1 The Real Economy

Overview

The full effect of the regional financial crisis on the Malaysian economy was felt in 1998. For the year as a whole, real output declined by 6.7% after 12 years of uninterrupted expansion averaging 7.8% per annum. Per capita income in nominal terms declined to RM11,835 (US$3,018) in 1998 from RM12,051 in 1997 (US$4,284).

Malaysia's strong initial conditions and the adjustment measures pursued in 1997 did not restore stability in the domestic financial markets. Instability in the international financial markets intensified in 1998, particularly in the early part of the year, which in turn spilled over into the domestic markets. Continued waves of adjustment in both the currency and stock markets, coupled with the decline in domestic and export demand subsequently prompted a shift to more growth promoting policies. As the regional crisis became more entrenched, the orthodox International Monetary Fund (IMF) policy prescription of tight fiscal and monetary policies would only have destabilised the situation further and induced a much sharper contraction in real output.

The tight fiscal and monetary policies that were adopted in an environment of weakening external demand caused aggregate demand to fall more sharply than anticipated. During this period, inefficiencies in the domestic money market and the loan intermediation process that emerged in the early part of the year were further factors

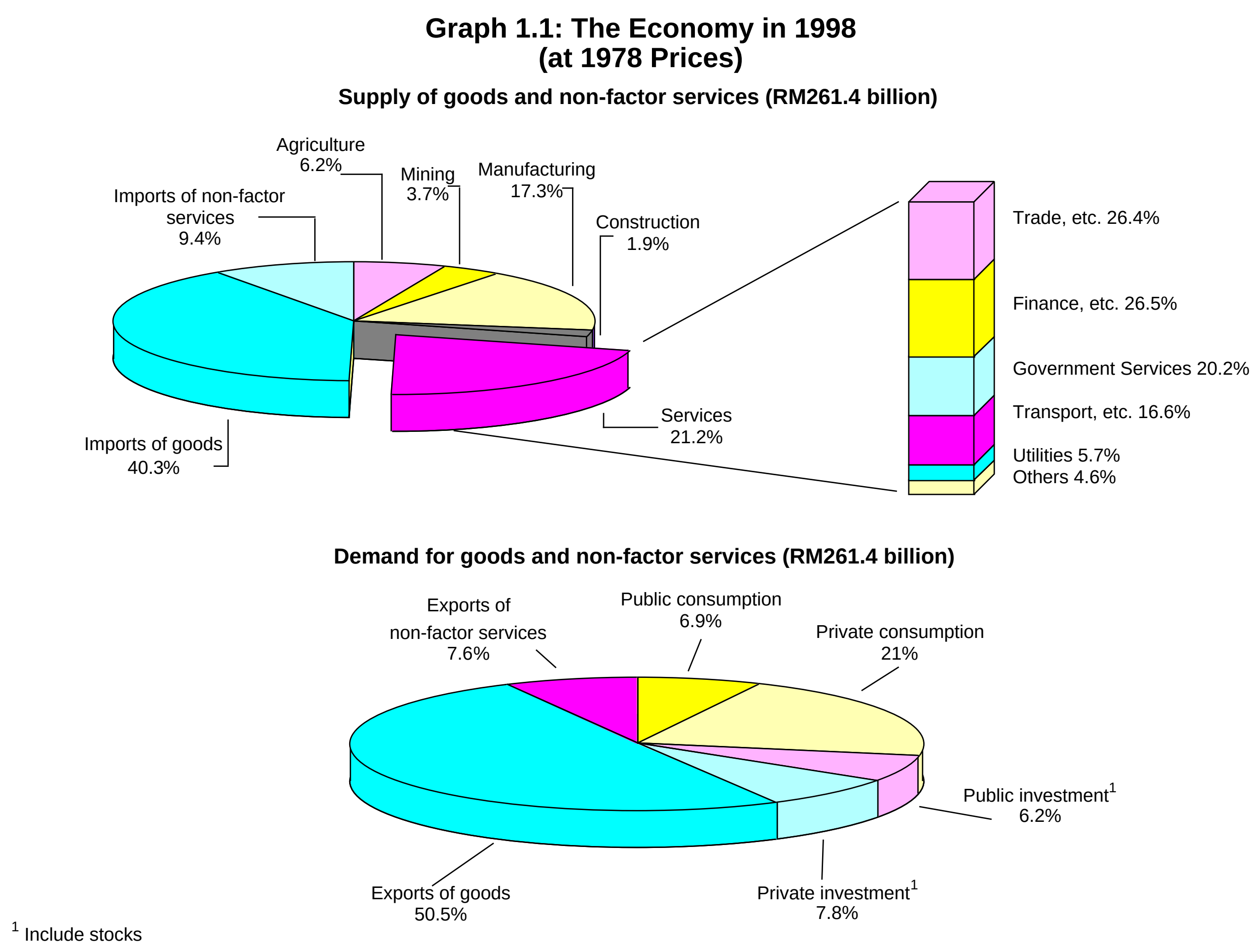


Table 1.1: Malaysia – Key Economic Indicators

	1996	1997	1998*p*	1999*f*
Population (million persons)	21.2	21.7	22.2	22.7
Labour force (million persons)	8.6	9.0	8.9	–
Employment (million persons)	8.4	8.8	8.5	–
Unemployment (as % of labour force)	2.6	2.6	3.9	4.5
Per Capita Income (RM)	11,228	12,051	11,835	11,831
(US$)	4,446	4,284	3,018	3,113
NATIONAL PRODUCT (% change)				
Real GDP	8.6	7.7	–6.7	1.0
(RM billion)	130.6	140.7	131.3	132.6
Agriculture, forestry and fishery	2.2	1.3	–4.0	5.0
Mining and quarrying	4.5	1.0	0.8	–0.4
Manufacturing	12.3	12.5	–10.2	0.8
Construction	14.2	9.5	–24.5	–8.0
Services	9.7	8.0	1.5	2.5
Nominal GNP	14.1	9.8	0.5	2.4
(RM billion)	237.7	261.1	262.5	268.7
Real GNP	8.3	7.8	–6.3	1.5
(RM billion)	123.2	132.8	124.5	126.3
Real aggregate domestic demand [1]	7.0	6.5	–25.9	4.3
Private expenditure [1]	9.0	6.3	–32.2	1.1
Consumption	6.0	4.7	–12.4	1.1
Investment	13.4	8.4	–57.8	0.9
Public expenditure [1]	1.3	6.9	–6.6	11.4
Consumption	1.4	5.3	–3.5	10.1
Investment	1.1	8.6	–10.0	12.8
Gross national savings (as % of GNP)	38.5	39.4	41.2	40.2
BALANCE OF PAYMENTS (RM billion)				
Merchandise balance	10.2	11.3	69.3	57.1
Exports (f.o.b.)	193.1	218.7	282.0	277.6
Imports (f.o.b.)	183.0	207.4	212.7	220.5
Services balance	–19.5	–21.8	–23.4	–21.0
(as % of GNP)	(–8.2)	(–8.3)	(–8.9)	(–7.8)
Transfers, net	–2.9	–3.7	–9.9	–6.6
Current account balance	–12.2	–14.2	36.1	29.5
(as % of GNP)	(–5.1)	(–5.4)	(13.7)	(11.0)
Bank Negara Malaysia reserves, net	70.0	59.1[2]	99.4[3]	–
(as months of retained imports)	(4.4)	(3.4)	(5.7)	–
PRICES (% change)				
CPI (1994=100)	3.5	2.7	5.3	< 4.0
PPI (1989=100)	2.3	2.7	10.7	1.5
Average wages in the manufacturing sector	8.4	7.3	0.3	–

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

1 Exclude stocks.
2 In 1997, the foreign exchange gain on the balance sheet date was not recognised in the Bank's account, in view of the volatility of the exchange rates during that year.
3 Arising from the fixing of ringgit/US dollar exchange rate at RM3.80 in September, 1998, all assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the cumulative gain has been reflected accordingly in the Bank's current year account. The US dollar equivalent of international reserves as at 31 December, 1998 was US$26.2 billion.
p Preliminary
f Forecast

Table 1.2: Malaysia – Financial and Monetary Indicators

	1996	1997	1998*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	58.3	65.7	56.7
Operating expenditure	43.9	44.7	44.6
Development expenditure	12.6	14.4	17.1
Overall balance	1.8	6.6	–5.0
Overall balance (% of GNP)	0.8	2.5	–1.9
Public sector development expenditure	30.8	40.0	47.2
Public sector overall balance (% of GNP)	4.2	6.6	–1.8
EXTERNAL DEBT			
Total debt (RM billion)	97.8	170.8	159.8
Medium & long-term debt	72.7	127.5	131.3
Short-term debt	25.1	43.3	28.5
Debt service ratio (% of exports of goods & services)			
Total debt	6.9	5.5	6.7
Medium & long-term debt	6.2	4.7	6.0

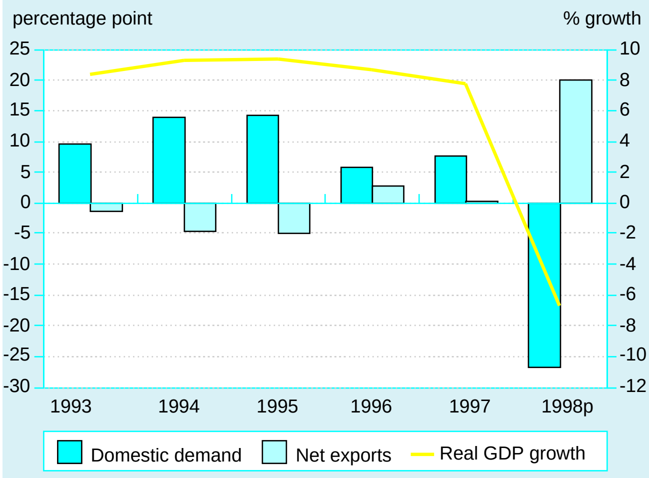
		Change in 1996		Change in 1997		Change in 1998	
		RM billion	%	RM billion	%	RM billion	%
MONEY AND BANKING							
Money supply	M1	8.7	16.7	2.8	4.6	–9.2	–14.6
	M2	39.3	19.8	54.0	22.7	4.3	1.5
	M3	57.8	21.2	61.1	18.5	10.6	2.7
Banking system deposits		74.5	26.3	76.1	21.3	–2.1	–0.5
Banking system loans[1]		72.1	27.6	88.2	26.5	–7.6	–1.8
Manufacturing		4.6	9.5	9.9	18.5	–0.1	–0.2
Property sector		30.8	41.9	35.5	34.0	6.2	4.4
Finance, insurance and business services		0.9	3.0	3.4	10.3	0.9	2.5
Loan-deposit ratio (end of year)		89.3%		92.7%		91.4%	

		1996 %	1997 %	1998 %
Interest rates (average rates at end of year)				
3-month interbank		7.39	8.70	6.46
Commercial banks				
Fixed deposits:	3-month	7.21	9.06	5.83
	12-month	7.26	9.33	5.74
Savings deposit		4.10	4.23	3.87
Base lending rate (BLR)		9.18	10.33	8.04
Finance companies				
Fixed deposits:	3-month	7.32	10.32	6.43
	12-month	7.36	10.25	6.57
Savings deposit		5.02	5.49	5.01
Base lending rate (BLR)		10.65	12.22	9.50
Treasury bill (3-month)		6.39	6.76	5.31
Government securities (1-year)		6.70	7.01	5.79
Government securities (5-year)		6.55	7.75	6.66

	1996 %	1997 %	1998 %
Movement of Ringgit (end-period)			
Change against composite	2.6	– 31.4	–0.2
Change against SDR	3.9	– 30.8	–1.8
Change against US$	0.5	– 35.0	2.3

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

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



contributing to this process. These inefficiencies resulted in higher lending rates than those reflected by the official intervention rate. These higher lending rates led to debt servicing problems in the corporate sector and threatened the stability of the financial system. It was evident towards mid-year that growth in GDP would contract significantly. Consequently, the strategies were reassessed to break the vicious cycle of destabilising developments in the financial sector and the economy reinforcing each other. As a result of these reassessments, the National Economic Action Council announced a comprehensive National Economic Recovery Plan to expedite recovery.

Policy response since May 1998 focused on counter-cyclical measures to avoid a recession-deflation spiral. Fiscal policy was relaxed in March 1998 and monetary policy was eased in early August 1998 when inflationary pressures became subdued. The volatility in the financial markets, however, persisted arising from several external developments including that in Indonesia in May, the weakening of the yen in June and the events leading to the devaluation of the Russian ruble. By the end of August 1998, the ringgit had depreciated by 40% against the United States dollar from the pre-crisis level, while the stock market declined by 72% during the same period. Given this continued adverse external environment, Malaysia imposed the selective exchange control measures on 1 September to eliminate the internationalisation of ringgit and to stabilise short-term capital flows. On 2 September 1998, the ringgit was also fixed at RM3.80 against the United States dollar. To complement the selective capital controls, further measures were introduced to improve the liquidity flows in the banking system to enhance the intermediation process and generate increased lending to viable businesses. Monetary policy was also eased further. Interest rates were brought down to levels prevailing at end-1995 following the progressive reduction in the intervention rate of Bank Negara Malaysia (BNM) and the statutory reserve requirement (SRR). The banking sector reform programme was also accelerated. Overall, the exchange control measures resulted in greater stability in the currency and stock markets and the financial system, as well as revival in domestic consumer and investor confidence. Although the economy continued to contract in the second half-year, on a year-to-year basis, the fundamentals had begun to strengthen towards end-1998.

Overall, the developments in 1998 clearly indicated that the financial crisis was not only due to the build-up of vulnerabilities in the region but also due to the shortcomings in the international monetary system in dealing with short-term flows. The “herd” behaviour among market participants led to market expectations becoming self-fulfilling. The international rating agencies also contributed to further market volatility with frequent rating reviews to compensate for earlier shortcomings of not having recognised the risks in the region. The positive features of the Malaysian economy that were acknowledged by the market and the international rating agencies included the low inflation, a high level of savings, Malaysia’s openness to international trade and foreign

Graph 1.3
GNP Growth and Nominal GNP per Capita

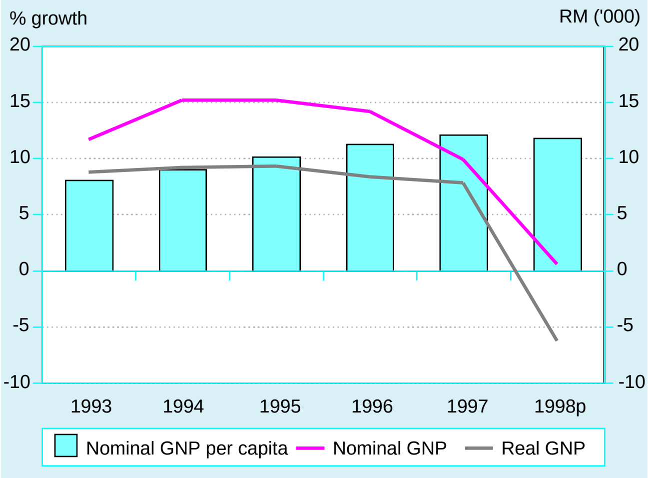


Table 1.3
Malaysia: Savings-Investment Gap,1997-99

	1997	1998*p*	1999*f*
	RM million		
Public gross domestic capital formation	31,564	31,750	36,809
Public savings	50,314	42,330	30,102
Deficit/surplus	18,750	10,580	–6,707
Private gross domestic capital formation	85,394	40,257	41,746
Private savings	52,493	65,745	77,991
Deficit/surplus	–32,901	25,488	36,245
Gross domestic capital formation	116,958	72,007	78,555
(as % of GNP)	44.8	27.4	29.2
Gross national savings	102,807	108,075	108,093
(as % of GNP)	39.4	41.2	40.2
Balance on current account	–14,151	36,068	29,538
(as % of GNP)	–5.4	13.7	11.0

p Preliminary
f Forecast

Source: Department of Statistics and Bank Negara Malaysia

investment, low external debt, strong fiscal position and a well-regulated and supervised banking system. The risks in the Malaysian economy which prompted adverse investor sentiment towards Malaysia were mainly the high loan-GDP ratio, the deficit in the current account of the balance of payments and strong credit growth. Although there was general recognition that Malaysia had relatively stronger fundamentals, investors did not differentiate the risks in countries in the Asian region. As Malaysia was not under an IMF programme, it was also perceived that without an IMF programme, Malaysia would be less committed to structural reform. Investors failed to recognise that Malaysia does not qualify for an IMF programme in view of its relatively strong balance of payments position and its relatively lower external debt exposure. Throughout the crisis period, external reserves of Malaysia were adequate to finance more than three months of retained imports. Since controls were introduced in September 1998, these reserves have increased significantly. The payments system continued to function effectively and did not break down during this crisis period. More importantly, Malaysia did not default on its external payments obligations.

In 1998, real GDP declined by 6.7%, with real aggregate **domestic demand** declining by 25.9%. The decline in private expenditure was significant. Uncertain economic outlook and employment prospects, the deferment of high import content projects, the negative wealth effects from the decline in share prices and the consequential balance sheet adjustments in the financial and corporate sectors led to a significant contraction in private sector spending. The adjustment was reflected in reduced consumption and investment. The decline in consumption and export demand

Table 1.4
Private Consumption Indicators

	1997	1998				
		Q1	Q2	Q3	Q4	Year
Sales of passenger cars, including 4WD ('000 units)	314.4	23.1	29.1	38.9	51.1	142.2
MIER Consumer Sentiments Index (points)	–	88.5	79.1	80.0	80.5	–
Imports of consumption goods (US$ billion)	5.0	0.9	0.8	0.8	0.9	3.4
Total loans approved by banking system (RM million)						
• Personal use	7,414	600	417	499	554	2,070
• Consumer goods	1,520	44	24	21	10	99
Stock market indicators [1]						
• Market capitalisation (RM billion)	375.8	452.9	285.9	249.1	374.5	374.5
• KLSE composite index (points)	594.4	719.5	455.6	373.5	586.1	586.1
DOS Business Expectations Survey (RM billion)		1H		2H		
• Gross revenue	48.1	15.9		17.1		33.0
Wholesale	*41.3*	*13.9*		*14.9*		*28.8*
Retail	*6.8*	*2.0*		*2.2*		*4.2*

[1] End-period

Table 1.5
Private Investment Indicators

	1997	1998 Q1	1998 Q2	1998 Q3	1998 Q4	1998 Year
Sales of commercial vehicles, including 4WD ('000 units)	90.4	4.8	4.2	5.0	7.6	21.7
Imports of capital goods (US$ billion)	15.5	2.8	2.2	2.3	2.0	9.3
MIER Business Conditions Index (points)	–	41.0	42.3	41.8	44.7	–
(RM billion)						
Applications to MITI						
• No. of projects	849	191	165	171	202	729
• Total capital investment	34.2	4.7	6.7	3.1	4.5	19.0
Foreign	*14.4*	*2.7*	*4.2*	*2.1*	*3.6*	*12.7*
Local	*19.8*	*2.0*	*2.5*	*0.9*	*0.8*	*6.3*
Approvals by MITI						
• No. of projects	759	261	167	199	217	844
• Total capital investment	25.8	11.2	4.8	7.0	3.4	26.4
Foreign	*11.5*	*4.8*	*2.0*	*5.2*	*1.1*	*13.1*
Local	*14.3*	*6.4*	*2.8*	*1.8*	*2.3*	*13.3*
Total loans approved by the banking system						
• Manufacturing sector	27.6	2.0	2.2	2.6	3.7	10.5
• Construction sector	18.6	1.2	1.2	1.2	2.0	5.6

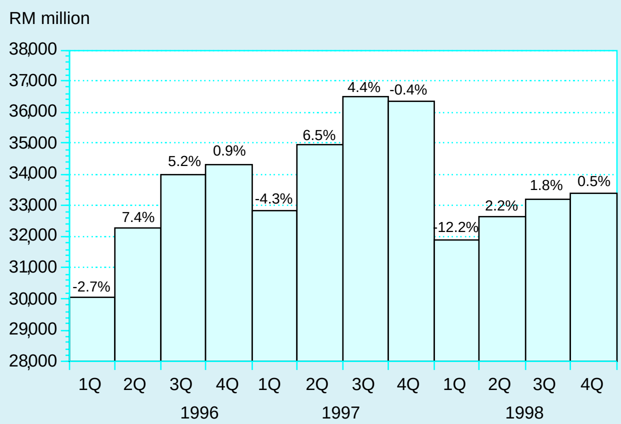
led to a build-up in stocks and excess capacity, depressing further private investment.

Following the imposition of selective exchange controls since September, monetary policy was eased further resulting in improved liquidity conditions and lower cost of funds. There was a revival in investor and consumer sentiment towards end-year. This improved sentiment was reflected in the Business Conditions Index of the Malaysian Institute of Economic Research (MIER), which indicated an increase in the index to 44.7 points in the fourth quarter from 41 points in the first quarter of 1998. In addition, other indicators such as the higher passenger car sales and loan approvals for personal use showed an improvement in domestic consumer sentiment. The Consumer Sentiments Index of MIER improved to 80.5 points in the fourth quarter from 79.1 points recorded in the second quarter of 1998. Reflecting mainly the sharp contraction in the first three quarters of 1998, private sector expenditure declined by 32.2% in real terms in 1998. The counter-cyclical policy adopted by the Government contained the decline in public spending to 6.6% in real terms.

On the **supply side**, the latest estimates showed that the annual decline in real GDP was most pronounced in the third quarter of 1998 (-9%). The decline in GDP moderated to 8.1% in the fourth quarter. However, on a preceding quarter basis, real GDP had begun to increase since the second quarter of 1998.

In 1998, activities in all sectors were affected, with the exception of the mining sector. The adjustment was most severe in the construction sector, followed by the manufacturing and agriculture sectors (decline in output of 24.5%, 10.2% and 4% respectively). The sharp contraction in the construction sector was due to completion of large projects, deferment of selected new infrastructure projects and the slow implementation of existing infrastructure projects as well as postponement of non-residential projects. Activity in the sector was sustained mainly by the less adverse developments in the residential sub-sector which recorded a smaller decline as Government policy continued to encourage the implementation of housing projects, especially low- and medium-cost housing. The lower output in the manufacturing sector was due to both weak domestic and external demand, particularly the decline in exports to the Asia-Pacific region, including Japan. The decline in

Graph 1.4
Quarterly GDP and Growth over Preceding Period



output was broad-based and affected both export- and domestic-oriented industries, with the exception of the rubber products industry. The decline in output of 4% in the agriculture sector reflected an across-the-board decline in the production of all major commodities. Output in this sector was affected by lower external demand that was aggravated by inclement weather, labour shortages, unfavourable prices, reduced cultivated area and lower yields. Reflecting the contraction of activities in the other major sectors, the performance of the services sector was sluggish, as evidenced by the decline in the wholesale and retail trade, hotel and restaurants sub-sector and a deceleration in the growth of the other services sub-sectors. Only output of the mining sector increased, mainly on account of higher crude oil production. Output of tin registered a positive growth in 1998 in response to the favourable price for the commodity, while gas production increased marginally.

On the positive side, the adjustment measures implemented succeeded in restoring the external balance and containing inflation. The current account in the **balance of payments** turned around to record the first surplus since 1989, amounting to RM36.1 billion or US$9.2 billion. In terms of GNP, the surplus amounted to 13.7% of GNP. The significant decline in investment, amidst an increase in savings, contributed to a large resource surplus in the balance of payments. The consolidation in private sector investment activity led to a 40.3% decline in imports of capital goods in United States dollar terms. With weak export demand, imports of intermediate goods also contracted, albeit at a lower rate of 21.3%. The increase in gross national savings (41.2% of GNP) reflected both higher income levels due mainly to gains arising from the weaker ringgit as well as the decline in consumer spending. Reflecting this trend, imports of consumption goods also registered a contraction of 32.7%. Developments on the export front in the fourth quarter were more encouraging. The decline in exports in United States dollar terms stabilised in September and increased thereafter.

The favourable balance of payments position and the stabilisation of short-term capital flows following the implementation of selective exchange controls led to a significant strengthening of the **external reserves** of BNM. The net international reserves increased from US$21.7 billion at the end of 1997 to US$26.2 billion at the end of 1998, adequate to finance 5.7 months of retained imports. External reserves increased further to US$28.7 billion as at the end of February 1999, adequate to finance 6.2 months of retained imports. At the same time, total **external debt** outstanding declined by 6.4% to RM159.8 billion at the end of 1998 (end-1997: RM170.8 billion). In United States dollar terms, external debt was equivalent to US$42 billion. Consequently, the ratio of external debt to GNP declined to 60.9% in 1998 from 65.4% in 1997. The decline in total external debt was due entirely to the decline in short-term external debt. Of significance, the ratios of short-term debt to total external debt and external reserves holdings were relatively low. The share of short-term external debt to total external debt declined from 25% at the end of 1997 to 18% at the end of 1998. This makes Malaysia less vulnerable to credit outflows over the short term. The nation's medium- and long-term external debt outstanding increased moderately by 3% to RM131.3 billion at the end of 1998, due largely to the drawdown of external loans of RM4 billion by the Federal Government. In the pre-crisis period, total external debt of the Federal Government had progressively declined to RM9.1 billion or US$3.6 billion (3.5% of GNP). This favourable position accorded greater flexibility to the Government to raise funds abroad to finance the stimulus package and strengthen the banking system.

Inflation, which trended higher towards the end of 1997 and in the first half of 1998 under the impact of the depreciation of the ringgit, declined progressively after June 1998. The sharper-than-expected contraction in aggregate demand and excess capacity in the economy reduced inflationary pressures arising from the decline in the ringgit. The rate of increase in the Consumer Price Index (CPI) moderated progressively to 5.3% in December 1998, after the year's peak of 6.2% in June. For 1998 as a whole, inflation rose by 5.3%, lower than the earlier expectations of 7–8%. Excluding food, the adjusted CPI rose more moderately by 3.1%. The fixing of the ringgit exchange rate against the United States dollar also reduced inflationary expectations.

On the **employment** front, the contraction in output led to a softening of the domestic labour market. The rate of unemployment is estimated to have increased to 3.9%, below the full employment level of 4%. During the year, 83,865 workers were retrenched. Nevertheless, the demand for labour remained strong in selected sub-sectors, with 74,610 vacancies reported throughout the country. Reflecting labour market flexibility, wage increases showed a moderating trend in 1998.

Macroeconomic policy management in 1998 focussed on reducing risks in the economy to ensure macroeconomic stability and promote a stronger financial system. The policies evolved at different stages of the economic crisis. Throughout the crisis period, the objectives of policy remained unchanged, namely to maintain price stability while avoiding a further contraction of the economy. However, as circumstances changed, policies had to be adjusted or modified to ensure objectives were realised.

Monetary policy was adjusted during the course of 1998. At the start of the year, the policy of monetary restraint was aimed at containing inflationary pressures arising from the ringgit depreciation as well as to preserve stability in the domestic financial markets. BNM believed that higher interest rates would not be effective in supporting ringgit exchange rates. The basic fundamental principle that was adopted in determining interest rates was to ensure that the expected real rate of return on ringgit deposits is not eroded and to ensure adequate return on ringgit assets to avoid capital outflows. The tight liquidity situation following the ringgit depreciation and the inefficiencies in the domestic financial markets were addressed by placement of RM34 billion by BNM into the banking system to reduce pressures on interest rates, which were kept relatively low in 1997. Interest rates were, however, raised to the highest level of 11% in February 1998 following the marked deterioration of the Indonesian rupiah by 45% and the depreciation of the ringgit to US$1=RM4.88 on 7 January 1998. Although interest rates were adjusted upwards in line with the increase in the expected rate of inflation during this period, consideration was also given to the need to ensure that the productive sectors of the economy had access to financing at reasonable cost and the need to maintain price stability and a stable exchange rate. Hence, interest rates in Malaysia remained significantly lower compared with levels in other countries in the region which were also affetced by the crisis. At the same time, BNM also reduced the SRR to lower funding costs for banks. This contributed to removing market distortions which had emerged during the flight to quality as depositors shifted funds to larger institutions. In order to offset the effects of higher lending rates on the more vulnerable segments of society, special funds were set up to enhance access to financing by selected sectors at concessional rates. In addition, measures to improve liquidity flows were implemented, including further reduction of the SRR and measures to make money market operations more transparent and to ensure efficient liquidity management.

Despite the injection of funds by BNM into the banking system, weaker business expectations and more cautious lending policies of the banking institutions led to a sharper-than-expected slowdown in loan growth. Thus, with banking institutions continuing to be preoccupied with managing their existing asset portfolios, total loans extended by the banking system generally declined since February 1998. The lack of access to credit by borrowers contributed to dampening the Malaysian economy further. Real output contracted by 2.8% in the first quarter and further by 6.8% in the second quarter. In the first half-year, real GDP contracted by 4.8%.

The adverse developments in the real and financial sectors led to the deterioration in the asset quality of the banking institutions. The lower stock prices and higher interest rates made it more difficult for companies to service loans. The non-performing loan ratio rose on the average by 1% a month. As at end-June 1998, the net non-performing loans (NPLs) to total loans ratio for the banking system had increased to 8.9% based on the 3-month classification from 4.7% as at 31 December 1997. The risk-weighted capital ratio (RWCR), however, remained high at 11.2% as at end-June 1998 from 12% as at end-June 1997. While the RWCR of the banking system as a whole remained well above the minimum Bank for International Settlements (BIS) requirement of 8%, some banking institutions required recapitalisation.

Given these adverse developments from the prolonged crisis and the sharper-than-anticipated contraction in the domestic economy, Malaysia adopted a comprehensive approach to avoid a deflation-recession spiral. Recognising the limited capacity of the private sector due to liquidity problems, it was decided in early 1998 that the public sector would bear the major burden of stabilising domestic demand. The successful fiscal consolidation since 1982, which was evident in the budget surpluses during the period 1993-97, gave greater flexibility to the Government to adopt an expansionary fiscal stance. In late July, the National Economic Action Council announced the National Economic Recovery Plan (NERP) to provide a comprehensive and action-oriented framework to expedite economic recovery. The six objectives of the NERP are interrelated and complementary, that is, stabilising the ringgit; restoring market confidence; maintaining financial stability; strengthening economic fundamentals; continuing the equity and socio-economic agenda; and restoring adversely affected sectors.

Fiscal policy was selectively relaxed beginning March 1998, following changing economic and financial conditions. At the time of the Budget 1998 (October 1997), the Federal Government targeted to maintain a fiscal surplus of 2.7% of GNP. This target was reduced to 0.5% in March 1998 and thereafter to a deficit of 3.7% of GNP. The fiscal deficit remained manageable, funded by non-inflationary finance, mainly domestic savings. The fiscal measures included selective increase in infrastructure spending, setting-up of funds to support small- and medium-sized enterprises, higher allocation on social sector development as well as reducing taxes. Additional expenditures have been carefully programmed to generate high multiplier effects, without rekindling inflationary pressures while preserving the improvement in the current account position of the balance of payments. Special funds were also established or expanded to provide credit to priority sectors at concessional rates.

With the moderation in inflation, monetary policy was eased in August to be consistent with fiscal policy in promoting new activities. The SRR and BNM 3-month intervention rate were reduced in stages. To encourage banking institutions to break from the self-imposed mentality of cutting back loans, banks which had the capacity to lend were encouraged to increase loan growth to at least 8%. Rules on recognition of NPLs were also adjusted to provide breathing room to both financial institutions and the corporate sector, without sacrificing financial prudence and supervision.

At the same time, BNM embarked on a comprehensive restructuring programme for the banking sector. The approach was to provide a mechanism to deal with the rising NPLs, the need for recapitalisation of certain banking institutions and corporate debt restructuring in a market-oriented and transparent manner. The approach was also pre-emptive because the institutional arrangement commenced as early as March 1998 before NPLs reached high levels. The institutional framework to restructure the banking institutions started as early as January 1998 with the **merger programme for finance companies** to consolidate the sector. The final outcome would be a reduction in the number of finance companies from 39 to less than half of this number. Subsequently, in June 1998, the Government set up **Pengurusan Danaharta Nasional Berhad (Danaharta)**, an asset management company, to purchase NPLs from the banking institutions. The objective was to enable the banking institutions to focus on loan intermediation to support economic activities. The banking system remained relatively resilient throughout the crisis. The existence of high prudential and supervisory standards prior to the crisis had placed the system on a strong foundation to cope with the stress from the crisis. However, while the industry as a whole remained resilient, certain banking institutions experienced capital loss. **Danamodal Nasional Berhad (Danamodal)**, a special purpose vehicle was set up as an interim funding vehicle which would meet the required capital injections of affected institutions.

In order to contain the growth in NPLs, it was essential to address financing problems of viable businesses which were affected by the crisis. In August, the **Corporate Debt Restructuring Committee (CDRC)** was set up to complement the restructuring of the financial institutions. The CDRC's main objective was to implement a comprehensive framework for debt restructuring through bringing together creditors and debtors for a voluntary debt workout. To co-ordinate the activities of the three agencies, a Steering Committee, chaired by the Governor of BNM, oversees and monitors the policies, operations, and progress of these agencies to ensure that they operate in a cohesive and structured manner to achieve the objectives. The financial corporate restructuring exercises in Malaysia are based on the following principles:

- Minimise the use of public funds;
- Transparency in the bank restructuring process as well as operating guidelines for the institutions established to undertake the restructuring process;

- Operations of institutions based on commercial and market-oriented principles;
- Recapitalisation of financial institutions must be tied to comprehensive restructuring of each financial institution including, where appropriate, a change in management; and
- Ensure equitable burden-sharing among stakeholders.

Despite the measures taken, uncertainty over international and regional developments remained. Instability in the ringgit exchange rates was further aggravated by outflows of ringgit to offshore ringgit markets. It was felt that ringgit exchange rates could only stabilise with a return of positive sentiment and confidence and economic recovery. The need to stabilise the ringgit exchange rates prompted the imposition of selective exchange controls on 1 September 1998. The controls were targeted at containing potential speculation against the ringgit by reducing the avenues for offshore markets to fund ringgit activities. Convertibility of the current account transactions was maintained, and inflows and outflows of long-term foreign investment remained free. On 2 September 1998, the ringgit exchange rate was also fixed at US$1=RM3.80. The exchange control measures are not intended to disrupt or dislocate genuine trade-related activities or foreign direct investment (FDI). The rules on FDI have not changed. Indeed, Malaysia had further liberalised the foreign equity investment guidelines in selected sectors in order to encourage the inflow of longer-term capital to further boost the foreign direct investment (FDI). The share of foreign equity investment had been raised to 49% in the telecommunications sector (61% for a period of 5 years on a case-by-case basis); 51% in the insurance sector (subject to certain conditions) and 49% in the stock broking industry. In the manufacturing sector, 100% foreign ownership was allowed for applications received between 31 July 1998 and 31 December 2000.

