3 Outlook and Policy

International Environment

The overall performance of the industrial countries was sustained in 1998. Real output growth of the industrial economies as a group, comprising members of the Organisation for Economic Co-operation and Development (OECD) expanded further, albeit at a slower pace of 2.3% (1997: 3.1%) amidst an environment of subdued inflation (1.4%), improved fiscal balance positions and labour market conditions. Nevertheless, there was a distinct cyclical divergence in the economic performance among the major industrial countries. The slower overall growth reflected largely the economic downturn in Japan and moderate growth in the United Kingdom, which offset the higher growth emanating from the United States and continental Europe.

Table 3.1
Industrial Countries: Key Economic Indicators

	Average 1991-95	1996	1997	1998*e*	1999*f*
	Annual change (%)				
Real GDP					
Industrial Countries	**1.7**	**3.0**	**3.1**	**2.3**	**2.0**
United States	2.0	3.4	3.9	3.9	2.8
Japan	1.4	5.0	1.4	–2.9	–1.2
Germany	2.0	1.3	2.2	2.8	1.5
United Kingdom	1.6	2.6	3.5	2.5	0.9
Consumer Prices					
Industrial Countries	**3.1**	**2.3**	**2.0**	**1.4**	**1.4**
United States	3.1	2.9	2.3	1.6	1.8
Japan	1.4	0.1	1.7	0.7	0.0
Germany	3.4	1.5	1.8	1.0	1.0
United Kingdom[1]	3.9	2.9	2.8	2.6	2.5
	% of labour force				
Unemployment					
Industrial Countries	**7.7**	**7.7**	**7.4**	**7.0**	**7.1**
United States	6.6	5.4	4.9	4.5	4.8
Japan	2.6	3.3	3.4	4.2	4.5
Germany	8.2	10.4	11.5	10.9	10.7
United Kingdom	9.1	7.3	5.5	4.7	5.1
	US$ billion				
Current account					
Industrial Countries	**+8**	**–39**	**+66**	**–5**	**–54**
United States	–76	–135	–155	–231	–288
Japan	+111	+66	+94	+128	+139
Germany	–19	–14	–4	+3	+4
United Kingdom	–11	–3	+7	+3	–7

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

Source: IMF World Economic Outlook, December 1998.
National sources.

In the United States, the economy reached its seventh year of expansion in 1998 with real GDP increasing at above potential. The stronger economic expansion emanated mainly from consumer spending and a strong build-up in inventories, induced by the wealth effects arising from the buoyant stock market. In addition, rising equity prices also sustained the buoyant housing sector and capital spending. In Germany, economic recovery continued to gain momentum in 1998, underpinned by strong domestic demand which took the lead from exports as the main impetus to growth during the year. Meanwhile, real output growth in the United Kingdom slackened after five years of sustained expansion at close to potential output. The slowdown reflected declining manufacturing output arising from deteriorating export growth, which was affected by the strong pound sterling and weak demand from East Asia. Domestic demand also moderated as a result of fiscal and monetary tightening since 1996. In Japan, the economic situation deteriorated significantly with output recording a sharp contraction in 1998. Factors underlying the sluggish performance included increased strains in the financial sector, weak consumer and business confidence and declining demand for exports from the crisis-affected Asian countries.

Real output in the developing countries as a group moderated significantly, reflecting largely the decline in output of the crisis East Asian economies and a marked slowdown in the Latin American region. Weak oil and non-fuel primary commodity prices as well as high interest rates caused growth to moderate significantly (See Box IV on "Developments in the Regional Countries").

Industrial Countries

In 1998, the industrial countries as a group had generally exhibited resilience to the East Asian financial crisis. However, towards the end of the year it was evident that some major industrial economies were affected by continued financial turbulence following the debt default by Russia in August, the near collapse of a major hedge fund in the United States in September and to a lesser extent, the Brazilian financial crisis which began in the same month. Policy responses included monetary easing in the United States and the United Kingdom to deal with the deteriorating external environment. Prospects for the industrial countries, however, remain uncertain in 1999. Signs of weakening business confidence, slowdown in domestic demand and increased risk aversion among financial institutions have emerged. In 1999, real GDP growth in the industrial countries is, therefore, expected to moderate to 2%, amidst a slowdown in the United Kingdom, continued weakness in the Japanese economy and some loss of momentum in the European economic recovery. Meanwhile, the United States economy will remain strong, although growth is expected to moderate.

In the **United States**, real GDP growth is expected to be sustained at close to the potential level of 2.8% in 1999 (1998: 3.9%). Output growth in the first half-year is expected from continued buoyant consumer spending sustained by strong wealth effects from the stock market. The slower growth reflects an anticipated deterioration in net exports, largely due to lower growth in Latin America, which accounts for 20% of total United States' exports. Investment outlays would likely weaken in response to expectations of lower corporate earnings and declining capacity utilisation. On the downside, there are some concerns over the sustainability of growth in the United States. The economy remains vulnerable to key imbalances, including the low private savings, a possible correction in the stock market and the large external deficit.

Following a year of firm recovery, the **German economy** is expected to record a below trend growth of 1.5% in 1999 (1998: 2.8%), reflecting mainly weak export performance and lower business investment in the face of unfavourable external environment. The expected slower growth in global capital spending is also likely to affect the performance of the manufacturing sector. With weakening external conditions affecting export prospects, the impetus to growth is expected to emanate from domestic consumer demand. Structural unemployment continues to remain a concern that could dampen further consumer confidence. Fiscal policy has, therefore, been relaxed with increased public expenditure mainly targeted at improving labour market conditions.

After six consecutive years of above trend growth, economic activity in the **United Kingdom** is expected to moderate, with growth slowing to 0.9% in 1999 (1998: 2.5%). The slowdown would be felt most in the external sector, which has been affected by the prolonged currency appreciation. On the domestic front, manufacturing output is expected to slow down, while signs of weakness have emerged in the services sector, which accounts for two-thirds of total GDP. Despite the easing of interest rates in the fourth quarter of 1998 and early 1999 to counter the slowdown in domestic economic activity, the effects of the previous tight fiscal and monetary policies are expected to adversely affect consumption and investment in 1999. At the same time, the employment situation is expected to be affected in 1999.

Meanwhile, the **Japanese economy** is expected to remain weak with real output declining further by 1.2% in 1999 (1998: –2.9%). Overcapacity and financial constraints will continue to impinge on business investment, while consumer demand is expected to remain sluggish amidst high unemployment and mounting deflationary pressures. While export performance is expected to improve, the slower growth in the United States and Europe, which together account for close to half of Japan's total exports, could become a constraint on the pace of export growth. However, the impact of the stimulus packages announced by the authorities to boost domestic demand through public sector spending and reductions in corporate and personal income taxes would be felt in the latter part of 1999. At the same time, the programmes to deal with troubled financial institutions via new legislation are also expected to resolve the banking sector problems during the year. The ¥60 trillion (12% of GDP) banking restructuring plan was announced in October 1998, comprising facilities for bank nationalisation, bridge bank operations, rehabilitation of weak banks, public funds to recapitalise banks and depositor protection.

Considerable uncertainty remains about the world economic outlook for 1999. There are several downside risks that could affect both the financial markets and the real economy. A potential risk is that growth in the United States economy could be adversely affected if a major consolidation in the stock market occurred. In view of the significant reliance of corporations on equity financing and the rising share of household assets in the form of equity, the negative wealth effects of a significant equity price correction would dampen consumption, which has been an important impetus to growth. A significant stock market correction would also have a destabilising impact on other equity markets worldwide. The outlook for the Japanese economy remains uncertain, being dependent on the implementation of the fiscal stimulus and reforms in the banking sector. A slow recovery in the Japanese economy would affect the recovery prospects in the regional economies, in view of their strong trade and investment links.

Although the impact of the Brazilian *real* devaluation on the global financial markets has so far been limited, intensification of the crisis could generate destabilising effects on the financial markets and spillovers to the rest of Latin America and other emerging economies. This could lead to a further loss of investor confidence and a retreat of private capital flows to emerging market economies. Deflationary pressures could intensify in the short-term amidst global overcapacity, weak commodity and oil prices and adjustment in asset prices. At the same time, excess capacity in the global goods markets may heighten the risks of protectionist measures in industrial countries with adverse implications on export growth of emerging market economies. The large external imbalances among the industrial countries stemming from uneven growth could give rise to destabilising movements in exchange rates among the major currencies. If these risks materialise, the slowdown in world growth could continue into the year 2000.

Amidst moderating economic activity, **inflation** in the industrial countries as a group is expected to stabilise at 1.4% in 1999 (1998: 1.4%). Continued weakness in primary commodity prices and intense competition from cheaper imports from Asia would contribute to lower prices. In the United States, inflation is likely to increase at a slightly higher rate of 1.8% (1998: 1.6%), due to wage pressures arising from continued tight labour conditions in the first half of 1999. In the United Kingdom, the core inflation rate is expected to meet the official target of 2.5%, consistent with expectations of lower average earnings and slower economic activity. Inflation in Germany is expected to remain stable at 1% in 1999. Meanwhile, inflation in Japan is expected to register zero growth in 1999 (1998: 0.7%), in the absence of demand pressures and a contraction in the economy.

Growth in the volume of **world trade** is expected to expand at a slightly higher rate of 3.9% in 1999 (1998: 3.4%), in line with the improving economic prospects in the East Asian crisis countries. The external deficit of the major industrial countries as a group is expected to widen to US$54 billion in 1999 (1998: –US$5 billion), reflecting mainly the higher deficit in the United States. The projected increase in the current account deficit of the United States (–US$288 billion; 1998: –US$231 billion) reflects mainly lower exports to Latin America and the sustained demand for imports. In contrast, Japan is expected to register a higher current account surplus of US$139 billion (1998: +US$128 billion), as demand for imports is likely to remain modest amidst weakness in domestic demand. Meanwhile, the current account balance of the United Kingdom is projected to revert to a deficit of US$7 billion (1998: +US$3 billion), on account of slower exports relative to imports, while Germany is expected to register a lower surplus in its current account amounting to US$4 billion (1998: +US$3 billion).

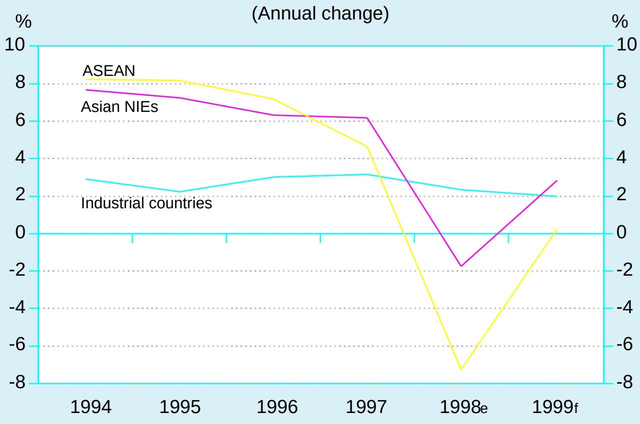
East Asian Economies

Several signs of an economic recovery suggest that the **outlook for East Asia would be more positive in 1999**. Signs of improvement include increasing stability and strength of the regional currencies, improved stock market performance and generally more favourable external positions. Exports are expected to benefit from a resumption in bank lending following the progress achieved in banking sector reforms, steps taken by the authorities to resolve problems in obtaining trade financing for exporters, as well as prospects of improvement in the global electronics industry. Indications are that industrial production has improved, particularly in Korea and Thailand. The international rating agencies have revised upwards the sovereign debt ratings for Korea and the Philippines to investment grade. These developments are likely to be positive on investor confidence leading to a resumption of private capital flows into the regional economies.

