3 Outlook and Policy

World Economic Outlook

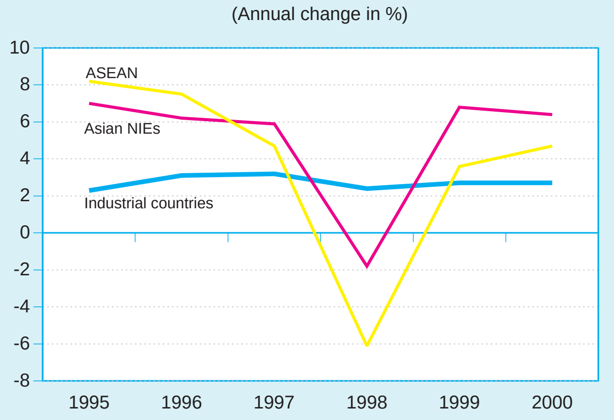
International Environment

In 1999, real GDP growth in the **major industrial countries** as a group expanded further by 2.7%, amidst moderating inflation and improved labour market conditions. The individual countries, however, continued to show divergent growth trends. The expansion in the United States economy remained strong in 1999, growth in the United Kingdom and the euro-11 area moderated, while Japan recorded a slight improvement.

The United States economy entered its eighth year of expansion, underpinned by strong domestic demand driven mainly by the positive wealth effects from a buoyant stock market, and to a lesser extent, due to inventory build-up related to potential Y2K computer problems. Some recovery was seen in the Japanese economy with a modest growth in 1999. Growth was stronger in the first half of the year due to the large fiscal stimulus and housing investment. Growth in the United Kingdom and euro-11 area moderated, affected mainly by the weakness of the economies in the early part of the year. However, economic activity in these countries picked up in the second half of 1999, led by domestic demand in the United Kingdom, while in Germany and the euro-11 area, growth was driven mainly by the external sector. In the **developing countries**, real GDP grew at a faster pace of 3.5% (1998: 3.2%), reflecting mainly an export-led recovery in the East Asian economies, which more than offset slower growth in Africa and the Middle East and virtually no growth in Latin America.

In **year 2000**, growth prospects remain positive for the world economy with moderate growth in the industrial countries and stronger growth in developing countries. Real GDP growth in the major industrial countries as a group is expected to stabilise at 2.7%, as a moderation in the United States' economy is likely to be compensated by higher growth in the euro-11 area, the United Kingdom and Japan. Meanwhile, real GDP of the developing countries as a group is projected to expand by 4.8%, reflecting a turnaround in Latin America and higher growth in Asia, Africa and the Middle East. In line with the

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



favourable growth prospects, growth in the volume of world trade is expected to increase significantly by 6–7% (1998: 3.7%).

Industrial Countries

In the **United States**, the economy is expected to continue with its ninth year of expansion in 2000, albeit at a slightly slower pace of 3.5%. The moderation is based on expectations that the domestic stock market would consolidate gradually during the year, in response to a series of expected monetary tightening. The probability for a sharp stock market correction is somewhat reduced by safeguard mechanisms such as programme trading, circuit breakers and margin requirement. The stock market is also likely to be supported, to some extent, by the continued trend in mergers and acquisitions of internet-related companies, rapid growth in employees' share options and better prospects for corporate earnings in view of the global recovery. The lower stock market and higher financing cost are likely to dampen both consumption and investment. The reduction in wealth effect and higher debt servicing would rein in consumption, which has been the prime source of growth in recent years. However, on the upside, continued productivity growth would help sustain growth at a relatively high level. Nevertheless, significant imbalances in the economy, including the growing current account deficit, high private sector borrowing and negative savings ratio combined with the present high valuation of stock prices accentuate the risks in the economy.

In **Japan**, the economy is expected to pick up further, albeit at a slow pace of 1% in 2000. The gradual improvement in the economy would be aided by the supportive economic policies and favourable external environment. In the early part of the year, growth would arise from the new fiscal stimulus package worth ¥18 trillion (about 3.7% of GDP) and improved export performance. The latest supplementary budget, the largest of the nine packages announced since 1992, focuses mainly on public works and measures to help small businesses. External demand is also likely to remain favourable given the recovery of overseas markets especially in Asia, which accounts for about 35–44% of Japan's total exports. However, the strength of the yen could impinge on Japan's competitiveness and restrain exports to some extent. In the latter part of the year, as the effect of fiscal spending tapers, private sector demand is likely to pick up. Increased profits and stronger balance sheets of corporations, incentives to replace existing capital stocks and a recovery in overseas demand should help to gradually restore business investment. Notwithstanding these favourable developments, the Japanese economy is likely to remain relatively weak during the year due to structural issues associated with excess employment and production capacity as well as the ongoing banking sector reforms.

Table 3.1
Major Industrial Countries: Key Economic Indicators

	Average 1992-96	1997	1998	1999*e*	2000*f*
	Annual change (%)				
REAL GDP					
Major Industrial Countries	**2.3**	**3.2**	**2.4**	**2.7**	**2.7**
United States	2.8	4.5	4.3	4.1	3.5
Japan	1.7	1.6	–2.5	0.3	1.0
Euro-11 Area	1.4	2.3	2.8	2.1	2.8
Germany	1.2	1.5	2.2	1.5	2.3
United Kingdom	2.4	3.5	2.2	2.0	2.7
INFLATION					
Major Industrial Countries	**2.6**	**2.0**	**1.4**	**1.5**	**1.8**
United States	2.9	2.3	1.6	2.2	2.5
Japan	0.7	1.7	0.7	–0.3	0.0
Euro-11 Area	3.3	1.6	1.1	1.1	1.7
Germany	3.3	1.5	1.0	0.6	1.3
United Kingdom[1]	3.2	2.8	2.7	2.3	2.2
	% of labour force				
UNEMPLOYMENT					
Major Industrial Countries					
United States	6.3	4.9	4.5	4.2	4.2
Japan	2.8	3.4	4.1	4.7	4.7
Euro-11 Area	11.0	11.7	10.9	10.2	9.6
Germany	8.0	9.8	9.3	9.0	8.7
United Kingdom	9.0	5.7	4.7	4.4	4.2
	US$ billion				
CURRENT ACCOUNT BALANCE					
Major Industrial Countries	**15.2**	**–20.3**	**–54.6**	**–193.6**	**209.9**
United States	–100.1	–143.5	–220.6	–321.0	–365.0
Japan	110.2	94.5	120.8	111.0	134.7
Euro-11 Area	27.5	109.2	67.5	40.5	45.3
Germany	–13.9	–1.7	–3.7	–1.1	2.6
United Kingdom	–8.5	10.1	–0.8	–22.0	–22.4

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

Source: IMF World Economic Outlook, October 1999.
OECD Economic Outlook, December 1999.
Datastream

In the **United Kingdom**, the recovery momentum is expected to continue in 2000 with GDP growth picking up to 2.7%. As the economy gathers pace, growth is likely to be more broad-based, spreading from the services sector to manufacturing and exports. A stronger external demand is anticipated with higher growth in the euro-11 area, which accounts for about one-half of the United Kingdom's total exports. At the same time, domestic demand is likely to remain strong in 2000, supported mainly by easier access to credit and gains in wealth emanating especially from buoyant house prices. The risks to growth would emerge from further monetary tightening. Prospects of higher interest rates would also exert a dampening impact on domestic economic activity as well as a loss in export competitiveness, especially if the euro weakens significantly.

Similarly, growth in **Germany** and the **euro-11 countries** as a whole are expected to pick up to 2.3% and 2.8% respectively in 2000. The higher growth would emanate from increased intra-euro trade and higher exports to non-euro markets due to the weak euro. In Germany, business investment is anticipated to improve gradually with the upturn in foreign demand and favourable monetary conditions. Tax reforms and measures taken to improve labour market rigidities in 1999 are also likely to yield positive results in the course of the year by stimulating private consumption. The German government had adopted a new approach to improve structural unemployment via the reduction in indirect labour costs, a greater resort to active labour market measures and roundtable discussions to reach consensus. Tax reforms to increase family allowances and a reduction in pension contributions from the wage base were also announced in 1999, which should contribute towards increasing overall disposable income. Therefore, growth prospects would not only depend on the performance of the overseas markets and nominal exchange rate of the euro but also on the effectiveness of the tax and labour market policies in addressing structural impediments to growth.

Despite the favourable outlook, there are **a number of potential risks and uncertainties** that could cloud prospects for growth of industrial countries in 2000. These downside risks include the possibility of a sharp correction in the United States' stock market, aggressive monetary tightening in the industrial countries as well as risks associated with a weak recovery of the Japanese economy. In the event that these risks materialise, they could have broad ramifications on the international financial markets and moderate growth in world trade. Given the large imbalances in the United States' economy with the present high valuation of Internet stocks and the large weighting of investors' portfolio in speculative stocks, the economy remains vulnerable to a sudden reversal in investor sentiment. A major stock market correction could undermine confidence and precipitate a cyclical downturn in investment and consumption, in view of the heavy reliance of corporations on equity financing and through the negative wealth effect (above 60% of the household's financial assets are in equities). Given the record high debt levels (share of private sector debt to GDP of 132%), borrowers could also face financial problems should asset prices fall sharply, thus adversely affecting their wealth and income levels. The extent to which a sharp correction of the stock market and its adverse effects could be mitigated by fiscal and monetary policies remains uncertain.

Another risk is the uncertainty over the strength of the economic recovery in Japan. The uncertainties include the deflation situation that could be aggravated by a possible strengthening of the yen, the extent of the impact of corporate and financial restructuring on employment and investment, as well as the limitations of further fiscal stimulus to stimulate the economy.

The risks of monetary tightening in the industrial countries could exert pressures on exchange rates and affect capital flows into emerging economies. Given the stronger economic fundamentals of the emerging economies compared with the situation during the crisis period, these economies are likely to remain resilient despite a gradual tightening of monetary policy in the industrial countries. However, an aggressive tightening cycle could destabilise the global stock markets with consequential adverse impact on growth prospects for the regional economies for 2000.

Inflation in the major industrial countries as a whole is expected to edge upwards to 1.8% in 2000, reflecting higher inflation in almost all the major industrial countries. Despite the downward pressure on prices due to higher productivity growth, retail competition and price transparency through online business, inflationary pressures are likely to emerge due to higher oil prices and tight labour markets. The increase in oil prices is expected to exert a larger impact on inflation in Europe than in the United States. Consumer prices in the United States and euro-11 area are likely to increase further by 2.5% and 1.7% respectively (1999: 2.2% and 1.1% respectively). Meanwhile, Japan is expected to experience zero inflation in year 2000 (1999: –0.3%), attributable to a pick-up in economic activity despite downward price pressures arising from structural disinflation. On the other hand, core inflation in the United Kingdom is expected to remain subdued at 2.2% in 2000, well below the official target of 2.5%. The favourable inflation situation would be partly policy-induced, arising from the prospects of higher interest rates, and partly due to falling prices of goods caused by intense retail competition, which would more than offset price increases in the services and housing sectors.

