies in 1997 except for Korea which is based on 1996.

Malaysia's competitive advantage has also been supported by a relatively well-developed financial infrastructure. There appears to be a strong correlation between financial sector expansion, real GDP growth, and increase in international trade. Reflecting the increasing intermediation process as trade activity expands, banking assets expanded at an average annual rate of 50.1% during the period 1988–97, while nominal GDP and international trade (total value of exports and imports) grew by 13.3% per annum and 19.3% per annum respectively. The capital market has increasingly played a more prominent role, particularly during the period 1988–97, with net funds raised from the capital market (both bond and equity markets) rising significantly by RM167.7 billion compared with RM45.6 billion in 1979–87. Based on the World Competitiveness Report, Malaysia is ranked 19 out of 46 countries in terms of performance of the banking system, the capital market and the quality of financial services.

The cost of doing business has also been relatively low in Malaysia as reflected in the low average lending rates and producer price index. Malaysia's corporate tax rate has also been reduced to 28% in 1998 compared with 30% each for Indonesia and Thailand. After taking into account tax incentives, the effective tax rate for the country is even lower. Several other factors supporting Malaysia's competitive edge include adequate physical and financial infrastructure, a pool of well educated workforce and the availability of natural resources.

Issues and Challenges

Maintenance of international competitiveness is a continuous process given the dynamic international environment. In the past, Malaysia's comparative advantage was in terms of abundant natural resources and labour to support a labour-intensive development strategy. However, with the more intense competition from emerging economies, the global scenario of comparative advantage has now changed. New approaches are necessary for Malaysia to strengthen its competitive advantage. Producing distinctive and differentiated products and investing in high value-added and knowledge-based industries may not be sufficient. Seven areas are being identified for improvement in order to increase the nation's resilience and competitiveness.

Macroeconomic, monetary and financial stability:

As a small and open economy, Malaysia is more vulnerable to world economic cycles as evident in the recent regional financial crisis. The regional crisis has exposed some of the risks in the economy, which have far-reaching implications on business decisions, inflation and asset markets, and ultimately, competitiveness. Given the current environment, policies that are firmly directed at attaining overall macroeconomic and monetary stability will help to restore confidence in the financial market and the ringgit. This calls for an appropriate mix of fiscal and monetary policies. At the same time, emphasis will also be directed at maintaining the soundness and stability of the financial system which has underpinned Malaysia's rapid rate of expansion. An important strategy is to build a well-capitalised financial sector comprising banks, insurance companies, stockbroking companies and fund managers. At the same time, strong emphasis on prudential conduct and financial transparency will instil confidence in the system. Further measures have been instituted to enhance disclosure of information and improve accounting standards that are consistent with international standards. The smooth functioning of the capital market also requires that rules and regulations of the marketplace continue to be strengthened and rationalised, with emphasis on corporate governance.

Deepening and broadening of the financial system:

The competitive environment can further be enhanced by a well-developed financial system that supports and facilitates trade and investment. The financial system must be able to respond to the needs of corporations by providing a broad range of instruments that suit the needs of customers as well as ensuring speedier and more efficient financial services at lower cost. Hence, the consolidation of the banking system with strong emphasis on liability and asset management, project evaluation and risk management is given priority. The present financial sector developments have, to some extent, induced the banking institutions to meet these challenges. The institutions have also become more active in the development of a wide range of banking activities, as well as more sophisticated retail banking services, regional banking and Labuan International Offshore Financial Centre (IOFC). The capital market is to be strengthened further in tandem with these developments. The broadening and deepening of financial market will provide an efficient and cost-effective source of funds for corporations. Efforts to further develop the capital market especially the corporate bond market, have been intensified.

Restrategising foreign and domestic investments:

Looking back, foreign direct investment has had an important role in the economic development and diversification of Malaysia. Foreign direct invesment has been beneficial to output and employment growth, and has brought with it both imported capital and new technology. The role of foreign direct invesment continues to remain significant for a small developing economy like Malaysia. More recently, efforts have been directed at attracting capital-intensive and high-technology investment. Amongst the steps that have been taken by the Government are the more selective approvals of projects, and providing a special incentive package for the establishment of wafer fabrication projects. In addition, incentives have been provided to attract companies in information technology (IT) to establish their operations in the Multimedia Super Corridor (MSC). These strategies have been successful as evident by the lower ratio of labour absorption to capital in new investments approved by MITI (three employees per RM1 million of investment in 1997 compared with 16 in 1988) and the larger average size of investments per project (RM12.4 million in 1988; RM34.2 million in 1997). The capital-intensive investments have been more pronounced in the electrical and electronics products industry, such as computer motherboards, hard disk media and silicon wafers. Investments totalling RM12.4 billion were approved by MITI during 1994–97 for the establishment of wafer projects, in response to the provision of special incentives to promote high-technology industries. Nevertheless, competition for such investments from other developing countries has also intensified over the past few years. In such an environment, a review of policies will ensure that they remain relevant and pragmatic in the new environment.