For 1999, **real GDP** in the **Asian Newly Industrialised Economies (NIEs)** is expected to revert to a positive growth of 2.8–2.9% (1998: –1.8%), reflecting the recovery in Hong Kong Special Administrative Region (SAR), The People's Republic of China; and Korea; and sustained economic performance in Taiwan, which would more than offset the moderation in output in Singapore. In **Korea**, output is expected to improve significantly to record a growth of 3.2% in 1999 (1998: –5.4%), underpinned by fiscal expansion and easier monetary conditions including low interest rates. Hence, a revival in domestic demand is expected during the year, induced mainly by higher consumer spending, amidst an environment of improved confidence. Similarly, the **Hong Kong SAR** economy is expected to turn around to record real GDP growth of 0.5% (1998: –5.1%). The improvement is supported by a sustained growth in The People's Republic of China which accounts for 90% of Hong Kong SAR's re-exports, higher government spending, and better performance in the services industry, particularly in tourism.

Meanwhile, real GDP growth in **Taiwan** is expected to remain stable at 4.7% (1998: 4.8%), supported by expansionary fiscal initiatives including higher public sector expenditure on infrastructure and state projects as well as better export performance boosted by the projected recovery in demand for electronics. Nevertheless, consumer demand is expected to remain moderate in the face of weak stock market performance, as households account for a high proportion (90%) of the total stock exchange turnover in Taiwan. The **Singapore** economy is expected to experience the lagged impact of the East Asian financial crisis in 1999 as well as weaker exports as a result of loss of international competitiveness. Real GDP growth is projected to range between –1% and 1% (1998: 1.5%). In order to mitigate the effects of the crisis and to regain the economy's competitiveness, the authorities introduced a S$10.5 billion package in late 1998, aimed at reducing business costs and stimulating private investment.

Graph 3.1
Real GDP Growth: Industrial Countries, Asian NIEs and ASEAN



Real output growth in **The People's Republic of China** is expected to expand at a more moderate pace of 7% (1998: 7.8%), supported mainly by strong government spending on infrastructure projects. The fiscal stimulus is expected to more than offset the dampening effects arising from the accumulation of inventories of industrial and consumer products, rising unemployment and slower foreign direct investment inflows.

Growth prospects for the **Association of South East Asian Nations (ASEAN)** economies are expected to improve slightly, with a combined real GDP growth of between –0.8% and +0.9% (1998: –7.3%). The better outlook reflects mainly the turnaround in growth for Thailand and the Philippines, while the recovery in Indonesia remains hesitant. In **Thailand**, real GDP is expected to turn around to record a modest positive growth of 1% in 1999 (1998: –8%), underpinned by a fiscal deficit, easier monetary policy and better performance in the agriculture and export sectors. Output growth in the **Philippines** is also expected to improve to 2.5–3.2% in 1999 (1998: –0.5%), as the industrial sector regains its growth momentum following a resumption in bank lending activities. Other underlying factors contributing to the higher growth projection for the Philippines include better agriculture sector performance and export growth. For 1999, recovery in the **Indonesian economy** is expected to remain weak, with growth forecast to range between –4 and 0% (1998: –13.7%). The economy is expected to begin its recovery process in the latter part of 1999. Factors supporting the recovery are increased foreign and public investments and resumption of bank lending to the productive sectors.

Inflationary pressures are expected to recede in the regional economies, due mainly to a strengthening in the regional currencies and low commodity and energy prices. Inflation in the **Asian NIEs** as a group is expected to moderate to 1.5–1.6% in 1999 (1998: 4.4%), reflecting mainly lower consumer prices in Korea and Taiwan as well as deflation in both Singapore and Hong Kong SAR. In Korea, inflation is expected to ease to 3% (1998: 7.5%), due to a stronger Korean won, low commodity prices as well as stable rental rates and wages. Inflation in Taiwan is expected to remain subdued at 1.6% (1998: 1.7%), contained mainly by mild imported inflation. Deflationary pressures which emerged during the later part of 1998 in Singapore and Hong Kong SAR, are expected to continue into 1999 (–1.0~0% and –2% respectively; 1998: –0.3%

Box IV

Developments in the Regional Countries

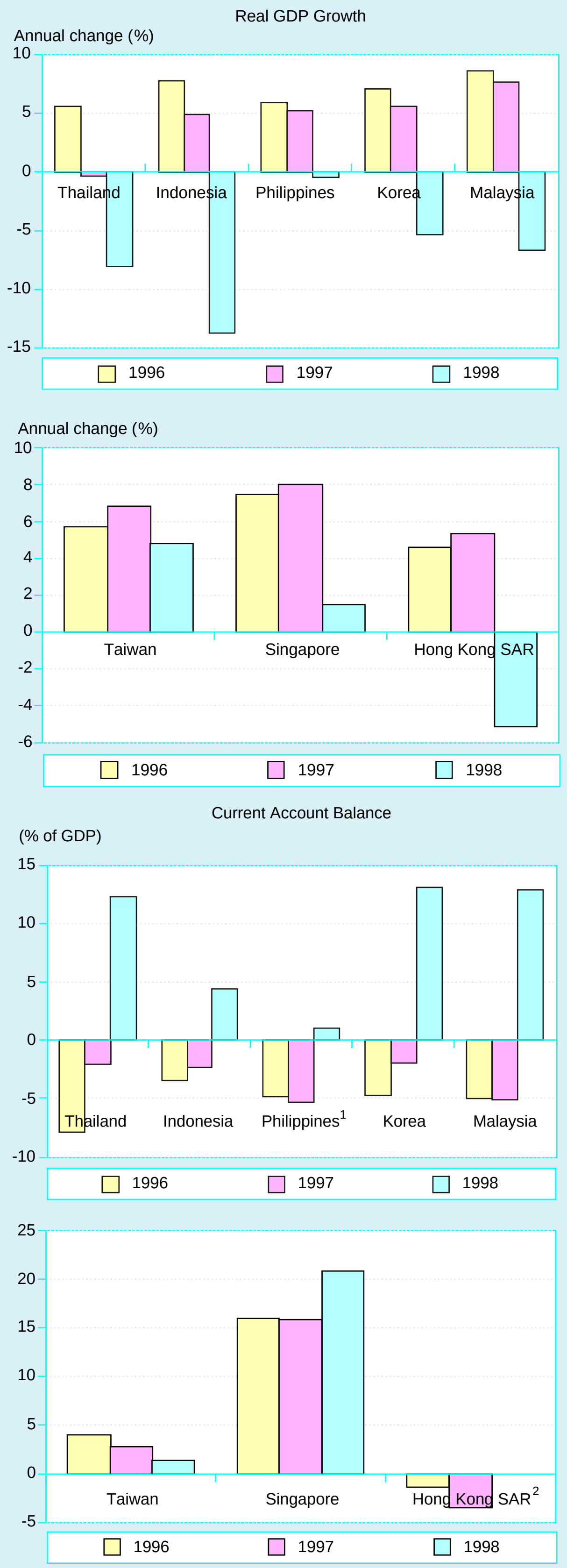
The impact of the East Asian crisis that began in July 1997 was more severe than anticipated and was unprecedented, in terms of depth, spread and duration. This was evident from the several downward revisions in growth forecasts in the regional countries in the course of 1998. The revisions reflected a larger-than-expected compression in domestic demand and the absence of an export-led recovery that was earlier envisaged to lift the economies out of the recession. As the crisis unfolded, the economic performance of the regional countries was severely affected by adjustments in both the real and financial sectors. Private consumption and investment fell sharply, reflecting cautious spending activity amidst deepening recession, rising unemployment, asset price deflation, increased corporate debt burden and narrowing corporate profits and reversals in capital flows. Export growth in the region was affected by the weak economic conditions in Japan, slowdown in the economies of the other major trading partners and trade financing problems in some regional countries. For the South-East Asian countries, namely Indonesia, Malaysia, the Philippines, Singapore and Thailand, Asia represents the largest export market, accounting for 50% of its combined exports.

The several waves of instability in the financial markets in early 1998 and again in the wake of the Russian crisis in August-September had heightened investors' risk aversion to emerging markets as a whole. Net private capital outflows from the five countries most affected by the crisis, namely Indonesia, Korea, Malaysia, the Philippines and Thailand rose to US$28.3 billion in 1998 (1997: –US$1.1 billion), reflecting mainly the decline in net bank and non-bank lending. Meanwhile, foreign direct investment (FDI) which had been one of the main sources of growth during the pre-crisis period in these countries remained sluggish in 1998, amounting to US$8.5 billion (1997: US$3.6 billion, 1995-96: averaged US$17.8 billion).

The impact of the crisis on the real sector was felt as early as in 1997, with Thailand posting a decline in **real output growth.** This was followed by a contraction in real GDP in several other economies in the first quarter of 1998, namely Indonesia, Korea and Hong Kong Special Administrative Region (SAR), The People's Republic of China. Growth declined in these countries amidst a contraction in domestic expenditure and increased unemployment arising from the ongoing restructuring in the banking, corporate and real sectors. Meanwhile, the Philippines slipped into a recession in the second quarter of 1998 due also to the weak agriculture performance which was affected by adverse weather conditions. The effects on Singapore were evident in the third quarter as the manufacturing sector was increasingly affected by the global electronics slowdown, as well as the negative impact from the regional downturn on commerce and financial service activities.

In 1998, the **Association of South-East Asian Nations (ASEAN)** economies as a group, including Singapore, registered a decline of 7.3% in real output (1997: +4.6%). In the ASEAN region, Indonesia recorded the largest output contraction of 13.7%, reflecting an across-the-board decline in economic activities. In Thailand, real GDP was estimated to have declined by 8% in 1998 as domestic demand contracted following economic restructuring and rising unemployment. In the case of the Philippines economy, real output contracted marginally by 0.5% in 1998, due mainly to the poor performance of the agriculture sector brought about by adverse weather conditions, and declines in the construction and manufacturing sectors arising from the high interest rates and volatile currency movement at the height of the currency crisis. Philippines' real GDP was supported by strong export growth in most months of 1998 following the robust demand for electronics and computer peripherals from the United States. Meanwhile, Singapore recorded an expansion in real output of 1.5% in 1998, arising from strong growth performance in the first half of 1998.

Graph IV.1
Regional Countries



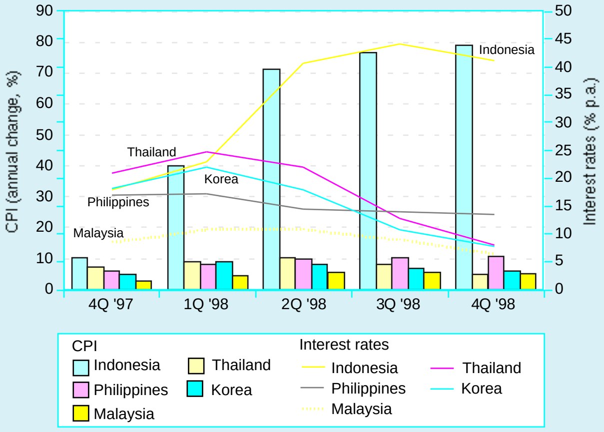
[1] Current account balance for 1998 is as % of GNP
[2] Current account balance refers to balance of goods and services.
Figure for 1998 is not available

The **Asian Newly Industrialised Economies** (including Singapore) as a whole recorded a decline in real GDP of 1.8% in 1998 (1997: +6.1%), with contraction in the Hong Kong SAR and Korean economies. In Korea, real output is estimated to have declined by 5.4% due to sluggish consumer spending, significant cutback in investment and slower export growth. Similarly, in Hong Kong SAR, real GDP fell by 5.1% due to a significant downward adjustment in consumer spending in view of rising unemployment and negative wealth effects following a sharp decline in asset prices. In contrast, Taiwan which had initially shown resilience to the crisis registered a slower growth of 4.8% in 1998, weakened by worse-than-expected export performance. In **The People's Republic of China,** real output growth moderated to 7.8% (1997: 8.8%), reflecting a stronger pick-up in economic activity in the second half of 1998, supported mainly by public investment projects.

