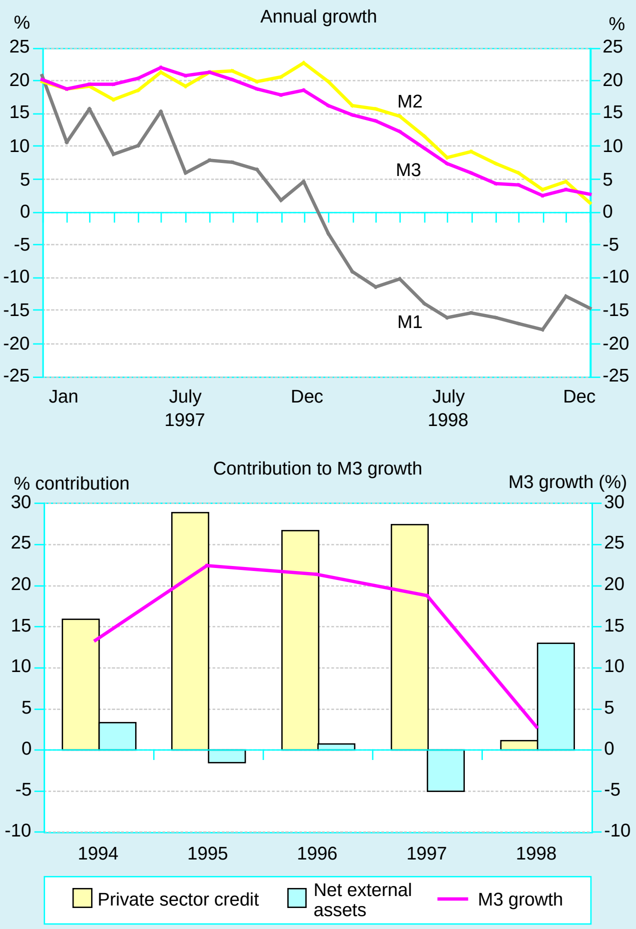
2 Monetary and Fiscal Developments

Monetary Developments

Monetary developments in 1998 were influenced by the policy measures implemented during the year as well as developments in the domestic corporate and banking sectors. Monetary growth slowed down significantly in 1998 in a period of severe economic contraction. Growth in money supply decelerated sharply as credit growth slowed down rapidly in an environment of sluggish economic activity; weak business prospects; lower private consumption; as well as more cautious lending policies of banking institutions amidst rising non-performing loans (NPLs). Against this background, monetary policy evolved according to the changing conditions during the course of the year to address emerging risks and challenges, with the aim of maintaining overall macroeconomic stability. In achieving this objective, Bank Negara Malaysia (BNM) relied on a combination of interest rate, and prudential and structural measures. While in the early part of the year the focus of policy was on ensuring stability and efficiency of the financial markets which is an important precondition to achieve the longer term policy objectives, the latter part of the year was focused on supporting economic recovery.

Graph 2.1
Money Supply



The annual growth rates of broad **monetary aggregates** - M2 and M3 - moderated significantly during the year, while narrow money or M1 declined for the first time in 1998. By end-1998, the annual growth of M2 and M3 decelerated to 1.5% and 2.7% respectively (22.7% and 18.5% respectively at end-1997), while M1 contracted by 14.6% (+4.6% at end-1997). On the whole, the deceleration of monetary growth during the year had been more severe than anticipated, with M2 and M3 expanding by only RM4.2 billion and RM10.6 billion respectively (+RM54 billion and RM61.1 billion respectively in 1997), while M1 contracted by RM9.2 billion (+RM2.8 billion in 1997). M3 had trended downwards since February and contracted during the months of April to July (–RM7 billion or –1.8%). However, since August money supply turned around to record a moderate expansion in response to the easing of monetary policy as well as the improved performance in the external sector. In comparison, the rate of deceleration in the growth of M3 during the previous recession experienced in the mid-1980s was more gradual. During that period, the annual growth of M3 slowed down from a peak of 16.3% at end-March 1985, to 8.8% at end-1986 and further to a trough of 3.9% at end-January 1988. The more rapid slowdown in M3 during the current economic downturn reflected mainly the larger GDP contraction as well as structural changes in the economy in which a more developed equity market exerted a relatively more significant negative wealth effect on the economy.

Reflecting the contraction in economic activity, the demand for transaction balances (currency holdings and demand deposits of the private sector) declined by RM8.9 billion in 1998. Demand deposits recorded a substantial decline of RM5.7 billion while currency in circulation contracted by RM3.2 billion. Except for January, June, September, November and December, the demand for transaction balances displayed a declining trend during the year. The generally weak business activity and poor business sentiments resulted in lower holdings of demand deposits by the corporate sector (–RM4.8 billion). Meanwhile, lower private sector consumption reduced households' requirements to hold more currency in their daily transactions, leading to a decline in the currency in circulation. In addition, the decline also reflected the return of currency to the banking sector following the announcement of the demonetisation exercise of the RM500 and RM1,000 denominations. It was announced on 12 September 1998 that the RM500 and RM1,000 notes will cease to be legal tender, effective 1 July 1999. In response to the announcement, about RM3.9 billion worth of RM500 and RM1,000 notes were returned to BNM between September and December 1998. The bulk of these currency notes was placed mostly in the form of deposits with banking institutions.

Broad quasi-money (private sector holdings of fixed and savings deposits, negotiable instruments of deposit (NIDs) and repurchase agreements (repos) with the banking system (excluding interbank transactions), expanded moderately by RM19.6 billion or 6% in 1998, compared with RM58.7 billion or 21.8% in 1997. The sharp deceleration in the growth of broad quasi-money reflected mainly lower income with the contraction in GDP. Deposit placement by individuals in savings and fixed deposits expanded by RM17.7 billion, compared with the increase of RM22.8 billion in 1997. For the corporate sector, a combination of weak business activities as well as relatively higher lending rates, particularly in the first half-year adversely affected their liquidity and cash flow position. As a result, total deposits placement by business enterprises in interest-bearing instruments with banking institutions declined, with a net withdrawal in fixed deposits (–RM4.9 billion) and NIDs (–RM425 million).

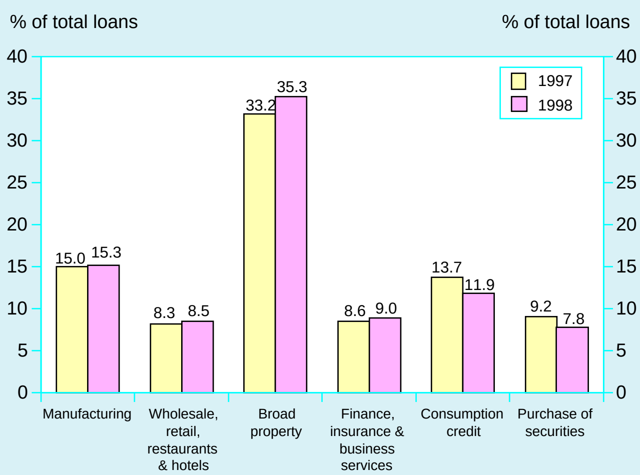
In terms of instruments, the moderate expansion in the broad quasi-money reflected the increase in fixed deposits (RM14.9 billion); foreign currency deposits (RM1.4 billion); savings deposits (RM1.3 billion); repos (RM1.1 billion) and NIDs (RM974 million). The large differential between savings and fixed deposits interest rates, in particular during the first half of the year, led to the increase in fixed deposits during the year. It also reflected the shift in preference among institutional and retail investors of the Kuala Lumpur Stock Exchange (KLSE) to less risky portfolios following the sluggish stock market performance.

In terms of determinants, the main impetus to the expansion in money supply emanated from external operations. Reflecting the surplus in the current account of the balance of payments of RM36.1 billion, as well as the impact from the introduction of selective exchange control measures in September, net external assets of BNM and the banking system expanded by RM51.2 billion. During the year, external reserves of BNM increased by RM40.3 billion, a turnaround from the decline of RM10.9 billion in 1997. However, it should be noted that effective 15 September 1998, following the fixing of the exchange rate of the ringgit against the United States dollar at US$1=RM3.80, all foreign currency assets and liabilities of BNM have been revalued into ringgit at rates of exchange prevailing on the reporting date. Hence, part of the increase in the external assets during the year reflected the exchange revaluation gains. This, however, had a neutral impact on money supply since the revaluation gains were offset by increases in the item "other influences", which also recorded a decline of RM32.4 billion during the year. In addition to the significant accumulation of reserves by BNM, the higher net external assets position was also due to the marked decline in the external liabilities of the banking system. In 1998, net external liabilities of the banking system declined by RM10.9 billion. This was largely attributed to the repayment of foreign loans by the banking institutions. Following the improved liquidity situation, especially in the second half of 1998, local banking institutions did not roll over the bulk of their maturing loans from abroad. The domestic banking institutions also reduced a large portion of their foreign interbank borrowings, especially those with shorter-term maturity.

Claims on the private sector, which had been the main expansionary factor in previous years, exerted a marginal impact on monetary growth in 1998, contributing about 1.1% to M3 growth compared with 27.3% in 1997. During the year, claims on the private sector expanded by only RM4.2 billion or 0.9%, compared with the significant expansion of RM90.4 billion or 25.3% in the previous year. The expansion in credit was due wholly to the higher holdings of private debt securities by the banking institutions of RM14.1 billion, partly reflecting subscriptions to Danamodal and Danaharta bonds. In the last quarter of 1998, Danamodal Nasional Berhad (Danamodal) issued zero-coupon bonds with a face value of RM11 billion, while Pengurusan Danaharta Nasional Berhad (Danaharta) issued two series of zero-coupon bonds with a total face value of RM2.6 billion in exchange for the banking institutions' NPLs. In contrast, loans and advances extended by the banking institutions (as defined under M3 determinants) declined by RM9.9 billion or 2.4%, compared with a substantial expansion of RM82.1 billion or 25.3% in 1997.

Total loans of the banking system (comprising commercial banks, finance companies and merchant banks) declined by RM7.6 billion or 1.8% in 1998. However, if the NPLs that were purchased by Danaharta during the year were included, total loans in 1998 would have increased by RM5.5 billion or 1.3%. By institutions, commercial banks continued to record a moderate increase in loans (+3.3%). Loans extended by finance companies and merchant banks, however, declined by 15% and 3.7% respectively. The ongoing merger exercise among the finance companies had affected their loan growth. The poor performance of the affected finance companies also contributed to the decline in loans extended to the private sector. On the whole, the decline in loans extended by the banking system in 1998 was attributed to both demand and supply factors. On the demand side, the relatively higher interest rates, particularly during the first half-year, as well as the contraction in economic activity were the main reasons that led to the lower demand for loans by the private sector. The decline in loans also reflected the higher repayments in response to higher interest rates in the first half-year and the postponement of expansion plans as the crisis became more severe. Furthermore, as inventory levels increased and capacity utilisation was lower, the demand for loans for new investments fell, leading to a decline in the overall financing needs of the economy. On the supply side, the decline in the extension of loans by the banking institutions was attributed to the tight liquidity conditions in early 1998 and more cautious lending policies by banking institutions. With the actual NPL ratio on a net basis increasing from 4.1% of total loans as at end-1997 to 9% of total loans as at the end of 1998, and the ensuing erosion of capital, banking institutions became more cautious in their lending activities during the year as they adjusted to strengthen their balance sheet.