The manufacturing sector remains the key sector in Malaysia in terms of output, exports and competitiveness. Nevertheless, given the changing global environment and the increased competition from newly emerging countries, past strategies have been reassessed. The new strategies emphasise on development of core capabilities to enhance the sector's competitive advantage. These core capabilities would be developed based on a cluster approach that places importance on the strength of the leading and supporting firms and institutions as well as linkages between them. Three broad types of potential industrial clusters have been identified for development in the Second Industrial Master Plan. These are the international-linked clusters; resource-based clusters; and policy-driven clusters. Besides developing the leading firms, the supporting industries (mainly SMIs) involved mainly in the production of machinery, engineering, fabricated metal products, automobile and component parts and foundry will also be developed. This will strengthen intra and inter-sectoral linkages in the manufacturing sector, which is particularly important, as Malaysia makes a strategic shift towards a more integrated approach in manufacturing production.

An area which has vast potential to be developed into a new engine of growth is the services sector. An efficient services sector will strengthen the competitive advantage of all sectors of the economy because of its inter-linkages with other activities. There is scope to promote the "tradable" services, with emphasis on developing the finance, education, tourism, insurance and shipping sub-sectors. Besides the potential in generating net foreign exchange earnings, the education sub-sector will also help to develop human resources. The tourism industry also has the potential to become a major foreign exchange earner for the nation.

Productivity enhancement:

An important element that will affect efforts to sustain international competitiveness is productivity. An analysis of total factor productivity (TFP) showed that past growth in value added has been largely input driven, indicative of a less-than-optimal use of scarce resources. In an environment of full employment and resource constraints, enhancing TFP will improve Malaysia's competitive edge. TFP can be enhanced through advancement in education of workers, skills and expertise, acquisition of superior management techniques and know-how, improvements in organisation, gains from specialisation, introduction of new technology and innovation or upgrading of existing technology and enhancement of IT. Indeed, the long-term strategy to sustain international competitiveness is through increased application of IT and to undertake research and development. IT will not only provide firms with access to an expanding array of services, but will also create new business opportunities. The rapid accessibility of information and the ability to process and use the results speedily will enhance the competitive edge of firms by boosting production, reducing costs and ensuring quality products. Recognising the importance of IT, the Government has launched a world-class IT hub, namely, the MSC to accelerate the pace of diffusion of IT in the country. At the firm level, value added can be raised by developing new IT products and services such as software, hardware and computer services through research and development, for use by the local industries and for export.

On the product side, competitiveness can be further enhanced through research and development. However, expenditure on research and development in Malaysia remains low and accounted for only 0.32% of GDP in 1995 (Singapore: 1.13%; Korea: 2.68%; and Taiwan: 1.81%). By international comparison, Malaysia was ranked only 37 out of 43 countries by the World Competitiveness Report in terms of research and development. Plans to enhance research and development in Malaysia would require specific targets in terms of experienced

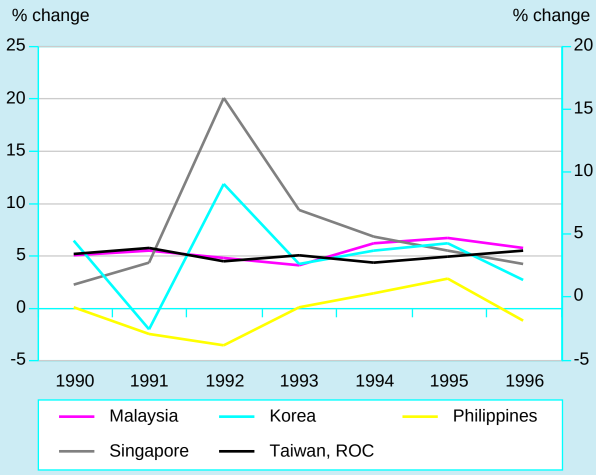
Table VI.7
Growth of Productivity, Labour Cost per Employee and Unit Labour Cost of the Manufacturing Sector

	1991	1992	1993	1994	1995	1996	1997*e*
	(Annual change in %)						
Productivity of labour	6.9	4.9	6.2	6.4	7.3	5.8	5.7
Labour cost per employee	11.9	10.7	5.3	7.3	5.2	9.3	7.0
Unit labour cost	3.2	3.6	-0.1	8.0	-1.6	2.7	1.5

e Estimate
Source: National Productivity Corporation & Bank Negara Malaysia (for 1997)

Graph VI.2
Overall Productivity Growth

(Percentage change of real GDP per person employed)



Source:Based on information from "Key Indicators of Developing Asian and Pacific Countries", Asian Development Bank, 1997 and National Productivity Corporation research and development personnel. At the same time, the Government would continue to play a proactive role in creating an environment that will be conducive to the private sector to undertake research and development activities. Provision of appropriate incentives may also be required.