Growth in the volume of **world trade** is expected to expand strongly by 6–7% (1999: 3.7%), in line with sustained growth in the industrial countries and improving growth performance of the developing countries, in particular in the East Asian and Latin American countries. The current account deficit of the major industrial countries as a group is expected to deteriorate further to US$210 billion in 2000, due largely to the higher deficit in the United States. In the United States, the current account deficit is expected to deteriorate further to US$365 billion in view of the worsening trade balance and rising servicing cost of the growing foreign debt. Despite the improvement in exports to the euro-11 countries, the current account deficit in the United Kingdom is likely to remain virtually unchanged on account of the rapid increase in imports arising from strong domestic demand. In contrast, the current account position in Japan is likely to improve due to resumption in export demand from Asia and increase in net investment income following continued profit repatriation by Japanese corporations abroad.

Similarly, the current account surplus of the euro-11 countries as a whole is likely to increase, arising from the increased intra-euro trade and gains in export competitiveness as a result of the weaker euro.

East Asian Economies

Growth prospects for the regional economies in year 2000 are expected to be favourable as economic recovery gathers momentum and the region moves on to the next phase of recovery. The countries are expected to return to more broad-based and balanced growth, with the impetus to growth gradually shifting from net exports and fiscal stimulus to domestic private demand. At the same time, capital flows are also likely to pick up further although not yet to pre-crisis levels, reflecting improved investor confidence and higher economic activity in the region. Other factors that point to a positive regional outlook include the supportive external environment with the continued strong performance in the global electronics industry and further pick-up in intra-regional trade. The strengthening of domestic demand is expected to reinforce a virtuous upward cycle in regional growth, which would help to mitigate the adverse impact of any shortfall in demand from the industrial countries. In addition, the authorities in the region are expected to continue with growth-supporting policies in year 2000 to ensure a solid and sustained economic recovery. Inflation, although upward-biased, would remain benign in 2000. Given the low inflation scenario and the continued weakness in the corporate and banking sectors, rapid monetary tightening is not likely to take place during the year. Meanwhile, the fiscal balance of the regional countries (especially the crisis countries) are likely to improve during the year, arising from higher tax revenues from increased economic activity and company profitability.

In year 2000, **real GDP** growth in the **Asian Newly Industrialised Economies (NIEs)** as a group is expected to stabilise around 6.3–6.5% (1999: 6.8%), reflecting higher economic growth in all the countries except Korea. After recording an exceptionally strong performance in 1999 (10.2%), real output growth in **Korea** is likely to moderate to a more sustainable pace of 7.2% in year 2000. Growth is likely to be underpinned by increases in private consumption, investment and exports. Meanwhile, in **Taiwan**, real GDP growth is likely to pick up further to 6.5% (1999: 5.7%), led mainly by exports and higher private investment associated with the post-earthquake reconstruction and implementation of other major projects. Private consumption is also expected to strengthen further during the year.

Similarly, the pace of economic activity in **Hong Kong SAR** is expected to strengthen in 2000, with real output growth rising to around 5% (1999: 2.9%), buoyed by exports and a pick-up in domestic demand amidst a moderation in real interest rates. In addition, the prospective entry of The People's Republic of China into the World Trade Organisation is expected to improve overall sentiment and support domestic demand in Hong Kong SAR. In **Singapore**, real GDP growth is expected to be in the upper range of 4.5–6.5% (1999: 5.4%), with impetus to growth emanating from manufacturing exports, especially in the electronics and chemical industries, as well as an increase in private demand. Meanwhile, in **The People's Republic of China**, real output growth is

Table 3.2
East Asia: Selected Key Economic Indicators

	Average 1992-97	1998	1999*e*	2000*f*
	Annual change (%)			
Real GDP				
Asian NIEs	**6.6**	**–1.8**	**6.8**	**6.3 ~ 6.5**
Korea	6.7	–5.8	10.2	7.2
Taiwan	6.6	4.6	5.7	6.5
Singapore	9.2	0.3	5.4	4.5 ~ 6.5
Hong Kong SAR	5.2	–5.1	2.9	5.0
ASEAN[1]	**7.2**	**–6.1**	**3.6**	**4.4 ~ 5.0**
Malaysia	9.2	–7.5	5.4	5.8
Thailand	6.4	–10.4	4.0	4.5
Indonesia	6.9	–13.2	0.2	3.0 ~ 4.0
Philippines	3.8	–0.5	3.2	4.0
Vietnam	8.9	5.8	4.8	5.5 ~ 6.0
The People's Republic of China	11.5	7.8	7.1	7.0
Consumer prices				
Asian NIEs	**4.9**	**4.0**	**–0.4**	**1.7 ~ 1.8**
Korea	5.2	7.5	0.8	3.1
Taiwan	3.2	1.7	0.2	2.0
Singapore	2.1	–0.3	0.4	1.0 ~ 2.0
Hong Kong SAR[2]	8.1	2.8	–4.0	–1.0
ASEAN[1]	6.6	19.9	7.9	4.0 ~ 4.9
Malaysia	3.6	5.3	2.8	3.2
Thailand	5.0	8.1	0.3	2.5 ~ 3.0
Indonesia	8.2	58.4	24.0	5.0 ~ 7.0
Philippines	8.1	9.8	6.4	6.0 ~ 7.0
Vietnam	13.6	7.7	1.3	6.0
The People's Republic of China	12.2	–0.8	–1.4	1.0

[1] Includes Singapore, but excludes Brunei Darussalam, Lao PDR, Myanmar and Cambodia
[2] Refers to composite prices
e Estimates
f Forecast

Sources: IMF World Economic Outlook 1999
National sources

likely to stabilise at around 7% (1999: 7.1%), supported by a new fiscal stimulus, increased foreign direct investments and higher export demand from the industrial countries, which account for about 70% of China's exports.

The combined real GDP growth of the members of the **Association of South-East Asian Nations (ASEAN)** is expected to improve further to 4.4–5% in 2000 (1999: 3.6%), reflecting higher activity in all the countries. In **Thailand**, real GDP growth is expected to pick up to 4.5% (1999: 4%), following a strong expansion in manufactured exports led by electronics and further strengthening in private demand, supported by accommodative monetary and fiscal policies. Similarly, the **Philippine economy** is likely to grow at a faster pace of 4% (1999: 3.2%), supported by strong exports and expansion in the manufacturing sector. Meanwhile, the recovery in **Indonesia** is expected to gather momentum, with real GDP increasing by about 3–4% (1999: 0.2%), supported by a pick-up in exports from both non-oil exports benefiting from the competitive rupiah as well as oil exports arising from higher oil prices. At the same time, recovery in domestic demand is taking place in an environment of lower interest rates.

However, **risks** that could affect growth prospects of the regional countries remain. The main source of risk would emanate from the external environment. Given the strong correlation between the regional bourses and the performance of the Dow Jones, a sharp correction in the United States stock market could trigger a new bout of instability and declines in the regional financial markets. Developments in the stock and foreign currency markets could result through shifts of funds from the emerging markets. In addition, the global trend of higher interest rates, initiated by monetary tightening in the industrial countries could also dampen capital flows to the region. With the region still dependent on exports for growth, a significant slowdown in the United States, which accounts for about 22% of the region's exports, would affect the regional growth performance.

On the **inflation front**, the regional economies are expected to face some upward trend in prices in year 2000 as industries absorb excess capacity and private consumption strengthens with the steady economic recovery. Higher oil and world commodity prices are also contributory factors to inflation during the year. Nevertheless, inflation should remain under control and is not likely to impact growth prospects. Inflation in the **Asian NIEs** as a group is expected to rise to 1.7–1.8% (1999: –0.4%), reflecting higher consumer prices in all economies. In **Korea** and **Taiwan**, consumer prices are expected to increase at a higher rate of 3.1% and 2% respectively (1999: 0.8% and 0.2%), fuelled by rising international prices for raw materials and oil as well as stronger domestic consumption. To some extent, the higher prices would also reflect the low base effect, higher wages in Korea and price increases in Taiwan due to post-earthquake reconstruction. Nevertheless, imported inflation would remain subdued, restrained by the appreciation of their currencies.

Meanwhile, inflation in **Singapore** is expected to remain in the region of 1–2% (1999: 0.4%). The upside risks to inflation emanating from higher disposable income due to the restoration of previously cut wages and an increase in bonuses for civil servants may be somewhat offset by the strengthening of the Singapore dollar and a continuation of tax rebates. Deflationary pressures in **Hong Kong SAR** are likely to subside and inflation is expected to resume marginally in **The People's Republic of China** in 2000. In Hong Kong SAR, the composite consumer price index is expected to decline at a slower rate of 1% (1999: –4%), reflecting continued competition among retailers. In The People's Republic of China, consumer prices are projected to increase by 1% in 2000 (1999: –1.4%), due partly to the effects of recent measures taken to stimulate consumption. The measures included an imposition of a 20% tax on bank interest income, seven interest rate cuts since May 1996 and significant increases in wages of civil servants and low-income workers. Nevertheless, the continued excess supply in agriculture products is likely to restrain price increases.

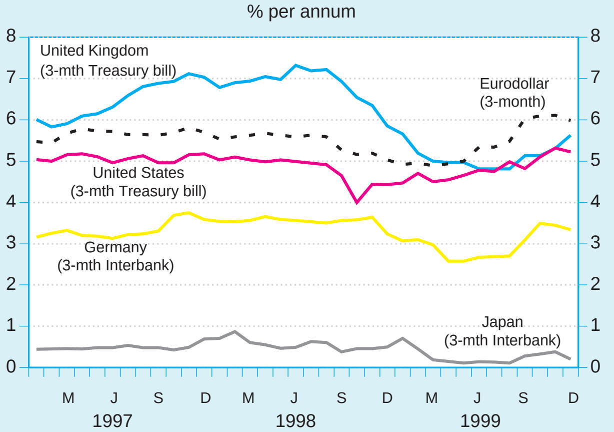
Despite higher price pressures in Thailand and the Philippines, inflation in the **ASEAN** countries as a group is expected to recede further to 4–4.9% in 2000 (1999: 7.9%), due mainly to the significant moderation in price increases in Indonesia. In **Indonesia,** inflation is expected to moderate to 5–7% (1999: 24%) reflecting the base effects, the appreciation of the rupiah and improving efficiency in the distribution network. In contrast, in **Thailand** and **the Philippines**, inflation is expected to rise to 2.5–3% and 6–7% respectively (1999: 0.3% and 6.4% respectively), reflecting the higher oil prices and stronger domestic demand. The reduction in excess capacity in Thailand and the increase in public sector wages in the Philippines are the contributory factors to inflationary conditions during the year.

In line with stronger economic growth, the **external account surpluses** in most of the regional countries are expected to narrow in year 2000. The pick-up in domestic demand is likely to stimulate import growth and lead to lower trade and current account surpluses. Hong Kong SAR, however, is expected to register a stronger current account surplus based on an expected strong export growth.