On the **inflation front,** the regional economies recorded mixed price trends in 1998. Inflationary pressures emerged in countries that had experienced significant currency depreciation arising from the pass-through effect on their domestic economy, with the highest inflation in Indonesia (78%), followed by the Philippines, Thailand and Korea at around 7-10% (1997: 4-6%). The sharp increase in consumer prices in Indonesia reflected higher import costs and supply shocks. In Thailand, inflation was more moderate than was forecast earlier. This was due to the fall in aggregate demand, the appreciation of the baht during the second half of 1998 and declining world commodity prices. Inflation in the Philippines was partly fuelled by food shortages arising from the disruption in crop production, while inflation in Korea was due mainly to the depreciation of the won. Nevertheless, offsetting factors that had helped to restrain price pressures to some extent in both the Philippines and Korea were weak aggregate demand, high interest rates and low prices of imported raw materials and oil products during the year. Meanwhile, there were signs of deflation in The People's Republic of China (1998: –2.6%), Singapore (1998: –0.3%) and in the last quarter of 1998 in Hong Kong SAR (1998: +2.6%). Factors contributing to deflationary trends in the latter two countries included cautious consumer sentiment amidst

Graph IV.2

Inflation and Interest Rates of Crisis Countries



rising unemployment and negative wealth effects from a sharp fall in asset prices. In The People's Republic of China, despite the authorities instituting price support for several basic items and higher food prices due to crop destruction in the floods, retail prices remained negative throughout the year, reflecting an oversupply of inventory. In Taiwan, inflation rose to 1.7% (1997: 0.9%) on account of imported inflation and higher farm prices.

As in any recession, **unemployment** posed a major problem in the crisis countries arising from the financial restructuring process and adjustment in the real sector. During the course of the crisis, an increased number of companies resorted to retrenchments to reduce costs amidst falling profits. The unemployment rate more than doubled in Thailand (4%) and Korea (6.8%), while in Indonesia, unemployment increased to 14.5% of the total labour force in 1998. In Singapore and Hong Kong SAR, unemployment reached record highs of 3-5%. The decline in real wages and reduced job prospects also indicated signs of an easing labour market situation in the regional countries.

On the **external front,** a significant feature was the speed and magnitude of adjustment in the current account balance in most of the crisis countries. Despite the weak export performance, the current accounts of these countries strengthened during the year due mainly to the sharp contraction in imports. Countries that had recorded current account deficits prior to the crisis, namely Indonesia, Korea, the Philippines and Thailand turned around to record surpluses in 1998. In particular, Korea and Thailand registered current account surpluses of more than 10% of GDP. The improvement in the current account positions in Indonesia, Korea, Singapore and Thailand mainly reflected the contraction in imports of 22-36% (in United States dollar terms), which had more than offset the decline in exports of 2-12%. In the case of the Philippines, the improvement in the current account was not only due to the decline in imports of 19%, but also to the sustained growth in exports at 17%, benefiting mainly from the robust external demand for electronics. Despite weaker imports in The People's Republic of China and Taiwan, the current account surplus narrowed slightly in 1998, due to the slowdown in regional demand for their products.

In the **financial sector,** corporate insolvency and rising debt defaults among local corporations as the crisis intensified eventually affected the financial institutions, especially those with large exposure to the property and stock markets. The asset quality of the banking system began to deteriorate following the sharp falls in asset

Table IV.I: Financial Indicators of Crisis Countries in 1997 and 1998

	End-Period	Thailand	Indonesia	Korea	Philippines	Malaysia
Non-performing loans (% of total loans)	1997	19.8	8.2	2.7	5.4	4.7[2]
	1998	45.9	63.3	10.5	11.0	13.2[2]
External debt (US$bn)	1997	93.4	136.1	158.1	45.4	43.8
	1998	86.2	143.0[1]	151.5	46.4	42.0

[1] Figure as at November 1998

[2] Refers to NPL classification of 3 months

Source: National authorities

prices and high interest rates, thus resulting in higher non-performing loans (NPLs) and provisioning requirements. In 1998, the NPLs of the banking system rose in Thailand and Indonesia to 46-63%, and by a lesser extent, in Korea and the Philippines to around 11%. On external debt, Korea and Thailand had succeeded in reducing their total outstanding external liabilities in 1998. Although the total amount of indebtedness only declined slightly in the two countries, the maturity composition of their debt improved significantly. As at end-1998, Korea and Thailand's short-term debt with maturity of less than one year declined to 21.4% and 27.3% of total debt respectively (1997: 40% and 37.3% respectively). In this regard, Korea rescheduled about US$22 billion of its short-term debt to medium and long-term. Meanwhile, the outstanding external debt for Indonesia increased slightly in 1998, but about US$4.2 billion of its external official debt had been restructured.

During the year, there was a discernible shift in macroeconomic policy in the regional countries. The initial response of the countries under the International Monetary Fund (IMF) programme, namely Indonesia, Korea and Thailand was to adopt a tight **monetary stance** by raising interest rates to curb speculative pressure on their currencies, restore investor confidence and contain inflation. Monetary tightening was also evident in other regional countries. Average short-term interest rates increased to 44% in Indonesia (pre-crisis: 11%), above 20% in Thailand and Korea, and 18% in the Philippines. Authorities were faced with a policy dilemma on high interest rates due to the trade-off between growth and stability in exchange rates. The tight monetary stance had, however, not brought about the desired effect of stabilising the currencies. On the contrary, during the course of the year, it became increasingly apparent that high interest rates for an extended period had severe ramifications on the economy with its further destabilising effects on the currency. The higher cost of funds and the consequent uncertainty caused a sharp contraction in aggregate demand. Given the depreciation in the currencies and prevailing high interest rates, corporations had to deal with declining returns and increased debt service and business costs. As an increased number of companies became insolvent, this affected the asset quality of the banking system. The banks responded by curtailing lending and creating a credit crunch situation, which in turn, adversely affected economic activity in these countries. When inflationary pressures subsided and currencies stabilised, monetary policy in the region became more accommodative. Interest rates were adjusted downwards in Thailand and Korea since February-March 1998, followed by Hong Kong SAR, Singapore, Taiwan and the Philippines towards mid-1998. In contrast, in Indonesia, high interest rates were maintained for a large part of the year in view of the high inflation and significant depreciation of the rupiah. The recovery of the yen and interest rate cuts in the industrial countries in the fourth quarter of 1998 allowed room for further cuts in short-term rates in the region, thus paving the way for more growth-oriented policies.

Similarly, **tight fiscal policies** were adopted by the regional countries until mid-1998 in order to restore market confidence, to facilitate non-inflationary financing for restructuring the banking sector and to deal with the weakening in fiscal positions arising from the depreciation of the currencies and lower revenue. In the first half of 1998, however, as the severity of the contraction became apparent and given that the export sector was not as robust as had been expected, fiscal policies were relaxed and more expansionary measures were introduced to revive domestic demand. Fiscal policies in the IMF programme countries and the other regional economies became more expansionary, with provisions for increased spending. Thus, the fiscal deficits in the crisis countries were increased to between 2 and 6% of GDP in 1998. The public expenditure measures included increased infrastructure spending, setting up of funds to support small- and medium-sized enterprises, trade financing and tax rebates for exporters, as well as provision of social expenditures for the more vulnerable segments of the society. On the revenue side, taxes were reduced to stimulate demand. In Singapore and Hong Kong SAR, tax measures were also introduced to support the property market.

During the year, **structural adjustments,** namely banking sector consolidation and recapitalisation; resolution of NPLs, strengthening prudential regulation and supervision; and corporate restructuring and corporate governance gained momentum in the crisis countries. In **Korea,** priority was given to financial sector reforms. In order to facilitate the financial restructuring, the Financial Supervisory Commission (FSC) was established and fifteen financial reform bills were legislated. During the year, five non-viable commercial banks were taken over by healthy banks. The remaining banks were required to submit voluntary rehabilitation plans with sufficient infusions of new capital to improve their soundness, failing which they had to be either nationalised temporarily, merged or closed. Subsequently, three large commercial banks were temporarily nationalised, of which two were merged into one clean bank, and the other was sold to a foreign consortium at end-1998. As of end-September 1998, 94 financial institutions had been suspended or closed. By end-year, the Korean Government had injected about 41 trillion won (US$30 billion) of public funds for financial restructuring. Meanwhile, the Korea Asset Management Corporation had purchased total NPLs from the financial system worth 44 trillion won (US$32.3 billion), and had sold 748.6 billion won (US$0.5 billion) at the disposal price of 30.3%. Meanwhile, the Korea Deposit Insurance Corporation provided fiscal support of 21 trillion won (US$15.4 billion) for the recapitalisation and depositor protection.

On corporate restructuring, the Korean Government expedited efforts in the fourth quarter of 1998 after the completion of the first phase of the financial restructuring. Corporate restructuring in Korea is significant given the importance of large family-based conglomerates (chaebols) in terms of market share and economic influence. Efforts were directed towards improving the capital structure and corporate governance, with creditor banks having an important role. Meanwhile, legal procedures involving corporate rehabilitation and bankruptcy filing were amended in early 1998 to facilitate the exit of non-viable firms. Creditor banks classified 55 corporations as non-viable and were denied further funding. By October 1998, more than 200 financial institutions had signed the "Corporate Restructuring Agreement" to carry out corporate workouts with the top 6-64 chaebols. Meanwhile, the restructuring of the five largest chaebols included improvement in capital structure as well as business restructuring. A framework for mergers and business swaps, referred to as "big deals" was established to enable these corporations to focus on the core competencies, create management efficiencies and reduce over-capacity and overlapping investments. The top five chaebols agreed to shed unprofitable businesses and concentrate on core industries, thus reducing the number of subsidiaries from 264 to 130 and the debt-equity ratio to less than 200% by end-1999 (1997: 476%). The government also amended labour-related legislation to enable companies to lay off excess workers and introduce flexible working hours.

In **Thailand,** priority was also given to financial sector restructuring. Following the closure of 56 insolvent finance companies in 1997, the assets of the companies worth 860 billion baht (US$21.2 billion) were transferred to the Financial Sector Restructuring Authority (FRA). By end-1998, the FRA had recovered about 105.5 billion baht (US$2.6 billion) or 56% of the nominal value of the assets of the failed finance companies that had already been sold in the auctions. During the year, the Bank of Thailand announced plans to privatise three of the banks it had intervened, merged 18 financial institutions, transferred good assets of one intervened bank to a public bank and bad assets of another intervened bank to a non-bank financial institution called the privately-owned Asset Management Company (AMC). The private AMC was entrusted with the task of managing low quality assets of financial institutions. Meanwhile, the Financial Restructuring Advisory Committee (FRAC) was established to facilitate Tier-1 and Tier-2 capital support schemes and other aspects of financial sector restructuring. About 300 billion baht (US$7.4 billion) of public funds in the form of government bonds were made available to support the recapitalisation of viable financial institutions and to accelerate corporate debt restructuring and encourage new lending. In order to restructure the corporate sector, the Corporate Debt Restructuring Advisory Committee (CDRAC) was formed in August 1998. By December, the CDRAC had accepted about 200 cases of complicated multicreditor-type of debt restructuring, involving 351 companies with debt and overdue obligations amounting to 678 billion baht (US$16.4 billion). As of December 1998, nine cases had been successfully restructured. Concurrently, creditor financial institutions were also negotiating with debtor corporations on simpler debt cases. By end-December 1998, 9,015 cases of debt restructuring totalling 157 billion baht (US$3.8 billion) were completed by the financial institutions.