Graph 2.2
Banking System: Direction of Lending



Total loans extended by the banking system were generally on a declining trend during the period February to September before reverting to an increase in October and November. Sales of gross NPLs to Danaharta amounting to RM13 billion in December, caused total loans to decline during the month. For the year as a whole, the decline in total loans was due to lower lending for consumption credit, purchase of securities, purchase of transport vehicles and community, social and personal services and manufacturing sectors, which more than offset the higher loans to the broad property; transport, storage and communication; electricity, gas and water; and finance, insurance and business services sectors. The bulk of the loans continued to be channelled to the broad property sector (+RM6.2 billion or 4.4%). By the end of 1998, total credit extended to the broad property sector represented 35.3% of total loans (33.2% in 1997). Nevertheless, the higher exposure to the broad property sector did not reflect new risks, as the increases in loans were mainly for the purchase of residential property (RM5.5 billion). Given the slowdown in the implementation of existing infrastructure and non-residential projects as well as the deferment of selected new projects, loans extended to the construction sector and for the purchase of non-residential property increased by only RM582 million and RM1.5 billion respectively. At the same time, loans for transport, storage and communication, as well as for finance, insurance and business services sectors continued to receive adequate financing with increases of RM1.9 billion or 14.9% and RM907 million or 2.5% respectively. Meanwhile, in line with the lower economic activity

Table 2.1
Banking System: Loans by Sector

	As at end		Change	Share of total
	1997	**1998**	**1998**	**1998**
	RM million			%
Agriculture, hunting, forestry and fishing	7,637.8	7,717.8	80.0	1.9
Mining and quarrying	1,348.5	1,673.6	325.1	0.4
Manufacturing	63,310.4	63,200.4	–110.0	15.3
Electricity, gas and water	4,461.1	5,879.2	1,418.1	1.4
Wholesale, retail, restaurants and hotels	34,940.7	35,111.4	170.7	8.5
Wholesale trade	*19,926.8*	*18,725.0*	*–1,201.8*	*4.5*
Retail trade	*10,531.4*	*10,240.0*	*–291.4*	*2.5*
Restaurants and hotels	*4,482.5*	*6,146.4*	*1,663.9*	*1.5*
Broad property sector	139,922.4	146,148.4	6,226.0	35.3
Construction	*42,615.9*	*43,198.4*	*582.5*	*10.4*
Purchase of residential property	*50,843.9*	*56,386.7*	*5,542.8*	*13.6*
Purchase of non-residential property	*28,440.2*	*29,967.0*	*1,526.8*	*7.2*
Real estate	*18,022.4*	*16,596.3*	*–1,426.1*	*4.0*
Transport, storage and communication	13,040.6	14,983.1	1,942.5	3.6
Finance, insurance and business services	36,209.4	37,116.8	907.4	9.0
Financial services	*26,617.3*	*28,375.0*	*1,757.7*	*6.9*
Insurance	*131.6*	*249.0*	*117.4*	*0.1*
Business services	*9,460.5*	*8,492.8*	*–967.7*	*2.1*
Consumption credit	57,836.0	49,418.5	–8,417.5	11.9
Personal uses	*14,924.8*	*13,446.9*	*–1,477.9*	*3.3*
Credit cards	*4,586.4*	*4,313.0*	*–273.4*	*1.0*
Purchase of consumer durables	*1,717.0*	*826.9*	*–890.1*	*0.2*
Purchase of passenger cars	*36,607.8*	*30,831.7*	*–5,776.1*	*7.5*
Purchase of securities	38,951.2	32,460.0	–6,491.2	7.9
Purchase of transport vehicles	5,687.3	4,504.8	–1,182.5	1.1
Community, social and personal services	6,872.0	6,671.4	–200.6	1.6
Others	10,985.1	8,752.8	–2,232.3	2.1
Total loans	**421,202.5**	**413,638.2**	**–7,564.3**	**100.0**
Adjusted total loans (Including NPLs sold to Danaharta)	421,202.5	426,677.3	5,474.8	

and contraction in disposable income, loans extended for consumption credit, including for purchase of passenger cars, recorded a net repayment of RM8.4 billion. Consequently, the share of outstanding loans declined to 11.9% at end-1998. Similarly, loans for the purchase of securities declined by RM6.5 billion or 16.7%. Loans to the manufacturing sector recorded a decline of RM110 million or 0.2%, reflecting lower manufacturing activities as well as large loan repayments. Meanwhile, loan approvals improved substantially in the second half of 1998 (RM38.2 billion compared with RM24 billion in the first half-year). For the year as a whole, the bulk of the approvals were for the manufacturing sector, the purchase of residential properties and the finance, insurance and business services sector. A total of RM10.5 billion of new loans had been approved for the manufacturing sector, which accounted for 16.9% of total loans approved. Loans approved for the purchase of residential property and the finance, insurance and business sector amounted to RM9.3 billion and RM8.1 billion respectively, accounting for 14.9% and 13.1% of total new approvals during the year.

In response to the slowdown in loans, several measures were implemented to promote credit expansion and to avoid a credit crunch in order to ensure that the banking sector is better able to support economic recovery. With the improvement in the medium-term inflation prospects, interest rates were lowered in stages during the second half of the year. Consequently, the average BLR of commercial banks declined steadily from a peak of 12.27% at end-June to 8.04% at end-1998. In addition, with effect from 14 September 1998, all banking institutions were also required to reduce the maximum margin over the quoted BLR from 4 percentage points previously, to 2.5 percentage points. These measures effectively reduced the borrowing cost to the borrowers and eased the burden in servicing interest payments. To ensure that there were sufficient funds to finance the economic recovery process, banking institutions with the capacity to lend were encouraged to expand their loan base and achieve a minimum loan growth of 8%. In addition, the SRR and liquidity ratios were also reduced to improve the liquidity conditions.

These measures have produced encouraging results. Even though the actual loans disbursed in the second half-year remained slow, the amount of loans approved by the banking system increased substantially in the latter half of 1998. Other initiatives that had been taken to improve the financial intermediation process and expand credit included the establishment of Danaharta to purchase NPLs from the banking institutions so that banking institutions can focus more on their core activity of providing credit. Similarly, Danamodal was set up to recapitalise the banking system. This recapitalisation process by Danamodal was also accompanied by a restructuring of the banking institutions. A Corporate Debt Restructuring Committee had also been established to assist borrowers and creditors to discuss solutions for debt restructuring.

During the year, the expansionary impact from the external operations and claims on the private sector were partially offset by the contractionary influences of other determinants. Net lending to the Government contracted by RM12.3 billion primarily due to the higher accumulation of deposits during the year. By end-year, total Government deposits placed with BNM and the banking institutions amounted to RM46.2 billion, an increase of RM17.5 billion from the previous year. The large increase in deposits was mainly attributed to the proceeds from domestic borrowing as well as disbursement of external loans, particularly during the last quarter of the year to finance the fiscal stimulus programme. As such, the accumulation of Government deposits during the period was expected to be temporary and would eventually be drawn down in stages to finance the Government's expenditure. In addition to Government operations, net other influences also exerted a contractionary impact on money supply. During the year, net other influences contracted by RM32.4 billion reflecting the exchange revaluation gains on external reserves holdings of BNM, the higher provisions for bad and doubtful debts as well as the capital injection by Danamodal to selective banking institutions.

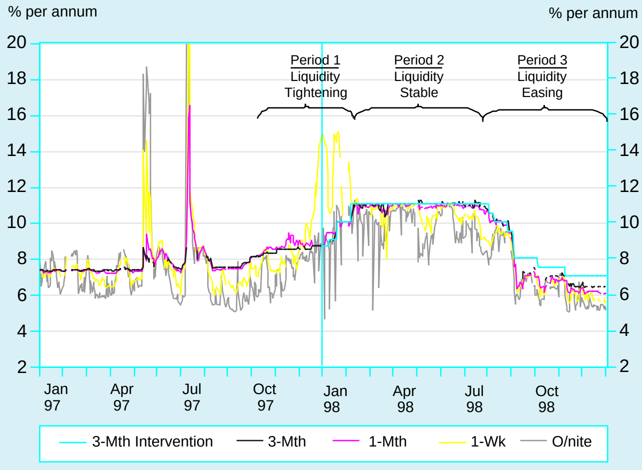
Table 2.2
Changes to BNM Intervention Rate & SRR Ratio

1998	Liquidity	Date	Intervention Rate	SRR Ratio
Jan-Feb	Tightening	End-97	8.70	13.5
		9 Jan	9.00	
		20 Jan	10.00	
		6 Feb	11.00	
Mid-Feb -Jul	Stable	16 Feb		10
		1 Jul		8
Aug-Dec	Easing	3 Aug	10.50	
		10 Aug	10.00	
		27 Aug	9.50	
		1 Sep		6
		3 Sep	8.00	
		16 Sep		4
		5 Oct	7.50	
		9 Nov	7.00	

In 1998, the movement of **interest rates** was primarily influenced by the level of liquidity, which was in turn affected by financial market expectations, as well as the shift in the monetary policy stance. On the whole, interest rates developments can be divided into three periods. Prior to February 1998, interest rates were on an upward trend. Between February and July 1998, interest rates were stable, while thereafter, interest rates were on a downward trend.

In the first two months of the year, interest rates continued its upward trend as a policy of monetary restraint was adopted since September 1997 to contain inflationary pressures arising from the ringgit depreciation as well as to discourage capital outflows. The 3-month interbank rate, which is BNM's policy rate, had been raised in several steps from 7.55% in mid-September 1997 to 8.7% at end-1997. It was raised twice again in January 1998 to 10% and again in February to 11%. Reflecting the tight liquidity situation and the uneven distribution of liquidity among banking institutions during this period, the average 1-month interbank rate rose above the average 3-month rate from October 1997 onwards, while the 1-week and overnight rates began to follow suit since December 1997. As a result, the term structure of interest rates was inverted during this period. The high shorter-term interest rates reflected the tight liquidity conditions faced especially by smaller financial

Graph 2.3
Interbank Rates

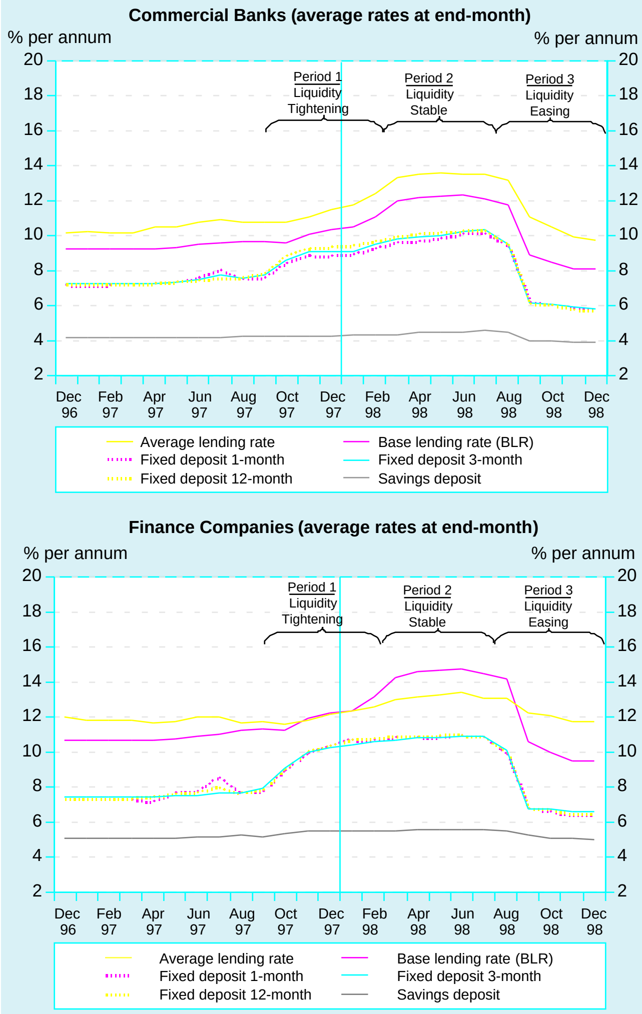


institutions. Furthermore, with increased uncertainties in the financial market, there was a flight to quality of retail deposits placed with these smaller institutions towards the end of 1997 and in early 1998. During this period, these institutions faced considerable difficulties in obtaining interbank funds due to selective lending practices by the larger institutions. The consequent aggressive bidding by the smaller institutions at the short end of the money market led to sharply higher short-end rates, with the 1-week rate peaking at 15.04% in January 1998 (see Graph 2.3: Interbank Rates). The resulting inverted term structure of interest rates, therefore, reflected the exceptionally tight liquidity situation of a few institutions rather than that of the banking system as a whole. The higher cost of funds incurred by these institutions led to a rapid increase in lending rates for loans priced on a cost plus basis.

Faced with this scenario, BNM injected liquidity through direct lending to banking institutions. To rationalise the term structure of interest rates as well as to improve liquidity flows in the system, BNM raised the intervention rate to 11% on 6 February as well as reduced the SRR from 13.5% to 10% on 16 February 1998. Consequently, the term structure of interest rates flattened from its inverted position. The purpose of the SRR reduction was not to add further liquidity but to improve the distribution of liquidity that had already been injected into the banking system as well as to reduce the cost of funds for banking institutions given that banks do not earn interest on SRR. The SRR was again lowered without causing a net injection on 1 July. This time around, the main objective was to reduce the cost of funds to banking institutions so as to enable them to lower the lending rates to their customers. On both occasions of the SRR reduction, the liquidity for the system as a whole was unchanged, resulting in the 3-month interbank rates remaining firm at around 11%.

