Monetary and Fiscal Developments

Monetary Policy in 2000

The major thrust of monetary policy in 2000 was directed at strengthening economic recovery and maintaining financial stability. During the year, the low and stable inflation environment enabled the conduct of monetary policy to remain accommodative. The pegged exchange rate arrangement provided a stable financial market environment. In particular, it avoided the necessity for domestic monetary policy to shadow the tightening cycle of the United States (US) monetary policy in spite of the US dollar/ringgit peg. Thus, the accommodative monetary policy was able to provide the foundation for the strengthening economic fundamentals as reflected in the substantial current account surplus, high level of reserves, low inflation rate, and improved business and consumer confidence. These developments, in turn, ensured that the pegged exchange rate remained consistent with underlying fundamentals.

With the low and stable inflation, monetary policy remained accommodative in 2000 to support economic growth and maintain financial stability. Favourable economic developments supported the sustainability of the exchange rate regime.

During the year, the focus of BNM's monetary operations were aimed mainly at achieving stable liquidity conditions amid ample liquidity in the banking system. Interest rates remained low but were judiciously managed to balance the need to support economic growth, preserve price stability and sustain the nation's level of savings. In an environment of ample liquidity and the maturing of higher-cost deposits, efforts were directed at ensuring that deposit rates were maintained at levels sufficient to provide positive real rates of return to savers.

The accommodative monetary policy stance to support growth was maintained in the absence of inflationary pressures. The subdued inflation situation was reflected in the moderate increase in the consumer price index (CPI) by 1.6% in 2000, compared with 2.8% in the previous year, despite the increase in bus fares and prices of petroleum products in the second half of the year. The overall rate of inflation was low, as the expansion in economic activity was in line with potential output. Furthermore, industries which were operating at close to full capacity had begun to undertake expansion programmes and wage increases were reflective of productivity improvements. Meanwhile, in the face of potential risks of sharper economic slowdown in the US, particularly towards the latter part of the year, and its implications on Malaysia's external demand, the accommodative monetary stance remained to ensure that domestic demand would be sufficiently strong to mitigate any potential contraction in external demand.

Table 2.1
Changes to BNM Intervention Rate and SRR Ratio

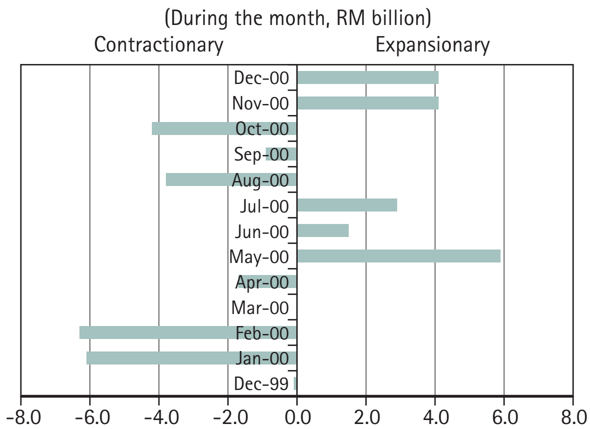
Period		Liquidity	Date	Intervention Rate	SRR Ratio
1997			End-Dec	8.70	13.50
1998	Jan-Feb	Tight	9 Jan	9.00	
			20 Jan	10.00	
			6 Feb	11.00	
	Mid-Feb -Jul	Stable	16 Feb		10.00
			1 Jul		8.00
	Aug-Dec		3 Aug	10.50	
			10 Aug	10.00	
			27 Aug	9.50	
			1 Sep		6.00
			3 Sep	8.00	
		Easy	16 Sep		4.00
			5 Oct	7.50	
			9 Nov	7.00	
1999	Jan-Dec		5 Apr	6.50	
			3 May	6.00	
			9 Aug	5.50	
2000	Jan-Dec			No change	No change

To support the economic recovery and subsequently to strengthen the growth momentum, the 3-month BNM Intervention Rate was reduced in several steps from 11% in February 1998 to 5.5% in August 1999. Since then, the Intervention Rate has remained unchanged. The decision to leave the 3-month Intervention Rate unchanged in 2000 was influenced by several factors. There was ample liquidity and coupled with increased employment prospects, maintaining the current level of Intervention Rate also contained inflationary expectations. Hence, prices remained relatively stable in 2000.

While low interest rates complemented the fiscal stimulus aimed at reviving consumption and investment, a balance of ensuring a reasonable return on deposits was also considered in order to provide the incentive to save. The average base lending rate (BLR) of the commercial banks declined to its historical low of 6.75% at end-May, or about 550 basis points lower than the peak at end-June 1998. The accommodative monetary policy, together with the continued expansionary fiscal stance, was effective in stimulating domestic economic activities and raising private domestic demand. In addition, the low lending rate and robust external demand also contributed to the pick-up in loan growth. Reflecting this, money supply (M3) expanded further by 5% in 2000, mainly due to rising bank financing and expansionary fiscal operations.

In 2000, the management of monetary policy was focused mainly on managing liquidity flows to ensure stable liquidity conditions in the banking system so as to maintain interest rates at levels low enough to promote economic activity but sufficiently high to ensure positive real rate of return to depositors. During January-April 2000, liquidity operations by BNM were largely contractionary to sterilise net inflows from the external sector arising mainly from the large trade surplus and portfolio inflows. To alleviate the downward pressure on interest rates, BNM absorbed RM14.1 billion from the market. This, together with the contractionary impact from claims on the Government (RM5.2 billion) and placement of deposits by a non-bank financial institution (RM6 billion), sustained the rates at prevailing levels. Consequently, the 3-month interbank rates remained relatively stable and moved within a tight range of 3.14% to 3.18% during January to April.

Graph 2.1
BNM Liquidity Operations



From May onwards, the external sector exerted a contractionary impact on domestic liquidity. During this period, there were net outflows reflecting mainly the higher level of economic activity, repayment of debt and overseas investment by Malaysians. In addition, the higher interest rates abroad prompted an increase in trade credits extended to foreign importers. There was a net outflow of portfolio funds of RM11.8 billion between May to December reflecting, to some extent, the overall uncertainty and volatility in the regional financial markets. Nevertheless, strong trade and long-term capital inflows offset these outflows. The outflows and the shift of funds from the banking system to BNM by a non-bank financial institution (NBFI) led BNM to increase liquidity in the banking system amounting to RM10.3 billion during the period May to July and RM8.2 billion in November to December. During the period August to October, however, BNM liquidity operations were contractionary following the expansionary operations of the Government together with the net withdrawal of deposits by a NBFI.

Following the marginal increase in interbank rates in late July, the 3-month interbank rates generally remained steady at 3.25% in the second half of the year. For the year as a whole, BNM absorbed a net amount of RM4.6 billion from the financial system. In order to facilitate the management of liquidity in the system, BNM recommenced the issuance of

BNM bills, which were last issued in 1997. The issuance of BNM bills mopped up RM6.7 billion for the whole year. This was, however, partially offset by direct borrowing amounting to RM2.1 billion that was not rolled over.

An important issue that was considered in the management of liquidity during the year was the emergence of downward pressure on deposit rates. This arose given the persistent ample liquidity in the banking system and the maturing of higher cost deposits as well as moderate loan growth.

In the first half-year, signs of downward pressure on deposit rates began to emerge. The average fixed deposit rates of commercial banks edged downwards from 3.24-3.95% at end-1999 to 3.20-3.90% at the end of July 2000. Amid ample liquidity and greater competition in lending activities, there were some concerns that the rates would slide further. Following discussions with banking institutions, deposit rates were raised in August. From early August, fixed deposit rates trended to a higher range of 3.44-4.08% for commercial banks and 3.46-4.23% for finance companies at end-2000. At the same time, given the continued competition in lending activities, the average lending rates trended lower to 7.45% at end-December from 7.66% at end-July.

The increase in deposit rates was not translated into higher lending rates. Banking institutions were in a better position to absorb the increase in cost of funds given their strengthened financial position. In addition, the growth in outstanding loans was moderate, while problem loans declined. There was also no change in the BNM Intervention Rate, which is the anchor rate for the computation of the base lending rate (BLR). These developments allowed the average BLR to remain unchanged at 6.78% and 7.95% for commercial banks and finance companies respectively.

On the external front, the negative interest rate differential between Malaysia and the US widened following the strong US economic performance in the first half of 2000 and an inflation rate exceeding 3% which prompted the Federal Reserve Board to raise the Fed Funds Rate by 100 basis points from 5.5% at end-1999 to 6.5% in May 2000. With a stable Intervention Rate in Malaysia, the interest rates differential in favour of the US increased to 3.15% at end-2000 from 2.82% at end-1999. However, the real interest rate differential narrowed from 2.61% at end-1999 to 1.15% at end-2000, reflecting higher inflation in the US while inflation rate in Malaysia moderated further. In early 2001, however, the interest rate differential between Malaysia and the US rates narrowed to 2.15% (+ 0.05% in real terms) following the reduction in the Fed Funds Rate by 100 basis points.

Capital flows during the year did not create destabilising conditions in the domestic financial markets. Capital outflows reflected mainly trade-related transactions and transfers by residents for overseas investment, payments of services including education and travel, repatriation of wages and debt repayment. The reserves position remained strong as inflows financed outflows. Continued maintenance of rules preventing off-shore ringgit transactions proved to be effective in ensuring stable conditions. Prevailing condition, therefore, accorded flexibility to monetary policy to be based mainly on domestic considerations. Lending activities intensified during the year in an environment of low interest rates, ample liquidity and the strengthened position of the banking system. Outstanding loans increased steadily since February, while approvals and disbursements were stronger during the year.

The monetary framework in 2000 continued to operate under a pegged exchange rate regime, with the ringgit pegged at RM3.80=US$1. This arrangement has been effective since September 1998. The stable exchange rate level continued

Rules preventing offshore ringgit trades ensured stable conditions when regional currencies experienced volatile movements. Depreciation of regional currencies was a factor in narrowing the small undervaluation of ringgit exhange rate to almost equilibrium value towards year-end.

Monetary Measures in 2000

Monetary measures implemented in 2000 continued to focus on supporting economic growth while maintaining monetary and financial stability. Given the subdued inflation environment, the accommodative monetary policy stance was maintained during the year. Several additional measures were introduced, aimed at sustaining savings and providing positive real rate of return to depositors, and ensuring that credit continued to be channeled to priority sectors. These measures were as follows:

- To sustain savings and provide depositors with a positive real rate of return, banking institutions agreed to increase deposit rates in early August. The strengthened position of the banking institutions in terms of capitalisation, quality of asset portfolio and profitability allowed banking institutions to absorb this increase in deposit rates without a corresponding increase in lending rates.