Interest Rates and Exchange Rates

Monetary policy in the major industrial countries was biased towards easing in the first half of 1999 against a backdrop of an economic slowdown, except for the United States. Both the European Central Bank (ECB) and Bank of Japan reduced their key rates by 50 and 10 basis points respectively, while the Bank of England was more aggressive, cutting interest rates four times during the period with a cumulative reduction of 125 basis points. On the other hand, in the United States, in view of the continued strength of the economy and robust stock market, the Federal Reserve Board embarked on pre-emptive monetary tightening to address inflationary pressures by raising the Federal funds rate by 25 basis points to 5% on 30 June. The move was subsequently accompanied by two further interest rate hikes totalling 50 basis points in the second half of the year. During this period, the Bank of England and the ECB also reversed their earlier monetary easing and raised interest rates by a total of 50 basis points each, prompted by the faster-than-expected economic recovery. Only the Bank of Japan maintained an accommodative monetary stance to facilitate the economic recovery as well as to contain excessive yen strengthening.

Graph 3.2
Industrial Countries : Short-Term Interest Rates



In the first two months of 2000, while Japan maintained its zero interest rate policy, the other major industrial countries continued to pursue monetary tightening due to concerns of overheating in their economies. The Federal Reserve Board and the ECB raised their key rates by 25 basis points each to 5.75% and 3.25% respectively to pre-empt potential inflationary risks. Meanwhile, the Bank of England was more aggressive, raising the key rates by 50 basis points to 6% to rein in the strength of the housing sector. For the remaining part of 2000, monetary policy in the major industrial countries other than Japan is expected to remain biased towards tightening. The extent of the tightening would, however, depend on the strength of the economic growth and on inflationary pressures, including developments in the asset markets. Policy directions would also be influenced somewhat by external factors such as the performance of the exchange rate and the sustainability of the current account. Meanwhile, Japan is expected to maintain an accommodative monetary policy to counter the risk of deflation and to support economic recovery.

In the **foreign exchange** markets, the United States dollar strengthened against all the major currencies in the first two months of 2000 to close at US$1=¥110.19, €1=US$0.9643 and £1=US$1.5786 at end-February. The dollar appreciated by 7.2% against the Japanese yen, 4.3% against the euro and 2.4% against the pound sterling compared with levels at the end of 1999. Against the yen, the dollar reversed its trend to strengthen, largely due to resumption in yen carry trades and to a lesser extent, weaker market sentiment on Japan's economic recovery. The dollar reached a six-month intra-day high of US$1=¥111.73 on 22 February, buoyed by continued expectations on the strength of the economic expansion in the United States.

Against the euro, the dollar strengthened markedly to a range below parity since the second half of January 2000 as European investors continued to diversify into non-euro financial markets. At end-month, market perception of lack of G-7 concern on the level of euro further exacerbated the weakness in the euro. Thereafter, the dollar continued to strengthen to touch an intra-day high of €1=US$0.939 on 28 February, its highest level against the euro since the debut of the euro on 4 January 1999. The euro was affected by uncertainty over the stance of the ECB in their foreign currency intervention and on structural issues such as the rules on corporate take-over in Germany. To some extent, the relative growth momentum between

Box IV

Pegged Exchange Rate Regime – Its Implications on the Malaysian Economy

Introduction

The Asian financial crisis was, to a large extent, a reflection of the shortcomings of the international financial system in coping with the growth in capital flows across borders. Among the many strategic issues highlighted in the aftermath of the crisis was the need to reassess exchange rate policies. The rapid movements in short-term capital, the so-called "hot money", had resulted in conflicts between domestic macroeconomic policy and exchange rate arrangements in many of the South-East Asian economies. As a result, most of the crisis-affected countries that had previously operated under pegged *(de facto* or *de jure)* or banded exchange rate regimes moved to more flexible exchange rate arrangements. On the other hand, Malaysia, which had previously operated under a managed float, adopted a pegged exchange rate arrangement, by pegging the ringgit exchange rate to the United States dollar on 2 September 1998. The ringgit was pegged at a level of RM3.8000 = US$1, which was the rate prevailing in the Kuala Lumpur interbank foreign exchange market at that time. This was also the rate at which the ringgit was, on average, traded during February to June 1998.

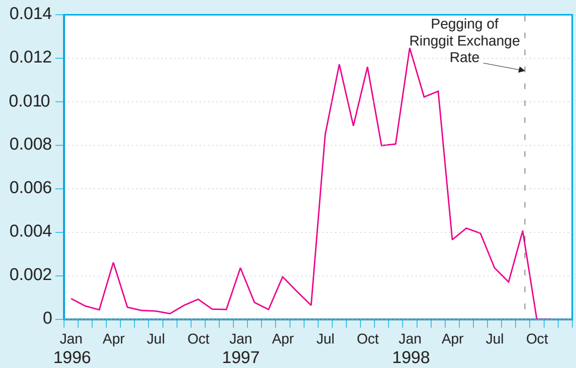
Why Malaysia moved to a pegged exchange rate arrangement

The move to a pegged exchange rate arrangement was to reduce the volatility of the ringgit exchange rate and to promote a stable environment conducive to economic recovery. As shown in Graph IV.1, throughout the crisis period, the ringgit experienced a sharp increase in volatility. The increased volatility was not due to any change in the fundamentals of the economy, but was the outcome of contagion, speculation and the movement of non-resident short-term capital. The resulting uncertainty made pricing and investment decisions of businesses increasingly difficult. The establishment of the pegged exchange rate arrangement aimed to restore some element of predictability within the economy.

For a small, open economy like Malaysia, the exchange rate is a very important price. Movements in the exchange rate can beneficially correct disequilibriums in the balance of payments that are caused by economic fundamentals. However, this becomes more complicated when the changes in the exchange rate are caused not by fundamentals, but by short-term capital flows. The increasing global market integration has led to surges of short-term foreign investment by institutional investors seeking higher returns mostly in the asset markets of emerging economies. By allowing the exchange rate to respond to these surges of inflows and outflows by appreciating and depreciating respectively, the exchange rate will experience greater volatility that will be highly costly to the tradables sector.

The question arises whether allowing the exchange rate to move in response to volatile short-term capital flows is the optimal policy for a trade dependent country like Malaysia. The degree to which different countries can tolerate wide swings in their exchange rates depends on the relative openness of their economies. The more open the economy, the greater would be the adverse economic consequence of any sustained volatility in the exchange rate. Countries like Hong Kong

Graph IV.1
Monthly Standard Deviation of RM/USD Exchange Rate



SAR and Singapore make the maintenance of exchange rate stability the primary focus of their monetary policy because of the crucial role external prices play in determining their economic welfare. Similarly, it is unrealistic to expect Malaysia, with trade accounting for 203% of GNP in 1999, to allow its exchange rate to move erratically in response to short-term flows over a prolonged period.

Benefits of a pegged exchange rate arrangement for the economy

The main benefit of the introduction of the pegged exchange rate regime in Malaysia was relative stability in the foreign exchange market. Economic agents, such as businesses and consumers, base their decisions concerning production, investment and consumption on the information that the price system provides. If these prices become more uncertain, the quality of these decisions will decline and it will be difficult for businesses to generate reliable forecasts of their future earnings. In a volatile environment, the exchange rate becomes less reliable as a mechanism to allocate resources efficiently. Thus, the reduction in exchange rate variability through the pegged system has resulted in efficiency gains to the economy. These welfare gains are more evident for countries such as Malaysia, which trade a large proportion of goods and services with foreign countries.

The pegged exchange rate regime has helped the pricing and investment decisions of companies in Malaysia. During the first three quarters of 1998, the volatility in ringgit movements against the US dollar complicated the process of business planning and cost accounting of exporters, resulting in uncertainties and causing a reduction of new export orders and potential export opportunities. With the pegged exchange rate arrangement in place, Malaysian manufacturers and exporters were able to capitalise on the exchange rate stability to resume normal business activities as external demand began to improve in October 1998. Approximately 85% of Malaysia's trade is settled in US dollars. With this high concentration of settlements in the dollar, the single currency peg has been effective in fostering stability for the majority of the trade sector.

During the crisis, the effective policy responses of the government were always hampered by the instability of the exchange rate. In the initial stages, the response of the Government was directed towards halting the further depreciation of the ringgit as well as limiting the effect on inflation. When the policymakers decided to shift to ease monetary policy following the sharper-than-expected contraction in the real economy, their efforts were constrained by the need to support the exchange rate. For policymakers, the pegging of the exchange rate removed the issue of managing the day-to-day movements of the ringgit exchange rate. Further depreciation of the ringgit was effectively halted and this, along with the selective exchange controls, allowed policymakers to concentrate on rebuilding the other sectors of the economy. Interest rates were reduced, facilitating the use of monetary policy to support fiscal policy in the recovery process. The low interest rates and stable exchange rates also ensured a greater chance of success for efforts to restructure the banking and corporate sectors.

The pegging of the ringgit exchange rate has benefited the external sector due to the subsequent favourable movement of the US dollar. Some improvement in external competitiveness can be seen in the strong performance of the current account of the balance of payments. The trade balance recorded a surplus of RM98.2 billion during the period from September 1998 to end-1999. This improvement in the current account balance has been due to favourable external demand, especially in the electronics sector, the stability of the ringgit exchange rate against a key currency and the improvement in external competitiveness following the pegging of the ringgit.

The effect of the increased competitiveness due to the subsequent appreciation of the regional currencies against the ringgit differs across the various sectors of the economy. Generally, the sectors of the economy that will benefit from both the increased stability in the exchange rate as well as the improved competitiveness are the tradable sectors of the economy. The largest traded sector in the Malaysian economy is the manufacturing sector. However, the degree to which the different industries within the manufacturing sector have benefited vary according to the mixture of import content in their production as well as the share of exports in total production. The following matrix

Exports	Low imports	High imports
High	**Quadrant I** *High exports, low imports* ● Rubber products ● Palm oil processing ● Wood products ● Petroleum products	**Quadrant II** *High exports, medium-high imports* ● Electronics ● Electrical products ● Textiles and clothing ● Chemical products
Low	**Quadrant III** *Low exports, low imports*	**Quadrant IV** *Low exports, high imports* ● Transport equipment

divides the various industries in the manufacturing sector into four quadrants according to their level of import content and share of exports.

Generally, the industries that are located in Quadrant I, which are the resource-based industries, would benefit the most from the improved competitiveness. To a lesser extent, the high exports, medium-high imports industries (Quadrant II) such as electronics and electrical products, would stand to benefit as well. In contrast, industries in Quadrant IV, such as the transport equipment industry, would benefit the least due to their higher cost of production. Table IV.1 shows the annual growth in exports and volumes of production of the respective industries in the manufacturing sector for 1998 and 1999.

On the whole, the export performance of the various industries reflect what would have been expected, given the distribution of the industries in the matrix above. The resource-based industries such as petroleum and wood products registered two of the three highest growth rates in terms of exports. However, the rubber products industry registered a negative growth in exports in 1999. This was a result of lower export prices for rubber products, particularly the rubber gloves segment. In the non-resource based industries, the high export, medium-high import industries all registered positive growths in their exports for 1999. As expected, the transport equipment sector, which is very import-intensive, registered a decline in export growth of 35.5%.