While the exchange control measures did not act as a constraint, long-term investors, however, remained cautious due mainly to the uncertain global environment. While the value of manufacturing investment approved by the Ministry of International Trade and Industry (MITI) increased to RM26.4 billion in 1998 (RM25.8 billion in 1997), the value of applications received by MITI for the establishment of manufacturing projects was lower amounting to RM19 billion (RM34.2 billion in 1997).

Overall, Malaysia ended the year on a positive note, with the underlying economic conditions generally favourable. Price pressures had abated, with CPI stabilising at 5.3% for 1998, lower than the earlier projection of 7–8%. The economy had shown signs of recovery, although real GDP in the second half-year, on a year-on-year basis, continued to contract due to the high base in 1997. Of significance, exports in key sectors, including electronics, had improved in United States dollar terms. The external reserves of BNM had not only remained intact and unencumbered, but had also continued to rise by US$8.5 billion from US$20.2 billion at end-August to US$28.7 billion at end-February 1999, adequate to finance 6.2 months of retained imports. On the employment front, the situation is improving, with the number of employees retrenched declining to 5,556 in December, from a peak of 12,335 in July. The number of registered job seekers is on a declining trend (33,345 as at end-1998; 34,514 as at end-July 1998).

The fixed exchange rate had been positive for economic activity. Lending rates had declined to below pre-crisis levels, and loan approvals have begun to increase. The value of loans approved by the banking system has picked up to a monthly average of RM7.1 billion in September-December, compared with an average of RM4.2 billion in the first eight months of 1998. On an annual basis, loans extended by the commercial banks rose by 3.3% as at end-December 1998. This increase was, however, more than offset by the decline in loans extended by the finance companies (–15%) and the merchant banks (–3.7%). The decline in loans extended by the finance companies was to some extent due to the ongoing merger programme and restructuring exercise that affected their lending operations. With the inclusion of NPLs sold to Danaharta, outstanding loans in the banking system would have increased by 1.3% on an annual basis.

The progress on bank restructuring had been on track. Danaharta had acquired and managed NPLs from the banking institutions amounting to RM15.1 billion, equivalent to about 20% of total NPLs of the banking system. Including NPLs

Box I

The Asian Crisis: A Survey of Views on the Causes and Policy Response

Introduction

The East Asian crisis that began in July 1997 was unprecedented in terms of the speed and severity of the contagion effect which spread to countries spanning three continents. At its initial stage, the crisis was perceived as an isolated problem affecting individual countries. However, as the crisis deepened and widened, an international consensus emerged that external factors also contributed to the crisis. This article summarises the evolving views on the roots of the Asian crisis and the corresponding policy responses. It concludes that both domestic and international factors contributed to the crisis and that the appropriate response would be needed to address weaknesses on both fronts.

Why is the Asian Crisis Different from Previous Crises?

The Asian crisis occurred following a decade of strong economic performance in all crisis-affected countries. To varying degrees across countries, the crisis resulted in a significant wealth loss, declines in asset prices, sudden capital flight and threats to currency and banking system stability. Adverse consequences were reflected in corporate problems, rising non-performing loans in the banking institutions, declining output, rising unemployment and deflation.

Unlike previous crises such as the global debt crisis in the 1980s, which originated mainly from the public sector, the source of instability in the Asian countries emanated mainly from the private sector. Conditions prevailing in the Asian crisis countries prior to June 1997 showed that these countries had strong fundamentals — price stability, high saving and investment ratios, fiscal surplus and high foreign exchange reserves. Capital inflows financed investment rather than consumption. However, there were some similarities between the Asian and Mexican crises in terms of large short-term capital inflows, large current account deficits, and nominal and real exchange rate appreciation. In the case of the Asian countries, the general consensus is that the "trigger" for the crisis was the rapid accumulation of private short-term foreign debt.

Causes of the Asian Crisis

The depth and severity of the contagion of the Asian crisis have created considerable debate on the cause of the crisis and the appropriateness of policy responses. The different views on the causes of the Asian crisis can be broadly categorised into two groups. The first view attributes the crisis primarily to policy weaknesses in the domestic economy, while the second view maintains that external factors were responsible for the crisis.

Among the proponents of the view that the crisis reflected domestic policy weaknesses was the **International Monetary Fund (IMF)**. While accepting that fiscal balances were generally favourable in the crisis-affected economies, the IMF had raised concerns on overheating pressures that became evident in many countries in the region that was manifested by large current account deficits and property and stock market bubbles. The IMF further suggested that the crisis stemmed from weaknesses in domestic financial systems and governance in these countries. According to this view, a combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates led banks and corporations to borrow large amounts of international capital. Much of the borrowing was short-term, denominated in foreign currency, and unhedged. Sluggish growth in the advanced economies, in particular Europe and Japan, made investments in fast-growing Asian countries relatively attractive and thus led to the build-up of foreign capital inflows. Over time, it was argued that these inflows tended to be used to finance poorer-quality investments. It was further suggested that this was exacerbated by governance issues, notably government involvement in the private sector and lack of transparency in corporate and fiscal accounting and the provision of financial and economic data. As the crises unfolded, the questions that were raised about the authorities' commitment and ability to implement the necessary adjustment and reforms also exacerbated pressures on currencies and stock markets.

The **World Bank** shared this view that the key problems were in the financial sector, where distorted incentives, weak regulatory standards, poorly managed financial liberalisation, and inadequate disclosure and supervision encouraged excessive risk taking. It was argued that these financial sector weaknesses led to poor investments and a proliferation of non-performing loans. Large capital inflows amplified these problems and fuelled domestic demand which, coupled with the depreciation of the yen against the dollar, caused real exchange rates to appreciate. When the crisis broke out, the currency depreciation increased the local currency value of the external debts owed by banks and businesses, creating solvency problems. As debts mounted, the firms attempted to reduce their foreign exchange liabilities by obtaining dollars to close out open positions. This further increased the demand for foreign exchange, thus leading to even greater depreciation of the domestic currency. The crisis also resulted in immense human suffering due to lack of social safety nets in crisis-affected countries as they had relied on rapid growth and employment to provide social security to their people.

Among the academia, **Professor Paul Krugman** of the Massachusetts Institute of Technology (MIT) attributed the crisis to macroeconomic policy slippages and weaknesses in financial systems in the affected countries. He suggested that the crisis originated from financial intermediaries whose liabilities were perceived as having an implicit government guarantee, but were essentially unregulated and, therefore, subjected to severe moral hazard problem. This resulted in financial excesses, over-investment, unrealistic speculation, particularly in real estate, and inefficient resource allocation to politically connected individuals, all of which inflated asset prices. Imprudent public spending also contributed to the build-up to the crisis, following several years of rapid growth. This view emphasises the reaction of currency and equity markets to payments disequilibrium and weak economic fundamentals, which include large current account deficit and external debt.

According to **Professor Rudi Dornbusch** of MIT, the Asian 'capital market crisis' reflected the varying degrees of exposure of Asian countries to external capital or financial instruments, which rendered the economies vulnerable to various developments. These vulnerabilities arose from a mismatch of maturities and currency denominations of assets and liabilities of financial systems and large corporations in the Asian countries. Another source of vulnerability was market risk where external funds were borrowed to purchase foreign stocks and commodities whose value fluctuated with the movements in the exchange rates. Since the banks and companies had collectively assumed a large risk position, the national credit standing was also at risk. The build-up of these vulnerabilities was the result of fragile financial structures arising from negligent or deliberate lack of regulation, supervision and transparency. External factors did play a role in the run up to the crisis, namely the performance of the Japanese economy which adversely affected the trade environment of the Asian economies. The other factor was the sharp fluctuation of yen/dollar exchange rate.

In contrast to the earlier views that blamed the crisis mainly on domestic economic conditions and policies in the Asian countries, an alternative view pointed to weaknesses in the international financial system. The main proponent of this view has been **Professor Jeffrey Sachs** of Harvard University, who noted that economic fundamentals in the crisis-affected countries were basically sound. The crisis was seen as a classic case of financial panic with capital flight aggravated by the mismatch of maturities and currencies of many Asian banks and borrowers. This view noted that the financial system in the affected countries was not adequately prepared to deal with the risks of rapid financial liberalisation, which rendered the countries vulnerable to external shocks. The problem was compounded by weaknesses in the international financial system. Such weaknesses permitted massive and volatile cross-border capital flows that often overwhelmed the relatively small size of financial markets in emerging economies.

Professor Jagdish Bhagwati of Columbia University has written that the Asian crisis was due partly to rapid financial liberalisation in the crisis countries, without the adequate policy and institutional framework. He voiced concern that while the benefits of free capital movements had frequently been propagated, its costs were often underestimated, including that of an outbreak of systemic crisis. The arguments in favour of free trade do not necessarily apply to capital movements. Unlike trade, failures in capital markets can be severe because of lack of information and the problem of mismatch of assets and liabilities.

In a recent speech, **Mr. Joseph Yam**, Chief Executive of the Hong Kong Monetary Authority, maintained that the crisis reflected the flaws in the global financial system. He noted that financial market liberalisation and globalisation, advancements in information technology and the increasing sophistication of investment tools have outpaced improvements in the management of the global financial system, which remained primitive and fragmented and rendered the international financial architecture incapable of coping with the demands of global finance. The essence of the problem was the operations of the highly leveraged institutions, which could move vast amounts of funds around the world rapidly and with little or no regulation. He maintained that, by distorting or manipulating markets in search of profits, the highly leveraged institutions were "capable of throwing many smaller, vulnerable economies into chaos".

Malaysia has been among the first countries to voice the view that the Asian crisis reflected shortfalls in the management of the international financial system. During the Joint Annual Meetings of the IMF and World Bank in September 1997, the Prime Minister, **Dato' Seri Dr. Mahathir Mohamad**, highlighted the dangers of volatile flows of speculative, short-term capital in disrupting trade and real economic activities. Large market players had been able to manipulate the financial markets to their advantage, to the detriment of the economic well-being of many economies. Furthermore, trade in currency, which had become so much bigger than real trade in goods and services, only contributes to huge uncertainties and volatile currency movements so as to cause financial crisis for the country concerned. As such, he had called for an international mechanism to regulate short-term capital flows. Despite the initial differences in views, there is now a growing consensus that the Asian crisis also reflected flaws in the international financial architecture.

Policy Response

At the initial stage of the Asian crisis, the predominant view of the international community was that the crisis was an isolated case of policy weaknesses in individual countries. Hence, the international response focused on efforts to encourage the crisis-afflicted countries to implement economic and financial reforms, increase transparency of government policies and undertake macroeconomic adjustments and measures to strengthen domestic economic and financial systems.

Thailand, Indonesia and Korea initially instituted measures to address their respective economic weaknesses and to stem speculative attacks on their currencies. These countries subsequently sought financial assistance from the **IMF**. In line with IMF programmes, conditionalities of tight monetary and fiscal policies, and structural reforms were imposed, particularly in the financial sector. The rationale was as follows: tight monetary policy was needed to restore confidence and contain inflation. Higher interest rates were viewed as necessary to support domestic currencies. Fiscal tightening was needed to correct macroeconomic imbalances and to make up for the cost of cleaning up the financial sector. Rapid structural reform was needed to address financial sector weaknesses, imbalances in corporate finances, improve governance, and market imperfections. Trade and financial liberalisation were also included in the programmes to attract foreign capital.

In all three countries, fiscal and monetary policies were tightened significantly from the inception of IMF programmes. Financial sector restructuring was initiated. The intensity and implementation of the reforms varied to reflect the different institutional framework and machinery in each country. Non-viable financial institutions were closed and legal and institutional frameworks were established for the disposal of assets, as well as bankruptcy and foreclosure procedures. The remaining viable financial institutions were recapitalised, either through domestic or foreign capital, or a combination of both. Labour market reform was also carried out. In some countries, structural reforms also included the dismantling of monopolies and abolition of subsidies which were subsequently reinstated, following social unrest.

The IMF programmes instituted in the three Asian countries were fairly similar to the Mexican programme in 1995. In the case of Mexico, apart from tight monetary and fiscal policies, adoption of a floating exchange rate, and advances in structural reform and market liberalisation, the Mexican government also implemented measures to avoid contagion. These measures included provision of liquidity in foreign exchange by the central bank to commercial banks to prevent them from becoming delinquent on their foreign obligations. Also included were the activation of a programme to provide temporary capital to banks and a subsequent programme to increase the incentives for investment in distressed banks, legal reforms to allow greater foreign equity participation in banks and programmes to back certain categories of bank debtors.

The difference though was in the timing of efforts to address the external debt problems. In the case of Mexico, negotiations with foreign creditors for debt restructuring purposes were initiated soon after the inception of the programme. In the case of the three Asian countries, debt restructuring came later in the programmes. In Mexico, there were fiscal imbalances, with very high public sector's short-term external liabilities. This was not the case in Asia. Thus, the cutback in public expenditure and fiscal consolidation, in addition to higher interest rates, exacerbated the economic downturn. As the domestic currencies continued to depreciate, the liquidity problems of the financial systems and corporate sectors worsened, because the depreciated currencies translated into rising debt denominated in domestic currencies. The problem was only resolved when the affected countries started negotiations for a rollover of short-term credit for a period of three months until end-March 1998 and to further convert them into medium-term bonds. In the case of Indonesia, other factors caused delays in assistance and the implementation of IMF programmes.

There has been significant debate on the IMF policy response. The **World Bank** has suggested that the IMF's prescription of high interest rates and fiscal restraint has contributed to the recessionary forces. **Jeffrey Sachs** argued that the rescue package by the IMF should have delivered more financial assistance and less conditionalities. Meanwhile, **Martin Feldstein** from Harvard University suggested that the demands by IMF for far-reaching structural reforms to resolve Asia's liquidity crisis were unnecessary and counter-productive. **Paul Krugman** provided an alternative to the crisis countries by advocating capital control, with certain preconditions. The imposition of exchange controls should complement, not replace economic and financial reforms and that the controls should not be used to defend an over-valued currency. Since it imposed distortions on the economy, it should not be maintained any longer than necessary, with a clear exit policy.

Contagion Dynamics

Contagion during the Mexican crisis was limited to a few countries in Latin America. In contrast, contagion was widespread in the case of the Asian crisis. An attack on one currency spilled over or spread to the currencies of other countries with apparently sound fundamentals. This could be attributed to trade and capital market linkages (through a devaluation in one country which adversely affected the international competitiveness of other countries) or interdependence in the creditors' portfolios (where illiquidity in one market forces financial intermediaries to liquidate assets in other markets).

The Asian crisis, which was initially confined to East Asia, spread to other regions by the end of 1997. This reflected market concern over the emergence of vulnerabilities in these regions similar to those seen earlier in Asia. In contrast to the Mexican crisis, the international setting prior to the outbreak of the Asian crisis was characterised by declines in non-oil commodity prices in 1996. The Asian crisis, which reduced aggregate demand in Asia, aggravated this downturn and partly led to the decline in oil prices. This weakened the balance of payments and partly, the fiscal position of commodity-exporting countries. On the other hand, currency depreciation in Asia gave rise to market concerns over external competitiveness, particularly in Latin America. In the case of Russia, both the fiscal and external debt positions were unsustainable. The devaluation of the ruble to significant investor pessimism over investments in emerging markets, and this adversely affected market sentiment over Brazil's fiscal position and therefore, its exchange rate arrangement.

Another factor that led to the contagion was the herd behaviour among investors when investors generalised the risks and grouped the Asian countries as having a common set of vulnerabilities despite the fact that these countries had different economic and financial structures. It became self-fulfilling of market expectations due to the impact of massive reversal in capital flows on the affected economies. The forces that allowed for this to occur included the advances in telecommunication and information technology, financial liberalisation, and the development of complex and innovative financial products.

In the Asian crisis, currency speculation by international investors proved more damaging because the amounts involved were very large. Less orthodox responses were implemented to protect the economies and avoid further economic contraction. In August 1998, Hong Kong Special Administrative Region (SAR), The People's Republic of China took action against market manipulation by currency traders by instituting general measures to counter speculative attacks on its currency and stock markets. The Hong Kong government also made substantial purchases in its stock and futures exchanges in an unexpected move to defend its financial system against concerted speculative attacks.

In the case of Malaysia, the authorities had initially focused on conventional macroeconomic measures to address the crisis. However, as conditions in the regional and global financial markets worsened, and speculative pressures against the Malaysian ringgit continued to build up, Malaysia implemented, in September 1998, measures to curb the internationalisation of the Malaysian ringgit and discourage destabilising short-term capital inflows. The measures sought to protect the domestic economy from potentially damaging external shocks in order to provide a stable environment to facilitate ongoing economic and financial adjustments. The measures were subsequently modified in February 1999 (see Box III).

Towards a New International Financial Architecture

As the crisis became more prolonged and severe than anticipated, there was a growing international recognition that remedial actions were needed at the international level as well. It was noted that several external factors, namely, imprudent foreign investor behaviour, herding behaviour and speculative activity, played a major role in aggravating the crisis. These developments highlighted weaknesses in the international financial system, notably the lack of an appropriate framework to ensure orderly global financial markets. One of the elements of the Basle capital-adequacy standard, for example, is that short-term lending requires less provisioning than long-term loans. This has encouraged international banks to indulge in the practice of lending short-term because such loans carried a lower risk-weighting.

Proposals for reforms of the international financial architecture have been discussed at various fora, including the IMF, Bank for International Settlements (BIS), the Willard Group or Group of 22, Association of South-East Asian Nations (ASEAN), the Group of Seven (G-7), Group of Fifteen, Group of 24 and Asia-Pacific Economic Co-operation (APEC). The clearest sign of the international recognition of the global nature of the Asian crisis came in October 1998, when the G-7 endorsed several G-22 proposals on reforms in the international financial system. These included a recognition of the need to examine the implications of the operations of highly leveraged and offshore institutions, with a view to encouraging offshore centres to comply with internationally agreed standards. The G-7 also emphasised the need to review and strengthen the role of the IMF, the World Bank, and other international financial institutions in crisis prevention and resolution.

It is recognised that the reform of the international financial system should, at least, include a number of important elements. First, there is a need for a more balanced approach to the issue of transparency and disclosure by not only the public but also the private sector. Second, there needs to be surveillance of capital flows, in particular short-term flows to ensure the orderly functioning of the international financial markets and that the destructive volatility of international capital flows can be prevented. Measures would be necessary to address the issue of cross-border manipulative activities in financial markets and the need for appropriate international prudential standards in financial institutions, especially on exposure of commercial banks to the highly leveraged financial institutions. Third, a mechanism is needed to ensure that international rating agencies are made more accountable for their actions, given the implication of their actions on financial markets. Lastly, a framework for the orderly liberalisation of the capital account with appropriate criteria to serve as guideposts for countries is needed.

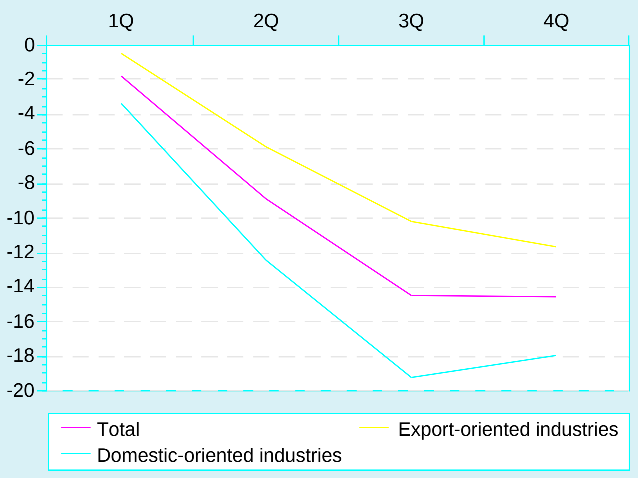
Notwithstanding the international recognition of the need for a global solution to the Asian crisis, progress in terms of building a consensus on concrete measures and initiatives to implement the proposed reform in the international financial system remain slow. In this connection, while moves on arrangements to reform the international financial system have been confined to the G-7 and multilateral institutions, developing and emerging market economies have been drawn in to participate at G-7 initiated forums to present their views. To be effective, discussions on the reform of the international financial architecture need to include the advanced and developing countries given the bond arising from the globalisation process.

Conclusion

There is a growing literature on the causes and consequences of the Asian crisis. As the crisis unfolded and its contagion spread, perceptions of the crisis have changed, from being a localised to a regional and international problem. While it is recognised that individual countries must implement economic and financial reforms to put their houses in order, there is also a realisation that such efforts would not be sufficient. As a result, the search for solutions has focused increasingly on reforms to the international financial architecture to ensure that globalisation and financial liberalisation proceed in an orderly manner. In particular, there are growing concerns on the need to manage capital flows and prevent manipulation of currencies. In this regard, appropriate safeguards and mechanisms need to be in place in order to maximise the benefits of globalisation while mitigating the potential destabilising effects of volatile short-term capital flows.

acquired from other financial institutions, the total NPLs acquired and managed amounted to RM21.7 billion. Danamodal had injected RM6.15 billion in the form of Exchange Subordinated Capital loans into ten institutions. CDRC had received 48 applications for assistance with debt restructuring. Total debt of the companies amounted to RM22.7 billion. A total of 26 creditor committees have already been formed and two debt restructuring schemes have been implemented. CDRC had also recently announced the debt restructuring proposal for one of the largest conglomerate, involving RM8.4 billion, without any need for Government financial assistance. This is consistent with the Government's policies where private sector solutions are applied for problems faced by Malaysian companies.

Graph:1.5
Manufacturing Production: Quarterly Annual Growth 1998



Overall, there are indications that the trough in the growth cycle had been reached in the third quarter of 1998. Greater stability in terms of the foreign exchange and stock markets and the financial system has encouraged a steady revival in consumer and investor confidence. Macroeconomic policies had been geared to ensuring that the non-inflationary expansion of output and employment would be maintained over the medium term.

Sectoral Review

Manufacturing

The manufacturing sector was affected by the slowdown in the Asia-Pacific region as well as in the domestic economy in 1998. Output of the manufacturing sector contracted by 10.2% during the year, the first decline since 1985. The decline was broad-based with almost all industries recording lower production levels although the declines were more pronounced in industries producing construction-related materials and transport equipment. The impact of the regional financial crisis was less severe in the first quarter as the manufacturing sector contracted by only 1.8%. However, the effects of the crisis became evident in the second quarter when production fell by 8.9%. The situation worsened in the third and fourth quarters when the sector contracted sharply by 14.5% and 14.7% respectively. Owing to the severe contraction in domestic demand, output of the domestic-oriented industries declined sharply by 13.4% in 1998. Export-oriented industries also recorded a decline in production, albeit at a less rapid pace of 7.3%, reflecting mainly the economic downturn in the Asia-Pacific region, which accounted for 40% of Malaysia's manufactured exports.

Production of **electrical machinery, apparatus, appliances and supplies** as a group shrank by 7.7% in 1998, attributable to weak demand from the Asia-Pacific region as well as a depressed global market for semiconductors. During the year, the global semiconductor market experienced another year of decline as the excess supply of memory chips continued to persist. The resultant sharp decline in prices prompted some major world producers to halt or cut back their production of DRAM chips, contributing to some price stability, particularly towards the end of the year. Some manufacturers in Malaysia had also taken a similar action as the product was no longer profitable. Consequently, the output performance of the electronics industry deteriorated from an increase of 3.1% in the first quarter to a decline of 11.3% in the third quarter. Nevertheless, the performance of the industry improved in the fourth quarter to record a more moderate decline of 6%, boosted mainly by the revival in the disk-drive sub-sector as well as higher sales of personal computers. Demand for disk-drives started to pick up towards the end of the year in line with the depletion of inventories. The recovery was facilitated by the need to upgrade facilities in preparation for the Y2K problem.

In the face of the regional economic slowdown, the performance of the electrical appliances sub-sector continued to deteriorate. As external demand started to dwindle, a number of companies resorted to shorter working days or reducing the number of shifts, resulting in a more severe contraction in output from 1.5% in the first quarter to 26.1% in the fourth quarter. The decline reflected mainly sharply lower production of air-conditioners and cables and wires.

Production of textiles declined by 8.8% in 1998 due to sluggish demand from the Asia-Pacific countries. In particular, the natural fibre spinning and weaving activities fell sharply due to cutbacks in production in response to the rising cost of imported cotton. The decline, however, was offset in part by an increase of 1.1% in the wearing apparel sub-sector, supported mainly by higher demand from the United States and Europe. On balance, the **textiles and wearing apparel industry** as a group contracted by 5.3% in 1998.

Table 1.6
Growth in Manufacturing Production (1993=100)

	1996	1997	1998
	Annual change (%)		
Export-oriented Industry	**8.2**	**10.3**	**–7.3**
Electrical machinery, apparatus, appliances and supplies	8.8	13.6	–7.7
Radio and television sets	*6.0*	*–7.2*	*3.9*
Semiconductors	*12.6*	*22.8*	*–4.2*
Cables and wires	*12.6*	*10.4*	*–29.4*
Manuf. of office, computing and accounting machinery	*–2.3*	*9.1*	*–4.5*
Manuf. of refrigerating, exhaust, ventilating and air-conditioning machinery	*–5.0*	*–0.7*	*–48.5*
(Electronics)	(12.6)	(22.8)	(–4.2)
(Electrical)	(3.2)	(–1.7)	(–14.8)
Textiles and wearing apparel	0.0	5.3	–5.3
Wood and wood products	11.4	–1.6	–11.3
Off-estate processing	10.2	9.8	–2.7
Domestic-oriented Industry	**16.9**	**14.6**	**–13.4**
Chemicals and chemical products	19.5	24.5	–1.8
Construction-related products	21.1	11.3	–27.6
Non-metallic mineral products	*24.5*	*10.1*	*–26.5*
Basic iron & steel and non-ferrous metal	*17.1*	*13.1*	*–29.1*
Transport equipment	22.3	14.3	–52.2
Food products	4.4	3.8	–2.1
Beverages	15.6	–0.2	–11.9
Tobacco products	7.4	19.9	–9.1
Rubber products	11.1	3.4	7.8
Petroleum products	12.7	8.9	–11.5
Fabricated metal products	23.1	11.9	–17.2
Paper products	–4.9	13.0	–8.7
Total	**12.3**	**12.4**	**–10.2**

Source: Department of Statistics

Lower demand from Japan and The People's Republic of China, coupled with the downturn in domestic construction activities and weak demand for furniture led to a sharp contraction of 11.3% in the **wood and wood products industry.** The lower output was attributed mainly to a sharp decline in the plywood, hardboard and particle board sub-sector, which mainly catered for the export market. However, the decline was offset partly by higher production in the sawn timber sub-sector.

Production in the **off-estate processing industry** was affected by insufficient supply of raw materials and higher crude palm oil prices. Following an increase of 1.4% in the first quarter, output contracted sharply by 10.4% in the second quarter as production of crude palm oil fell markedly. With a slower decline in crude palm oil production in the second half-year, output of the off-estate processing industry improved to record a marginal decline of 0.8% in the second half of 1998 (–5% in the first half of 1998). For the year as a whole, output declined by 2.7%.

Growth in the domestic-oriented industries was affected by the slowdown in the domestic economy. However, due to the lag effect, the impact was less severe in the first quarter as output of the domestic-oriented industries declined only moderately by 3.4%. As the economic situation deteriorated, output declined further by 12.4% and 19.2% in the second and third quarters respectively. The decline moderated to 17.9% in the fourth quarter as domestic demand improved following the implementation of several measures to stimulate the economy. For the year as a whole, output declined by 13.4%.

Reflecting the sharp downturn in construction activities, output of the **construction-related products industries** contracted sharply by 22.4% in the first half of 1998, followed by a sharper decline of 34.6% in the third quarter and a more moderate decline of 30.6% in the final quarter. For the year as a whole, the output of this group of industries declined by 27.6%. The postponement of several large projects, including the development of higher cost residential houses, caused demand for non-metallic mineral products and iron and steel to fall sharply, particularly in the third quarter. Consequently, these industries were faced with excess capacity and inventories. The situation was aggravated by the expansion programmes undertaken by companies before the onset of the financial crisis in mid-1997.

The **fabricated metal products industry** was not severely affected by the economic slowdown in the first half of 1998 as its output declined by only 5.1%. However, in the face of the sharp downturn in the construction sector, output contracted sharply by 29.3% in the second half of 1998. For the year as a whole, the industry recorded an output decline of 17.2%. The lower output level reflected mainly the decline in the production of structural metal products attributable to slack demand from the heavy and light engineering sub-sector, especially in the construction sector. Output of other sub-sectors, namely, tin and metal boxes, wire and wire products and brass, copper and aluminium also declined due to poor domestic demand.

Despite the economic slowdown, output of the **chemicals and chemical products industry** continued to record an impressive growth of 8.3% in the first quarter of 1998, supported mainly by the expansion in the plastic products, fertilisers and pesticides and soap and cleaning products sub-sectors. As experienced by other industries, output of this industry also declined in the last three quarters, albeit at a relatively low rate of 4.9%. The decline was attributable mainly to lower production of industrial gases (mainly LNG) arising from lower demand from Japan and Korea. In addition, production in the paints, varnishes and lacquers sub-sector also declined due to the downturn in the construction sector. For the year as a whole, the chemicals and chemical products industry declined marginally by 1.8%.

Table 1.7
Manufacturing Production: Selected Indicators

	1998	1997	1998
	Output	Annual change (%)	
Integrated circuits (million units)	11,652	28.6	–7.3
Semiconductors (million units)	8,950	41.9	20.4
Television sets ('000 units)	8,057	–12.7	3.6
Room air-conditioners ('000 units)	1,284	–28.8	–39.3
Household refrigerators ('000 units)	206	–3.1	–17.3
Vehicles assembled ('000 units)	418	22.0	–52.6
Passenger cars	*149*	*15.7*	*–58.8*
Commercial vehicles	*20*	*20.3*	*–78.9*
Motorcycles & scooters	*249*	*28.5*	*–41.3*
Pneumatic tyres ('000 units)	13,567	12.2	–1.1
Rubber gloves (million pairs)	10,588	4.8	–18.8
Plywood ('000 cu.metre)	3,660	1.5	–18.9
Veneer sheets ('000 cu.metre)	1,156	–4.3	–8.6
Liquefied petroleum gas ('000 tonnes)	1,271	–2.9	–6.1
Kerosene & gasoline ('000 tonnes)	2,184	3.1	–2.6
Diesel and gas oil ('000 tonnes)	5,974	7.4	–12.0
Fuel oil ('000 tonnes)	2,390	12.8	–24.2
Cement ('000 tonnes)	10,495	2.6	–17.2
Iron and steel bars and rods ('000 tonnes)	1,892	11.4	–43.9

Source: Department of Statistics

As output of the manufacturing sector weakened, especially in the electronics and electrical products industry, output of the **paper products industry** also declined by 13.2% in the last three quarters of the year (+6% in the first quarter). The decline was attributed to lower production of containers and boxes of paper and paperboard, which were used for packaging purposes. In addition, output of the paper and pulp products sub-sector also declined due to sluggish domestic demand.

The **transport equipment industry** was severely affected by the economic downturn, with output contracting by 52.2% as the demand for motor vehicles declined sharply. Sales of motor vehicles fell from a high of 41,591 units in October 1997 to a low of 6,872 units in February 1998. The decline was caused mainly by increased cost of financing due to tight liquidity as well as difficulties faced by finance companies in sourcing deposits. Subsequently, with the easing of hire purchase criteria since April 1998, reduction in interest rates and promotion activities conducted by car distributors, sales started to increase gradually to reach 23,058 units in December. Overall, output of the transport equipment industry sub-sectors, namely assembly of motor vehicles, motor vehicle parts and accessories and assembly of motor cycles and scooters contracted by 59.5%, 40.1% and 42.1% respectively.

Spurred by strong external demand from the United States and Europe for rubber gloves, output of the **rubber products industry** recorded a strong growth of 7.8% in 1998, representing the only industry that continued to record a positive growth during the economic downturn. The demand for latex-based examination and surgical gloves was particularly strong for the high quality Malaysian gloves that met stringent international standards. In addition, sales were boosted further by competitive pricing of Malaysian products due to the depreciation of the ringgit. Nevertheless, the strong increase was offset in part by the decline in the output of the tyres and tube industry caused by the sharp decline in car sales. Despite its encouraging growth, the rubber products industry continued to face competition from Thailand.

With the slowdown in the car industry, the demand for **petroleum products** also declined, particularly in the last three quarters (at an average of –13.3%; –5.5% in the first quarter). For the year as a whole, the industry recorded an output decline of 11.5%. The decline reflected lower production by the crude oil refineries as well as lower output of other petroleum products, such as lubricating oil for motor vehicles and premixed asphalt for road construction purposes.

In tandem with the slowdown in domestic demand, output of the **food, beverages and tobacco products industries** as a group was also affected, particularly in the second half of 1998 when its output fell by 9.8% from a marginal increase of 0.4% in the first half of 1998. The decline was broad-based, affecting almost all sub-sectors.

Construction

In 1998, the construction sector experienced a contraction in output due mainly to lower aggregate demand. Value added of the sector declined by 24.5% in 1998, compared with a growth of 9.5% in 1997. To a large extent, the sharp adjustment reflected the strong growth of the sector in recent years. Following the sharp contraction in demand for high end residential and commercial properties during the course of 1998, the value and volume of property transactions fell by 47.6% and 32.3% respectively by the end of the year. The decline of the sector was generally broad-based, affecting the residential, non-residential and civil engineering sub-sectors. However, sustained demand for medium- and low-cost residential properties mitigated the contraction of the sector. The adjustment was more severe in civil engineering due to the completion of large projects and the deferment of new projects. Construction activity was also affected by a stock overhang, particularly of non-residential and high-end condominium properties as a result of the completion of several large projects in the previous few years. Towards the latter part of 1998, several measures were introduced to stimulate residential construction activity in order to moderate the over-adjustment of this sector to the financial crisis.