- BNM introduced the Enterprise Programme on 9 June to expedite the resolution of non-performing loan (NPL) problems of small and medium-sized enterprises (SMEs), primarily those affected by the financial crisis. The Programme is aimed at assisting those borrowers that have credit facilities with a number of banking institutions to restructure their entire facility in a cohesive manner, using simple and standard loan restructuring guidelines. This would accelerate the debt restructuring process of the SMEs.

  A key feature of the programme is the mechanism to encourage banking institutions to provide additional financing to the SMEs to enable them to continue with their business operations and enhance their viability in the longer run. The risk associated with the new financing will be borne by BNM and the banking institution on a 70:30 basis. The portion borne by BNM would be in the form of a Credit Guarantee Corporation Malaysia Berhad (CGC) guarantee. All new financing is capped at an amount not exceeding 30% of the old funds. The total guarantee cover provided by the CGC is limited to RM500 million. The terms of the new financing are as follows:
  i) The maximum tenure of new financing would be 3 years, with an option to extend up to another 2 years;
  ii) The financing rate on the new funds would be BLR+1% per annum for a tenure of 3 years, after which market rates would apply;
  iii) All transactions pertaining to the new loans would be conducted through a non-checking account maintained and monitored by one of the banking institutions, which would be required to verify the drawdown of the funds against invoices of suppliers;
  iv) All new financing provided under this Programme would rank in priority against the old funds; and
  v) All new financing can only be used for business operations, while inter-company transactions are not allowed.

- The Government terminated the Fund for Small and Medium Industries (FSMI) and the Bumiputera Industrial Fund (BIF) with effect from 3 April. With the overwhelming response for the FSMI, the total allocated funds of RM1.85 billion has been fully utilised. In addition, the allocation of RM100 million under the BIF which was in operation for seven years has almost been fully utilised. As at 29 February 2000, the total loans that had been approved under the FSMI and BIF amounted to RM3.5 billion and RM98 million respectively. Despite the closure, all eligible borrowers under the BIF are able to access financing under the New Entrepreneurs Fund.

- The Fund For Small and Medium Industries 2 (FSMI2) was established effective 15 April 2000.

With an initial allocation of RM200 million, FSMI2 is specifically set up to promote SMIs with linkages to export-oriented industries. The lending rate on funds accessed via the FSMI2 is 6.5% per annum. The FSMI2 is managed by the CGC.

- Tabung Projek Usahawan Bumiputera (TPUB), with an allocation of RM300 million, was established on 10 February 2000 to assist small and medium scale Bumiputera entrepreneurs. The main objective of the TPUB is to provide financing at reasonable cost to enable Bumiputera entrepreneurs who have difficulty in obtaining financing from financial institutions to undertake new projects or continue viable projects in hand. This is to provide support to Bumiputera entrepreneurs and to promote greater participation in business. The scope of TPUB's assistance will cover all economic sectors. The interest chargeable for loans under the TPUB is 5% per annum.

- New guidelines on lending to the priority sectors were issued effective 1 April 2000. These guidelines set targets for lending to the Bumiputera community and the housing sector to ensure that the two respective sectors continue to have access to credit from banking institutions. They replace the earlier guidelines for lending to the Bumiputera community and housing loan commitments under the Lending Guidelines to Priority Sectors, which were issued in 1998 and expired on 31 March. Under the new guidelines, loans to the Bumiputera community are set at a minimum of 30% of the total loans outstanding as at 31 December 1999, to be complied with by 31 December 2001. In addition, commercial banks and finance companies as a group are required to make firm commitments to finance the purchase or construction of at least 150,000 units of houses, each costing RM100,000 and below, by 31 December 2001.

to provide an environment of greater certainty and predictability, facilitating planning and investment decisions by the business community. During the year, regional currencies experienced volatile movements. In formulating the ringgit exchange rate policy, distinguishing between developments that are transitory against those that are more fundamental in nature is considered critical to achieving a stable regime. The ringgit's rate should not be determined solely on short-term developments in the foreign exchange market. Constantly re-pegging the ringgit in response to short-term developments which are not reflective of fundamentals would undermine the benefit of stability that the pegged exchange rate has accorded. Of importance is that the determination of the ringgit's rate is based on domestic macroeconomic fundamentals as well as external developments that have implications on economic fundamentals.

In this regard, BNM monitors several indicators to ensure that the exchange rate is consistent with economic fundamentals. The ringgit's real effective exchange rate was slightly undervalued by about 6-8% at the end of 1999. The undervaluation occurred against a background of improved economic fundamentals as well as the appreciation of regional currencies since the ringgit was pegged in September 1998. As the degree of undervaluation was small, it did not result in inflationary pressures on the economy. In 2000, the regional currencies experienced a significant depreciation in the range of 3.9% to 37.1% against the US dollar and the ringgit, mostly as a result of domestic developments in the regional economies. These developments led to an increase of 4.8% in the real effective exchange rate of the ringgit during the year, suggesting that the degree of undervaluation of the ringgit had narrowed and that the currency is now almost at its equilibrium value. Therefore, the pegged exchange rate of the ringgit continues to remain consistent with the fundamentals of the economy, with the current account of the balance of payments continuing to be in surplus, inflation low and the level of reserves strong.

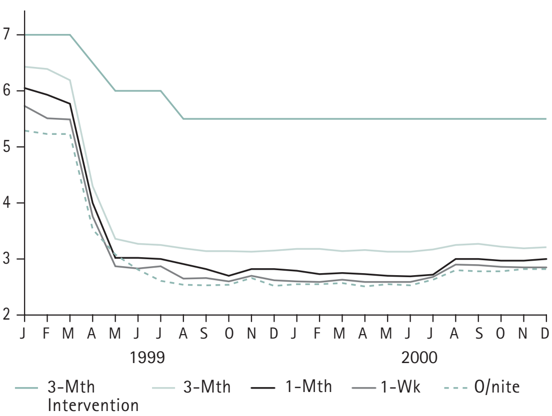
Throughout the year 2000, the macroeconomic policies in terms of fiscal and monetary policies were aimed at promoting growth in an environment of low domestic inflation. These factors, together with the strong current account surplus and the high level of international reserves, have supported the sustainability of the ringgit peg. In addition, the improved external position has reduced Malaysia's vulnerability to external shocks. External debt is low with reserves exceeding short-term external debt by more than six times. The low inflation and the restructuring undertaken by the corporate sector after the crisis period has improved international competitiveness through efficiency gains and price stability.

Monetary Developments

Monetary developments in 2000 were stable and within expectations of BNM. Reflecting this, **interest rate** movements during the year remained largely unchanged amid an ample liquidity situation in the banking system. For the larger part of the year, BNM continued to absorb excess liquidity from the system to maintain stable liquidity conditions.

The 3-month BNM Intervention Rate was maintained at 5.50% throughout the year (see Graph 2.2). Similarly, the interbank rates remained stable at relatively low levels. In the first seven months of 2000, the average 3-month interbank rate stayed at its trough and fluctuated within a tight range of 3.13-3.18% (3.13-6.43% in 1999). However, interbank rates increased marginally in late July, as reflected by the increase in the average 3-month interbank rate to 3.19-3.27% in the second half-year. Therefore, compared to the level at end-1999, the 3-month interbank rate had increased marginally by seven basis points to 3.25% at end-2000.

Graph 2.2
Interbank Rates (average for the month)



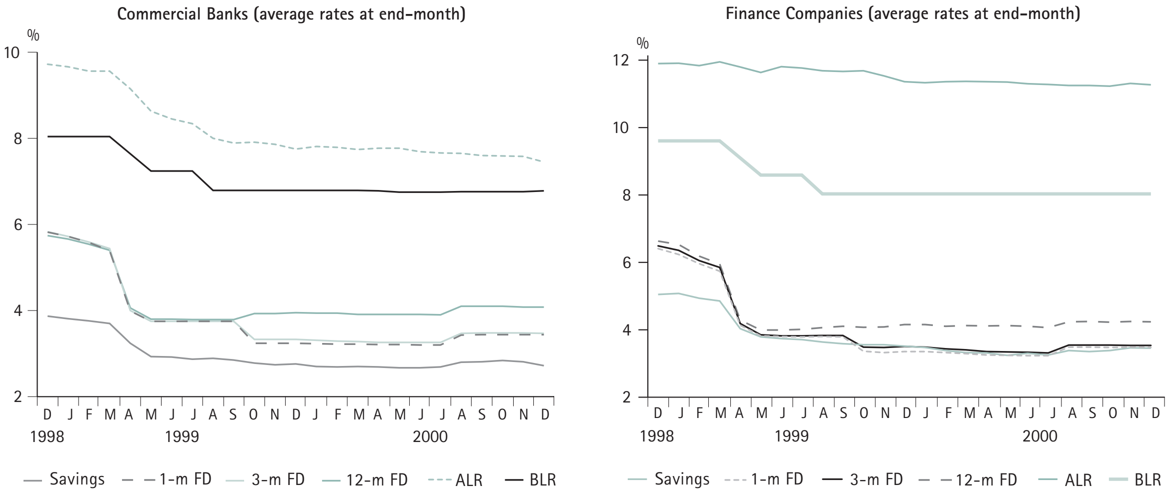
Retail interest rates of banking institutions were also generally stable during the year (see Graph 2.3). Competition among banking institutions amidst the ample liquidity environment led to a marginal decline in lending rates, while deposit rates edged upwards following the increase in interbank rates towards end-July. The average base lending rate (BLR) of commercial banks (CBs) declined to its historical low of 6.75% in May from the previous low of 6.79% recorded since August 1999, before stabilising at 6.78% at end-2000. In the case of finance companies (FCs), their average BLR had remained unchanged at the historical low of 7.95% since August 1999. In terms of average lending rates (ALRs), lower rates were also recorded for both CBs and FCs (30 and nine basis points respectively at 7.45% and 11.14%) at end-December.

Overall monetary conditions improved further. Inflation was low and bank lending increased. All monetary aggregates continued to expand broadly in line with the overall economic performance.

