# Outlook and Policy

*World Economic Outlook*

**Developments in 2000 and Early 2001**

**In 2000, world output** expanded strongly by 4.7%, reflecting strong performance in the major industrial countries as well as higher growth in the developing countries, including East Asia. The favourable external environment supported the continued recovery of the East Asian countries which expanded by 7.7% during the year. Growth in the **major industrial countries** as a group rose by 3.8%, reflecting higher growth across all countries, particularly in the first half of the year. Following stronger growth and ongoing reforms in the euro area, labour market conditions in the major industrial countries improved further during the year. Inflation was contained through tight monetary policy despite price pressures emerging from higher energy cost, and to a lesser extent, from demand pressures.

In 2000, the United States (US) economy recorded the highest real output growth in 16 years, led mainly by strong private investment and robust consumer spending amidst high productivity growth. Similarly, growth in the euro area and the United Kingdom (UK) expanded further during the year, mainly underpinned by domestic demand and continued strength in export growth. In the euro area, export growth benefited from the weakness in the euro. Japan's growth remained weak as the recovery lost momentum from the second quarter of the year following a sharp slowdown in exports and continued sluggishness in private consumption.

In the second half of the year, the pace of growth in the major industrial countries began to slow down, notably in the US. Growth in the US economy decelerated from 5.8% in the first half-year to 2.7% in the second half-year arising from the tight monetary conditions, correction in technology stocks and higher energy prices. Interest rates in the US had been raised by a total of 175 basis points during the period June 1999 – May 2000.

As the US economy entered 2001 in a relatively weaker position amidst the rapid decline in consumer confidence, stress in the corporate bond market and sharp contraction in the manufacturing sector, the US Federal Reserve Board (Fed) has responded aggressively in early January. The Fed cut interest rates twice by a total of 100 basis points in January alone and has hinted towards further easing in the coming months to counter the slowdown in the real sector. This has prompted monetary easing in Canada, Australia, United Kingdom, Japan and in some of the East Asian countries. The easing by the Fed had contributed towards some improvement in investor confidence and some relative stability in the financial market conditions in the US. Besides the steepening of the US yield curve, there was an improvement in the US bond market where the spreads of the more risky securities have narrowed.

**Table 3.1**
**World Economy: Key Economic Indicators**

| | Real GDP growth (%) | | | Inflation (%) | | |
|---|---|---|---|---|---|---|
| | 1999 | 2000*e* | 2001*f* | 1999 | 2000*e* | 2001*f* |
| **World growth** | **3.4** | **4.7** | **3.5** | **–** | **–** | **–** |
| **World trade** | **5.1** | **10.0** | **6 ~ 7** | **–** | **–** | **–** |
| **Major industrial countries** | **2.9** | **3.8** | **2.1** | **1.4** | **2.4** | **2.0** |
| United States | 4.2 | 5.0 | 2.0 | 2.2 | 3.4 | 2.6 |
| Japan | 0.8 | 1.7 | 0.9 | -0.3 | –0.7 | –0.5 |
| Euro Area | 2.5 | 3.4 | 3.0 | 1.1 | 2.3 | 1.9 |
| United Kingdom | 2.3 | 3.0 | 2.6 | 2.3 | 2.1 | 2.2 |
| **East Asia** | **6.5** | **7.7** | **5.7 ~ 6.0** | **0.9** | **1.1** | **2.1 ~ 2.6** |
| **Asian NIEs** | **7.3** | **8.4** | **5.0 ~ 5.2** | **–0.3** | **0.8** | **2.3 ~ 2.4** |
| Korea | 10.7 | 9.0 | 5.3 | 0.8 | 2.3 | 3.7 |
| Taiwan | 5.4 | 6.0 | 5.3 | 0.2 | 1.2 | 2.0 |
| Singapore | 5.4 | 9.9 | 5.0 ~ 7.0 | 0.0 | 1.3 | 1.0 ~ 2.0 |
| Hong Kong SAR[1] | 3.1 | 10.5 | 4.0 | –4.0 | –3.7 | 0.0 |
| **ASEAN [2]** | **3.7** | **6.1** | **4.2 ~ 5.4** | **9.5** | **2.8** | **3.5 ~ 4.0** |
| Malaysia | 5.8 | 8.5 | 5.0 ~ 6.0 | 2.8 | 1.6 | 1.5 ~ 2.0 |
| Thailand | 4.2 | 4.5 | 3.0 ~ 4.5 | 0.3 | 1.6 | 1.5 ~ 2.0 |
| Indonesia | 0.2 | 4.8 | 4.5 ~ 5.5 | 24.0 | 3.7 | 5.2 |
| Philippines | 3.3 | 3.9 | 3.8 ~ 4.3 | 6.7 | 4.4 | 6.0 ~ 7.0 |
| **The People's Republic of China** | **7.1** | **8.0** | **7.0** | **–2.9** | **0.4** | **1.0 ~ 2.0** |

[1] Inflation refers to composite price.
[2] Includes Singapore.
*e* Estimate
*f* Forecast

Source: International Monetary Fund, Datastream, OECD Economic Outlook, National Sources

## Prospects for 2001

Going forward, prospects for world growth in 2001 depends on the magnitude and duration of the slowdown in the US economy. The positive policy moves by the authorities and prospects for further rate cuts together with the move to expedite fiscal measures to complement the monetary easing has somewhat improved the overall medium-term prospects. The prompt policy response has aimed to facilitate the re-balancing process as producers cut back output in line with the significant slowdown in overall demand in the economy. With the advent of information technology, the required adjustments in the real sector are expected to be much faster than in previous economic downturns. Thus, real GDP growth is expected to slow down to a very low level in the first half-year before a rebound in activity to potential levels in the second half-year, induced by growth-recovery in the US economy in the second half of 2001. However, the slower growth in the first half of the year will result in growth for the year as a whole to be below potential, ranging between 2 – 2.5%.

The slowdown in the US economy is expected to cause some moderation in global growth. Pre-emptive policy response and prompt inventory adjustments are expected to facilitate a recovery in the second half-year.

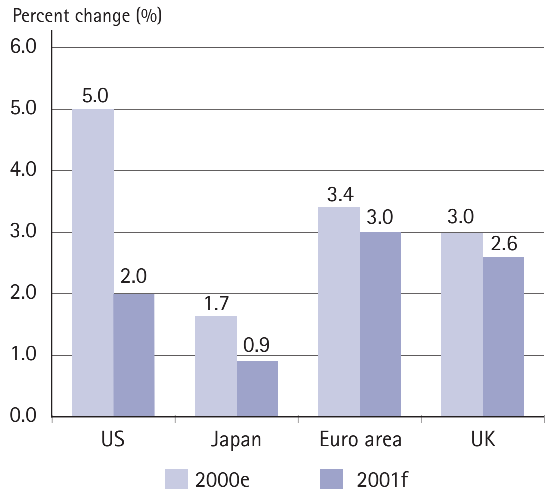
Given that the US is the largest economy in the world, accounting for slightly above one-fifth of world output, and absorbing about 19% of world exports, its slowdown is expected to result in a more moderate **world growth** of 3.5% in 2001 (2000: 4.7%). The growth, however, would still be higher than the average growth recorded during the last decade (3.2%). Real output growth in the **major industrial countries** is expected to slow down to 2.1% in 2001, reflecting weaker growth in the US and Japan. The euro area is expected to remain relatively resilient during the year. Meanwhile, growth in the **developing countries** is expected to moderate to 4.8% (2000: 5.6%) due mainly to a slowdown in exports following the downward adjustment in demand in the US. The East Asian region is projected to grow at a more moderate pace of 5.7 – 6% as expansionary domestic policies are likely to offset the negative impulse from exports. Growth would remain strong in the People's Republic of China and the impact of the US slowdown is expected to be more severe in the other East Asian economies. In line with the slowdown in the global economy, growth in the volume of **world trade** is expected to moderate to around 6 - 7% during the year (2000: 10%).

## Industrial Countries

In 2001, real GDP growth in the **United States** is expected to slow down sharply to 2 – 2.5% from 5% in 2000. The economy is likely to adjust in the first half of the year, reflecting an inventory supporting policies. The authorities currently have greater flexibility for policy to counter the slowdown. This is against a backdrop of a favourable fiscal position (in surplus since 1998 after 29 years of deficit) and improving inflationary prospects as oil prices ease from its peak in 2000. The co-ordination of monetary policy and fiscal policy with the US$1.6 trillion tax reduction plan spread over 10 years are likely to support an early recovery.

The aggressive Fed easing is expected to facilitate a virtuous upward cycle in the economy via four positive effects on GDP, namely psychological effect, traditional effect, liquidity effect and wealth effect. Both the psychological (confidence factor) and traditional effects (that boost spending relative to saving) arising from lower interest rates are aimed at ensuring that US households would

**Graph 3.1**
**Major Industrial Countries: Real GDP Growth (2000-2001)**



continue to spend rather than allocate more resources to saving. The liquidity effect is likely to ease the credit conditions for the corporations that need to access the financial markets. The positive impulse from the wealth effect is expected to be significant because historical evidence indicate that the US stock markets have tended to rally after the Fed's initial monetary easing, thus, improving the balance sheets of both households and corporations which in turn encourages consumption and investment. Nevertheless, the scope for monetary easing hinges on the stability of the dollar on a trade-weighted basis, thus, ensuring inflation remains well contained during the monetary easing. The performance of the dollar in turn is contingent on the health of the US financial system and overall investor confidence. Based on previous trends, the monetary easing has the desired effect on real economic activity within a six-month period, thus, it is expected that growth will pick up in the second half of 2001.