In the subsequent months, the ringgit rates became more stable following the monetary measures undertaken between February and July 1998. There were also emerging signs that inflationary pressures had moderated. These developments enabled BNM to ease monetary policy to complement fiscal policy to revive the economy. In August, the 3-month intervention rate was adjusted downwards in three steps to 9.50%. Since September when selective exchange controls were introduced, further monetary easing was pursued. The intervention rate was reduced to 7% over three successive reductions, while the SRR was reduced in two steps to 4%. Consequently, the interbank rates fell below the BNM intervention rates as a

Graph 2.4
Interest Rates of Financial Institutions



result of the significant increase in liquidity in an environment of continued weak loan growth.

Reflecting the movements in the interbank money market rates, **interest rates of financial institutions** also increased up to June and subsequently adjusted downwards (*see Table 2.3: Interest Rates of Financial Institutions*). As these rates tend to lag behind interbank rates, the rates peaked in June. In the case of **fixed deposit rates**, the finance companies' fixed deposit (FD) rates adjusted more rapidly in response to the increases in interbank rates, whereas commercial banks' rates had a longer lagged response. As a result, the average spread offered by finance companies over commercial banks' FD rates increased from 0.2% before the crisis in June 1997 to as high as 1.5% in January 1998, before declining to 0.6% by end-1998. The greater responsiveness of finance companies' FD rates reflected the more aggressive competition for funds following their tighter liquidity situation compared with commercial banks. Meanwhile, **savings deposit rates** for both types of institutions were more stable, moving within a narrower range of only 0.6–0.8% during the year (the corresponding range for FD rates was 4.4–4.5%). A similar trend was also evident for the **base lending rates** (BLRs), which was linked to the 3-month interbank rate under the BLR framework. These BLRs are also linked to the SRR and as such, the reductions of the SRR in February, July and twice in September all contributed to a decline in the BLR. With the reduction in both the 3-month interbank rate and the SRR, the BLR for commercial banks adjusted downwards by 4.23 percentage points from a peak of 12.27% at end-June to 8.04% by mid-November. It remained unchanged thereafter until the end of the year.

Meanwhile, the **interest margins** or interest spreads of financial institutions also narrowed during

Table 2.3
Interest Rates of Financial Institutions

		End-97		June 98		End-98
Commercial Banks	3-Month FD	9.06	↗	10.19	↘	5.83
	Savings Deposit	4.23	↗	4.51	↘	3.87
	Base Lending Rate	**10.33**	**↗**	**12.27**	**↘**	**8.04**
Finance Companies	3-Month FD	10.32	↗	10.97	↘	6.43
	Savings Deposit	5.49	↗	5.56	↘	5.01
	Base Lending Rate	**12.22**	**↗**	**14.70**	**↘**	**9.50**

Table 2.4
Interest Margins of Financial Institutions

		End-97		June 98		End-98
Commercial Banks	Avg. Lending Rate (ALR)	11.51	↗↗	13.51	↘↘	9.72
	Less Avg. Cost of Funds (ACF)	7.62	↗	8.60	↘	6.17
	Interest Margin	**3.89**	**↗**	**4.91**	**↘**	**3.55**
Finance Companies	Avg. Lending Rate (ALR)	12.16	↗	13.35	↘	11.76
	Less Avg. Cost of Funds (ACF)	8.47	↗↗	11.67	↘↘	7.68
	Interest Margin	**3.69**	**↘**	**1.68**	**↗**	**4.08**

1998. The smaller margin was due to the faster reduction in the average lending rate (ALR) compared with the average cost of funds (ACFs) during the year. The spread, however, widened towards mid-year in the case of commercial banks but narrowed in the case of finance companies, before reversing trends in each case towards year-end. This asymmetry reflected the different relationships of these institutions' ALR and ACF to changes in liquidity and the general level of interest rates (see Table 2.4). Essentially, despite the sharp increase in the BLRs of finance companies at end-1997 and early 1998, their ALRs were relatively stable. The bulk of finance companies' loans was in the form of fixed rate hire purchase loans rather than BLR-plus loans. As a result of the relative stability or "stickiness" of the ALR of the finance companies, the rates were lower than their BLRs for the 10 months between November 1997 and August 1998. In contrast, the ALR of commercial banks moved in tandem with their BLR. On the other hand, the ACFs of finance companies were more sensitive to changes in liquidity and interest rates and had, therefore, increased significantly when there was a flight to quality in late 1997 and early 1998. Meanwhile, the ACFs of commercial banks increased more marginally. As a result of the stickiness of the ALR and the greater responsiveness of cost of funds to monetary developments, the margins of finance companies were squeezed in times of rising interest rates, while in contrast, the margins of commercial banks increased during periods of tight liquidity.

Interest rate differentials with other countries also changed significantly during the year. The real interest rates (nominal interest rates adjusted for inflation) in Malaysia have moderated and are now lower than the real interest rates in the United States and Singapore. The trend reflects the more significant decline in Malaysia's nominal rates and the relatively higher Consumer Price Index vis-a-vis

Monetary Measures in 1998

Adjustment and Stabilisation Measures (January - July 1998)

Monetary measures implemented in the first seven months were aimed at enhancing the efficiency of the money market to allow interest rates to reflect underlying liquidity conditions. The measures were also aimed at reinforcing the fundamental thrust of policy to achieve the objectives of monetary and financial stability while supporting economic recovery. The measures were as follows:

- On **26 January**, banking institutions were allowed to continue to provide bridging finance to housing developers to start new projects for residential properties costing RM150,000 and below as long as the project was deemed viable.

- On **6 February,** Bank Negara Malaysia (BNM) announced the **streamlining of the interest rate structure** to better reflect liquidity conditions in the market. Arising from developments in late 1997 and early 1998, the term structure of the interbank and lending rates was not reflective of the prevailing market conditions. The shorter-end interbank rates mainly reflected the exceptionally tight liquidity situation of a small number of banking institutions. Following uncertainties during the period, there was a tendency for lending rates to be based on these short-term rates on a cost-plus basis. To improve the flow of liquidity in the system, and to streamline the term structure of interest rates that would better reflect the liquidity in the financial system, the 3-month BNM intervention rate was adjusted upwards to 11% from 10%.

- With effect from **16 February, the statutory reserve requirement (SRR)** for all commercial banks, finance companies and merchant banks was reduced from 13.5% to 10% of their eligible liabilities. This was aimed at enhancing the efficiency of the intermediation process rather than to provide additional liquidity to the system. BNM further reduced the SRR to 8% on **1 July** so as to reduce the cost of funds to the banking institutions and improve the liquidity distribution among the banking institutions.

- Effective **1 May**, the band for the permissible daily variation in the average balance that is required to meet the SRR was widened to ±2% of the prescribed SRR rate from the previous band of ±0.5%. The widening of the SRR band would accord banking institutions greater flexibility in managing their daily liquidity operations.

Economic Recovery Plan (from August 1998)

Beginning early August, monetary measures reflected easing of monetary policy to support economic recovery. The measures were also aimed at strengthening the financial system. These measures were as follows:

- In early August, with the improvement in the medium-term inflation prospects, **BNM reduced its 3-month intervention rate** in three steps from 11% to 10.5% on **3 August**, to 10% on **10 August** and further to 9.5% on **27 August**. Following the introduction of the new exchange control measures, the 3-month intervention rate was further reduced to 8% on **3 September**, to 7.5% on **5 October** and to 7% on **9 November**.

- On **1 September**, the Government introduced selective exchange controls to insulate the Malaysian economy from the prospects of further deterioration in the world economic and financial environment and to regain monetary independence. On **2 September**, BNM announced that the exchange rate for the ringgit was fixed at RM3.80 against the United States dollar.

- Meanwhile, to ease liquidity in the banking system and make available more loanable funds to borrowers at a lower rate, the **SRR was reduced from 8% to 6% on 1 September and further to 4% on 16 September.**

- As of **3 September**, commercial banks were no longer required to maintain **vostro balances** of foreign banking institutions with BNM.

- The **base lending rate (BLR) framework was revised** on **1 September** to ensure a more rapid transmission of changes in monetary policy on interest rate levels into the BLR of banking institutions. The calculation of the BLR is now based on the BNM 3-month intervention rate instead of the KLIBOR. In addition, to ensure that borrowers benefit from the higher level of operational efficiency within the banking industry, the flat administrative margin of 2.5 percentage points was reduced by 25 basis points to 2.25 percentage points. The maximum margin over the quoted BLR was also reduced from 4 percentage points to 2.5 percentage points.

- To ensure that there was sufficient funds to finance the economic recovery process, banking institutions with the capacity to lend were encouraged to achieve a **minimum annual loan growth of 8%**.

- In an effort to assist the construction sector that had been severely affected by the economic crisis, some **relaxation to the earlier ceilings on the broad property sector** were implemented on **7 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. In addition, effective **5 October**, 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.

- The **ceiling on loans for the purchase of shares and unit trust funds was also raised** from 15% to 20% of total outstanding loans for commercial banks and finance companies on **23 September**. The limit for merchant banks remained at 30%. The increase in the limit was aimed at promoting long-term investments in the stock market.

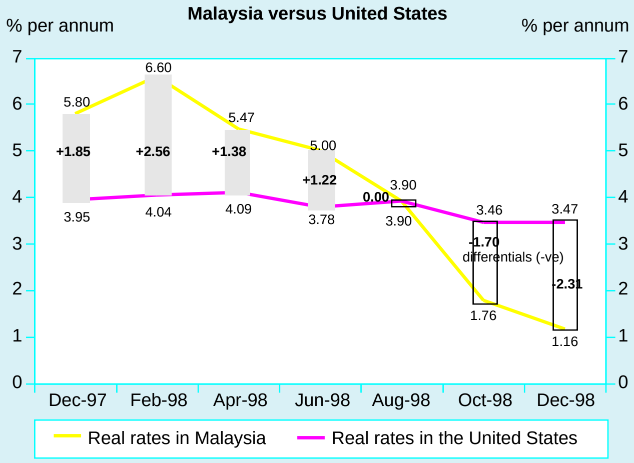
- The **margin of financing for all passenger cars was raised** from 70% to 85% on **23 April** and the restriction on the maximum repayment period was removed on **28 July**. The margin of financing of 85% was abolished on **21 November**, and banks were free to determine the percentage of financing based on their credit assessment of the borrower.

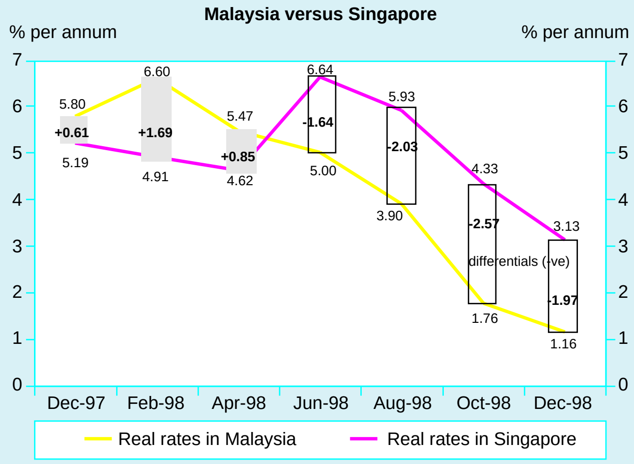
- Effective **5 December, BNM reduced the maximum lending rate under the Fund for Small and Medium Industries and the Special Scheme for Low and Medium Cost Houses** from 10% per annum to 8.5% per annum and the funding rate from 8% per annum to 6% per annum.

- Effective **20 November, the minimum monthly repayment on credit cards was reduced** from 15% to 5% of the outstanding credit card balances in order to ease the cash flow burden of credit card holders. To ensure that the charges imposed on the credit card holders were reasonable, banking institutions that issue credit cards were required from **30 December** to impose a maximum finance charge of not more than 1.5% per month or 18% per annum and that the late payment charges should not be more than 1% of the amount in default. However, banking institutions were allowed to charge a minimum penalty of RM5.