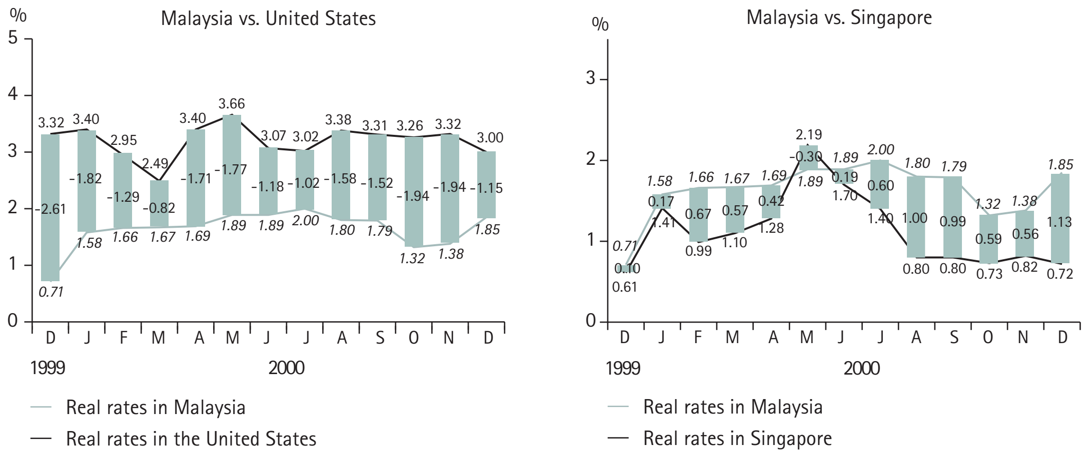
The objective of maintaining positive real rates of return to savers continued to remain an important priority. The average fixed deposit (FD) rates of all maturities remained consistently higher than the average inflation rate during the year. Nonetheless, there was some downward pressure in the first half of the year reflecting the ample liquidity environment. The average 3-month FD rates of CBs and FCs declined by seven and 19 basis points respectively to 3.26% and 3.30% respectively at end-July (3.33% and 3.49% respectively at end-1999). This trend was, however, reversed following the increase in interbank rates at end-July resulting in an increase in deposit rates in August. In this environment, savers continued to earn a reasonable positive real rate on their savings. Hence, the average 1 and 12-month FD rates of CBs and FCs increased to 3.44-4.08% and 3.46-4.21% respectively at end-December (3.20-3.90% and 3.22-4.04% respectively at end-July).

A larger increase was recorded in the shorter maturities compared with longer maturities.

Graph 2.3
Interbank Rates of Banking Institutions



Graph 2.4
Real Interest Rate Differentials



In the case of CBs, the average 1-month FD rate increased by 24 basis points versus 18 basis points for the 12-month FD rate. Similarly, for FCs, the increase was 24 basis points versus 17 basis points. Consequently, the term structure of FD rates became more concave than that at end-1999.

The savings rates of both the CBs and FCs also moved in a similar trend as the FD rates, with a slight weakening in the first half-year and subsequent increase in August following the increase in interbank rates. Thus, the savings rates of CBs and FCs stood at 2.72% and 3.44% respectively at end-2000 (2.69% and 3.24% respectively at end-July, 2.76% and 3.50% respectively at end-1999).

In terms of the interest margin, CBs experienced relatively stable margins in the first seven months of the year, reflecting the decline in the ALR which was generally in tandem with the decline in the average cost of funds (ACF). Subsequent to the increase in deposit rates in August, the ACF of CBs increased, while the ALR continued to decline. This led to a narrowing of interest margin by 23 basis points to 4.29% at end-2000. For the year as a whole, the interest margin of the CBs declined by 17 basis points. These positive developments reflected the transmission of the lower cost of funds to borrowers as competition increased in the loan market amid an environment of ample liquidity.

On the other hand, the FCs experienced increased interest margin for the larger part of the year as evidenced from the increase in their margin by 33 basis points from 6.83% at end-January to 7.16% at end-July. This reflected the faster decline in their ACF with the maturity of the higher-cost deposits, which outpaced the decline in their ALR. Since the increase in deposit rates in August, their ACF also increased, resulting in a narrowing of their interest margin by eight basis points to 7.08% at end-2000.

International comparison of real interest rates (interbank rates adjusted for inflation) between Malaysia and the United States showed that the differential remained negative, as both the economies pursued divergent monetary policies to address domestic concerns. Comparison with rates in Singapore, however, showed that the real interest rate differentials were positive in favour of Malaysia.

During the year, **money supply** continued to expand broadly in line with the economic recovery. Nevertheless, the monetary aggregates expanded at a slower rate compared with 1999, reflecting a combination of factors. In the case of narrow money, M1, the slower growth following the rapid increase in 1999 was mainly attributable to the return of currency by the private sector, with the successful rollover of Y2K. Meanwhile, broad money was influenced by domestic economic activities, some outflow of funds due to special factors, as well as the placement of a non-bank financial institution (NBFI) deposits with BNM. On the whole, the overall performance of the monetary aggregates were consistent with the policy stance of ensuring sufficient liquidity to finance real output expansion whilst ensuring price stability.

Narrow money or M1, which increased sharply in the fourth quarter of 1999, moderated substantially in the first half of 2000, following the successful rollover of Y2K and the eventual return of currency by the private sector. In the period July to October, the expansion in M1 reflected the increased demand for transaction balances. However, the annual rate of growth moderated thereafter to 6.5% as at end-December 2000 reflecting the high base at the end of 1999. Of the large increase in the issuance of currency in 1999 (RM6.5 billion), slightly more than one-third of the increase in the currency in circulation was returned in 2000. Consequently, while the currency in circulation fell by RM2.5 billion during the year, demand deposits rose by RM7.3 billion. Similarly, the broader monetary aggregates, M2 and M3, also expanded further during the year (5.2% and 5.0% respectively at the end of 2000).

Table 2.2
Interest Rates of Banking Institutions (%)

	As at end	1999	2000	Difference
Commercial banks	3-month FD	3.33	3.47	0.14
	Savings deposit	2.76	2.72	–0.04
	Base lending rate	6.79	6.78	–0.01
Finance companies	3-month FD	3.49	3.52	0.03
	Savings deposit	3.50	3.44	–0.06
	Base lending rate	7.95	7.95	0.00

Table 2.3
Interest Margins of Banking Institutions (%)

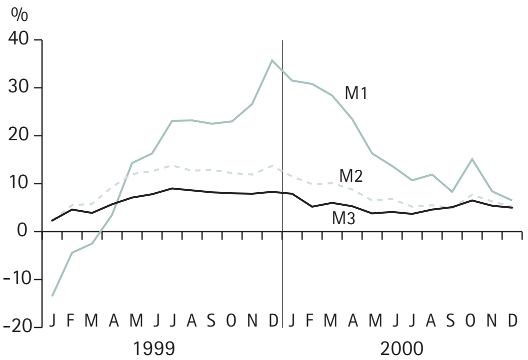
	As at end	1999	2000	Difference
Commercial banks	Average lending rate (ALR)	7.75	7.45	–0.30
	Less Average cost of funds (ACF)	3.29	3.16	–0.13
	Interest margin	**4.46**	**4.29**	**–0.17**
Finance companies	Average lending rate (ALR)	11.23	11.14	–0.09
	Less Average cost of funds (ACF)	4.57	4.06	–0.51
	Interest margin	**6.66**	**7.08**	**0.42**

During the year, M3 increased by RM21.9 billion (RM33.1 billion in 1999) to RM456.5 billion at the end of 2000. In terms of components, demand for transaction balances was similarly influenced by the shift of funds out of currency into other types of deposits, following the successful rollover of Y2K. This, coupled with the higher earnings arising from the robust economic activities and the large trade surpluses led to an increase in broad quasi-money (private sector holdings of fixed and savings deposits, negotiable instruments of deposits or NIDs, and repurchase agreements or repos with the banking system) by RM16.2 billion or 4.5% (1999: RM14.7 billion or 4.2%).

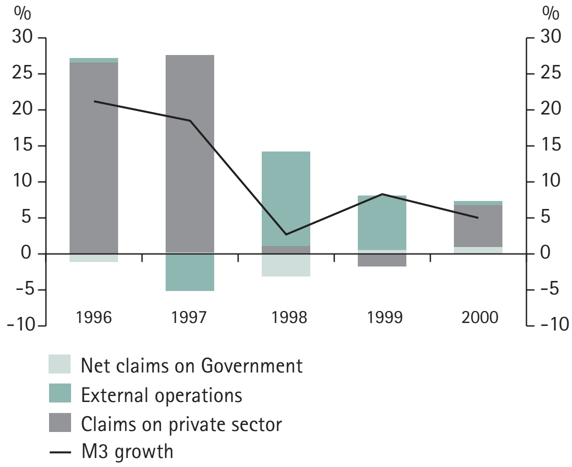
In terms of instruments, fixed deposits as well as savings deposits continued to register increases during the year, by RM8.2 billion and RM6.4 billion respectively (RM29.7 billion and RM7.9 billion respectively in 1999). The increase in fixed deposits was on account of the increase in Islamic investment deposits (RM7.5 billion), reflecting the narrowing gap between the rates

Graph 2.5
Money Supply

Money Supply: Annual Growth



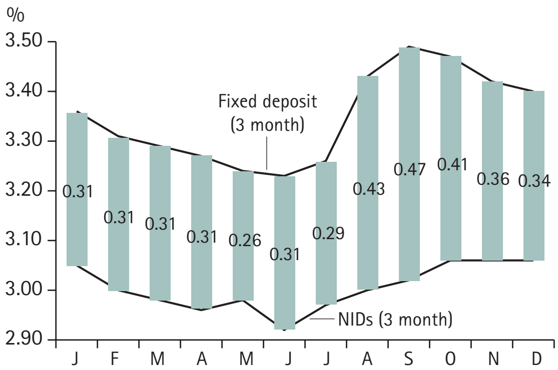
Money Supply: Contribution to M3 growth



of return on these deposits and conventional fixed deposits as well as the efforts to promote the Islamic financial and banking system in Malaysia. During the year, foreign currency deposits also increased by RM2.9 billion or 41.8% (RM1.4 billion or 25% in 1999), mainly placed by business enterprises to facilitate trade transactions. However, repos and NIDs registered declines during the year, by RM0.3 billion and RM0.9 billion respectively, largely reflecting the lower rates of returns compared with FD rates (see Graph 2.6) and, hence, the switch amongst deposit instruments.

Private sector deposits held with the banking sector rose moderately by RM23.8 billion or 5.8% in 2000 (7% in 1999). This moderate growth is attributed to a combination of factors. Generally, deposits growth tends to lag credit growth during a post-recovery period. In addition, given the improvement in

Graph 2.6
Interest Rate Differential: NIDs vs. Fixed Deposits



business performance and subsequent higher earnings, several corporations drew down their deposits to repay their loans. Meanwhile, overseas investments by Malaysian companies were also financed by funds sourced from the domestic banking system. Other outflows reflected repayment of external debt as well as repatriation of portfolio investments. Another factor contributing to the lower deposit growth was the placement of deposits by a NBFI with BNM instead of with the banking system, in contrast to the drawdown of deposits with BNM a year ago. Including these funds, deposits would have registered an increase of 7.5% during the year.