Table 1.8
Supply of Office Space and Condominiums in the Klang Valley

	Office space		Condominiums		
	No. of projects	Area in sq. metres	No. of projects	No. of units	Area in sq. metres
1983	11	159,840	5	782	81,698
1984	12	342,899	4	561	60,065
1985	28	747,757	9	1,240	204,638
1986	11	304,780	2	460	70,857
1987	10	244,069	6	1,143	175,975
1988	4	43,255	4	936	95,771
1989	2	45,628	4	682	64,248
1990	0	0	8	1,221	139,386
1991	6	57,470	13	2,576	266,252
1992	7	95,296	21	3,346	380,897
1993	12	232,693	26	5,013	565,439
1994	15	350,951	40	8,507	973,202
1995	20	451,119	52	14,241	1,576,297
1996	16	321,629	35	8,342	1,022,444
1997	21	639,375	25	7,530	864,057
1998	29	909,219	45	14,151	1,645,172
1999*e*	19	639,673	28	9,215	967,751
Total	**223**	**5,585,653**	**327**	**79,946**	**9,154,149**

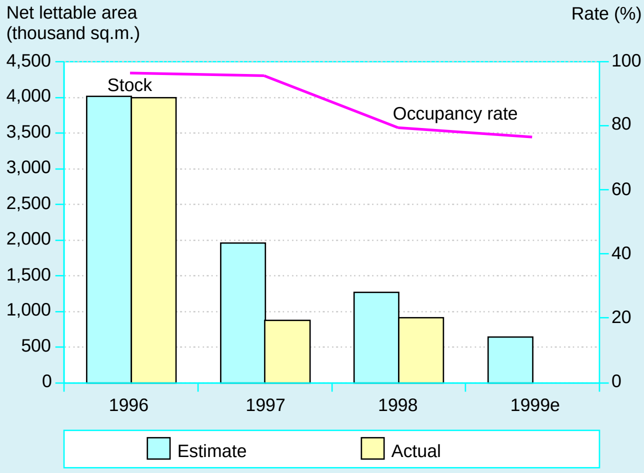
e Estimate

Source: Survey by Bank Negara Malaysia, Valuation and Property Services Department

In the **civil engineering sub-sector**, growth was affected by the deferment of infrastructure projects totalling RM65.6 billion as announced in the 1998 Budget as well as completion of projects associated with the KLIA and the Commonwealth Games Village. The impact became more severe in the second half of 1998 as more projects were deferred, including the Dedicated KL-KLIA Expressway, the People Mover-Rapid Transit System (Phase 1) and the South Klang Valley Expressway. As a result, growth was only supported by other on-going projects related to power plants, airports, roads, rail, water and sewerage and waste disposal. This was confirmed by the findings of the Central Bank's Ad-Hoc Survey of the Civil Engineering Sub-sector which indicated that 75% of the respondents had deferred or stopped work on at least one project.

Recognising the importance of infrastructure development to facilitate economic recovery, the Government announced in July 1998 an initial fund of RM5 billion for the development of infrastructure. The Fund would assist in reviving selected infrastructure projects which have low import content and high spin-off effects on the economy. The 1999 Budget had also dedicated RM4.04 billion specifically for the building of roads, bridges, rail, ports and civil aviation. Although some of the projects have since been revived, the effect on the economy is expected to be gradual. This was confirmed by Bank Negara Malaysia's survey findings which indicated that of the respondents (64%) who expected their projects to be revived, 86% expressed that activity would only begin in either the first or second half of 1999.

Graph 1.6
Supply of Purpose-Built Office Space in the Klang Valley



The **non-residential sub-sector** contracted sharply by 29% in 1998 (+8.1% in 1997) due mainly to the postponement or delay in the completion of some of the ongoing projects affected by falling demand and financing difficulties that were experienced in the early part of the year. At the same time, growth was constrained by the large increases in capacity which occurred since 1995. The correction was reflected in the decline in the number and value of commercial property transactions by 44.1% and 43.9% respectively in 1998. In particular, industrial property transactions contracted by 48.1% in volume terms and 55.5% in value terms. The hotel sub-sector also slowed down markedly after the completion of several hotels prior to the hosting of the Commonwealth Games in September 1998.

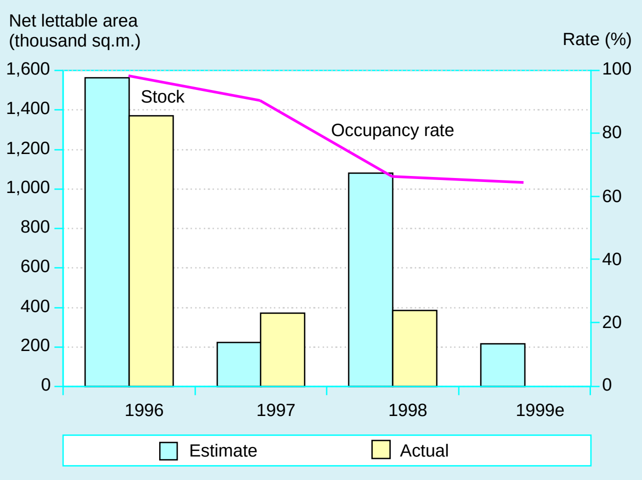
In the **purpose-built office space sub-sector**, growth was mainly supported by ongoing projects, which had started before 1998. Despite the postponement in the completion of some projects, a net lettable area of 0.9 million square metres in the Klang Valley entered the market, bringing the total supply to 5.8 million square metres (+18.7%) at end-1998. Nevertheless, the new supply was substantially lower than the previous estimate of 1.3 million square metres. Most of the office buildings that were completed were located in the central areas of Jalan Sultan Ismail, Jalan Ampang and Jalan Tun Razak. With lower occupancy in the new buildings, especially those in the peripheral areas of the Klang Valley, the average occupancy rate in the office space market continued to decline to around 79% at end-1998 from 95% at end-1997. Nevertheless, office buildings in the Golden Triangle, on average, enjoyed higher occupancy rates compared with secondary areas of Kuala Lumpur and Petaling Jaya. Although the supply of new space will continue to increase due to past commitments, the economic downturn and curbs on financing for high-end properties had prompted developers to postpone further or scale down their projects. As a result, the supply of office space coming on-stream in 1999 and 2000 are expected to moderate significantly. Reflecting the oversupply situation, the average monthly rental declined further to RM41.40 per square metre in 1998 (RM3.85 per square foot) from RM49.75 in 1997. The decline was more pronounced for office buildings in relatively decentralised areas. Rentals in the prime locations in the Golden Triangle also declined, by about 15%.

Similarly, reflecting the completion of projects started earlier, the total stock of **retail space** in commercial complexes in the Klang Valley increased by 0.4 million square metres to 2.1 million square metres at end-1998 (1.7 million square metres at end-1997), lower than an earlier estimate of an additional 1.1 million square metres. Retail space under construction amounted to 1.2 million square metres in 1998 (representing 55.6% of the existing stock), reflecting mainly the continuation of work on delayed projects. The new supply, however, will not come on-stream until 1999 and beyond. With lower demand, occupancy rates in retail centres in the Klang Valley fell to 65.7% at end-1998 (90.5% at end-1997). Nevertheless, commercial complexes in selected areas of Kuala Lumpur that were over two years old continued to have relatively high occupancy rates, averaging 91%.

Construction activity was also lower for the hotel sub-sector, with supply of new hotels moderating to 54 or 9,351 rooms (122 hotels or 27,832 rooms in 1997). The increased supply amidst lower demand from the tourism industry, resulted in a decline in the average occupancy rate to 49.9% in 1998 from 58% in 1997. The decline was across the board with the Klang Valley, Penang and Johor Bahru recording lower occupancy rates of 53.2%, 56% and 48.3% respectively (68.8%, 57% and 56.5% in 1997).

Despite the strong underlying demand, the performance of the **residential sub-sector** was affected by declining income, poor market sentiment and job uncertainties in 1998. Value added of the sub-sector declined by 16.5%. The value of residential property transactions fell by 36% to RM13.9 billion in 1998 (1997: +15.2% to RM21.8 billion). The number of residential transactions declined by 30% to 122,881 units. The contraction in residential construction was also reflected in slow construction starts. New sales and advertising permits for Peninsular Malaysia declined by 28.3% (1997:+18.9%). The number of renewals for sales and their advertising permits, however, increased considerably by 38.8% (1997: –1.2%), reflecting the slowdown in the sale of houses, especially high-cost units costing RM250,000 and above. Similarly, BNM's Ad-hoc Survey of the Residential Sub-sector also showed that construction activity for the period January-August 1998 had contracted by 21-30%, compared with the same period a year ago. Nevertheless, due to past construction activity, the estimated number of completed housing units rose by 7.2% to 154,519 in 1998. A sharp contraction in demand for high end units resulted in an oversupply situation, particularly of condominiums. The situation was aggravated by the supply of high-end condominiums (above RM250,000), coming on-stream in 1998, which increased significantly by 87.9% to 14,151 units, with a total built-up area of 1.6 million square metres.

Graph 1.7
Supply of Retail Space in the Klang Valley



The falling demand and oversupply situation caused a downward correction in house prices for the first time since 1988. The National House Price Index for the first half of 1998 declined by 8.5% compared with an increase of 1.9% for the whole of 1997. The decline was more significant for detached houses (–9%), followed by high-rise units (–5.9%), semi-detached houses (–5.4%) and terraced houses (–4.3%). By region, the decline was more pronounced in Johor Bahru (–21.9%), the Klang Valley (–11.2%) and Pulau Pinang (–11.5%). Among the states, the fall in house prices was most evident in Kuala Lumpur, with prices of semi-detached houses declining by 17.3%, followed by detached houses (–8.8%), high-rise units (–6.8%) and terraced houses (–5.0%). House prices in certain areas, however, declined by up to 30%, especially in areas where prices had recorded higher rates of increase in previous years.

The contraction of the construction sector had severe implications on the economy, affecting especially the low-income group. Several measures were, therefore, introduced during the year to avoid an over-adjustment of the sector and to continue to ensure that construction of medium- and low-cost houses would continue since demand for such houses remained strong. A balanced adjustment among the various sub-sectors in the construction sector was also important as the sector has strong linkages with other economic sectors, especially the manufacturing and services sectors. To meet these objectives, the measures to assist the construction sector focused mainly on reducing the excess stocks built up by several years of investment and ensuring the lower-income group continued to have access to affordable housing. The measures, therefore, supported mainly the construction of low- and medium-cost houses where import content was low and sectoral linkages were high and for which the underlying demand remained strong. In May 1998, a RM2 billion fund for the Special Scheme for Low and Medium Cost Houses was established, of which RM1 billion was made available for bridging finance and another RM1 billion for end-financing. This measure was deemed necessary as the number of houses built for this category had failed to meet demand. For the period 1996-98, only 24.4% of the low-cost and 20.2% of the medium-cost houses were built out of the respective targets set under the Seventh Malaysia Plan, compared with 80% for the high-cost range. Other measures included the liberalisation of lending for the construction or purchase of residential properties costing RM250,000 and below. Lending for these purposes were exempted from the 20% limit on lending to the broad property sector. The 60% limit on margin of loan financing for the purchase of non-owner occupied properties was also abolished. To help clear the excess stock of residential properties, the Government also assisted in the Home Ownership Campaign (12 December 1998 to 12 January 1999). Financing incentives included exemption of stamp duties and lower financing costs for houses purchased during this period. At the close of the Campaign, total sales amounted to RM3.5 billion for 19,281 units of residential and commercial properties, or about a third of the total number of units offered for sale (56,338) worth RM15.4 billion.

Measures were also introduced to stimulate foreign demand for high-end properties. The RM100,000 levy on foreign purchases was removed with effect from August 1997 and the Real Property Gains Tax was reduced to 5% for disposal of properties after the fifth year as announced in the 1998 Budget. Effective 22 April 1998, foreigners were allowed to purchase all types of residential units, shop houses, commercial and office space costing above RM250,000 per unit, provided financing for such purchase was not obtained in Malaysia and the purchase was only confined to newly completed projects or those which were at least 50% completed. Encouraged by lower prices and the effect of the above measures, foreign purchases of residential property increased considerably by 143% to 1,164 units valued at RM434 million in 1998 (–68.5% to 479 units valued at RM215.6 million in 1997). The bulk of the purchases was mainly for condominiums and terraced houses. Transactions for these properties increased significantly by 141.5% to 891 units valued at RM328.5 million and 564.6% to 165 units valued at RM49 million respectively. In the case of commercial property, however, foreign purchases declined sharply in value by 86.4% to only RM44.3 million (+52% to RM326.2 million in 1997).

The measures to balance the adjustment in the construction sector helped to improve sentiment. The number of housing units approved by the Ministry of Housing and Local Government for construction by private developers rose by 3.4% in Peninsular Malaysia to 194,092 by the end of 1998 (63% to 187,625 units in 1997). These comprised 26.6% low-cost units, 41.1% medium-cost units and 32.3% high-cost units. In line with the Government's effort to promote the construction of low and medium-cost houses, approvals for medium and low-cost units rose significantly by 31.1%, while the number of high-cost units fell by 26.4%. The increase in housing approvals is expected to result in greater construction activity for the residential sub-sector in 1999.

Meanwhile, the downturn in the construction sector had affected the performance of construction-related industries. The production of cement and concrete, iron and steel, and construction-related products declined sharply by 40.8%, 35.6% and 27.6% respectively in 1998. Prices of several major building materials were also adjusted downwards amid a contraction in demand during the year. The average price of glass sheet fell by 12.5% and sand by 17.9%. Nevertheless, the average prices of mosaic floor tiles and glazed wall tiles continued to rise steadily by 15.8% and 42.9% respectively. The price of ordinary portland cement fell by 2.4% to RM10.10, below its ceiling price of RM10.35 per 50 kilogramme bag in Peninsular Malaysia, while the average prices of mild steel round bars and high tensile deformed bars fell marginally by 1.1% and 0.6% respectively.

Demand for construction workers also contracted, although this was moderated by flexible adjustment in the wage rates. The average daily wage for skilled and unskilled foreign workers decreased by 1.5% and 4.5% respectively in 1998 (+15% and –2.6% respectively in 1997). The average daily wage for semi-skilled foreign workers, on the other hand, rose albeit marginally by 0.7% in 1998 (7.7% in 1997). The decline in wages was accounted mainly by the local construction workers. For all three categories i.e. skilled, semi-skilled and unskilled workers, the average daily wage fell by 14.3%, 13.3% and 8.6% respectively. Nevertheless, their wages were still higher by 18.9-24.7% (25–43.3% in 1997) compared to their foreign counterparts.

In 1998, total employment in the construction sector declined by 16.9% to 726,000 (8.5% of total national employment), of which 19.7% (30% in

1997) were foreign workers. The share of foreign workers has become smaller following the repatriation of the surplus foreign workers during the year. Foreign workers in the construction sector constituted 18.3% of total foreign workers in the country.

With the slowdown in construction activities, growth in total loans extended by the banking system to the broad property sector, comprising residential, non-residential, real estate and construction companies moderated to 4.4% (1997: 34%) or RM6.2 billion to RM146.1 billion (including loans sold to Cagamas). However, reflecting the lower volume of total loans extended by the banking system in 1998, the share of loans to the broad property sector increased to 35.3% (1997: 33.2%) as at the end of 1998. Under the broad property sector, loans for the construction sector, purchase of residential property, purchase of non-residential property and real estate accounted for 10.4%, 13.6%, 7.2% and 4% respectively of the total loans extended by the banking system in 1998 (10.1%, 12.1%, 6.8% and 4.3% respectively in 1997). Following the easing of the credit situation in the second half-year, the purchase of housing loans by Cagamas moderated, accounting for 33.9% (1997:38%) of total outstanding housing loans. Reflecting the impact of the measure to limit lending to construction and purchase of high-cost residential properties costing RM150,000 and above (subsequently revised to RM250,000), loan growth for the purchase of high-cost properties (> RM150,000) moderated to 19.4% (1997:72.8%). In contrast, loans extended for the purchase of residential properties costing RM150,000 and below was higher by 17.2% as at end-1998 (end-1997 : -9.0%) to account for 34.5% of total outstanding housing loans. The balance of the total housing loans were for purchases in the RM150,000-RM250,000 and above RM250,000 categories which accounted for 18.6% and 13% of total housing loans, respectively.

In 1998, total loans extended by the banking system and housing credit institutions for purchase of residential houses totalled RM56.8 billion in 1998, an increase of 13.2% compared with 1997. Financing of owner-occupied houses costing RM100,000 or less provided by the banking system amounted to RM11.2 billion. As at end-1998, the commercial banks and finance companies had made firm commitments to finance 46,822 and 14,894 of these units respectively. Major housing credit institutions comprising the Treasury Housing Loans Division, the Malaysian Building Society Berhad, the Borneo Housing Mortgage Finance Berhad, Sabah Credit Corporation, Bank Kerjasama Rakyat Malaysia Berhad and Bank Simpanan Nasional, as a group, extended a total value of housing loans worth RM19.6 billion (RM18.7 billion in 1997) as at end-1998, representing an increase of 4.7% (4.8% or RM852.3 million in 1997).

Table 1.9
Agriculture: Production

	1997	1998*p*	1997	1998*p*
	'000 tonnes		Annual change (%)	
Rubber	971	885	–10.3	–8.8
Saw logs[1]	31,163	22,700	3.4	–27.2
Crude palm oil	9,069	8,315	8.1	–8.3
Fish	1,277	1,350	3.2	5.7
Cocoa	106	90	–11.7	–14.9

[1] Expressed in thousand cubic metres
p Preliminary

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

Agriculture, Forestry and Fishery

Value added of the agriculture, forestry and fishery sector declined by 4% in 1998 (1997:+1.3%), reflecting declines in the production of all major commodities. The output performance of the sector was affected mainly by adverse weather, labour shortages, unfavourable prices, reduced cultivated area and lower yields. Production of crude palm oil declined by 8.3% due mainly to the reversal in the biological yield cycle for oil palm trees during the year. Meanwhile, the declining trend in rubber production persisted into 1998 (–8.8%) as the industry continued to face unfavourable prices, labour shortages and a decline in cultivated area. Saw log production also contracted by 27.2% as logging activities remained depressed because of lower demand from the major markets in the region as well as the downturn in the domestic construction sector. In addition, adverse weather conditions arising from the El Nino effect had also affected production. Cocoa production was also markedly lower by 14.9% in 1998, being affected mainly by inclement weather. On the other hand, the production of fish increased by 5.7% during the year. Overall, the agriculture, forestry and fishery sector accounted for a higher share of GDP, 12.3% in 1998 (1997: 12%), 10.5% of gross exports (1997: 10.5%), and 16.8% of total employment (1997: 17%).

Crude palm oil production recorded a decline of 8.3% to 8.3 million tonnes in 1998. The decline was due mainly to lower yields brought about by the reversal in the biological yield cycle of the oil palm trees, which occurs once every three or four years. To some extent, the lower yields were also attributable to the lagged impact of the haze and dry weather, which occurred during the second half of 1997, while labour shortages resulted in a lower harvest as loose fruits tended to be uncollected. The decline in yields during the year had more than offset the expansion in the mature oil palm cultivated area. With the increasing viability of oil palm cultivation in the wake of attractive prices in recent years, the total area under oil palm cultivation expanded further by 2.6% to 2.9 million hectares in 1998, with the mature area increasing by 2.4% to 2.5 million hectares. Despite the decline in production, Malaysia maintained its position as the world's largest producer of crude palm oil, accounting for about one-half of the world's production, with Indonesia as the next major producer, accounting for 31%.

On a regional basis, production in Peninsular Malaysia declined by 9.8% to 6 million tonnes in 1998, while Sabah recorded a decline of 5.6% to 2 million tonnes and Sarawak by 8.1% to 0.3 million tonnes. Growth in mature area under oil palm cultivation was most marked in Sarawak (an increase of 10.8%), followed by Sabah (6.4%) while

Table 1.10
Oil Palm: Area, Production and Yield

	1997	1998*p*	1997	1998*p*
			Annual change (%)	
Area (000 hectares)				
Planted	2,819	2,893	4.7	2.6
Mature	2,455	2,513	4.3	2.4
Production ('000 tonnes)				
Crude palm oil	9,069	8,315	8.1	–8.3
Yield (tonnes/mature hectare)				
Crude palm oil	3.69	3.31	3.9	–10.3

p Preliminary

Source: Department of Statistics
PORLA

the mature area in Peninsular Malaysia increased only marginally (0.5%). Expansion of mature area in East Malaysia is expected to continue in the future as immature planted areas in Sabah and Sarawak expanded further by 4.2% to 146,700 hectares and 43.6% to 53,500 hectares respectively. Immature planted areas in Peninsular Malaysia declined by 3.5% to 179,600 hectares. In terms of ownership, private estates accounted for the largest share of 55.2% of the total oil palm cultivated area or 1.6 million hectares. Organised smallholder schemes under the Federal Land Development Authority, Federal Land Consolidated and Rehabilitation Authority and the Rubber Industry Smallholders Development Authority as a group accounted for 28.7% or 0.8 million hectares, while schemes under the states and independent smallholders, accounted for the remaining share of 16.1% or 0.5 million hectares.

In 1998, a total of 19 new palm oil mill licences were issued by the Palm Oil Registration and Licensing Authority (PORLA). With the rapid expansion of land under oil palm cultivation in Sabah, the State was granted 14 licences for new mills bringing the total number of mills approved in Sabah to 91. Two new licences were granted in Sarawak and three in Peninsular Malaysia. By end-1998, there were 242 mills operating in Peninsular Malaysia, 70 in Sabah and 13 in Sarawak. These 325 mills in Malaysia had an aggregate capacity to process 59.1 million tonnes of fresh fruit bunches annually. Following the seasonal trend in crude palm oil production, the average rate of capacity utilisation of the mills was 68.4% in the first half of the year and 81.1% in the second half of the year. For the year as a whole, the average rate of capacity utilisation declined to 74.8% from 88.3% in 1997, in line with the lower production of crude palm oil.

With the lower level of crude palm oil production, domestic processing of the commodity by refineries declined by 2% to 8.8 million tonnes in 1998. During the year, there was no new refinery licence issued by the Ministry of International Trade and Industry. However, approvals were given to the existing refineries to expand their installed production capacity. Hence, the total installed capacity of the 45 refineries in operation was 12.7 million tonnes. In order to increase the oil extraction rate (OER), which declined to 18.91% in 1998 from 19.03% in 1997, the smallholders and small estates were encouraged to harvest only the ripe

Table 1.11
World Elastomer: Production and Consumption

	1998*e*		1997	1998 *e*
	'000 tonnes	% share	Annual change (%)	
Production	16,380	100.0	1.8	–0.6
Natural rubber	6,315	38.6	0.3	–1.6
Thailand	2,100	12.8	3.2	3.3
Indonesia	1,583	9.7	–1.5	5.2
Malaysia	885	5.4	–10.3	–8.8
India	500	3.1	7.4	–13.8
The People's Republic of China	455	2.8	3.3	2.4
Vietnam	212	1.3	6.3	5.5
Sri Lanka	96	0.6	–6.0	–9.1
Nigeria	87	0.5	–5.3	–3.3
Others	397	2.4	8.1	–16.6
Synthetic rubber	10,065	61.4	2.8	0.0
Consumption	16,470	100.0	5.0	–0.4
Natural rubber	6,540	39.7	6.0	0.5
Synthetic rubber	9,930	60.3	4.4	–0.9
Deficit(–)/surplus(+)	–90			

e Estimate

Source: Department of Statistics
International Rubber Study Group

fruits. In this regard, training in the grading of fresh fruit bunches was conducted by PORLA.

Natural rubber production declined by 8.8% to 885,400 tonnes in 1998, representing the fourth consecutive year of decline in production. The decline was due mainly to continuing low prices as well as labour constraints. Slackening external demand amidst ample global supplies resulted in a further decline in prices. The price of SMR20 fell from 274.50 sen per kilogramme at the turn of the year to 217.00 sen per kilogramme at end-year. As rubber was traded in ringgit, it did not benefit from the valuation effects arising from the depreciation of ringgit. Meanwhile, the persistent problem of labour shortages has affected tapping activities, resulting in a significant decline in productivity. The Malaysian Rubber Board initiated measures to address the declining productivity. Measures included the active promotion of labour-saving technologies such as the low intensity tapping systems, particularly among the smallholders.

Imports of natural rubber, mainly latex, rose significantly by 30.7% to 564,100 tonnes in 1998 to meet the demand of domestic rubber products manufacturers. The major source of imports was Thailand. Despite lower production in 1998, Malaysia remained as the world's third largest producer and a net exporter of natural rubber.

On a regional basis, the production of rubber in Peninsular Malaysia, which accounted for 95% of total national output, declined by 10% to 842,220 tonnes, with the production of smallholders and estates declining by a similar magnitude. Lower production was also recorded in Sabah (–10.2%). On the other hand, production in Sarawak remained at the previous year's level. In terms of planted area, Peninsular Malaysia recorded a decline in rubber cultivated area by 4% to 1,244,560 hectares, accounting for about 80% of the total area under rubber, with the mature area declining by 4% to 1,029,250 hectares.

With the declining interest in rubber cultivation aggravated by the prolonged weakness of prices for the commodity, there was a need for a revival of the industry in order to sustain its long-term survival. In this regard, the Association of Natural Rubber Producing Countries (ANRPC) has proposed that the International Natural Rubber Price Stabilisation Scheme under the ANRPC be revived. Meanwhile, Malaysia withdrew from the International Natural Rubber Organisation (INRO) with effect from 15 October 1998. On the home front, in an effort to improve the institutional role of the agencies relevant to the rubber industry, the Malaysian Rubber Board (MRB) was established on 1 January 1998, with the amalgamation of the three previous

Table 1.12
Rubber: Area, Production and Yield

	Estates		Smallholdings	
	1997	1998*p*	1997	1998*p*
	'000 hectares			
Planted area	206	197	1,404	1,365
Replanting	4	4	34	30
Newplanting	6	6	106	108
Production ('000 tonnes)	216	199	755	686
Yield (kg./mature ha.)	1,069	997	661	613

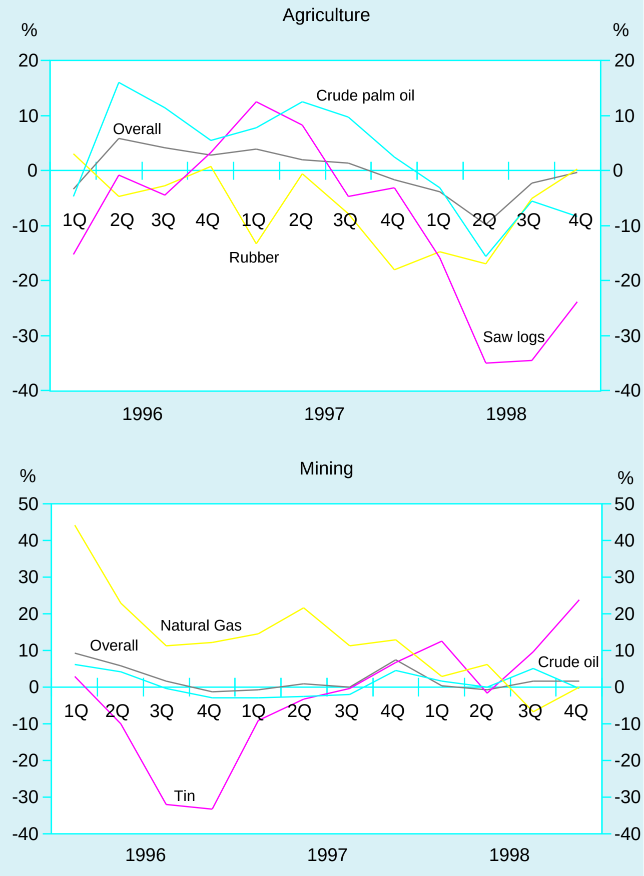
p Preliminary

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

rubber agencies, namely, the Malaysian Rubber Research and Development Board, the Malaysian Rubber Exchange and Licensing Board and the Rubber Research Institute. MRB would be responsible for all activities pertaining to the development of the rubber industry to bring about a more co-ordinated and effective approach to the policies on development of the rubber industry. Specifically, the new organisational set-up would have research and development as its core activity. MRB would also consolidate all other related functions and activities from the upstream sector to the mid and downstream sectors in terms of production, processing, value-added manufacturing and market promotion for raw rubber, manufactured rubber and rubberwood products. The MRB has formulated a Revised Rubber Strategy to maximize production from existing rubber trees as well as to promote replanting with Latex Timber Clones to maximize rubber and wood yields.

In 1998, the Rubber Industry Smallholders Development Authority (RISDA) allocated a total of RM157 million to finance replanting projects and

Graph 1.8
Production Growth Rate



an additional RM1.8 million for the rehabilitation programme to assist smallholders with financial difficulties. The replanting projects involved 19,421 hectares of rubber land, while the rehabilitation programme covered 1,272 hectares. These programmes were aimed at ensuring stable production by the smallholders, who accounted for 78% of the nation's rubber production.

Production of **saw logs** declined sharply by 27.2% to 22.7 million cubic metres in 1998. The decline was due mainly to weaker demand from the traditional buyers, which were mainly from the Asia-Pacific region. Production in Sarawak and Sabah was also affected by adverse weather conditions. At the same time, logging activities were in line with the Government's conservation policy and commitment to sustainable forest management by the year 2000, in compliance with the requirement of the International Tropical Timber Organisation. Production was lower in all regions. Sarawak's production, which accounted for 49% of the total saw log production, declined by 33.9% to 11.1 million cubic metres, while that for Peninsular Malaysia (28% of total production) was lower by 13.6% to 6.4 million cubic metres. For Sabah (23% of total production), production declined by 25.3% to 5.2 million cubic metres.

The downtrend in the production of **cocoa** continued in 1998 for the eighth consecutive year. Although cocoa prices improved significantly during the year, production of cocoa beans declined by 14.9% to 90,200 tonnes, the lowest since its record production of 247,000 tonnes in 1990. A severe drought, arising from the El Nino weather phenomenon had affected fruit setting and had also delayed the fruit setting for the second season. Besides the weather factor, cocoa output was also affected by rising production cost due to increased labour cost and higher prices of agricultural inputs. During the year, about 6,000 hectares of cocoa areas were converted into oil palm with no conversion of other crop areas into cocoa. Conversion was primarily carried out by the smallholders in Peninsular Malaysia. In Sabah, where production accounted for 68% of the total national output, conversion activity was less active. In the face of lower production of cocoa beans, the domestic cocoa processing industry imported cocoa beans, particularly from Indonesia. Nevertheless, the overall processing of cocoa beans by the local grinders declined by 4.8% to 100,000 tonnes in 1998.

Production of the **fishery** industry increased further by 5.7% to 1.4 million tonnes in 1998. The continued favourable performance in fish production was due to the marked increase in the production of aquaculture (23.2%) and marine fisheries (4.1%), which together accounted for 90.4% of the total fish production. The marine fisheries, which included inshore fisheries, recorded a production of 1,087,380 tonnes while production from aquaculture totalled 133,060 tonnes. Deep sea fishing, on the other hand, contributed 129,420 tonnes to total production. The higher production of fish during the year enabled exports to increase by 1.9% to 238,600 tonnes, mainly to Thailand, Singapore and Japan, while imports declined by 3.4% to 207,840 tonnes, the bulk of which was from Thailand. Meanwhile, Malaysian per capita consumption of fish increased to 42 kilograms in 1998 against 41 kilograms a year ago.

Mining

Value added in the mining sector increased further by 0.8% in 1998 (1997: +1%), reflecting primarily higher crude oil and gas production and a turnaround in tin production. The quarrying sector, on the other hand, contracted sharply by 24.5% in line with the slowdown in construction activities. Overall, the mining sector contributed a slightly higher share of 7.3% of GDP in 1998 (1997: 6.7%), 0.5% to employment (1997: 0.4%) and 5.2% to total exports (1997: 6.9%).

The production of **crude oil including condensates** increased by 1.7% to 726,100 barrels per day (bpd) in 1998. Excluding condensates, crude oil production was higher at 640,600 bpd (1997: 629,200 bpd). Output of condensates (from gas fields) was higher at 85,500 bpd (1997: 84,700 bpd). On a regional basis, the output of crude oil and condensates from Peninsular Malaysia (58% of national production) declined by 1.5% to 422,000 bpd, while that from Sarawak which accounted for 28% of production, declined by 7.7% to 205,000 bpd. In contrast, Sabah's crude oil production increased markedly by 59.6% to 99,100 bpd as one new oilfield commenced operations in December 1997. As at the end of 1998, there were 37 oilfields in production, with two new oilfields in Peninsular Malaysia and one in Sabah. In total, Peninsular Malaysia had 16 oilfields, while Sabah and Sarawak had 13 and eight oilfields respectively. In the upstream sector, five production sharing contracts were signed in 1998, of which three were in Sarawak and two in Peninsular Malaysia. One oilfield in offshore Terengganu Darul Iman was discovered during the year. By end-1998, a total of 18 exploration wells and 81 development wells were drilled in addition to 68,693 kilometres of seismic data acquired for exploration and development purposes. Most of the development activities in 1998 were concentrated in Peninsular Malaysia and Sabah.

Table 1.13
Mining: Production

	1997	1998*p*	1997	1998*p*
	'000 tonnes		Annual change (%)	
Crude oil[1]	713,928	726,100	–0.5	1.7
Natural gas[2]	3,846	3,857	12.7	0.3
Tin-in-concentrates[3]	5,065	5,610	–2.1	10.8
Bauxite	279	158	27.4	–43.4
Iron-ore	216	372	–33.5	72.2
Copper	81	63	–6.9	–22.2

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

Source: Department of Mines
PETRONAS

Reflecting weak demand from domestic and international markets, **natural gas** production increased only marginally by 0.3% to 3,857 million standard cubic feet per day in 1998. Domestic demand was sluggish due mainly to lower consumption by the power generation sector. On the external front, exports of LNG to Japan, Korea and Taiwan as a group, declined by 2.6% to 14.7 million tonnes (1997: +18.6%). A total of 10 gas fields were in production in 1998, with five each in Peninsular Malaysia and Sarawak. A gas field located offshore Terengganu Darul Iman was discovered during the year.

Production of **tin-in-concentrates** recorded a positive growth in 1998 after eight consecutive years of decline. Production grew by 10.8% to 5,610 tonnes. The significant increase in tin prices of 43.6% in ringgit terms triggered higher production from the 35 tin mines operating in Malaysia. Meanwhile, domestic consumption of tin metal declined further by 15.4% to 5,575 tonnes, reflecting lower demand from the tin-based industries. Utilisation of tin metal by the solder industry, which accounted for 60% of local consumption, declined by 6% to 3,350 tonnes as demand from the electronics industry was lower. Similarly, demand by the tin plating industry declined by 32.2% to 595 tonnes, while that by the pewter industry declined by 23.4% to 590 tonnes. As the domestic production was insufficient to meet the demand of local smelters, tin-in-concentrates continued to be imported, mainly from Peru, Australia, Portugal, Bolivia and the United States.

Services

Following the contraction in the economy, the growth of the services sector moderated in 1998 given its strong inter-linkages with the other sectors in the economy. The services sector recorded a growth rate of 1.5% in 1998 compared with 8% in 1997. Growth continued to be led by the intermediate services sub-sector, while the final services sub-sector expanded at a much slower pace. Despite weaker performance of the services sector, it remained as the largest sector in the economy in 1998, contributing to a higher share of GDP of 48.8% and total employment of 47.5%.