After contracting in the third quarter of 2000, the **Japanese economy** is expected to recover, albeit gradually in 2001, supported mainly by government spending. Real GDP growth is expected to be slightly below 1% for the year. In view of a less favourable external environment, export demand from Japan's main markets, namely US (31% of its exports) and East Asia (37% of its exports) is expected to slow down. While the slowdown from the external sector is likely to continue in the first half of 2001, the ¥11 trillion fiscal package announced in 2000 amidst easy monetary conditions should provide some impetus to growth. In addition to that, the government announced in early March 2001 an emergency package to revive the economy, comprising tax cuts and measures to support the banking system. Meanwhile, private sector demand is likely to remain subdued in view of weak labour market conditions and deflation. The outlook for Japan remains sensitive to adverse external developments, domestic uncertainties and vulnerabilities on the fiscal side (high public debt).

The major industrial countries in Europe are expected to remain relatively resilient to the US slowdown in view of their lower exposure in terms of trade to the US and also due to the potential expansionary policies that are expected to somewhat cushion the impact. The US accounts for about 8% of the euro area's total exports and 15% of the UK's exports. Growth in the **euro area** as a whole is expected to **remain strong, above trend at 3% in 2001** (2000: 3.4%), mainly supported by relative strength in the core countries. The structural changes during the 1990s in preparation for the single currency as well as labour market reforms benefited the euro area, in terms of increasing overall efficiency in the economy and strengthening its economic fundamentals. The euro area is currently characterised by lower core inflation, improved fiscal position and lower unemployment amidst the ongoing privatisation and deregulation. The region is also expected to benefit from productivity gains arising from the structural reforms, and to a lesser extent, from the "new economy". Another favourable development that should support growth in the euro countries is the proposed plans for tax reforms announced by several countries, including Germany, France, Belgium, Ireland, the Netherlands, Italy and Finland. The tax cuts, estimated to range between 0.5 - 0.6% of real GDP would provide a counter-cyclical lift to the economy of the euro area. Against a backdrop of stable oil prices and stronger currency, the European Central Bank is also expected to ease monetary policy during the year. These policies are likely to stimulate domestic demand and partly offset the negative impulse from lower exports.

Similarly, the **UK economy** is expected to continue to expand for the ninth consecutive year, but at a moderate pace of 2.6% in 2001, mainly supported by domestic demand. Fiscal policy will have an expansionary influence on growth, especially as public spending accelerates. The prospects of higher government investment spending equivalent to about 4% of real GDP in education, medical care and reforms on the pension system, as well as the proposed tax cut package worth about 0.4% of GDP should sustain consumption and improve the investment environment. The authorities have also room to complement fiscal policy with monetary easing in view of receding inflationary pressures.

**Inflation** in the major industrial countries as a whole is expected to ease to 2% in 2001, reflecting continued deflation in Japan and lower or stable inflation in the other major industrial countries. Stable oil prices, ongoing retail competition and continued productivity gains, particularly in the euro area and UK, are expected to contain price pressures during the year. The expansionary policies taken by the authorities are not likely to rekindle inflationary pressures in view of moderating domestic demand.

Reflecting the lower cost and demand pressures, inflation in the US is expected to moderate to 2.6%. Similarly, in the euro area, inflation is expected to subside below its official target of 2% due to the expected appreciation of the euro currency and stabilising energy prices. In the United Kingdom, despite the wage pressures, core inflation is expected to stabilise at 2.2%, well below the official target of 2.5% due to productivity gains and retail competition. In Japan, consumer prices are expected to decline by 0.5% in 2001 (2000: -0.7%). Downward pressures arising from technological innovations, retail competition and streamlining of distribution channels are expected to more than offset the upward pressures from the recent yen depreciation amidst weak consumer demand.

Despite recent improvements in financial market conditions and other indicators that show signs of improvement in the US economy following the Fed easing in January, the **main risk for the world economy is a "hard landing" in the US.** It is perceived that some surprises other than what is already being currently addressed could precipitate the "hard landing". At a time of a cyclical turning point, the confidence factor has a pivotal role in determining the magnitude of the slowdown in the economy. There are existing vulnerabilities in the US economy that could trigger a shift in investor sentiment during the current phase of adjustment leading to a vicious cycle of an extended slowdown in the economy. These vulnerabilities include the high leverage of the private sector (corporations and household debt as share of GDP: 132%), high household exposure to equity market (above 60% of households' financial assets are in equities) and low personal savings rate (close to 0%). The economic slowdown could expose the financial system to undue stress, which in turn could affect the confidence of foreign investors in US asset markets. Such developments could affect the stability of the dollar, and result in a pull back of financing, retrenchment in consumer spending and further decline in business investment. With consumer spending accounting for two-thirds of the US GDP, the ramifications would be widespread. In addition, a weak dollar could also limit the extent of monetary easing by the authorities in view of its implications on inflationary pressures.

**On balance**, structural improvements in the US economy have increased policy flexibility to mitigate the severity of the slowdown in the economy. These structural improvements include the strong fiscal position, high productivity growth, highly diversified and sophisticated financial system and low inflation expectations. The strength provides the authorities room for manoeuvre, both on the monetary and fiscal fronts. Furthermore, initial conditions of relatively lower interest rates than in the previous downturns should allow the US economy to weather the current slowdown better.

While the main risk is centred on the performance of the US economy, the **other risk** that could impact world growth is the **resurgence of oil prices.** Given the narrow gap between supply and demand for oil, prices are currently sensitive to adverse developments and political uncertainties in the oil producing countries. Any surge in oil prices could limit the scope for monetary easing to counter the current slowdown.

### East Asian Economies

In 2000, the regional economies recorded exceptionally strong economic growth. This strong performance was due to a revival in aggregate demand, supported by favourable external factors. In 2001, the impact of slower US growth on the regional economies would be seen in a more moderate pace of GDP growth. The **growth for the region** as a whole, however, would remain relatively strong in the range of 5.7 – 6% due mainly to strong growth in the People's Republic of China. Excluding the People's Republic of China, the region is expected to record GDP growth of 4.7 - 5.2%.

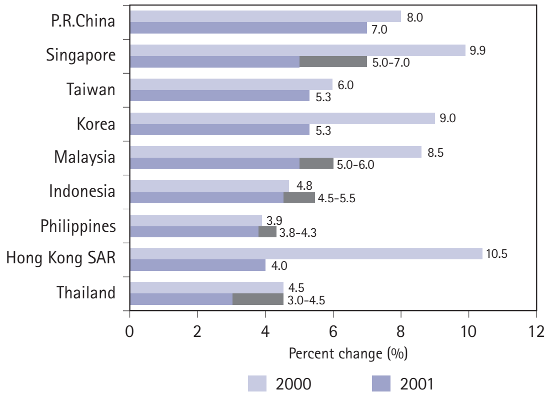
The external environment is expected to be less favourable due to a weaker US economy and the downturn in the global electronics cycle. The US slowdown is likely to impact growth in the regional countries given that about 22% of the region's exports are to the US. The impetus to growth in the regional countries is expected to shift from net exports to domestic demand, supported by continued accommodative monetary and expansionary fiscal policies. The backdrop of mild inflation amidst strong growth in the region in the last two years as well as the current monetary easing cycle in the major industrial countries allow scope for the regional countries to continue with growth-supporting policies to ensure sustainable growth. These policies are expected to ensure sufficient liquidity in the economy and to promote bank lending and, hence, moderate the negative impact of the external slowdown on investment, employment and consumption.

Overall, the regional economies are now in a stronger position to absorb any external shocks.

East Asia is in a better position to absorb external shocks. Given the stronger fundamentals, expansionary policies would support domestic sources of growth.

Significant progress has been made in addressing areas of vulnerabilities. In particular, the external position of the countries are now stronger compared with the pre-crisis period. Foreign exchange reserve holdings of the countries are higher and provide adequate coverage against short-term obligations, while an active programme has been undertaken to lengthen the maturity structure of the external debt. The current account balances of the regional countries in 2001 are expected to remain in surplus, although the surplus is likely to narrow, reflecting partly the expected slowdown in external demand and partly the deterioration in the terms of trade. The soft prices for electronics exports and the relatively high import prices for oil are likely to affect the terms of trade of some of the regional countries. A large part of the post-crisis restructuring, especially in the financial sector, that has been undertaken would lead to higher efficiency and contribute positively to growth. Inflation, although upward-biased, would remain benign during the year in view of weaker demand conditions and relatively stable global oil prices, giving flexibility to monetary policy to play a role in supporting growth-oriented policies.

**Graph 3.2**
**Regional Countries: Real GDP Growth (%)**




In 2001, the **Asian Newly Industrialised Economies (NIEs)** as a group is expected to expand at a moderate pace of 5 - 5.2% (2000: 8.4%), reflecting slower growth across all countries. The slowdown reflects partly the high base effects from the year before, and partly the NIEs' large exposure to the electronics sector. In **Korea**, the growth momentum is likely to slow down to 5.3% in 2001 from about 9 - 11% in the last two years, arising from weaker export demand, particularly for electronics, as well as slowdown in domestic demand. Similarly, real GDP growth in **Taiwan** and **Singapore** are expected to moderate to 5.3% and 5 - 7%, respectively, reflecting the effects from slower external demand and also the slowdown in capital investment in Taiwan. However, both countries have announced plans for expansionary fiscal policy during the year to stimulate domestic demand and to counter the negative impact from the US slowdown. For Singapore, the coming onstream of new manufacturing capacity from recent investments is expected to contribute to growth in 2001.

**Hong Kong Special Administrative Region's (SAR)** economy is also expected to be affected by the US slowdown with growth moderating to 4% in 2001. The lower growth is due partly to the high base effect. The spillover effects from entry of the People's Republic of China into the World Trade Organisation (WTO) and its policy to develop the Western interior are likely to provide support to economic activity in Hong Kong SAR and partially offset the impact from slower global demand. Real GDP growth in the **People's Republic of China** is expected to be sustained at a high level of 7% in 2001, supported mainly by foreign direct investment induced by the anticipated WTO entry, continued fiscal spending as well as the accommodative monetary policy.