In terms of determinants, the primary source of monetary growth emanated from claims to the private sector, which increased by RM25.5 billion (-RM6.8 billion in 1999), contributing about 5.9 percentage points to M3 growth. This reflected higher loans extended to the private sector (RM17.9 billion) as well as higher holdings of private debt securities by the banking system (RM7.6 billion).

The Government operations also exerted an expansionary impact on money supply in 2000 (RM4.4 billion). However, reflecting the seasonally low expenditure in the first half-year, Government operations exerted a contractionary impact on money supply as reflected by the increase in Government deposits with BNM and the banking system (RM7.4 billion). In contrast, in the second

Table 2.4
M3 Determinants

	Outstanding		Change	
	1999	2000	1999	2000
	RM billion			
M3	**434.6**	**456.5**	**33.1**	**21.9**
M3 annual growth (%)			**8.3**	**5.0**
of which:				
Net claims on Government	–18.8	–14.4	2.2	4.4
Claims on private sector	444.9	470.4	–6.8	25.5
Loans	*380.4*	*398.3*	*–16.8*	*17.9*
Securities	*64.5*	*72.1*	*10.0*	*7.6*
External operations	124.7	126.9	30.0	2.2
Net other influences	–116.2	–126.4	7.7	–10.2

half-year, Government operations were highly expansionary as the Government withdrew its deposits from BNM and the banking system (RM8.5 billion) to finance the increased spending and loan repayments. For the year as a whole, the expansionary Government operations also reflected the higher holdings of Government securities by banking institutions (RM3.3 billion). Meanwhile, the external operations of the non-bank private sector were also expansionary on money supply, albeit to a smaller extent, by RM2.2 billion.

The expansionary impact from claims on the private sector and the Government, as well as external operations were offset partially by the contractionary "other influences". This reflected mainly the increase in deposit placements by a NBFI with BNM; higher profits of the banking institutions during the year; as well as higher provisions on loans, associated with the higher bank credit.

In line with the stronger economic growth, financing extended by the banking system recovered during the year. Total loans outstanding (including loans sold to Cagamas and Danaharta) increased by RM23.2 billion or 5.4% in 2000. Commercial banks and finance companies recorded annual growth rates of 6.4% and 4.3% respectively, while merchant banks recorded a contraction of 5.7%. Including banking institutions' holdings of private debt securities (PDS), which increased by RM7.1 billion, financing provided by the banking system was higher by RM30.3 billion or 6.9% in 2000.

While the banking system loans had provided most of the financing for the economy, other means of financing have gained significance. The equity and PDS markets expanded significantly during the year to complement financing from the banking system.

In the banking system, loans outstanding has been on the up-trend since February, amid ample liquidity and the strengthened position of banking institutions. While the increase in total loans outstanding was significant in comparison to 1999, the increase, on the whole was moderate, reflecting a combination of factors:

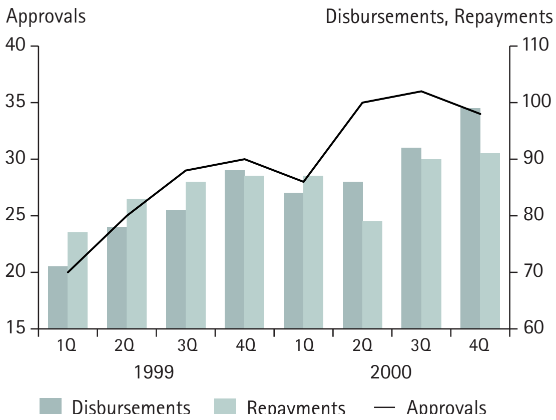
- The economic recovery was initially led by the strong export sector as well as fiscal stimulus and, subsequently, a revival in domestic demand. Many of the MNCs and larger manufacturing firms which had strong export performance relied mainly on internal funds and their improved cash flow position to fund business operations, rather than on loans from the banking system.

- There has also been increased recourse to non-bank debt financing and equity issues by the corporate sector. In the current low

Table 2.5
Sources of New Financing by the Private Sector (during the year)

	RM million				
	1985	1997	1998	1999	2000
Banking system (change)	8,082	89,210	5,377	1,140	23,206
Other financial institutions	–37	1,102	1,564	1,596	1,510
Venture capital	–	201	200	104	117
Capital market	645	32,461	7,804	16,201	21,912
Equities	*645*	*18,358*	*1,788*	*6,096*	*6,004*
Private debt securities	–	*14,103*	*6,016*	*10,105*	*15,908*
Total	**8,690**	**122,974**	**14,945**	**19,041**	**46,745**

Graph 2.7
Loan Approvals, Disbursements and Repayments (RM billion)



interest rate environment, there was incentive to raise funds in the PDS market and lock-in long-term funds at competitive rates.

- Whilst the banking institutions have expanded substantially their lending activities, as evidenced by the sharp increase in loan disbursements and approvals during the year, the high disbursements of loans were almost matched by high loan repayments, especially in the manufacturing and wholesale and retail trade, restaurants and hotels sectors. Firms generally tended to borrow short-term to meet working capital needs as opposed to borrowing long-term for investment. As such, there was a high turnover of disbursements and repayments, resulting in the moderate increase in outstanding loans.

- Given the excess capacity in selected industries, businesses tend to use their surplus cash to repay their loans and reduce their leverage.

- To some extent, the strong lending activities by banking institutions were also offset by loan write-offs and debt conversions.

On the whole, the increased repayment of loans and increased recourse to the PDS market are positive developments as it

Table 2.6
Banking System[1]: Loans Outstanding by Sector

	As at end 1999	As at end 2000	Change 2000	Share of total 2000
	RM billion	RM billion	RM billion	%
Agriculture, hunting, forestry and fishing	9.5	12.0	2.5	2.6
Mining and quarrying	1.7	1.7	...	0.4
Manufacturing	66.2	68.4	2.2	15.1
Electricity, gas and water supply	7.4	7.8	0.4	1.7
Wholesale and retail trade, restaurants and hotels	36.8	38.3	1.5	8.4
Broad property sector	155.2	163.2	8.0	35.9
Construction	*43.4*	*41.1*	*–2.3*	*9.1*
Purchase of residential property	*63.1*	*74.3*	*11.2*	*16.4*
Purchase of non-residential property	*30.0*	*29.4*	*–0.6*	*6.5*
Real estate	*18.7*	*18.4*	*–0.3*	*4.1*
Transport, storage and communication	15.7	13.7	–2.0	3.0
Finance, insurance and business services	34.0	34.5	0.4	7.6
Consumption credit	51.4	59.7	8.4	13.1
Credit cards	*5.5*	*7.4*	*2.0*	*1.6*
Purchase of passenger cars	*31.1*	*37.5*	*6.4*	*8.2*
Purchase of securities	33.7	33.5	–0.2	7.4
Purchase of transport vehicles	2.0	1.7	–0.2	0.4
Community, social and personal services	7.2	6.3	–0.9	1.4
Others	10.4	13.3	3.0	2.9
Total loans outstanding [2]	**431.0**	**454.2**	**23.2**	**100.0**
Plus: Holdings of PDS	11.0	18.1	7.1	
Total financing	**442.0**	**472.3**	**30.3**	

[1] Including Islamic banks.
[2] Including loans sold to Cagamas and Danaharta.

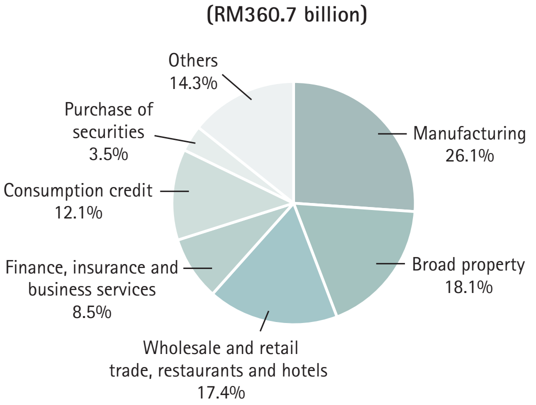
reduces the risk of potential loan defaults as well as over dependence on the banking system, particularly for long-term financing. Nevertheless, as companies, especially those in the manufacturing sector reach full capacity, new investments are beginning to take place with increased recourse to financing from the banking system.

During the year, loan disbursements and approvals of the banking institutions increased significantly by 13.4% and 27.7% respectively. The channelling of loan disbursements was broad based with most of the disbursements directed to the manufacturing sector, the wholesale and retail trade, restaurants and hotels sector, the broad property sector, and for consumption credit. Meanwhile, loan approvals amounted to RM133.2 billion, the bulk of which was for the purchase of residential property, manufacturing activities, the purchase of passenger cars and construction activities.

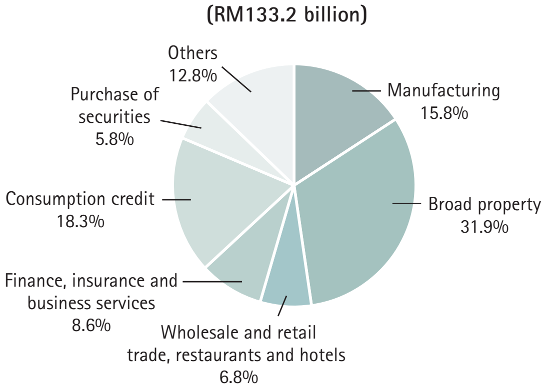
By sector, the increase in outstanding loans was most apparent in terms of loans extended for the purchase of residential property, the purchase of passenger cars, manufacturing activities, the agriculture sector and credit cards. Lending to the household sector rose significantly as disposable income rose, coupled with the improvement in consumer confidence and pent-up demand following the uncertain period of the economic slowdown. As in previous business cycles, loans extended to the household sector recovered more rapidly in the aftermath of the economic slowdown compared to business enterprises. In addition, historical low interest rates and competitive prices, particularly in the property market, also made the purchase of houses and automobiles more attractive to the average household. Furthermore, banking institutions also aggressively promoted flexible and innovative financing schemes.

While banking institutions were proceeding with the merger exercise during 2000, efforts were taken by BNM to ensure that the process of institutional change should not affect the lending operations of banking institutions. In this regard, each banking group established a steering committee to co-ordinate the merger activities and monitor the level of lending activities within the group. In addition, banking institutions also ensured that their operations staff and those involved in loan approvals and processing were separated from the merger team.

Graph 2.8
Loan Disbursements in 2000



Loan Approvals in 2000



With the relaxation of guidelines in 1999 and the aggressive promotional activities by banking institutions, BNM continued to monitor credit card developments. Outstanding credit card debt accounted for only 1.6% of total loans outstanding and 12.5% of total consumption credit as at end-2000. The increase in the outstanding credit card debt during the year reflected the rise in the number of credit cards in circulation from 2.3 million at end-1999 to 2.8 million at end-2000. In terms of the quality of loans, the amount of NPLs (based on a three-month classification) as a percentage of total outstanding credit card debt had, in fact, declined from 7.2% at end-1999 to 5% at end-2000. Meanwhile, the bulk of the credit card spending or 86.5% was for the purchases of goods and services during the year, as opposed to cash advances (13.4%).