Following the contraction in aggregate demand, **intermediate services** comprising transport, storage and communications; and finance, insurance, real estate and business services registered a slower growth of 3.1% in 1998 (1997: 9.1%). A marked slowdown was observed in the **transport, storage and communications** sub-sector, where growth moderated to 1.2% from 8.4% in 1997. Transport activities were affected by the decline in the volume of domestic and international trade, particularly imports. The decline in trade, particularly with regional countries, was reflected in the lower volume of cargo handled at major ports. Estimates for the five major ports in Malaysia showed that cargo handled by these ports declined markedly by 13.8% to 121.1 million freight weight tonnes (f.w.t) in 1998. In terms of container throughput, the growth moderated significantly to 1.2% (1997: 17.1%) to 2.8 million twenty-foot equivalent units (TEUs). Despite the slowdown, several ports embarked on expansion plans to enhance their facilities and services, while new ports were being completed or developed. For example, the new port in Tanjong Pelepas, Johor is under construction and is expected to be operational in early 2000. The Segamat Inland Port began operations in October 1998 and is mainly expected to attract shippers located in southern Melaka and northern Johor. Similarly, the North Port Business Park in Port Klang, upon completion, would provide support to downstream activities in the surrounding area at Port Klang. Several major shipping companies also expanded their capacity by acquiring ships valued at RM3.5 billion. During the year, the Government continued its efforts to enhance port facilities and to promote Port Klang as a load centre and a regional hub. Several measures were undertaken to enhance cargo volume in order to attract main line operators to call at the port, which yielded positive results. In 1998, a total of 67 main line operators called at Port Klang compared with only 10 in 1992. Incentive schemes in the form of rebates, volume discounts, and waiver of certain port charges were made available to encourage main line operators to call at Port Klang. Additional warehousing facilities and inland clearance depot were also established. In an effort to enhance its competitiveness, the Government abolished the inter-terminal transfer fee for cargo at Port Klang, effective 30 November 1998.

For air transport, the decline in cargo handled was partly attributed to some redirection of cargo by domestic traders to Singapore for a brief period after the relocation of the cargo services to the new Kuala Lumpur International Airport (KLIA) in Sepang at the end of June 1998. Domestic and international air travel, on the other hand, were affected by the economic downturn and uncertainties as well as a weaker ringgit. In view of these developments, Malaysia Airlines stepped up efforts to restructure its operations. While the delivery of several new aircraft during the year was partly offset by the sale of old aircraft, flight routes were also rationalised to maximise passenger load. Service to unprofitable destinations was suspended while more aircraft were redeployed to profitable destinations in Europe and Australia.

In the case of rail transportation, revenue from cargo declined during the year, while revenue from passenger services recorded some growth. In particular, the Light Rail Transit extended its service to an increased number of destinations within Kuala Lumpur, thus resulting in greater ridership towards year-end. In the communications sub-sector, the performance of telecommunications services remained buoyant in 1998, weakening only slightly compared with 1997. The number of telephone subscribers grew by 3.8% during the year. The number of residential subscribers increased by 5.7%

Table 1.14
Growth in the Services Sector in 1978 Prices

	1997	1998*p*	1997	1998*p*
	Annual change (%)		% share of GDP	
Services	**8.0**	**1.5**	**44.9**	**48.8**
Intermediate services	9.1	3.1	19.0	21.0
Transport, storage and communications	8.4	1.2	7.5	8.1
Finance, insurance, real estate and business services[1]	9.5	4.4	11.5	12.9
Final services	7.2	0.4	25.8	27.8
Electricity, gas and water	13.0	3.6	2.5	2.8
Wholesale and retail trade, hotels and restaurants	7.0	–2.0	12.3	12.9
Government services[2]	6.1	2.4	9.0	9.9
Other services[3]	7.2	2.5	2.0	2.2

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

Source: Department of Statistics and Bank Negara Malaysia.

to 3.2 million, while that of business subscribers declined by 1.2% to 1.2 million. The Government liberalised the limit on ownership of telecommunication firms by foreigners to 49% from 30% on 25 February 1998.

In the **finance, insurance, real estate and business services** sub-sector, value added increased more moderately by 4.4% in 1998. Total loans extended by the banking system declined in 1998 due in part to the contraction in economic activity. Meanwhile, the sharp decline in prices and volume of shares traded on the Kuala Lumpur Stock Exchange also affected the performance of this sub-sector. At the same time, slower growth was recorded by the insurance industry, as evidenced by the smaller increase of 1.9% in premium income collections in 1998 (1997: 14.4%).

In the **final services** group, comprising utilities; wholesale and retail trade; hotels and restaurants; government services and other services, growth decelerated sharply to 0.4% from 7.2% in 1997. Within this group, the wholesale and retail trade, hotels and restaurants sub-sector, particularly those trading in non-essential and high-end products, were severely affected by the economic downturn and cautious consumer spending. The Malaysian Retail Association's survey findings showed that sales in the retail sector fell by 17% during the period July 1997-June 1998. Amongst the major items which recorded a substantial decline in sales were telecommunication products, fashion and accessories, jewellery, toys and gifts, general merchandise, food and beverages and entertainment. The downward trend was also reflected in the Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index, which fell by 37.5 points to an average of 82.5 points during the first three quarters of 1998. Subsequently, the index recovered slightly indicating an improvement in sentiment in the fourth quarter. The poor consumer sentiment was attributed mainly to the negative wealth effect of the sharp decline in the equity and property markets, uncertainty about employment prospects and business losses. The slowdown in the domestic trade sector was reflected in lower sales tax collection (–38.7%). Value added in hotels and restaurants also showed a significant decline due mainly to lower tourist arrivals (–10.6%). The regional economic downturn affected tourist arrivals in 1998. This, together with a sharp increase in the supply of hotel rooms (+9,351 rooms), led to a decline in the average occupancy rate for hotels to 49.9% in 1998 (1997: 58%). Meetings and conventions, however, showed a sharp increase and provided some boost to the local tourism industry.

During the year, value added in the **utilities** sub-sector slowed down markedly to 3.6% (13% in 1997), mainly attributable to the sharp reduction in electricity supply during the second half of the year in response to lower demand, particularly from the industrial and commercial sectors. On the other hand, growth in water consumption, another component of the utilities sub-sector, remained stable, increasing by an annual rate of 3% to 8,710 million litres per day in 1998, the same rate of growth recorded in 1997. Overall, the production capacity of water in 1998 was 10,428 million litres per day, an increase of 5% compared with a growth of 2% in 1997.

Growth in the **Government services** sub-sector moderated to 2.4% in 1998 (6.1% in 1997). However, its share to GDP increased to 9.9% from 9% a year ago. The moderation was due mainly to the freezing of all vacant posts that are non-critical, salary cuts by senior Government officials and the reduction in allowances for civil servants.

Box II

The 1985 and 1998 Recessions: A Comparison

Malaysia experienced a period of 12 consecutive years of growth, which averaged 7.8% after the economic recession in 1985. In 1998, following the regional financial crisis, Malaysia has entered a period of economic contraction. While the magnitude of the contraction in output in 1998 was larger, the overall impact has been less severe on the population. In particular, unemployment was widespread in 1985. In contrast, in the 1998 recession, structural changes in the economy, the full employment situation and the development of a more flexible labour market have moderated the rise in unemployment. This box article examines the two recession periods, and analyses the causes and the policy responses. Lessons are also drawn from the experience in both the periods.

Economic Structure and Risks

The prevailing structure of the Malaysian economy significantly influenced the depth and magnitude of the recessions. While both recessions emanated from external sources, the impact of the external shocks on the domestic economy were different, given the structural changes in the economy. Policy responses have accordingly differed.

In 1985, the economy was vulnerable to fluctuations in world output and prices of commodities. During this period, the public sector dominated investments, accounting for 30.9% of **total domestic demand**. This was due primarily to the implementation of counter-cyclical policies to ride out the prevailing global recession as well as the Government's entry into heavy industries. While the counter-cyclical policies sustained the growth momentum, it led to the twin deficits in the fiscal and external payment positions, and an increase in the external debt position.

Similar to 1985, the export sector remained vulnerable **in 1997-98**, despite structural changes. The difference was in the product composition of exports. While in 1985 the major export was commodities, in 1998, it was electronics and electrical products. The distribution of markets for export products was also more diversified in 1998, with 40% from East Asia. However, the greater integration of markets meant that the loss of market share in East Asia would also affect demand from other markets. In this regard, diversification of products was less effective in offsetting risks due to the additional vulnerability caused by the integration of global products and financial markets.

More important was the creation of new risks arising from volatile capital flows as the domestic economy became more integrated with the global economy. The Malaysian economy is very open with imports and exports of goods and non-factor services accounting for about 211% of GDP in 1998 (105% in 1988), while the long-term capital account expanded with gross inflows of RM34.6 billion in 1998 compared with RM11.4 billion in 1985. The globalisation of international capital flows and the relatively open capital account exposed the economy to new areas of vulnerabilities, in particular to the sudden reversal of capital flows and the contagion effect of a crisis emanating in other parts of the world. This risk was heightened when the share of short-term capital flows exceeded foreign direct investments in financing the current account deficit.

The shift from the public sector to the private sector as the engine of growth also created new risks. The slow development of the bond market resulted in loans to the private sector rising to 148.4% of GDP in 1998 from 98.5% in 1990. Loans were collateralised against properties and shares which made the banking system vulnerable to declining asset prices. The mitigating factor to this risk was that loans to the property sector were secured at a

Economic Structure and Risks

1985	1998
• Economy small (nominal GDP of US$31.2 billion) and vulnerable to external shocks.	• Economy much larger (nominal GDP of US$71.1 billion) and fundamentally stronger.
• Economy open with exports at 49.1% of GDP, but concentrated in commodities (66.7% of total exports).	• Economy more open, with exports at 102.9% of GDP, but risks shifted to manufacturing (82.9% of gross exports), especially electronics (39.8% of gross exports).
• Inflation low at 0.4%.	• Inflation much higher at 5.3%.
• Unemployment of 6.9%, no pressure on inflation.	• Full employment, with foreign labour at about 10% of total employment, exerting inflationary pressures.
• Weak fiscal position - large fiscal deficit (peak of 16.6% of GDP in 1982; public sector deficit was 18% in 1982). Revenue base was dependent on export taxes, and expenditure was focused on heavy industries. Deficit was reduced to 0.6% of GDP in 1985.	• Strong fiscal position - fifth year of fiscal surplus in 1997 (2.4% of GDP). Revenue was broad-based, and expenditure has been directed mainly to education, health and infrastructure. Still in surplus in 1997 (2.4% of GDP) but moved to deficit of 1.8% of GDP in 1998 to stimulate recovery.
• Public sector (including NFPEs) engine of growth, accounted for 46.9% of investment (nominal) and 22.7% of consumption (nominal).	• Public sector important in recovery process. Share of public investment amounted to 44.1% (nominal) and consumption to 20.9% (nominal).
• External sector weak with current account deficit high at 2.1% of GDP, attributable to high consumption and high Government expenditure.	• Current account surplus at 12.9% of GDP due mainly to export growth and declining imports.
• High external debt in 1986 (75.6% of GNP), mainly by public sector (64.9% of GNP) and high debt service ratio (DSR) of 18.9%.	• Low external debt of 60.9% of GNP and DSR of 6.7% due to improved debt management and prepayments. Public sector debt low at 26% of GNP.
• Exchange rate stable, fluctuating between US$1=RM2.41–2.60. No change in exchange rate policy, but the rate depreciated following realignment of yen/US$ rate under the Plaza Accord.	• Extreme volatility of exchange rates, breaching intra-day trading levels of RM3.35 to 4.88 between January-August. Fixed exchange rate regime adopted on 2 September 1998, where the ringgit was fixed at US$1=RM3.80.

- Basic thrust of monetary policy generally expansionary to revive economic growth in the face of serious budgetary restraints and declining commodity prices.
- Loans to private sector equivalent to 85.2% of GDP. Growth was fuelled through expansionary fiscal policy.
- Authorised deposit-taking cooperatives that were relatively less regulated, and illegal deposit-takers proliferated. Regulated banking sector in early stage of observing new prudential regulations. Several banking institutions experienced large losses, arising from imprudent lending, poor management and fraud in certain cases.
- Capital adequacy ratio of 7.5% at the end of 1985. NPL of 30.1% at the end of 1988 based on the 12-month classification.
- By the end of 1989, four commercial banks and eight finance companies rehabilitated through capital injection or assumption of control by BNM and placed under receivership prior to absorption by a larger banking institution.

- Tight monetary policy stance in late 1997 to address emerging inflation in early 1998, and to restore stability in the foreign exchange markets. Monetary policy gradually relaxed as inflation eased, to support economic recovery.
- Domestic loans to private sector much higher at 148.4% of GDP.
- Comprehensive regulatory and supervisory framework for licensed banking institutions, with provisions to extend purview of BNM to other financial institutions when required to preserve financial stability. Stronger banking system, and prudential standards largely in line with international standards.
- At end-1998, RWCR of 11.8%; NPLs of 7.6% (net) and 12.6% (gross) under the six-month classification.
- Comprehensive bank restructuring plan implemented. For further details, please refer to Box IV on "Restructuring the Banking Sector".

comfortable margin, at more than 100%, while the proportion of loans extended for the purchase of shares was approximately 8%, well below the prudential limit of 20% for commercial banks and finance companies, and 30% for merchant banks.

The Recessions in 1985 and 1998

Both the 1985 and 1998 recessions were triggered by external developments. **In 1985**, there was a global decline in the prices of major commodities. The slowdown in exports led to a sharp cutback in private sector expenditure. Together with the dampening impact of the fiscal restraint, this led to a severe deflationary effect on the economy. In 1985, real GDP declined by 1.2%. On the business front, the sharp downturn in aggregate demand resulted in excess capacities, a drop in profits and rising number of corporate bankruptcies. The property market which experienced a boom in the period 1983-84 was badly affected, with prices estimated to have declined by between 10-30%. The prevailing unemployment situation deepened with the recession.

Amidst the slowdown in economic activity, the financial system was affected by a crisis of confidence, triggered by the failure of some deposit-taking cooperatives (DTCs) as well as illegal deposit-takers, such as credit and leasing companies. The deterioration in the health of the DTCs and illegal deposit-takers was a result of falling property and share prices as well as weak management, and in some instances, fraudulent and dishonest management. The crisis of confidence in this “unregulated” sector of deposit-taking institutions posed a systemic threat to the banking system. At the same time, the combination of a sharp contraction in cash flows, deflation in property and share prices, and a rise in debt servicing exposed the financial over-commitments of many entrepreneurs, which consequently resulted in the deterioration in the health of the banking system. Non-performing loans (NPLs) as at end 1988 was approximately 30% and several banking institutions experienced an erosion in capital. By the end of 1989, four ailing commercial banks and eight ailing finance companies had been rehabilitated via capital injection or assumption of control by BNM or placed under receivership prior to absorption by other larger institutions.

While the 1985 recession was triggered by the sharp decline in commodity prices, **the 1998 recession** was, on the other hand, caused by the adverse developments in the regional financial markets following the speculative attacks on the currencies of the East Asian economies. Markets panicked and foreign investor confidence evaporated. Malaysia was not spared from the contagion effect of these developments, despite its relatively strong economic fundamentals. The ringgit and stock market experienced significant downward pressures as a result of weak investor confidence and large outflows of short-term capital. The depreciation of the ringgit and the decline in share prices reinforced each other, creating a vicious circle of exchange rate depreciation and falling stock prices that further undermined confidence.

As the crisis prolonged, the fall in aggregate demand in Asia affected Malaysian exports. Measures to stabilise the domestic economy also caused severe declines in consumption and investment. As the financial crisis permeated to the real economy, the financial system was adversely affected. Banking institutions became preoccupied with managing the deterioration in asset quality and capital and curtailed their lending operations. Total loans outstanding (including NPLs sold to Danaharta) extended by the banking system increased by only 1.3% (26.5% in 1997). This development, combined with the negative wealth effectand the moderation in exports, had a dampening impact on economic activities. Consequently, the economy experienced a contraction of 6.2% in the first nine months of 1998, and an overall contraction of 6.7% in 1998. Furthermore, both the inflation and unemployment rate increased to 5.3% and 3.9% respectively in 1998.

Policy Responses

(a) Monetary Policy

The conduct of monetary policy in addressing the recessions was particularly difficult in an environment of open capital account regimes and significant volatility in exchange rates. BNM was confronted with conflicting objectives of maintaining stability in the foreign exchange market and reducing interest rates to reflect the domestic economic conditions. In the recessionary environment of 1985-86, the basic thrust of monetary policy was generally expansionary to revive economic growth in the face of serious budgetary restraints and declining commodity prices. The easing of monetary policy was achieved principally through the easing of bank liquidity and containing the upward pressure on interest rates. However, attempts to inject liquidity were neutralised to a large degree by outflows of funds, fuelled by speculative pressures on the ringgit in the periods April-May and August-September in 1986. Only when pressures on the ringgit subsided in mid-October 1986 that BNM was able to further ease monetary policy to support economic recovery.

The situation was not dissimilar in 1997-1998. The difference was mainly in the magnitude of the speculative activities. Limits to the effectiveness of monetary measures were greater due to the availability of large amounts of ringgit funds abroad that continually destabilised the ringgit exchange rate. In an environment of unprecedented depreciation of the ringgit in late 1997, BNM monetary policy was tightened to contain inflation and restore stability in the foreign exchange market. While inflation was contained and the current account balance had improved, the ringgit exchange rate continued to be subject to speculative pressure. The tight monetary stance amidst slowing aggregate demand contributed to further weakening of the economy. As the adverse economic conditions became evident by mid-1998, monetary policy was gradually relaxed to support economic recovery. The easing of monetary policy was facilitated by the moderation in inflationary pressures. Several initiatives were also taken to improve the liquidity situation in the banking system, moderate the intermediation cost and generate lending activities. Subsequently, the stability achieved through the imposition of selective exchange control measures on 1 September 1998 enabled BNM to further ease monetary policy.

Inefficiencies in the intermediation process also emerged during the two periods of recession. There was undue competitive bidding by a small number of banking institutions for deposits that led to increases in the cost of funds for the system as a whole and slow downward adjustment in the base lending rate when the situation improved. As a result, measures were introduced to enhance the efficiency of the intermediation process as well as improve the transmission of monetary policy and the flow of liquidity in the banking system. During the period 1985-87, the authorities suspended the market determination of interest rates, and pegged the deposit rates and the base lending rate. The authorities were pragmatic and recognised that these moves, while not market-oriented, were necessary for the period to ensure that the banking system functioned to support economic recovery.

In 1998, monetary management focused on making liquidity management more transparent as well as ensuring a better distribution of liquidity to improve the efficiency in the loan intermediation process. During both recession periods, the authorities also introduced and expanded various special funds to ensure that viable borrowers and priority sectors continued to have ready access to credit at reasonable rates. These funds also helped to stimulate new fixed investment and to rehabilitate viable borrowers and industries.

(b) Fiscal Policy

A major difference was in the stance of fiscal policy adopted by the Government in dealing with the two recessions. During the **1985-86 period**, the policy response focused mainly on fiscal restraint. Government expenditure was reduced through downsizing its role in the economy. Despite the fiscal restraint, the fiscal deficit increased to 11.2% of GNP in 1986, due mainly to a substantial decline in revenue.

In contrast, **during the 1998 recession**, the healthy fiscal position following five years of fiscal surplus and low government external borrowings provided the Government greater flexibility in the use of fiscal policy in stimulating economic activity. While the Government continued to pursue fiscal discipline and prudence at the beginning of the crisis in late 1997, the severity of the slowdown and the threat of a recession prompted the Government to switch to counter-cyclical fiscal measures in early 1998. However, the expenditure was directed at sectors that had strong economic linkages to maximise the multiplier effect on economic activity, and to protect the vulnerable segments of society. Unlike the situation in 1985-1986, the fiscal deficit in 1998-1999 is not expected to cause strains in the balance of payments position.

(c) Strengthening and Restructuring the Banking Sector

The deterioration in the health of the banking sector during both recessions prompted the authorities to undertake measures to strengthen and restructure the sector. The measures were aimed at preventing the emergence of a systemic crisis and thus, maintain public confidence in the banking system. As a result, the intermediation function continued without disruption during both periods of recession. For the greater part of the early 1980s, banking sector policy was focused on strengthening the prudential regulations through the adoption of capital adequacy standards, single customer limit, prohibition of connected lending and rules on the treatment of NPLs. In addition, a series of amendments and new provisions to the banking legislation were also introduced in January 1986, which, among others, enabled BNM to control abuses by bank management; diversify equity control of banks; and lend to or inject equity into banking institutions whose capital was impaired. These powers allowed BNM to promptly address the problems of ailing institutions that emerged during this period. Consequently, BNM assumed control of four commercial banks and eight finance companies during 1985-89, and rehabilitated them. By 1998, three of these institutions had turned around, following which BNM's investments in these banking institutions were sold to the private sector.

Another important development during this period was the role of BNM in the resolution of the DTC crisis. The promulgation of the Essential (Protection of Depositors) Regulations, 1986, provided BNM with wide-ranging powers to deal effectively with the DTCs, and allowed BNM to suspend the operations of the 24 ailing DTCs to facilitate investigative operations. The problems were resolved with the formulation and implementation of various rescue schemes, the last of which was finalised in 1988.

The restructuring of the banking system following the 1985 recession enabled the banking system to strengthen during the period of strong economic growth in the next decade. Hence, the banking sector entered the **financial crisis in 1997** from a position of strength. Nevertheless, the severity of the crisis weakened the banking sector. The first steps taken to further strengthen the banking system was to strengthen prudential regulatory and supervisory standards, and promote greater disclosure on the financial condition of banking institutions. Subsequently, mechanisms and the institutional framework were put in place to deal with potential banking sector problems and promote market confidence, in the face of deteriorating economic conditions. These measures were pre-emptive and involved the consolidation of the finance companies which were the most vulnerable segment in the banking system, as well as the establishment of Pengurusan Danaharta Nasional Berhad, Danamodal Nasional Berhad and the Corporate Debt Restructuring Committee, to address the expected rise in NPLs, erosion of capital and deterioration in corporate performance respectively. These measures provided market-oriented mechanisms to deal with potential problems in a systematic manner. In January 1999, BNM assumed control of two finance companies as part of the ongoing measures to strengthen the banking system. These policy initiatives (discussed in detail in chapter 4 of the Annual Report) were different from those measures adopted in 1985. Assets of the banking system had expanded from RM198.4 billion in 1985 to RM616.4 billion in 1998. Capital and reserves were substantially larger, amounting to RM37.4 billion compared with RM4.1 billion in 1985.

(d) Selective Exchange Control Measures

The Government was aware that the uncertainty and instability of international developments could undermine the progress of various measures taken to support the economic recovery process. Hence, selective exchange control measures were introduced on 1 September 1998 and the exchange rate was fixed at US$1=RM3.80 on 2 September. The measures were aimed at insulating the domestic economy from the risks of external developments, containing the speculation on the ringgit and minimising the impact of short-term capital flows, thus enabling the country to regain a greater degree of **monetary independence**. The measures have been successful in limiting the contagion effects of external developments on the domestic economy, while providing an environment of stability so that the authorities could focus on promoting economic recovery with price stability and accelerate the plans to restructure the financial and corporate sector. For details, refer to Box III on "The Exchange Control Measures as a Policy Option".

(e) Other Policies

The centrepiece of the package introduced during the 1985 recession to encourage the private sector to be the main engine of growth was the introduction of the Promotion of Investments Act, 1986, which provided tax and other incentives to generate the expansion in private investment. This included the liberalisation on foreign equity ownership, which acted as a catalyst in reviving private investment. This led to a rapid recovery of the economy. FDI flows, which had declined since 1984, turned around in 1987 to record net inflows of RM1.1 billion and increased further to RM1.9 billion in 1988. Since then, FDI flows had accounted for a significant portion of the financing of economic activities in Malaysia.

The economy in 1998, compared with 1985, was considerably more open. The foreign share in the domestic market was high as reflected in the significant foreign participation in all sectors of the economy. As a result, there was limited scope for the Government to further liberalise the foreign investment guidelines without marginalising domestic entrepreneurs. Nevertheless, the Government has taken bold steps to allow 100% foreign equity irrespective of the level of exports for all applications received until the year 2000 to set up manufacturing projects, with the exception of specific activities and products including paper packaging and plastic packaging. The foreign equity participation in the telecommunications and insurance sectors has also been relaxed.

During both recessions, the Government took pre-emptive steps to protect vulnerable segments of society. During the 1985 recession, these measures included the Government's three-year programme to build up to 240,000 low cost houses as well as building more roads, especially rural roads. In the current period, the Government also promoted low-cost housing projects, as reflected in the establishment of the Special Scheme for Low and Medium Cost Houses with an allocation of RM2 billion. In addition, funds have also been made available to finance social, health and education projects.

Conclusion

The recovery from the 1985 recession was relatively rapid with GDP expanding by 1.2% in 1986 and 5.4% in 1987, aided by the favourable external environment. The policies implemented during the period helped to set the stage for the economy to record high growth in the subsequent years. In contrast, the recovery from the 1998 recession is expected to be more gradual (growth of 1% in 1999). However, the structural adjustments and financial sector reforms would provide the foundation for sustainable growth and a stronger economy. Nevertheless, uncertainty and the threat of contagion and systemic risk remains, given recent developments on the international front. It is clear that, given the openness of the Malaysian economy, external developments would continue to significantly

Table II.I: Key Macroeconomic and Financial Indicators

	1984	1985	1986	1996	1997	1998*p*
Real GDP growth (%)	7.8	–1.2	1.2	8.6	7.7	–6.7
CPI (% change)	3.6	0.4	0.6	3.5	2.7	5.3
Unemployment rate (%)	8.3	6.9	8.8	2.6	2.6	3.9
Federal Government overall balance (% of GNP)	–6.4	–6.1	–11.2	0.8	2.5	–1.9
Current account balance (% of GNP)	–5.3	–2.1	–0.5	–5.1	–5.4	13.7
External debt (% of GNP)	50.1	59.0	75.6	41.5	65.4	60.9
Debt service ratio (% of exports of goods and services)	11.8	15.8	18.9	6.9	5.5	6.7
Net international reserves (RM bil)	9.6	12.5	16.5	70.0	59.1	99.4
M3 growth (annual change, %)	15.6	9.8	8.8	21.2	18.5	2.7
Banking system deposits (annual change, %)	20.7	10.6	7.5	26.3	21.3	–0.5
Banking system loans (annual change, %)	20.9	14.0	6.0	27.6	26.5	–1.8
3-month interbank rate (average, %)	9.39	7.74	6.41	7.34	8.60	6.48
Average base lending rate (commercial banks, %)	12.25	10.75	10.00	9.18	10.33	8.04
Risk-weighted capital ratio of banking system[1] (%)	6.8*	7.5*	7.0*	10.6	10.6	11.8
Non-performing loans (NPLs)[2] / total outstanding loans (%)	n.a.	n.a.	n.a.	3.7	4.1	7.6
Movement of RM (against composite, %)	+1.8	–8.6	–13.7	+2.6	–31.4	–0.2

[1] Minimum requirement of 8% based on Basle Capital Accord.
* Commercial banks only (Pre-Basle Capital Accord) - minimum requirement of 4% for domestic banks and 6% for foreign banks.
[2] Loans classified as NPLs based on individual banking institution's NPL classification policy, i.e. 3-month or 6-month classification.

P Preliminary

influence the growth cycle of the domestic economy.

The objectives of policy to maintain price stability and achieve sustainable growth remained unchanged during the 1985 recession and in the current situation. The priority of the Government was to put in place policies that would support an early economic recovery. The approach reflected the different circumstances and causes of the economic crisis during these two recessions. In particular, given the more integrated nature of the world economy and the more hostile external environment, the policy responses in the 1998 recession have been more dynamic and unorthodox. The imposition of selective exchange controls has provided an environment of stability which has enabled the Government to continue with implementation of the necessary structural reforms to support economic recovery. Similarly, the Government had to invoke emergency regulations to deal swiftly and decisively with the DTC crisis in the mid-1980s in response to the erosion in depositor confidence.

In both periods, the respective measures restored confidence and preserved stability in the banking system and the intermediation process continued to function effectively. The experience during both recessions demonstrates the need for policies to vary according to circumstances. Success depends on the ability to be pragmatic and flexible, while remaining committed to the objective of restoring financial and economic stability and supporting growth with price stability.

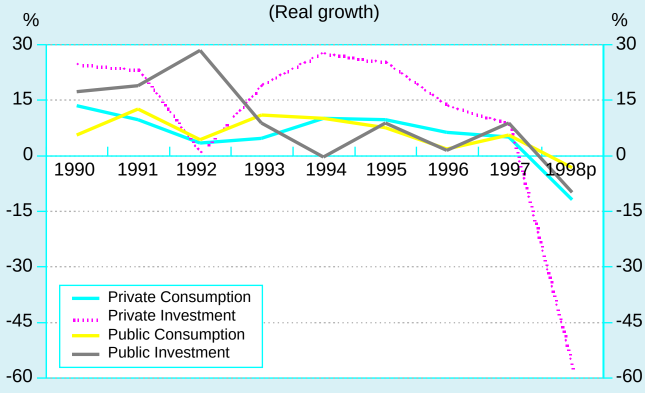
Nevertheless, the Government services sub-sector continued to provide improved public services and amenities to facilitate private sector activities during the year.

Domestic Demand Conditions

Aggregate domestic demand declined in 1998 for the first time since 1986. The major correction in the currency and stock markets and the subsequent negative effects of balance sheet adjustments in the financial and corporate sectors amidst weak external demand contributed to a significant contraction in both private sector investment and consumer spending. The reversal of fiscal consolidation and adoption of a stimulative budget in the second half-year helped to avoid a larger contraction in aggregate demand. As inflationary pressures abated, monetary policy also turned expansionary from August to complement the expansionary fiscal measures. Increased liquidity from domestic and external sources, significantly lower cost of funds and greater stability in the currency and equity markets following the implementation of selective exchange control measures contributed to improved investor and consumer sentiment towards year-end. Reflecting mainly the sharp adjustment in the first three quarters of 1998, aggregate domestic demand (excluding stocks) declined by 20.6% in current prices, as against a growth of 9.6% in 1997 and an average annual growth rate of about 13.5% in the period 1987-97. In real terms, the decline in total domestic expenditure was more pronounced (–25.9%, 1997: +6.5%), with the decline in public expenditure exacerbating the sharp contraction in private sector expenditure.

Total consumption spending declined by 6.5% in nominal terms in 1998, following an increase of 8% in 1997. In real terms, total consumption spending, which accounted for about 67% of total demand, declined by 10.3% (1997: +4.9%). The negative wealth effects arising from the decline in share prices, rising inflation rate and uncertain employment prospects led to more cautious consumer sentiment. The major consumption indicators pointed to a significant adjustment as households reduced consumption, increased savings and reduced existing debt levels. Sales of passenger cars in 1998 registered a decline of 54.8%, compared with an increase of 12.3% in 1997. Total loans approved by the banking system for personal use and for purchasing consumer

Graph 1.9
Domestic Demand Aggregates



goods declined markedly by 72.2% and 93.6% respectively. Similarly, the Business Expectations Survey of the Department of Statistics showed that revenue from wholesale and retail trade declined by 31.4% in 1998, compared with an increase of 14.4% in 1997. Imports of consumption goods in terms of United States dollars declined for the second consecutive year by 32.7% (1997: -0.7%). Reflecting the sharp decline in consumer spending, revenue from sales tax by the Federal Government declined by 37.7% (1997: +12.7%). Nevertheless, consumer sentiment picked up towards end-year as evidenced by the upward trend in several major indicators. Sales of passenger cars increased to 20,248 units in December 1998, compared with a low of 5,724 units sold in February 1998. The latest Business Expectations Survey conducted by the Department of Statistics indicated that gross revenue of the wholesale and retail sectors are expected to increase by 7.3% during the second half year of 1998, compared with a decline of 37.4% during the preceding first half-year. This improved sentiment was also reflected in the Consumer Sentiments Index of the MIER, which indicated an increase in the index to 80.5 points in the fourth quarter from a record low of 79.1 points in the second quarter. Under the recent one-month Home Ownership Campaign which ended on 12 January 1999, properties valued at RM3.5 billion were sold. For 1998 as a whole, **private consumption** spending declined by 7.7% in nominal terms and 12.4% in real terms.

Public consumption expenditure which accounts for about 20% of total consumption also declined, albeit at a more moderate rate of 1.5% in nominal terms and 3.5% in real terms. Following the outbreak of the financial crisis in mid-1997, several measures were announced in the fourth quarter of 1997 to manage the level of aggregate demand as a means to contain the current account deficit in the balance of payments. The economic adjustment measures included an across the board 18% cut in Government spending. However, in the second half of the year, the Government reversed the policy stance and adopted an expansionary fiscal policy with the objective of avoiding further contraction in domestic demand. In practice, the fiscal policy outturn was tighter than planned owing to the implementation gap. Hence, the fiscal deficit is estimated at 1.9% of GNP compared with the Government's 1999 Budget estimate of –3.7% as announced in October 1998. This cutback in non-essential expenditure led to the reduction in public consumption spending on supplies and services and defence expenditure.

The contraction in **total investment** was significantly higher at 39% in nominal terms and 44.9% in real terms. The key investment indicators pointed to the consolidation of investment activities. Imports of capital goods, a leading indicator of investment activity, declined significantly by 40.3% in United States dollar terms (1997: +6.7%). Similarly, sales of commercial vehicles registered a sharp decline of 76.1%, following an increase of 8.4% in 1997. Loans extended by the banking system to the broad property sector (excluding loans sold to Cagamas) increased at a much slower rate of 5.3%, while loans extended to the manufacturing sector declined by 0.2% in 1998 (1997: 32.9% and 18.5% respectively). However, several key indicators have turned positive since September 1998, reflecting some revival in investor sentiment. The performance of the capital market improved with the Kuala Lumpur Composite Index increasing by 123.1% to 586.1 points as at 31 December 1998, from the lowest level of 262.7 points as at 1 September 1998, while the market capitalisation of the Kuala Lumpur Stock Exchange also improved by 106.3% to RM374.5 billion from a low of RM181.5 billion. Sales of commercial vehicles increased to 2,545 units in December 1998 compared with a low of 1,148 units sold in February. The value of proposed investment in the manufacturing sector increased to RM4.5 billion in the fourth quarter, compared with RM3.1 billion in the preceding quarter. The positive sentiment was also reflected in the latest MIER Business Conditions Index, which improved to 44.7 points in the fourth quarter of 1998, from a record low of 41 points in the first quarter.