Table IV.1: Performance of Major Industries in the Manufacturing Sector

	Exports (US$)		Production	
	1998	1999	1998	1999
	Annual growth in %			
Overall Manufacturing Sector	–4.6	17.6	–10.2	12.9
Non-resource based industries				
High export, medium-high import				
Electronics	*1.9*	*30.4*	*–4.2*	*21.2*
Electrical products	*–11.4*	*8.8*	*–14.8*	*2.7*
Textiles and clothing	*–11.0*	*3.4*	*–5.3*	*4.0*
Chemical products	*–6.6*	*7.6*	*–1.8*	*17.1*
Low export, high import				
Transport equipment	*17.1*	*–35.5*	*–52.2*	*53.5*
Resource-based industries				
High export, low import				
Rubber products	*3.9*	*–9.1*	*7.8*	*3.6*
Wood products	*–34.3*	*20.3*	*–11.3*	*–7.3*
Petroleum products	*–33.4*	*48.9*	*–11.5*	*–0.3*

In terms of volumes of production, the non-resource based industries that have experienced a growth in exports have also experienced a growth in production. The exception to this generality is the transport equipment industry. While exports declined for the year, the volume of production for the transport equipment sector increased by 53.3% in 1999, primarily due to a surge in domestic demand.

It is important to note, however, that the pegged exchange rate arrangement only pegs the nominal exchange rate and not the real effective exchange rate. The true measure of competitiveness comes from the real exchange rate, which takes into account the relative inflation performance of the economy as well. Therefore, the benefits derived from the movements of the US dollar against other currencies which has increased our competitiveness, will be insofar as the inflation in Malaysia is lower than that of our competitors. Furthermore, the competitive benefit from an exchange rate is transitory, and true competitiveness can only be obtained by increasing efficiency and enhancing productivity.

Risks of a pegged exchange rate regime

The move to a pegged exchange rate regime also introduces a new set of risks to the economy. The possibility of misalignment of the currency is one of the major risks in a pegged exchange regime. Misalignment is defined as a departure in the existing exchange rate from some measure of a fundamental equilibrium exchange rate. Misalignment can originate from a variety of sources. Changes in relative price levels, trade barriers, preferences of domestic versus foreign goods as well as improvements in the relative productivity of the economy are key factors that affect the fundamental exchange rate over the long run. Apart from these fundamental factors, movements of short-term capital as well as substantial movements in the value of the anchor currency can result in temporary misalignment.

When there is a misalignment in the exchange rate, some form of nominal adjustment has to take place in order to bring the real exchange rate into equilibrium. This nominal adjustment can take place through wage and price changes or through factor mobility. Misalignments can also cause the inefficient allocation of resources in an economy.

The degree of misalignment of an exchange rate needs to be assessed carefully. It is recognised that the “correct” level of an equilibrium exchange rate is difficult to determine due to the dynamic nature of the equilibrium as well as the variety of short-term and long-term factors that influence the rate. Therefore, continuous monitoring of developments in the Malaysian economy as well as in the regional economies is important to ensure that the exchange rate is consistent with the fundamentals. Currently, the issue of misalignment is not a concern given that inflation is expected to remain moderate over the medium term.

In the literature on exchange rates and financial fragility that followed soon after the outbreak of the Asian crisis, the risk of moral hazard behaviour by corporations has been continuously raised. Pegged exchange rate regimes were seen to be equivalent to an implicit guarantee by the Government and hence a source of moral hazard. This guarantee implies that, under a pegged exchange rate regime, companies and investors do not take into account the full risks of their investments, which in turn creates an incentive to take on excessive risk. Apart from promoting unhedged foreign currency borrowing, pegged regimes also skew flows more toward shorter maturities as these regimes are not seen to be credible in the long run. The experience of some Latin American and South-East Asian countries in the 1990s seem to corroborate this hypothesis.

In the Malaysian case, the risk of moral hazard under a pegged exchange rate regime has been contained. Prudential guidelines regarding external borrowing have long been in place even prior to the crisis. BNM’s approval is required for all external borrowings. Approvals are only given for investments that would generate sufficient foreign exchange receipts to service the debt, hence serving as a natural hedge with regards to foreign exchange exposure. Banks, on the other hand, are subject to net open position limits that vary according to the dealing capacity of the individual bank. Regulation and more vigorous supervision of the financial system have ensured that the financial institutions comply with these regulations. These prudential guidelines have limited the external exposure of Malaysian companies and banks, making thems less vulnerable to the effects of the depreciation of the ringgit during the crisis.

However, there is still the risk that there may be companies that have foreign currency exposures, such as exporters and importers, that are not adequately hedged. One of the lessons learnt from the experience of other countries during the crisis was that there should not be too much reliance on the level of the exchange rate. While it may be profitable to cut back on the cost of hedging, such practices reflect poor risk management on the part of the exporters and importers and may result in higher costs in the long run.

Another argument that has been put forward is that the pegged exchange rate regime might reduce the incentive for the corporate sector to restructure. Countries that emerge from recessions due to exchange rate advantages, in which export-oriented companies benefit significantly as a result of the depreciation following a crisis might be adversely affected over the medium term. Because of the exchange rate edge during the crisis period, the corporate sector might not restructure their operations to become efficient and lower unit cost of output. As a result, such countries would be subsequently set back. For those corporations that became much leaner and have reduced their costs of operations through restructuring, they have greater potential to prosper. There is a need for new investments in technology and to identify new growth areas, in order to gain the competitive edge in the global market. While Malaysian companies may be enjoying some benefits due to the movements in the regional countries' nominal exchange rates, it is recognised that this may not be a permanent phenomenon. Progress will have to be made to restructure in order to gain greater competitiveness.

Implications of a pegged exchange rate regime on monetary policy

A pegged exchange rate regime has implications for the conduct of monetary policy. Generally, domestic monetary policy has to follow the monetary policy of the country to which the currency is pegged. However, in the case of Malaysia, the pegged exchange rate regime was instituted against the backdrop of selective exchange controls. The selective exchange controls, which reduced the degree of the free-flow of capital, have granted the authorities some degree of independence in monetary policy. In this environment, Malaysia has the latitude to set its own level of interest rates in order to achieve domestic objectives.

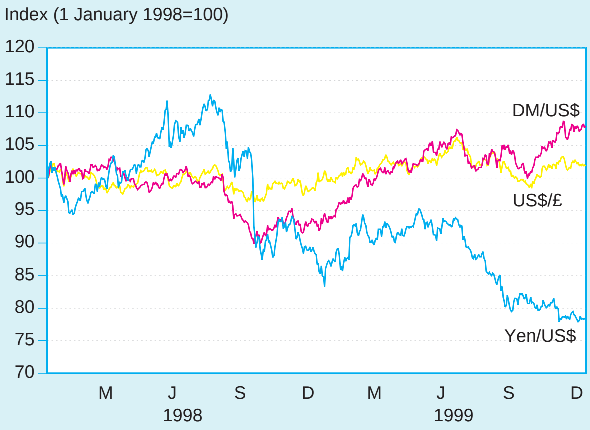
Another implication of a pegged exchange rate arrangement on monetary policy is that in an environment of capital inflows, BNM has to conduct sterilisation operations by absorbing the excess liquidity. In an environment of capital outflows, however, the reverse will be the case. Thus, the liquidity operations of BNM has to adjust in order to preserve the objectives of monetary policy.

Under a pegged exchange rate regime, the burden of adjustment to external shocks will fall on the international reserves of the country. The volatility in exchange rates will be substituted by volatility in the level of reserves. Due to BNM's intervention operations in order to maintain the peg in the face of capital flows, the level of reserves will experience corresponding changes. An adequate level of reserves is therefore important for promoting confidence in the sustainability of a pegged regime.

Conclusion

A large amount of literature on exchange rates have concluded that there is no one exchange rate regime that is appropriate for all countries. The differences among countries in levels of economic and financial development as well as in other aspects of economic situation will determine the suitability of a particular exchange rate arrangement. The pegged regime has functioned efficiently for Malaysia in providing a stable environment against which the revival of economic activity and the acceleration of financial reforms have taken place. The stability has been welcomed by manufacturers as it has allowed them to conduct their operations in an environment of greater predictability. This has contributed to the overall economic recovery process.

Graph 3.3
Movement of the US Dollar against Major Currencies



the United States economy and the euro-11 reinforced the weakness of the euro.

Against the sterling, the dollar fell initially to reach an intra-day low of £1=US$1.6578 on 21 January 2000, dampened by expectations of more aggressive monetary tightening in the United Kingdom relative to the other major economies. Nevertheless, the gains were reversed thereafter as the dollar strengthened since end-January to reach a seven-month high of £1=US$1.5786 on 29 February, as a result of spillover effects from the cross currency trading of euro/dollar and sterling/euro. However, relative to other currencies, the dollar had traded in a narrow range against the pound sterling as both the tightening cycle in the United States and the United Kingdom were perceived to be in line with minimal overshooting. For the remaining part of the year, the major currencies are likely to be influenced by a number of factors, such as portfolio adjustments in response to interest differentials and asset market valuations as well as the fundamental strength of the major economies during the monetary tightening cycle.

Malaysian Economy in 2000

Growth in the Malaysian economy is expected to be sustained in year 2000, while the external sector will continue to strengthen. Against the more favourable external environment and strengthening domestic economy, the forecast for GDP growth for 2000 has been revised upwards to 5.8%, from the earlier estimate of 5%. Given the strong recovery in the regional economies and the generally favourable world economic outlook for 2000, export growth is expected to be sustained at a high level. Other assumptions for growth in 2000 include an expansionary fiscal policy supported by an accommodative monetary policy. The external sector is expected to remain strong although the current account will narrow in line with higher output growth.

All domestic demand components are expected to record positive growth in 2000. In particular, **private consumption** is estimated to increase by 9.5% to become the main driver of growth. Measures to promote consumption under the 2000 Budget together with strong export performance will increase the disposable income of Malaysians, thereby strengthening consumer sentiments and expenditure. Consumption-related measures under the 2000 Budget include a one percentage point across-the-board reduction in personal income tax rates, higher tax relief and salary adjustments for civil servants and pensioners and another round of tariff reductions on 305 items. The fiscal stimulus will also support growth in consumption. The bulk of the net development expenditure of the public sector will continue to be spent on small- and medium-size projects, educational infrastructure and low-cost housing. These areas have strong linkages with other sectors in the economy and will, therefore, enhance the multiplier impact on private consumption. In addition, the broad-based recovery in exports of manufactured goods, saw logs and crude oil will support further improvement in capacity utilisation and generate more employment opportunities. Thus, these developments are expected to raise private consumption to exceed pre-crisis levels in real terms.