Box II

Core Inflation

Introduction

The objective of monetary policy is to maintain price stability - in the form of low and stable inflation - to create a conducive environment for sustainable economic growth. Inflation is defined as a rise in the general price level. At a practical level, inflation is generally measured by changes in the Consumer Price Index (CPI), which is commonly also known as the headline inflation. There are, however, various concepts in the measurement of inflation beyond the standard CPI in order to more accurately analyse the sources of inflation. One of these measures is core inflation. This article discusses the concept of core inflation and its application and usefulness, particularly in Malaysia.

Usefulness of Measures of Core Inflation

Changes in the inflation rate are caused by changes in either demand or supply conditions, or both. Changes in demand conditions generally lead to persistent changes in the price level and hence, a change in the underlying inflationary trend. Demand shocks are, therefore, shocks to the long-run inflation rate. In contrast, supply shocks to the price level generally give rise to a temporary increase in inflation, with inflation returning to the underlying trend as the shock wears off. However, even a supply shock can lead to a persistent increase in the price level, if it is accompanied by an accommodative monetary policy.

Effective conduct of monetary policy, therefore, requires that monetary authorities are able to accurately assess the sources of current and future movements in inflation. More precisely, it is important for policymakers to distinguish whether an increase in the inflation rate is the result of supply shocks, which monetary policy cannot influence but could worsen, or is the result of demand conditions, which can be directly influenced by monetary policy. The ability of policymakers to identify the sources of a rise in inflation would assist in the formulation of the appropriate policy responses. A rise in inflation that is due to changes in demand conditions would require a monetary policy response. A rise in inflation arising from changes in supply conditions should be addressed through other policies, such as fiscal and trade policies, that are aimed at increasing efficiency, improving the distribution network and increasing supplies of goods and services.

The CPI, as it is ordinarily measured, is a weighted index of a basket of goods and services representing the expenditure pattern of households. Price movements of some components in the basket, such as food and energy, are often influenced more by supply shocks than changes in demand conditions and, hence, are more volatile. As a result, monetary authorities generally rely on alternative measures of inflation to provide a clearer assessment of the underlying inflationary trends in the economy.

Measures of Core Inflation

Core inflation seeks to measure inflation that is due to a persistent increase in the price level, which is due to demand shocks that result in a permanent increase in the inflation rate. At the same time, it excludes the effects of temporary or one-off increases in the price level caused by supply shocks. As core inflation is meant to be a measure of underlying inflation that is influenced by demand rather than supply conditions, the modified inflation measure excludes or minimises the influence of prices of items that are subject to supply factors.

Statistically, there are several alternative approaches to measuring core or underlying inflation. The best known statistical and conventional method of computing a measure of core inflation is through the **exclusion of price-volatile and controlled items** of the CPI basket. However, permanent exclusion of these items presupposes that price fluctuations of such items are purely transitory and do not provide information that reflects the underlying inflation trends. An alternative approach to overcome the above problem is to include all items of the CPI, but to use alternative or **modified weights**, by giving higher weights to items that have low price volatility and lower weights to items that have high price volatility. One can also gauge core inflation through two measures of central tendency of distribution, namely

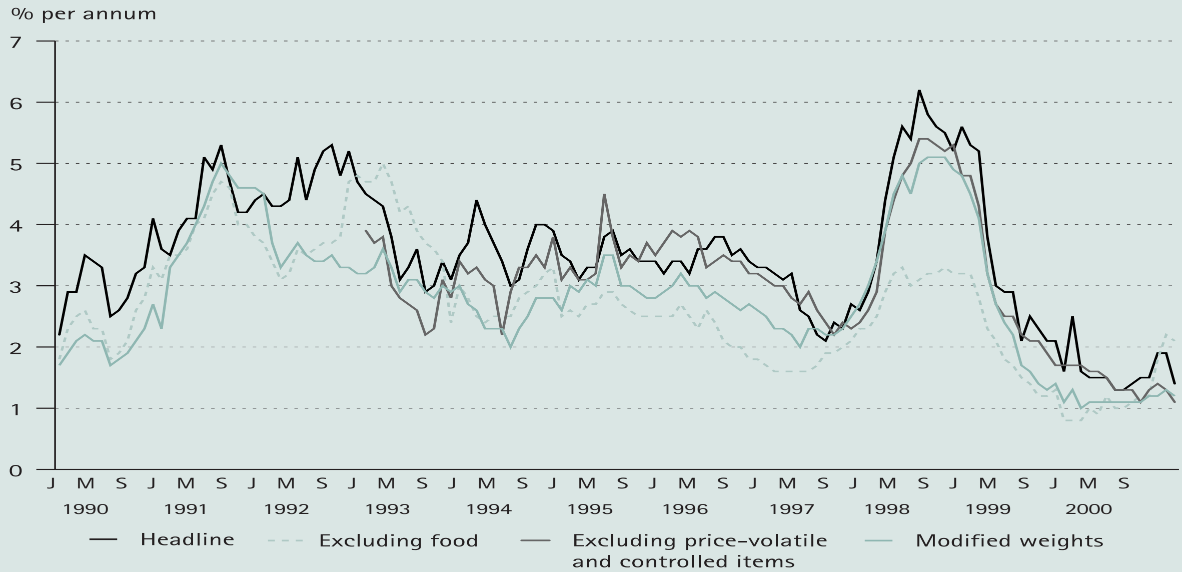
trimmed-mean and **weighted-median**. Finally, core inflation can also be deduced through **principal component** analysis, which measures the common price trend that drives prices of the various components of the CPI.

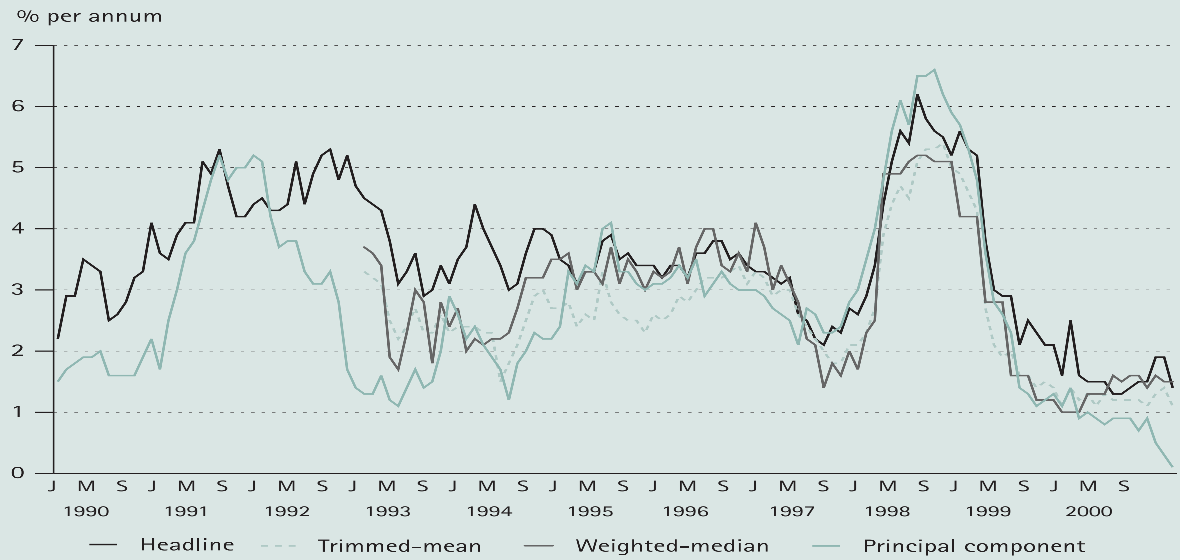
In some inflation targeting countries - like UK, New Zealand, Finland and Thailand - core inflation instead of headline inflation is used as their target variable. Generally, the target variable in these countries is an "adjusted" CPI which excludes certain items from the original basket. The other core inflation indices discussed are also constructed and used for internal policy analysis. Other inflation targeting countries - like Australia, Canada, Spain and Sweden - use headline inflation as their target variable rather than core inflation. While headline inflation is used for its monetary policy clarity, core inflation measures are, nonetheless, used to provide a better understanding of sources of inflationary pressures.

Core Inflation in Malaysia

Bank Negara Malaysia has constructed these indices of core inflation to enhance the analysis of the underlying inflationary trend in the economy. Graph II.1 plots headline inflation and the various measures of core inflation for Malaysia over the period 1990-2000. The potential usefulness of measures of core inflation is evident by analysing two brief period of high inflation, i.e. 1991-94 and 1997-98.

Graph II.1
Headline and Core Inflation





The initial increase in inflation in 1991 appears to reflect the increase in underlying inflation. However, between 1992-94, the various measures of core inflation suggested that the underlying inflation prevailing during the period was lower than headline inflation. While headline inflation increased in 1992 before declining to a lower level, core inflation was trending downwards. The core inflation measures showed that part of the increase in inflation in 1992 and the pick-up in early 1994 were due to supply constraints rather than demand conditions. It was, therefore, appropriate that the policy measures undertaken to contain the inflationary pressure focussed on fiscal restraint and the abolition and reduction of import duties on more than 600 items, including food, household goods, clothing, and electrical and electronic goods. Nonetheless, given the large liquidity overhang, interest rates were also raised during the year in order to ensure that the supply-driven inflationary pressure was not being translated into a demand-driven inflationary pressure.

Since 1995, however, the movement of headline inflation appears to be consistent with the movement of its underlying trend, as reflected by the movement of various measures of core inflation. Movements of core inflation measures over 1997-2000, showed that the depreciation of the ringgit in 1997 did lead to an increase in the underlying inflation rate. With the exception of the index excluding food, all the other indices showed roughly similar increases in the core inflation rate during the period. Under these circumstances, some precautionary tightening of monetary policy was justified in order to contain inflationary expectations and avoid second-round price increases. Similarly, the subsequent sharp easing of inflationary pressures since the second half of 1998, as reflected in the core inflation measures, allowed for the aggressive easing of monetary policy.

Conclusion

Effective policy responses necessitate that policymakers are able to distinguish the underlying inflationary trend from changes in prices driven by supply-side factors. This provides the motivation for the construction of various indices of core inflation. While BNM continues to analyse the movement in headline inflation, policy formulation also relies on various measures of core inflation to enhance the understanding as to the origin of movements in headline inflation.