Table 1.15
Private Investment by Sector[1]

	1996	1997	1998
	RM billion		
Private investment	77.1	86.1	40.2
Of which:	% share		
Manufacturing	26.5	25.7	34.1
Construction	9.7	9.0	12.6
Services	32.9	34.0	31.4

[1] Estimates

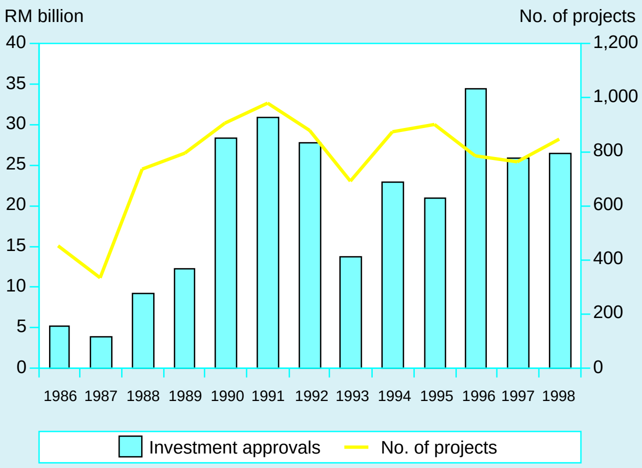
The preliminary estimate for 1998 as a whole, indicated that **private investment** declined markedly by 53.3% in nominal terms. The breakdown of private investment by sector showed that activity in the services and construction sectors were more affected by the financial crisis and the adjustment measures implemented to address the economic imbalances in the economy. The decline of 56.9% in capital outlay in the services sector reflected mainly the completion of large infrastructure projects and the slowdown in implementation of existing projects, while selected new projects with high import content were deferred to strengthen the balance of payments position. Large infrastructure projects deferred in 1997 included the Bakun Hydroelectric project, the Kuala Lumpur Linear City project, the Northern Regional International Airport, Putrajaya Administrative Centre Phase II, the Cameron Highlands-Fraser Hill-Genting Highlands Road project and the Malaysia-Indonesia Bridge project over the Straits of Malacca. The slower rate of investment in the transport sub-sector was also attributed to the delay in the implementation of the Express Rail Link project and slow progress of the KL Monorail project. The scaling down of investment in the finance, insurance and business services sub-sector reflected mainly the substantial reduction in investment in office space, hotels and retail outlets in shopping malls in view of the oversupply situation and weak demand following the economic downturn. Following the marked decline in capital outlays in the services sector, the contribution of the services sector to total investment declined from about 34% in 1997 to 31% in 1998.

The construction sector also experienced severe adjustment in 1998. Capital outlay in this sector, which accounted for a share of 13% of total private sector investment, declined by 34.1%. With the deferment and delayed implementation of several privatised road projects, investment activity in the construction sector was supported mainly by the construction of low- and medium-cost houses. The two privatised projects that were deferred in 1998 were the South Klang Valley Expressway and Kuala Lumpur-Kuala Lumpur International Airport Dedicated Highway.

Structural changes in the economy and the uncertain business climate also affected investment activity in the manufacturing sector. Investment in this sector, which accounted for 34% of total private investment, declined by 38% in 1998 (1997: +8.3%). The decline was broad-based, affecting investment in both the domestic and export-oriented industries. Gross inflows of foreign direct investment into the manufacturing sector was estimated to moderate to RM10.5 billion in 1998, compared with RM18 billion a year ago. The uncertainty in the region, in particular weak export demand and less favourable developments in investing countries caused foreign investors to defer several capital-intensive projects, including wafer fabrication plants. New investment activity in the manufacturing sector was supported mainly by the commencement of several joint ventures in petrochemical projects. The total value of investment approved for these projects exceeded RM6 billion in 1998.

The value of investment approved in the manufacturing sector by the Ministry of International Trade and Industry (MITI) in 1998 recorded an increase of 2.3% to RM26.4 billion (RM25.8 billion in 1997). Of the total investment approved, four large projects, each with proposed capital investment exceeding RM1 billion, accounted for an approximate share of 27.2%. The petroleum products (including petrochemicals) industry accounted for the largest share of 24.4% of the total value of investment approved, followed by the chemicals and chemical products industry (22.4%), basic metal products (10.8%), electrical and electronic products (9.1%) and transport equipment (6.3%) industries. In terms of ownership, the share of domestic investors and foreign investors was 51% and 49% respectively, compared with 56% and 44% respectively in 1997. Reflecting mainly the uncertainty caused by the crisis, the value of applications for investment was lower for 1998, registering a decline of 44.5% to RM19 billion from RM34.2 billion in 1997. Nevertheless, there was a discernible reversal in trend in the fourth quarter of 1998, when the value of applications increased to RM4.5 billion from RM3.1 billion in the third quarter.

Graph 1.10
Malaysia : Investment Approvals



The share of foreign investment in approved projects varied among industries. Foreign investment approved in the chemicals and chemical products industry accounted for 31.7% of total approvals. The share of foreign participation was smaller in other industries, in particular, petroleum products (16.4%), electrical and electronic products (14.5%), basic metal products (7.6%) and textiles and textile products (4.8%). The top five foreign investors in 1998 were the United States (49% of the total foreign investment approved in 1998), Japan (14%), Taiwan (8%), Singapore (7%) and the Netherlands (5%). These countries together accounted for 83% of the total foreign investment approved by MITI.

In line with the objective of attracting foreign investment into the country, the Government has further liberalised the foreign equity policy for the manufacturing sector in respect of new investment, expansion or diversification. Under this new guideline, foreign investors can now hold 100% equity irrespective of the level of exports. This relaxation is applicable for all applications received between 31 July 1998 and 31 December 2000 to set up manufacturing projects. All projects approved under this policy will not be required to restructure their equity after the period, provided that the company continues to comply with the original conditions of approval and retains the original features of the project.

In contrast to the developments in the main sectors, capital investment in the agriculture and mining sectors increased during the year. Investment in the mining sector, which accounted for 6% of total private investment, increased by 18.8% mainly on account of the strong investment in the oil and gas sub-sector. The more favourable export prices for crude palm oil due to the exchange rate factor have also led to some increases in investment in the agriculture sector (7% of total private investment).

Counter-cyclical fiscal policies adopted in early 1998 helped sustain **public investment,** which recorded a marginal decline of 0.3% in nominal terms in 1998 (1997: +11.9%). In line with the implementation of the fiscal stimulus programme, the Federal Government increased the allocation for socio-economic development. Public sector investment was also sustained by capital investment by the non-financial public enterprises (NFPEs). Investments were mainly undertaken for the ongoing capacity expansion and modernisation programmes by the major NFPEs and to meet higher import cost. PETRONAS continued to invest in both upstream and downstream activities, including the construction of two new gas processing plants, central utility facilities in Kertih and Gebeng, several petrochemical projects, development of University Technology PETRONAS and Kuantan-Kertih Railway project. Capital investment by Tenaga Nasional Berhad (TNB) was mainly to expand and upgrade its power generation capacity and its transmission and distribution networks to meet future demand for electricity by commercial and industrial sectors for the industrialisation process. Major projects undertaken by TNB included Phase I of the 500kw transmission network, Phase III of the Port Klang Sultan Salahuddin Abdul Aziz Power Station, the rehabilitation and conversion plants in Melaka, Port Dickson, Prai and Pasir Gudang, development of electricity infrastructure for Putrajaya and Cyberjaya and construction of Phase II of Tenaga Nasional University Complex. Capital outlay by Telekom Malaysia Berhad was largely to upgrade its telecommunication network, including implementation of a host of services and products for the Corporate Information Superhighway, an integral part of the Multimedia Super Corridor and the National Information Infrastructure.

In 1998, **gross national savings** (GNS) continued to increase despite the contraction in the domestic economy. As overall consumption declined significantly, GNS increased further by 5.1% in 1998 (12.3% in 1997 and 24.7% in 1996). The slower growth in 1998 reflected the marginal increase in nominal income. In terms of GNP, the share of GNS increased to 41.2% in 1998, compared with 39.4% recorded in 1997. With gross domestic capital formation declining by 38.4% (1997: +12.7%), the savings-investment gap turned around to register a record surplus of RM36.1 billion or 13.7% of GNP in 1998, from a deficit of RM14.2 billion or 5.4% of GNP in 1997.

In the public sector, public savings declined by 15.9% to RM42.3 billion in 1998 (1997: +26.6%; RM50.3 billion) reflecting lower revenue performance of the public sector arising from the economic downturn and higher expenditure associated with the weakening of the ringgit as well as the counter-cyclical fiscal stance adopted by the Federal Government to address the economic downturn. Nevertheless, the public sector continued to record a surplus, albeit a smaller surplus of RM10.6 billion in 1998, as growth in public investment decelerated to 0.6%.

While the export sector benefited from higher income, due mainly to the depreciation of the ringgit, earnings in other sectors were affected by the erosion of profit margins following the contraction in the economy. Therefore, the increase in private sector savings by 25.2% to RM65.7 billion was mainly on account of the marked decline in private consumption. At the same time, the decline in private investment was significantly higher (–52.9%). Consequently, the private sector resource balance turned around to register a surplus of RM25.5 billion in 1998, from a deficit of RM32.9 billion in 1997.

The high rate of savings has represented one of Malaysia’s strengths and has enabled Malaysia to achieve a decade of high growth that has been financed primarily from domestic sources. This has reduced reliance on external sources of financing and thereby had increased the resilience of the nation to withstand the effects of the depreciation of the currency. In the current environment, it has allowed Malaysia to rely to a greater extent on domestic sources of financing to support the expansionary macroeconomic policy and the restructuring of the financial sector. While savings continue to be important, it is necessary to recognise that consumption is equally important. In particular, during this period of economic contraction, increased consumption is important to support the economic recovery process. The private sector should, therefore, recognise the need to balance between consumption and savings. Over-cautious spending behaviour and an over increase in savings would result in a slowing down of the recovery process.

Recognising the importance of the need to balance consumption and savings, the efforts of the savings programme in 1998/1999 have emphasised on the efficiency of managing household income and expenditure. Towards this objective, two publications were produced during the year, that is, the Household Accounts Book and a Pocket Money Book for students as part of this programme. The objective of the Household Accounts Book is to encourage households to plan and manage their expenses to be in accordance with their present and future income. It also aims to promote more goal-oriented consumption and savings, in particular, to encourage savings for a specific purpose, that is, for a specific future expenditure, such as education, purchase of cars and houses. Greater planning and efficiency in managing income and expenditure will result in greater benefits from the limited resources and contribution towards better living standards. The student's Pocket Money Book is aimed at introducing financial management of personal accounts at a young age and, therefore, produce a society that has an awareness of the gains that can be obtained from such efficiency. This will contribute towards building the foundation for future growth.

External Sector

Balance of Payments

In 1998, the balance of payments outturn was significantly better than expected. The most significant development was the speed and magnitude of the adjustment in the current account balance. Reflecting both the favourable valuation impact of the weaker ringgit on export earnings as well as the rapid decline in imports, the current account recorded an unprecedented large surplus of RM36.1 billion (US$9.2 billion) in 1998, far exceeding the RM20.1 billion surplus projected in the 1999 Budget announcement in October. This was a significant turnaround from a deficit position of RM14.2 billion (US$5 billion) in 1997 and was the first current account surplus since 1989. In terms of GNP, the surplus increased to 13.7%

Table 1.16
Balance of Payments

Item	1998*e* +	1998*e* –	1998*e* Net
	RM million		
Merchandise balance (f.o.b.)	**282,007**	**212,685**	**69,322**
Balance on services	**49,088**	**72,469**	**–23,381**
Freight & insurance	4,129	12,781	–8,652
Other transportation	6,547	4,278	2,269
Travel & education	9,344	6,273	3,071
Investment income	5,789	21,500	–15,711
Government transactions n.i.e.	331	491	–160
Other services	22,948	27,146	–4,198
Balance on goods and services	**331,095**	**285,154**	**45,941**
Unrequited transfers	2,938	12,811	–9,873
Balance on current account	**334,033**	**297,965**	**36,068**
Official long-term capital			2,138
Federal Government	4,001	2,182	1,819
Market loans	2,435	1,324	1,111
Project loans	1,566	858	708
Suppliers' credit	–	–	–
Non-financial public enterprises	4,705	4,344	361
Other assets and liabilities			–42
Private long-term capital			8,740
Balance on long-term capital			10,878
Basic balance			**46,946**
Private short-term capital (net)			–21,700
Errors and omissions			15,055
Overall balance (surplus +/ deficit –)			**40,301**
Allocation of Special Drawing Rights			–
IMF resources			–
Net change in international reserves of Bank Negara Malaysia (increase – / decrease +)			–40,301
Special Drawing Rights			–315
IMF reserve position			–757
Gold and foreign exchange			–39,229
Bank Negara Malaysia international reserves, net [1]			**99,424**

[1] Arising from the fixing of ringgit/US dollar exchange rate at RM3.80 in September 1998, all assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the cumulative gain has been reflected accordingly in the Bank's current year account. The US dollar equivalent of international reserves as at 31 December was US$26.2 billion.

e Estimate

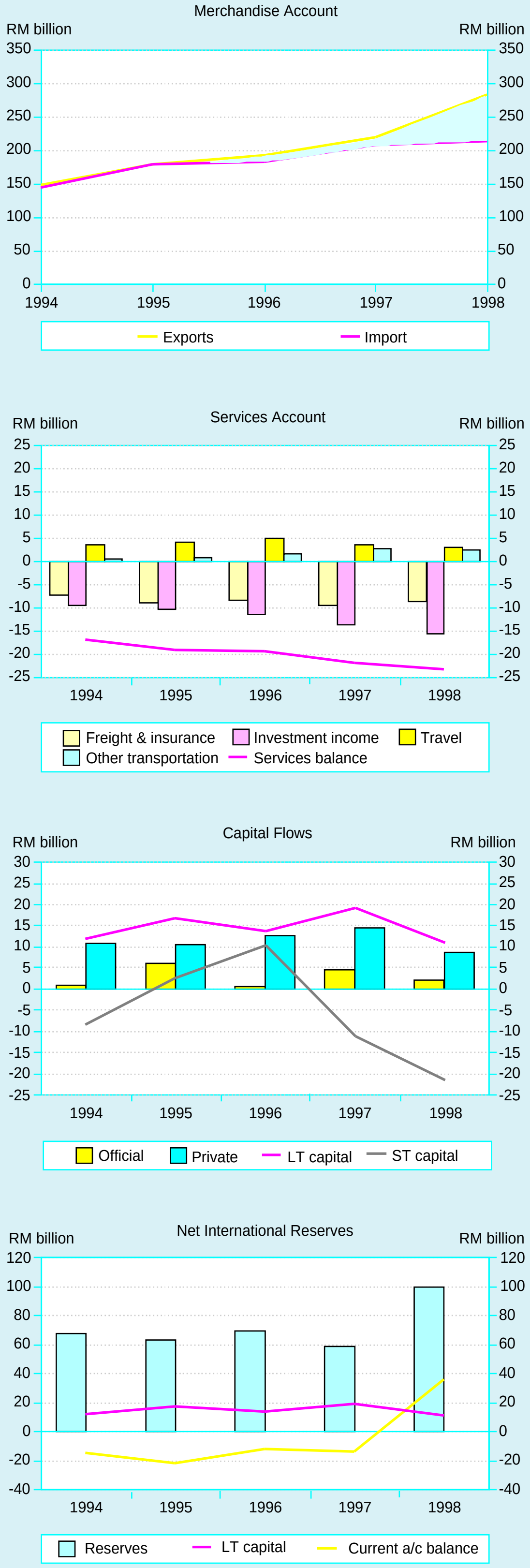
Source : Bank Negara Malaysia and Department of Statistics

(1997: –5.4%), surpassing the previous high of 8.9% achieved in 1987, after the last recession. The improved current account position reflected an exceptionally large surplus in the merchandise account, which more than offset both the higher services account deficit and the large outflows on the transfers account. The merchandise surplus rose to a record high of RM69.3 billion (US$17.7 billion) in 1998, due mainly to a reduction in import volume, particularly of capital goods, reflecting the impact of the sharp contraction in domestic demand combined with the deliberate policy to defer non-critical infrastructure projects and rationalise the purchase of imported goods by public agencies. At the same time, export earnings increased sharply in ringgit terms, due mainly to valuation gains. More significantly, exports in United States dollar terms recorded positive growth in the last three months of 1998, reflecting a surge in the exports of electronic equipment and parts.

The global financial market turmoil and investors' risk aversion to emerging markets, including Malaysia, resulted in a decline in new capital inflows in 1998. The net inflow of long-term capital declined to RM10.9 billion from RM19 billion in 1997. This was attributable to the lower net inflows of both official and private long-term flows, which were affected by the tightening of lending conditions in international debt markets, continued uncertainty in the region and the cautious approach of new long-term foreign investors following the introduction of selective exchange control regulations in September 1998. Meanwhile, the widening spreads following the downgrading of Malaysia's sovereign debt rating (but still at investment grade) made external borrowing a more costly funding option for Malaysian borrowers. Nevertheless, Malaysia continued to receive official loans from the World Bank and bilateral lenders, especially Japan. Reflecting the above developments, the basic balance, comprising the current account and long-term capital account, recorded a large surplus of RM46.9 billion in 1998 (RM4.8 billion in 1997).

For the second consecutive year, the short-term capital account recorded a substantial outflow of RM21.7 billion (1997: –RM11.3 billion), reflecting the decline in short-term debt of the commercial banks in response to the stagnation in domestic demand, sluggish external trade and liquidation of portfolio investment by foreign investors. After adjusting for errors and omissions of RM15.1 billion,

Graph 1.11
Malaysia: Balance of Payments



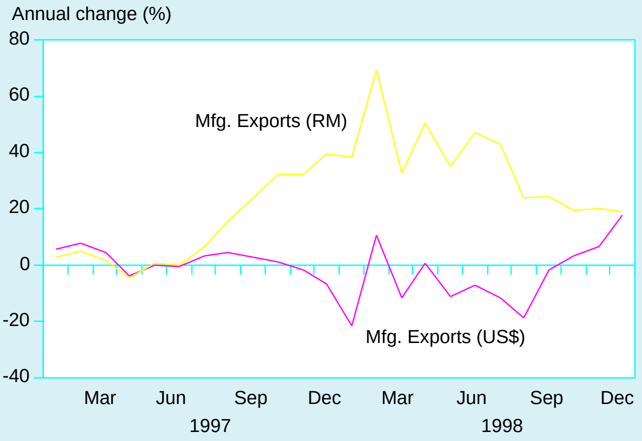
reflecting mainly the exchange rate gain from the revaluation of external reserves, the overall balance of payments reverted to a surplus of RM40.3 billion (US$10.3 billion) from a deficit of RM10.9 billion (US$3.9 billion) in 1997. Net international reserves of Bank Negara Malaysia increased to RM99.4 billion (US$26.2 billion) at the end of 1998 from RM59.1 billion (US$21.7 billion) at end-1997. This level of reserves was sufficient to finance 5.7 months of retained imports (3.4 months in 1997).

The stimulative measures introduced since mid-July did not result in significant leakage abroad in 1998. The additional funds were directed at projects which used, to a large extent, domestic raw materials and services to ensure sustained improvement in the balance of payments to strengthen Malaysia's external reserves position. Maintaining a strong reserves position is important to both the short-term objective of economic recovery as well as the long-term aim to maintain a sustainable external position. A large reserves cushion is indeed a key element in protecting the country against unforeseen destabilising developments. This would help to sustain market confidence and stability, enhance creditworthiness and at the same time, provide the Government with greater flexibility in the conduct of domestic policies.

In 1998, the performance of the **merchandise account** exceeded all targets set during the year to achieve a substantial surplus of RM69.3 billion, far higher than the RM11.3 billion recorded in 1997. The expansion in the surplus was the result of the stronger expansion of merchandise exports (28.9%) compared with merchandise imports (2.6%). In the case of exports, this was primarily due to valuation gains from the depreciation of the ringgit as international prices for most of Malaysia's major exports were lower while export volume remained stable. In the case of imports, both volume and prices declined to offset the higher import costs due to the weaker ringgit.

The **trade account** performed better than expected. The trade surplus rose to an unprecedented level of RM58.4 billion in 1998, far exceeding the previous high of RM13.3 billion recorded in 1987. Export receipts grew by 29.8% in ringgit terms to reach RM286.8 billion, due in large part to the depreciation of the ringgit against most major currencies, especially the United States

Graph 1.12
Manufactured Exports



dollar. Growth in imports decelerated to 3.3% to reach RM228.3 billion. In United States dollar terms, imports recorded a large reduction of 26.2%, reflecting the sharp contraction in domestic demand. The Government also implemented deliberate measures to strengthen the external balance, including rationalisation of the purchases of imported goods by public agencies and the deferment of large projects.

By the end of 1998, the trade account had been in surplus for 14 consecutive months since November 1997. More importantly, the size of the surpluses has also been rising. This has primarily been the result of the sustained strong export growth in ringgit terms. In United States dollar terms, exports registered a decline of 6.9% for 1998 as a whole. However, a positive development was that the value of exports in United States dollars stabilised by September 1998 to levels recorded a year ago and expanded gradually for the remaining months of the year.

Export earnings in ringgit terms rose by 29.8% in 1998, reflecting increases in the exports of manufactured goods (32.8%) and commodities (17.4%). However, export receipts in United States dollar terms contracted by 6.9%, as the marginal increase in the export volume was offset by the relatively sharper slide in United States dollar export prices. Despite recording lower earnings in United States dollar terms, manufactured exports remained the major contributor of foreign exchange earnings to account for 82.9% of total gross exports (1997: 81%). Reflecting mainly the strong export growth of the electronic equipment and parts sub-sector, gross exports recorded a positive growth of 5.2% in the fourth quarter of the year (1Q: –11.3%; 2Q: –10.1% and 3Q: –10.8%).

Exports of **manufactured goods** in ringgit terms rose by 32.8% to RM237.6 billion in 1998 (1997: 12.9% to RM178.9 billion). All industries recorded higher export receipts except for wood and petroleum products. Higher exports reflected mainly exchange rate valuation effects as well as a marginal increase of 1.4% in export volume (exchange rate of ringgit vis-à-vis United States dollar averaged US$1=RM3.92 in 1998 compared with US$1=RM2.81 in 1997). Exports rose sharply in the first half-year (44.2%) reflecting mainly valuation effects before moderating in the second half of the year (23.8%). The moderation in the second half-year reflected partly the sharper deterioration in the export volume in the third quarter before it recovered strongly in the fourth quarter. In United States dollar terms, manufactured exports contracted by 7.8% in the first half-year and its performance worsened to record a sharper decline of 11.1% in the third quarter. However, during the fourth quarter of the year, a turnaround was recorded when exports rebounded to increase by 8.8%, representing the first quarterly

Table 1.17
Gross Exports

	1998				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Manufacturing sector	**237,649**	**32.8**	**82.9**	**60,797**	**–4.6**
Of which:					
Electronics, electrical machinery and appliances	161,733	35.9	56.4	41,375	–2.4
Electronics	114,175	41.3	39.8	29,238	1.9
• *Semiconductor*	*54,483*	*33.3*	*19.0*	*13,931*	*–4.2*
• *Electronic equipment & parts*	*59,692*	*49.6*	*20.8*	*15,307*	*8.2*
Electrical machinery & appliances	47,558	24.3	16.6	12,138	–11.4
• *Consumer electrical products*	*20,648*	*16.1*	*7.2*	*5,267*	*–17.3*
• *Industrial & commercial electrical products*	*15,065*	*25.5*	*5.3*	*3,841*	*–10.5*
• *Electrical industrial machinery and equipment*	*10,974*	*41.8*	*3.8*	*2,807*	*1.2*
• *Household electrical appliances*	*871*	*19.0*	*0.3*	*223*	–13.5
Textiles, clothing and footwear	9,442	24.0	3.3	2,408	–11.1
Chemicals & chemical products	10,627	30.6	3.7	2,717	–6.6
Wood products	5,982	–7.8	2.1	1,528	–34.3
Manufactures of metal	8,255	45.8	2.9	2,114	5.0
Transport equipment	8,064	62.6	2.8	2,085	17.1
Rubber products	5,739	45.0	2.0	1,465	3.8
Optical and scientific equipment	4,760	21.7	1.7	1,217	–11.8
Agricultural sector	**30,201**	**30.4**	**10.5**	**7,704**	**–6.4**
Of which:					
Rubber	2,829	–4.8	1.0	723	–32.5
Saw logs	1,866	–20.5	0.7	475	–43.4
Sawn timber	2,526	–9.0	0.9	644	–36.0
Palm oil	17,779	64.4	6.2	4,533	17.8
Minerals	**14,874**	**–2.4**	**5.2**	**3,786**	**–32.7**
Of which:					
Tin	485	1.5	0.2	123	–29.2
Crude oil	7,510	6.2	2.6	1,917	–23.8
LNG	5,981	–4.4	2.1	1,525	–37.1
Other	**4,032**	**16.9**	**1.4**	**1,039**	**22.1**
Total	**286,756**	**29.8**	**100.0**	**73,326**	**–6.9**

Source: Bank Negara Malaysia and Department of Statistics increase since the third quarter of 1997. As a result, the decline in exports in United States dollar terms moderated to 4.6% in 1998 (+1.1% in 1997). A surge in the exports of electronic equipment and parts and rubber products contributed to the rebound in exports during the fourth quarter.

Although exports in United States dollar terms declined, overall **export volume** of manufactured goods rose by 1.4% during the year. This reflected a 5.9% decline in export prices expressed in United States dollars. Price competition in the major markets had intensified during the year, owing to excess capacity and competition among countries affected by the regional financial crisis. At the same time, external demand was affected by poor orders from the Asia-Pacific region, which accounted for about 40% of total manufactured exports (including exports to Singapore which were mainly re-exported to the Asia-Pacific region, the United States and Europe). Exports to the United States, which was the single largest export market, however, improved to increase by 9.3% in United States dollar terms (1997: 2.7%) and helped to offset in part the declining trend in exports to the East Asian countries. The United States accounted for 25.4% of Malaysia's total manufactured exports in 1998 (22.1% in 1997).

Exports of electronic goods in United States dollar terms rose by 1.9% in 1998, accounting for 48.1% of total manufactured exports, due mainly to the contribution from electronic equipment and parts. The revival of the disk-drive sub-sector, coupled with improved sales of personal computers and intensified efforts to deal with the Year 2000 problem, boosted the demand for electronic equipment and parts, which posted an increase of 8.2% during the year. Exports of semiconductors, however, shrank by 4.2% on account of the persistent oversupply of memory chips and the resultant sharp decline in prices. The severity of the downward adjustment in chip prices only moderated towards year-end following the decision of some major world producers to halt or cut their production levels in an effort to restrain falling prices and rapidly dwindling margins. Meanwhile, according to the latest report of the Semiconductor Industry Association, global semiconductor sales fell by 8.4% in 1998, although the contraction in annual sales moderated towards year-end. In particular, sales in the Asia-Pacific market increased by 2.4% in December 1998 after declining for eight consecutive months.

Poor external demand caused the exports of electrical products in United States dollar terms to decline by 11.4% in 1998. Although exports to the United States were higher, they were not sufficient to offset the lower demand from the Asia-Pacific region. The export performance of this industry was also affected by aggressive price cutting by other producer countries. The decline in exports of electrical products was across-the-board, encompassing consumer electrical products (mainly audio-visual products), industrial and commercial electrical products, electrical industrial machinery and equipment, and household electrical products. The introduction of digital electrical products (such as digital television and digital video disk players) had not stemmed the downward trend of foreign orders, reflecting cautious consumer spending in the face of the economic downturn.

Exports of textile and clothing valued in United States dollars also fell by 11.1%, attributed mainly to sluggish demand from the Asia-Pacific region. Meanwhile, demand for wearing apparel in the United States and the European Union was sustained despite intense price competition. However, this was offset by lower exports of textiles, particularly synthetic textiles to the East Asian countries, including Hong Kong Special Administrative Region (SAR), The People's Republic of China; Japan; The People's Republic of China; and Singapore. In the chemical products industry, Malaysian manufacturers succeeded in expanding their exports to the United States. Nevertheless, the slow pace of industrial activities in Hong Kong SAR, Singapore and Japan resulted in reduced offtake of organic chemicals and chemical materials from these countries. Overall, exports of chemical products contracted by 6.6% during the year.

The wood products industry recorded a sharp decline in exports of 34.3% in 1998, due to both lower prices and external demand. Sluggish construction activities in The People's Republic of China, Japan and Korea dampened demand for plywood, hardboard and particle board. Towards the end of the year, prices of plywood improved moderately due mainly to stock replenishment by major buyers. The market was also boosted by the reconstruction activities in The People's

Republic of China, following the big flood and the ban on logging in some locations.

The downturn in the domestic construction sector prompted manufacturers of metal products to seek export markets. Higher export earnings were recorded for the metal products industry (+5%), particularly from exports to the United States and Hong Kong SAR. Exports of non-metallic mineral products, however, declined further (–13.2%) as construction activities in the Asia-Pacific region, which accounted for about 60% of the industry's exports, remained sluggish. The decline in the United States dollar export price was also more severe in the case of non-metallic mineral products as compared with metal products.

Exports of transport equipment, on the other hand, rose by 17.1% in United States dollar terms, owing to higher re-exports of aircraft upon completion of repairs and servicing. Meanwhile, the export performance of motor vehicles was hampered by poor global sales of automobiles. The sluggish global demand had also affected major world producers as reflected in their move towards consolidation through mergers and acquisitions.

Exports of rubber products rose by 3.8% in United States dollar terms in 1998, bolstered by sustained demand for examination and surgical gloves from the United States, the European Union and Australia. Stringent quality controls set by the Malaysian glove manufacturers to meet the international standard requirement of the major markets helped gain market shares. Meanwhile, intense competition from low-cost producing countries which had abundant supplies of raw materials prompted the Malaysian manufacturers to move towards higher value-added surgical gloves, particularly those which were powder-free. The industry is faced with a major challenge in the immediate term as competing producers in the major export markets are campaigning for greater use of synthetic gloves.

The optical and scientific equipment industry, which has gained prominence in recent years, registered lower exports valued in United States dollars (–11.8%), due to lower demand for measuring, checking and controlling instruments as well as watches and clocks, particularly in Singapore, Hong Kong SAR, Japan and the United States. Similarly, lower consumption in the region had affected the exports of food products. Meanwhile, sluggish industrial demand in the region, coupled with weak prices in the international markets also resulted in lower export earnings from petroleum products.

The export performance of the **commodity** sector remained strong during 1998. Export earnings from this sector increased by 17.4% to RM45.1 billion (1997: +8.2% to RM38.4 billion). Export prices in ringgit terms increased by 29.7%, reflecting mainly the valuation gains while the overall export volume remained stable as the higher volume of crude oil exports was offset by the declines in the export volumes of other major commodities. However, in United States dollar terms, commodity export earnings declined by 17.1% during the year, due to lower export prices for all major commodities, except palm oil and cocoa.

Exports of **agricultural** commodities increased significantly by 30.4% to RM30.2 billion (1997: +3.2% to RM23.2 billion), reflecting mainly a marked increase in palm oil exports, which more than offset lower proceeds from the export of rubber, saw logs, sawn timber and cocoa. Export earnings from palm oil increased strongly by 64.4% to RM17.8 billion in 1998, reflecting mainly a sharp increase in export unit value, thereby maintaining its position as the single largest export earner for the commodity sector. During the year, the export unit value of palm oil rose by 19.1% in United States dollar terms (66.1% in ringgit terms), on account of the decline in the global supply of palm oil. On the other hand, the export volume of palm oil declined by 1%, due mainly to supply constraints. The nation's crude palm oil production fell by 8.3% in 1998 attributable primarily to the reversal in the biological yield cycle for oil palm trees.

Export earnings from rubber continued to decline by 4.8% to RM2.8 billion, largely due to a further decline in prices (–2%) as demand from the major consuming countries remained weak during the year amidst excess global supplies of the commodity. Export proceeds from saw logs also declined sharply by 20.5% to RM1.9 billion due to both lower export volume (–15.3%) and export unit value (–6.1%). Similarly, export earnings from sawn timber and cocoa declined by 9% and 17.3% respectively.

Adverse developments in the market for saw logs and sawn timber were due mainly to lower demand from the Asia-Pacific region. Malaysia exported almost all of its saw logs and 61% of its sawn timber to the region.

Total export earnings from the **mining** sector declined by 2.4% to RM14.9 billion in 1998 (1997: +16.9% to RM15.2 billion). Crude petroleum remained as the top export earner accounting for 50.5% of total export receipts of this sector and 2.6% of total gross exports. The export volume of crude oil increased by 13.5% to 18 million tonnes as demand for Malaysian superior grade crude oils remained favourable. However, arising from lower crude oil prices which reflected weak global demand and excess supplies, the export unit value of Malaysian crude petroleum declined by 32.8% to US$14.00 per barrel. The decline in world crude oil prices accelerated in the second half of the year as global demand weakened in the face of high inventories of crude oil and a mild winter in the Northern Hemisphere. Nevertheless, in ringgit terms, the export unit value of crude oil declined less sharply by 6.4% to RM417 per tonne from RM445 per tonne in 1997. Export earnings from liquefied natural gas (LNG) fell by 4.4% to RM6 billion during the year, contributing to 40.2% of total export proceeds of the mining sector. The export unit value of LNG declined by 1.9% to RM408 per tonne, in line with lower crude oil prices. The volume of LNG exports also declined by 2.6% reflecting lower demand from the major buyers, namely, Japan and Korea as these economies experienced a contraction in output.

The weak growth in **gross imports** of 3.3% reflected both declines in volume and lower international prices for most major import commodities, which largely offset the valuation impact of the depreciation of the ringgit. Import volume was estimated to be lower by about 20.5%, while import prices declined by 7.2%. As a result, gross imports in United States dollar terms were lower by 26.2% (1997: +0.8%). The decline in the import volume reflected weak domestic demand conditions, as well as the reduction in imports of inputs for manufacturing exports in response to the less favourable export environment. The postponement of non-critical infrastructure and other large projects by both the public and private sectors also contributed to the reduction in imports.

Since 1970, Bank Negara Malaysia (BNM) had been the only source of information for data on **gross imports by economic function**, which was compiled based on the methodology suggested by the United Nations Economic Commission for Asia and the Far East (now known as the Economic and Social Commission for Asia-Pacific or ESCAP). However, in February 1998, the Department of Statistics published for the first time in its Monthly External Trade Statistics Bulletin, information on imports by end use classified according to the Broad Economic Categories (BEC) system. The switchover to the BEC methodology is timely for the following reasons:

- The BEC classification ensures compatibility with the national accounts data, which is already being compiled based on the System of National Accounts of the United Nations; and
- Malaysia's adoption of the BEC classification system brings us in line with practices in most countries and allows international comparison of imports by economic functions.

Based on the BEC classification, the shares of capital and consumption goods imports are lower, while the share of intermediate goods is higher compared with the classification based on the ESCAP system.