- In view of the need to clear the current backlog of properties, effective **5 January 1999**, banks were not allowed to finance the development of new residential properties and shophouses where the individual unit costs more than RM250,000 each. In addition, banking institutions were not allowed to provide financing to develop hotels, resorts, office buildings, golf courses, clubs and shopping complexes.

Graph 2.5
Real Interest Rate Differentials



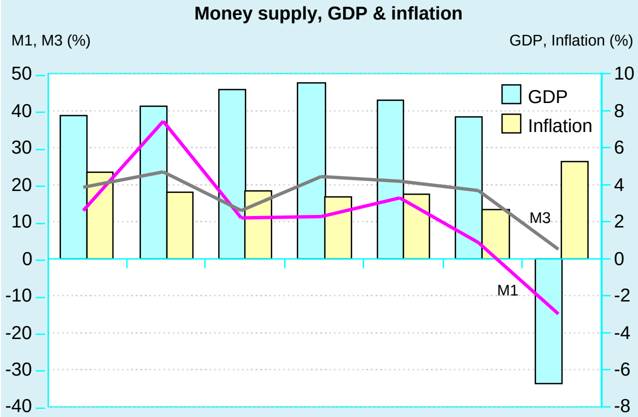


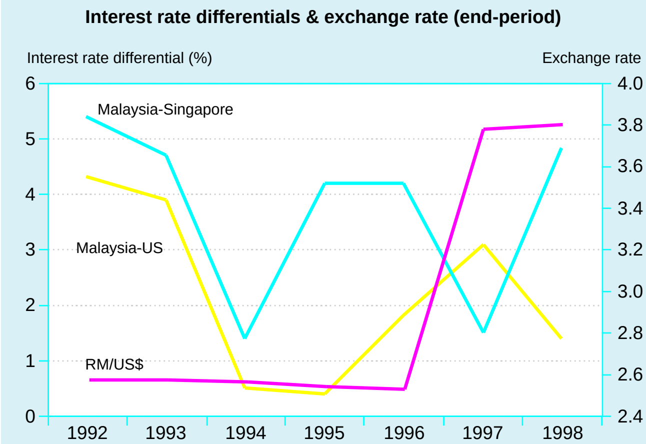
the United States and Singapore. The low real rates in the region of 1% at end-1998 was previously experienced in 1994 in Malaysia, during the period of massive capital inflows, and in 1988, during the recovery years after the recession of the mid-1980s.

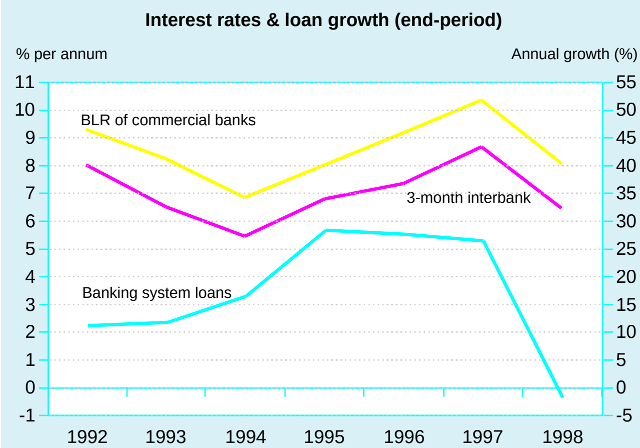
Monetary Policy in 1998

As the Asian financial crisis became more severe in 1998, the formulation of monetary policy was governed by the need to address the increasing volatility in the financial markets, the irrational market behavior, the deterioration in the financial position of the banking and corporate sectors, the existence of imbalances in the economy and the contraction in economic activities. In this context, monetary policy was pursued as part of a comprehensive set of policies to maintain macroeconomic and financial stability with the ultimate objective of stabilising and reviving the economy. While price stability remained the primary objective of monetary policy, it was necessary that monetary policy was also implemented to create a conducive environment to achieve sustainable long-term growth. Given the severe adverse effects of too tight a monetary policy on the economies of countries in the region, Malaysia adopted a different approach. It was recognised that high interest rates would not stabilise the exchange rate due to the strong external factors. It was more important to ensure that monetary policy would promote domestic macroeconomic stability and confidence and contain the severity of external developments on economic growth.

Graph 2.6







In a rapidly changing environment and a global environment of uncertainty, monetary management needs to be appropriately sequenced. The timing of policy is important. While several issues may need to be addressed, it is important to prioritise these policy responses to minimise disruptions in the system. Monetary policy, therefore, evolved at different stages of the economic crisis to adapt to changing domestic and external developments as well as to address new risks and challenges. Nevertheless, throughout the crisis period, the fundamental objective of policy remained unchanged.

At the start of the year, the tight monetary policy that was pursued before the onset of the crisis aimed to address the rising inflationary pressures associated with the depreciation of the ringgit and the consequent outflow of short-term funds. Towards mid-1998, it was evident that inflationary pressures were contained and the external balance turned around from a deficit to a surplus position. However, this contributed to reinforce the effects of a worsening external environment on domestic activity. Consequently, in response to early indicators of a weaker-than-expected growth and lower inflation in July, monetary policy was eased in early August. The policy aimed to complement the fiscal stimulus to create an environment in which the prospects for economic recovery would be enhanced. It was also recognised that growth could only recover and be sustained in an environment of stability and investor confidence. Given the build-up in risks that emerged in the regional and global financial markets during August-September, Malaysia acted decisively to stabilise the economy. On 1 September, selective exchange control measures were introduced and the ringgit was fixed against the United States dollar on the following day. This, together with an easing of monetary policy and an expansionary fiscal policy, had a positive effect on the economy. Key macroeconomic indicators as well as financial aggregates at the end of 1998 and in early 1999 suggested that the economy is emerging from the country's worst economic turbulence.

An integral part of financial policy has been the promotion of a sound financial system that is able to carry out its intermediation function efficiently. As Malaysia had entered the crisis with a relatively strong and well-regulated financial sector, the payments system and loan intermediation process remained relatively intact. However, the behaviour of markets caused distortions. Throughout the crisis period, Bank Negara Malaysia (BNM) had focused on improving the intermediation process and ensuring that sufficient funds were available at reasonable cost for productive activities. This became critical when credit growth slowed down faster than envisaged in the Credit Plan for 1998. During this period, the prolonged contraction led to a deterioration in the asset quality of the banking system. Besides taking pre-emptive steps to address the latter concern, a comprehensive four-pronged strategy was also initiated to strengthen the banking system.

Against this backdrop, monetary policy in 1998 can be classified into three phases, namely the adjustment phase from the outbreak of the crisis to early 1998; followed by the stabilisation phase up to the period in July; and subsequently, the recovery phase.

The start of 1998 witnessed a sharp increase in the volatility in both the foreign exchange and stock markets. Inflation also began to edge upwards as the effects of the depreciation filtered through to the real economy. During this period, the ringgit depreciated further following the depreciation of the Korean won in December 1997 and the near collapse of the Indonesian rupiah in early 1998. Meanwhile, loans which had still been expanding rapidly up to the end of 1997 began to experience a significant slowdown. The outflow of foreign short-term funds during this period contributed to a progressive tightening of liquidity in the banking system. Inefficiencies in the intermediation process also emerged as the sharper depreciation of the ringgit raised concerns on the banking system, particularly on the smaller institutions. This led to a shift of deposits from the smaller to the larger banking institutions. During this period, a small number of banking institutions faced significant liquidity problems due to the flight to quality of deposits. The competition for funds by these institutions contributed to the sharp increases in money market interest rates which resulted in higher interest rates for the industry as a whole. In such an environment, monetary policy focused on addressing this distortion. The most important objective of policy during this period was to improve liquidity distribution and remove distortions in the intermediation process, thereby enabling the banking institutions to reduce their lending rates.

To address these problems, BNM lowered the statutory reserve requirement (SRR) from 13.5% to

10% on 16 February, followed by another reduction to 8% on 1 July. Prior to this, BNM had placed RM34 billion in the banking system to provide liquidity to the system. The funds released by the reduction in the SRR was therefore offset by the non-rollover of funds previously lent by BNM to financial institutions. The purpose of the SRR reduction was aimed at improving the distribution of liquidity that had already been injected into the banking system and to reduce the cost of funds for the banking institutions given that banks earned zero interest on the SRR. As a result of these measures, the money market rates declined, leading to a corresponding reduction in the lending rates, which fell from 21.5% in early February to 16.3% at the end of February.

During this period, there was little leeway to reduce the money market intervention rate. In the initial stages of the crisis in July 1997, interest rates were spiked up briefly for about a week. Interest rates were subsequently reduced to the pre-crisis level from mid-August until September 1997. As the crisis became more prolonged, it was viewed that higher interest rates would have an adverse effect on the real sector, but by itself would not contribute to restore stability in the foreign exchange markets (see article on Monetary Policy in 1997 in the 1997 BNM Annual Report). However, when the Indonesian rupiah experienced a near collapse in January 1998, the ringgit depreciated to its weakest level to touch US$1=RM4.88 on 7 January. Under these conditions, concerns over the potential outflows of funds and rising inflationary pressures prompted increases in interest rates. Interest rates were then allowed to edge up to 11% to ensure that depositors continued to receive positive real rates of interest. This move contained further capital outflows and ringgit rates stabilised in the region of US$1=RM3.84–3.98 in the first and second quarters of 1998. Although interest rates were raised to the level of 11%, it was to a significantly lesser extent than that recommended by the International Monetary Fund (IMF) and expected by the market. The Bank's view was that such high interest rates would dampen economic activity and cause strains on the banking system, resulting in further pressure on the ringgit, thereby making economic recovery more difficult to achieve.

The Bank also undertook a number of other initiatives to ensure the efficient management of liquidity and increase the efficiency of loan intermediation. Procedures were introduced on 30 April to make money market operations more transparent and to promote efficient liquidity management. Under the new procedures, BNM undertook to provide daily forecasts of the cash flows of the financial system, as well as information on the major factors that were expected to influence liquidity, including details of BNM's money market activities. With effect from 1 May 1998, the band for the daily variation in the average balance required to meet the SRR was widened from ±0.5% to ±2%. In addition, a new framework for liquidity management was introduced to enable banking institutions to manage their liquidity positions with greater flexibility without compromising prudential standards. The new framework was set on a six-month trial run starting July 1998. On 3 September 1998, the liquid asset requirement of the commercial banks was reduced from 17% to 15% of total eligible liabilities. The Bank also undertook measures to increase the efficiency of monetary policy. The base lending rate (BLR) framework was revamped. Under the previous BLR computation based on the 3-month average weighted interbank rate of the preceding month, the retail interest rates responded to changes in monetary policy with a lag of several weeks. To rectify this, with effect from 1 September 1998, the calculation of the BLR was based on BNM's 3-month intervention rate rather than the KLIBOR. The banking institutions were required to adjust their BLRs within a week of a change in BNM's intervention rate, leading to a more rapid transmission of changes in monetary policy. The administrative margin included in the BLR was also reduced from 2.50% to 2.25%. These measures resulted in a downward adjustment in lending rates and contributed to increases in the efficiency of the banking institutions given that they provided the banking institutions with greater flexibility in the management of existing liquidity. The measures also resulted in a lower cost of funds. At the end of July, the BLR had declined to 12.07% from 12.27% at end-June 1998.

Apart from efforts to lower the cost of funds to banks, the Government also recognised the adverse implications high interest rates would have on small businesses. A number of funds were established and existing funds expanded so that banking institutions could provide credit to priority sectors at reasonable lending rates. These funds included the Fund for Food (RM1 billion); Petty Traders and Hawkers Fund (RM500 million); Fund for Small and Medium Industries (RM1.5 billion); Export Credit Refinancing Facility (RM3 billion); Special Scheme for Low and Medium Cost

Houses (RM2 billion); Suppliers, Buyers and Overseas Investment Credit (RM1 billion); New Entrepreneurs Fund (RM1.25 billion) and Rehabilitation Fund for Small and Medium Industries (RM750 million).