Fiscal Operations and Policy

The 2000 Budget was formulated in October 1999 at a time when the economy had just turned around to record positive growth, after five consecutive quarters of negative growth. Domestic demand remained weak and excess capacity continued to prevail in some sectors. External developments could also threaten Malaysia's economic recovery process. In view of these downside risks, the focus of the 2000 Budget was aimed at strengthening recovery and raising economic growth to a level consistent with Malaysia's growth potential. This would be achieved through a five-pronged strategy, namely to revitalise economic growth; enhance the competitiveness and resilience of the nation; transform the services sector; enhance human resource development; and develop programmes to safeguard the well being of the people. The Budget was retabled in Parliament on 25 February 2000 following the dissolution of Parliament on 11 November 1999 for the General Elections. The revised 2000 Budget retained the original strategies as well as all the tax and non-tax proposals.

The budgetary operations of the Government in 2000 continued to be expansionary to stimulate economic activities through higher allocations for both operating and development expenditures. The fiscal deficit was budgeted at -4.1% of GDP for the year 2000. In addition, the 2000 Budget contained both tax and non-tax fiscal incentives focused on expanding domestic demand, while strengthening the nation's competitiveness and resilience through promoting new sources of growth, developing skilled manpower and technological competence, and expediting the restructuring of the financial and corporate sectors. Besides incentives, the Government also established several funds to support high-technology projects and venture capital companies as well as small- and medium-scale industries. On tax policy, the Government continued with its tax reform programme aimed at improving tax buoyancy and tax collection.

During the course of the year, additional allocations were provided for operating and development expenditures, mainly for education, salary adjustment for civil servants and petroleum subsidy. As a result, the overall fiscal deficit widened to -5.8% of GDP, which, nevertheless, remained within a prudential level. The stronger fiscal stimulus was a key factor in facilitating economic growth in 2000. Public sector expenditure contributed 3.2 percentage points to the 8.5% real GDP growth in 2000. In addition, it provided a strong growth impetus to the private sector, which contributed 8.9 percentage points to economic growth in 2000. As a result, the positive private sector response to Government measures led to a more broad-based economic recovery, strengthening the resilience of the economy to external risks.

Fiscal policy remained expansionary in 2000 to strengthen economic recovery. The Government maintained its fiscal flexibility and sustainability through strong commitment to fiscal prudence and discipline in its financial management.

While the thrust of the fiscal policy remained expansionary, the Government maintained its fiscal flexibility and sustainability through strong commitment to fiscal prudence and discipline in its financial management. This was necessary to ensure that the fiscal stimulus did not jeopardise long-term growth. Fiscal prudence resulted in a manageable Federal Government debt level and low debt servicing. As at end-2000, the total Federal Government debt was contained at 37% of GDP. Federal Government's external debt accounted for 15% of the total outstanding debt. Debt servicing remained low, accounting for 16% of operating expenditure.

In the management of expenditure, the Government placed high priority in ensuring that revenue was sufficient to meet operating expenditure. Overall fiscal deficit was expected to be contained at a sustainable level (within 6% of GDP); and the Government would resort to domestic financing without crowding-out the private sector. In terms of development expenditure, priority continued to be placed on projects with strong linkages within the domestic economy; minimum leakage in terms of imports; short gestation period; and expenditures to meet socio-economic objectives. A large share of the allocation was for education and skills training, infrastructure and industrial development as well as health services.

The Government stepped up efforts to ensure that the fiscal stimulus package was implemented fully. Measures taken to accelerate the pace of implementation of projects included faster processing of tenders, fast track implementation using the Turnkey, Design and Build concept and relaxing guarantee procedures. At the same time, the Government also instituted measures to ensure prompt disbursement and timely completion of projects. These included creating a Late Payments Unit to handle late payment grievances faced by suppliers and contractors, allowing greater flexibility for Government agencies in handling project management, and forming a special squad to ensure timely implementation of projects. As a result of these measures, the Government had disbursed RM27.9 billion of the RM28.3 billion in development expenditure earmarked for spending in 2000.

Table 2.7
Consolidated Public Sector Finance

	1999	2000*e*	2001 Forecast
	RM million		
General government[1]			
Revenue	71,007	73,588	81,327
Operating expenditure	53,868	63,005	67,277
Current surplus of general government	17,139	10,582	14,050
Current surplus of NFPEs[2]	33,509	38,713	32,793
Public sector current surplus	**50,648**	**49,295**	**46,843**
(% of GDP)	**16.9**	**14.5**	**13.3**
Net development expenditure	48,451	58,979	57,408
General government	*20,963*	*29,794*	*30,007*
NFPEs	*27,488*	*29,185*	*27,401*
Overall balance	**2,197**	**–9,684**	**–10,565**
(% of GDP)	**0.7**	**–2.9**	**–3.0**

[1] Comprises Federal Government, state governments, statutory bodies and local governments.
[2] Refers to 37 NFPEs.
e Estimate

Source: Ministry of Finance, state governments and non-financial public enterprises

In financing the fiscal deficit, there was greater reliance on domestic resources in the light of accumulation of public sector assets due to fiscal surpluses from previous years and the prevailing high domestic savings. Hence, the Government reduced its reliance on external funds to minimise the public sector's exposure to foreign exchange and interest rate risks. In the international capital markets, the Government reopened its US$1 billion Global Bond Issue by US$500 million, which was over-subscribed by four times. In addition, the Government also raised Euro650 million with the objective of setting a benchmark for the Malaysian corporate sector in accessing the Euro markets.

During the year, the Government continued to pursue its privatisation policy but on a more selective basis. New privatised projects were assessed more critically in terms of the potential impact on the economy, balance of payments, strong domestic linkages and multiplier effects. In 2000, a total of seven projects were privatised comprising three existing projects and four new projects, mainly in infrastructure and land development. The new projects included the Kuala Lumpur-Shah Alam-Kuang Highway, Sungai Selangor Phase III Water Supply and the Kuala Lumpur City Walk.

Consolidated Public Sector

In 2000, the financial position of the consolidated public sector continued to record a large surplus in the current account. This was due to better revenue performance of non-financial public enterprises (NFPEs) following further expansion of economic activities and sharply higher petroleum prices. Nevertheless, the significantly higher development expenditure, especially by the Federal Government to stimulate economic activities, led to an overall deficit of -2.9% of GDP.

Federal Government Finance

In 2000, the current account of the Federal Government remained in surplus (1.6% of GDP). However, the overall financial position of the Federal Government recorded a larger fiscal deficit of RM19.7 billion (-5.8% of GDP) in 2000 due largely to an expanded fiscal stimulus programme. While the fiscal deficit was higher than that planned in the 2000 Budget (a deficit of RM13 billion or -4.1% of GDP), it remained within prudent level. These developments were in line with the Government's policy of fiscal

Table 2.8
Federal Government Finance

	1999	2000*p*	2001 Budget
	RM million		
Revenue	58,675	61,864	69,238 [2]
Operating expenditure	46,699	56,547	60,710
Current account	**11,976**	**5,317**	**8,528**
(% of GDP)	**4.0**	**1.6**	**2.4**
Net development expenditure	21,462	25,032	25,036
Gross development expenditure	*22,614*	*27,942*	*26,836*
Less Loan recoveries	*1,152*	*2,910*	*1,800*
Overall balance	**-9,486**	**-19,715**	**-16,508**
(% of GDP)	**-3.2**	**-5.8**	**-4.7**
Sources of financing			
Net domestic borrowing	5,423	12,714	–
Gross borrowing	*19,281*	*23,182*	–
Less Repayment	*13,858*	*10,468*	–
Net foreign borrowing	2,923	864	–
Gross borrowing	*4,763*	*4,767*	–
Less Repayment	*1,840*	*3,903*	–
Special receipts	238	13	–
Realisable assets[1] and adjustments	902	6,124	–
Total	**9,486**	**19,715**	**–**

[1] Includes changes in Government's Trust Fund balances. A decline in the accumulated realisable assets is indicated by a positive (+) sign.
[2] Includes potential net revenue loss of RM373 million arising from the tax changes for 2001.
p Preliminary

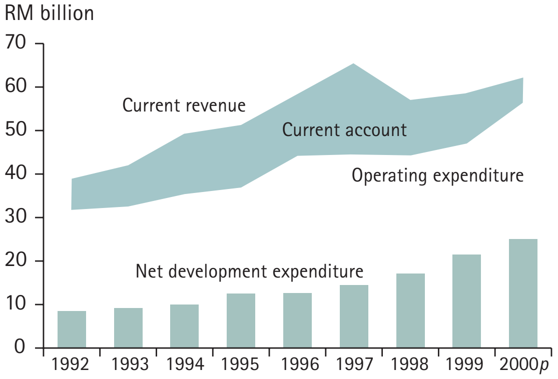
Source: Ministry of Finance

prudence, which was based on principles such as ensuring that the current account would always be in surplus and that the fiscal deficit be contained at a manageable level, within 6% of GDP.

Federal revenue expanded further to RM61.9 billion (18.2% of GDP). The favourable revenue receipts stemmed largely from the higher economic activities; the implementation of the current year tax assessment; and a larger contribution from petroleum-based revenue. Benefiting from higher petroleum prices in 1999 (the income tax base for 2000), the petroleum-based revenue accounted for one-half of the increase in total revenue collection during the year. Meanwhile, several tax measures introduced in the 2000 Budget were estimated to have resulted in revenue foregone of RM1.1 billion. In aggregate, the increase in revenue emanated from direct taxes (+RM1.9 billion) and non-tax revenue and receipts (+RM1.4 billion) as collection from indirect taxes was slightly lower (-RM83 million).