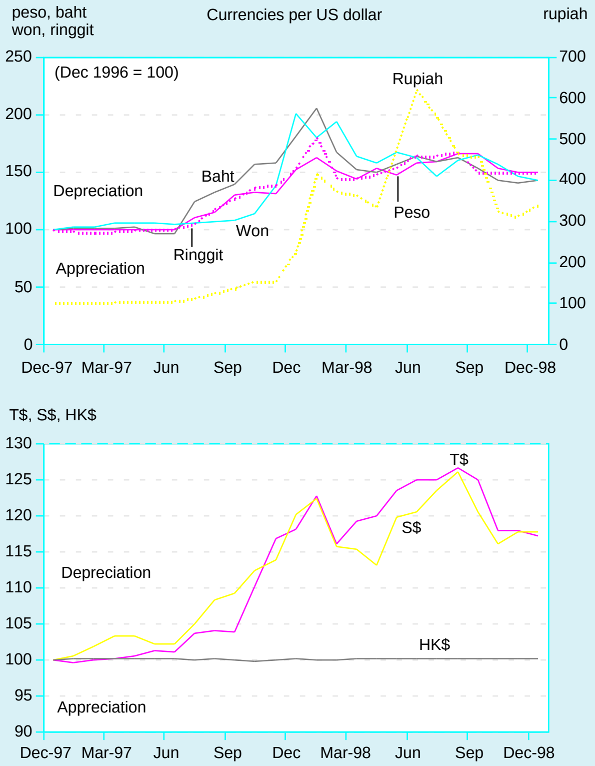
In **Indonesia,** efforts were directed towards reducing structural impediments and market inefficiencies through removal of public subsidies and liberalisation of monopolies and foreign trade. The financial restructuring was undertaken via the establishment of the Indonesia Bank Restructuring Agency (IBRA) to rehabilitate the ailing banks and manage the non-performing assets of intervened banks. After the closure of 16 banks in 1997, Bank Indonesia guaranteed depositors and creditors of all domestic banks to boost confidence in the banking system. In 1998, the government placed seven banks under IBRA's management, froze the operations of ten banks and declared four private banks as insolvent. In December 1998, the authorities conducted due diligence on 150 banks, out of which 40 banks had failed to meet the capital adequacy ratio (CAR) of –25% and were given one month to recapitalise, failing which the bank would be closed or merged, while state banks that had not met the CAR would be recapitalised. In January 1999, a decree was passed allowing the government to provide 80% of the funds needed to raise the capital levels of 56 banks to 4% if these banks could meet certain requirements. On corporate sector restructuring, emphasis was placed on the resolution of private sector debt as it accounted for 58% of Indonesia's total external debt. The first agreement called the Frankfurt Accord created the Indonesian Debt Restructuring Agency (INDRA) to provide an exchange rate guarantee and act as an intermediary between domestic debtors and external creditors in the servicing of renegotiated external debt. The INDRA scheme was later complemented by the Jakarta Initiative, comprising a set of non-binding guidelines for debt workouts with domestic and foreign creditors. As of February 1999, it was reported that more than 128 companies had registered with the Jakarta Initiative, involving foreign debts worth US$18 billion. In early 1999, several conglomerates had also agreed with their main creditors to repay or swap their debt for equity.

Besides the IMF programme countries, the Philippines and Singapore also tightened prudential guidelines in the banking sector. In the **Philippines,** the authorities stepped up the implementation of banking sector reforms during the year to strengthen the banking system. Towards this end, the central bank introduced several prudential measures, including an increase in the minimum capital requirements of banks; the imposition of a 2% general loan loss provisions (to be complied with by all banks by 1 October 1999) in addition to specific loan loss provisions; and the imposition of a 20% ceiling for real estate loans. The central bank also imposed higher disclosure requirements and tighter requirements for granting bank licences, including the approval of new foreign banks.

In **Singapore,** the Monetary Authority of Singapore (MAS) implemented a series of reforms to further develop Singapore as a financial centre. The reforms covered treasury and fund management; equity markets; general debt issuance; corporate finance and venture capital; insurance and re-insurance; and cross-border electronic banking. In April 1998, the MAS created the Financial Sector Promotion Department to promote new financial activities, develop information technology (IT) infrastructure, manpower resources and new incentives for the financial sector. In the banking sector, prudential regulations were strengthened further and greater foreign competition was allowed. In the insurance industry, efforts were made to create niches in captive insurance, reinsurance and marine insurance. Measures to develop Singapore's stock exchange included the deregulation of commission rates, widening of the product range and opening up to more foreign stockbroker participation. Measures were also taken to develop the bond market which included allowing foreign entities to issue Singapore dollar-denominated bonds in Singapore. During the year, Singapore also announced several measures to improve its competitiveness by reducing the overall cost of doing business in Singapore.

In the closing months of 1998, the crisis countries began to show signs of improvement, with the appreciation and increased stability in their currencies and upturn in the stock markets. Most regional currencies appreciated against the United States dollar, above levels recorded at end-1997. The Korean won and the Thai baht in particular had gained around 27-41% of their

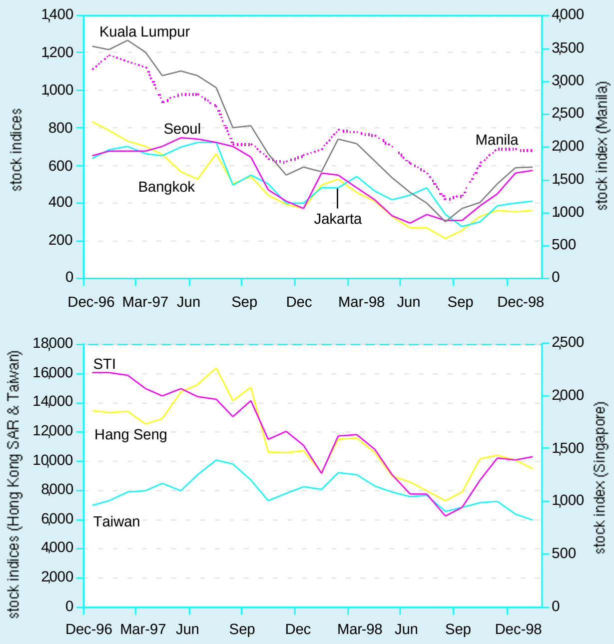
Graph IV.3
Exchange Rate Movements in the Regional Countries



value. At end-1998, the stock indices in the Philippines, Singapore, Thailand and Korea had risen by 63-81% from the lows at the end of August, while in Indonesia, the stock index had recovered by 44% against end-September 1998 level. Among the regional countries, the stock indices in Korea and the Philippines were higher at end-1998 compared with the levels at end-1997. Following the spread of the crisis and the turmoil in the global financial markets to other continents, investors appeared to have reassessed and repriced their risks of the East Asian region as being a relatively more attractive market. Nevertheless, it is too early to conclude that FDI and portfolio flows have returned to the region. Much of the inflows to date reflected essentially foreign loans and multilateral support as well as equity purchases associated with the restructuring of the corporate and banking sectors.

Although investor sentiment remains cautious, other encouraging developments have paved the way for more supportive domestic policies. Interest rates have declined across the region, especially in Hong Kong SAR, Korea, Singapore, Taiwan and Thailand, where rates have declined to pre-crisis levels. Inflationary pressures have also shown signs of receding in the crisis countries and industrial production has improved, notably in Korea, Thailand and the Philippines. The improvements in the real sector appear to indicate early signs of bottoming in several of the regional countries. The renewed optimism in the region was also reflected by the upward revision in the sovereign rating of selected regional countries, namely Korea and the Philippines in January 1999, the first upgrade in the region since the onset of the crisis. In addition, The People's Republic of China and the Philippines have successfully launched sovereign bonds worth US$1 billion and US$1.2 billion respectively in early 1999. At the same time, private and state companies in Korea, Singapore and Thailand have also recently issued bonds in the global market. At this stage, it may be premature to pre-empt a recovery based on these positive advances given that the affected countries are still subject to external uncertainties. Nevertheless, barring any major risks, the recent favourable developments in the real sector and increased financial stability would provide the foundation for a sustainable recovery in the region.

Graph IV.4
Stock Market Performance of the Regional Countries



and 2.6%). Despite the anticipated improved output performance in Hong Kong SAR, the downward price pressure is attributable mainly to continued cautious consumer spending due to weak labour market conditions, wage cuts and a fall in property and asset prices. In Singapore, the introduction of cost-cutting measures, including the reduction in utility, communications and land transport charges, are expected to contain price pressures in the economy. Following a year of deflation, retail prices in The People's Republic of China are expected to increase by 2% (1998: –2.6%), due to higher food prices following reforms in the grain distribution system and adverse weather conditions which are expected to affect crop yields. In addition, higher expenditure on household furnishing items, following reforms initiated by the authorities to abolish welfare housing and encourage residential construction, are also expected to contribute to rising price pressures and to offset the effects of weak consumer demand and inventory overhang. Similarly, the consumer price index, which is a broader measure of inflation in The People's Republic of China, is expected to increase by 4% in 1999 (1998: +0.4%).

In the **ASEAN** countries as a group, inflation is expected to moderate significantly to 7.1–9.3% in 1999 (1998: 34.2%), reflecting a strengthening in the ASEAN currencies and stable food and farm prices following better performance in the agriculture sector, particularly in Thailand, Indonesia and the Philippines. In Thailand and Indonesia, inflation is expected to moderate significantly to the region of 3% and 12–17% respectively in 1999 (1998: 8.1% and 77.6% respectively). The continuation of subsidies on essential products such as gasoline, kerosene and diesel fuel would also mitigate price pressures in Indonesia. In the Philippines, inflation is expected to ease slightly to 8–9% in 1999 (1998: 9.7%).

On the **external front**, except for Taiwan, current account surpluses in the regional economies are expected to narrow, largely due to a pick-up in imports in tandem with the recovery in domestic economic activity. Export performance of Korea, Thailand and the Philippines are expected to improve in 1999 due to higher exports of agriculture and high-technology products such as semiconductors and telecommunications products. Taiwan's current account position is expected to improve further in 1999, due mainly to an improvement in the trade account reflecting a recovery in demand from the Asian economies, which accounts for about 40% of Taiwan's total exports. Taiwan's export growth is expected to increase by 2% (1998: –9.3%), attributable to rising orders for semiconductors as well as information and telecommunications products. In The People's Republic of China, the current account balance is expected to remain in surplus, albeit at a lower level than in 1998, reflecting greater competition from the regional countries.

There are, however, a number of **downside risks** that could affect the recovery prospects of the regional economies. In particular, real output growth in the East Asian countries could be slower than projected in the event of a weak export recovery, arising from slower economic activity in the United States, a loss of momentum in the European recovery and continued weakness in the Japanese economy. Other downside risks include a further deterioration in global financial conditions, the deceleration of equity and other private capital flows to the region and a less-favourable-than-expected outlook for the global electronics industry. Rising unemployment and a deterioration in labour market conditions with the attendant adverse social and economic implications could also dampen the prospects for economic recovery.

Nevertheless, following the encouraging progress on financial sector reforms and corporate restructuring, the restoration of financial stability in the regional countries is expected to support the economic recovery process. The stable and more favourable financial market conditions would continue to allow the authorities to pursue accommodative macroeconomic policies including fiscal expansion and lowering of interest rates to revive domestic demand. The emergence of stronger and healthier banks following the restructuring exercises would enhance the intermediation process of financial institutions in supporting economic activity. At the same time, the stability of the financial markets in the region would encourage the resumption of private capital inflow to the region to complement multilateral and bilateral financing initiatives. Barring any major risks, the recent favourable developments in the real sector and increased financial stability would provide the foundation for a sustainable recovery in the region.

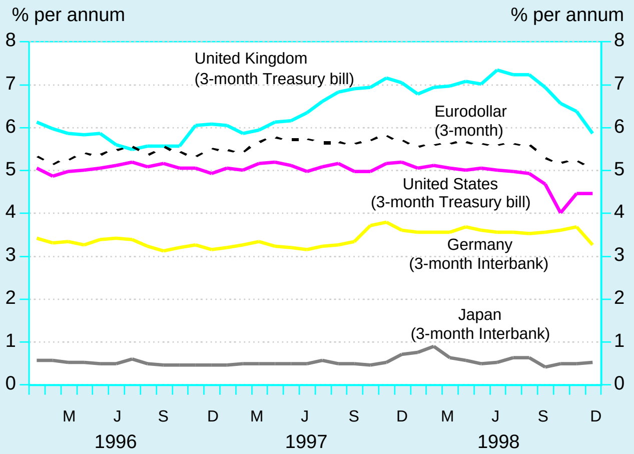
Interest Rates and Exchange Rates

Monetary policy in the major industrial countries was biased towards easing in the second half of 1998 after the Russian debt default and the near-collapse of a major hedge fund in the United States in September. These moves have contributed to preventing significant dislocations in the global financial markets that could precipitate a slowdown in the growth of the industrial countries. Both the United States' Federal Reserve Board and the Bank of England reduced their key interest rates thrice successively, while the euro-11 central banks jointly reduced their interest rates in early December. In the first two months of 1999, monetary policy remained unchanged in the United States and the euro area, while the Bank of England reduced its base lending rate twice, by a total of 75 basis points to 5.50%. The aggressive monetary easing in the United Kingdom was in response to increasing evidence of slowdown in the economy amidst moderating inflationary pressures. Meanwhile, the Bank of Japan reduced its overnight rate from 0.25% to 0.15% on 12 February 1999 and subsequently, to 0.02% in early March. The move was aimed at preventing the economy from falling into a deflationary spiral.