The worsening of the regional crisis following the IMF intervention in Korea and Indonesia took the region into a phase of severe economic contraction with its consequent effect on the financial sector. Lower aggregate demand in the region amidst the exchange rate instability and uncertainty and the negative wealth effect from declining asset markets contributed to the contraction in domestic activity. By July 1998, it was evident that the economy had undergone a sharper correction than earlier anticipated. Indications were that the economy would contract for the second consecutive quarter, indicating that the country was technically in an economic recession. The annual loan growth had decelerated sharply from 26.5% at the end of 1997 to 8.9% at the end of July 1998. Similarly, the growth rate of the broad monetary aggregate (M3) had also decelerated from 18.5% to 5.9% over the same period. Other macroeconomic indicators showed that there was a sharp contraction in car sales and collections of sales tax, indicating a sharp slowing down of economic activity. To revive the economy, an adjustment in macroeconomic policies was necessary.

The deceleration in the inflation rate and an absence of demand pressures enabled BNM to undertake an easing of monetary policy beginning in early August to complement fiscal policy to contain the contraction and promote recovery of the economy. The 3-month intervention rate of BNM was reduced in three successive steps, from 11% to 9.5% during the month of August. A cautious and gradual easing of monetary policy was necessary given the threat of volatility in the foreign exchange markets and the risk of capital outflows. Of special concern was the high rates being offered to attract ringgit funds in Singapore and the build-up of offshore ringgit balances to fund speculative activity on the ringgit. During this period, external risks in the regional and global markets had also worsened since end-August. The crisis had spread to Russia and Latin America. In this environment, BNM introduced selective exchange controls on 1 September, while the exchange rate was fixed at RM3.80 to the United States dollar on 2 September. The new measures were aimed at ensuring that Malaysia could gain greater independence in the conduct of domestic monetary policy as well as insulate the economy from the potential risks and vulnerabilities of external developments in the international financial markets. Other considerations included preserving the gains that had been made to stabilise the domestic economy; ensuring stability in prices and the ringgit exchange rate; as well as promoting a stable environment for restoring investor and consumer confidence to revive the economy. Hence, the exchange control regulations were carefully designed to contain speculation on the ringgit and minimise the impact of short-term capital flows on the domestic economy. These regulations did not affect trade and investment in economic activity. Full convertibility remained for current account transactions.

The new measures provided the Bank with the ability to further ease monetary policy to support the domestic economic recovery process given the absence of inflationary pressures. Following the introduction of the exchange control measures and the fixed exchange rate, additional monetary measures were introduced to improve the liquidity flows in the banking system to generate lending activities, as well as to ensure that viable businesses continued to receive financing at lower cost. Consequently, the SRR was reduced to 6% on 1 September, and then again to 4% on 16 September. Similarly, the 3-month intervention rate was reduced from 9.5% to 8% on 3 September, to 7.5% on 5 October, and to 7% on 9 November. As a result of the easing of monetary policy, the average BLR of the commercial banks and finance companies declined further from 11.70% and 14.17% respectively in August 1998, to 8.04% and 9.50% by November.

The period of stability that followed was fully utilised to expedite reform of the financial sector through the institutional framework that was already established. Targets set for Danamodal Nasional Berhad (Danamodal) and Pengurusan Danaharta Nasional Berhad (Danaharta) were brought forward. As at 15 March 1999, Danaharta, the asset management company, has acquired and is managing gross non-performing loans (NPLs) from the banking system amounting to RM15.1 billion. Danamodal, the special purpose vehicle to recapitalise the banking system, injected RM6.15 billion in capital into 10 banking institutions and additional injections are in the pipeline. The Corporate Debt Restructuring Committee (CDRC) has received 48 applications involving debt totalling

RM22.7 billion. In the case of the small and medium industries (SMIs), a rehabilitation fund was also set up in 1998, with an initial allocation of RM750 million to provide financial assistance to SMIs which are viable but have temporary cash flow problems and NPLs. Amongst others, banking institutions can utilise 30% of the total loans approved under this Fund to replace and restructure problem loans.

Throughout the crisis period, the Bank recognised the importance of ensuring the efficient functioning of the intermediation role of the banking institutions. However, given the protracted financial crisis and rising NPLs, the banking institutions placed greater emphasis on balance sheet considerations. With rising NPLs and the erosion of capital, banking institutions had become excessively cautious in their lending decisions. A sharp slowdown in credit ensued. A credit crunch, if allowed to develop, would deepen the economic recession, thus compounding the financial difficulties of sound companies and subsequently affecting the health of the financial system. Hence, additional measures were undertaken to encourage banking institutions to continue to lend for productive purposes. With effect from 9 September 1998, banking institutions with capacity were encouraged to achieve a minimum annual loan growth of 8% for 1998. The motivation for the 8% credit floor was to free the banking institutions from the self-imposed credit freeze. The introduction of the credit growth target, however, did not sacrifice prudential consideration. Banking institutions were required to continue exercising financial discipline in providing credit and making their decisions without compromising prudential standards to ensure that the balance sheets of the banking institutions do not deteriorate further. Nevertheless, banking institutions should not unnecessarily complicate the credit process, making it difficult for borrowers to obtain credit.

Other measures adopted to revive economic activities of identified sectors included the relaxation of the earlier ceilings on the broad property sector and the share markets. Earlier rules restricting consumption credit imposed during the period of high credit growth were also relaxed.

On the whole, although there has been a tendency to generalise the problems confronting the East Asian region, there are important differences in these economies that require alternative policy approaches in dealing with the crisis. It is important to recognise that there is no standard prescription. The approach adopted in Malaysia has differed from that of its neighbours in response to differences that exist in its financial and macroeconomic environment. Malaysia went into the crisis from a position of favourable economic and financial fundamentals of a high savings rate, full employment, low external debt, a strong fiscal position, and a strong and well-capitalised banking system. These favourable initial conditions gave Malaysia greater flexibility in its policy response to the crisis and enabled the country to formulate a series of pre-emptive monetary and financial policy initiatives.

Fiscal Operations and Policy

The 1998 Budget was formulated in October 1997 when Malaysia was in the initial phase of the regional crisis and was still experiencing robust growth. Fiscal policy during this period focused on strengthening macroeconomic stability and restoring investor confidence. The policy aimed to address the key areas of vulnerabilities, including containing inflationary pressures arising from the ringgit depreciation and addressing the current account deficit in the balance of payments. The fiscal policy stance was therefore one of prudence and restraint. In line with these objectives, the Government budgeted for a fiscal surplus of 2.7% of GNP in the 1998 Budget. This was effected through restraint on consumption spending, the rightsizing of the public sector and the privatisation of Government activities. Less critical projects were also deferred to narrow the resource gap. The Government, however, continued to provide essential expenditure to address supply constraints, raise productivity and enhance potential output. Priority was also accorded to poverty eradication programmes and upgrading the quality of life.

In the wake of continued regional instability and its adverse impact on Federal revenue, the Government announced in December 1997, further fiscal austerity measures involving a reduction of 10% across the board and 8% on a selective basis, of both operating and development expenditure allocations in the 1998 Budget. The cutback, was however, implemented without affecting essential public services, poverty eradication programmes and key infrastructure development. As the crisis became more prolonged, this tight fiscal policy became unsustainable. On 24 March 1998, the Government reversed the earlier policy and reduced the targeted budget surplus to 0.5% of GNP as the contraction in the economy became evident in the first quarter. An additional expenditure of RM1 billion was also provided for socio-economic projects to protect the more vulnerable segments of society.

The adjustment measures taken in terms of restrained fiscal and monetary policies in the early part of the crisis contributed towards improving the current account of the balance of payments and containing price pressures. However, the public sector expenditure cutbacks aggravated the decline in investor and consumer demand, causing a severe deflationary impact on the domestic economy. Given the change in economic conditions, the Government adopted counter-cyclical measures to revitalise the domestic economy. The policy change aimed to minimise the severity of the economic downturn. In July 1998, the Government announced a fiscal stimulus package involving an additional allocation of RM7 billion for implementing projects with strong linkages within the domestic economy; minimum leakage in terms of imports; short gestation period; and expenditures to meet socio-economic objectives. In this regard, the projects that were given priority included those related to housing, education, health, and rural and infrastructure development. In addition, an Infrastructure Development Fund, with an initial allocation of RM5 billion was established to assist the financing of infrastructure projects and large public facilities so that their implementation could proceed. The projects identified included the mass-transit transportation system, ports, highways, water supply and waste disposal as well as sewerage projects. The Government also established or expanded special funds to ensure continued access to credit at reasonable costs for priority sectors. With the change in the fiscal policy stance, the fiscal account was estimated to have recorded a deficit of 3.7% of GNP in 1998.

After five years of fiscal surpluses, the 1999 Budget, announced in October 1998, maintained a fiscal deficit of 3.7% of GNP for 1998 and targeted for an increase to 6.1% of GNP for 1999. The expansionary fiscal policy was designed to support economic activities to promote economic recovery, to strengthen the nation's resilience and competitiveness, to restructure the financial sector and to ensure social well-being. Although the thrust of budgetary operations was expansionary, fiscal prudence and discipline was being maintained to contain the fiscal deficit at a manageable level so as not to jeopardise long-term growth. These objectives are being achieved through budgetary control on non-essential and non-productive spending, whilst according priority to infrastructure and socio-economic projects that could generate economic activities, promote efficiency, improve competitiveness and long-term productivity, but which are low in import content. Emphasis was also being placed on an adequate programme to protect the lower income group and the poor from the adverse effects of the crisis. Hence, a large share of the 1999 Budget allocation was for public utilities, education and skills training and health and medical services. Emphasis was also being placed on agriculture and rural development and special assistance schemes to assist the low-income group, petty traders and small businesses.

Given the prospect of weak revenue performance in 1999, the comprehensive plan to revitalise and restructure the economy was carefully framed to ensure that sufficient resources are available and that the private sector would not be crowded out. The total financing requirement has been initially estimated at RM62 billion for 1998-99, to finance the recovery package including the fiscal deficit, restructuring of banking institutions and development of infrastructure. In view of the smaller overall fiscal deficit of RM5 billion for 1998 (–RM9.6 billion estimated in the 1999 Budget), the total financing requirement is now estimated to be lower at RM58 billion for 1998-99. The financing requirement would be raised from non-inflationary domestic sources and, to a lesser extent, from selective external financing. In 1998, funding was largely met from domestic sources. For 1999, the bulk of the financing would continue to be met from domestic sources. Besides new funds from the provident, pension and insurance funds, there is sufficient liquidity in the banking system. Additional liquidity would be generated from the large current account surplus in the balance of payments recorded in 1998 and estimated for 1999. In order to avoid crowding out the funding for the private sector, approximately one-third of the funding requirements would be met from external sources. The latter would comprise mainly loans from bilateral and multilateral sources. The Government would continue to ensure prudence in its recourse to external borrowing so as to maintain the external debt at a manageable level and to ensure favourable international credit ratings. The Government would continue to maintain a policy of containing the overall debt service ratio of the nation at a low level.

Throughout the crisis period, the Government has persevered with its programme to reform and simplify the tax system, provide a conducive environment for investment, and enhance competitiveness and productivity. Tax measures that were implemented in 1998 and announced in the 1999 Budget included the two percentage point reduction in both the corporate and petroleum income tax rates to 28% and 38% respectively, aimed at reducing the cost of doing business and providing tax incentives to boost exports. Wide-ranging tax incentives and exemptions were also introduced to expedite the shift to higher value-added and technology-intensive industries, especially for exports. These included tax exemption on the increase in the export value. There was also a review of the reinvestment allowance to encourage industries to move up the industrial ladder and an extension of research and development incentives to accelerate the development of indigenous technology capability. In addition, incentives were also introduced to promote the services sector to address the persistent services deficit in the balance of payments. Comprehensive measures were introduced to strengthen the banking system and improve transparency, while ensuring stability in the financial markets to facilitate trade and commerce. The measures included the introduction of several prudential measures; the change in the tax treatment on actuarial surplus; tax exemption (50%) for interest-in-suspense; as well as the exemption of stamp duty and real property gains tax on mergers of financial institutions. Meanwhile, the 1999 Budget also announced several changes in the tax administration system to enhance its efficiency and responsiveness in the collection of income tax. Most important was the change in the tax assessment, which would now be based on income received in the current year instead of the previous year basis, with effect from year 2000.