Meanwhile, growth for the **ASEAN** economies are expected to moderate to 4.2 - 5.4% in 2001, reflecting slower economic activity in most of the member countries, although growth is expected to be supported by easier monetary policy and expansionary fiscal policy. Growth in the **Philippines** and **Thailand** are projected to be slower at 3.8 - 4.3% and 3 – 4.5% respectively, following the slower world growth and slackening domestic demand. However, stimulus from a larger fiscal package should help support growth in Thailand. Output growth in **Indonesia** is projected to be in the region of 4.5 - 5.5% in 2001. Impetus to growth would emanate mainly from net exports as Indonesia continues to benefit from higher revenues from oil prices which are expected to stabilise at a relatively high level.

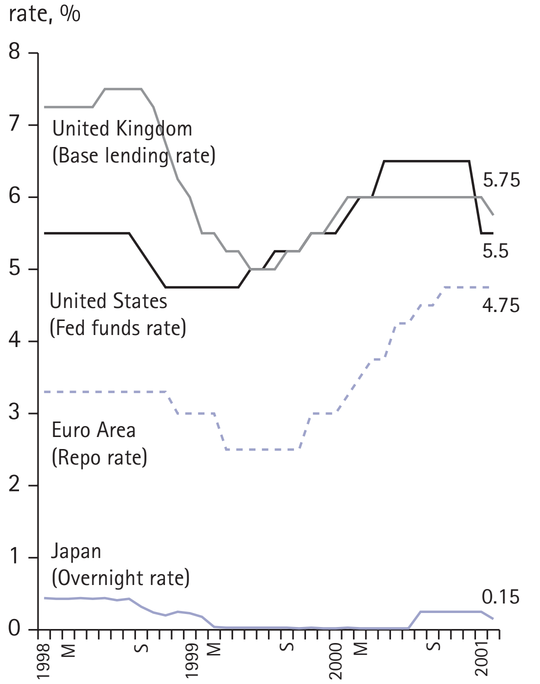
Meanwhile, **inflation** would remain relatively low in the regional countries although edging slightly higher to 2.1 – 2.6% in 2001. Price pressures are likely to emerge from the lagged effects from past increases in oil prices and currency depreciation, which to some extent would be moderated by the expected slowdown in demand. Inflation in the **Asian NIEs** as a group is expected to rise moderately to 2.3 – 2.4%, reflecting higher consumer prices in all the member countries. Of significance, deflationary pressures are likely to ease in Hong Kong SAR as the effect of earlier cost adjustments gradually tapers off. While inflation in Korea is expected to rise to 3.7% due to the pass through effect from higher oil prices and weaker currency, inflation in Taiwan and Singapore is expected to remain mild in view of the slower economic activity.

Inflation in the **ASEAN** countries as a group is expected to rise at a faster rate of 3.5 - 4% in 2001, due mainly to higher inflation in the Philippines and Indonesia. Excluding the two countries, inflation would remain fairly stable in 2001. Price pressures in the Philippines and Indonesia are likely to emanate from the full impact of higher oil prices, currency depreciation and wage rises for civil servants as well as expected weak agriculture output in the Philippines. Meanwhile, in Thailand, inflation is likely to remain benign due to the slowdown in demand arising from the moderation in economic activity. In the **People's Republic of China**, consumer prices are expected to pick up slightly due to improved consumer sentiment following the increase in civil servants' wages amidst the low interest rate environment.

## Interest Rates and Exchange Rates

**In 2000, monetary policy** in the major industrial countries was generally biased towards tightening against a backdrop of inflationary threat arising from higher energy prices, and to a lesser extent, domestic demand. In the US, the **Fed** continued to pursue pre-emptive monetary tightening in the first half of 2000, raising interest rates in three steps by a total of 100 basis points to 6.5% on 16 May 2000. However, the Fed shifted towards an easing bias in late December as the US economy began to show signs of a slowdown that would be sharper than earlier anticipated. Similarly, the **Bank of England** (BOE) raised its base lending rate (BLR) twice in 2000 by 25 basis points each on 13 January 2000 and 10 February 2000 to 6% and maintained it at this level for the rest of the year as inflationary pressures receded amidst evidence of moderation in economic activity. Monetary tightening was more aggressive in the euro area as the **European Central Bank** (ECB) raised its repo rate six times by a cumulative of 175 basis points to 4.75% on 5 October 2000 to

**Graph 3.3**
**Major Industrial Countries: Official Interest Rates**



counter the combined impact of a weak euro and higher oil prices on inflation. The **Bank of Japan** (BOJ) also ended its 18-month zero interest rate policy (ZIRP) when it raised the overnight rate to 0.25% on 11 August 2000 as a step to "normalise" its monetary policy and to remove market distortions amidst tentative signs of improvement in economic activity.

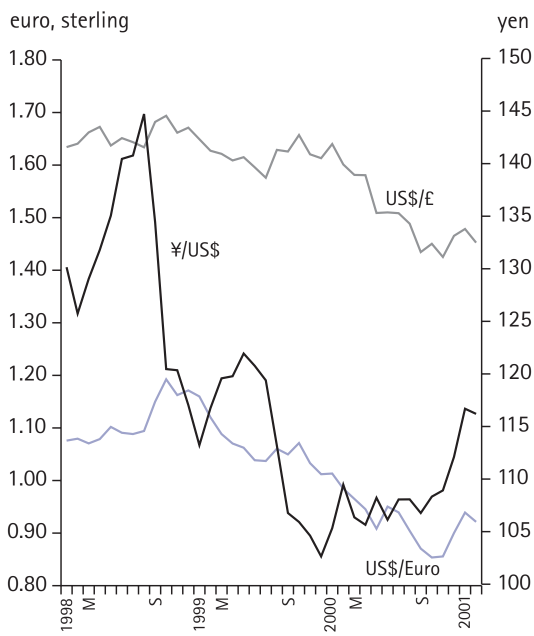
In **early 2001**, monetary policy in the major industrial countries shifted towards easing with the US, United Kingdom and Japan reducing interest rates in the first two months of the year. The Fed took the lead, with an aggressive easing of a total of 100 basis points in two steps in January alone, representing the largest monthly reduction since 1984 in order to counter the sharp slowdown in the US economy. The BOE followed suit to ease its BLR by 25 basis points to 5.75% on 8 February as a pre-emptive move to soften the impact of global slowdown on the economy amidst a benign inflation outlook. Similarly, the BOJ eased interest rates twice in February following signs of weakening economic activity amidst persistent deflation, slowing external demand and declining stock market. On 9 February, the BOJ eased its symbolic discount rate from 0.50% to 0.35% and introduced a standby lending facility. On 28 February, the BOJ reduced its overnight interest rate by 10 basis points to 0.15% and cut further the discount rate to 0.25%.

For the **remaining part of 2001**, the central banks in the major industrial countries are likely to continue to pursue further monetary easing, especially in the first half of the year in view of the weakness in the US economy and the knock-on effects on the global economy. The extent of the easing, however, would depend on a number of factors, namely the lag for monetary policy to take effect and how fast the real economic activity will respond. A critical and more uncertain factor that would influence the pace and magnitude of the monetary easing would be the performance of financial markets, particularly the behaviour of financial institutions in response to the credit conditions and the stability of the major currencies.

However, as the recent monetary policy cycles become shorter, there is a possibility that the current easing cycle might be temporary, leading authorities to become more cautious in the second half of the year. Meanwhile, in Japan, there may be less room for further easing and the BOJ is likely to seek alternative measures to inject liquidity into the system to counter the deflationary pressures as well as potential impact of the stricter accounting rules on the financial sector.

In the **foreign exchange** markets, the United States dollar strengthened against all major currencies **in 2000**. The dollar appreciated against the yen, euro and pound sterling by 10.6%, 6.5% and 7.6% respectively, supported by the relative robustness of the US economy, especially in the early part of 2000, as well as large capital inflows in favour of the US. After hitting a record intra-day low of E1=US$0.8225 on 26 October 2000, the euro reversed trend towards year end to close at E1=US$0.9424, supported by the shift in market perception that the euro area would grow faster than the US economy following the sharp slowdown of the latter. Despite the uncertainty on the slowdown of the US economy, the dollar remained firm against all major currencies in the **first two months of 2001.** The sentiment on the dollar was underpinned by the new US administration's continued support for the strong dollar policy as well as the positive impact of the recent monetary easing on investor confidence and US financial markets. At the same time, the yen was affected by

**Graph 3.4**
**Movement of the US Dollar against Major Currencies**



increasing pessimism over the deterioration in Japan's economic conditions.

**Going forward,** the movement of the dollar against the other major currencies in the short term would be influenced by several factors, namely portfolio adjustments in response to interest differentials, performance of capital markets and the extent of the US slowdown relative to the other economies. While the Fed's aggressive easing is likely to cause the dollar to be less favourable in terms of interest differentials, the positive impact of the Fed's easing on US financial markets and on real economic activity could lend some support to the dollar. Nonetheless, it is expected that the major currencies will trade within a narrow range against the dollar. Any sharp volatility in the currencies could amplify the impact of the current global slowdown. At the G7 meeting on 17 February 2001, monetary authorities reiterated that they would continue to monitor developments closely and to co-operate in exchange rates in order for the exchange rates among major currencies to reflect economic fundamentals.