During the course of 1999, monetary policy in the major industrial countries is expected to be mainly influenced by domestic considerations which include prospects on growth, inflation, as well as performance in the financial markets. In the United States, the Federal Reserve Board is likely to maintain a neutral stance in the conduct of monetary policy in the short term, against a background of subdued inflation and the unexpected strength in the domestic economy.

In Japan, monetary policy is expected to continue to be expansionary to complement the fiscal stimulus to revive the economy. Following the introduction of the euro on 1 January 1999, the European Central Bank (ECB) has assumed the responsibility for the conduct of monetary policy for the euro-11 countries. As the core countries such as Germany, France and Italy show increasing evidence of slowdown, this would increase the possibility of more accommodative policies. Similarly, in the United Kingdom, after the aggressive interest rate cuts of two percentage points since the fourth quarter of 1998, it is expected that the accommodative policy would be maintained to prevent a sharp slowdown in the economy.

Graph 3.2
Industrial Countries : Short-Term Interest Rates



In the **foreign exchange** markets, the United States dollar strengthened against all the major currencies in the first two months of 1999. The dollar appreciated by 4.8% against the Japanese yen and 3.2% against the pound sterling compared with levels at the end of 1998, and 6.1% against the euro compared with the debut rate. However, in early January, the yen appreciated strongly against the dollar by 35% to a 28-month high of US$1=¥108.74 on 11 January 1999 from the low of US$1=¥147.27 on 11 August 1998. Consequently, on 12 January 1999, the Bank of Japan intervened in the foreign exchange market to contain an overadjustment. Thereafter, the yen continued to remain relatively strong, trading in the range of US$1=¥110–116, largely influenced by technical factors, such as unwinding of dollar positions, the repatriation of profits by Japanese corporations for the financial year ending in March 1999 and rising long-term interest rates. However, with the easing in interest rates to near zero on 17 February, the yen weakened to close at US$1=¥121.50 on 24 February. The yen closed at US$1=¥117.70 on 15 March.

Against the euro, the dollar strengthened to EUR1=US$1.1025 on 26 February after its initial debut at EUR1=US$1.1747 on 4 January 1999. The weakness of the euro, which fell to an intra-day low of EUR1=US$1.0969 on 22 February, is likely to be temporary. The euro was affected by the expected interest rate cut by the ECB in the first quarter of 1999 following the release of weak economic data from the core countries, namely Germany, France and Italy. Nevertheless, market expectations are for euro to strengthen against the dollar in the latter part of 1999 due to the expected increase in the demand for euro arising from the gradual portfolio diversification into euro by global financial institutions and central banks. The sentiment on the euro is also expected to be underpinned by the large trade surplus in the euro-11 zone compared with the significant trade deficit in the United States.

Box V

Euro 1999: Implications for the Malaysian Economy

Introduction

The launch of the euro on 1 January 1999 represented an important milestone in the evolution of the international monetary system. At the regional level, the euro marked the culmination of a long process of European economic and financial integration, which began with the Treaty of Rome in 1957. On the global scene, the euro is envisaged to change the manner in which world trade, investment and financial transactions would be conducted in the future. Indeed, the euro heralds the advent of a new tri-polar world currency system, with the United States dollar and Japanese yen constituting the other two major world currencies. The implications of the euro would be far-reaching for the global economy, particularly in the case of small, open, trade-oriented economies such as Malaysia. This article provides a brief overview of aspects of the euro and highlights some of the likely implications for the Malaysian economy.

The Euro

The euro made its debut on 4 January 1999, when it was quoted at Euro 1 = US$1.1747 from the official fixing level of Euro 1 = US$1.16695. In the process, the currencies of 11 European states were irrevocably locked against the euro, signalling the coming into effect of the European Economic and Monetary Union, EMU (Table V.I). Of the 15 members of the European Union (EU) which were signatories to the Maastricht Treaty in 1991, 11 countries fulfilled the "convergence criteria" for participation in the initial phase of the EMU and euro. Britain, Denmark and Sweden had opted to be out of the EMU. The five convergence criteria were:

- Fiscal deficit of not more than 3% of GDP;
- Government debt of not more than 60% of GDP;
- Inflation within 1.5 percentage points of the 12-month average of the three best performing members;
- Long-term interest rates (10-year benchmark bond yields) within 2 percentage points above the 12-month average of the three best performing members in terms of inflation; and
- Exchange rates within the fluctuation margins provided by the European Monetary System's Exchange Rate Mechanism (ERM) for at least two years.

During the transition period from 1 January 1999 until end-2001, government debt in the 11 countries would be re-denominated into euro. Non-cash transactions such as bank accounts, bank transfers, mortgages, credit card payments, traveller's cheques and personal cheques can be conducted in euros with immediate effect. In the transition period from 1 January 1999 to

Table V.I
Conversion Rates of the Euro-11 National Currencies

Country	Conversion per euro[1]		Exchange rate per RM[2] (1 Euro=RM4.4639)	
Austria	13.7603	schillings	3.0826	schillings
Belgium	40.3399	francs	9.0370	francs
Finland	5.94573	markkaa	1.3320	markkaa
France	6.55957	francs	1.4695	francs
Germany	1.95583	marks	0.4381	marks
Ireland	0.787564	punt	0.1764	punt
Italy	1,936.27	lire	433.77	lire
Luxembourg	40.3399	francs	9.0370	francs
Netherlands	2.20371	guilders	0.4937	guilders
Portugal	200.482	escudos	44.91	escudos
Spain	166.386	pesetas	37.27	pesetas

[1] On 31 December 1998, the currencies of the 11 euro members were fixed irrevocably against the euro during the transitional period of 1999-2001.
[2] Exchange rates of euro-11 national currencies against the Malaysian ringgit on 4 January 1999.

Source: European Central Bank

31 December 2001, the rule of “no compulsion, no prohibition” applies and national currencies continue to exist while euro will be used in all electronic transactions. By 30 June 2002, euro notes and coins will replace the national notes and coins in the euro-11 zone. The European Central Bank (ECB) was established in June 1998 to assume responsibility for monetary policy in the euro-11 zone. The ECB is the sole issuer of the euro. Its main objective is to maintain price stability. It will, however, not function as a “lender of last resort” and is prohibited from supporting any EMU country through debt purchases.

Impact of Euro on World Economy

As a global currency, the euro will be a viable alternative to the United States dollar as the world’s premier financial asset. The euro represents the euro-11 economies, with a combined GDP of US$6.3 trillion of the euro-11 countries (United States GDP: US$8.1 trillion) while euro-11’s share of international trade is 19% (United States: 18%). The euro would also be backed by the world’s largest pool of external reserves. The combined foreign exchange reserves (excluding gold) of the euro-11 countries amount to US$266 billion, while the reserves of the United States is US$84 billion, Japan (US$203 billion) and The People’s Republic of China (US$145 billion). The impact of the euro on the world economy is expected to be significant. The euro would be expected to play an increasingly important role in the international monetary system as a reserve currency as well as a currency of settlement for international trade and investment.

Table V.2
Key Economic and Financial Indicators of Major Industrial Countries

	Euro-11	United States	Japan
Population (in million)	290	268	126
1997			
GDP level (in US$ trillion)	6.3	8.1	4.2
GDP growth (%)	2.5	3.9	1.4
Fiscal balance (as % of GDP)	–2.5*	0.2	–3.5
Current account (in US$ billion)	112	–155	94
1998			
Inflation (%)	1.3	1.6	0.7
Unemployment (%)	11.6	4.5	4.2
Interest rate at end-year (%)	3.0	4.75	0.25
Financial data			
Share in world bond index (%)	33	34	18
Share in world foreign exchange reserves (%)	21	64	8
Share in world exports (%)	34	48	5
Total financial assets (in US$ trillion)	21	23	16
Bank assets (in US$ trillion)	12	5	7

* Refers to General Government Financial Balance.

Source: IMF, World Economic Outlook, December 1998
OECD Economic Outlook, December 1998
Eurostat, European Commission, 1998

Over the medium term, the euro is envisaged to become a strong and attractive reserve currency as well as a viable alternative international currency of settlement for trade and investment transactions. This view is based on the following factors:

- **External positions**. The euro-11 zone is expected to sustain large current account surpluses of about US$103 billion in 1998 and 1999, while the United States could incur larger deficits of US$231 billion in 1998 and US$288 billion in 1999.

- **Shift in reserve composition**. There is likely to be some diversification of reserves from United States dollars to euro by the central banks worldwide.

- **Shift in private investors’ portfolio**. Some adjustment in global portfolio holdings of private institutions in favour of the euro is also expected as they are currently relatively underweight in euro. At the same time, the euro countries have deep and liquid bond markets, equivalent to about one-third of the world’s market capitalisation.

Notwithstanding the favourable medium-term outlook for the euro, however, its prospects in the immediate term may be confronted by a number of uncertainties. In view of this, financial markets could adopt a cautious approach to the euro in the near term. These uncertainties include:

- **Challenges facing the ECB**. The ECB would need to build its credibility and track record over time. It needs to address issues such as market perceptions on transparency and accountability, and the absence of a 'lender of last resort' facility.

- **Risk of deflation**. Financial markets are also concerned that the ECB might adopt a highly anti-inflationary stance. This would cause the euro to exert considerable pressure on corporate sector profit margins and performance. In December 1998, the euro-zone inflation was at 0.8%.

- **Differences between policy makers**. Another potential source of market uncertainty was the plausible policy differences between the ECB's monetary policy (on euro and price stability) and the national governments' fiscal and structural policies (on sustaining growth and employment). In the post-EMU period, the euro-11 central banks' excess reserves (estimated at US$50 - 100 billion) have become the centre of political debate as a possible source to finance economic growth and job creation. This move has been resisted by the central bankers in order to maintain stability.

- **Possible asymmetric shocks**. The shocks may arise from a common monetary policy, that will affect the euro-11 countries which have different economic structures and production bases. There is also no fiscal federalism to distribute resources across the euro-11 to stabilise the possible shocks. Empirical studies indicated that the effects of changes in monetary policy would be unevenly distributed across the euro-11 members.

Impact of Euro on Malaysia

Overall, the euro is expected to have a positive effect on emerging economies, including Malaysia, as the single currency and integrated market in Europe would facilitate trade business and financial transactions with the euro-11 countries. The impact of the euro on the Malaysian economy would be felt in both the real economy and the financial sector.

On the **real side**, the impact would be on trade and investment. With respect to **trade**, the euro is likely to have a positive effect. The euro would allow for greater efficiency and reduce the turnaround time for Malaysian exports to the euro-11 countries, as trade would be based on a standardised system. It is envisaged that the use of the euro would simplify and enhance Malaysia's trade relations with the euro-11 countries. The use of the euro for trade settlement with the euro-11 countries would result in cost savings in terms of transparent pricing in euro-11. Malaysian traders would also benefit from lower transaction costs as they would no longer need to hold several currencies. In the medium- and long-run, the euro is expected to be positive for economic growth in the euro-11 zone. The resulting lower transaction and hedging cost is estimated at 0.5% of EU's GDP or US$40 billion a year. The rise in charges for euro settlement is expected to be temporary due to technical problems associated with the new TARGET system in coping with the unexpected high volume of transactions.

The use of the euro would also benefit Malaysia in terms of alleviating the current mismatch between the pattern of trade and the choice of currency used in trade settlement. Although the United States accounts for only 20.8% of Malaysia's total trade in 1998, more than 70% of Malaysia's trade transactions are settled in United States dollars. The launch of the euro offers scope to reduce this imbalance, by providing an alternative to the use of the United States dollar in Malaysia's trade settlement. Currently, Malaysia's trade with the euro-11 countries accounted for 10.6% of total trade in 1998. Asia (excluding Japan) represented 40.3% of Malaysia's total trade. It would, therefore, be in Malaysia's interest to diversify its use of currencies in trade settlement.