Revenue from **direct taxes** recovered to increase by 7% following two consecutive years of decline, accounting for a higher share of total revenue (47%). The increase, however, was moderated to some extent by a number of tax concessions announced in the 2000 Budget to promote domestic consumption and investment. These fiscal measures included reduction of the individual and co-operative income tax; increased personal relief from RM5,000 to RM8,000; and introduction of separate tax relief for premium on annuity purchased from the EPF annuity scheme. Despite the tax concessions, collection from individual income tax was higher due mainly to stronger economic growth. The implementation of the current year assessment in year 2000 meant that revenue from higher economic growth could be realised in the same year. Reflecting higher petroleum prices averaging US$18.18 per barrel in 1999

Graph 2.9
Federal Government Finance



Federal Government Debt

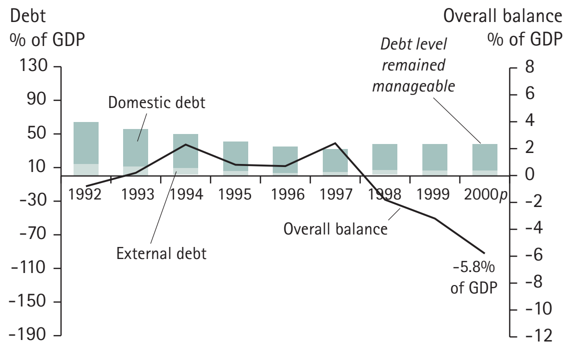


Table 2.9
Federal Government Revenue

	1999	2000*p*	1999	2000*p*
	RM million		Annual change (%)	
Tax revenue	**45,346**	**47,173**	**...**	**4.0**
(% of GDP)	**15.1**	**13.9**		
Direct taxes	27,246	29,156	-9.2	7.0
Income taxes	25,159	27,016	-11.3	7.4
Companies	*15,742*	*13,905*	*-9.0*	*-11.7*
Petroleum	*2,856*	*6,010*	*-29.4*	*110.4*
Individuals	*6,419*	*7,015*	*-7.0*	*9.3*
Co-operatives	*142*	*87*	*10.1*	*-39.0*
Real property gains tax	287	247	-27.5	-13.9
Stamp duties	1,566	1,799	31.6	14.9
Others	234	94	290.0	-59.8
Indirect taxes	18,100	18,017	18.1	-0.5
Export duties	670	1,032	7.6	53.9
Import duties	4,720	3,599	22.0	-23.8
Excise duties	4,723	3,803	31.7	-19.5
Sales tax	4,488	5,968	16.7	33.0
Service tax	1,459	1,701	0.8	16.6
Others	2,040	1,914	4.5	-6.2
Non-tax revenue and receipts	**13,329**	**14,691**	**17.2**	**10.2**
Total revenue	**58,675**	**61,864**	**3.5**	**5.4**
(% of GDP)	**19.5**	**18.2**		

p Preliminary

Source: Ministry of Finance

(tax base for 2000), petroleum income tax also recorded an exceptionally large increase. Revenue collection from stamp duties rose further due to higher volume and value of transactions in property and stock markets, the latter, mainly in the first quarter of 2000.

Collection from **indirect taxes** was affected by the introduction of several tax concessions to enhance efficiency and competitiveness. These tax concessions (including extension of sales tax and import duties exemptions on spares and consumables as well as abolishment or reduction of import duties on selected consumer goods and food products) were estimated to result in a revenue loss of RM259 million. With effect from 1 January 2000, the Government imposed sales tax on petroleum and petroleum products, while abolishing import and excise duties on these products, in line with Malaysia's commitment to the Asean Free Trade Area (AFTA) Agreement. Consequently, import and excise duties collection declined sharply. Meanwhile, sales tax revenue increased significantly due to higher collection from manufactured goods and petroleum products. Service tax collection also increased reflecting largely higher demand for selected professional services and a miscellany of other services.

Overall, the share of tax revenue was slightly lower at 76% of total revenue. The share of non-tax and non-revenue receipts accounted for 24% with higher receipts from petroleum royalty and service fees.

Total gross expenditure of the Federal Government was substantially higher in line with the expansion in the fiscal stimulus programme. In tandem with available resources, **operating expenditure** was substantially higher (21.1%) to stimulate public and private sector consumption. A large part of the increase in operating expenditure reflected the one-time salary and pension adjustment for civil servants as well as increased subsidy payment. Reflecting the 10% salary adjustment and 50% increase in housing allowances for selected categories of civil servants, the total wage bill, the largest component of operating expenditure (29%), increased by 13.3% in 2000. A substantial amount was also expended for subsidies mainly on account of large increases in subsidies for diesel, petrol and liquefied petroleum gas arising from the sharp increase in petroleum prices worldwide. With effect from 1 October 2000, the Government raised the retail prices of petroleum products by 7.7-9.1%.

Table 2.10
Federal Government Operating Expenditure by Object

	1999	2000*p*	1999	2000*p*
	RM million		% share	
Emoluments	14,436	16,357	30.9	28.9
Supplies and services	6,074	7,360	13.0	13.0
Asset acquisition	422	572	0.9	1.0
Debt charges	7,941	9,055	17.0	16.0
Pensions and gratuities	3,792	4,186	8.1	7.4
Subsidies	1,402	4,824	3.0	8.5
Other grants and transfers[1]	10,858	11,758	23.3	20.9
Other expenditure[2]	1,774	2,435	3.8	4.3
Total	**46,699**	**56,547**	**100.0**	**100.0**

[1] Includes grants and transfers to state governments as well as public agencies and enterprises.
[2] Includes grants to international organisations, insurance claims and gratuities and others.
p Preliminary

Source: Ministry of Finance

All other expenditure also recorded higher growth. In particular, there was a significant increase in disbursement on supplies and services, mainly for procurement of office supplies related to e-government flagship applications, repairs and maintenance as well as payments for professional services engaged to assist the Government in upgrading the quality of the civil service. Debt servicing of both domestic and external debt was also higher, reflecting the increased debt level to finance the fiscal stimulus programme. In addition, the higher global interest rate, especially in the first half of 2000 also contributed to the increased debt servicing. However, the share of debt servicing of 16% of operating expenditure was well below the ceiling of 20% set by the Government in 1990 when the rising share of debt charges was an area of concern. Other transfer payments were higher due largely to grants and transfers to government agencies, including state governments for development and maintenance purposes, including roads and common user buildings.

Gross development expenditure also rose significantly (23.6% to RM27.9 billion), attributable to the continued fiscal expansion to strengthen economic recovery. Reflective of the Government policy of ensuring sustainable economic growth over the long term, the thrust of spending was on human resource development, industrial development and provision of infrastructure.

Table 2.11
Federal Government Development Expenditure by Sector

	1999	2000*p*	1999	2000*p*
	RM million		% share	
Defence and security	3,122	2,332	13.8	8.3
Economic services	8,969	10,411	39.7	37.3
Agriculture and rural development	1,088	1,183	4.8	4.2
Trade and industry	2,798	3,667	12.4	13.1
Transport	2,893	3,635	12.8	13.0
Public utilities	1,850	1,517	8.2	5.4
Others	340	409	1.5	1.5
Social services	6,936	11,077	30.7	39.6
Education	3,865	7,099	17.1	25.4
Health	836	1,272	3.7	4.6
Housing	1,081	1,195	4.8	4.3
Others	1,154	1,511	5.1	5.4
General administration	3,587	4,122	15.8	14.8
Total	**22,614**	**27,942**	**100.0**	**100.0**

p Preliminary

Source: Ministry of Finance

Significantly higher expenditure was expended by the social services sector, notably for education and training. For the first time, the social services sector accounted for the largest component of the total development spending (40%). This was reflective of the Government's concerted efforts to embark on the development of a knowledge-based economy and to narrow the digital divide through education and human resource development as well as upgrading the quality of life. Expenditure for education and training was mainly for the construction and upgrading of primary, secondary, vocational and polytechnic schools and matriculation centres, as well as upgrading the education facilities, including the construction of computer laboratories. Larger allocation was also accorded to the Higher Education Fund to provide loans for higher learning. Outlays on health were also higher to support the increasing demand for public health services. This included the construction and upgrading of hospitals and health clinics. Similarly, the higher expenditure on housing was largely on low-cost public housing projects and the Integrated Rakyat Housing Projects as well as housing programmes for the armed forces, police personnel, customs and excise officers and teachers in rural areas.

In the economic services, emphasis continued to be placed on industrial, infrastructure as well as agriculture and rural development. Under the trade and industry sub-sector, priority continued to focus on industrial research and development, provision of infrastructure facilities, development of small- and medium-scale industries, and the promotion of tourism. Allocation was also provided to set up venture capital funds to increase sources of funding for high-tech companies. Expenditure on transport absorbed a sizeable share of the development expenditure, consistent with the Government's efforts to complement privatised entities in the provision of an integrated transportation network. About two-thirds of the expenditure was for the construction and upgrading of roads (including highways) as well as the development of the rail system, including the dual track from Seremban to Rawang and to Ipoh. Greater priority was accorded to development and expansion of ports and airports to increase their capacity and efficiency in handling the increasing volume of international and regional passenger traffic and trade. The Government also intensified its efforts during the year to upgrade the standard of living of the rural population. Expenditure for agriculture and rural development (including land development and drainage) was higher. Investment to improve rural roads, water supply and electrification programmes remained high.

Expenditure for general administration was largely for the construction and maintenance of the new administrative centre at Putrajaya and the implementation of electronic government to enhance the efficiency and effectiveness of the administrative machinery. Meanwhile, outlays on defence and internal security declined during the year.

Given the ample liquidity in the banking system and high domestic savings, the Federal Government **financed** its fiscal deficit largely from domestic sources. External borrowing remained small. The Government also drew down some of its accumulated realisable assets. Overall, the Federal Government recorded a **total net borrowing** of RM13.6 billion in 2000. Together with a small net exchange revaluation gain arising from the strengthening of the ringgit against the Japanese yen, the total outstanding debt of the Federal Government rose to RM125.6 billion or 37% of GDP as at end-2000. This level of debt remained manageable, with domestic debt accounting for 85% of the total debt.

Besides raising funds to finance its development expenditure, the Federal Government's **domestic borrowing** programme was also aimed at

Graph 2.10
Federal Government Outstanding Debt as at end-2000

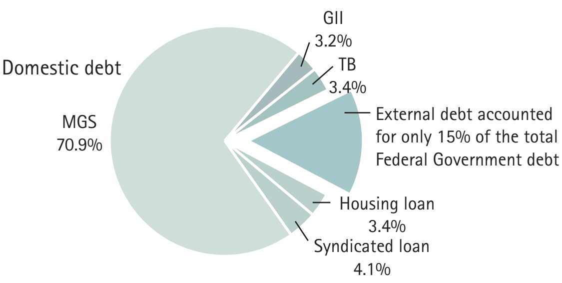


Table 2.12
Public Debt of Federal Government

	Annual change 1999	Annual change 2000*p*	At end 2000*p*
	Nominal value in RM million		
Domestic debt	5,553	13.055	106,805
Treasury bills	0	0	4,320
Government Investment Issues	0	2,000	4,000
Malaysian Government Securities	3,324	10,714	89,050
Treasury Housing Loans Fund	130	341	4,296
Market loans	2,099	0	5,139
External debt	3,445	452	18,821
Market loans	3,382	966	12,040
Project loans	63	–514	6,780
Total	**8,998**	**13,507**	**125,626**

p Preliminary

Source: Ministry of Finance

providing a benchmark yield curve to support the development of the domestic bond market. Therefore, the Government issued Malaysian Government Securities (MGS) on a more regular basis, totaling RM16 billion in 2000. The proceeds were partly used to refinance maturing MGS. A sole Government Investment Issue (GII) worth RM2 billion was also raised. Meanwhile, there were no net new funds raised through Treasury bills (TB), while the Treasury Housing Loans Fund recorded a small net borrowing during the year.