**Table 3.2**
**Contribution of Demand Components to Real GDP Growth**

| | 2000*p* | 2001*f* |
|---|---|---|
| | % point of contribution | |
| **Aggregate domestic demand (excl. stocks)** | **12.5** | **7.3** |
| Private sector expenditure | 8.9 | 4.6 |
| *Consumption* | *5.4* | *3.2* |
| *Investment* | *3.5* | *1.4* |
| Public sector expenditure | 3.2 | 2.8 |
| *Consumption* | *0.2* | *1.4* |
| *Investment* | *3.0* | *1.4* |
| **Net exports of goods and non-factor services** | **-4.0** | **-2.3** |
| Exports of goods and non-factor services | 17.9 | 5.8 |
| Imports of goods and non-factor services | 22.0 | 8.1 |
| **Gross Domestic Product** | **8.5** | **5.0-6.0**[1] |

[1] Forecast for demand components is based on 5% real GDP growth.
*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

partner for Malaysia, developments in the US would have an impact on Malaysia. The growth projection for 2001 is based on the assumption that external demand will moderate due to the slowdown in the US economy, the still fragile

Real output to expand by 5-6% in 2001. Strong fundamentals allow macroeconomics policies to strengthen domestic demand.

## *Malaysian Economy in 2001*

In an external environment that is less encouraging, the main impetus to growth in Malaysia in 2001 is expected to come from the strength of domestic demand. The momentum of growth built up over the last two years and the strong fundamentals are expected to generate sufficient impetus for **real output in the domestic economy to expand by 5-6% in 2001**, compared with 8.5% in 2000. Malaysia has the policy flexibility to respond and implement pro-growth measures to raise domestic demand to compensate for slower external growth. In the context of these developments, real GDP is forecast to experience a slower growth in the first two quarters of 2001 before strengthening in the second half-year.

The indications are that the moderation in growth in the major industrial countries would persist for the first half-year before an upturn can be expected in the second half. As the United States (US) is an important trading

Japanese economy and the moderating demand for electronics due to the build-up in global inventory in the second half of 2000. Real output in the US is projected to slow down from 5% in 2000 to 2% in 2001.

The expected impact of a slowdown in the US economy has been built into the fiscal stimulus package contained in the 2001 Budget. The public sector would, therefore, continue to assume a counter-cyclical role. In addition to higher public sector expenditure, the fiscal stimulus aims to encourage private sector expenditure in the face of a slower external demand. The adjusted overall budget deficit is projected to remain large, at 5.1% of GNP (4.7% of GDP). Public sector expenditure is projected to expand by 10.4% in 2001 to cushion the slowdown in external demand and provide the impetus for the continued growth in domestic consumption and investment. Growth in **public consumption** is projected to increase further by 12.3% on account of higher expenditure for all three components, namely emoluments, defence

**Table 3.3**
**GDP by Expenditure Components**
**(in 1987 prices)**

| | 2000*p* | 2001*f* |
|---|---|---|
| | Annual change (%) | |
| **Aggregate domestic demand**[1] | **14.6** | **8.4** |
| Consumption | 10.0 | 8.1 |
| Investment | 24.1 | 9.1 |
| **Aggregate private demand**[1] | **15.7** | **7.5** |
| Consumption | 12.4 | 7.0 |
| Investment | 26.7 | 9.2 |
| **Aggregate public demand**[1] | **12.3** | **10.4** |
| Consumption | 1.7 | 12.3 |
| Investment | 21.7 | 8.9 |
| **Gross Domestic Product** | **8.5** | **5.0-6.0**[2] |

[1] Excluding stocks.
[2] Forecast for demand components is based on 5% real GDP growth.
*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

and supplies and services. **Public investment** spending is projected to increase by 8.9%. The Government has allocated RM26.8 billion for development expenditure in 2001. In terms of spending priorities, a higher allocation is given to the social services sector, notably for education and training (RM5.9 billion), housing (RM1.7 billion) and health services (RM1.2 billion). Emphasis is also accorded to infrastructure development (RM4.4 billion), industrial development (RM2.5 billion) and agriculture and rural development (RM1.5 billion).

The higher fiscal expenditure, specific tax incentives introduced in the 2001 Budget and the low interest rate environment can be expected to contain the moderation in growth in private sector expenditure to 7.5%, from 15.7% in 2000. **Private consumption** is estimated to increase by 7%. Measures introduced in the 2001 Budget to further increase disposable income and encourage consumption spending were higher tax rebates for individual taxpayers from low and middle-income groups and an increase in the eligible taxable income bracket for this rebate from RM10,000 to RM35,000 with effect from the year of assessment 2001.

**Private investment** is projected to increase at the rate of 9.2% in 2001. In line with the objective of making the private sector the engine of growth, the Government continued to provide the Pre-Packaged Incentives to domestic and foreign investors. A significant number of approvals was granted in 2000. Indications from the manufacturing sector are that, despite the slowdown in the US economy, the planned expansion of factory space would continue. Meanwhile, development expenditure allocated for education and training as well as industrial and infrastructure development would continue to encourage investment in the construction, manufacturing and services sectors.

The production of manufactured goods is estimated to slow down to 8.7% in 2001 from 25% in 2000, reflecting the moderation in the output of the export-oriented sector, especially the electronics industry. While the output of electronic goods during the first quarter of 2001 would be supported by firm orders already received, the slowdown in growth is expected to occur in the second quarter as production adjusts to the lag effect of the slowdown in external demand. However, **value added in the manufacturing sector** is expected to expand more strongly in the second half-year, with the production volume exceeding that in the corresponding period of 2000. Output growth of the domestic-oriented sector is expected to slow down to a lesser extent. For the year as a whole, value added in this sector is forecast to increase by 8.5%.

In the **agriculture sector**, value added is expected to increase by 1.1%, due mainly to the higher production of crude palm oil following an expansion in mature areas. Rubber production is expected to decline further, affected by low prices. Similarly, the production of saw logs is forecast to decline as logging activity slows down. Value added in the **mining sector** is,

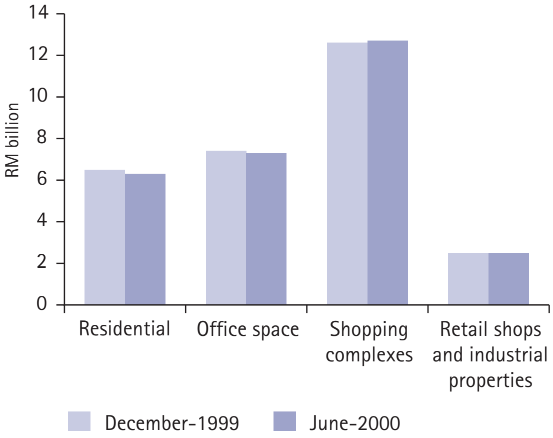
**Table 3.4**
**Real GDP Growth by Economic Activity**
**(in 1987 prices)**

| | 2000*p* | 2001*f* |
|---|---|---|
| | % annual growth | |
| **Real GDP** | **8.5** | **5.0-6.0**[1] |
| Agriculture | 0.4 | 1.1 |
| Mining | -0.5 | 1.4 |
| Manufacturing | 21.0 | 8.5 |
| Construction | 1.1 | 1.0 |
| Services | 4.7 | 3.6 |

[1] Sectoral projections are based on 5% real GDP growth.
*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

**Graph 3.5**
**Property Overhang**




however, expected to turn around to record a growth of 1.4% due to the higher production of natural gas in response to an expected increase in domestic demand. On the other hand, crude oil production is projected to stabilise.

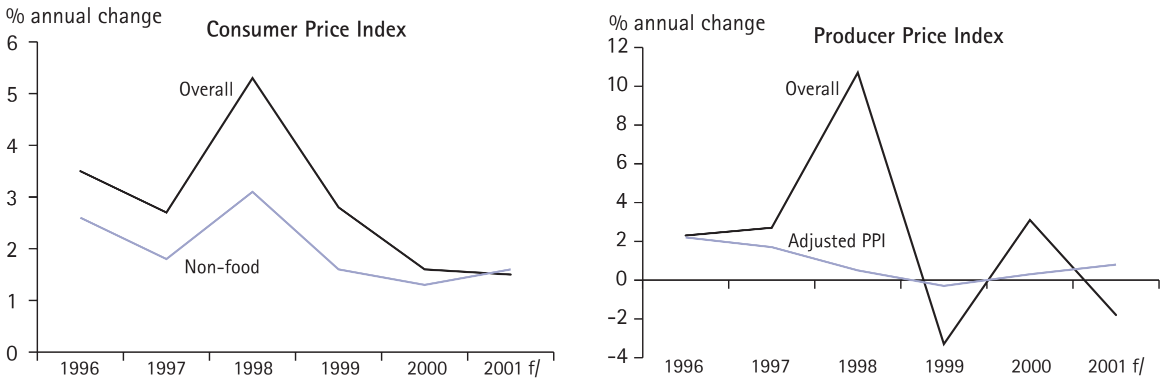
The recovery in the **construction sector** is projected to continue at a steady pace of 1%, with growth emanating mainly from the civil engineering and residential sub-sectors arising from the Government's fiscal stimulus programme and promotion of home ownership with incentives introduced by both the Government and the banking sector. Measures introduced to promote construction activity in the residential sector included the relaxation of the EPF withdrawal criteria to allow contributors to purchase a second home. In the non-residential sub-sector, construction activity continues to be affected by excess capacity, with activity being focussed mainly on on-going projects.

In view of the strong linkages of the construction sector with the other sectors of the economy, the fiscal stimulus has focussed on the construction sector to support the economic recovery during the downturn in the Malaysian economy. Recent efforts to support the economy through Government development expenditure and housing development have mitigated the severity of the adjustment in the construction sector and contributed to an increase in domestic activity. However, the property overhang in the non-residential sub-sector will limit the overall growth potential of the sector. The sector's growth in the near term would, nevertheless, continue to remain positive. Stronger growth would require a more rapid depletion of the large overhang in the sub-sector.