Consolidated Public Sector

The financial position of the consolidated public sector weakened in 1998 largely attributable to the deterioration in the revenue performance of the Federal Government and the increase in expenditure, particularly by the non-financial public enterprises (NFPEs). The consolidated public sector account recorded an overall deficit compared with significant surpluses in 1996 and 1997. This largely reflected the significant deterioration in the overall financial performance of the NFPEs as well as the general government, in particular the Federal Government. In aggregate, the overall account of the consolidated public sector recorded a deficit of RM4.7 billion or 1.8% of GNP compared with a large surplus of RM17.3 billion or 6.6% of GNP in 1997. This is the first deficit recorded since 1993. The increase in development expenditure of the general government was mainly to finance the stimulus package as well as for providing facilities and social amenities to the poor. The bulk of the expenditure was mainly for education, health, housing, rural development and infrastructure.

The general government, comprising the Federal Government, 13 state governments, statutory bodies and local governments continued to record a current account surplus, albeit a much lower surplus of RM19.5 billion or 7.4% of GNP (11.4% of GNP in 1997). The lower surplus was mainly attributable to the decline in aggregate revenue collection (–12.4%), as operating expenditure remained virtually unchanged. Increased outlays were recorded mainly for debt servicing, the expansion of several education funds and Fund for Food, as well as reactivating the Sinking Fund. However, these outlays were offset by the decline in other expenditures.

As in previous years, the surplus was mainly generated by the Federal Government and the state

Table 2.5
Consolidated Public Sector Finance

	1997	1998*p*	1999*r*
	RM million		
General government [1]			
Revenue	81,528	71,392	64,581
Operating expenditure	51,884	51,896	54,852
Current surplus of general government	29,644	19,496	9,729
Current surplus of NFPEs [2]	27,680	23,046	23,971
Public sector current surplus	**57,324**	**42,542**	**33,700**
(% of GNP)	**22.0**	**16.2**	**12.5**
Net development expenditure	39,992	47,219	48,559
General government	*18,651*	*21,442*	*23,768*
NFPEs [2]	*21,341*	*25,777*	*24,791*
Overall balance	**17,332**	**–4,677**	**–14,859**
(% of GNP)	**6.6**	**–1.8**	**–5.5**

[1] Comprises Federal Government, state governments, statutory authorities and local governments.
[2] Refers to 28 NFPEs in 1997 and 1998 respectively.
p Preliminary
r Revised

Source: Ministry of Finance, state governments and non-financial public enterprises governments, while statutory bodies remained in deficit due to their narrow revenue base. Several major public enterprises also experienced less favourable performances due mainly to higher cost of operations and debt servicing arising from ringgit depreciation during the year. As a result, the operating surplus of the NFPEs was also reduced to RM23 billion or 8.8% of GNP (10.6% of GNP in 1997). Consequently, the consolidated public sector current account recorded a reduced surplus of RM42.5 billion or 16.2% of GNP in 1998 (22% of GNP in 1997).

The public sector development expenditure increased by 18.1% to RM47.2 billion in 1998 (29.8% in 1997) due to the substantial increase in capital spending by the NFPEs (20.8%; 37.6% in 1997), while the development outlays of the general government moderated to 15% (21.9% in 1997). Increases in development expenditure were recorded by several major NFPEs, including the Petroliam Nasional Berhad (PETRONAS) and Malaysian International Shipping Corporation Berhad (MISC), mainly on project expansion and modernisation programme. A sizeable proportion of the capital spending was also for the acquisition of companies related to their core business, including investment overseas. However, due to the adverse economic developments, several other NFPEs consolidated their positions and deferred or scaled down development projects during the year.

Federal Government Finance

The financial position of the Federal Government was less favourable in 1998 in the face of a substantial decline in revenue as well as the implementation of the fiscal stimulus package since July. The overall fiscal position reverted to a deficit of RM5 billion or –1.9% of GNP from a surplus of RM6.6 billion or 2.5% of GNP in 1997. This is the first overall deficit since 1992. The current account continued to remain in surplus, albeit smaller, at RM12.1 billion or 4.6% of GNP (RM21 billion or 8.1% of GNP in 1997).

In 1998, **Federal revenue** fell by 13.7% to RM56.7 billion or 21.6% of GNP, reflecting the contraction in economic activity and weak domestic demand. This decline also reflected the reduction in tax rates as well as several tax concessions provided in the 1998 Budget to promote productivity-driven growth and reduce the cost of doing business. Revenue foregone from lower taxes was estimated at about RM1.3 billion in 1998. Meanwhile, the marked decline in petroleum prices coupled with the reduction in the rate of petroleum income tax and export duty also affected receipts from petroleum income tax, exports, imports and excise duties which together with PETRONAS dividends accounted for about one-fifth of total revenue (–5.1% to RM11.8 billion). In aggregate, revenue decline was recorded across the broad categories of direct taxes (–RM417 million), indirect taxes (–RM7.9 billion) and non-tax revenue and receipts (–RM735 million).

For the first time since 1988, **tax revenue** fell by 15.5% to account for a lower share of 80% of the total Federal revenue. As a result, the ratio of tax receipts to GNP declined to 17.3% (20.5% in 1997). Revenue from **indirect taxes** declined significantly (–33.9%), thereby reducing its share to

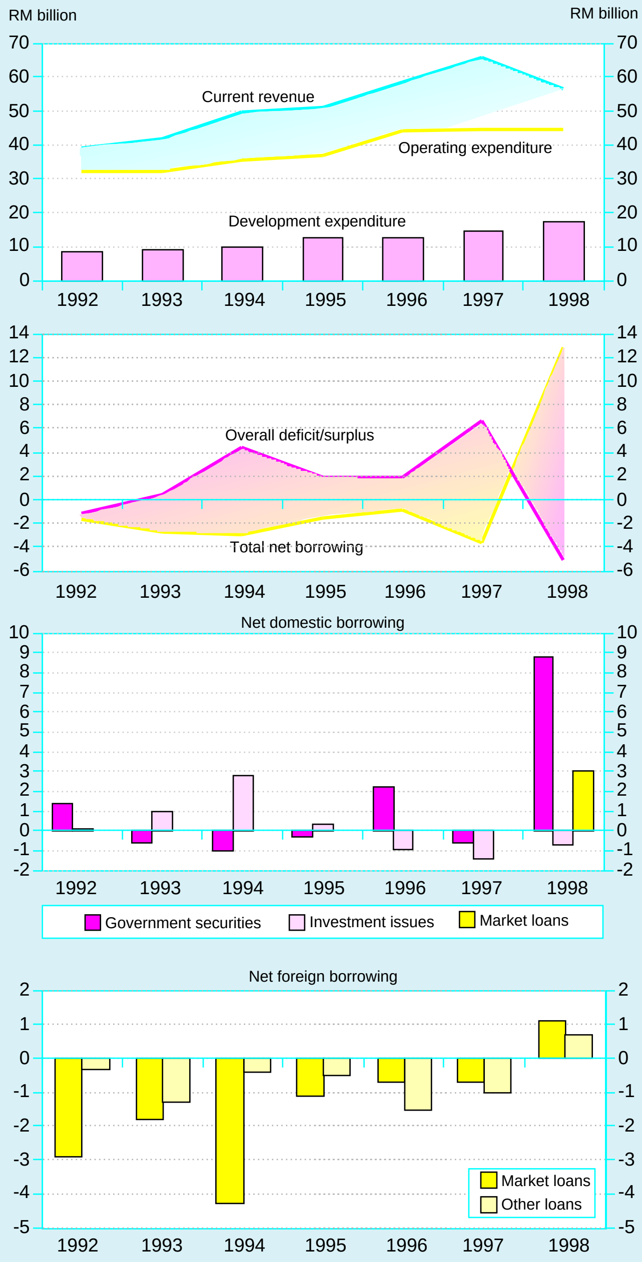
Table 2.6
Federal Government Finance

	1997	1998*p*	1999*r*
	RM million		
Revenue	65,736	56,710	50,332
Operating expenditure	44,665	44,584	47,220
Current surplus	**21,071**	**12,126**	**3,112**
(% of GNP)	**8.1**	**4.6**	**1.2**
Development expenditure	14,445	17,128	19,202
Gross development expenditure	*15,750*	*18,103*	*20,202*
Less Loan recoveries	*1,305*	*975*	*1,000*
Overall balance	**6,626**	**–5,002**	**–16,090**
(% of GNP)	**2.5**	**–1.9**	**–6.0**
Sources of financing [1]			
Net domestic borrowing	–2,048	11,040	–
Gross borrowing	*3,000*	*17,990*	–
Less Repayment	*5,048*	*6,950*	–
Net foreign borrowing	–1,681	1,819	–
Gross borrowing	*462*	*4,001*	–
Less Repayment	*2,143*	*2,182*	–
Special receipts	91	1	–
Realisable assets [2] and adjustments	–2,988	–7,858	–
Total	**–6,626**	**5,002**	**–**

[1] Data for 1999 are not given.
[2] Includes changes in Government's Trust Fund balances. An increase in the accumulated realisable assets is indicated by a minus (–) sign.
p Preliminary
r Revised

Source: Ministry of Finance

Graph 2.7
Federal Government Finance



27% of total revenue. Reflecting the contraction in domestic demand and lower petroleum prices, almost all major categories of indirect taxes recorded double-digit declines. Receipts from import and excise duties registered sizeable declines of 40.7% and 40.8% respectively. Lower collection of these duties were apparent across the whole spectrum of goods, in particular, duties on motor vehicles and spare parts; petrol and petroleum products; electrical appliances and machinery. The poor performance of import duties also reflected the sharp deceleration in import growth. The lower private sector spending affected sales tax collections (–37.7%), with lower receipts in all sub-sectors, especially transport equipment (including passenger, commercial and bus vehicles). Meanwhile, the decline in the collection of service tax was marginal (–1.9%) as widening the scope of the service tax in the 1998 Budget to include services provided by employment agencies, limousine and management services had, to some extent, offset the lower collection particularly from professional services. The reduction in the export duty on petroleum from 20% to 10% as well as the lower crude oil prices also contributed to the lower collection from export duties. However, the decline was moderated somewhat by higher export volume of crude petroleum.

Revenue from **direct taxes** recorded a lower decline (–1.4%) than receipts from indirect taxes and, hence increased its share of total revenue (53%; 46% in 1997). This was largely because income tax collections were mainly based on the previous year's earnings which were still experiencing strong growth in the first-half of 1997. Nevertheless, the rescheduling of some tax payments due to corporate cashflow problems as well as the provision of several tax concessions and incentives in the 1998 Budget to enhance productivity and boost exports had moderated income tax collections. These fiscal measures included the two percentage point reduction in corporate and petroleum income tax, and tax incentives to boost exports, promote research and development, human resource development and tax rebate for the purchase of personal computers. On the whole, the higher receipts from personal (+7.3%), petroleum (+4.8%) and corporate (+3.6%) income taxes were more than offset by lower revenue collection from stamp duties (–56.2%) and real property gains tax (–24.3%). The decline in these two taxes reflected lower prices and volume of transactions in both the stock and property markets.

The sustained high level of income tax collection during the year was partly due to the increased number of taxpayers (+151,930 in 1998). It also reflected to some extent the success of the Inland Revenue Board (IRB) in widening the tax base and its concerted efforts to strengthen the efficiency of the tax collection machinery, improve compliance and ensure enforcement. Further measures were introduced in the 1999 Budget to increase the efficiency and responsiveness in the collection of income tax and to ensure that the cashflow of the Government reflects the current performance. This included the change in the tax assessment based on income received in the current year instead of the previous year basis, beginning from

Table 2.7
Federal Government Revenue

	1997	1998*p*	1997	1998*p*
	RM million		Annual change (%)	
Tax revenue	**53,627**	**45,336**	**13.4**	**–15.5**
Direct taxes	30,432	30,015	17.7	–1.4
Income tax	27,121	28,369	19.7	4.6
Corporate	*16,688*	*17,294*	*17.8*	*3.6*
Petroleum	*3,861*	*4,046*	*75.3*	*4.8*
Personal	*6,429*	*6,900*	*4.2*	*7.3*
Co–operative	*143*	*129*	*19.1*	*–9.7*
Real property gains tax	523	396	21.6	–24.3
Stamp duties	2,714	1,190	0.2	–56.2
Other	74	60	42.3	–18.9
Indirect taxes	23,195	15,321	8.3	–33.9
Export duties	1,053	623	1.2	–40.8
Import duties	6,524	3,868	6.4	–40.7
Excise duties	6,054	3,586	4.6	–40.8
Sales tax	6,167	3,845	12.7	–37.7
Service tax	1,475	1,447	19.8	–1.9
Other	1,922	1,952	9.6	1.6
Non–tax revenue and receipts	**12,109**	**11,374**	**10.0**	**–6.1**
Total	**65,736**	**56,710**	**12.8**	**–13.7**

p Preliminary

Source: Ministry of Finance

year 2000, as well as the implementation of the self-assessment system for companies; businesses, partnerships and co-operatives; and the salaried group, commencing from year 2001, 2003 and 2004 respectively.