At the micro level, the euro would have implications for Malaysian companies in dealing with the euro-11 countries. Malaysian firms would, for example, need to modify their accounting and administrative practices to incorporate the use of the euro. With the standardisation and transparency across the euro-11, Malaysian exporters would no longer be able to depend on a strategy of price

Table V.3
Economic Links Between Malaysia and Euro-11 Countries

	1992	1998
	% share	
Total trade with euro-11	10.0	10.6
Gross FDI to euro-11[1]	2.0	7.2
Gross FDI from euro-11[1]	4.7	8.2
Outstanding external debt with euro-11	5.4	4.3
Settlement of trade with euro-11 currencies	3.9	3.4
Euro-11 banks in Malaysia (number)	2	2

[1] Refers to equity and loans, excluding retained earnings.

Source: Department of Statistics, Bank Negara Malaysia
Accountant General's Office of Malaysia

differentiation. As the euro increases the level of price transparency across the euro-11 countries (where in the past, prices varied by 23% on average), Malaysian companies would find the price differentiation strategy redundant. Malaysian companies can expect greater price competition in the zone.

While it is envisaged that the euro would have a positive effect on trade and generate higher economic activity in Europe, it could expose the disparities between the more competitive and the less competitive countries in euro-11. In the event that this occurs, it would result in a resource transfer from one country to another, leading to structural problems such as higher unemployment in the weaker countries. In such a scenario, protectionist pressures could increase in the euro trading bloc.

With the elimination of uncertainty over exchange rate risks following the launch of the euro, cross-border **investment** within the euro-11 zone is expected to pick up rapidly. Lower foreign exchange risk could encourage investment within the euro countries from higher cost to lower cost members. As the industrial and corporate concentration increases through mergers and acquisitions, opportunities outside the region will encourage the euro-based companies to invest outside the euro-11 zone, including Asian markets. Conversely, Malaysia's investment strategy in the diversified European region will become simpler, less costly and less time-consuming. Malaysia needs to continue to accelerate structural changes to attract European investment.

On the **financial side**, the impact of the euro on Malaysia is mainly in the area of foreign exchange and bond market operations. In terms of central bank **reserve management**, existing holdings of euro member countries' papers are automatically denominated in the euro. It can be expected that some further diversification would take place from existing reserve currencies into the euro, as the euro gains prominence in international finance and trade. Countries with close trade ties to euro-11 would be expected to convert a larger portion of their reserves portfolio to euro. Amongst Asian central banks, Hong Kong Special Administrative Region (SAR), The People's Republic of China; Taiwan; The People's Republic of China; Thailand; and Singapore have indicated plans to increase their reserves denominated in euro. In the case of Malaysia, the automatic conversion of papers issued by the euro-11 countries into euro has resulted in the euro forming part of Malaysia's reserves. However, increased diversification of the reserve portfolio is expected to be gradual, with most countries monitoring market developments closely before undertaking any major shift in the currency composition of their reserves. Larger shifts are only expected in the medium to longer term, as the euro establishes itself as a credible global reserve currency.

On the choice of **exchange rate arrangements**, the proportion of countries which pegged their exchange rate to the United States dollar has declined from 50% in 1975 to 33% in 1996. The debut of the euro could increase the number of countries with an euro peg, in particular, in Eastern Europe, North and West Africa. Generally, the gradual shift from the unipolar system (based on the United States dollar) to a bipolar system (based on the United States dollar and the euro) could ensure greater stability in international foreign exchange markets. Recently, Japan had proposed a tri-polar world exchange rate system based on the United States dollar, the euro and the Japanese yen. Malaysia would give due cognisance to the role of the euro in determining the appropriate exchange rate arrangement for the country in the future.

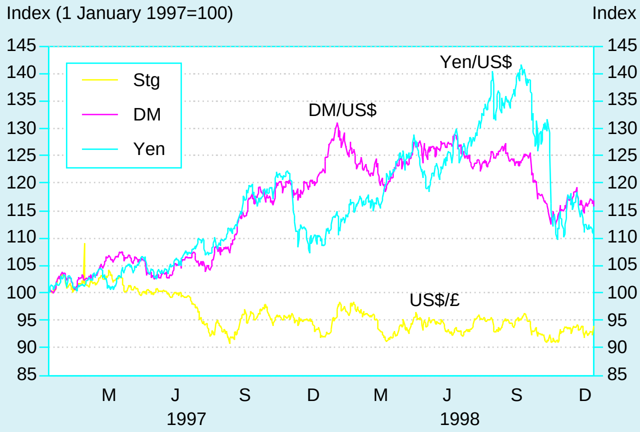
On the outlook for the **currency** and **bond** markets, the euro is expected to create deeper and more liquid markets, offering much broader investment and financing opportunities than the existing domestic markets. The development of the euro-denominated bond market would allow the other governments and corporates to diversify their funding away from over-reliance on the United States dollar or Japanese yen markets. The euro market could become an attractive source of funding for Malaysian corporations.

In the currency markets, a healthy arbitrage between the Eurolibor (based in London) and Euribor (based in Frankfurt) has improved financing opportunities. In considering the option, however, Malaysia would need to weigh all the options and risks before contemplating a similar move to tap the euro markets. Over time, the launch of euro would lead to greater financial innovations and new products in the financial market. Malaysian financial institutions could participate in this process, for example, by offering euro deposits. In the long run, the euro would enhance competition, with positive spillover effects for the rest of the world, including Malaysia.

Conclusion

The euro marks an historic milestone for both European economic and financial integration and the international monetary system. It is envisaged that the shift from a dollar hegemony to a bipolar monetary system will contribute to greater exchange rate stability. However, this will be dependent on the United States and Europe as economic powers exercising their joint responsibility in the smooth functioning of the international financial system. The development of the euro as a credible world reserve currency will allow for greater diversification and thereby reduce the risks associated with over-dependence on the use of any particular currency in international trade and finance. To the extent that the benefits of euro in terms of fostering greater efficiency and growth in the euro-11 countries are realised, there would be positive spillover effects on the global economy, particularly for trade-oriented countries such as Malaysia. The advent of the euro has also spurred discussion on the merits and prerequisites for the creation of a common currency in the ASEAN and Asian region. In this connection, the development of the euro over the next few years will provide important lessons for ASEAN and Asian countries as these economies strive to promote greater regional economic and financial co-operation in the region.

Graph 3.3
Movement of the US Dollar against Major Currencies



Meanwhile, the pound sterling moved in a range of £1=US$1.60-66 during the first two months of 1999 and market expectation is for continued weakness against the dollar in 1999. The sterling fell to a 16-month low, below £1=US$1.60 on 24 February 1999 following the positive indications by the authorities on joining the European Monetary Union. For the remaining part of the year, movements of the major currencies are likely to be affected by the expected slower economic performance in the major industrial economies, movements in interest rate differentials, market adjustments and financial market developments.

Malaysian Economy in 1999

The Malaysian economy is expected to stage a recovery in 1999 with real GDP recording a positive growth of 1%. Export growth has shown a recovery since October 1998 and going into the first quarter of 1999. However, given that its prospects remain uncertain, the main source of growth for the Malaysian economy will emanate mainly from domestic demand, supported by the fiscal stimulus.

Since the fourth quarter of 1998, the outlook for the Malaysian economy has turned positive with indicators showing signs of a revival in consumer and investor sentiment. These signs of economic recovery are likely to continue in line with the improved outlook for the region. Important pre-conditions to ensure sustainability of the economic recovery are already in place. Growth is expected to be mainly domestic-driven despite the recent favourable performance of the Malaysian trade sector. Fiscal policy will lead economic growth through the fiscal stimulus package, while monetary policy will remain accommodative to encourage bank lending to support the growth process. The restructuring of the banking institutions has also progressed at a faster rate than earlier envisaged. This augurs well towards allowing banks to focus on their intermediation function. Meanwhile, the progress in the recapitalisation of banks and corporate debt restructuring will reinforce this process. To date, loan approvals by the banking system have already increased considerably and efforts at addressing the risks in the economy are being accelerated. These include issues relating to improving transparency in policy formulation and issues concerning good governance. The fixing of the ringgit against the United States dollar and the selective exchange controls have provided a stable environment to facilitate sound business decisions. The balance of payments is expected to remain favourable. The large current account surplus provides adequate margins to promote growth without resulting in imbalances in the external sector. On the domestic front, inflation has moderated further in an environment of excess capacity and is likely to remain subdued.

These are important conditions that provide a strong foundation for recovery in 1999. Consistent sound macroeconomic policies during the course of 1999 will ensure that the recovery will be sustained and economic growth will gather momentum in line with potential output, in the medium term. Economic recovery in 1999 is expected to be gradual in view of the high inventory build-up in the first half of 1998, and the increase in capacity in many industries resulting from several years of expansion. Growth will likely be marginal in the first half-year, allowing the economy to consolidate. Restructuring of the financial and corporate sectors will intensify in the second and third quarters of 1999. This would create more favourable conditions for stronger growth in the second half-year.

There is a possibility that GDP growth could be higher than projected in 1999 should the prospects for the international environment improve or the private sector respond more favourably to the policy measures. In addition, the tourism industry has much potential that remains untapped. As the infrastructure in the tourism sector is already in place, the prospects are positive for promoting a significant increase in tourist arrivals, without any significant additional cost. Barring any adverse external developments, the prospect of a higher real GDP growth, closer to 2%, is possible in 1999 in view of the Government's commitment to accelerate work on a comprehensive restructuring programme for the banking and corporate sectors as well as measures to increase utilisation of excess capacity in the economy.

The forecast hinges on three important factors, namely, the international economic outlook, the timely implementation of the fiscal stimulus package and the private sector response to this package. On the international front, the potential downside risks would be a sharper-than-expected moderation of growth in the industrial countries and a delayed recovery of regional economies, including Japan. These developments could affect the projection for manufactured exports and output in the export-oriented industries for 1999. In particular, a lower growth for the regional and international economies could impact export demand for electronics, rubber and metal products. A deterioration in the external environment could develop in the event of a major correction in the stock market in the United States and further volatility in the financial markets. Secondly, the growth hinges on the recovery of private consumer spending and a moderate increase in private investment activity. A recovery in consumption is expected with the easing of inflationary pressures and improved liquidity as well as lower interest rates in response to the easing of monetary policy. Growth in 1999 also hinges on the expansion in public sector expenditure. The Government would need to press ahead with its planned spending and investment programmes to ensure orderly and timely implementation of projects in the pipeline.

On a sectoral basis, growth in real output in 1999 is expected to reflect positive growth in output in the manufacturing, services and agriculture sectors. The decline in the construction sector is expected to moderate, while production in the mining sector is projected to contract.

In the **manufacturing sector**, output is projected to turn around to register an increase of 0.8% in 1999. In view of the gradual recovery in external demand, output in the export-oriented industries is expected to turn around to record a marginal increase of 0.1%. Consequently, the main impetus to growth in the manufacturing sector would emanate from the stronger expansion of 1.3% in output of the domestic-oriented industries. Chemicals, rubber products, food and beverages and transport industries are expected to benefit from the expansion in domestic demand. An increase of 9% is projected for the rubber products industry, supported by strong external demand for rubber gloves. With the strengthening of demand for passenger cars, output in the transport equipment industry, particularly the production of the national cars, is expected to recover to register a positive growth in 1999. In the export-oriented industries, weak demand for electrical products, wood and wood products, and textiles and wearing apparel industries is expected to be more than compensated by the recovery in output of the electronics and off-estate processing sectors. In the electronics sub-sector, the favourable developments include the expected cutback in production of memory chips by Korean manufacturers (production of the top three Korean producers account for about 40% of world DRAM chip production) as well as the postponement of capacity expansion programmes worldwide. The projected recovery of the sector is also supported by signs of strengthening global demand for semiconductors, which was evident in the fourth quarter of 1998. In particular, the problems caused by the millennium bug (Y2K) on older computer systems are expected to boost demand for computer replacements from both the corporate and home markets.