Developing a competitive labour force:

In the past, foreign direct investment inflows into Malaysia were attracted by low wages and quality of the labour force. However, in recent years, Malaysia has begun to be affected by the erosion of its wage competitiveness vis-a-vis emerging countries in Asia, Latin America and Eastern Europe which have relatively lower wages and vast domestic markets. Given the full employment situation in Malaysia, the current focus of industrial development is directed at promoting high-technology industries, emphasising on products with potential for market and technology development and with high value added. This shift in the industrial structure will require a highly trained workforce. In this regard, the education curriculum has been reviewed to produce a larger number of technicians and engineers. Vocational schools have been restructured into technical schools and measures have been taken to expand computer education. To match skill requirements with the rapid change in technology, the private sector has been encouraged to constantly upgrade employees' skills through in-house training as well as training in technical institutions. In this context, a multinational electronic company in Malaysia provides training to local engineers by involving them in product development locally as well as overseas. Other large public corporations such as Tenaga Nasional Berhad, Telekom Malaysia Berhad and PETRONAS also have their own training facilities.

A related issue that requires further attention is the relative growth in wage gains vis-a-vis productivity increases. In recent years, productivity growth in the manufacturing sector which increased strongly in the first half of 1990s moderated in 1996–97, reflecting the increase in labour cost per employee. Cost competitiveness requires that wage increases correspond with productivity growth. While the Government has introduced a set of guidelines on a productivity-linked wage system, its implementation has been limited. The implementation of this system will ensure that Malaysia's export competitiveness will not be eroded.

Cost competitiveness:

Theoretically, a large depreciation in the exchange rate of the domestic currency should result in valuation gains from exports. However, in the present environment, it was observed that keen competition arising from the exchange rate depreciation in countries in the Asia–Pacific region had prompted exporters to provide discounts in United States dollar terms, thus benefitting purchasers and negating, to some extent, valuation gains to exporters. Furthermore, a depreciation will ultimately lead to increased business costs and undermine competitiveness. Domestically, there have also been upward pressures on utility charges. Industries with rising labour and material input costs can shift towards greater automation and mechanisation as well as seek alternative sources of materials including domestic substitutes, in order to offset the increased costs. The existence of an efficient infrastructure as well as the supply of utilities and other support services at competitive costs become vital in the current environment.

Appropriate marketing strategies:

In the face of the changing global trade configuration, Malaysian manufacturers can enlarge their export market shares by promoting distinctive and differentiated products as well as diversifying aggressively into non-traditional markets. The surge in private investment in the manufacturing sector since the second half of the 1980s has provided the sector with a more diversified industrial base, and many firms are now producing products of relatively higher technology and skills content. Nevertheless, in comparison with the more developed countries, Malaysia continues to export goods that require lower advanced technology and skills content. There is also a need to improve marketing strategies. In this aspect, a more active role by the business associations or councils can take the form of dissemination of trade information and establishing contacts with potential buyers overseas for local manufacturers, particularly the small- and medium-scale enterprises which generally have weak marketing networks.

Conclusion

In a globalised world market, efforts to enhance international competitiveness through incentives, lowering of tax rates and other orthodox measures are clearly no longer adequate. In addition, the globalisation process has also opened new avenues through which risks can spread rapidly, posing potential systemic damage to the financial system and the economy. While the recent depreciation of the ringgit, to some extent, will help to strengthen the competitiveness of exports, the nation should not rely solely on the exchange rate to sustain long-term competitiveness. Improving the, competitive position in the longer term is a structural issue to be attained through the development of new approaches, strategies and products.

more sophisticated savings, credit and risk management instruments. The shift towards a more efficient financial system involves further institutional development. In this regard, work is underway to move towards risk-based supervision of banking institutions, which will facilitate a more effective assessment of emerging risks in the financial system. Under this approach to enhance the financial system, there will be much closer interaction in the consideration of monetary policy, prudential standards and institutional development.

During this period of turbulence in the foreign exchange market, the Bank's exchange rate policy has remained unchanged. No targets are set for the ringgit exchange rate level and market forces will continue to determine the value of the ringgit. As a matter of policy, Malaysia has never relied on the exchange rate to promote export competitiveness. Instead, the country has sought to maintain and enhance its competitiveness by lowering costs and via improvements in productivity. Currently, the ringgit is assessed as being grossly undervalued. Consequently, the ringgit exchange rate has been driven more by changes in market sentiments rather than underlying shifts in economic fundamentals in recent months. To address this situation, particularly market concerns about existing imbalances, Malaysia has undertaken a comprehensive package of economic adjustment and stabilisation measures to further strengthen the economy and the financial system against the impact of the regional currency crisis. As these measures take effect and market confidence is restored, it is envisaged that the exchange rate will adjust to reflect the economic fundamentals of the country. As in recent years, the option for BNM to intervene in the foreign exchange market will continue to remain. Such intervention operations, however, are aimed at maintaining a degree of stability and not to support any specific level.

As monetary policy operates in a dynamic environment, it must always be pragmatic and flexible. This approach in the implementation of monetary policy is particularly relevant in 1998, given the uncertainties in regional and domestic economic conditions. Regular monitoring of the monetary aggregates, such as credit and monetary growth and interest rate developments will be complemented by close monitoring of price developments, including asset prices, and indicators of consumption and investment demand, to facilitate timely policy responses to monetary and economic developments. During this period of uncertainty, the dissemination of timely and accurate information to the public becomes more important in order to promote a better understanding of monetary conditions and issues confronting the conduct of monetary policy to facilitate the effectiveness of monetary policy.