Non-tax revenue declined in 1998 (–4.7%; +10.6% in 1997), reflecting lower collections from licences and permits. Substantially lower receipts were recorded on the levy on foreign workers as well as road tax, despite the doubling of fees for international and restricted travel documents and the increase in fees for driving licences in the 1998 Budget. Service fees also recorded a decline. Meanwhile, collections from investment income and petroleum royalty were higher. **Non-revenue receipts**, which included refunds of expenditure, receipts from Government agencies and revenue from the Federal territories, were substantially lower during the year (–28.6%; +1.5% in 1997).

Total Federal Government expenditure increased by a modest 3.8% to RM62.7 billion in 1998. Reflecting the fiscal austerity package announced in the 1998 Budget as well as in December 1997, the Government's total outlays fell sharply by 34.4% in the first half-year compared with the preceding half-year. However, with the shift in fiscal stance since July, total expenditure expanded by 56.6% in the second half-year. In undertaking the fiscal stimulus, the Government is committed to ensuring that the fiscal deficit would be kept within prudent limits. Hence, whilst operating expenditure would be tightly controlled, high priority will be accorded to development projects with strong linkages in the economy and low import content.

Operating expenditure declined marginally by 0.2% in 1998 reflecting continued restraint on expenditure to avoid wastage and to curtail less essential spending. During the year, the total wage bill, the largest component of operating expenditure (31.3%), rose by 3.2%. The higher wage bill reflected largely the payment of the balance of the 1997 bonus and the RM400 financial assistance to civil servants as well as the upgrading of the scheme of service for teachers including time-based promotions. These were partly offset by the reduction in allowances for civil servants and a freeze on all vacant posts that were non-critical. The payment for pensions and gratuities increased by only 0.5% due to the lower annual contribution to the Pensions Trust Fund as well as a review of the policy on the payment of gratuities for optional retirement. Under the revised policy, the Federal Government would only pay 10% of the total gratuities on optional retirement, while the balance would be paid at the age of 55.

In the light of lower revenue receipts, there were increased budgetary controls on transfer items, leading to the decline in payment of grants and transfers. Nevertheless, the Government continued to provide for social programmes. Besides providing the annual grants to the state governments and other government agencies for development and maintenance purposes, increased allocations were made for the Fund for Food and several education funds such as the Education Loan Fund and the National Education Fund, to assist students facing financial constraints. In addition, two new funds were established, namely, the Fund for Car Loans and for Computer Loans for Teachers, while the Sinking Fund was reactivated to meet future debt obligations. Similarly, there was a sharp decline in disbursements on supplies and services and asset acquisition. Meanwhile, expenditure for refunds was higher, reflecting mainly increased tax refunds during the year.

Table 2.8
Federal Government Operating Expenditure by Object

	1997	1998*p*	1997	1998*p*
	RM million		% share	
Emolument [1]	13,195	13,984	29.5	31.3
Supplies and services	6,363	5,212	14.2	11.7
Asset acquisition	905	434	2.0	1.0
Public debt charges	6,426	6,928	14.4	15.5
Pensions and gratuities	3,638	3,658	8.2	8.2
Other grants and transfers [2]	12,101	11,972	27.1	26.9
Other expenditure	2,037	2,396	4.6	5.4
Total	**44,665**	**44,584**[3]	**100.0**	**100.0**

[1] Excludes statutory bodies.
[2] Includes grants and transfers to state governments as well as public agencies and enterprises.
[3] Excludes principal loan repayment of RM2.1 billion.
p Preliminary

Source: Ministry of Finance

In 1998, debt servicing, which is the second largest component in the operating expenditure (15.5%) rose by 7.8%. The higher outlay reflected the increased external indebtedness arising from the depreciation of the ringgit, the charges incurred in raising new loans as well as the higher domestic interest rate during the first half-year.

Gross **development expenditure** rose by 14.9% to RM18.1 billion in 1998. The higher expenditure was mainly attributable to the implementation of the RM7 billion fiscal stimulus package to revitalise the economy as well as the provision of several assistance schemes totaling RM1 billion to mitigate the adverse impact of the economic adjustments on the lower-income group and the vulnerable segments of society. The bulk of the expenditure was channelled to projects with strong domestic economic linkages and low import content. These included agriculture and rural development, infrastructure, housing, health and education projects.

In terms of sectoral distribution, economic services absorbed a larger share or 51% of total expenditure. In particular, disbursements on the trade and industry sub-sector were significantly higher. A large part of the increased expenditure was disbursed to Cyberview Sendirian Berhad (RM654 million), Pengurusan Danaharta Nasional Berhad (RM500 million), Export-Import Bank of Malaysia (RM100 million) and the Multimedia Development Corporation (RM90 million). In addition, part of the allocation was for infrastructure facilities for new and specialised industrial estates as well as for strategic investments including information technology. Priority was also given to the development of the small and medium-scale enterprises, industrial research and development, and the promotion of tourism. In contrast, disbursements on the transport sub-sector were substantially lower in 1998 reflecting largely the ongoing privatisation programme as well as the deferment or scaling down of selective projects that were less critical. The bulk of the expenditure was for the construction and improvement of Federal roads (including highways) and the development and expansion of rail, port and airport projects in tandem with the Government's efforts to provide for an integrated transportation network. This was mainly to strengthen and increase the capacity to facilitate the flow of goods and passenger traffic to support the industrialisation process. The Government also intensified its efforts during the year to meet the socio-economic objectives of the nation. Expenditure on agriculture and rural development (including land development) remained high, while investment to improve rural roads, water supply and electrification programmes was increased.

Development expenditure on the social services sector was also higher, accounting for a larger share of 32% of total development expenditure. Investment in education and training increased during the year, with priority placed on human resource development, especially to develop skilled manpower to support the productivity-driven growth. The expenditure was mainly for the upgrading of education facilities, the construction of primary and secondary schools, polytechnics, vocational and technical schools as well as the development of universities, including the construction of the Universiti Malaysia Sabah and the Universiti Islam Antarabangsa. Outlays on health and family planning were also higher to enhance the quality of health services. The bulk of the expenditure was for the construction and upgrading of hospitals as well as the provision of health facilities. Similarly, the higher expenditure on housing was largely on low-cost public housing projects and housing programmes for the armed forces, customs officers, police personnel and teachers in rural areas, as well as establishing a housing fund for the hardcore poor. Meanwhile, outlays on social and community services included a further contribution to the Commonwealth Games 1998, as well as the establishment of the Amanah Ikhtiar Malaysia and the micro-credit programme to assist the hardcore poor, hawkers, petty traders and small enterprises. Expenditure for general administration was higher,

Table 2.9
Federal Government Development Expenditure by Sector

	1997	1998*p*	1997	1998*p*
	RM million		% share	
Defence and security	2,314	1,379	14.7	7.6
Economic services	7,501	9,231	47.6	51.0
Agriculture and rural development	1,105	960	7.0	5.3
Trade and industry	1,285	3,227	8.2	17.8
Transport	3,578	3,051	22.7	16.9
Public utilities	1,496	1,968	9.5	10.9
Other	37	25	0.2	0.1
Social services	4,919	5,795	31.2	32.0
Education	2,521	2,915	16.0	16.1
Health	449	716	2.8	4.0
Housing	735	1,041	4.7	5.7
Other	1,214	1,123	7.7	6.2
General administration	1,016	1,698	6.5	9.4
Total	**15,750**	**18,103**	**100.0**	**100.0**

p Preliminary

Source: Ministry of Finance

largely for the construction and development of the new administrative centre and the implementation of the electronic Government to enhance efficiency in the provision of services. In contrast, outlays on defence and internal security were lower.

With an expansionary fiscal policy stance in July 1998, the Government reviewed and expanded its planned borrowing for the year. Increased borrowing emanated mainly from domestic sources and, to a lesser extent, from external sources in 1998, to finance the fiscal deficit. As a result, total **net borrowing** (RM12.8 billion) of the Federal Government increased for the first time, following six consecutive years of net repayment of loans. The increased borrowings, particularly from domestic sources, coupled with a marginal net exchange revaluation loss arising from the weakening of the ringgit against the Japanese yen had led to a deterioration in the total debt position of the Federal Government. The total debt outstanding increased by 14.7% to RM103.1 billion at the end of 1998 (end-1997: +0.3% to RM89.9 billion). As a percent of GNP, it increased from 34% to 39% at the end of 1998. Nevertheless, this ratio is still significantly lower, compared with 111% in 1986.

During the year, net **domestic borrowing** amounted to RM11 billion, in contrast to a net repayment of domestic loans of RM2 billion in 1997. This domestic borrowing was mainly from non-inflationary domestic sources to fund its development expenditure. Gross funds raised through Malaysian Government Securities (MGS) amounted to RM15 billion, exceeding the previous high of RM8.6 billion raised in 1987. Part of the new issue was for the refinancing of MGS and Government Investment Issues (GII) which matured in 1998, amounting to RM7 billion. In December 1998, the Government signed a syndicated loan agreement with 12 locally-incorporated foreign banks in Malaysia for a foreign currency loan amounting to US$1.35 billion (equivalent to RM5.1 billion), comprising largely loans denominated in the United States dollar. The loan was drawn down in three tranches, namely in December 1998 (first tranche of US$800 million) and January 1999 (second and third tranches totalling US$550 million). The loan with a maturity period of five years has an interest rate spread of 2.9% over the 6-month USD LIBOR. Meanwhile, there was no net new funds raised through the GII or Treasury bills (TB), while the Treasury Housing Loans Fund recorded a small net borrowing during the year. Consequently, the total domestic debt of the Federal Government increased by 14.6% to RM88.2 billion at the end of 1998 to account for 86% of the total outstanding debt.

In 1998, the Government floated six issues of MGS worth RM15 billion, mainly through private placements and by way of open tender through the principal dealers. The new issues were for a

Table 2.10
Public Debt of Federal Government

	Annual change		At end 1998*p*
	1997	1998*p*	
	Nominal value in RM million		
Domestic debt	–2,243	11,229	88,197
Treasury bills	–	–	4,320
Investment issues	–1,400	–750	2,000
Government securities	–648	8,750	75,012
Treasury Housing Loans Fund	–195	189	3,825
Market loans	–	3,040	3,040
External debt	2,480	1,973	14,924
Market loans	1,312	1,221	7,693
Project loans	1,168	752	7,231
Total	**237**	**13,202**	**103,121**

p Preliminary

Source: Ministry of Finance

wide range of maturities of 3, 5, 7, 10, 15 and 20 years to provide a benchmark yield curve to support the development of the bond market. Longer-dated MGS were mainly offered to institutional investors such as the social security institutions. After adjusting for loan redemptions, total MGS outstanding increased by 13.2% to RM75 billion at the end of 1998 and accounted for 85% of the total domestic debt outstanding. In terms of the ownership structure of MGS holders, the significance of the social security and insurance institutions increased, resulting in a slightly higher share of 70% of the total outstanding MGS. The Employees Provident Fund (EPF) remained the single largest institutional investor in 1998, raising its holdings to 61% of the total MGS, through investment in new issues of MGS as well as absorption of the divested amounts of the Social Security Organisation (SOCSO). The share of MGS held by banking institutions also increased (21%) reflecting the shift to holdings of low-risk financial instruments. The remaining MGS (9%) were held by the public enterprises, the non-bank financial institutions and foreign investors.

The balance of the domestic debt was in the form of TB (5%), the Treasury Housing Loans Fund (4%), the domestic syndicated loan (4%) and GII (2%). The banking institutions, which remained the major investors of **TB**, continued to hold 85% of the total TB outstanding for liquidity purposes. In terms of the profile of holders of GII, the banking institutions increased its holdings to account for a larger share of 45% of total GII outstanding. All banking institutions, in particular commercial banks including Bank Islam, increased their holdings of GII reflecting the growing Islamic banking businesses as well as attractive returns. Meanwhile, the share of BNM was reduced further to 47%, reflecting the net redemption of loans during the year. The main lenders to the **Treasury Housing Loans Fund** were Cagamas Berhad, the EPF, the National Savings Bank and the commercial banks.