By economic function, all types of imports, except imports of intermediate goods, declined. When valued in United States dollar terms, all categories of imports recorded substantial reductions. **Imports of capital goods** declined by 15.1% even in ringgit terms (–40.3% in United States dollar terms), a significant decline following the sharp contraction in private investment during the year. The decline also reflected deliberate adjustment measures undertaken by the Government to reduce imports of lumpy capital goods to strengthen external balances. Imports of all categories of capital goods were lower during the year. In United States dollar terms, the decline was most noticeable for construction and mining equipment (–93.9%), reflecting the severe downturn in the construction sector, industrial machinery (–46.4%) and industrial transport equipment (–46.4%) . Imports of telecommunications equipment declined by 45.6% as most operators had either completed their investment in the run-up to equal access or shelved investment plans due to the economic downturn. Imports of generators and power transmission equipment declined by 20.6% following the completion of the capacity expansion programmes in the utilities sector. Similarly, imports of ships fell by 19.7% with the deferment of investment plans. Imports of ships and aircraft together amounted to US$2.5 billion, lower than the US$2.7 billion incurred in 1997.

Imports of intermediate goods in United States dollar terms, declined by 21.3%. The decline was in line with the decline in manufacturing production in response to weak domestic and export demand, especially from the East Asian countries. The decline in the imports of intermediate goods was mainly the result of lower imports of processed industrial supplies (–35%). Inputs used in domestic market-oriented industries in this category contracted severely. Imports of metals, in particular, were lower by 42.1%, while those of metal products declined by 25.5%. Imports of semi-manufactured gold were lower by 70.9%, reflecting a decline in domestic demand for jewellery as well as a sharp drop in tourist arrivals. Reflecting the severe contraction of activities in the construction sector, imports of mineral products declined by 57.4%. Inputs used in export-oriented industries in this category were relatively less severely affected. Imports of non-electronic parts for electrical apparatus (–44.8%), textiles and fabrics (–24.3%) and chemicals (–20.4%) recorded substantial declines reflecting the poor the performance of these sectors within the manufacturing sector. The decline in imports of non-electrical parts for electrical apparatus reflected, to some extent, lower costs from the significant depreciation of other East

Table 1.18
Gross Imports by Economic Function

	1998				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Capital goods	**36,339**	**–15.1**	**15.9**	**9,258**	**–40.3**
Capital goods (except transport equipment)	29,757	–13.4	13.0	7,582	–38.8
Industrial machinery	*10,965*	*–24.9*	*4.8*	*2,789*	*–46.4*
Transport equipment	6,582	–22.1	2.9	1,676	–46.4
Intermediate goods	**159,958**	**9.8**	**70.1**	**40,875**	**–21.3**
Food and beverages, mainly for industry	4,166	27.8	1.8	1,065	–7.4
Industrial supplies, n.e.s.	50,315	–8.5	22.0	12,846	–34.9
Metals	*11,855*	*–19.3*	*5.2*	*3,026*	*–42.1*
Fuels and lubricants	4,627	3.6	2.0	1,183	–44.6
Parts and accessories of capital goods (except transport equipment)	98,752	24.1	43.3	25,251	–10.5
Electronics	*64,201*	*40.2*	*28.1*	*16,415*	*0.8*
Parts and accessories of transport equipment	2,098	–38.4	0.9	531	–57.0
Consumption goods	**13,152**	**–6.1**	**5.8**	**3,361**	**–32.7**
Food and beverages, mainly for household consumption	5,681	1.6	2.5	1,453	–27.0
Transport equipment, non-industrial	37	–79.3	0.0	10	–85.4
Consumer goods, n.e.s.	7,435	–9.8	3.3	1,899	–35.4
Consumer durables	*1,107*	*–23.4*	*0.5*	*282*	*–45.5*
Consumer semi-durables	*2,778*	*–13.2*	*1.2*	*709*	*–37.7*
Consumer non-durables	*3,550*	*–1.3*	*1.6*	*907*	*–29.3*
Dual use goods	**3,826**	**–38.5**	**1.7**	**974**	**–56.1**
Motor spirit	2,286	21.7	1.0	583	–13.5
Passenger motor cars	1,540	–64.5	0.7	391	–74.7
Others	**4,215**	**–12.4**	**1.8**	**1,081**	**–37.9**
Re-exports	**10,819**	**45.7**	**4.7**	**2,799**	**6.1**
Gross Imports	**228,309**	**3.3**	**100.0**	**58,348**	**–26.2**

n.e.s: Not elsewhere specified.

Source: Department of Statistics

Asian currencies. Imports of other accessories for motor vehicles and engines and engine parts for motor vehicles contracted by 63.1% and 55.7% respectively, reflecting the downturn in the motor assembly industry due to higher interest rates and tight credit conditions for the greater part of the year. However, the moderate decline in imports of parts and accessories of capital goods (excluding transport equipment) of 10.5% helped slow the overall decline in imports of intermediate goods. This was mainly the result of a 0.8% increase in the imports of electronic component parts, in part reflecting the pick up in exports towards the end of the year.

Imports of consumption goods declined by 32.7% in United States dollar term, reflecting weak consumer demand amidst uncertainty regarding income and employment prospects as well as the negative wealth effects arising from the decrease in asset values. This decline was mainly the result of lower imports of durable and semi-durable consumer goods. The weaker ringgit also resulted in greater domestic substitution of consumer durables. In particular, imports of sound and video reproducing equipment declined by 48.9%, while those of cameras and optical equipment were lower by 56.8%. Among semi-durable consumer goods, particularly significant declines were evident in imports of tapes and records (–37.6%), toys, games and sports equipment (–39.9%), clothing and footwear (–50.1%) and household furnishings and goods (–39.4%). Imports of processed food declined by 27.1% while those of primary food fell by 26.8%. In United States dollar terms, imports of **dual use goods**, namely motor spirit (gasoline) and passenger motor cars, declined by 56.1%, mainly on account of the 74.7% decline in the import of passenger motor cars. The 1998 Budget had raised import duties on luxury motor vehicles, which further contributed to this decline.

The relatively more moderate decline in imports of intermediate goods resulted in its share of total imports increasing to 70.1% (1997: 65.9%), primarily at the expense of a lower share of imports of capital goods of 15.9% of gross imports (19.4% in 1997). Imports of consumption goods remained relatively stable to account for 5.8% (6.4% in 1997).

The effects of the depreciation of ringgit was seen in the expansion in Malaysia's **total trade** by 16.6% (12.1% in 1997) to RM515 billion or 196% of GNP in 1998 (RM442 billion or 169% of GNP in 1997). In United States dollar terms, however, total trade declined by 16.5%, vis-à-vis the growth in world trade of 3.4%. During the year, the relative importance of various trade partners shifted, reflecting domestic demand conditions prevailing both in Malaysia as well as in partner countries. The United States continued to remain Malaysia's largest trade partner and its relative importance grew during the year. In terms of total trade, the United States increased its share from 17.7% in 1997 to 20.8% in 1998. Singapore continued to remain a major trade partner with a share of 15.5%, in view of the transhipment of a significant portion of Malaysian trade through the republic. However, Japan's share of total trade fell from 17.2% to 14.6%, reflecting the weak demand conditions in the Japanese economy. As a result, Japan slipped into third place, behind Singapore. Countries of the European Union continued to maintain their share of Malaysia's total trade at 14.3%. Germany, the United Kingdom and the Netherlands remained the largest trading partners in this group. Trade with these four major trading partners (including the European Union) accounted for 65.1% of total trade.

In terms of **export destination**, the United States became Malaysia's largest export market in 1998 while Singapore was relegated to second position. Japan retained its position as the third largest export market. In terms of **import origin**, the United States and Japan were the largest source of imports with a share of 19.6% each, followed by Singapore (13.6%). Reflecting the substitution of imports from cheaper alternative sources, the share of imports from Indonesia, the Philippines, The People's Republic of China and Korea increased mainly at the expense of imports from Japan and Europe.

In 1998, the depreciation of the ringgit yielded significant improvement in Malaysia's favour in terms of **bilateral trade balances**. Malaysia recorded larger trade surpluses with Singapore, the United States, the European Union (mainly the Netherlands, the United Kingdom and Belgium), Hong Kong SAR and India. Of significance, Malaysia's trade surplus with the United States rose to RM17.4 billion, substantially higher than the RM4 billion surplus recorded in 1997. The trade surplus with the Eurupean Union also increased sharply to RM19.4 billion (1997: RM692 million), especially with the Netherlands and the United Kingdom. In the case of several other trading partners, the trade deficits turned into surpluses in 1998, especially the trade balance with The People's Republic of China, Taiwan and Australia. The significant improvement in the trade balance was due in part to higher demand for cheaper Malaysian goods following the currency depreciation as well as the valuation impact on export earnings. Meanwhile, the persistent deficit with Japan remained, albeit much smaller at RM14.6 billion (1997: RM21 billion). The discernible shift by Malaysia to source imports from lower cost suppliers, especially from countries experiencing large currency depreciations led to the widening trade deficits with Indonesia, the Philippines and Korea.

For the first time since 1989, the surplus in the merchandise account was more than sufficient to offset the higher services deficit and higher outflows on the transfers account. In 1998, the net outflow in the **transfers account** increased significantly to RM9.9 billion (RM3.7 billion in 1997). This reflected mainly the one-time lump sum repatriation made by nearly half a million foreign workers returning to their home countries. The deficit in the **services account** widened by RM1.6 billion to RM23.4 billion, reflecting mainly the valuation impact of the depreciation of the ringgit as the services account valued in United States dollars recorded a smaller deficit of US$6 billion (US$7.7 billion in 1997). In terms of ringgit, the deterioration was due mainly to higher gross payments of RM72.5 billion (RM71.3 billion in 1997). Overall, reduced demand for imported services following the slowdown in economic activity was more than offset by the higher cost of transactions on account of the weaker ringgit. Gross receipts were marginally lower at RM49.1 billion (RM49.5 billion in 1997). The poorer performance of the services account essentially reflected larger net outflow of investment income arising from higher cost of debt servicing during the year. At the same time, the net surplus in the travel and other transportation accounts were smaller, with receipts affected by the lower demand for Malaysia's exported services due to the regional economic downturn. Meanwhile, the freight and insurance and other services accounts showed some improvements in 1998.

Table 1.19
Direction of External Trade

	1998				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	
ASEAN countries	68,578	23.9	51,492	22.6	17,086
Singapore	48,689	17.0	30,944	13.6	17,745
Thailand	9,059	3.2	8,832	3.9	227
Indonesia	3,932	1.4	5,778	2.5	–1,846
Philippines	4,521	1.6	5,386	2.4	–864
Brunei Darussalam	907	0.3	15	0.0	892
Vietnam	1,470	0.5	538	0.2	932
European Union	46,432	16.2	27,072	11.9	19,361
United Kingdom	10,328	3.6	5,067	2.2	5,261
Germany	8,655	3.0	9,019	4.0	–364
Netherlands	13,437	4.7	2,001	0.9	11,436
Other	14,012	4.9	10,985	4.8	3,027
United States	62,130	21.7	44,762	19.6	17,367
Japan	30,237	10.5	44,854	19.6	–14,618
The People's Republic of China	7,764	2.7	7,250	3.2	514
Hong Kong SAR	13,300	4.6	5,943	2.6	7,356
Taiwan	11,798	4.1	11,647	5.1	151
South Korea	6,516	2.3	13,126	5.7	–6,610
India	6,744	2.4	1,830	0.8	4,914
Australia	6,617	2.3	4,997	2.2	1,621
Rest of the world	26,640	9.3	15,336	6.7	11,303
Total	**286,756**	**100.0**	**228,309**	**100.0**	**58,446**

Source: Department of Statistics.

Net payments in the **investment income** account increased further by RM1.9 billion to RM15.7 billion in 1998, affected by the deterioration in both the interest income and profits and dividends components. The interest income account remained in deficit (–RM2.1 billion) for the second successive year, reflecting higher cost of debt servicing due to the weaker ringgit and the increase in the medium and long-term external debt. Similarly, the profits and dividends component recorded larger net payments, attributed to substantially lower receipts from Malaysian investment abroad during the year. Profits and dividends accruing to foreign investors from higher ringgit export earnings were largely offset by increased import costs, higher provisions for valuation losses as well as lower oil prices affecting profits of oil campanies. As in previous years, net investment income outflows remained the largest contributor to the services deficit, with its share rising further to 67% (63% in 1997).

In 1998, the regional economic downturn affected the performance of the tourism industry. The net surplus in the **travel account** fell to RM3.1 billion, representing an annual decline of 13.6%. Tourist arrivals fell for the third consecutive year, by a further 10.6% to 5.6 million, below the initial official target of 6.8 million visitors for the whole of 1998. Average per capita expenditure of tourists also declined, albeit at a marginal rate of 1%, due primarily to a 5% reduction in per diem expenditure as the length of stay of tourists per visit increased to 5.5 days (1997: 5.3 days). Similarly, the number of excursionist arrivals also dropped by 16.4%. As a result, the combined earnings from tourists (who stayed for more than one day), excursionists (day travellers) and transit passengers, fell by RM1.2 billion to RM9.3 billion. On the payments front, expenditure on travel and education abroad fell by 8% and 16.4% to RM4.1 billion and RM2 billion respectively. The economic uncertainty, the negative wealth effect from falling asset price and the weaker ringgit resulted in a significant reduction in the number of Malaysians travelling abroad as well as a smaller number of students studying abroad, including Government-sponsored students. The decline in the number of students abroad was also attributable to the Government's policy to increase the intake at local universities and to promote the establishment of twinning programmes between foreign universities and private colleges and the setting up of branch campuses of foreign universities in Malaysia. The promotion of domestic tourism also contributed to the smaller outflow on the travel account. Meanwhile, payments for pilgrimage rose by 33.6% to RM200 million, reflecting mainly the exchange rate effect.

The net surplus in **other transportation** account (consisting of passenger fares; charter fees; and port and airport-related activities, such as stevedoring, bunkers and port and airport disbursements) declined by 11.7% to RM2.3 billion, after registering a record surplus of RM2.6 billion in 1997. Gross receipts were marginally lower at RM6.5 billion, due mainly to lower earnings on passenger fares by the national airline and lower receipts for port-related activities. Passenger traffic and the demand for port services were affected by the regional economic slowdown. Several cost cutting measures were implemented by the national airline during the year, mainly to rationalise capacity on the domestic and Asian routes, while focusing on long haul routes particularly to North America and Europe where traffic growth was largely unaffected. At the same time, concerted efforts to promote Port Klang as a national load centre and transhipment hub yielded positive results. Despite the economic slowdown, the port recorded some 136,000 twenty-foot equivalent units (TEUs) or an 8% improvement in terms of throughput. In particular, transhipment volume increased significantly in terms of tonnage (36.5%) and TEUs (57.3%). Gross payments for other transportation increased by 5.9% to RM4.3 billion, as most payments were settled in United States dollars.

The **freight and insurance** account improved in 1998, with a smaller net payments abroad of RM8.7 billion (RM9.5 billion in 1997). Gross payments abroad recorded a marginal increase of 0.6%, with the gains associated with the contraction in import volume and lower freight rates offset by higher cost of transactions due to the weak ringgit. Total earnings from provision of freight and insurance services increased further by 30.1% to RM4.1 billion, reflecting mainly higher receipts in ringgit terms as overall cargo throughput declined. In terms of United States dollars, net payments abroad declined by US$1.2 billion. Consequently, the share of net freight and insurance payments to total services deficit declined to 37% (1997: 44%).

The deficit in the **other services** account narrowed only marginally to RM4.2 billion from RM4.5 billion a year ago, due to the valuation loss from the weaker ringgit. The improvement reflected reduced demand for other services, in tandem with the overall contraction in the economy and the completion or deferment of some big projects, particularly in the infrastructure sector. Consequently, the share of other services in the overall services deficit fell to 18% from 21% in 1997.

Less favourable global economic conditions in the wake of the prolonged financial crisis in Asia and investors' continued risk averse attitude towards Asia led to the deterioration of the **capital account** of the balance of payments in 1998. The long-term capital account declined to RM10.9 billion in 1998 (1997: RM19 billion), reflecting the lower net inflows in both the official and private long-term capital accounts. The short-term capital account recorded a substantial net outflow for the second successive year amounting to RM21.7 billion.

The **official long-term capital account** registered a smaller net inflow of RM2.1 billion in 1998 compared with RM4.6 billion in 1997. This was due mainly to the lower gross external borrowings by the non-financial public enterprises (NFPEs) which declined sharply to RM4.7 billion (1997: RM9.4 billion). Following the tightening of lending conditions in international debt markets in the wake of increased aversion to Malaysian credit risk, the NFPEs revised their investment plans. At the same time, the scheduled repayment of loans by the NFPEs increased to RM4.3 billion in 1998 (1997: RM3 billion), reflecting mainly the valuation losses arising from the ringgit depreciation. Hence, on a net basis, the NFPEs recorded a much lower net external borrowing of RM361 million in 1998 (1997: RM6.4 billion). In contrast, gross external borrowings by the Federal Government increased significantly to RM4 billion in 1998 (1997: RM462 million) to finance the recovery package. Repayment of loans, however, was maintained at about the previous year's level of RM2.2 billion. There was no prepayment of loans during the year (1997: RM911 million). Hence, in 1998, the Federal Government registered a net borrowing of RM1.8 billion for the first time in seven years.

The **private long-term capital account** recorded a significantly lower net inflow of RM8.7 billion in 1998 (1997: RM14.4 billion), reflecting mainly the lower net **foreign direct investment** (FDI) of RM11.6 billion, compared with a net inflow of RM19.1 billion in 1997. Domestic problems in the major investing countries, global excess capacity and continued uncertainty in the region contributed to the lower FDI in 1998. Reinvestment by foreign investors in Malaysia also declined as a result of higher repatriation of profits and dividends, mainly by the Japanese firms to meet liquidity needs of their parent companies. In addition, although the imposition of selective exchange control regulations did not affect FDI, foreign investors had adopted a cautious approach towards new investment.

The bulk of the FDI in 1998 was channelled into the manufacturing sector, which accounted for 60%, followed by the oil and gas sector (23%) and the services sector (14%). External loans from parent and associated companies, although lower in 1998 due mainly to the reduced corporate profitability and liquidity problems faced by the parent companies, accounted for 36% of the FDI, followed by retained earnings by the existing companies (34%) and equity (30%). However, new inflows of equity increased in 1998, reflecting mainly funds brought in by foreign investors to acquire stakes in Malaysian companies following the liberalisation of foreign equity participation in the telecommunication and manufacturing sectors.

Despite the economic slowdown in major investing countries, the value of proposed foreign investments received by the Ministry of International Trade and Industry (MITI) continued to remain significant in 1998, amounting to RM12.7 billion (1997: RM14.4 billion). In general, long-term foreign investors, particularly the existing foreign companies in Malaysia, continued to maintain a positive outlook on the long-term prospects for the Malaysian economy. The applications for the expansion and diversification projects by the existing foreign companies amounted to RM6.2 billion in 1998 (49% of the total value of proposed foreign investment). In terms of sources of investment, the bulk of the applications were received from the United States (51.6% of total foreign investment), followed by Japan (9%), Netherlands (8.6%), Singapore (6.4%) and the United Kingdom (4.9%). Within the oil and gas sector, the United States and Netherlands continued to remain the major foreign investors in the country.

Gross **overseas investment** by Malaysian-owned companies declined to RM8.1 billion in 1998 (1997: RM11.5 billion). The slowdown in domestic economic activity and uncertainty in the region prompted a significant cutback in overseas investments. This declining trend was reinforced by the Government's directive to defer overseas investments that do not have direct linkages with the domestic economy as well as the tightening of exchange control regulations on overseas investment since 1 September 1998. The economic slowdown also resulted in the liquidation of some assets of Malaysian companies abroad to help finance the companies' domestic operations and investments. Hence, the net outflow from overseas investment declined substantially to RM3.1 billion in 1998 (1997: -RM8.2 billion). The major recipient countries of overseas investment in 1998 were Singapore (28% of total overseas investment), the United States (22%), the United Kingdom (11%), Thailand (7%) and Netherlands (4%). Investment in Singapore was largely concentrated in the finance and business services sector (mainly investment holding companies) and in the manufacturing sector. Malaysian companies continued to participate in high value added industries on a joint venture basis with firms in the United States and the United Kingdom as part of the corporate strategy to acquire technical know-how.

The **short-term capital account** recorded a substantial net outflow of RM21.7 billion in 1998 (1997: –RM11.3 billion) due mainly to the decline in net external liabilities of the commercial banks and the liquidation of portfolio investments by foreign investors. The decline in the net external liabilities of commercial banks reflected both the decline in short-term external debt of commercial banks in response to the stagnation in domestic demand, as well as the unwinding of trade-related hedging activities following a decline in forward sales of export proceeds by the exporters. Heightened uncertainty, including increased concerns over the risks in the financial system and economic outlook, led to the large outflows of portfolio investment, especially in the second and third quarters of 1998. However, short-term capital flows stabilised in the last quarter following the implementation of the one-year holding period for portfolio investment in Malaysia effective from 1 September 1998.

External Debt

Malaysia's overall external debt situation remained manageable in 1998, despite the prolonged regional financial crisis. This outturn reflected the Government's prudent external debt management strategy, as a result of which Malaysia did not experience a payment crisis and has been able to meet its higher external obligations in 1998 due to the depreciation of the ringgit. Regular prepayment exercises had contained the nation's external debt at moderate levels while refinancing programmes had improved the debt maturity profile, smoothened the bunching of repayments and lowered interest costs. To a large extent Malaysia's resilience to the regional crisis was due to its relatively low reliance on short-term financing. Short-term borrowings accounted for only 18% of the total external debt and 29% of international reserves, while the bulk (60%) of the medium and long-term debt were with remaining maturity of more than three years. In addition, the external loans were channeled mainly to export-oriented industries and to fund overseas investments. Hence, these companies had a natural hedge from their foreign exchange earnings to cover their increased debt service obligations.

The nation's total external debt outstanding declined by 6.4% to RM159.8 billion at the end of 1998. In United States dollar terms, the total debt was equivalent to US$42 billion (US$43.8 billion in 1997). Consequently, there was an improvement in the debt indicators in 1998. The ratio of external

Table 1.20
Outstanding External Debt

	1997		1998*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**170,757**	**43,840**	**159,775**	**42,046**
Medium & long-term debt	*127,500*	*32,734*	*131,271*	*34,545*
Short-term debt[1]	*43,257*	*11,106*	*28,504*	*7,501*
As % of GNP				
Total debt	65.4	47.2	60.9	62.8
Medium & long-term debt	48.8	35.3	50.0	51.6
As % of exports of goods and services				
Total debt	63.7	46.0	48.3	49.8
Medium & long-term debt	47.5	34.3	39.6	40.9
Debt service ratio (%)				
Total debt	5.5	5.5	6.7	6.7
Medium & long-term debt	4.7	4.7	6.0	6.0

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

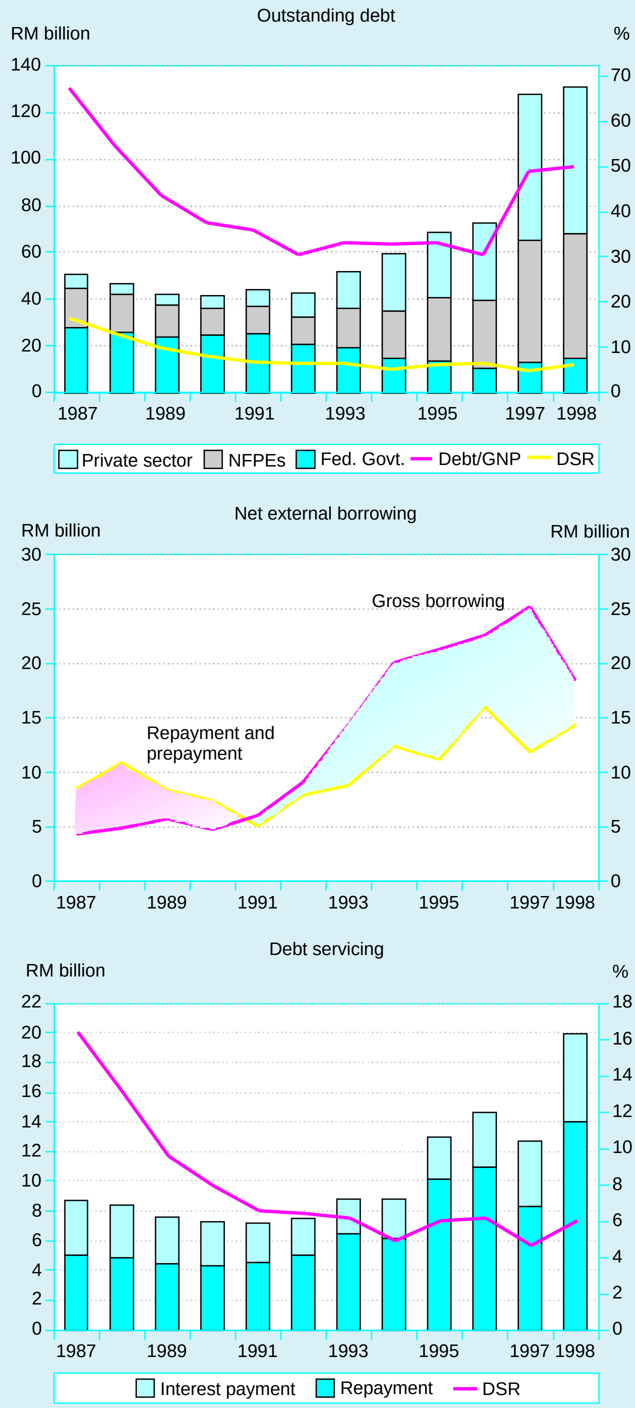
debt to GNP and exports declined to 60.9% and 48.3% respectively (65.4% and 63.7% respectively in 1997).

External borrowing of medium and long-term loans registered a sharply lower net inflow of RM4 billion in 1998 (1997: RM13.4 billion). The drawdown of loans by the non-financial public enterprises (NFPEs) and the private sector fell by 50% and 37% respectively in 1998. The lower borrowings were due to revisions in investment plans amidst the tightening of lending conditions and wider spreads in the wake of investors' increased risk aversion towards lending to Asian countries. The reassessment of lending to the region, including Malaysia, was triggered by increased uncertainty and the flight to quality in offshore markets. The aversion of lenders to market risk also resulted in a shortening of the maturity period for loans. Consequently, both the private sector and the NFPEs recorded smaller net inflows of RM1.8 billion and RM361 million respectively in 1998 (RM8.7 billion and RM6.4 billion respectively in 1997). The Federal Government, in contrast, recorded a net inflow of RM1.8 billion for the first time since 1991, reflecting official borrowing to finance the fiscal deficit. As a result, the **nation's medium and long-term external debt** increased by 3% to RM131.3 billion at the end of 1998. In United States dollar terms, the debt increased by 5.5% to US$34.5 billion (1997: US$32.7 billion).

Short-term debt, comprising mainly the external borrowings of commercial banks and non-bank private sector, declined by 34% to RM28.5 billion at the end of 1998. This reflected lower short-term loans of the banking institutions as trade financing requirements were reduced following the stagnation in domestic demand and reduction in external trade. As a result, the ratio of short-term debt to total external debt declined to 18% from 25% in 1997.

In terms of **currency composition**, debt denominated in United States dollar continued to dominate the medium and long-term debt profile with a share of 74% of total debt outstanding at the end of 1998 (1997: 76%). The share of yen denominated debt increased to 17% (1997: 15%), reflecting the increase in new yen loans during the year as well as the exchange revaluation loss which raised the yen debt in ringgit terms. The share of external debt denominated in other international currencies including the French franc,

Graph 1.13
Medium and Long-Term External Debt



Singapore dollar, Deutsche Mark and pound sterling remained at 9%.

The overall cost of servicing the external debt increased significantly in 1998, due mainly to the valuation losses arising from the ringgit depreciation. Total **debt servicing payments** increased by 50% to RM22.1 billion, due to both higher principal repayment, especially by the NFPEs, and higher interest payments. In United States dollar terms, total debt servicing increased by 8%. Therefore, the total **debt service ratio** (ratio of debt servicing to export of goods and services) increased to 6.7% from 5.5% in 1997.

Public sector external debt: The **Federal Government's** external debt which accounts for 9.3% of total external debt, increased by 15.2% to RM14.9 billion at the end of 1998. While a large part of its borrowing to fund the increased fiscal deficit was met from non-inflationary domestic sources, the Federal Government also increased its recourse to external borrowing in 1998. Gross borrowings increased significantly to RM4 billion, mainly from official creditors such as the multilateral institutions and bilateral lenders. There has been less incentive to access the international capital markets as interest spreads had widened following several instances of downgrading of Malaysia's sovereign debt rating by the international credit rating agencies. Although the sovereign ratings had remained at investment grade, spreads for Malaysian issues widened significantly in 1998. Recently, following modification to the exchange control rules on portfolio investments, these spreads had narrowed considerably. In June 1998, the World Bank disbursed a US$300 million (RM1.2 billion) loan to mitigate the adverse effects of the economic adjustment on the more vulnerable segments of society. In December, Malaysia signed the ¥74 billion (RM 2.4 billion) five-year term loan agreement/Euroyen bond with Sumitomo Bank Ltd./ Nomura Securities Co. Ltd. The structured financing was through a combination of a term loan and Euroyen bond issue guaranteed by Ministry of International Trade and Industry, Japan. Drawdown of existing project loans totalled another RM381 million during the year. There was no prepayment in 1998. Malaysia made scheduled repayments totalling RM2.2 billion following the maturity of a Samurai bond of ¥30 billion (RM882 million) and a 100 million Swiss franc bond (RM274 million).

Gross borrowing of the **NFPEs** declined to RM4.7 billion (1997: RM9.4 billion). The drawdown of loans were mainly made by Tenaga Nasional Berhad and Telekom Malaysia Berhad to refinance loans due in 1998 and for funding domestic capital expenditure and investment in subsidiaries abroad. The NFPEs recorded a small net inflow of RM361 million (1997: RM6.4 billion) with scheduled repayments increasing by 45% to RM4.3 billion, reflecting mainly the valuation losses arising from the ringgit depreciation. Together with an exchange revaluation loss of RM403 million largely due to the appreciation of Japanese yen, the outstanding debt of the NFPEs increased by 1.5% to RM53.2 billion at the end of 1998.

Private sector external debt: In the face of a slowdown in domestic economic activity and a contraction in private investment, gross borrowing of the private sector declined by 37.4% to RM9.6 billion in 1998 (1997: RM15.4 billion). About 67% of the external borrowings were undertaken by non-resident controlled companies (NRCCs). These loans were mainly long-term from their offshore shareholders and parent and associated companies. Hence, NRCCs were less affected by the diminution of credit in international debt markets. Repayments increased by 16.7% to RM7.8 billion, reflecting mainly the impact of the ringgit depreciation. While a substantial part of external repayments due in 1998 were hedged, the unprecedented magnitude of the currency depreciation created liquidity problems for some corporations. However, these borrowers did not face problems in rescheduling these debts. Many borrowers restructured their debts through refinancing to roll over existing loans or by extending the repayment period. Following these developments, private sector external debt outstanding recorded a modest increase of 1.7% to RM63.1 billion at end-1998, due in part to the exchange revaluation gain of RM777 million, following the fixing of the ringgit exchange rate at RM3.80 to the United States dollar on 2 September 1998. The private sector remained the single largest borrower in 1998, accounting for a large share of 48% of the total medium and long-term debt.

The Government will continue to exercise prudence in its recourse to external borrowing. The aim of policy is to contain the nation's external debt within prudent levels in order to minimise the impact of adverse global financial market developments on the Malaysian economy. With this objective, the debt management strategy will continue to balance the need to ensure that the corporate sector can have access to the most competitive funding sources.

In the immediate term, however, the financing requirements for the economic recovery package and restructuring of the banking institutions will necessitate some increase in the Government's recourse to external borrowing. While the funding requirements will be primarily met from domestic non-inflationary sources, some external loans will be raised in 1999, from multilateral institutions and bilateral sources. The Japanese Government, for example, has offered bilateral financial assistance to Malaysia under the ODA programme and the Miyazawa Initiative. Such assistance will include loans from the OECF and EXIM Bank of Japan. Such borrowing from official creditors will not adversely affect the overall external debt profile, as they are offered on more favourable terms, including concessionary interest rates or lower risk premiums and longer maturities.

International Reserves

The **gross international reserves** held by the Bank, comprising gold, foreign exchange, reserve position with the International Monetary Fund (IMF) and holdings of Special Drawing Rights (SDRs) rose significantly by RM40,305 million to RM99,438 million at the end of 1998, following a decline in 1997. After taking into consideration the current external liabilities of the Bank of RM13.7 million, the net international reserves of the Bank stood at RM99,424 million at end-1998. The United States dollar equivalent of gross reserves was US$26.2 billion at end-1998, a level sufficient to finance 5.7 months of retained imports. In SDR terms, the international reserves held by the Bank amounted to SDR18.6 billion.

During the year, net holdings of **gold and foreign exchange** rose by RM39.2 billion to RM96.3 billion at the end of 1998. Foreign exchange holdings rose rapidly subsequent to the introduction of selective exchange control measures on 1 September, and the fixing of the exchange rate on the following day. Between end-August and December 1998, reserves rose by US$6 billion. On the whole, the rise in foreign exchange holdings reflected partly Malaysia's large trade surplus in 1998, as well as foreign currency loans from both official and private institutions. The increase in reserves in ringgit terms was also due to the revision in the accounting policy of recognising the foreign exchange revaluation gain or loss in 1998. Since 15 September 1998, the exchange gain from the revaluation of foreign assets and liabilities has been reflected in the Bank's books, with assets and liabilities in foreign currencies being revalued at the exchange rate prevailing on the reporting date. With effect from January 1999, foreign exchange revaluation will be calculated on a quarterly basis.

Table 1.21
Net International Reserves

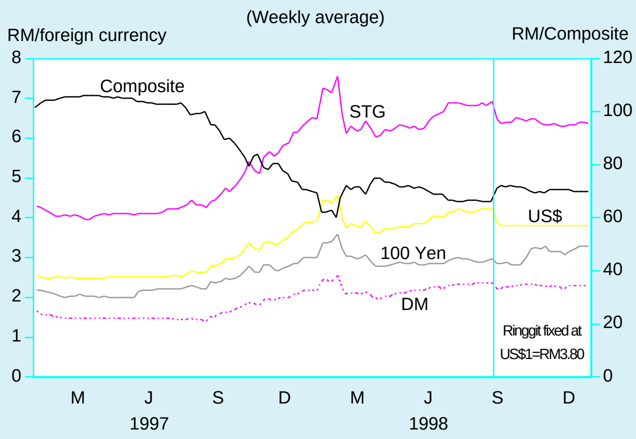
	As at end		
	1996	1997	1998
	RM million		
Net Reserves	**70,014.6**	**59,122.8**	**99,424.4**
SDR holdings	427.7	478.9	793.9
IMF reserves position	1,738.2	1,622.0	2,379.2
Gold and foreign exchange	67,848.7	57,021.9	96,251.3
	US$ billion		
Gross Reserves	**27.7**	**21.7**	**26.2**
Months of retained imports	**4.4**	**3.4**	**5.7**

Holdings of reserves in the form of **SDR** rose by RM315 million during the year to RM793.9 million at the end of 1998. The increase was mainly on account of the receipts of remuneration from the IMF arising from Malaysia's net creditor position with the Fund as well as exchange revaluation gain. During the year, Malaysia was not included in the quarterly SDR Designation Plans of the Fund, under which countries were required to provide convertible foreign currency in exchange for SDRs upon request.