Table 3.3
Contribution of Demand Components to Real GDP Growth

	1999*p*	2000*f*
	(% contribution)	
Aggregate Domestic Demand	**1.6**	**6.2**
Private Consumption	1.1	4.1
Private Investment	–3.3	0.6
Public Consumption	2.3	0.0
Public Investment	1.3	1.3
Net Exports	**3.8**	**–0.4**
Exports of Goods & Non-factor Services	14.0	11.4
Imports of Goods & Non-factor Services	10.2	11.8
Gross Domestic Product	**5.4**	**5.8**
Aggregate Consumption	3.4	4.2
Aggregate Investment	–2.1	1.9

p Preliminary
f Forecast

Source: Department of Statistics and Bank Negara Malaysia

Table 3.4
GNP by Expenditure Components
(in 1987 prices)

	1999*p*	2000*f*
	Annual change (%)	
Real aggregate domestic demand[1]	**1.6**	**7.3**
Consumption	6.1	7.4
Investment	–6.8	7.2
Aggregate private demand[1]	**–3.5**	**8.3**
Consumption	2.5	9.5
Investment	–19.0	4.5
Aggregate public demand[1]	**14.8**	**5.2**
Consumption	20.1	0.2
Investment	10.1	10.0

[1] Exclude stocks
p Preliminary
f Forecast

Source: Department of Statistics and Bank Negara Malaysia

Private investment, which had remained subdued in 1999 owing to excess capacity in several sectors in the economy, is now projected to turn around to register a positive growth of 4.5% in 2000 (–19% in 1999). Companies are expected to expand capacity in 2000 in response to the steady rise in consumer demand underpinned by strong economic recovery, improved employment opportunities, favourable export prospects and higher commodity prices. Ample liquidity conditions due to large surpluses in the current and long-term capital accounts of the balance of payments and a low inflation environment will enable interest rates to remain supportive of private investment. Private sector investments are expected to be channelled into new growth areas and promoted sectors such as education and skills training, venture-type projects, medium- and low-cost housing, and agriculture and rural development. While public sector expenditure continues to provide a stimulus, the Government will gradually scale down its fiscal spending given the recovery in private expenditure. Consequently, growth in **public sector expenditure** is expected to moderate from 14.8% in 1999 to 5.2% in 2000. Overall, **real aggregate domestic demand** is expected to strengthen further by 7.3% in 2000 (1999: 1.6%) due mainly to stronger recovery in private sector expenditure.

On the **supply** side, growth is expected to be more broad-based, led by the manufacturing and services sectors. The construction, agriculture and mining sectors are also expected to contribute to growth, although at relatively moderate rates.

Table 3.5
Real GDP Growth (in 1987 prices)

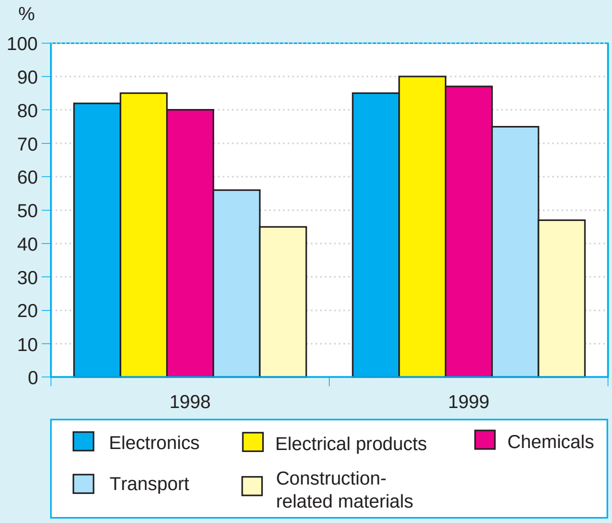
	1999*p*	2000*f*
	Annual growth (%)	
Real GDP	5.4	5.8
Agriculture	3.9	2.0
Mining	–4.0	2.1
Manufacturing	13.5	10.0
Construction	–5.6	5.0
Services	2.9	5.4

p Preliminary
f Forecast

Source: Department of Statistics and Bank Negara Malaysia

Prospects for the **manufacturing sector** remain favourable in 2000. Expected sustained external and domestic demand will support further expansion of value added by 10%. In January 2000, the industrial production index of the manufacturing sector increased by 37.4%. During the year, a broad-based expansion is expected to continue, with the export- and domestic-oriented industries recording further increases in output, at 10% and 9.6% respectively. Among the export-oriented industries, the electronics industry, in particular, is expected to maintain a strong output growth, supported by more widespread usage of the internet, e-commerce and mobile phones and other telecommunications equipment worldwide. At the same time, the production of electrical products is envisaged to increase amidst sustained improvement in demand especially from the US, Japan and the Asia Pacific region. Moreover, the introduction of new products such as flat screen televisions, digital video disc and

Graph 3.4
Capacity Utilisation of Selected Industries in the Manufacturing Sector



video compact disc players would also contribute to growth. In the domestic-oriented sector, the expected strengthening in domestic consumption and pick-up in construction sector activity augur well for output performance of the transport equipment and construction-related materials industries. Meanwhile, the production of chemical products is expected to increase, in tandem with favourable developments in the electronics, transport equipment and construction-related materials industries. The expected expansion of output in the manufacturing sector is envisaged to lead to higher capacity utilisation in the sector. Currently, capacity utilisation has risen to an average of 85% for export-oriented industries and 78% for domestic-oriented industries.

With the improved outlook for the economy, value added in the **services sector** is expected to increase by 5.4%. Growth will emanate from the intermediate and final services sub-sectors. For the intermediate services sub-sector, growth is expected to be sustained by buoyant activity in the manufacturing sector based on the expectation of continued growth in both the external and domestic sectors. In particular, demand for transport, storage and communications services is expected to pick up strongly, reflecting mainly a strong increase in external trade. Activity in the finance sub-sector is also expected to increase, reflecting the projected higher loan growth and the favourable outlook in the equity market. Meanwhile, the return of consumer confidence and the expected increase in tourist arrivals from 8 million in 1999 to 8.5 million in 2000, are expected to contribute to higher growth in the wholesale, retail trade, restaurants and hotels sub-sector. Similarly, value added in the utilities sub-sector is projected to increase further in response to expected higher demand from the industrial and commercial sectors.

In the **agriculture sector,** growth is expected to moderate to 2% in 2000, due mainly to the slower increase of 2.7% in crude palm oil production as yields will be affected by the downturn in the biological yield cycle of the oil palm trees. While rubber production is projected to decline further during the year, the production of saw logs is forecast to increase by 3.3% in response to expected higher external demand, especially from Japan, The People's Republic of China and Korea.

Value added in the **mining sector** is expected to turn around to record a positive growth of 2.1%, attributable mainly to higher gas production (9.3%) as crude oil production is expected to increase marginally by 0.4%. The projected increase in natural gas production was premised on expectations of higher domestic and external demand, in addition to the commencement of operations of a new gas field during the year. Crude oil production will be maintained at about the level in 1999, at 694,000 barrels per day (bpd) (1999: 693,200 bpd), in line with the National Depletion Policy.

Following two years of adjustments, the **construction sector** is expected to turn around to grow by 5%. Growth will emanate mainly from development of residential and civil engineering projects. In the residential sector, construction of low- and medium-cost houses is expected to remain strong, underpinned by strong underlying demand and low interest rates. At the same time, the increase in new developers' licences issued and loans approved by the housing credit institutions during 1999 will pave the way for new construction activity in 2000. The civil engineering sub-sector will benefit from the Government's continued efforts to improve infrastructure development, particularly for the construction, upgrading and improvement of roads and highways. On the other hand, construction of new commercial buildings is expected to remain subdued in view of excess supply and the guideline prohibiting banking institutions from financing the development of new hotels, resorts, office buildings, golf courses, clubs and shopping complexes effective 6 January 1999. Hence, activity will be supported mainly by ongoing projects. Reflecting the prospects of a recovery in the construction sector, BNM's 1999 Survey of the Construction Sector showed that construction activity of the companies surveyed is expected to pick up by 17.8%.

Generally there is greater optimism that **downside risks** to growth prospects for 2000 are limited. The main area of vulnerability for the region is the downturn in the US economy arising from a sharp correction in the United States stock market. However, pre-emptive measures taken by the Federal Reserve Board to rein in aggregate demand emerging from the wealth effect of the strong performance of the equity markets have so far successfully avoided this development. Interest rates have been gradually raised in four steps of 0.25 percentage points since June 1999 to ensure a soft landing. The Federal Reserve Board has also clearly indicated that further increases in interest rates are likely to manage the inflationary expectations and to deflate the emerging asset bubble. Notwithstanding this development, the Federal Reserve Board is likely to reduce interest rates in the event of a major correction in the United States stock market so as to manage the systemic risks emerging from a downturn in economic activities. This is based on the track record of the Federal Reserve Board in using monetary policy to prevent an over-adjustment if share prices experience a major correction. In 1987, the Federal Reserve Board responded promptly after the stock market crash on 19 October by injecting liquidity into the system to prevent the economy from spiralling downwards abruptly. Similarly, in 1998, the Federal Reserve Board was quick to arrange financing support in response to emerging systemic risks to the US economy arising from the collapse of the hedge fund, Long-Term Capital Management, following the Russian debt moratorium in August 1998.

Another area of concern is the uncertainty over the sustainability of the current upswing in the electronics industry although there is increasing evidence that the upward trend in the electronic cycle is expected to continue beyond 2000. While there is concern about the over-reliance of the manufacturing sector on the electronics industry (accounting for more than half of total manufactured exports and one-fifth of manufacturing value added), the relatively well diversified product mix exported by the Malaysian electronic manufacturers would help to mitigate any undesirable effects arising from the cyclical nature of the electronics industry. Moreover, both the multinationals and domestic manufacturers have built a strong foundation for the industry in terms of capital investment, input sourcing and product marketing channels. These developments, complemented by adequate infrastructure and the availability of skilled labour, would continue to provide strength to the electronics manufacturers and exporters to build on existing capabilities as well as enhance their competitiveness in niche products/ markets with growth potential.

On the domestic front, the current ringgit peg against the US dollar has often been cited as a possible source of instability, contributing to loss of competitiveness. The main concern of market participants at this point is that ringgit is undervalued and the external liquidity generated from the strong balance of payments position would contribute to inflationary pressures. An appreciation in the real effective exchange rate arising from an increase in domestic inflation would undermine external competitiveness of the economy. However, a closer look at the fiscal position, the savings-investment gap as well as the potential output gap indicates that inflationary pressures are likely to remain subdued in 2000. With the momentum in the domestic economic activity increasing, the output gap will narrow and this may result in some inflationary pressures in 2000. However, while excess capacity is declining, it is likely to remain significant in several industries. The increase in inflation, is therefore projected to edge up slightly to 3.2% from 2.8% in 1999, largely reflecting the structural constraints in the food sector. While the labour market situation is expected to tighten with the unemployment rate remaining low at 2.9% in 2000, wage pressures are expected to remain subdued because of the expectation of greater labour mobility from surplus to deficit areas. In addition, given the competitive environment, the increases in wage costs are expected to be commensurate with productivity improvements, hence mitigating the potential for the build-up of inflationary pressures.