Table 2.11
Holdings of Federal Government Domestic Debt

	1997	1998*p*	1997	1998*p*
	Nominal value in RM million		% share	
Treasury bills	**4,320**	**4,320**	**100.0**	**100.0**
Insurance companies	304	183	7.0	4.2
Banking sector	3,959	3,678	91.7	85.1
Other	57	459	1.3	10.7
Government Investment Issues	**2,750**	**2,000**	**100.0**	**100.0**
Insurance companies	119	131	4.3	6.5
Banking sector	2,610	1,848	94.9	92.4
of which:				
Bank Negara Malaysia	*1,588*	*940*	*57.7*	*47.0*
Commercial banks	*930*	*757*	*33.8*	*37.9*
Other	21	21	0.8	1.1
Malaysian Government Securities	**66,262**	**75,012**	**100.0**	**100.0**
Social security and insurance institutions	45,329	52,851	68.4	70.4
of which:				
Employees Provident Fund	*38,068*	*45,662*	*57.5*	*60.9*
Insurance companies	*5,256*	*5,307*	*7.9*	*7.1*
Banking sector	12,805	15,419	19.3	20.6
Other	8,128	6,742	12.3	9.0

p Preliminary

The Government also relied, albeit to a lesser extent, on external borrowing largely from bilateral and multilateral sources, to fund its increased financing needs. Consequently, for the first time since 1991, net **external borrowing** of the Federal Government recorded a net inflow of RM1.8 billion in 1998. Gross external borrowing amounted to RM4 billion, reflecting largely the raising of two loans during the year. In June 1998, Malaysia signed an agreement with the World Bank (US$300 million or RM1.2 billion) under a multilateral arrangement to finance projects to revive the economy as well as to mitigate the adverse effects of the economic adjustment on the more vulnerable segments of society. In December, Malaysia signed the ¥74 billion (RM2.4 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 the Ministry of International Trade and Industry, Japan. Meanwhile, the large scheduled repayments of external loans (RM2.2 billion) in 1998 reflected largely the maturity of a Samurai bond of ¥30 billion (RM882 million) and a 100 million Swiss franc bond (RM274 million). Consequently, the external debt of the Federal Government rose by 15.2% to RM14.9 billion at the end of 1998.

State Governments

Preliminary estimates indicated a smaller current account surplus of RM4.3 billion in the consolidated financial position of the 13 state governments in 1998. The substantial decline in revenue collection was partially offset by a moderate contraction in budgetary operations. In tandem with the policy of fiscal prudence, all states achieved surpluses in their current accounts. However, with most states recording deficits in their overall balance, the consolidated position reverted to a small deficit of RM169 million. This is the first deficit recorded after five consecutive years of surpluses. As Federal Government loans were more than sufficient to finance the overall deficit, there was a build-up of RM856 million in the accumulated financial assets of the state governments.

The contraction in economic activity and depressed prices of selected commodities affected the **revenue** of the state governments which fell sharply by 15.5% to RM8.4 billion in 1998. The decline in revenue was experienced by most state governments. Receipts from state sources declined, while contributions from Federal grants and transfers increased. The lower revenue collections from state sources was attributable mainly to lower receipts of both tax and non-tax revenue. The decline in revenue from direct taxes reflected lower receipts from forest taxes due to the sharp reduction in both saw log production and prices, following lower demand from both domestic and external markets. Nevertheless, it remained as the largest single source of state revenue, although its share fell to 16%. Similarly, the decline in indirect taxes was due to lower collection from export duties on timber, and import and excise duties on petroleum products. Non-tax revenue also declined, largely due to lower receipts from most major components, particularly from commercial undertakings and investment income. The larger receipts from Federal sources were channelled to assist the states in providing infrastructure and other essential amenities to improve the quality of life and to support the increasing urbanisation in the states.

The total expenditure of the state governments as a group declined by 6.2% attributable largely to the lower operating expenditure. In light of the lower revenue receipts, there was tighter control on non-essential expenditures and transfer payments. Hence, the **operating expenditure** of the state governments fell by 12.5% to RM4.1 billion (–6% in 1997). However, expenditure on emoluments was higher due mainly to the part payment of the 1997 bonus in 1998 as well as the financial assistance of RM400 each to civil servants. Similarly, gross **development expenditure** was marginally lower by 1.4% to RM4.9 billion as the state governments consolidated their position in line with reduced resources. Nevertheless, eight states provided for an increase

Table 2.12
Consolidated State Government Finance

	1997	1998*p*	1999 *Budget*
	RM million		
Revenue	9,968	8,421	7,725
State sources	*8,389*	*6,668*	*6,273*
Federal grants and transfers	*1,579*	*1,753*	*1,452*
Expenditure	4,715	4,123	4,665
Current surplus	**5,253**	**4,298**	**3,060**
Development expenditure	4,442	4,467	3,267
Gross development expenditure	*4,975*	*4,904*	*3,716*
Less Loan recoveries	*533*	*437*	*449*
Overall balance	**811**	**–169**	**–207**
Sources of financing			
Federal loans	816	1,025	666
Realisable assets [1]	–1,627	–856	–459
Total	**–811**	**169**	**207**

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

Source: State governments

in their capital expenditure. The bulk of the expenditure was channelled to the economic sector, particularly for infrastructure (roads, bridges and public amenities), industrial and commercial investments and agriculture and rural development. The balance was expended on social programmes, including housing and social and community programmes. After taking into account a smaller loan recovery of RM437 million, net development expenditure rose marginally by 0.6% to RM4.5 billion.

Non-Financial Public Enterprises

Preliminary estimates of the consolidated position of the 28 non-financial public enterprises (NFPEs) indicated that the overall financial position of the NFPEs as a group reverted to a deficit of RM1.5 billion or 0.6% of GNP in 1998 after recording a large surplus of RM6.7 billion or 2.6% of GNP in 1997. The poorer outturn was attributed to the strong increase in operating expenditure, including debt servicing arising from the weak ringgit and higher capital spending, amidst more moderate revenue growth. The strong increase in capital expenditure reflected mainly large investments by several major enterprises including PETRONAS and MISC, mainly in new projects, capacity expansion and modernisation programmes, as well as acquisition of companies related to their core businesses, and overseas investment. Nevertheless, given the economic uncertainties, several other NFPEs either scaled down or deferred projects in the pipeline.

The consolidated **revenue** of the NFPEs continued to expand, albeit at a slower pace of 11.8% to reach RM78.4 billion (1997: 21.3%). While the revenue collection was adversely affected by the contraction of economic activity and poor petroleum prices, it benefited from the sharply higher crude palm oil prices and gains from overseas operations in ringgit terms, as well as higher returns from investments, especially overseas ventures. Meanwhile, **operating expenditure** rose sharply by 28.8% to RM54.1 billion (1997: 13.5%). Higher spending reflected the increased cost of operations and supplies, including higher import costs due to the weak ringgit. Debt servicing was also substantially higher, following higher domestic interest rates, especially in the first half-year. External debt servicing also increased due to a weaker ringgit.

The operating surplus of the NFPEs as a group was maintained at a high level of RM24.3 billion or 9.3% of GNP (10.7% of GNP in 1997). The large operating surplus was contributed mainly by the larger NFPEs, notably PETRONAS, Telekom Malaysia Berhad (Telekom) and Tenaga Nasional Berhad (TNB). A small number of enterprises experienced further losses in 1998.

Table 2.13
Consolidated NFPEs Finance[1]

	1996	1997	1998*p*
	RM million		
Revenue	57,794	70,086	78,378
Expenditure	37,032	42,033	54,129
Current surplus	**20,762**	**28,053**	**24,249**
(% of GNP)	**8.7**	**10.7**	**9.3**
Development expenditure	15,512	21,341	25,777
Overall balance	**5,250**	**6,712**	**–1,528**
(% of GNP)	**2.2**	**2.6**	**–0.6**

[1] Refers to 28 NFPEs in 1996, 1997 and 1998.
p Preliminary

Source: Ministry of Finance and non-financial public enterprises

During the year, the **capital expenditure** of the NFPEs registered a strong growth of 20.8% to RM25.8 billion. Several major public enterprises continued to undertake capital investment, mainly on infrastructure and utility projects (transport, telecommunications and energy), as well as investment in the oil and gas and manufacturing sectors. The increase in expenditure also reflected the investment diversification of some NFPEs through the acquisition of companies related to their core businesses, including overseas ventures. In particular, higher capital spending was incurred by PETRONAS and MISC. However, several other NFPEs consolidated their position and deferred or scaled down development projects in line with available resources.

During the year, PETRONAS continued to invest in both upstream and downstream activities, including the construction of two new gas processing plants (GPP 5 and 6) and the central utility facility projects in Kertih and Gebeng. Other projects undertaken by the company included the development of several petrochemical projects jointly with multinational companies and the construction of the University Technology PETRONAS and the Kuantan-Kertih Railway project. PETRONAS also continued to expand its overseas investment during the year. This included the acquisition of a South African oil company, namely Engen Limited. Meanwhile, the capital investment of TNB was mainly for capacity expansion as well as to expand and upgrade the transmission and distribution networks to meet the increasing demand for electricity by the commercial and industrial sectors as well as residential consumers. Major projects underway included the construction of Phase I of the 500kw transmission network, Phase III of the Port Klang Sultan Salahuddin Abdul Aziz Power Station and the rehabilitation and conversion of power plants including the Melaka, Port Dickson, Prai and Pasir Gudang plants. TNB was also involved in the development of the electrification infrastructure for the XVI Commonwealth Games, 1998, and the development of a world-class electricity infrastructure for Putrajaya and Cyberjaya. Other projects included the construction of Phase II of the Tenaga Nasional University Complex. TNB also continued to invest in power projects abroad including in Pakistan and India. Similarly, Telekom continued with its expansion and modernisation programme to provide the nation with a sophisticated telecommunication infrastructure. A large portion of the expenditure was expended on developing a range of services and products for the Corporate Information Superhighway (COINS), which would be an integral part of the Multimedia Super Corridor (MSC), and the National Information Infrastructure (NII). Telekom continued to diversify its investments overseas, including projects in South Africa, Malawi and the Republic of Guinea. In line with the policy to encourage the transportation of goods by Malaysian carriers, MISC continued its long-term fleet expansion programme to enhance its capacity to handle the growing volume of international trade. The construction of the new Kuala Lumpur International Airport was completed during the year. Meanwhile, further work was undertaken by Keretapi Tanah Melayu Berhad to modernise and enhance the quality and efficiency of rail services as an alternative commuter transport system.

With these large capital expenditures, the consolidated overall account of the NFPEs as a group reverted to a deficit of RM1.5 billion or 0.6% of GNP (+2.6% of GNP in 1997). This is the first deficit following three consecutive years of sizeable surpluses. The capital outlays were mainly financed by internally generated funds and increased domestic borrowing. Recourse to external borrowing was constrained by the ringgit depreciation. Hence, there was only a marginal increase in the outstanding external debt of the public enterprises to RM53.2 billion (representing 41% of the nation's external debt). The increase reflected a small net inflow of RM361 million as well as an exchange revaluation loss as a result of the appreciation of the Japanese yen against the ringgit. The external debt level of the NFPEs remained manageable as the capital investments currently being undertaken by the public enterprises were expected to generate additional revenue to service the debt, besides strengthening the NFPEs' financial performance. Nevertheless, in view of the large financing needs of the nation to revitalise the economy, investment activities and borrowings of the NFPEs need to be closely monitored.

Following the regional crisis, the privatisation policy was implemented on a more selective basis. New privatised projects were assessed more critically in terms of their macroeconomic impact, especially on the balance of payments, strong economic linkages and domestic multiplier effects. During the year, seven projects were privatised comprising three existing projects and four new projects, mainly involving infrastructure and construction. The projects included several highways such as the Ipoh-Lumut Highway and the East-coast Highway, and the construction of the hostel for Universiti Putra Malaysia. Meanwhile, several approved privatised projects, which were viewed to be less strategic, were deferred.