The **reserve position of Malaysia with the IMF** defined in terms of SDR, reflected transactions with the Fund during the year. In 1998, this component of external reserves remained unchanged at SDR444.7 million. However the SDR holdings in ringgit terms increased by RM757.2 million during the year to RM2,379.2 million at the end of 1998 on account of exchange revaluation gains for the year. The reserve position of Malaysia with the IMF remained stable during the year.

The overall objective of the Bank in managing the foreign reserves is to optimise returns without compromising on safety and liquidity. The foreign assets of the Bank comprise major foreign currencies, which are held in the form of cash, investments in allowable fixed income securities issued by foreign governments and multilateral agencies, and gold. The concern for safety encompasses the preservation of value and diversification of assets to reduce portfolio volatility

Graph 1.14
Exchange Rate of the Malaysian Ringgit against Major Currencies



and minimise risk. The foreign reserves are managed against a customised benchmark and within the investment guidelines of the Bank. **The Bank ensures adequate supply of liquidity to meet its obligations and has not entered into any forward transactions in its investment operations.**

Exchange Rates

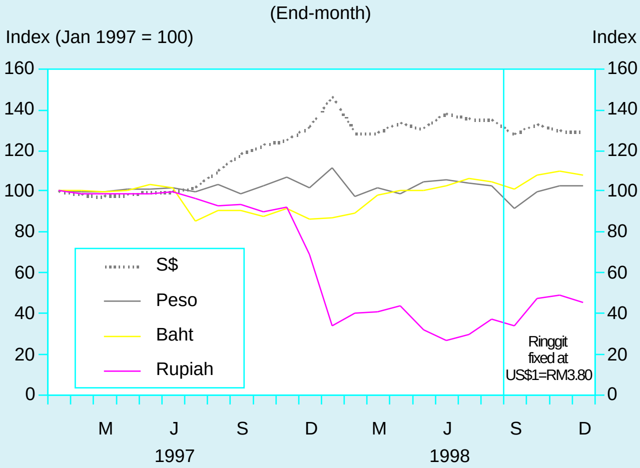
During the year, the **ringgit** recorded a mixed performance against the major currencies, depreciating marginally by 0.2% (1997: –31.4%) against the composite basket of currencies of Malaysia's major trading partners. The ringgit appreciated by 2.3% against the United States dollar and by 1.8% against the pound sterling. The ringgit's rise against the pound sterling reflected the dollar's strength, as well as concerns over Britain's weaker export sector, the threat of slower economic growth and the advent of the Euro in 1999. However, the ringgit depreciated by 2.7% against the Swiss franc, 4% against the Deutsche Mark and 9.7% against the Japanese yen largely reflecting the strength of these currencies against the dollar. Against the regional currencies, the ringgit appreciated by 1.4% against the Singapore dollar and 51.5% against the Indonesian rupiah, but depreciated by 1.1% against the Philippine peso, 20.5% against the Thai baht and 27.7% against the Korean won.

The prolonged and severe Asian financial crisis continued to exert downward pressure on the ringgit during the first eight months of the year. However, compared with 1997, the ringgit was relatively stable in 1998. The ringgit's standard deviation against the United States dollar was 0.253 on a daily basis during this period compared with 0.419 in the second half of 1997. Since 2 September when the ringgit rate was fixed at US$1=RM3.8000, there was reduced volatility of ringgit rates against major currencies. Consequently, for 1998 as a whole, the ringgit's standard deviation against the United States dollar moderated to 0.222 on a daily basis (1997: 0.437). Similarly, the ringgit's volatility moderated to 0.123 against the Deutsche Mark (1997: 0.231), 0.198 against the Japanese yen (1997: 0.307) and 0.326 against the pound sterling (1997: 0.749).

The most notable event in exchange rate developments in 1998 was the adoption of a fixed exchange rate regime on 2 September 1998, following the imposition of selective exchange controls on 1 September. This is the first time Malaysia departed from the floating exchange rate regime adopted in June 1973. With this significant development, the performance of the ringgit during 1998 can be distinguished in terms of two distinct phases.

During the earlier phase of **January-August 1998**, the ringgit continued to be affected by the turbulent regional developments as well as the contraction in domestic economic activity. Three distinct periods were observed prior to September 1998. The ringgit experienced extreme volatility in the early months of 1998. Following the sharp depreciation in the Indonesian rupiah on 7 January, the Asian currencies, including the ringgit, weakened

Graph 1.15
Exchange Rate of the Malaysian Ringgit against Selected ASEAN Currencies



during this period. The ringgit breached a historical intra-day low of US$1=RM4.8800 on 7 January, with the ringgit's standard deviation rising significantly to 0.233 in January. Subsequently, the ringgit strengthened significantly and recovered to an intra-day high of US$1=RM3.3500 on 11 February. Positive developments that supported the ringgit included the improvement in Malaysia's trade account for 1997 and announcement of further stabilisation measures by the Government, including a tightening of monetary policy. During the period mid-February to June, the ringgit was relatively more stable, fluctuating within the range of US$1=RM3.5800 to RM4.1750.

Towards end-June until August, the ringgit experienced another phase of downward pressure while the regional instability intensified. The pressure on the ringgit rates was also affected by the significant depreciation of the Japanese yen against the United States dollar. The yen reached an eight-year low of US$1=¥147.2650 on 11 August causing the ringgit to depreciate to US$1=RM4.2430. The other regional currencies were also influenced by the yen's performance in view of the region's substantial trade and investment ties with Japan. In addition, the spill over effects from adverse developments in Indonesia as well as indications that the region had entered a period of slower growth exerted further downward pressure on the Asian currencies, including the ringgit. On the domestic front, the release of the first quarter GDP data at end-May, which showed an economic contraction for the first time since 1985, also fuelled concerns over the adverse impact of the depreciation on the corporate and financial sectors. Although the Government had been proactive in managing the negative impact of the domestic contraction and to stabilise the economy and the ringgit in particular, the efforts were constrained by the vulnerability of the ringgit to sustained speculative activity, especially in offshore markets.

The rapid increase in the internationalisation of the ringgit since April 1998 also contributed to the ringgit's weakness during this period. This development caused outflows of ringgit deposits which were attracted by higher offshore interest rates ranging from 20-40%. Onshore rates were then around 11%. Opportunities to speculate on the ringgit increased with the build-up of offshore ringgit leading to further depreciation of the currency in July and August. The ringgit traded to an intra-day low of US$1=RM4.3260 on 10 July and subsequently recovered to trade within a range of US$1=RM4.0900-4.2650 during the period July to August.

Following the introduction of selective exchange control measures on 1 September, the ringgit appreciated to an intra-day high of US$1=RM3.8200. On 2 September, the ringgit was trading at US$1=RM3.8000 in the foreign exchange market prior to the fixing of the exchange rate at that level at 11 a.m.. This was also the rate at which the ringgit was, on average, traded during February to June 1998. The fixed exchange rate allowed

Table 1.22
Movement of the Ringgit

	RM to one unit of foreign currency[1]					Annual change (%)		
	1997	1998				1997	Sept. 2* 1998	1998
	End-Dec.	Sept. 2	End-Dec.	Low	High			
Composite	69.70	72.11	69.57	58.23	77.38	–31.4	–19.8	–0.2
SDR	5.2539	5.1177	5.3505	4.6701	6.3076	–30.8	–22.3	–1.8
US$	3.8883	3.8000	3.8000	3.4600	4.7250	–35.0	–22.6	+2.3
S$	2.3200	2.1998	2.2879	2.1378	2.6516	–22.1	–12.2	+1.4
100 Yen	2.9921	2.7742	3.3141	2.7439	3.5972	–27.3	–12.5	–9.7
Pound Sterling	6.4449	6.3708	6.3313	5.6250	7.6604	–33.7	–25.7	+1.8
Deutsche Mark	2.1729	2.1743	2.2640	1.9147	2.5754	–25.1	–25.6	–4.0
Swiss franc	2.6742	2.6450	2.7497	2.3691	3.1861	–29.8	–25.5	–2.7
100 Thai baht	8.2337	9.3713	10.3613	7.8031	10.6592	+19.8	–9.5	–20.5
100 Indonesian rupiah	0.0721	0.0354	0.0476	0.0248	0.0671	+48.4	+176.3	+51.5
100 Korean won	0.2305	0.2827	0.3190	0.2159	0.3418	+29.8	+14.8	–27.7
100 Philippine peso	9.6024	8.8302	9.7064	8.5336	10.7031	+0.1	+8.3	–1.1

[1] With the exception for 1996 data, where the Thai baht, Indonesian rupiah, Korean won and Philippine peso are based on customer rates, all other data is based on the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.
* Compared with 2 September 1997's levels.

Box III

Exchange Control Measures as a Policy Option

Introduction

The exchange control measures introduced by Malaysia on 1 September 1998 were part of a series of pre-emptive measures implemented to reduce several areas of vulnerabilities in the economy. Of significance, Malaysia did not rush to impose exchange control measures to address issues arising from the contagion impact of the currency crisis. The use of exchange controls as a policy option was imposed 14 months after the outbreak of the currency crisis following macroeconomic adjustment policies undertaken to restore internal and external balance. More importantly, the circumstances prevailing in the country in September were favourable to achieve the desired objectives of the exchange control measures. Policy measures implemented in the early part of the crisis had already improved the key areas of vulnerabilities in the economy. In terms of the overall macroeconomic framework, Malaysia had contained inflation and improved its external balance. External reserves were intact, while external debt exposure remained low. The banking sector continued to perform its intermediary function. By end-August 1998, the institutional framework to restructure the financial sector was completed and its operations on track.

Objectives of the Exchange Control Measures

The exchange control measures adopted by Malaysia have been designed and implemented to achieve specific objectives in response to specific circumstances. Malaysia imposed selective measures, directed mainly at reducing the internationalisation of the ringgit. On its part, Malaysia had already undertaken adjustment policies and implemented financial reforms to reduce the risks and vulnerabilities to external developments. The prospects for these initiatives to yield the desired results could only be achieved in a stable environment. However, the worsening of the international financial environment led to continued domestic financial instability, contributing to a sharper-than-expected contraction of the economy of 4.8% in the first half of 1998. Despite macroeconomic adjustment policies in all crisis countries, exchange rates remained volatile and susceptible to speculative pressures. Although it had become clear that there was a need for greater transparency among the large players, and for reforms in the international financial system, a concerted international effort to stem this volatility was not forthcoming. For Malaysia, a major source of concern that was emerging since April 1998 was the increase in the rate of internationalisation of the ringgit, resulting in an outflow of ringgit to offshore markets. This ringgit outflow was attracted by higher interest rates in the region of 20% to 40% offered by offshore centres, while onshore rates were in the region of 11%. The strong demand for offshore ringgit and the consequent build-up of offshore ringgit increased the vulnerability of the ringgit. This trend, if left unchecked, would undermine the prospects for recovery and the ability to conduct monetary policy based on domestic conditions, thereby resulting in fundamental damage to the real economy.

Malaysia, therefore, designed the selective exchange control measures to specifically achieve the objective of reducing the internationalisation of the ringgit. This was achieved by eliminating access to ringgit by speculators, both at home and abroad. This involved the introduction of rules relating to the external account transactions of non-residents and currency of settlement of trade transactions, while general payments, including movements of funds relating to long-term investments and repatriation of profits, interest and dividends remained unaffected. The measures are also aimed at stabilising short-term capital inflows, by requiring inflows of capital to remain in the country for a period of 12 months. The measures are temporary and would be modified or removed when its objectives have been achieved. In this regard, on 4 February 1999, the rule on the one-year holding of portfolio capital was modified to allow the foreign investors to repatriate the principal capital and profits subject to a graduated levy.

Features of the Exchange Control Measures

The exchange control measures involved the following:

- Selected ringgit-denominated transactions among non-residents effected via non-resident external accounts require approval;

- Short-term capital flows by requiring such inflows to remain in the country for a minimum period of one year. These funds, however, could be actively managed in the form of ringgit assets;

- Import and export of ringgit by travellers, both residents and non-residents, are restricted for amounts exceeding RM1,000;

- Malaysian investments abroad exceeding the equivalent of RM10,000 require prior approval; and

- Malaysians travelling abroad require approval to carry foreign currencies in excess of RM10,000 equivalent.

The changes were directed at containing speculation on the ringgit and at stabilising short-term capital flows. **There are no controls on:**

- Current account transactions (amendment in rules only require trade transactions, both in goods and services, to be settled in foreign currencies and no longer in domestic currency);

- Repatriation of profits, dividends, interest, fees, commissions and rental income from portfolio investment and other forms of ringgit assets; and

- Foreign direct investment inflows and outflows.

The main change in rules, therefore, pertains to **external account transactions of non-residents.** Under the new requirements, transfers of funds between external account holders who are non-resident corporations and non-resident individuals residing outside Malaysia are restricted. Prior approval is required for transfer of funds between external accounts and for uses of funds for other than permitted purposes. The uses of funds from external accounts are freely permitted for the following purposes, other purposes are allowed subject to approval by Bank Negara Malaysia (BNM):

- Purchase of ringgit assets/placements of deposits;

- Payment of administrative and statutory expenses in Malaysia;

- Payment of goods and services in Malaysia; and

- Granting of loans and advances to staff in Malaysia according to the terms and conditions of service.

All external account holders are free to fund these accounts from proceeds from:

- Sale of ringgit instruments, securities registered in Malaysia or other assets in Malaysia;

- Salaries, wages, commissions, interest or dividends; and

- Sale of foreign currencies.

As part of the measures, the ringgit has been fixed against the United States dollar to provide a greater degree of certainty to the market for the conduct of trade and investment activities. Following the introduction of these measures, the ringgit strengthened against the United States dollar by 10.5% from the end-August level of RM4.22 to an intra-day high of US$1=RM3.82 on 1 September 1998. The ringgit appreciated further to US$1=RM3.80 after which the ringgit's rate was fixed at that rate, effective 11 a.m. on 2 September 1998. During the period February to mid-June, the ringgit traded at about this level against the United States dollar.

Preconditions for Controls

The experience of countries in achieving the objectives of capital control measures has been varied. The use of controls has been widely criticised by proponents of the free market system on the grounds that it leads to distortions and inefficiencies. Capital controls have been identified as a major cause for creating distortions in some of the economies, undermining their prospects for growth and development. The potential costs associated with controls on capital flows are lower real interest rates and capital flight, thereby contributing to higher rates of inflation and deterioration in the balance of payments position over the long term. Consequently, there has been general perception that the measures introduced by Malaysia would create distortions in the economy. In judging the use of exchange controls as a policy option, it is important to consider when and under what circumstances such capital controls can be applied, in what form they should take, the preconditions that would ensure it would yield the desired results and how it might be efficiently implemented.

Malaysia imposed the controls under conditions and circumstances that increased the prospects for successfully achieving its objectives. Firstly, capital controls have historically been imposed by countries facing balance of payments constraints. Many of these countries imposed restrictions on almost all transactions with non-residents, including current account transactions, in the face of weak external reserves position. Malaysia, on the other hand, has maintained free movement of all current account transactions. Prior to the controls, Malaysia already had taken corrective measures which led to a significant improvement in the current account from a deficit of 5.4% of GNP in 1997 to a surplus of 13.7% of GNP in 1998, thus resulting in a strong build-up of reserves.

Several of the countries that imposed capital controls also faced capital flight. Malaysia has generally not experienced significant capital outflows of the type and magnitude experienced by countries facing balance of payments and reserves constraints. In Malaysia, capital outflows have been in the form of prepayments of external loans by both the public and private sectors, Malaysian investments in ventures abroad in sectors which yield spin-off benefits for the domestic economy and the liquidation of investments by portfolio investors.

Meanwhile, the external reserves of the country was intact, unencumbered and increasing. Before the implementation of the controls, external reserves stood at US$20.2 billion, sufficient to finance 4 months of retained imports. To date, the build-up of external reserves has been significant. As at end-February 1999, international reserves stood at US$28.7 billion, an increase of US$8.5 billion from end-August 1998 level, adequate to finance 6.2 months of imports. This growth in reserves would provide greater overall confidence and place the Government in a better position to cope with any bunching of short-term capital outflows that could occur on 1 September 1999. In addition, the short-term debt is less than half the size of foreign exchange reserves. Malaysia is therefore, not vulnerable to credit outflows over the short term, and 60% of Malaysia's external debt have remaining maturity that exceeds three years. Furthermore, the bulk of the short-term debt is in the form of trade financing. Experience of countries has shown that countries with strong balance of payments position such as The People's Republic of China and Taiwan have achieved a greater degree of success with capital controls.

Other desired objectives of capital controls are not achieved because they were implemented in an inflationary environment caused by an inappropriate mix of macroeconomic policies. Most of these countries have either had protective trade and payments regimes or public expenditure had been diverted to less productive sectors. This in turn resulted in supply constraints and a general rise in prices of goods and services. In comparison, such risks for Malaysia are low. Inflationary pressures have been subdued due to several factors:

- On the domestic front, weak domestic demand has more than offset the effects of the depreciation of the ringgit against the currencies of major trading partners. Excess capacity in product and labour markets contributed to lower inflation so that consumer prices rose by 5.3% in 1998, as against earlier expectations of 7-8%;

- Generally, the low inflation environment and the strong expansion in income levels in the last decade have resulted in high savings and is expected to remain high at about 40% of GNP. Consequently, the fiscal stimulus is being funded by non-inflationary domestic sources of financing, primarily through the issuance of bonds and Malaysian Government Securities; and

- Malaysia also ranks favourably in terms of overall competitiveness. Malaysia has pursued an export-oriented industrialisation strategy since the 1970s, which has exposed the economy to international competition. Malaysia's economy is open with high foreign presence in the domestic industries, including financial services. Several policy measures have been put in place to enhance productivity improvements on an ongoing basis to increase the nation's competitiveness. Given the low inflation rate, the ringgit is also not overvalued when measured in terms of the real effective exchange rate.

It is important to recognise that Malaysia is not relying on controls to address macroeconomic imbalances in the economy. In administering the exchange control measures, the approach has been that such measures complement other monetary and fiscal measures to bring about sound and balanced development of the country. Malaysia is not substituting capital controls for sound and transparent domestic economic policies. Malaysia has shown commitments to undertake the necessary structural adjustment policies that are critical for long-term growth with price stability. The facts show that the breathing space provided by the exchange control measures has been used effectively to undertake further macroeconomic policies and accelerate structural reform measures. To date, the restructuring of the financial sector has been comprehensive. The achievements of the programme to restructure the financial sector has exceeded the targets. Furthermore, the target dates for completion of acquisition of non-performing loans and recapitalisation of the financial institutions have been brought forward. Work on corporate debt restructuring to facilitate debt workouts on a voluntary basis has also been accelerated.

In the implementation of the selective exchange control rules, the Government has also adopted a flexible approach. The situation has been closely monitored. Emphasis has been placed on the efficiency of the implementation process as well as the dissemination of information on the changes to the exchange control rules to provide a greater understanding of the measures. Efforts have been directed to ensure that the administrative machinery is in place to provide prompt response to emerging issues to ensure that any disruptions are addressed.

Malaysia has a track record for showing flexibility in the implementation of policies. Similarly, once the policies have achieved the desired results, such policies will be removed. Although Malaysia has adopted over time an increasingly liberal exchange control regime, the country had, under certain circumstances, used selective exchange control regulations to complement the macroeconomic policies to restore stability. Use of such selective exchange control measures occurred in 1993-94 and were removed after six months. These measures were effective and allowed stabilisation to be achieved with reduced cost to the economy. During this period, the distortionary effects were minimised.

The exchange control measures implemented on 1 September 1998, which included the requirement for portfolio capital to remain in Malaysia for at least 12 months, have contributed significantly to the stability of the economy. Accordingly, on 4 February 1999, the Government announced a new rule to replace the one-year holding rule for portfolio capital. Under the new rule, the principal capital and profits will be allowed to be repatriated subject to a graduated levy depending on when the funds were brought into Malaysia and the duration of investment. The details are as follows:

For funds brought in before 15 February 1999

- The principal capital repatriated after one year from 1 September 1998 or one year from the actual date (after 1 September 1998) the funds were brought in will not attract any levy;

- If the principal capital is repatriated within one year, it will be subject to a levy at a decreasing rate, depending on the duration the principal is held (up to 7 months: 30%, exceeding 7 months and up to 9 months:

20%; and exceeding 9 months and up to 12 months: 10%);

- No levy will be imposed on the repatriation of profits on investment made within the 12-month holding period;

- However, all profits on investments made after the 12-month holding period will be subject to a repatriation levy of 10%.

For funds brought in on or after 15 February 1999

- The principal is allowed to be repatriated without any levy;

- However, profits made and repatriated within 12 months after the investment is made are subject to a levy of 30% of the profits;

- Profits realised and repatriated after 12 months from the date of investment are subject to a levy of 10%; and

- Profits realised during the 12-month period of the investment, but repatriated after 12 months from the date of investment are also subject to a levy of 10%.

These measures are aimed at encouraging existing portfolio investors to take a longer-term view of their investments in Malaysia, attract new funds into the country, while at the same time discourage destabilising short-term flows. In addition, the rule was designed to allow a smoother outflow of funds, rather than a sudden and massive outflow upon the expiry of the one-year holding period. With respect to rules on external account transactions, Malaysia would remain cautious and lift the controls only when there are clear indications that the necessary safeguards are in place in the international financial environment to contain excessive speculative activities on currencies.

Conclusion

Initial indicators point to the success of the exchange control measures. The greater stability in the currency, stock markets and the financial system is contributing to some revival in consumer and investor confidence. The controls, although limited in scope, have been sufficient to provide a greater degree of independence for the conduct of monetary policy to support the recovery process. The measures have been positively received by long-term investors. The measures have enabled an intensification of the ongoing reform. Malaysia has taken full advantage of the “breathing space” provided by these controls to further expedite economic and financial reforms. On the international front, there has been an important shift in thinking on the broader issue of policy response to the financial crisis in general, and on the issue of exchange controls in particular. There is now increasing recognition that such controls are appropriate under specific circumstances, particularly when they are targeted at short-term destabilising capital flows and when the controls complement, and are not a substitute for policy adjustments.

External Accounts

Definition

An External Account is defined as a ringgit account maintained with a financial institution in Malaysia where the funds belong to a non-resident individual or corporation.

A resident and a non-resident are defined, for exchange control purposes, in Table III.1.

Sources and Uses of Funds Held in External Accounts

External Accounts are mostly maintained by foreign non-bank entities, which include corporations and individuals. Funds in the External Account represent a claim on Malaysia's reserves. The types of deposits held in External Accounts are as follows:

(i) Ringgit demand deposits from foreign non-bank entities;

(ii) Ringgit savings deposits from foreign non-bank entities;

(iii) Ringgit fixed deposits from foreign non-bank entities;

(iv) Ringgit fixed deposits from foreign banking institutions;

(v) Islamic Banking ringgit deposits from foreign banking institutions;

(vi) Islamic Banking ringgit deposits from foreign non-bank entities; and

(vii) Ringgit vostro accounts of foreign banking institutions.

Prior to the implementation of the selective exchange controls, the sources of funds in these accounts would be either in the form of ringgit receivables, conversion of foreign currency, or

Table III.1
Definition of Non-Resident and Resident

Non-Resident	Resident
• Non-Malaysian citizen	• Malaysian citizen
• Malaysian citizen with permanent resident status abroad and resides abroad	• Malaysian citizen with permanent resident status of another country but resides in Malaysia
• Foreign embassies, high commissions, supranationals, central banks and international organisations	• Non-Malaysian citizen with permanent resident status in Malaysia and resides in Malaysia
• Business entities established abroad	• Business enterprises or any body, whether incorporated or unincorporated, or registered with or approved by any authority in Malaysia.

ringgit earnings in Malaysia. There was no limitation as to the sources and uses of ringgit balances in this account. A non-resident could freely transfer the ringgit balances from one External Account to another for any purpose. Effective 1 September 1998, balances in the External Accounts can continue to be used for settlement of ringgit asset transactions and payment of services and administrative expenses in Malaysia. Other transactions are detailed in Table III.2. In addition, External Account holders may also transfer funds between their own External Accounts. Other than the permissible purposes mentioned above, use of these balances for other purposes, including transfers between External Accounts, require approval of BNM.

An increase in the External Account balance at any particular time does not necessarily reflect or indicate new inflow of foreign funds into the country as it could also reflect the sale of ringgit assets to residents of Malaysia, the proceeds of which are then deposited into the External Account. Similarly, decreases in the External Account balance do not necessarily reflect an outflow of foreign funds from the country since the External Account balance could also be used to purchase ringgit assets from residents. However, the movements in ringgit balances in the External Accounts to a certain extent reflect the activities of non-residents in the country.

External Accounts and Money Supply

All External Account balances, except for the vostro balances, are captured in the components of money supply, as money supply is a measure of the non-bank private sector liquidity. As ringgit vostro balances of foreign banking institutions represent transactions between banking institutions, it is therefore excluded from the compilation of money supply. The various impact of the movements in the External Accounts on money supply are as follows:

(i) When non-residents sell their assets in Malaysia to residents, there should not be an increase in money supply, as the increases in the External Accounts from the proceeds of the sales would be offset by corresponding withdrawals of funds by residents to purchase the assets.

(ii) In the event of non-residents bringing in foreign exchange and converting them into ringgit and placing the ringgit funds in their External Accounts, money supply would increase.

(iii) Ringgit funds held abroad and brought back to Malaysia and deposited into the External Accounts would increase money supply.

(iv) Increases in vostro balances would not have an impact on money supply as these represent transactions among banking institutions. Nevertheless, if the banking institutions use the funds to extend loans to the non-bank private sector, this would increase money supply.

Types of External Accounts

Apart from the External Accounts described above, two other types of External Accounts have been established. The first is the Designated External Account (DEA). This Designated External Account is set up solely for non-residents wishing to trade on the COMMEX and KLOFFE exchanges, and must be funded from the sale of foreign currency. This measure was carried out to encourage participation in the domestic derivatives market. Funds in DEAs can freely be converted to foreign currency and repatriated without any levy.

On 4 February 1999, the Government announced a new rule to replace the one-year holding rule for portfolio capital. Under the new rule, the principal capital and profits will be allowed to be repatriated subject to a graduated levy depending on when the funds were brought into Malaysia and the duration of the investment. To distinguish between the different periods when the funds were brought in, funds brought in on or after 15 February 1999 will be placed in Special External Accounts (SEAs). For the funds under the SEAs, the principal amount brought in is allowed to be repatriated without any levy. However, profits made are subject to a levy upon repatriation depending on the duration of the investment.

Table III.2:
Sources and Uses of Funds in External Accounts

Account Holder	Sources of Funds	Uses of Funds
Non-resident corporations not incorporated in Malaysia	• Sale of ringgit assets in Malaysia • Sale of foreign currency • Interest, dividends and rental from ringgit assets • Fees and commissions for services done in Malaysia	• Purchase of ringgit assets in Malaysia • Administrative and staturory expenses in Malaysia • Payment of goods and services provided in Malaysia • Granting of loans and advances to staff in Malaysia pursuant to the terms and conditions of service • Payment of trade transactions for outstanding contracts entered into prior to 1300 hours on 1 September 1998
Embassies, consulates, central banks and international organisations	• No restrictions	• No restrictions
Non-resident individuals residing outside of Malaysia	• Sale of ringgit assets • Sale of foreign currency	• Purchase of ringgit assets in Malaysia • Statutory expenses in Malaysia • Payment of goods and services provided in Malaysia provided in Malaysia • Payment of import transactions entered into prior to 1300 hours on 1 September 1998.
Non-resident individuals with work permit and residing in Malaysia	• No restrictions	• No restrictions
Offshore entities in Labuan International Offshore Financial Centre	• Sale of foreign currency • Proceeds of permitted credit facilities in ringgit • Fees and commissions from residents	• Administrative and statutory expenses in Malaysia • In the case of Licensed Offshore Insurance entities, also for the purpose of reinsurance of domestic insurance business • Other permitted activities

Offshore Ringgit Market

Definition

The offshore ringgit market encompasses all ringgit-related activities transacted outside the boundaries of Malaysia. These activities include ringgit trading as well as trading in derivatives on the ringgit such as options, forwards, futures and swap contracts. The offshore ringgit market also encompasses all ringgit deposit-taking and lending activities outside of Malaysia. The offshore ringgit market activities take place mostly in Singapore, and to some extent, in other financial centres such as London, New York and Hong Kong Special Administrative Region (SAR), The People's Republic of China.

Development of Offshore Ringgit Market and Sources of Funding

Prior to the introduction of selective exchange controls, there was an active market for trading in ringgit outside Malaysia. The offshore ringgit market developed partly due to Malaysia's liberal exchange control regime prior to 1 September 1998. There were no restrictions on the sources of funds placed in External Accounts as well as on the transfer of funds into or out of the External Accounts. Before the selective exchange control measures were put in place, import and export settlements could be denominated in ringgit. This had relieved resident importers and exporters from the need to hedge their export proceeds and import payments. At the same time, this had given rise to the development of an offshore market in ringgit as the burden of hedging these trade transactions had to be borne by the non-resident counterparties.

Prior to the implementation of the exchange control measures, funding for speculative activity in ringgit was obtained from:

(i) Offer side swaps with a resident bank. This was essentially a ringgit borrowing by non-residents to fund their speculative ringgit activities. Bank Negara Malaysia (BNM) had limited the access of non-residents to ringgit through the implementation of an outstanding limit of US$2 million for each bank group of vostro accounts since August 1997.

(ii) Offer side swaps with another non-resident bank. This was effected through the transfer of ringgit funds from one External Account to another External Account.

(iii) Repo transactions on ringgit instruments. This avenue arose from the borrowing of United States dollars by banks in Malaysia from non-resident banks collateralised by ringgit securities. The offshore banks in turn used the securities to obtain ringgit funding through repo transactions with banks in Malaysia.

(iv) Other sources of funding through the External Accounts are payments for imports by residents in ringgit; outright purchase of ringgit with foreign currency; and dividends, interest, wages, salaries, commission and sale of ringgit assets.

Over the years, the existence and development of offshore ringgit activities, particularly in 1997 and 1998 had reached the extent of affecting domestic monetary policy implementation. In early 1998, the offshore ringgit deposit interest rates started to increase. Offshore banks in Singapore were offering interest rates of over 20% for ringgit deposits. The differential arose due to a large demand for ringgit offshore to meet the ringgit cash flow requirement from the speculative ringgit trading activities. To limit the supply of ringgit offshore, BNM announced on 4 August 1997 a limit of US$2 million on Malaysian banks for non-commercial related ringgit offer side swap transactions with foreign customers. With this regulation, ringgit funding from swap transactions for speculative activities in ringgit was severely curtailed. This regulation drove a wedge between the demand and supply of ringgit outside of Malaysia, causing the price of ringgit offshore (i.e. the interest rate) to increase. This large interest rate differential made the conduct of domestic monetary policy difficult as interest rates could not be reduced significantly without facing a threat of a large capital outflow by residents.

Size of Offshore Ringgit Market

Although it is very difficult to estimate the size of the offshore ringgit market, the magnitude of the amount is reflected in the External Account balance. Non-residents hold ringgit balances in External Accounts maintained with resident banks. These accounts are held in the form of vostro accounts in the case of non-resident banks, or normal over-the-counter accounts maintained with the banking institutions in Malaysia in the case of non-resident non-banks. As at end-August 1998, the outstanding balance in the External Accounts maintained with the banking system was RM9.1 billion.

The External Account balance essentially represents the amount of ringgit that is under the control of non-residents. Any ringgit that is placed with an offshore bank will ultimately be reflected in a corresponding entry in the bank's vostro account with commercial banks in Malaysia. Transactions in ringgit among offshore players are ultimately settled through credits and debits to the External Accounts concerned.

It should be noted, however, that the External Account balance is an estimate of the stock of ringgit offshore, and not the volume of offshore ringgit transactions. The actual volume of transactions is many multiples of the underlying stock figure. If trading in the secondary market of ringgit-denominated contracts is active, the volume of trade can be a large multiple of the underlying ringgit asset. For example, if a contract on RM100 million was traded three times in a day, the volume of transactions would be RM300 million, even though the underlying asset is only RM100 million.

Effect of Exchange Controls on the Offshore Ringgit Market

To curb the ringgit-related activities outside Malaysia as well as to repatriate ringgit currency notes from abroad, Malaysia decided to impose selective exchange controls beginning 1 September 1998.

Details of the measures, which form part of the selective exchange controls, and other complementary measures are as follows:

Selective Exchange Control Measures

- **Prohibit crediting of External Accounts among External Account holders**: To reduce the volume of offshore market activity in ringgit among non-residents, the transfer of funds among non-residents was disabled by prohibiting the crediting of an External Account by another External Account holder. However, to facilitate business transactions among non-residents who maintained External Accounts, the above prohibition was relaxed for the sale and purchase of ringgit assets among such non-residents. The measure curtailed the availability of ringgit to speculators, brought the ringgit market back to Kuala Lumpur, and trade in ringgit was confined only to trading hours in Kuala Lumpur.

- **Prohibit granting of credit line to non-resident banks and stockbrokers**: Previously, banks in Malaysia were allowed to grant a credit line of RM5 million to non-resident banks and stockbrokers, and permission of BNM was required for any amount in excess of RM5 million. To cut off ringgit funding to non-resident banks and stockbrokers, banks in Malaysia were prohibited from providing any credit line to non-resident banks and stockbrokers. Offshore banks were, therefore, no longer able to overdraw their External Accounts to fund their activities in ringgit.

- **Require imports and exports to be denominated in foreign currency**: As the non-residents were no longer allowed to pay in ringgit for imports from Malaysia and would receive payment for their exports to Malaysia in foreign currency, they no longer had the need to hedge in ringgit. This would reduce the offshore ringgit market activity related to trade with Malaysia.

- **Restricting the import and export of ringgit currency notes:** The amount of ringgit currency notes that can be taken into or out of Malaysia was limited to RM1,000.

Other Measures

- **Prohibit transactions in offer side swaps by banks in Malaysia with non-resident banks:** To eliminate this source of funding, the outstanding limit of US$2 million per bank group of vostro accounts was replaced by a total prohibition of such transactions with non-resident banks.

- **Prohibit reverse repo transactions with non-resident banks:** Banks in Malaysia were prohibited from engaging in reverse repo transactions collateralised by ringgit instruments with non-resident banks, to eliminate this avenue for non-residents to raise ringgit funds.