Notwithstanding the mildly expansionary public sector spending programme, the fiscal position is not expected to be a source of inflationary pressures. Based on the revised 2000 Budget announced on 25 February 2000, the current account of the Federal Government is expected to remain in surplus notwithstanding the 10% salary adjustment for civil servants and pensioners. With higher revenue collection, the current account is expected to record a surplus of RM7.5 billion or 2.5% of GNP. While net development expenditure is expected to remain high at RM20.9 billion, this amount is marginally lower than in 1999 (RM21.5 billion). Overall, the fiscal deficit of the Federal Government is expected to amount to RM13.4 billion or 4.5% of GNP, well below the 6% cap set earlier. As the recovery process strengthens to allow the private sector to resume its role as the engine of growth, there will be fiscal consolidation, enabling the Government to revert to

Table 3.6
Federal Government Finance

	1999*p*	2000*f*
	(RM billion)	
Revenue	58.7	61.8
Operating expenditure	46.7	54.3
Current account	**12.0**	**7.5**
(% of GNP)	**(4.3)**	**(2.5)**
Net development expenditure	21.5	20.9
Overall account	**–9.5**	**–13.4**
(% of GNP)	**(–3.4)**	**(–4.5)**

p Preliminary
f Forecast

Source: Ministry of Finance

a surplus position. Given ample liquidity in the banking system, a large proportion of the fiscal deficit would continue to be financed from non-inflationary domestic sources. As a result, the Federal Government's external debt would be maintained at low levels (5.4% of GNP in 2000), due mainly to drawdown of loans committed earlier under both bilateral and multilateral programmes. Private sector activities are not likely to be crowded out given that liquidity generated from the surplus in the current account of the balance of payments in 2000 is expected to be sustained.

Despite the projected stronger growth in imports, the **current account of the balance of payments** is expected to remain in surplus in 2000 due to several factors. The projected import growth is expected to emanate mainly from higher imports of intermediate goods, which are necessary inputs for the production of manufactured goods for exports. Imports of capital goods are expected to register a marginal increase, as the import content of investment activity is likely to be low in the immediate term because of high capital outlay in the pre-crisis period, particularly in infrastructure projects. Generally, the increases in imports would be mainly for capital imports in projects with shorter gestation period that are likely to directly generate export earnings, for example, expansion in the higher value-added electronics sector. The fiscal stimulus package has also targeted those activities with low import content such as basic infrastructure, education and low-cost housing. Moreover, the new growth is anticipated to be supported by more efficient use of existing resources. Consequently, the current account of the balance of payments is expected to remain strong in 2000, recording another surplus of RM42.6 billion or 14.2% of GNP.

In the merchandise account**, exports of manufactured goods** in US dollar terms are projected to increase by 14% in 2000, arising from expected sustained demand from the industrial countries and a stronger economic performance in the region. During the year, growth is expected to emanate mainly from the electronics, electrical products, wood products, furniture and parts and chemical products industries. With its high contribution to total manufactured exports, the electronics industry is envisaged to remain an important impetus for growth. Exports of the electronics industry is projected to be sustained at a double-digit expansion, underpinned mainly by increased usage of the internet, e-commerce and increasing demand for communication chips for use in computer modems and cellular phones. The favourable growth forecast is in line with the projection of the Semiconductor Industry Association that sales of the global semiconductor industry is expected to grow by 21% in 2000 (1999: 18.9%). Reflecting the favourable external demand prospects, export volume is expected to expand by 13.3%, while US dollar export prices are expected to turn around to record a marginal growth of 0.4% in 2000.

Table 3.7
Balance of Payments

	1999*e*	2000*f*	1999*e*	2000*f*
	RM billion		US$ billion	
Merchandise	83.5	83.4	22.0	21.9
Services	–28.9	–32.9	–7.6	–8.7
Transfers	–7.2	–7.9	–1.9	–2.1
Balance on current account	**47.4**	**42.6**	**12.5**	**11.2**
(% of GNP)	*16.9*	*14.2*	*16.9*	*14.2*
Long-term capital	11.7	7.9	3.1	2.1
Basic balance	**59.1**	**50.5**	**15.6**	**13.3**
Short-term capital	–36.0		–9.5	
Errors & Omissions	–5.3		–1.4	
Overall balance	**17.8**		**4.7**	
BNM international reserves	**117.2**		**30.9**	
Months of imports	*5.9*		*5.9*	
Reserves/ST debt	*5.1*		*5.1*	

e Estimates
f Forecast

Source: Department of Statistics and Bank Negara Malaysia

Total export earnings from the commodity sector is forecast to decline by 8.5% to RM41.1 billion in 2000 due mainly to lower export earnings from palm oil. Overall, the outlook for **commodity prices** in 2000 is somewhat mixed. While prospects for crude oil, timber and rubber are favourable, further declines in crude palm oil prices are expected. The overall commodity export unit value is forecast to decline by 3.8% during the year. However, excluding crude palm oil prices, the overall commodity price index is expected to increase by 5.5%. During the year, crude palm oil prices are expected to average RM1,250 per tonne (1999: RM1,615 per tonne) as the current situation of ample global supplies of vegetable oils is expected to remain. In particular, the large carry-over of palm oil stocks from 1999 is expected to weigh down on palm oil prices during 2000. On the other hand, the price outlook for saw logs and sawn timber is expected to be more favourable with prices expected to increase further on expectations of increased external demand,

Table 3.8
Exports and Imports

	1999	2000*f*	1999	2000*f*
	RM billion		US$ billion	
Gross exports	**321.2**	**356.2**	**84.5**	**93.7**
(% change)	**12.1**	**10.9**	**15.3**	**10.9**
Manufactures	271.7	309.9	71.5	81.5
(% change)	14.3	14.0	17.6	14.0
Minerals	17.2	17.1	4.5	4.5
(% change)	15.9	–0.6	19.6	–0.6
– Crude oil	9.3	9.1	2.4	2.4
(% change)	23.9	–1.8	27.7	–1.8
– Production ('000 bpd)	693.2	694.0	693.2	694.0
– Unit value (US$/bbl)	18.18	20.00	18.18	20.00
Agriculture	27.7	24.0	7.3	6.3
(% change)	–8.4	–13.4	–5.5	–13.4
Gross imports	**248.9**	**286.0**	**65.5**	**75.3**
(% change)	**9.1**	**14.9**	**12.3**	**14.9**
Capital goods	33.0	33.6	8.7	8.8
(% change)	–8.9	1.8	–5.9	1.8
Intermediate goods	182.2	215.1	48.0	56.6
(% change)	13.2	18.0	17.3	18.0
Consumption goods	15.5	16.5	4.1	4.4
(% change)	17.8	7.0	21.3	7.0
Dual-use goods	4.9	5.2	1.3	1.4
(% change)	29.0	5.3	33.4	5.3

f Forecast

Source: Department of Statistics and Bank Negara Malaysia

particularly from the Asia-Pacific markets amidst tight global supplies of tropical wood. Meanwhile, rubber prices are expected to increase moderately as global demand improves. In the minerals sector, **crude oil prices are forecast to average US$20 per barrel** (1999: US$18.18 per barrel). Prices recorded during January-February 2000, averaging US$26 per barrel, are not expected to be sustained as global production of crude oil is expected to increase in the face of rising global demand and declining inventories. Developments in crude oil prices would be influenced largely by OPEC's production.

With **merchandise imports** expected to increase only at a slightly faster rate, the surplus in the merchandise account is expected to be sustained at about the same level as in 1999 (RM83.4 billion), more than adequate to finance the net payments for services imported. Higher net outflows in investment income, freight and insurance as well as other services accounts are expected to contribute to the higher deficit in the **services account** (–RM32.9 billion or 11% of GNP). The projected larger outflow in investment income is due to the strong export performance by the electronics industry as well as other export-oriented industries. Higher imports are also expected to lead to higher payments for freight and insurance. However, the travel and other transportation accounts are expected to post improved performances with expected net inflows of RM6.7 billion and RM3 billion respectively, contributed mainly by the tourism sector. Net transfer payments are expected to increase to RM7.9 billion.

In the **capital account**, the Federal Government is expected to record a net repayment in 2000 due to both lower borrowings as well as higher repayment of loans. The NFPEs, however, are expected to continue to record a larger net borrowing in 2000 due to increased borrowings to finance capital expenditure, domestically as well as abroad. Gross inflows of direct foreign investment are expected to increase moderately in 2000. Overall, the basic balance, comprising the current account and the long-term capital account is projected to record a surplus of about RM50.5 billion or US$13.3 billion.

The total **external debt** outstanding is expected to decline by 1% to RM158.8 billion by end-December 2000, equivalent to 53% of GNP. The decline in medium- and long-term debt is attributable to lower borrowings by the banks and the non-bank private sector as well as the Government. This development reflects the reduced recourse to external borrowing in the wake of higher interest rates abroad and the ample liquidity and more favourable terms offered in the domestic market. Despite higher principal repayments and interest payments, the debt service ratio is expected to stabilise at 5.6% given the sustained strong export growth.

In a global environment that is increasingly more competitive, the **management of the Malaysian economy** in the year 2000 will face new challenges. While the objective of maintaining macroeconomic stability and sustained growth with low inflation remains unchanged, the globalised financial markets, new technological developments and the advent of even larger and more influential multinationals, require that Malaysia adopt new strategies to sustain growth. Economic management in 2000 will focus on developing new areas of growth and improving competitiveness in traditional growth sectors. At the same time, focus is also directed at continued restructuring of banks, corporations and industries to increase resilience while improving

Table 3.9
External Debt of Malaysia

	1999*p*			2000*f*		
	RM billion	US$ billion	% share	RM billion	US$ billion	% share
Medium & long-term	**136.8**	**36.0**	**86**	**137.9**	**36.3**	**87**
Public sector	**77.0**	**20.3**	**48**	**79.6**	**21.0**	**50**
Federal Government	*18.4*	*4.8*	*12*	*16.1*	*4.2*	*10*
NFPEs	*58.6*	*15.4*	*37*	*63.6*	*16.7*	*40*
Private sector	**59.8**	**15.7**	**37**	**58.3**	**15.3**	**37**
Short-term	**22.8**	**6.0**	**14**	**20.8**	**5.5**	**13**
Non-bank private sector	*9.0*	*2.4*	*6*	*7.0*	*1.8*	*4*
Banking institutions	*13.8*	*3.6*	*9*	*13.8*	*3.6*	*9*
Total External Debt	**159.7**	**42.0**	**100**	**158.8**	**41.8**	**100**
% of GNP						
Total debt	57.0			53.0		
Medium & long-term debt	48.8			46.0		
Short-term debt	8.2			7.0		
Debt service ratio						
Total debt	5.3			5.6		
Medium & long-term debt	4.8			5.3		

p Preliminary
f Forecast

Source: Ministry of Finance and Bank Negara Malaysia

competitiveness. Similarly, macroeconomic policies will also be directed at managing emerging risks. Such risks, should they occur, will be associated with the sharp correction of major stock markets and a sudden fall in export demand. In the strategy to ensure sustainable growth, an investment-driven growth may be less relevant. In the past, investment-driven growth had benefited the economy by building capacity for future growth. The Government's policy is to target for quality investments to strengthen competitiveness and value added, and accelerate technology and skills development. In addition, small- and medium-size enterprises (SMEs) with specialised technology and strong linkages with the domestic economy will continue to be promoted.