The value added in the **services sector** is expected to increase at the rate of 3.6%, with the growth supported mainly by the transport, storage and communication; wholesale and retail trade, hotels and restaurants; and utilities sub-sectors. The wholesale and retail trade, hotels and restaurants sub-sector is expected to benefit from various programmes including promotional campaigns, international sports meets and sales carnivals planned for the year. Higher value added is also expected to emanate from the expected increase in tourist arrivals.

In 2001, **inflation** is forecast to remain low. While the domestic output gap has narrowed, inflationary pressures would likely remain subdued during the year. Increases in wage costs are not expected to fuel inflationary pressures as improvements in labour productivity are generally forecast to remain at higher levels.

**Graph 3.6**
**Inflation Indicators**



## Details on the Rebased Consumer Price Index

With effect from January 2001, the CPI has been rebased to year 2000. The previous base year was 1994. The CPI is usually rebased about once every five years. This ensures that the CPI continues to reflect accurately the current expenditure pattern of all households in Malaysia and, in the process, remain a reliable and relevant indicator for consumer inflation. The Department of Statistics used the findings of the Household Expenditure Survey conducted for twelve reference months from July 1998 to June 1999 to derive the new regional level expenditure weights for Peninsular Malaysia, Sabah and Sarawak. These expenditure weights were subsequently adjusted to base year 2000. In order to obtain national level expenditure weights, the mean household expenditure values for the three regions were increased to reflect the expenditure values for all households in each of the three regions. Using these values, the regional expenditure proportions were obtained as 81.57% for Peninsular Malaysia, 8.90% for Sabah and 9.53% for Sarawak. The regional weights were then converted to national level weights using the regional expenditure proportions. Prices of about 430 items continue to be used in the computation of the CPI, and these are obtained from about 16,000 retail outlets in 88 collection centres in Peninsular Malaysia, 1,800 outlets in 15 collection centres in Sabah and 1,600 outlets in 13 collection centres in Sarawak.

The difference in weights between the rebased CPI (2000=100) and the previous CPI (1994=100) are shown in the table. Notable increases in weights are for the "gross rent, fuel and power" and "transport and communication" groups, and a decline in weight for the "food" group, chiefly for the "food at home" category. For the classification according to durability and services, there is a significant increase for services and a decline for all types of goods. This denotes the growing importance of services in the consumer expenditure.

**Table 3.5**
**Malaysia: Weights in the Consumer Price Index (%)**

| | Current CPI (2000=100) (a) | Previous CPI (1994=100) (b) | Difference between (a) and (b) |
|---|---|---|---|
| Food | 33.8 | 34.9 | –1.1 |
| Beverages and tobacco | 3.1 | 3.6 | –0.5 |
| Clothing and footwear | 3.4 | 3.6 | –0.2 |
| Gross rent, fuel and power | 22.4 | 21.1 | 1.3 |
| Furniture, furnishing and household equipment and operation | 5.3 | 5.6 | –0.3 |
| Medical care and health expenses | 1.8 | 1.9 | –0.1 |
| Transport and communication | 18.8 | 17.9 | 0.9 |
| Recreation, entertainment, education and cultural services | 5.9 | 5.8 | 0.1 |
| Miscellaneous goods and services | 5.5 | 5.6 | –0.1 |
| **Total** | **100.0** | **100.0** | |

| | Current CPI (2000=100) (a) | Previous CPI (1994=100) (b) | Difference between (a) and (b) |
|---|---|---|---|
| FOOD TOTAL 33.8 | 34.9 | –1.1 | |
| Food at home | 24.1 | 25.1 | –1.0 |
| Rice, bread and other cereals | 5.5 | 5.5 | 0.0 |
| Meat | 3.4 | 3.8 | –0.4 |
| Fish | 4.9 | 4.9 | 0.0 |
| Milk and eggs | 2.1 | 2.3 | –0.2 |
| Oils and fats | 0.8 | 0.7 | 0.1 |
| Fruits and vegetables | 5.0 | 5.4 | –0.4 |
| Sugar | 0.5 | 0.6 | –0.1 |
| Coffee and tea | 0.8 | 0.8 | 0.0 |
| Other foods | 1.1 | 1.1 | 0.0 |
| Food away from home | 9.7 | 9.8 | –0.1 |
| Durable goods | 9.4 | 10.0 | –0.6 |
| Semi-durable goods | 5.4 | 5.5 | –0.1 |
| Non-durable goods | 40.2 | 41.2 | –1.0 |
| Services | 45.0 | 43.3 | 1.7 |
| **Total** | **100.0** | **100.0** | |

At the same time, given prospects of lower oil prices in 2001 and slower world growth, inflation from abroad is projected to be contained. Major supply related shocks to inflation are also not envisaged. Prices of most commodities are projected to be lower than in the previous year due to higher supplies amid slowing demand. Prices for food, particularly rice and animal and vegetable oils and fats, are expected to increase at a slower pace, barring cyclical shortages due to weather conditions. Food prices are also expected to benefit from the incentives given to companies providing facilities and services for food products.

Up to the first ten months of 2001, the inflation rate is expected to continue to reflect the lagged impact of the several one-off upward price adjustments that occurred in the second half of 2000. In addition, several price adjustments, such as the rationalisation of the 5% tax on selected services, standardisation of the stamp duty rate on selected instruments, increase in water charges in some states and the increase in prices of some pharmaceutical products have either taken effect since the beginning of 2001 or will be effective in March 2001. While inflation is likely to edge upwards during this period, inflation for year 2001 as a whole would be contained at 1.5%. In the event of other upward price adjustments, such as electricity tariffs, now under consideration, come into effect, the rate of inflation is expected to rise, but this is estimated to lead to an inflation rate of not more than 2% in 2001. In the period January-February 2001, inflation increased by 1.5%.

The **labour market situation** is expected to remain stable in year 2001. Following the regional crisis in 1997, companies have undertaken major rationalisation exercises and hence most companies are operating with optimal labour/capital levels. The shift to a Knowledge-based Economy is also envisaged to generate new employment prospects, particularly in high tech industries, such as the ICT related areas. Overall, the economy is projected to continue to operate at full employment level, with the unemployment rate at around 3%.

The **current account of the balance of payments** is expected to remain in significant surplus, but the surplus is expected to narrow to RM22.1 billion (US$5.8 billion) or 6.8% of GNP. The narrowing of the current account surplus in 2001 essentially reflects the slowdown in **export growth** from 16.1% in 2000 to 4.9% in 2001. **Import growth** is also expected to moderate from 25.7% in 2000 to 8.4% in 2001. Import growth, however, is expected to be stronger than exports due to continued demand for imported materials and equipment to support

**Table 3.6**
**Balance of Payments**

| | 2000*e* | 2001*f* | 2000*e* | 2001*f* |
|---|---|---|---|---|
| | RM billion | | US$ billion | |
| Merchandise balance | 79.5 | 71.2 | 20.9 | 18.7 |
| Trade account | 60.9 | 52.9 | 16.0 | 13.9 |
| *Exports (% change)* | *16.1* | *4.9* | *16.1* | *4.9* |
| *Imports (% change)* | *25.7* | *8.4* | *25.7* | *8.4* |
| Balance on services account | –40.6 | –41.3 | –10.7 | –10.9 |
| Unrequited transfers | –7.7 | –7.8 | –2.0 | –2.1 |
| **Current account** | **31.2** | **22.1** | **8.2** | **5.8** |
| (% of GNP) | 10.0 | 6.8 | 10.0 | 6.8 |
| Balance on long-term capital | 11.5 | 11.6 | 3.0 | 3.1 |
| **Basic balance** | **42.6** | **33.7** | **11.2** | **8.9** |
| Private short-term capital | –36.0 | | –9.5 | |
| Errors and omissions | –10.3 | | –2.7 | |
| **Overall balance** | **–3.7** | | **–1.0** | |

*e* Estimates
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

the ongoing investment activity. This is in contrast to developments in 1998 where the large trade surplus was derived from a significant contraction in imports, following a sharp contraction in investment activity. Total investment as a percent of GNP is forecast to stabilise at about 29% in 2001.

**Export growth of manufactured goods** is projected to increase by 8.5% in 2001 (2000: 17%). Indications are that the manufacturing sector is supported by the well-diversified product mix through efforts to implement structural changes in past years. Currently, exports of major ICT-related electronic export items account for about 66% of total exports of the electronics industry and 35% of total manufactured exports. This would help Malaysia to benefit from the expansion in the global ICT sector outside the US, especially in Europe and the Asia-Pacific region. The increasing global trend towards miniaturisation and digitalisation of electronic and electrical equipment, as well as the outsourcing practised by major multinationals would also contain the moderation in export growth. Consequently, **export volume** is estimated to expand by 10.2%, while **prices** are expected to decline by 2%.