Growth in the **agriculture sector** is expected to turn around to increase by 5% from a decline of 4% in 1998 due mainly to higher output of crude palm oil. After undergoing a downturn in the biological yield cycle, crude palm oil production is expected to increase by 7% to 8.9 million tonnes, due mainly to higher yields. Meanwhile, saw log output is projected to decline by 1% to 22.5 million cubic metres in line with the Government’s conservation policy and commitment to sustainable forest management by the year 2000.

In the **mining sector**, higher production of gas and tin is expected to be more than offset by lower production of crude oil. Given the global oversupply of crude oil and continuing weak demand, the existing plans are for the reduction in crude oil production to 713,000 barrels per day, a decline of 1.8% from the 1998 level. Gas production, on the other hand, is expected to increase by 8% in response to higher domestic demand as well as some pick-up in external demand in the second half of the year. Tin production is also expected to increase further by 24.8% with more mines re-opened in response to favourable tin prices.

The **construction sector** will continue to experience a further consolidation of activities in 1999. Nevertheless, the decline in output is projected to moderate to 8%. The construction of residential units, especially low- and medium-cost units is expected to intensify following an increase in housing approvals as well as public sector expenditure under the fiscal stimulus programme. The civil engineering sub-sector stands to benefit from the Budget allocation for infrastructure projects and the revival of selected deferred projects to be funded by the fund for infrastructure development. A higher level of residential construction activities (4.3%) and the implementation of several civil engineering projects (7.1%) would offset, to some extent, the continued significant decline in the construction of commercial buildings, mainly office and retail space (–54.8%).

Activity in the **services sector** is expected to increase in 1999 in line with the expansion of the leading sectors in the economy. Overall, the services sector is projected to grow by 2.5% (1.5% in 1998). The pick-up in activity in the manufacturing sector is expected to strengthen the demand for intermediate services. Within this category, the finance sector is expected to perform better as banking institutions refocus on lending activity, following the accelerated implementation of the restructuring exercise in the financial sector. Similarly, the performance of the transport and distributive trade sector; and electricity, gas and water sub-sector is estimated to improve in line with the expected pick-up in both domestic and export-oriented industries. After contracting by 2% in 1998, output in the wholesale and retail trade, hotels and restaurants sector is expected to register a positive growth, benefiting from the anticipated recovery in consumer spending as well as the efforts to promote tourism in 1999.

Real aggregate **domestic demand** is projected to turn around to record an increase of 4.3% in 1999, reflecting mainly the positive response to the measures undertaken by the Government to stimulate domestic economic activities. **Public sector expenditure** is expected to turn around to register a growth of 11.4% (–6.6% in 1998) with the pick-up in momentum in the implementation of the Government's fiscal stimulus package. **Public consumption** is estimated to increase by 10.1% mainly on account of higher expenditure on supplies and services and defence expenditure by the Federal Government. **Public investment** is expected to increase at a faster rate of 12.8% attributable to higher allocation for socio-economic projects, including the construction of roads, bridges, upgrading of rural amenities, agriculture, health and education. Investment expenditure by the non-financial public enterprises (NFPEs) is expected to increase in 1999 due to some pick-up in momentum in the implementation of some of the projects that were deferred in 1997-98 due to the economic downturn.

Private sector expenditure is expected to register a small increase of 1.1% in real terms (–32.2% in 1998), with both private investment and consumption recording positive growth rates. The consolidation in the corporate sector will strengthen the foundation for increased private investment activity. Private investment activity is expected to increase by 0.9%, supported by the implementation of infrastructure projects. Although applications received by the Ministry of International Trade and Industry (MITI) for investment in the manufacturing sector in 1998 were lower, quarterly data showed a noticeable increase in the fourth quarter of 1998. With the revival in consumer confidence, **private consumption** is projected to increase by 1.1% in 1999. Consumption spending is expected to increase following the Government's stimulus package, tax exemption for income earned in 1999 and lower cost of borrowings.

The **Federal Government** is projected to record a higher fiscal deficit in 1999, with continued lower revenue performance and fiscal stimulus to spearhead economic recovery. However, the policy of fiscal prudence and discipline will continue to be maintained to ensure that the revenue will be sufficient to meet the operating expenditure. The fiscal deficit is estimated at RM16.1 billion or –6% of GNP, unchanged from the position announced in October 1998. The consolidated public sector financial position is also expected to record a larger overall deficit of RM14.9 billion or –5.5% of GNP.

The recovery projected for 1999 is not expected to cause a significant decline in the **current account surplus of the balance of payments**, for several reasons. Excess capacity would ensure growth is achieved with less need for capital imports. Similarly, the large investments on infrastructure during the past years would facilitate economic activity, so that new growth is supported by higher productivity based on more efficient use of capital. Finally, the fiscal stimulus package is targeted at economic activities where import content is low, inter- and intra-sectoral linkages are strong and market potential is high. In particular, expenditures targeted at low-cost housing, rural roads, basic infrastructure and education all have very low import intensity.

Within this policy framework, the current account surplus of the **balance of payments** is expected to remain significant at RM29.5 billion or 11% of GNP. The moderate decline in the current account surplus reflects lower surplus projected in the merchandise account (RM57.1 billion), while the services account deficit is forecast to improve to RM21 billion (1998: RM23.4 billion). The surplus in the merchandise account is expected to narrow marginally due mainly to expectations of moderate expansion in imports, in tandem with economic recovery. The improvement in the services account is mainly due to the expected surplus in the travel account, on the basis of an expected recovery in the ASEAN region and aggressive campaigns to increase tourist arrivals. The long-term capital account is forecast to strengthen with a net inflow of RM15.2 billion, reflecting higher inflow of both official and private long-term capital.

Manufactured exports valued in United States dollars are expected to increase by 2.3% in 1999. However, in terms of the ringgit, the value of exports would decline by 0.6% as a result of valuation loss arising from the fixing of the ringgit against the United States dollar. Following the fixing of the ringgit against the United States dollar at US$1=RM3.80 on 2 September 1998, the ringgit would record an appreciation of 3.2% compared with the average exchange rate of RM3.92 for 1998 as a whole. The higher export earnings valued in United States dollars reflect expectations of increased exports of electronic goods, rubber products, metal products, transport equipment, optical and scientific equipment and beverages and tobacco. The projected gradual recovery of demand from the Asia-Pacific region would lend support to the already improved external demand for electronic goods, particularly the disk-drive sub-sector and semiconductors. However, the external demand for electrical goods is not expected to recover significantly given the developments in the region. Nevertheless, the competitiveness of Malaysian exporters could improve due to the more competitive REER for the Malaysian ringgit. Overall, while export volumes are expected to increase, there are concerns of downward pressure on export prices in United States dollar terms (–3.3%).

Commodity prices are expected to remain generally weak in 1999. The overall commodity export unit value is projected to decline by 11.9%. The export unit value for minerals are expected to decline further by 16.2% (–2.7% in 1998), primarily on account of continuing declines in the prices of crude oil and LNG. Malaysia's crude oil prices are expected to decline to US$12.00 per barrel, in the face of high global inventories of crude oil amidst weak demand. Similarly, prices for the agricultural commodities are expected to decline by 9.7% (1998: +46.3%), but would remain significantly higher than the levels recorded in 1997. Palm oil prices are expected to decline given an expected increase in the supplies of palm oil arising from higher production of crude palm oil during the year. In addition, more intense competition from other vegetable oils particularly soya oil, is expected to add pressure on palm oil prices. In the case of saw logs, prices are expected to decline further as external demand is projected to remain subdued, while the lifting of the ban on log exports from Indonesia would exert some pressure on Malaysian log prices. Prices of sawn timber and rubber are also projected to trend downwards due to gradual recovery in external demand. Total export earnings of the commodity sector is projected to decline by 12.2% to RM39.6 billion arising mainly from the expected decline in prices.

Gross imports are expected to increase in 1999 with a volume growth of 5% (–20.5% in 1998). In United States dollar terms, imports are projected to rise by 6% as imports of intermediate goods are expected to rise by 11.6% with the expected recovery in the manufacturing sector. Imports of capital goods are expected to continue to decline by 17.4% as private investment is forecast to recover gradually. Similarly, public investment is not expected to contribute significantly to import growth, as the projects being earmarked by the Government are those with a low import content. Imports of consumption goods are expected to remain low, expanding by just 6.2% given the exchange rate factor.

The total **external debt** outstanding is expected to increase moderately by 4.2% to RM166.4 billion. This forecast is based on the assumption that the short-term debt level would remain unchanged at end-1998 level. The moderate increase in medium- and long-term debt is due mainly to the net drawdown of loans by the Federal Government from multilateral and bilateral sources to finance the recovery and financial restructuring programme. Nevertheless, Malaysia would remain a moderately-indebted country, with the ratio of total external debt to GNP stabilising at 62%. Meanwhile, the debt service ratio is expected to decline slightly to 6.5% due to lower principal repayments and interest payments in ringgit terms.

Inflation is projected to be contained below 4% in 1999 (5.3% in 1998). The absence of inflationary pressures from abroad due to a moderate appreciation of the ringgit and low inflation in the industrial countries and lower commodity prices, particularly low oil prices, would help to contain domestic price pressures. Although several measures have been put in place to ensure revival of the economy, the expected recovery in domestic demand and more accommodative monetary policy are not expected to lead to an output gap.

The recovery in the economy in 1999 is expected to generate increased **employment** opportunities in all the major sectors of the economy. However, in view of the higher entrants into the domestic labour market, the unemployment rate is expected to increase above the full employment level. The pressure for wage increases is also expected to remain moderate as adjustments in the labour market continue in 1999.

The year 1999 would be another challenging year to Bank Negara Malaysia and the Malaysian Government in terms of **macroeconomic management**. The impact of the less conventional approach to economic management adopted in 1998 will be felt in 1999. Policy measures will remain dynamic and implemented with flexibility, continuing to evolve to adjust to changing circumstances in domestic and external conditions. However, the basic objective will remain unchanged. Malaysia will aim to target for growth with price stability. While it is crucial to achieve economic recovery in 1999 in order to preserve the standard of living and the quality of life attained during the past decade, such recovery would not be at all costs and at the expense of overall fundamental macroeconomic stability.

The broad thrust of policy in 1999, therefore, will be directed at re-engineering the growth strategies for the immediate and long term, while addressing the vulnerabilities in the economy. This strategy would provide the basis for greater expansion in economic activities that are consistent with the changing environment of world trade and global financial markets. It is also important to ensure that policies to revive growth in the short term do not create new risks. The growth promoting strategy, therefore, contains several “safeguard” elements to ensure that the medium-term prospects remain favourable for the Malaysian economy. In particular, policy measures have been designed to ensure a balanced macroeconomic policy mix to create a conducive environment to stimulate investment and consumption while maintaining stability in the financial markets. Central to the counter-cyclical policy is the need to promote consumption. The average propensity to consume has declined in Malaysia from more than 50% prior to 1996 to 43.6% in 1998, lower than the level recorded during the recession in the mid-1980s. Given the build-up in inventory and excess capacity, promotion of consumption is necessary before investments can pick up. At the same time, Malaysia recognises the need for a large reserves cushion as a key element against unforeseen destabilising developments, to sustain market confidence and enhance credit worthiness. The Asian crisis has shown that high reserves level provide added strength to weather instabilities due to market failure.

The Government has already embarked on a fiscal stimulus programme as early as March 1998 to stimulate domestic demand as the main engine of growth. This strategy of domestic-driven growth would continue in 1999. In this regard, the Federal Government would manage the level of expenditure by taking into consideration the need to revive growth, maintain a balanced position in the current account of the Federal Government, avoid excessive reliance on external financing and avoid crowding out the private sector in terms of access to loanable funds. Therefore, for 1999, only projects and programmes of high priority in terms of revitalising economic growth and improving the efficiency of the economy are given the necessary expenditure allocations. This is to ensure that expenditure is contained at a level in line with available resources and ensure that every ringgit spent will generate the highest increase in value-added activities without the need for excessive recurrent expenditure. The bulk of the development expenditure is allocated for socio-economic projects and for projects that will expedite economic recovery and generate demand for domestic goods.