In the recent past, a significant portion of domestic investment was channelled into the property sector. Given the excess capacity in this sector, more efforts are required to ensure that the resource surplus (savings exceeding investments) generated from the favourable balance of payments position are channelled to fund productive investments. This is particularly important to ensure that in a low interest rate environment, the strong growth in liquidity does not create excessive or speculative investments in the asset markets.

A major focus of policy is to ensure that there will be an increase in access to funding for productive investments. This is critical to ensure that excess liquidity in the system is utilised efficiently to raise the potential output of the economy in the medium term. In the drive to promote productive investments, policy initiatives are directed at promoting investments in the SME sector. In particular, BNM is reviewing policies which are aimed at increasing banks' participation in financing the growth of SMEs. In this respect, the Credit Guarantee Corporation would be reorganised to enhance its efficiency and effectiveness to ensure financing for SMEs. At the same time, the new emphasis on growth emanating from IT-related industries would mean that appropriate financing vehicles need to be developed to finance the higher risk ventures. While traditional bank financing would extend to cover some part of the investment in this area, more innovative and flexible non-bank financing is required. In this regard, the Government has taken several steps to enhance venture capital financing to accelerate the development of high-technology SMEs. Over and above the amounts being allocated by the Government and BNM, additional venture capital funding will need to be secured, should demand for venture capital funds become large during the course of 2000.

While promoting new growth areas, it is also necessary to review the strategies in the main sectors of agriculture, manufacturing and services, to address the risks and other areas of vulnerabilities that could emerge in view of rapid technological change. The new strategies should aim at alleviating structural impediments in the economy in order to remain competitive. While the strategic shift towards high technology-based industries in the manufacturing sector will continue to be promoted, the Government has also identified and encouraged new growth industries in the main sectors which are low in import content, high in value added and have high interlinkages with other industries and sectors of the economy. In particular, there is greater emphasis on revitalising the agriculture sector given that the phsyical infrastructure is already in place. The development of the agriculture sector is to focus more on the efficient utilisation of resources. Bold steps are being taken to encourage modernisation of the production process of existing industrial units, and the establishment of new industrial units using the latest technologies. In this regard, the Government has established various funds to provide financing for the acquisition of technology.

The Government also recognises the vulnerability of over-reliance on a narrow base of exports from the manufacturing sector, particularly the electronics industry. While electronics will remain important, the Government is promoting the development of resource-based industries with high growth potential within the wood-based, rubber-based and palm oil-based industries. At the same time, emphasis will be given to the promotion of new industries such as the composites and petroleum-based industries. Besides manufacturing and traditional commodities, the Government will continue to focus on the promotion of Malaysia as a regional centre for education services and tourism.

In all sectors, adjustments will be made to move from a production-based economy towards greater dependence on knowledge and information technology or knowledge-based economy. Accordingly, renewed emphasis is being directed at education and human resource management. In order to enhance labour productivity, the present education system would be reviewed to move to more creativity and solution-orientation than the present system. While high employment remains an important goal in economic policy, the Government would encourage high labour mobility. In this regard, restrictive and inflexible market practices in the labour market are being reviewed to produce a more adaptable labour force in the country.

In 2000, attention will also be given to the assessment of the most appropriate manner in which Malaysia can continue to integrate with the global economy but at the same time ensure stability in the domestic economy. In this regard, strengthening the financial sector remains a central policy objective. Measures in 2000 will build upon those effected since 1998. Corporate and bank restructuring will continue to be emphasised in 2000.

It is expected that Pengurusan Danaharta Nasional Berhad (Danaharta) would progress further in the restructuring of the banking and corporate sectors. Danaharta is currently in the midst of its secondary carve-out of non-performing loans (NPLs) from the financial system, having completed the primary carve-out involving a total of RM39.3 billion on 30 June 1999, six months ahead of the original schedule. The secondary carve-out, which comprises incidental and common loan accounts, is expected to be completed by 31 March 2000. In terms of loan workout targets, Danaharta expects to conclude workout proposals with the largest 20% of its borrowers, or transfer them for asset management workouts (i.e. sale of business or collateral) by 30 June 2000. These borrowers represent 85% of the total value of NPLs acquired by Danaharta during the primary carve-out period. In addition, Danaharta will hold further tenders for its foreign loan assets. The tenders will offer non-ringgit loans and marketable securities extended to or issued by foreign companies. Danaharta will also embark on the sale of businesses of companies that fall under Special Administration. With regard to foreclosed properties, the second sale by open tender will be launched at end-March 2000. Danaharta plans to hold these sales on a quarterly basis. Properties which are unsold will be transferred to its subsidiary, which will be entrusted to undertake value enhancement measures before selling them eventually in the open market.

Since its inception in August 1998, Danamodal Nasional Berhad (Danamodal) has injected funds totalling RM7.1 billion into 10 banking institutions. The improved confidence in the banking system and stronger economic performance has enabled five of the recapitalised banking institutions to repay Danamodal. In all of the exits to date, the “first-loss principle” has essentially been applied. In line with BNM’s policy on consolidation of the banking industry, Danamodal is in negotiations with various parties to divest its investments of RM5.3 billion in the remaining five recapitalised banking institutions. The divestments are expected to be achieved within the planned time frame.

Box V

Potential Output Revisited

Malaysia's recovery from the financial crisis in the region was stronger than expected. After five consecutive quarters of output contraction, Malaysia recorded the first positive growth in the second quarter of 1999. Since then, output expansion has strengthened, with economic activity in the final quarter of 1999 rebounding to end-1997 levels. The quick and strong recovery in the economy has prompted many analysts to question if the current growth in output is sustainable. Of more concern is whether actual growth is within the potential output growth. Potential output is defined as that level of output in the economy at which there are no inflationary pressures or external imbalances. The sustainability of growth involves both a demand and a supply dimension. This article focuses on the supply dimension of whether actual output growth is in line with potential output growth and whether the output gap that emerged during the economic contraction in 1998 has narrowed.

As in the previous study of potential output published in the 1997 Annual Report, the post-crisis potential output was estimated based on the single equation production function:

$$Y_t = f(KCU_t, L_t)$$

where KCU represents the utilised level of capital stock (capital stock, K, multiplied by the capacity utilisation rate) and L represents the labour force in employment. Based on quarterly data for the period 1991 to 1999, the short-term and long run elasticities for capital and labour were derived. KCU and L were then substituted with K and L* to derive potential output from the relationship, where L* represents the potential employment, that is, the labour force that is consistent with the "natural" or "long run" rate of unemployment[1].

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[1] In this case, the "natural" or "long-run" unemployment rate is not an explicitly defined Non-Accelerating Inflation Rate of Unemployment (NAIRU), but is a rate that has been cyclically adjusted. The cyclical natural rate should be the same as NAIRU if the economy operates at the NAIRU over the course of the cycle.

The estimates from the previous study are not strictly comparable to the present study as the data used differs in terms of the period of time covered and the frequency of the data. The earlier study was based on annual data for 1970 to 1995 while the present study used quarterly data for 1991 to 1999. Nevertheless, there are some similarities in trends between the studies.

Firstly, in both studies the absolute value of the error-correction factor indicated that there was a stable long run relationship between output and the main factors of production, namely capital and labour. Secondly, the long run elasticity of labour was much higher than for capital. This implies that output has been relatively more responsive to labour than capital. Thirdly, the elasticity of capital was low in both studies. While low elasticity might imply an inefficient use of capital or that capital was being channelled into activities where returns were low, it could also be explained by the significant investment in infrastructure projects which have long gestation periods spanning over a decade. During the period 1993 to 1997, Malaysia made significant investments in improving the infrastructure in the country, as evidenced by the high ratio of investments to GDP averaging 46% over the period and therefore the return would be realised only after a time period.

The similarities in the findings of the two studies indicate that the production structure of the economy has remained largely unchanged in the sense that there have been no significant changes in the allocation of resources. Generally, companies gained higher output either through recruiting more labour or increasing the work shifts. The study shows that the efficiency of capital has declined. Hence, the improvement in efficiency in the utilisation of capital needs to be given greater priority.

Pre-crisis Period (1992-1997)

The period 1992-95 was characterised by high growth. Actual GDP expanded by 9.5% during this

Table V.1: Compound growth rate of actual output and potential output (1992-1999)

	Actual Output (GDP)	Potential Output
	(growth rate in %)	
1992-1995	9.5	7.2
1996-1997	8.8	9.0
1998-1999	–1.3	–1.5

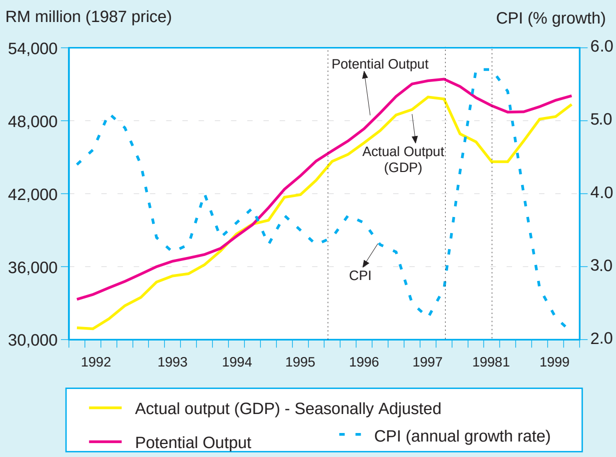
period, significantly higher than the growth rate of potential output of 7.2%. However, inflation rate as measured by Consumer Price Index (CPI) was well contained below 4% for the period 1993-95 due mainly to macroeconomic measures and the recourse to imported inputs as reflected in the widening of the current account deficit. The negative output gap narrowed gradually as actual output growth was above the trend growth of potential output. Beginning from the third quarter of 1994, there were signs of over-utilisation of production factors as actual output was above potential output. While the rate of inflation moderated, the current account deficit widened.