During the year, the Federal Government floated five issues of MGS, mainly by way of open tender through principal dealers and private placements. For the first time in 2000, the Government announced an auction calendar on the issue of government securities. This was to enhance transparency and assist investors in the formulation of their investment strategies. The Government also reopened four of its existing MGS issues with a larger value to generate more active trading in the secondary market. After adjusting for loans redemption, total MGS outstanding increased by 13.7% to RM89.1 billion at the end of 2000 and accounted for 83% of the total domestic debt outstanding.

In terms of ownership structure of MGS holders, the social security and insurance institutions increased their holdings to 80% of total outstanding MGS. The Employees Provident Fund (EPF) remained the single largest institutional investor in 2000, raising its holdings to 69% of the total MGS outstanding through investment in new issues of MGS as well as absorbing the liquidation of MGS, especially by the public enterprises. The share of MGS held by banking institutions remained high at 14%. The remaining MGS was held mainly by the public enterprises, non-bank financial institutions and foreign investors.

The balance of the domestic debt was in the form of a domestic foreign currency syndicated loan (5%), TB, GII and the Treasury Housing Loans Fund (4% each). The banking sector, which remained the major investors of TB and GII, increased its holdings to 96% for TB and 95% for GII outstanding for liquidity purposes. The insurance companies also held TB and GII, albeit with a smaller share, largely to comply with the statutory requirement. The main lenders to the Treasury Housing Loans Fund were Cagamas Berhad, commercial banks and the EPF.

In August 2000, the Government undertook a re-pricing exercise for the domestic foreign currency syndicated loan (RM5.1 billion equivalent) comprising US$1.25 billion and ¥11.6 billion. The loan, with a maturity period of five years, was first secured in December 1998 with a spread of 2.9% over the 6-month US$ LIBOR for the US$ portion and over the 6-month ¥TIBOR for the Yen portion. It was then refinanced in November 1999 at a lower spread of 1.2%. In the latest re-pricing exercise, this rate was further reduced to 0.52%, in the face of improved outlook on Malaysia's economic performance.

Table 2.13
Holdings of Federal Government Domestic Debt

	1999	2000*p*	1999	2000*p*
	Norminal value in RM million		% share	
Treasury bills	**4,320**	**4,320**	**100.0**	**100.0**
Insurance companies	41	76	1.0	1.8
Banking sector	3,720	4,166	86.1	96.4
Other	559	78	12.9	1.8
Government Investment Issues	**2,000**	**4,000**	**100.0**	**100.0**
Insurance companies	139	194	7.0	4.9
Banking sector	1,858	3,805	92.9	95.1
of which:				
Bank Negara Malaysia	*3*	*41*	*0.2*	*1.0*
Other	3	1	0.1	...
Malaysian Government Securities	**78,336**	**89,050**	**100.0**	**100.0**
Social security and insurance institutions	59,988	71,385	76.6	80.2
of which:				
Employees Provident Fund	*51,757*	*61,476*	*66.1*	*69.0*
Insurance companies	*6,094*	*6,652*	*7.8*	*7.5*
Banking sector	12,403	12,458	15.8	14.0
Other	5,945	5,207	7.6	5.8

p Preliminary

The Government also relied, albeit to a lesser extent, on external borrowing to fund the fiscal deficit. Recourse to the international capital market was also aimed at establishing market presence as well as setting a benchmark for the corporate sector. Two bonds were raised during the year in the international capital market. Other sources of external borrowing comprised mainly the drawdown of a number of project loans secured under bilateral sources, especially from Japan under the New Miyazawa Initiative and from multilateral sources such as the World Bank and the Asian Development Bank. Together with the bond issues, external borrowing by the Federal Government amounted to RM4.8 billion in 2000. As repayment was also large, amounting to RM3.9 billion, total net external borrowing in 2000 amounted to only RM864 million.

In September 2000, the Government reopened its US$1 billion Global Bond issue 1999/2009. The initial size of the reopening was US$350 million. However, since it was over-subscribed by four times, the issue size was increased to US$500 million (RM1.9 billion). Subsequently, in November 2000, the Government launched its inaugural euro bond with a five-year maturity, amounting to Euro650 million (RM2.1 billion). The issue established a sovereign euro benchmark for Malaysia. It also fulfilled the Government's objective of diversifying its funding sources to the eurobond market. The euro issue was over-subscribed by two times. The proceeds of these two loans were largely used to refinance the maturing US$200 million Yankee Bond 1990/2000 of RM760 million and also for the early redemption of the US$650 Floating Rate Note arising from the put option available to the note holders totaling US$617 million.

State Governments

Based on preliminary estimates, all 13 state governments achieved surpluses in their current

Table 2.14
Consolidated State Government Finance

	1999	2000e	2001 Budget
	RM million		
Revenue	8,912	9,707	9,895
State sources	*7,133*	*7,511*	*7,557*
Federal grants and transfers	*1,779*	*2,196*	*2,338*
Expenditure	4,595	5,221	5,459
Current surplus	**4,317**	**4,486**	**4,436**
Development expenditure (net)	3,826	5,751	5,422
Gross development expenditure	*4,443*	*5,958*	*5,680*
Less: Loan recoveries	*617*	*207*	*258*
Overall balance	**491**	**–1,265**	**–986**
Sources of financing			
Federal loans	713	716	1,228
Realisable assets[1]	–1,204	549	–242
Total	**–491**	**1,265**	**986**

[1] A positive (+) sign indicated a draw down in the accumulated realisable assets.
e Estimate

Source: State governments.

accounts reflecting continued financial prudence. Nevertheless, the consolidated financial position of the state governments recorded a small overall deficit in 2000 due to the significant increase in development expenditure. The overall deficit was financed largely by the Federal Government loans and drawdown of accumulated financial assets of the state governments.

During the year, the higher consolidated state revenue was derived from both state and Federal sources. The states' own sources of revenue were enhanced mainly by higher receipts of royalties on petroleum and gas and taxes on land and forestry. As in previous years, receipts from Federal sources were channeled to assist the states in providing infrastructure and essential amenities to improve the quality of life and support the increasing urbanisation in the states. The increased operating expenditure of the state governments reflected mainly higher payments for emoluments following the salary adjustment of civil servants (8.4%) as well as supplies and services (2.5%). A major share of the increased development expenditure was directed to the economic sector, especially infrastructure (roads, bridges and ports) and industrial development. Higher expenditure was also recorded for agriculture and rural development as well as public utilities and housing.

Non-Financial Public Enterprises

Preliminary estimates of the consolidated financial position of the 37 **non-financial public enterprises (NFPEs)** indicated that the overall financial position of the NFPEs as a group strengthened further in 2000 to record a larger overall surplus of RM11.5 billion or 3.4% of GDP. Favourable economic conditions resulted in a strong expansion in revenue that was more than sufficient to finance the higher expenditure.

The consolidated revenue of the NFPEs rose by 13.5% to RM108.3 billion (1999: +27.6%). The bulk of the total revenue was contributed by the three major NFPEs, namely, Petroliam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TMB). The strong expansion of economic activities and higher petroleum prices contributed to the higher revenue collection. Overseas investments also contributed to the increased revenue, accounting for about 13% of the total increase in revenue. Increased business activities led to a larger operating expenditure (13%). However, the increase in operating expenditure was contained somewhat by the financial discipline and the restructuring exercises undertaken by some NFPEs as well as lower debt servicing.

Table 2.15
Consolidated NFPEs Finance [1]

	1998	1999	2000e
	RM million		
Revenue	74,715	95,364	108,258
Expenditure	49,529	59,766	67,557
Current account	**25,186**	**35,597**	**40,702**
(% of GDP)	**11.3**	**11.9**	**12.0**
Development expenditure	29,659	27,488	29,185
Overall balance	**–4,473**	**8,109**	**11,517**
(% of GDP)	**–2.0**	**2.7**	**3.4**

[1] Refers to 37 NFPEs.
e Estimate

Source: Ministry of Finance and non-financial public enterprises

In 2000, several public enterprises including PETRONAS, TNB, TMB and Putrajaya Holdings Sdn. Bhd. continued to undertake large capacity expansion and modernisation programmes. The NFPEs also diversified their investments related to their core businesses, including the acquisitions of domestic companies to strengthen their business earnings. PETRONAS continued to invest in both upstream and downstream activities, including the construction of several gas processing plants and the integrated petrochemical complexes in Kertih and Gebeng. PETRONAS also continued to invest in strategic projects which included investments abroad. Besides acquiring a 27.2% shareholding of Perusahaan Otomobil Nasional Berhad (PROTON), it also ventured into the power generation business through acquiring a stake in TNB's gas-fired power plant in Paka, Terengganu. Overseas investments by PETRONAS included the construction of the Chad-Cameroon Intregrated Oil Development and Pipeline as well as oil exploration in Pakistan, South Africa, Gabon, Sudan, Algeria, Syria and Tunisia. Other major projects undertaken during the year included fleet expansion by the Malaysian International Shipping Corporation to enhance its capacity to handle the growing volume of international trade.

The capital expenditure of TNB was directed mainly at capacity expansion as well as infrastructure improvement at all levels, namely, generation, transmission and distribution of electricity to meet increased demand by the commercial and industrial sectors as well as residential consumers. TNB's major projects included the upgrading and expansion of the Port Klang Phase III Sultan Salahuddin Abdul Aziz Shah Power Station and the coal-fired power plant in Manjung. During the year, TNB continued with its overseas investments, where the major investment was towards the construction of a power plant in Pakistan. To enhance the competitiveness of the power generation sector as well as to ensure an adequate supply of electricity, TNB has reviewed its power plant divestment programme.

A large portion of the expenditure of TMB was channeled towards upgrading and developing a range of services and products to meet new challenges in the cellular industry as well as to maximise benefits from the convergence of the telecommunications, internet and cellular industries. In the case of Putrajaya Holdings Sdn. Bhd., capital outlays were mainly for the new administrative centre in Putrajaya.

The capital outlays of the NFPEs were financed mainly by internally-generated funds, with some recourse to domestic and external borrowings. Their total external debt was only slightly higher in 2000 (RM59.5 billion) or 38% of the nation's medium- and long-term external debt. Debt servicing stood at a low level of 1.3%. Most of the new loans were utilised to fund productive investments including overseas investments, which would generate returns to service debt as well as strengthen the financial position of the NFPEs. While the performance of the NFPEs has generally been favourable, their investment activities and borrowings continued to be closely monitored by the Government. Regular reviews ensured that the activities of the NFPEs continued to contribute to economic growth.