Malaysian commodity prices are expected to decline, with the **overall commodity export unit value index** expected to fall by 17.3% in 2001. **Palm oil prices** are not expected to change

**Table 3.7**
**Exports and Imports**

| | 2000*p* | 2001*f* |
|---|---|---|
| | RM billion | |
| **Gross exports** | **373.3** | **391.5** |
| **(% change)** | **16.1** | **4.9** |
| Manufactures | 317.9 | 344.9 |
| *(% change)* | *17.0* | *8.5* |
| Minerals | 26.8 | 20.8 |
| *(% change)* | *55.8* | *–22.3* |
| Agriculture | 22.9 | 20.0 |
| *(% change)* | *–17.2* | *–12.8* |
| **Gross imports** | **312.4** | **338.7** |
| **(% change)** | **25.7** | **8.4** |
| Capital goods | 47.1 | 52.0 |
| *(% change)* | *47.7* | *10.6* |
| Intermediate goods | 230.6 | 246.6 |
| *(% change)* | *25.6* | *6.9* |
| Consumption goods | 17.4 | 18.8 |
| *(% change)* | *17.2* | *8.0* |

*p* Preliminary
*f* Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

significantly from current levels, given that global supplies of vegetable oils are projected to remain ample. Export **prices of saw logs and sawn timber** are also expected to decline due to slower external demand as well as competition from softwoods and African timber. For these two products, export volume is expected to decline on account of slower external demand. **Rubber prices** are, however, forecast to increase, following an expected decline in the world production of rubber. Nevertheless, the price is projected to remain at an unremunerative level and, therefore, is not likely to result in higher production. Consequently, export earnings from rubber are expected to decline. In line with expectations of a moderation in the international price for crude oil, Malaysia's **crude oil price** is forecast to average US$23.00 per barrel (US$29.58 in 2000). The current global crude oil price of about US$27-28 per barrel is not expected to be sustained for the rest of the year, given that global demand is forecast to be lower in 2001 following a moderation in economic growth. While external demand for LNG is expected to remain favourable, exports of **LNG** are also forecast to decline due entirely to lower export prices, following the downward trend in crude oil prices. Reflecting mainly lower export prices for crude palm oil, crude oil and rubber, **exports of agricultural commodities and minerals** are forecast to decline by 12.8% (2000: -17.2%) and 22.3% (2000: +55.8%), respectively.

While import volume is expected to increase at a moderate rate, import prices are projected to trend downwards. Growth in all the three broad categories of imports is expected to lead to an overall import growth of 8.4%. While the imports of intermediate goods are projected to increase at a much slower rate of 6.9%, the growth in imports of capital goods is expected to remain relatively strong due to continued investment activity in the economy.

The **services deficit is projected to be marginally higher at RM41.3 billion** in 2001. In relation to economic activity, however, the deficit is expected to improve to 12.7% of GNP (13.1% in 2000). This positive development is attributable to further improvements in the travel and education account and to a lesser extent, the interest income component in the investment income account. The strength of the services account would emanate from higher inflows in travel and education as well as other transportation accounts. Tourism and education offer opportunities to sustain growth during this period. In 2001, tourist arrivals are expected to increase further to 10.6 million visitors (10.2 million in 2000), thereby increasing foreign exchange earnings in the travel account. Whilst a large proportion of tourists is expected to continue to come from the ASEAN countries, there will be a stronger push to increase the number of visitors from other parts of Asia, focussing particularly on the emerging middle classes of India and China as well as from the Middle East.

The interest income component is expected to record a larger surplus, reflecting lower interest payment on the external debt due to the expected decline in global interest rates. The increase in net outflows of investment income, freight and insurance as well as other services payments will be reflective of the slower growth during the year. Excluding profits and dividends accruing to foreign investors, the services deficit would be lower at 9.7% of GNP (10.2% in 2000). Net unrequited transfer payments are expected to remain high at

RM7.8 billion, reflecting the repatriation by foreign workers.

The **long-term capital account** is expected to remain stable at RM11.6 billion in 2001 (2000: RM11.5 billion). Higher net inflows of official long-term capital of RM5.7 billion (2000: RM4 billion) is expected to be offset by lower private long-term capital inflows of RM5.9 billion (2000: RM7.5 billion). The Federal Government is expected to draw down committed loans and raise new funds totaling RM5 billion to finance the fiscal deficit. Malaysian investment overseas is expected to remain significant, resulting in a lower surplus in the private long-term capital account.

The **external debt outstanding** is expected to increase moderately to RM163.2 billion at end-2001, equivalent to 50.3% of GNP, reflecting mainly the increase in Federal Government debt while short-term debt is expected to remain at the end-2000 level. The net external borrowing of NFPEs and the private sector are expected to be relatively small in 2001. As a result, the **debt service ratio** is expected to stabilise at 5%, reflecting the prudent debt management policy.

The long-term growth strategies of the Government aim to promote the development of a broad-based economy. The Third Perspective Outline Plan, 2001-2010, the Eighth Malaysia Plan, 2001-2005, and the Knowledge Masterplan contain strategies to take Malaysia into the next phase of endogenous-led growth.

## *Management of the Economy in 2001*

In the **management of the Malaysian economy** in year 2001, the strong fundamentals accord policy flexibility for the effective management of the impact of the slowdown in world growth on the domestic economy. Policy adjustments during the crisis have provided policy makers greater flexibility to respond to developments in the US and other industrial countries. Macroeconomic policies would therefore strengthen domestic demand if the downturn in external demand becomes more severe. Other strengths include the high

**Table 3.8**
**External Debt of Malaysia**

| | 2000*e* | | | 2001*f* | | |
|---|---|---|---|---|---|---|
| | RM billion | US$ billion | % share | RM billion | US$ billion | % share |
| **Medium and long-term** | **139.4** | **36.7** | **89** | **145.6** | **38.3** | **89** |
| **Public sector** | **78.3** | **20.6** | **50** | **84.1** | **22.1** | **51** |
| *Federal Government* | *18.8* | *5.0* | *12* | *24.1* | *6.3* | *15* |
| *NFPEs* | *59.5* | *15.6* | *38* | *59.9* | *15.8* | *37* |
| **Private sector** | **61.1** | **16.1** | **39** | **61.6** | **16.2** | **38** |
| **Short-term** | **17.5** | **4.6** | **11** | **17.5** | **4.6** | **11** |
| *Banking institutions* | *9.3* | *2.4* | *6* | *9.3* | *2.4* | *6* |
| *Non-bank private sector* | *8.3* | *2.2* | *5* | *8.3* | *2.2* | *5* |
| **Total External Debt** | **157.0** | **41.3** | **100** | **163.2** | **42.9** | **100** |
| **% of GNP** | | | | | | |
| Total debt | 50.5 | | | 50.3 | | |
| Medium and long-term debt | 44.9 | | | 44.9 | | |
| **Debt service ratio (%)** | | | | | | |
| Total debt | 5.0 | | | 5.0 | | |
| Medium and long-term | 4.7 | | | 4.7 | | |

*e* Estimates
*f* Forecast

Source: Ministry of Finance and Bank Negara Malaysia savings rate and low inflation. In this situation, monetary and fiscal policies can be supported by other specific measures to promote domestic aggregate demand.

In view of the uncertainty in the international environment, the overall fiscal stance would continue to sustain the counter-cyclical stance. The low level of debt, both external debt and Federal Government debt, provides flexibility to rely on fiscal measures to absorb the economic impact of the moderating global growth. The current financial position of the Government is sufficiently strong to provide flexibility for further stimulus programmes (details in Fiscal Policy in 2001).

The low inflation rate and large current account surplus also allow monetary policy to remain accommodative to reinforce fiscal measures (details in Monetary Policy in 2001). The management of risks will be essential in preserving stability in the financial markets against a backdrop of evolving financial and economic landscapes. Efforts will be intensified to monitor and respond to risks while meeting the needs of the marketplace in a way that strengthens the underlying financial and economic structures.

Given increased globalisation, pervasiveness of information technology and liberalisation of capital markets, strategies to enhance long-term growth prospects have been tailored to transform the economy so as to be driven by more efficient complementarities between labour, technology and capital. With the launch of several strategic plans in 2001, efforts will be directed at enhancing domestic capacity, harnessing competitive advantages and developing complementary niches in all sectors. The long-term strategies of the Government for the next decade will be outlined in the Eighth Malaysia Plan (2001-2005) and the Third Outline Perspective Plan (2001-2010) to be unveiled in April 2001. In the financial sector, the Capital Market Masterplan and the Financial Sector Masterplan were launched on 22 February 2001 and 1 March 2001, respectively.

These plans set out the strategies for the development of the financial sector over the next decade. The Knowledge Economy Master Plan which is also slated for release this year represents a blueprint to propel Malaysia into the new economy by leveraging on the intensive use of knowledge, skills, linkages, ideas and technology. The Plan will identify the strategies that need to be adopted by all sectors of the economy in order to achieve the transition from a production-based economy to a knowledge-based economy for wealth creation.

In a nutshell, these plans would provide the framework and appropriate strategies to take the country into the next phase of endogenous-led growth that is supported by indigenous capabilities. A common thread in all the plans is enhancing competitiveness. While focus of the plans would be on the development of domestic capacity, both as sources of growth as well as in delivery of the growth performance, partnerships with international players will also be established. The existing dependence on foreign direct investment and the export sector would be managed in a manner that would create better synergy between domestic and international players to achieve growth and per capita targets as well as economic and social stability.

As human resource development is recognised as a defining element in increasing the nation's competitiveness, special attention will be given to this area to speed up the transition to a knowledge-based economy. In this regard, the Government has pledged additional resources to the education sector in order to narrow the knowledge and skills gap. The share of expenditure on the education sector to total development expenditure remains high at 22.1% for 2001. The holistic approach taken in education will emphasise higher productivity growth through investments in IT and knowledge-intensive technologies. Hence, measures are in place to promote computer literacy amongst students and workers, improve teaching and learning methods and review the existing curriculum in schools and institutions of higher learning in tandem with current developments and needs. By the end of 2001, all schools are expected to be equipped with computers and software through the Smart Schools programme, with priority being given to rural schools.

The education system will be strengthened to generate highly trained labour to meet industry demand and create opportunities for lifelong learning after students have completed their formal education. Whilst emphasis will be placed on intensifying advanced skills development through training, retraining and apprenticeship schemes, efforts to pool the best talents from Malaysia and abroad have also been intensified. As such, incentives have been provided in the 2001 Budget to attract highly skilled Malaysian citizens working abroad to return to Malaysia.