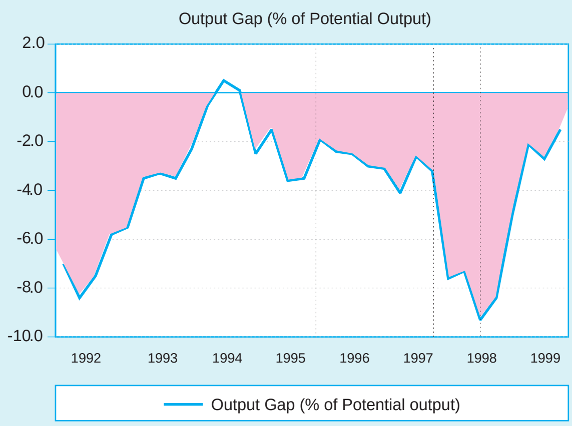
Following deliberate policies to contain aggregate demand in order to reduce the current account deficit in the balance of payments, actual output began to expand at a slower pace in 1996 and 1997, compared with trend growth of potential output. During this period, GDP increased by 8.8% while potential output expanded at a faster rate of 9%. The high investment rate coupled with the significant increase in potential new entrants to the labour force (population age of 20–24 years) contributed to the expansion of potential output during this period. Actual output expanded at a slower rate as bulk of the investments was in infrastructure projects. Consequently, the negative output gap began to widen. The inflation rate moderated from 3.7% in the second quarter of 1996 to 2.3% in the third quarter of 1997, before increasing subsequently due to the depreciation of ringgit.

Crisis and Post-crisis Period (1998-99)

The output gap began to widen significantly since the first quarter of 1998, when the GDP registered its first contraction of 3.1% on an annual basis. The impact of ringgit depreciation also began to have its adverse implications on the economy as manifested partly in the acceleration of inflation and the contraction of output. At the height of the recession in the third quarter of 1998, the output gap was the largest at 9.3% of potential output. However, the economic performance has improved since September 1998, after the introduction of selective exchange controls and the fixing of ringgit at RM3.80=US$1 to provide stability, enabling the authorities to implement growth-oriented policies and undertake structural reforms. The success of these measures was significantly aided by the recovery in export demand. Since the fourth quarter, actual output expanded at a faster pace compared with potential output, thus, narrowing the negative output gap. GDP recorded the first double-digit growth of 10.6% in the fourth quarter of 1999, closing the output gap to 1.5% of potential output. Potential output has trended upwards again since the first quarter of 1999 due mainly to higher investments by the public sector, some pick-up in private investment and increases in employment.

Graph V.1
Actual Output vs Potential Output





Conclusion

The findings indicate that the output gap is narrowing and potential output is back on its growth path. With the closing of the output gap in the near-to-medium term, high growth with low inflation can be sustained through measures to raise efficiency both in terms of technology and the use of capital and labour. The Government's current and long-term strategies in transforming the economy to a knowledge-based economy, as well as developing new growth areas based on information, communication and technology would raise potential output. The commitment to sound macroeconomic policies will provide the environment for the narrowing of the gap between actual output and potential output without creating economic imbalances in the economy.

The consolidation exercise of the banking institutions is expected to be completed by end-December 2000. It is recognised that continued change in the financial sector will take place given the expected changes that are likely to occur in both the external and domestic environment. Such changes will involve both the deregulation and liberalisation of the financial sector. At the same time, it is also recognised that financial sector deregulation and liberalisation that is too rapid can be destablising. Malaysia's approach to financial liberalisation is, therefore, one that is gradual and progressive to ensure that the country fully benefits from the liberalisation and that the reforms have the best chance of success without undermining stability. Presently, the focus is to prepare for greater liberalisation through the following steps:

- Strengthen the financial sector and deepen the capital markets in order to benefit from liberalisation and reduce risks.

- Ensure adequate prudential regulation for banks to manage risks and adapt to imposition of best practices in line with international standards.

- Strengthen institutions so that existing firms will be able to compete on a stronger foundation with new entrants into the markets.

BNM has adopted a proactive approach to prepare the industry to meet increased competition. A blueprint for the further development of the domestic banking sector would be presented in the Master Plan for the Malaysian Banking Sector, which is currently being developed by BNM and slated for implementation this year. Hence, the development and liberalisation of financial markets in this context would ensure that the financial sector remains effective in providing the financial requirements to realise the new strategies and to ensure sustainable growth with price stability.

While strategies to develop a more competitive banking sector are being undertaken, measures are also being implemented to ensure that in the process banking institutions are not detracted from their lending activities in 2000. In the merger exercise, procedures have been established to allow acquirer banks to influence lending practices of acquiree institutions. Lending by banking institutions would be monitored by the Steering Committee which will be set up by each banking group to co-ordinate the merger activities and monitor the level of loan activities within the group. In addition, banks will ensure that their operation staff and those involved in loan approvals and processing are separated from the merger team.

Overall, the indicators point toward a favourable economic and financial outlook for Malaysia in the year 2000. Macroeconomic management would continue to be flexible and pragmatic to respond promptly to changing conditions. BNM will continue to be vigilant of risks of inflationary pressures and new risks that could undermine the medium-term growth potential. In order to face the challenges in an increasingly competitive global environment, public sector structural adjustment policies will continue to aim at nurturing a more competitive environment so that private sector activities will resume their role in the growth process beyond 2000.

Monetary Policy in 2000

Monetary policy in 2000 will continue to meet the objective of strengthening the economic recovery while maintaining price stability. As a matter of policy, monetary policy would continue to aim at influencing inflationary expectations by a prudent management of excess liquidity arising from the continued strong balance of payments position. The exchange rate peg would be sustained as long as it is supported by consistent economic fundamentals.

The stance of monetary policy is determined by developments in the international environment and the domestic economy. On the international front, the monetary environment in 2000 is expected to be different from that in 1999. The benign inflation situation in 1999 would likely give way to greater concern about international inflationary pressures, especially in the United States. Interest rates have been raised both in US and Europe in the later part of 1999 and monetary policy in these countries is likely to maintain a tightening bias in 2000. However, Japan is likely to maintain its easy monetary policy. If the current round of oil price hikes are sustained, then the danger of higher inflation in the major industrial and regional economies would be greatly increased. The tightening of monetary policy and the resulting slower growth in the industrial countries would have an impact on the export-led growth of the regional countries.

On the domestic front, factors that are expected to influence monetary policy in 2000 include the inflation outlook, strong capital inflows under the pegged exchange rate regime and the availability of adequate financing to support the economic recovery. GDP growth is forecast to strengthen further in 2000, with continued reduction in excess capacity. The international outlook is vulnerable to the bias towards monetary tightening and a sharper than expected correction in the US stock prices. Both these developments would impact US aggregate demand and their import growth. On the domestic front, private investments have only recently shown signs of recovery, while excess capacity continues to exist in several sub-sectors. Against these uncertainties, fiscal policy would remain counter-cyclical to ensure that the recovery will strengthen further. Inflation, however, is expected to edge up only slightly, but can be maintained at relatively low levels. Under these circumstances, monetary policy in 2000 would remain accommodative to complement fiscal policy in strengthening the economic recovery given the absence of inflationary trends.

This accommodative monetary policy stance, however, would only be sustainable as long as there is no danger of inflation in the domestic economy. Inflationary pressures would carry additional risks to Malaysia, apart from the inefficiencies associated with higher inflation. It is recognised that inflation would contribute to a misalignment of the exchange rate and result in a loss of international competitiveness. Under a pegged regime, the exchange rate does not adjust in response to capital flows or changes in domestic aggregate demand but rather domestic prices would adjust upwards affecting the competitive position in regional and international markets.

In this regard, the monetary policy stance would be pre-emptive to contain inflation and maintain an environment of monetary stability. The assessment is therefore that the exchange rate peg would remain consistent with macroeconomic fundamentals over the medium term. This overall outcome would be achieved through close monitoring of all relevant indicators. In an economy recovering from a recession, some of the most important lead indicators would be inventories, excess capacity and productivity levels. These indicators and other price, wage and employment indicators as well as external factors would be monitored closely in the management of monetary policy to ensure subdued inflationary expectations.

Looking ahead, there are several challenges to monetary management in 2000. Efforts to ensure that inflation remains low need to monitor closely developments in asset prices. Higher incomes, easy liquidity conditions and low interest rates amidst slow demand for financing of private investment could still pose an inflationary threat if it leads to speculative activities in the asset markets. Excessive increases in asset prices could result in higher consumer prices if the positive wealth effects of higher equity and property prices led to excessive consumption spending. Asset prices, however, are not an objective of monetary policy. Asset price increases should reflect strengthening fundamentals. Credit-driven increases in asset prices should be avoided to prevent a repeat of earlier experiences. Of concern is that sharp increase in asset prices could also create an illusion of strengthening balance sheets which would reduce the urgency to restructure to become more competitive.

A further challenge to monetary management is managing the continued inflows, reflecting the performance in both the current and capital accounts in the balance of payments. BNM has intervened in the foreign exchange market to absorb the surplus foreign currency to maintain the currency peg. This has resulted in additional liquidity within the banking system, exerting downward pressures on interest rates. BNM has conducted sterilisation operations to absorb the liquidity from the money market. These sterilisation operations have been largely conducted through direct borrowings from the market.

Given that the balance of payments is expected to remain strong in 2000, the challenge to monetary policy in 2000 would focus on the effective management of excess liquidity. While a large amount of surplus funds have already been absorbed, under the current interest rate developments in Malaysia and abroad, further sterilisation of inflows would not create new risks. In addition, BNM has sufficient instruments to manage the liquidity. In the near term, BNM would continue to absorb the excess liquidity. BNM would also continue to recycle Government deposits placed with BNM to influence the liquidity situation in the banking system. The issuance of BNM bills has been particularly important in 2000 with the issuance of RM3.5 billion of these bills in February. The statutory reserve requirement also remains an option should the need arise. Managing the liquidity will remain important to ensure that the excess liquidity would not exert inflationary pressures and undermine the sustainability of the recovery process.

The accommodative monetary policy is aimed at providing an environment in which there is access to financing for productive and viable investments to support a higher level of economic activity. The balance sheet problems that may have constrained bank lending in the past have been addressed through the mechanism of Danamodal, Danaharta and the CDRC. As the banking institutions' balance sheets have improved and as NPLs have been on a declining trend, loan disbursement is expected to expand further in 2000. Drawing from past lessons, BNM would monitor closely lending activities to ensure prudent lending and avoidance of concentration and over-exposure to any particular sector.

On the exchange rate front, the focus of policy would be to ensure that the ringgit exchange rate remains consistent with the fundamentals of the Malaysian economy. The peg would not be adjusted in response to any marginal and short-term misalignments that could easily be reversed by subsequent changes in the major international currencies. The purpose for fixing the exchange rate is to provide an environment of stable domestic financial markets to facilitate economic recovery. It is, therefore, not the intention to adjust the rate frequently. Currently, there are no compelling reasons to warrant an adjustment of the peg. The medium term outlook suggests that domestic inflation would remain subdued and the threat of misalignment remains small. Nevertheless, BNM will monitor developments on both the external and internal front, that may have implications for the ringgit's exchange rate, and will respond accordingly in a highly transparent manner to ensure that the ringgit is at an appropriate rate.

As in the past, monetary policy would be implemented in a flexible and pragmatic manner. While the objective of low inflation would remain unchanged, the strategies to achieve this objective would need to be adjusted to changing circumstances and domestic and global developments. In terms of instruments, BNM would continue to work towards conducting monetary policy through more market-based instruments. The development of the bond market would enhance this process. At the same time, current measures to strengthen and improve risk management in the banking system would set a sound framework for more effective monetary policy.