The selective exchange controls and other measures have effectively eliminated the offshore ringgit market. The supply of ringgit outside Malaysia has ceased and this has resulted in traders and speculators being unable to trade in ringgit-denominated contracts outside of Malaysia. While ringgit remains fully convertible, conversion of ringgit must be undertaken through banks in Malaysia.

The elimination of the offshore ringgit market will not affect the efficiency of trade. While importers and exporters in Malaysia are required to settle their transactions in foreign currency, they are also allowed to maintain part of their export proceeds in foreign currency accounts with banks in Malaysia.

stability to return to the foreign exchange market and facilitated a greater degree of certainty for traders, investors and consumers.

Subsequent to the adoption of the fixed exchange rate regime, the ringgit's performance against major currencies had been influenced by dollar movement in the international foreign exchange market. During the period 2 September-31 December 1998, the ringgit appreciated by 0.6% against the pound sterling but depreciated by 3.8% against the Swiss franc, 4% against the Deutsche Mark and 16.3% against the Japanese yen. Against the composite index, the ringgit depreciated by 3.5%. The ringgit's depreciation reflected movements of the dollar, which had weakened against the yen and Deutsche Mark in the fourth quarter of 1998. Meanwhile, against selected regional currencies, the ringgit depreciated by 3.9% against the Singapore dollar, 9% against the Philippine peso, 9.6% against the Thai baht, 11.4% against the Korean won and 25.6% against the Indonesian rupiah.

In terms of policy direction, Malaysia adopted a less orthodox approach. It has been suggested that interest rates should be raised sharply to avoid further depreciation. Bank Negara Malaysia's view, however, was that higher interest rates by itself would not strengthen the currency in view of the regional currency instability that was being experienced. Events outside Malaysia's control could take the currency in the opposite direction, even if interest rates were raised. Not only would such a move not provide support for the currency, higher rates would be detrimental to the economy and the banking system, and therefore contribute towards further weakening of the currency. There was also no evidence of outflows of foreign currency by residents, indicating that Malaysia did not experience capital flight.

It was viewed that the ringgit exchange rate could only stabilise with the resumption in confidence, positive sentiment as well as an overall economic recovery. Interest rates were, therefore, only raised in small steps since October 1997 mainly to address the expected increase in inflation due to the ringgit depreciation. (Interest rate policy is discussed in detail under Monetary Policy 1998, in Chapter 2). Developments in the offshore markets further constrained the use of interest rates to

Table 1.23
Movement of the Ringgit

	Foreign currency to one unit of RM[1]					Annual change (%)		
	1997	1998						
	End-Dec.	Sept. 2	End-Dec.	Low	High	1997	Sept. 2* 1998	1998
Composite	69.70	72.11	69.57	58.23	77.38	–31.4	–19.8	–0.2
SDR	0.1903	0.1954	0.1869	0.2141	0.1585	–30.8	–22.3	–1.8
US$	0.2572	0.2632	0.2632	0.2890	0.2116	–35.0	–22.6	+2.3
S$	0.4310	0.4546	0.4371	0.4678	0.3771	–22.1	–12.2	+1.4
Yen	33.4213	36.0464	30.1741	36.4445	27.7994	–27.3	–12.5	–9.7
Pound Sterling	0.1552	0.1570	0.1579	0.1778	0.1305	–33.7	–25.7	+1.8
Deutsche Mark	0.4602	0.4599	0.4417	0.5223	0.3883	–25.1	–25.6	–4.0
Swiss franc	0.3739	0.3781	0.3637	0.4221	0.3139	–29.8	–25.5	–2.7
Thai baht	12.1452	10.6709	9.6513	12.8154	9.3816	+19.8	–9.5	–20.5
Indonesian rupiah	1,386	2,824	2,100	4,032	1,490	+48.4	+176.3	+51.5
Korean won	433	353	313	463	292	+29.8	+14.8	–27.7
Philippine peso	10.4141	11.3248	10.3025	11.7184	9.3431	+0.1	+8.3	–1.1

[1] With the exception for 1996 data, where the Thai baht, Indonesian rupiah, Korean won and Philippine peso are based on customer rates, all other data is based on the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market.
* Compared with 2 September 1997's levels.

support ringgit rates. The need to stabilise the ringgit exchange rate was the main reason for the introduction of selective exchange controls on 1 September 1998 and the fixing of the ringgit rate at US$1=RM3.8000 on 2 September 1998.

Inflation

The inflation rate increased in 1998 but was substantially lower than expected. The effects of higher import prices due to a weaker ringgit was not fully transmitted to domestic prices. Inflation as measured by the **Consumer Price Index** (CPI, 1994=100) rose by 5.3% in 1998, lower than the earlier estimates of 7-8%. This was, however, the highest level recorded since 1982 (5.8%). The 28.3% depreciation in the average exchange rate of ringgit against the United States dollar in 1998 would have raised consumer prices by about five percentage points, based on the findings that a 1% depreciation in ringgit would increase CPI by 0.176 percentage points. However, the full impact of the depreciation was not passed through to the consumers as firms absorbed part of the increase in order to maintain market share in an environment of weak domestic demand and excess capacity in the economy. On the external front, low inflation abroad and lower oil and commodity prices in the world markets also had a moderating effect on domestic prices. During the first two month of 1999, the CPI rose at an average of 4.5%. On a regional basis, the CPI for Peninsular Malaysia, Sabah, and Sarawak rose by 5.5%, 4.3%, and 4.2% respectively in 1998.

Excluding food, the adjusted CPI rose more moderately by 3.1%. In Malaysia, a system of administered prices has been put in place for approximately 11% of the basket, whereby prices are administered to stabilise them at reasonable levels. Hence, there is no price controls as such, contrary to general perceptions. The Government approves price increases for the price administered items based on their production costs as well as agreements arrived at after negotiations with producers. Producers and distributors, however, are free to lower prices below the determined prices. Except for Liquified Petroleum Gas (LPG), there is also no subsidy element in the system. A total of 46 items are currently covered under the Supplies Control Regulation and are classified under two groups. Supplies of 21 items are monitored all year around. Of this total, prices of 11 items are administratively controlled, namely, white sugar, wheat flour, round steel bars, cement, petrol, diesel, sweetened condensed milk, LPG, standard loaf bread, chicken, and cooking oil (100% palm olein). For these 11 items, price adjustments are allowed to reflect changes in economic fundamentals such as higher imported prices. Supplies of another 25 items are monitored during festive seasons. Prices of these items are supervised, but not administered. Meanwhile, only prices of locally-produced rice (which accounted for 2.8% of the CPI basket) are controlled by legislation. In terms of contribution to the basket of goods and services in the CPI, the 10 items (excluding round steel bars) whose prices are administered accounted for 10.8%, while the other items under the Supplies Control Regulation whose prices are supervised but not administered by the Government accounted for another 4.2%. Of the latter 4.2% share of the CPI basket, only 0.3% are supervised throughout the year, while the balance of 3.9% are supervised during festive seasons.

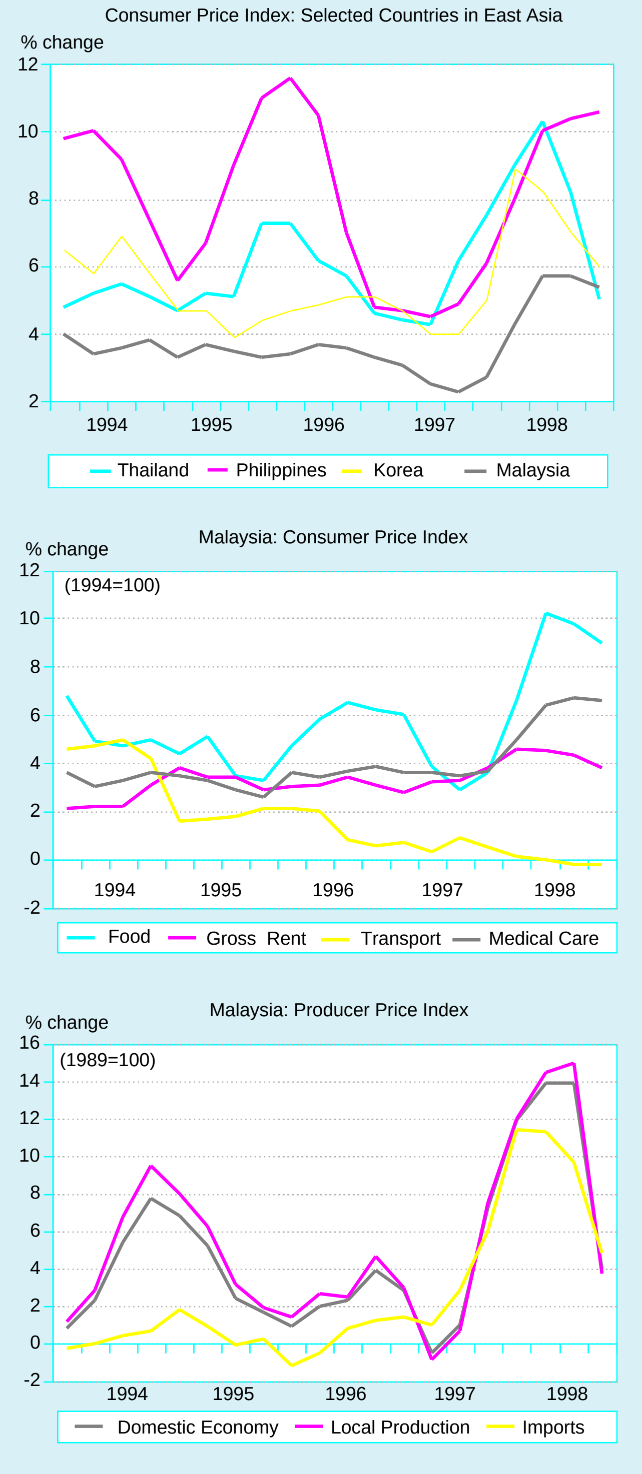
Inflationary expectations started to build up towards the end of 1997 as the ringgit declined to successive lows, buffeted by a volatile external environment. The ringgit traded at US$1=RM3.8883 as at the end of 1997, a depreciation of 35.1% from the level recorded as at the end of June 1997. The Consumer Sentiments Survey conducted by the Malaysian Institute of Economic Research (MIER) in the fourth quarter of 1997 indicated that 83% of the households surveyed were expecting price increases in the first half of 1998 (79% in the third quarter of 1997). However, as the financial crisis became more prolonged, the subsequent deterioration in investor and consumer demand as well as weak export demand led to a sharper-than-expected contraction in domestic economic activities. Consequently, inflationary pressures abated, reflecting mainly the slack in the product and labour markets. The rate of increase in the CPI moderated progressively to 5.3% in December 1998, from the year's peak of 6.2% in June. The introduction of the new exchange control measures on 1 September and the fixing of the ringgit exchange rate against the United States dollar at US$1=RM3.80 on 2 September 1998 further reined in inflationary expectations.

Reflecting mainly rising cost pressures arising from higher import prices and cyclical supply shortage of essential food items, prices of non-durable goods rose at a faster rate of 6.9%. Prices for services which were less affected by exchange rate changes also rose, albeit more moderately by 5.2%, attributable to higher inflationary expectations and the higher cost of business following higher prices in the goods sector. Meanwhile, price increases for semi-durable goods and durable goods such as electrical and electronic goods and cars were more subdued (1.4% and 0.4% respectively), reflecting adjustments to weaker global prices and weak consumer demand. For these categories of goods, producers had reconsidered their pricing strategies and reduced their profit margins to maintain market shares. Consumers had greater flexibility either to reduce consumption of the non-essential goods or to substitute for lower cost products.

In terms of components, the CPI for food; miscellaneous goods and services; and medical care and health expenses, recorded stronger increases exceeding 5.3%. The CPI for food, which accounted for 34.9% of the weight in the overall CPI basket, rose by 8.9% in 1998. Higher prices for both food consumed at home (9.1%) and food consumed away from home (8.4%) reflected, to some extent, the stronger pass-through effect of higher imported food prices following the depreciation of the ringgit. Prices of most imported essential items, namely, sugar; rice, bread and other cereals; oils and fats; and coffee and tea increased at a faster rate during the year. Following the higher cost of imports, the Government approved increases in the ceiling prices of two essential items, namely, cooking oil (5% increase) and chicken (10%) from mid-December 1997. This was followed by increases in prices of another three administered items, namely, flour (20%), sugar (21%), and milk (6%), effective 1 February 1998. These five items together accounted for about 6% of the weight in the CPI basket. The total impact (direct as well as indirect effects) of higher prices for these items added nearly 1.1 percentage points to the rate of inflation.

Among the non-food sub-groups, above-average price increases were observed in the sub-groups of miscellaneous goods and services; and medical care and health expenses, which together accounted for 7.5% of the weight in the consumer basket. Key imported consumer goods that registered substantial price increases under the sub-group of miscellaneous goods included items such as jewellery; watches; toiletries; goods for personal care; and writing and drawing equipment. Moderate price increases, ranging between 3.3% and 4.4%, were recorded for gross rent, fuel and power, the second largest sub-group accounting for 21.1% of the weight in the CPI basket; as well as recreation, entertainment, education and cultural services; furniture, furnishing and household equipment; and beverages and tobacco. The increase in import and excise duty on cigarettes, tobacco products and alcoholic beverages in the 1999 Budget is estimated to have a direct effect of nearly 0.2 percentage point rise in inflation. Prices of clothing and footwear registered a marginal increase of 0.4%. Of significance, prices of transport and communication, the third largest sub-group

Graph 1.16
Inflation: Average Annual Rate of Change



accounting for 17.9% of the weight in the consumer price basket, declined by 0.1%. Within this category, prices of motor cars, motorcycles and bicycles declined by 2.9% in response to a sharp reduction in demand and excess capacity in the transport-related industries. This decline was partly offset by increases in fares paid for public transportation, particularly rail transportation.

While the pass-through impact of the weaker ringgit on the CPI was evident with a longer time lag, the **Producer Price Index** (PPI, 1989=100), adjusted with a relatively short lag. The PPI, which measures prices of both intermediate and final goods charged by domestic producers and paid by importers in the country, started recording stronger increases since October 1997. In the first eight months of 1998, double-digit increases were recorded, with the largest increase of 17% recorded for the month of July. The increase in producer prices, however, moderated from October, partly reflecting the decline in prices of mineral fuels, lubricants and related materials. The decline in the prices of mineral fuels, lubricants and related products, which accounted for 18% of the weight of the PPI basket, reflected lower world oil prices of US$13.00 per barrel in the fourth quarter of 1998 (US$20.90 per barrel in the fourth quarter of 1997). For 1998 as a whole, the PPI increased by 10.7%. The largest increase in prices was registered in the animal and vegetable oils and fats sub-index (63.8%) due largely to higher prices of palm oil arising mainly from valuation effects from the weaker ringgit. Palm oil accounted for 7% of the weight in the PPI basket. Meanwhile, higher import prices due to the weaker ringgit and higher local production costs contributed to a substantial increase in the prices of machinery and transport equipment; manufactured goods; miscellaneous manufactured articles; and chemical and chemical products, which together accounted for 37% of the weight in the PPI basket. Excluding the prices of animal and vegetable oils and fats, the adjusted PPI showed an increase of 3.8% in 1998.

In 1998, the Government adopted a more integrated approach to address supply constraints in the food sector. In March 1998, the Government widened the activities financed by the Fund for Food (3F) to include rice production, ostrich, rabbit, quail and deer farming. The 1999 Budget also contained a number of supply enhancement measures. To reduce excessive reliance on imports and to promote investment in large-scale food production, the Government would allow losses incurred in the production of approved food items to be deducted from the profits of the companies in the same group for purpose of income tax computations. For a start, food and feed items such as cattle and maize have been identified to qualify for this incentive because they are largely imported. At the same time, import duties and sales tax were abolished or reduced on selected food items, such as canned anchovies. Local importers have also been urged to import food from cheaper sources. With respect to non-food items, import duties and sales tax were abolished or reduced on paper products and all types of printed paper for the purpose of reducing publishing costs, particularly items used in schools. Meanwhile, under the ongoing programme to curb unjustified increases in prices and ensure an adequate supply of essential goods, the relevant Government agencies stepped up enforcement and price checks. Since mid-October, foreigners were prohibited from carrying across the border four essential items, namely, cooking oil, sugar, sweetened condensed milk and flour. The Ministry of Domestic Trade and Consumer Affairs also conducted weekly price monitoring exercises on 233 daily used items through 34 collection centers to improve the flow of information on prices of essential goods.

The downward movement in **asset prices** which emerged towards the end of 1997 became more pronounced in 1998. In terms of share prices, the Kuala Lumpur Composite Index (KLCI) touched a low of 262.70 points on 1 September 1998, a decline of 55.8% from the end-1997 level. This initially reflected to a large extent the liquidation of portfolio capital by non-residents. However, overall market sentiment weakened further in 1998 due to increasing concerns over the health of the corporate sector as domestic output contracted at a faster pace than anticipated. The KLCI, however, recovered following the implementation of the exchange control measures on 1 September 1998 and other policy measures implemented to support economic recovery. The improved performance of the regional markets also contributed to greater investor confidence. The KLCI ended the year at 586.13 points (end-1997: 594.44 points).

With regard to property prices, the **Malaysian House Price Index** (MHPI) declined by 8.5% in the first half of 1998 (+1.9% in 1997). By the end of 1998, residential property prices were about 10% lower than the peak level recorded in 1997. In view of the linkages of the construction sector to the services and manufacturing sectors and the oversupply of houses, Bank Negara Malaysia selectively relaxed the requirements with respect to lending to the residential property sector. In early September, lending for the construction or purchase of residential properties costing up to RM250,000 were exempted from the 20% limit on lending to the broad property sector. With effect from 5 October 1998, the 60% maximum margin of financing was abolished for the purchase of non-owner occupied residential properties costing RM150,000 and above; the purchase of shophouses costing RM300,000 and above which are not for the conduct of own business; and the purchase of land lots. This relaxation was aimed at facilitating efforts to clear the backlog of properties. It was complemented by the “Home Ownership Campaign” launched in October. (The details on policy measures affecting asset markets are contained in the sections on “Sectoral Review” in Chapter 1 and “Financial Markets” in Chapter 4).

Table 1.24
Inflation Indicators

	Weights	1997	1998
		Annual change (%)	
Consumer Price Index (1994=100)	100.0	2.7	5.3
Of which:			
Food	34.9	4.1	8.9
Beverages and tobacco	3.6	1.3	4.3
Clothing and footwear	3.6	–0.5	0.4
Gross rent, fuel and power	21.1	3.2	4.4
Furniture, furnishings and household equipment	5.6	0.1	3.9
Medical care and health expenses	1.9	3.6	6.2
Transport and communication	17.9	0.6	–0.1
Recreation, entertainment, education and cultural services	5.8	0.4	3.3
Miscellaneous goods and services	5.6	4.6	7.1
Peninsular Malaysia CPI	100.0	2.8	5.5
Sabah CPI	100.0	2.0	4.3
Sarawak CPI	100.0	1.7	4.2
Producer Price Index (1989=100)	100.0	2.7	10.7
Of which:			
Local Production	79.3	2.5	11.2
Imports	20.7	2.8	9.2
House Price Index (1990=100)		1.9	–8.5[1]
Of which:			
Klang Valley		4.4	–11.2
Johor Bahru		0.1	–21.9
Penang Island		4.3	–11.5

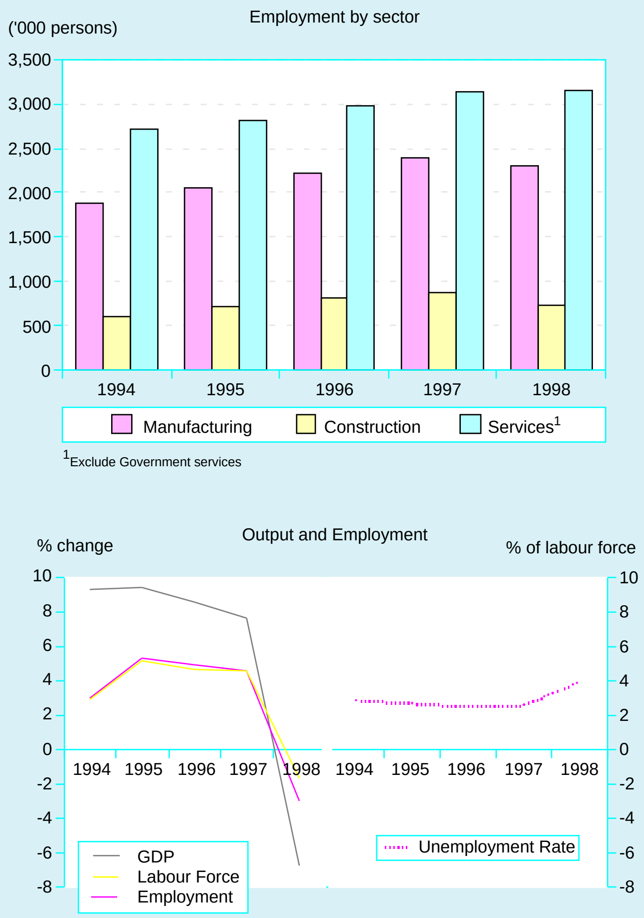
[1] January-June.
Source: Department of Statistics
Department of Valuation and Property Services

Labour Market Developments

In the face of a contraction in domestic economic activity, the **unemployment** rate is estimated to have increased from 2.6% in 1997 to 3.9%, below the 4% or full employment level. During the year, the number of unemployed increased by 109,000 to 342,000 in 1998. A total of 83,865 workers were officially recorded as being retrenched in 1998. The slack labour market conditions contributed to some moderation in wage increases in 1998.

On a positive note, labour demand for selected categories of workers remained strong in 1998 with a total of 74,610 job vacancies. The quarterly indicators also pointed to more favourable developments in the fourth quarter, following the improvement in the domestic economic and financial conditions in the fourth quarter of 1998. The number of retrenchments declined to 6,039 workers per month during the fourth quarter of 1998, from the year's peak of 12,335 in July 1998. At the same time, the number of job seekers declined to 33,345 persons at the end of 1998, compared with a peak of 34,514 persons at the end of July 1998. After declining from 126.3 points at the end of 1997 to 80.5 points in the third quarter of 1998, the MIER Employment Index increased to 86.4 points in the fourth quarter.

Graph 1.17
Labour Market Conditions



In 1998, total **employment** declined by 3%. The decline was more pronounced in the construction sector (148,000 persons); followed by manufacturing (86,000); and agriculture (61,000). Fewer job opportunities created by the services and mining sectors also added to the weaker employment conditions. Reflecting mainly the significant slowdown in the construction sector (-24.5%), the job loss in this sector was the largest. Consequently, the share of the *construction sector* in total employment declined from 9.9% to 8.5%. The net job loss in the *manufacturing sector*, which accounted for 27% of total employment, was lower compared with 170,000 new jobs created in this sector in 1997. The decline in jobs was concentrated in industries producing construction-related materials and transport equipment. The *services sector* continued to create new job opportunities, although at a slower pace. In 1998, an additional 27,000 jobs were created in this sector, with the finance, insurance, real estate and business services sub-sector accounting for 40% of the total, followed by transport and communication (11%), Government services (7%), and electricity, gas and water (4%) sub-sectors. However, employment in the wholesale and retail trade, hotels and restaurant sub-sector was more affected by the contraction in the economy. Employment in this sector declined by 0.6% in 1998, following lower demand and closure of businesses.

As earnings contracted, employers reduced their workforce as part of the overall rationalisation process to reduce the cost of production. In 1998, a total of 83,865 workers were officially recorded as being retrenched, with 54% from the manufacturing sector. Of those retrenched in the manufacturing sector, 58% were workers in the transport-related industries and another 18% were in industries producing construction-related materials. The services sector as a whole accounted for 28% of the total number of workers retrenched. Based on data provided by the Ministry of Human Resources, the retrenchments were attributed to the decline in demand following the downturn in activity (60%); financial constraints (13%); closure of companies (8%); and restructuring of companies (6%). In terms of broad job category, the majority of workers retrenched were production workers

(54%), followed by professional and technical staff (14%), clerical staff (12%), managers (7%), and others (12%). In the production workers category, skilled workers accounted for 35%, semi-skilled workers, 33%; and general workers, 32%.

During the year, the Government had monitored closely the employment situation and adopted pre-emptive measures to address the problem arising from rising retrenchment and weak domestic labour market conditions (the measures are summarised in the Box on "Measures Implemented to Stabilise the Labour Market Conditions in 1998"). The measures included the amendment of the labour law which gave more flexibility to companies to adjust wages according to changing economic conditions and productivity levels. Data compiled by the Ministry of Human Resources showed that more employers adopted alternative measures such as pay cuts, temporary layoffs and voluntary layoffs before resorting to permanent layoffs during the period August-December 1998. During this period, 795 employers implemented pay cuts involving 22,514 workers, while another 52 employers implemented temporary layoffs involving 6,342 workers. At the same time, 336 employers implemented voluntary layoffs involving 6,193 workers during the same period.

Table 1.25
Job Vacancies and Retrenchment in 1998

	Job Vacancies[1]		Retrenchment	
	Number	% Share	Number	% Share
Total	**74,610**	**100.0**	**83,865**	**100.0**
Agriculture, forestry and fishing	5,231	7.0	5,108	6.1
Mining and quarrying	188	0.3	877	1.1
Manufacturing	52,159	69.9	45,151	53.8
Construction	2,156	2.9	9,334	11.1
Services	14,876	19.9	23,395	27.9
Wholesale and retail trade, hotel and restaurant	*5,281*	*7.1*	*10,434*	*12.4*
Finance, insurance, real estate and business services	*3,070*	*4.1*	*6,596*	*7.9*
Transport, storage and communication	*1,066*	*1.4*	*2,007*	*2.4*
Electricity, gas and water	*122*	*0.2*	*1*	*...*
Social and private services	*–*	*–*	*4,242*	*5.1*
Other services	*5,337*	*7.1*	*115*	*0.1*

[1] The number of job vacancies could have been under-reported as it is not compulsory for firms to report vacancies to the Manpower Department.

Source: The Ministry of Human Resources
Manpower Department

Labour demand as reflected by the number of job vacancies remained strong as a total of 74,610 job vacancies were reported throughout the country in 1998. The number of job vacancies could have been under-reported as it is not compulsory for firms to report vacancies to the Manpower Department. Feedback from industry sources indicated that demand existed for certain categories of workers, particularly production workers. According to *The Business Expectation Survey of Limited Companies, Second Half 1998* conducted by the Department of Statistics (DOS), selected manufacturing and non-manufacturing firms continued to demand for workers. At the same time, the Government also approved the intake of 55,463 new foreign workers to meet the demand for production workers in 1998. Of this total, 17% was for manufacturing, 8% each for plantation and construction, and 6% for services. The balance (61%) was for the domestic services sub-sector.

The number of registered **foreign workers** employed in the country declined to 781,548 from 1.2 million in 1997. Foreign workers were mainly employed in the manufacturing sector (35%), followed by plantation (19%), construction (18%), domestic services (17%) and other services sectors (10%). In terms of country of origin, workers from Indonesia and Bangladesh remained the biggest group, accounting for 60% and 31% respectively. During the year, the Government introduced additional measures on foreign workers to ensure that employers gave priority to hiring local labour, amidst the weak domestic labour market. The measures included the imposition of a new levy structure and the freezing of the recruitment of new foreign workers. The levy charges were increased to RM360 from RM300 for domestic helpers and plantation workers, while a levy of RM1,500 was imposed on those in the construction, manufacturing and services sectors. In addition, it was made mandatory for registered foreign workers to contribute to the Employees Provident Fund (EPF).

With the retrenchment of workers and the reduction in salaries experienced by selected sectors of the economy, **wage pressures** eased. Indicators on wages showed moderating increases in the wage rates. As measured by the Malaysian Employers Federation (MEF) survey, the salary increases in the private sector slowed from 8.9% in 1997 to 6.2% in 1998. The findings of the Monthly Surveys of Manufacturing Industries conducted by DOS also showed a similar trend, with wages increasing at a slower rate of 5.6% in 1998, compared with 10.2% in 1997. At the same time, the weighted average wage of the three-year collective wage agreements, covering 143,000 workers in the private sector or 2% of the total labour force, increased at a slower rate of 9.6% in 1998 (13.1% in 1997). All sectors, except for commerce and mining, registered slower wage increases. Following the wage agreements concluded in the manufacturing sector during the year, wages in the sector rose at a slower rate of 8%, while wage increases in the services and agriculture sectors moderated to 10.1% and 8.9% respectively. Wage increases in the electricity sector also moderated to 10% in 1998 from a strong growth of 18.1% in 1997. In contrast, wage increases in both the commerce and mining sectors increased at a higher rate of 13.8% and 10.6% respectively in 1998, compared with 11.8% and 7.7% respectively in 1997. However, this trend is not reflective of the wage profile for the commerce and mining sectors as a whole, as less than 12% and 1% respectively of the workforce in these sectors were covered by the collective agreements concluded in 1998. The findings of the Monthly Surveys of Manufacturing Industries of DOS also indicated that the labour cost in the manufacturing sector as measured by real average wages increased at a slower rate of 0.3%, reflecting a decline in the nominal wage bill (–1.1%), and an increase in the inflation rate.

Labour productivity, as measured by the ratio of GDP to total employment, declined by 3.8% in 1998. In the manufacturing sector, labour productivity declined by 0.1%. The poor productivity results in 1998 reflected the reduction in output in response to the build-up in inventories due to the sharp contraction in domestic demand as well as weak external demand. Recognising that productivity continued to lag behind wage growth, efforts have been intensified to enhance productivity levels through the implementation of productivity and quality management systems, improvements through benchmarking activities, intensifying the application of information technology, skill upgrading of human resource, and quality products through research and development.

In 1998, the Government implemented further measures to upgrade **industrial skills**. To strengthen the quality of manpower to meet the increasing demand for highly skilled manpower, the Government increased new intakes of trainees in the existing training institutes. The number of trainees in the nine Industrial Training Institutes increased by 35.5% to 2,842 trainees, while 3,147 instructors were trained by the Centre for Instructors and Advanced Skill Training (CIAST). The existing bilateral training centers, namely, the German Malaysia Institute (GMI), Malaysia French Institute (MFI) and British Malaysia Institute (BMI) recruited another 701 trainees (742 trainees in 1997). In addition, the Japan-Malaysia Technical Institute (JMTI) was established under the technical co-operation between the Governments of Malaysia and Japan. The institute started operations in July 1998 with its first intake of 58 trainees to specialise in computer engineering technology and electronics engineering technology. In January 1999, the JMTI absorbed another 31 trainees and has plans to increase its intake to 100 in the July 1999 session. At the same time, two new courses, namely, mechatronics engineering technology and manufacturing engineering technology would be introduced in the July session to widen the scope of industrial training for both the industrial and public sectors.

In the 1999 Budget, the Government also introduced several fiscal incentives to promote human resource development. In line with the objective of promoting Malaysia as the centre of excellence for education, the Government allocated RM13.5 billion to provide and upgrade educational infrastructure as well as for curriculum development. Vocational schools would be upgraded and new technical schools constructed. With the additional expenditure of RM2.85 billion allocated to upgrade existing education facilities, the intake of students into local universities will be increased from 77,600 to 84,000 students in 1999. A sum of RM1.145 billion is allocated for skills training in the 79 vocational and technical schools, 16 Skills Development Training Institutes and 135 Pusat Giat

Measures Implemented to Stabilise the Labour Market Conditions in 1998

Measures	Rationale
With effect from 1 February 1998, it became mandatory for employers to inform the Director General of Labour Department at least one month before retrenchment exercise.	➪ To monitor the retrenchment situation closely, facilitate investigation and provide the necessary advisory services to employers to safeguard the welfare of the retrenched workers.
Task forces were set up to provide employment services to retrenched workers at the state and district levels, improving the mobility of labour through publication of vacancies and regular dialogues with employers' and employees' organisations as well as industry associations.	➪ To help redeploy retrenched workers into alternative jobs via tripartite cooperation involving all parties, the Government, employers and workers' union.
With effect from 1 August 1998, *Employment Act 1955* was amended to promote more flexible working practices and encourage employers to provide incentives for productivity.	➪ To raise productivity.
On 1 August 1998, *Guidelines on Retrenchment* was issued.	➪ To guide employers and workers on alternatives to retrenchment and if unavoidable, the procedures to be followed.
Encourage employers to provide exit services such as counselling service and career guidance to assist those retrenched to find new jobs.	➪ To help and facilitate retrenched workers seeking alternative jobs.
As an alternative to retrenchment, encourage employers to resort to other cost cutting measures, such as pay-cuts or reduced working hours, temporary or voluntary lay-off.	➪ To maintain industrial harmony and labour market stability.
On 2 May 1998, the Ministry of Human Resources established a RM5 million retraining programme for retrenched workers.	➪ To upgrade skills to meet demand for higher skilled workers while assisting retrenched workers seek alternative employment.
Employers in particular sector which were facing difficulties were exempted from paying a levy to the HRDC for 6 months, from 12 February to 11 August 1998. In August, this exemption was extended to some industries for another six months till February 1999. The industries which benefited included manufacturers of plastic products; professional, scientific and controlling instruments and apparatus; rubber;	➪ To ease the financial burden of affected employers and moderate the level of retrenchment.

tobacco; electrical machinery; electronic apparatus and appliances; paper and paper products; telecommunications, postal services and courier; and air transport and shipping. However, industries which registered better performance and were in a stronger financial position were required to re-contribute a levy to the HRDC.

MARA besides the construction of an additional 24 new skills training centres.

Under the **Human Resource Development Fund (HRDF)**, which was established in 1993, companies conducted courses to retrain and upgrade skills of a total of 2.1 million employees in 1998. Employers who faced financial problems were given exemption from contributing to the HRDF during the period 12 February to 11 August 1998. This exemption was extended for another six months to industries that continued to face financial constraints. As a result, the value of levy collected under HRDF in 1998 was lower at RM62 million, compared with RM144 million in 1997. Of this total, RM340 million was allocated for training. Meanwhile, the Human Resource Development Council (HRDC) implemented 12 training schemes, involving 409,814 trainees and extended financial support for employees participating in retraining and skill upgrading courses of RM141 million. More importantly, the Council established on 2 May 1998 a RM5 million retraining programme for retrenched workers. Under this programme, firms are allowed to seek financial assistance for retraining workers. Of the total of 572 trainees under this scheme in 1998, 36% were trained in computers, 28% in technical/engineering, and 37% in management.

Overall, some adjustment was observed in the domestic labour market. All parties concerned, including the Government, the industry and workers demonstrated greater flexibility to changing circumstances in the domestic labour market. The Government facilitated the adjustment through changes in the labour laws. The workers were more receptive to salary adjustments while the industry accelerated efforts in retraining workers.