In year 2001 and beyond, the growth strategy would essentially be directed at promoting the development of a broad-based economy. In order to further reduce vulnerabilities to external demand, a balanced approach has been taken, targeted at expanding the traditional areas, whilst developing new sources of growth in the manufacturing, services and agriculture sectors. In the traditional services sector, issues being addressed pertain to the need to raise efficiency and productivity to optimise the use of large capacity that has been built up as a result of investment in pre-crisis years. The new growth areas will focus on resource-based sectors, services and ICT-related activities.

In the agriculture sector, development would focus on enhancing its contribution to GDP. Traditional plantation crops would remain the major contributors to growth of the sector. In tandem with the industrialisation policy of the country, the restructuring and modernisation of the plantation crop sector (oil palm, rubber, cocoa) will be given new impetus given their roles in increasing the contribution of domestic resource-based industries in the manufacturing sector. This target is being achieved through incentives to reduce the cost of doing business and measures to modernise and reduce the dependence on labour in the plantation sector. In the 2001 Budget, incentives include import duty and sales tax exemption on related machinery and equipment for use in agriculture.

At the same time, the non-traditional agriculture sub-sector, comprising mainly vegetables, fruits, livestock and aquaculture, is targeted to increase its contribution in line with efforts to increase domestic food production. For 2001, a total of RM84 million has been allocated to develop 18,400 hectares of Permanent Food Production Parks by the State Governments. These Parks will be set aside as permanent agriculture production zones that can be leased at low rates to entrepreneurs. In addition, the existing tax incentives to encourage food production in the agriculture sector have also been extended to companies which invest in subsidiary companies in food production projects. To improve the distribution of food products, companies which provide cold chain facilities and services will be eligible for tax incentives.

New approaches are also being developed in the financing of agriculture activities. In this regard, Bank Negara Malaysia has been working with the Ministry of Agriculture and the banking institutions to address the issue of availability of credit to finance activities in the agriculture sector. At the same time, efforts are being taken to enhance the operations and efficiency of Bank Pertanian Malaysia in providing credit to the agriculture sector. Efforts are also being directed at identifying and developing insurance coverage and services required for the agriculture sector. A task force on agriculture insurance, consisting of representatives from Bank Negara Malaysia, the Ministry of Agriculture, Bank Pertanian Malaysia and insurers, has been set up to develop the appropriate insurance protection and services to complement other efforts on enhancement of credit sources for financing of agriculture activities.

An important source of growth is new industries in the ICT area. While the development of the MSC has been successful, further work is needed to achieve its full potential. In particular, efforts are being directed at enhancing financing avenues and developing entrepreneur skills. In the 2001 Budget, the promotion of local entrepreneurship has been accorded priority in order to create a vibrant group of entrepreneurs in the ICT area. Venture capital financing for such high-risk activities is being emphasised. In developing the venture capital industry, particularly as an alternative source of capital financing for ICT, the Government announced in the 2001 Budget that a RM500 million Venture Capital Fund would be established. Also, the Government has broadened the scope of research under the Intensification of Research in Priority Areas (IRPA) to include venture capital companies interested in carrying out research and development (R & D) in the Multimedia Super Corridor (MSC) and other approved places. In order to encourage investment in high-risk sectors that venture companies operate in, investments in approved venture companies at start-up, seed capital and early stage financing were allowed tax deductions equivalent to the value of the investment.

In both traditional and new growth areas, attracting foreign direct investment to these new growth areas is receiving a new focus. Foreign direct investment will be more biased towards higher-end manufactured products, whilst greater emphasis is accorded to R & D and the need to increase synergies between operations in Malaysia and abroad. To encourage foreign direct investment, the policy of allowing 100% foreign equity ownership in promoted manufacturing industries, irrespective of export levels was extended until 2003. In this regard, efforts will be intensified to attract quality investments to promote technology transfers, besides investments to expand production capacity. As a measure to accelerate the development of the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak, incentives given to manufacturing, agriculture and tourism projects, comprising Pioneer Status and Investment Tax Allowance that expired on 31 December 2000 were extended for another five years until 31 December 2005. To encourage continuous reinvestment in the production of promoted products by the manufacturing and food producing companies, companies have been given accelerated capital allowance on capital expenditure to be utilised within three years upon the expiry of the reinvestment allowance.

The promotion of smart partnerships, not only via foreign equity holdings but also management, is encouraged. In providing support services as well as R & D for high technology industries, the Government announced an allocation of RM16.7 million in the 2001 Budget to equip the Tecno Centre in the Kulim Hi-Tech Park. Since packaging design is an important factor in determining successful market penetration, professional fees incurred in packaging design will be eligible for double deductions, provided that the products are of export quality and the company employs local professional services.

In the financial sector, the unveiling of the Financial Sector Masterplan and the Capital Market Masterplan provide clear statements of the philosophy underpinning developmental efforts over the next ten years, and plans of action incorporating specific recommendations in the short-, medium- and long-term. Phase one of the Financial Sector Masterplan which spans over three years will focus on enhancing domestic capacity and capabilities, before proceeding to the second phase to gradually liberalise, and subsequently in the third phase, to move towards greater international integration.

In building domestic capacity, the merger of 54 banking institutions into 10 banking groups represents the first step in strengthening domestic banks. To ensure that the merged banking groups are strongly capitalised to meet future challenges, Bank Negara Malaysia raised the minimum capital funds unimpaired by losses for domestic banking groups to RM2 billion, while the minimum capital funds for foreign-owned banking institutions was raised to RM300 million. This will ensure that each banking institution will reach a certain critical size to enable them to be effective competitors in an increasingly liberalised environment. The banking institutions are given until 31 December 2001 to comply with the new capital requirements. By the end of the first quarter of 2001, nine merged domestic banking groups and nine foreign-owned banking institutions have met the new minimum capital funds ahead of schedule.

Consonant with the country's economic outlook for the year 2001, the Islamic banking industry is expected to witness an expansion of its financing activity and improved performance. The consolidation exercise of the domestic banking institutions is not expected to hamper the growth of the industry. Arising from the rationalisation, banking institutions participating in the Islamic Banking Scheme would become stronger and more efficient. The Islamic banking industry is expected to expand during the year and enhance its market share to 8% relative to the total banking system in the year 2001. It is anticipated that the commencement of the framework to strengthen the operational and institutional infrastructure of the Islamic banking industry, as outlined in the Financial Sector Masterplan would contribute constructively to the expansion of the industry. Plans have also been formulated to position Malaysia as the regional Islamic financial centre with the Islamic banking and Takaful industry playing a more significant role in the financial system. This will be augmented by efforts to position Labuan International Offshore Financial Centre to play a lead role in global Islamic banking and finance activities.

As in the case of the banking sector, efforts will be stepped up to consolidate the insurance and stockbroking companies, with the objective of creating a core of strong domestic firms capable of competing successfully. In addition to encouraging mergers among insurers, Bank Negara Malaysia has increased the minimum paid-up capital requirement for insurers from RM50 million to RM100 million, aimed at further strengthening the financial resilience of insurers. It is envisaged that some insurers will choose the option of merging with other insurers to comply with the higher new minimum capital requirements which will be effective from 30 June 2001. As a further step towards enhancing the role of development financial institutions (DFIs), a new regulatory framework will be put in place. The new regulatory framework aims to streamline the operations and regulation of DFIs through a single supervisory authority.

The corporate restructuring exercise will see further progress in 2001, moving on beyond financial restructuring to increased operational restructuring to enhance the overall competitiveness of the economy. Recognising that problems of the corporate sector such as over-gearing and over-diversification could increase vulnerability to shocks, efforts are being made towards divestments and greater focus on core activities. Investments undertaken in business process reengineering, technology, marketing, R & D, production and management structure are aimed at producing lean companies that take advantage of economies of scale. This process needs to continue to ensure price and product competitiveness so as to be well integrated into the international value chain. Despite the high cost of restructuring, businesses need to understand that this is important to ensure the sustainability of the business entity. On its part, the Government will continue to promote sound and prudential regulations that respond to the requirements of the market as well as internationally accepted standards of corporate governance to facilitate transparency and accountability.

In addition to introducing appropriate checks and balances to ensure that decisions are made on the basis of sound rationale, efforts will be intensified to promote the comparability, relevance, reliability and timeliness of information disclosed so that information is regarded as sufficiently credible. In line with this, the Kuala Lumpur Stock Exchange (KLSE) has revamped its Listing Requirements by setting out comprehensive regulations to further improve the corporate conduct of companies listed on the KLSE. As enhanced disclosure by public listed companies facilitates informed decisions to be made by investors, access to capital by companies will become faster and easier. All provisions to be complied with in the revamped Listing Requirements will take effect from 1 June 2001, except for selected provisions which came into effect on 15 February 2001.

Overall, the combination of both macroeconomic and structural adjustment measures is envisaged to result in a stable, strengthened and more diversified economy and financial sector. Going forward, the Malaysian economy is expected to register growth that is characterised by productivity improvements and increased resilience. The establishment of mechanisms to deal with risks such as early warning systems in the financial sector as well as stronger economic fundamentals are expected to provide a defence against potential adverse developments. Of significance, the introduction of strategies contained in the long-term Plans that will be released in 2001 will set the stage for sustainable growth that leverages on knowledge, innovation and technological development.

## *Monetary Policy in 2001*

In 2001, monetary policy will continue to be committed to meeting the objective of supporting economic growth while maintaining low and stable inflation. The policy stance would be based on the assessment of the balance of risks that are biased towards slower economic growth in the industrial countries, which could impact the export-led growth of regional economies, including Malaysia. On the exchange rate front, the focus of policy would be to ensure that the exchange rate of the ringgit is consistent with economic fundamentals and that it would not be the source of macroeconomic imbalances.