An important aspect of policy is to ensure positive private sector response to the fiscal stimulus. It is essential to improve performance in the real sector to match, within a reasonable time lag, the improved market sentiment in the stock markets, so that the momentum can be sustained. Sustaining the improved market confidence has, therefore, become a priority objective of policy. In particular, a return of foreign investors would create the watershed to restore confidence to the levels that prevailed during years of strong growth.

While interest rates have declined, the real rate of return to savers has remained positive, given the low inflation environment. It is recognised that in the present environment, the role of monetary policy will remain accommodative to support an expansionary fiscal stance as the risk of inflationary pressures from domestic demand is no longer a source of instability. The excess capacity in the economy and weak domestic demand would contain inflationary pressures. The fixing of the ringgit will lower inflationary expectations. A lower inflation will accord greater flexibility to lower interest rates.

Past prudent fiscal policies have accorded Malaysia greater flexibility in financing the economic recovery and restructuring of financial institutions, while keeping external debt low. In this regard, Malaysia will continue to rely on non-inflationary sources of financing. As the total requirement is not large, the bulk of the requirements can be financed through domestic savings. Malaysia's savings rate is high, at over 40% of GNP. The total financing requirement of the fiscal stimulus, the restructuring of the banking institutions and infrastructure development projects was initially estimated at RM62 billion for 1998-99. In view of the smaller fiscal deficit of RM5 billion for 1998 (–RM9.6 billion in the 1999 Budget), the total financing requirement is now estimated to be lower at RM58 billion for 1998-99. The Government will finance the fiscal deficit through the issuance of Malaysian Government Securities that will be absorbed mainly by provident, pension and insurance funds. Financing of Pengurusan Danaharta Nasional Berhad (Danaharta) is being effected through the issue of government-guaranteed bonds, while financing of bank restructuring is through Danamodal Nasional Berhad (Danamodal) issuing bonds to the banking institutions. Bonds issued by Danamodal are not guaranteed by the Government. In 1999, some increases in external financing is likely to materialise mainly from multilateral and bilateral sources. Given the favourable developments, it would be advantageous for Malaysia to re-enter the capital markets to establish a benchmark borrowing rate for Malaysia. The last market loan was raised in December 1998. Nevertheless, maintaining a low external debt level continues to remain an important policy objective.

It is recognised that the ratio of bank credit, including loans securitised by Cagamas, to GDP in Malaysia was high at 148% of GDP in 1998. However, the ratio of deposits to GDP was also high at 154.8%. The banks, therefore, have financed their lending operations from their own domestic mobilisation of savings, which is non-inflationary, primarily from deposits. If the capital of the banking system is taken into account, the total fund base (deposits and capital)/GDP, was at 172.4%, exceeding the loans/GDP ratio, indicating that banks do have the required resources to lend. As such, the high loan/GDP ratio would not induce instability. Nevertheless, the Government recognises the need to diversify the risks away from the banking system and allow investors to assume a higher share of risks. In recent years, particularly since 1996, efforts have intensified in developing the private debt securities market in an effort to diversify financing away from the banking sector. While emphasis in the immediate term will focus on strengthening the banking system to support recovery, efforts will be stepped up to develop the capital market, particularly the bond market. Currently, the Bank has embarked on a programme to develop the bond market as part of the overall plan to deepen and broaden the financial markets. Hence, the loan/GDP ratio would decline over time.

Addressing structural issues in the economy will be pursued aggressively in 1999. Much of the reform process in the financial system would be completed during the course of the year. More emphasis is being given to corporate debt restructuring and in the process, the restructuring of corporations as well, to improve efficiency. Other long-term issues on which work has begun in 1999 include addressing issues affecting competitiveness. These include strategies to lower the cost of doing business in Malaysia and improve industrial efficiencies. Economic regulation of utility services provided by privatised entities is important to ensure that the cost of operations in Malaysia is maintained at a low level, to be competitive and attract foreign direct investments. Development of human resource continues to be given priority attention, especially to meet the needs of industry for skilled

Table 3.2
Financing of the Economy

	1985	1990 (RM billion)	1998	1985	1990 (% of GDP)	1998
Domestic Debt	106.8	190.3	562.4	137.8	164.5	201.8
Private	66.0	120.3	469.4	85.2	103.9	168.4
Loans by banking system [1]	66.0	114.1	394.5	85.2	98.6	141.6
(Loans by banking system [2])	(66.0)	(116.0)	(413.6)	(85.2)	(100.2)	(148.4)
Private debt securities [3]	-	6.2	74.9	-	5.4	26.9
Public [4]	40.8	70.0	93.0	52.6	60.5	33.4
External Debt	42.5	45.9	159.8	54.8	39.7	57.3
Long-term	42.5	41.5	131.3	54.8	35.9	47.1
Private	7.2	4.9	63.1	9.3	4.3	22.6
Public	35.3	36.6	68.2	45.5	31.6	24.5
Short-term	-	4.4	28.5	-	3.8	10.2
Private	-	-	8.8	-	-	3.1
Bank	-	4.4	19.7	-	3.8	7.1
Total Debt	149.3	236.2	722.2	192.6	204.1	259.3
Total Deposits of the Banking System	73.0	120.8	431.4	94.2	104.4	154.8

[1] Exclude loans sold to Cagamas.
[2] Include loans sold to Cagamas.
[3] Refers to corporate bonds and Cagamas bonds.
[4] Refers to MGS, TB, GII, Khazanah Bond and other loans.

labour. In this regard, the amendment of the Employment Act 1955 in August 1998 to allow greater flexibility in the labour market is a step in the right direction.

Malaysia continues to adopt a pragmatic approach in economic management. The policy response has addressed the vulnerabilities of the economy that emerged through the crisis. To date, these measures have begun to yield positive results. In particular, the measures will strengthen the foundation upon which sustainable growth will be achieved over the medium and longer term.

Monetary Policy in 1999

More than one and a half years since the onset of the regional crisis, the volatility and turmoil, which engulfed the East-Asian countries is slowly receding, giving way to more stable market conditions. The economies in East Asia which were adversely affected by the crisis are expected to recover in 1999 following growth promoting policies undertaken by the authorities, some resumption of capital flows and signs of recovery in the electronics sector. In Malaysia, significant progress has been made towards restoring stability in the economy and the financial markets. The overall economic and financial policy will be directed at supporting economic recovery. The focus of monetary policy in 1999 is, therefore, to create a conducive environment that will support the nascent economic recovery while preserving price stability. In pursuit of this objective, the current stance of monetary policy will be maintained. The policy stance ensures that there are adequate funds at reasonable cost to support private sector activity. At the same time, every effort will be made to ensure that interest rates are kept competitive to promote investments in the real sector and also to provide a positive real rate of return on savings so as not to create disincentives to save. Several measures have also been implemented to ensure stability in the banking system and the smooth functioning of banks' intermediation process. BNM is committed to accelerate the process of restructuring the banking system to strengthen the capital base and structure of banking institutions so that the banking system can effectively meet the needs of the economy in the medium term.

Nevertheless, given the economic uncertainties, especially in the regional and international environment, BNM will continue to monitor the economic and monetary situation closely to respond to the risks and vulnerabilities, so as to ensure that the objective of sustainable growth with stable prices is not jeopardised. The major factors that are expected to influence monetary policy in 1999 include the outlook for inflation; ensuring attractive returns on ringgit assets; and ensuring adequate access to credit by viable activities. In responding to these factors, monetary policy, during the course of the year, will be managed with flexibility and a close watch on prospective developments in the economic and financial environment. At the same time, achieving growth with financial stability calls for a well co-ordinated and effective implementation of macroeconomic policies as well as structural adjustment measures. Fiscal, monetary, structural and prudential measures have already been put in place to revitalise the economy. Based on past experiences, the impact of monetary policy is only felt with a lag, unlike the immediate impact of fiscal measures. Hence, in the immediate term, the implementation of the wide range of fiscal measures already in place would need to be expedited to promote a revival of domestic demand.

For 1999, the external environment is not expected to provide the major stimulus to the domestic economy. The main impetus to growth will need to be generated from greater domestic activity, including investment and consumption. In the current environment, **inflation** is not expected to be a serious risk given the weak but rising domestic demand and existing excess capacity in the product and labour markets. Inflationary pressures from abroad are expected to remain relatively subdued in the absence of imported cost pressures, as world prices, including oil prices, are expected to remain weak. While the employment rate could increase in 1999, the prospect of wage-push inflation is unlikely. Nevertheless, the close monitoring of the price situation will continue. Monetary expansion in 1999 will be managed consistent with the growth in the real economy, without refuelling inflationary expectations.

In line with this objective, the current level of **interest rates** is likely to be maintained so long as there are no build-up of inflationary pressures. The prevailing level of interest rates is sufficient to support the economic recovery process, as well as to provide for an incentive to save in Malaysia. Meanwhile, the rates of domestic inflation and interest rates in most developed countries are expected to fall in 1999. These developments would provide the Bank with greater room for manoeuvre to support the economic recovery process without endangering price stability as well as stability in the domestic financial markets.

Despite the downward adjustment of lending rates from 12.27% at end-June 1998 to 8% currently, loan growth has been sluggish. The slow loan growth reflects the confidence factor and, to some extent, the high excess capacity and inventories in selected industries. At the same time, banks have continued to be cautious in view of rising NPLs and perceived economic uncertainties. The focus of monetary policy in 1999 would be to create a conducive environment that would support and encourage the growth of domestic economic activity. The challenge to the Bank is to ensure that adequate funds would be readily available to investors at reasonable cost. It is recognised that the ability of banks to lend, within prudent practices, is critical to achieve economic recovery. Hence, efforts to strengthen and restructure the banking sector that have been undertaken in 1998 will be intensified in 1999. BNM will closely monitor lending activities of the banking institutions, to ensure that there is no disruption to the intermediation process.

Efficiency in the implementation of monetary policy is crucial so that policy measures can be transmitted in the quickest manner and at least cost to the economy. In order to achieve this, there must be sound financial intermediaries, which act as an efficient transmission mechanism for monetary policy. BNM has undertaken several measures to ensure an efficient intermediation process. In this regard, a number of policy initiatives were taken to ensure the efficient management of liquidity so as to reduce cost. These included the revision of the permissible daily variation band for the statutory reserve requirement (SRR) in May; the revision in the framework for the computation of the base lending rate (BLR); the announcement of information on BNM daily operations in the money market; and the implementation of the New Liquidity Framework. The new framework has enabled individual banks to better manage their holdings of liquid assets to match the maturity profile of their liabilities. Indirectly, it will also help to promote a more market-oriented pricing of liquid assets which is necessary to develop the secondary market in securities. At the same time, the new BLR framework has allowed the faster transmission of changes in monetary policy and interest rate levels. On the part of BNM, by announcing information on its daily operations in the money market, there is greater transparency in the implementation of monetary policy. Efforts to increase efficiency will continue and be intensified in 1999 as BNM focuses on ensuring that the intermediation process functions effectively to support economic activity and the growth process. Development of the bond market will also enhance efficiency of monetary policy through increased dependence on market-oriented instruments rather than direct instruments.

Malaysia had adopted a **fixed exchange rate regime** on 2 September 1998 with the objective of creating a stable domestic environment that would be conducive for a revival of investor and consumer confidence. Given that the objective is to provide greater certainty for the conduct of real economic activity, it is not the intent for frequent changes to take place. In view of the many destabilising forces prevailing in the international environment, Malaysia will continue to maintain the fixed exchange rate regime until there is a discernible normalisation in the global financial markets and the global financial system has been strengthened to ensure orderly conditions. The exchange rate would need to reflect long-term fundamentals of the economy. On the whole, the comprehensive measures, including the September measures implemented by the Government had accorded greater stability for producers, traders, investors and consumers. These, however, will be temporary gains unless investors and exporters take advantage of this period of relative stability to sharpen their competitive edge through enhancing productivity; improving quality of products; expanding to non-traditional markets; intensifying market penetration in existing markets; and providing improved services to customers.