While monetary policy in 2001 will continue to be based on domestic considerations, developments in the international environment will also have implications on monetary policy decisions. On the **international front**, there has been an emerging threat of a stronger-than-expected economic slowdown, especially in the United States, leading to expectations of significant moderation in growth of world trade. As inflation is expected to be a lesser concern, amid a softening in global demand coupled with the moderation in oil prices, there is greater flexibility for monetary policy to continue to support growth. The shift in monetary policy stance towards an easing bias in the US and the subsequent reduction of interest rates in some industrial and regional countries is likely to lead to a global monetary easing cycle. Of greater uncertainty, however, is the behaviour of financial markets and global liquidity flows.

The conduct of monetary policy will also be guided by the need to strike a balance in order to promote investment and savings in the most efficient manner. The structural transformation in which the economy is currently undergoing demands a paradigm shift in the provision of financing to support the new economy in a prudent manner. There is a need to effectively tap the high savings rate of the Malaysian economy in order to ensure adequate financing at reasonable cost to support the knowledge and technology-based small-medium enterprises. A priority of policy would also be to ensure a positive real rate of return on deposits. At the same time, efforts will be intensified to provide alternative sources of financing to support the knowledge-based economy without creating new risks in the economy, notably in the areas of bond financing and venture capital financing.

Monetary policy will continue to support economic growth, while preserving price and financial stability. Low inflation allows monetary policy to remain accommodative.

On the **domestic front**, given the openness of the Malaysian economy, the slowdown in global growth is expected to affect the performance of the Malaysian economy. The overall real GDP growth is expected to moderate to 5 - 6% from 8.5% in 2000. In an environment of slower growth and given the mild inflation globally, domestic inflation rate is expected to remain subdued. While the Malaysian economy is not immune to developments in the US economy, Malaysia's strengthened economic fundamentals and financial system will provide greater policy flexibility to address the country's vulnerability to these developments. In this regard, the significant and rapid easing of monetary policy in 1998 and 1999 will continue to create a favourable environment to sustain domestic demand at levels that would support overall domestic economic activity.

Against this backdrop, monetary policy will continue to emphasise on creating an environment of stability and predictability in market conditions, which provides the foundation for economic activity to take place. The conduct of monetary policy will continue to strive towards preserving price and financial stability. Monetary policy will pursue this primary objective as a means to achieve long-term sustainable economic growth. In this context, liquidity will be judiciously managed to facilitate economic growth at close to potential output of the economy without rekindling inflation.

Monetary policy will continue to be pragmatic and flexible to adjust to the rapid changes in the economic and financial environment and the underlying risks associated with the increasing trend towards globalisation. In such an environment, monetary policy will be conducted increasingly through market-based instruments. As monetary policy operates through the financial system, the current measures to strengthen the banking institutions and increase their efficiency should enhance the effectiveness of monetary policy. The further deepening of the capital market would also enable BNM to move towards more open market operations, rather than rely on direct instruments such as the SRR in its conduct of monetary policy. Inevitably, the financial innovations and new payment mechanism such as "e-money" would also make the operations of monetary policy more complex. In this regard, BNM will remain vigilant to ensure that monetary policy is well-coordinated with other macroeconomic policies to ensure the achievement of long-term economic growth with monetary stability.

The sustainability of the accommodative monetary policy stance, nevertheless, would depend on several factors, notably, the outlook for macroeconomic fundamentals in the domestic economy and the macroeconomic developments in the industrial and regional economies. On the external front, the declining international interest rates and the greater convergence in the monetary policy stance between Malaysia and the developed economies will also provide BNM with greater policy flexibility to support economic growth, without endangering price and external stability. On the domestic front, the current assessment is that the medium-term outlook of low inflation and positive external balance would continue to provide the flexibility for continued accommodative policies. Inflation would remain subdued in the absence of demand pressures and imported inflation. The ringgit exchange rate is expected to remain consistent with economic fundamentals, with the threat of significant misalignment minimised.

In this current environment, the Malaysian economy has strengthened on several fronts following measures taken to enhance the resilience of the economy to external shocks. Banking system soundness has improved significantly. The stronger capitalisation of banks has increased their resilience, which is important for the effective implementation of monetary policy. The external debt has declined with the maturity structure significantly improved. The ratio of short-term debt to total debt and international reserves has declined, improving Malaysia's external liquidity position. The recent measures have also created more stable asset markets. The increased resilience through improved economic fundamentals together with high domestic savings will accord greater flexibility and efficiency for macroeconomic policies including monetary policy. A strengthened domestic banking sector and economy enables policies to support domestic economic activity.

Looking ahead, there are **several challenges** facing monetary policy in 2001. Of importance is the ability to assess future risks so that appropriate pre-emptive policy measures can be taken to contain any potential strains that may emerge in the economy. With increasingly more globalised markets and uncertainty in the global economic environment, it is difficult to predict the future prospects of world trade growth and the response of capital flows. This is particularly more so in 2001 when the slowdown in the US coincides with the downturn in the electronics cycle, as well as emerging uncertainties in the "new" economy. As such, policy will be based on close monitoring of all leading, coincident and lagging economic and monetary indicators. The challenge is to be pre-emptive, and ensure that measures taken will not only enhance prospects for sustained growth, but will also increase the nation's resilience to external shocks. The development of early-warning indicators initiated since the recent Asian crisis will facilitate the monitoring of any emerging risks and allow greater focus on areas of vulnerabilities in the economy. In this regard, monetary policy would be implemented in a flexible and pragmatic manner to address changes in economic and financial trends.

A further challenge to monetary policy management is **managing liquidity** in the financial system. Currently, there is ample liquidity in the system, which would increase further through trade and long-term inflows. These inflows will provide the necessary liquidity to finance outflows arising from the normal course of business transactions, debt repayment as well as overseas investments. BNM also has sufficient instruments to ensure that the underlying liquidity is consistent with the need to provide adequate funds at reasonable cost to the private sector. There is also flexibility to release the liquidity currently locked in with BNM without creating new risks in the financial system.

Also important is to provide a stable environment in which the **on-going financial restructuring can proceed in a smooth manner**, without undue disruption to the intermediation process. While efforts to strengthen the financial sector will be intensified, BNM will continue to monitor closely the lending activities of banks so that the private sector continues to have access to financing to support economic growth. At the same time, BNM would continue to ensure that lending activities of banking institutions are prudent, and that banks are not over-exposed to any particular sector that may be detrimental to the health of the banking system and the economy as a whole. Meanwhile, BNM will also continue to ensure that the financial restructuring proceeds at a pace that will not result in significant dislocation and destabilisation.

On the **exchange rate front**, the prevailing ringgit exchange rate of RM3.80 to the US dollar remains consistent with the fundamentals of the Malaysian economy. The exchange rate continues to be supported by a strong current account surplus, a high level of international reserves and a low and stable inflation rate. External debt remains low with reserves exceeding short-term external debt by more than six times. Domestic macroeconomic policies continue to remain consistent with the pegged exchange rate regime. It has always been Malaysia's policy to maintain international competitiveness through efficiency and productivity gains, and not to rely on the exchange rate for international competitiveness. The latter would only provide temporary gains in export performance and would do so at the expense of significant costs to the economy, including higher inflation, higher debt servicing costs and erosion of private sector confidence in the currency. On the other hand, stability of the currency is itself a competitive factor. In Malaysia, this stability has lowered business costs by facilitating planning and pricing decisions by economic agents. This is confirmed by the private sector, particularly the manufacturers and traders. Therefore, the policy of the Government continues to be to maintain a stable and fundamentally sound exchange rate, and not to respond to marginal and short-term misalignments that can reverse within a short period in response to changes in sentiment.

## *Fiscal Policy in 2001*

The expansionary fiscal policy of the Government will continue into year 2001. Although the economic recovery strengthened markedly in 2000, the uncertainties in the economic and business environment may have adverse effects on growth prospects. In particular, the stronger-than-expected slowdown in the US economy raises concerns over the impact on the domestic economy in the light of the expected slowdown in external demand. As such, the Government's budget strategies and measures focus on the fiscal impulse required to strengthen domestic aggregate demand. Taking this into consideration, the main thrust of the 2001 Budget that was presented to Parliament in October 2000 was directed at stimulating the nation's economic growth; implementing strategic initiatives to enhance the nation's competitiveness; and achieving the agenda of a caring society.

The budgetary operations of the Federal Government will remain expansionary to collaborate with the private sector in supporting growth of the economy. Although fiscal policy has been expansionary since 1998, Malaysia enjoys fiscal flexibility without creating risks in the economy. This is because public sector debt remains manageable with total Federal Government debt to GDP of less than 40%. Debt servicing of the Federal Government is also low with interest payments accounting for only about 16% of operating expenditure.

The policy of commitment to fiscal prudence and discipline has ensured long-term sustainability in the fiscal position, thereby strengthening flexibility of fiscal policy during downturns in the economy. In 2001, the Federal Government will continue to practise fiscal prudence. The level of expenditure will be managed by taking into consideration the need to stimulate economic activities, maintain a surplus position in the current account, avoid excessive reliance on external borrowings and avoid crowding out the private sector in terms of excessive borrowings from the domestic financial system. Equally important, the fiscal stimulus will ensure that expenditure is directed at industries with domestic linkages and thereby high multiplier effects. As in the past, the fiscal stimulus programme will ensure minimum leakages so that the favourable current account position in the balance of payments will be maintained.

The overall financial position of the Federal Government for 2001 is budgeted to record a fiscal deficit amounting to RM16.5 billion or 4.7% of GDP. Increased allocations will be given to projects and programmes with high priority in terms of strengthening long-term productivity and domestic demand. This will ensure that expenditure is contained at a level which is in line with available resources. In terms of development expenditure allocation, emphasis continued to be accorded to the social services sector, notably for education and training. This is in line with the Government's efforts to develop a knowledge-based economy and to narrow the digital divide through education and human resource development. Emphasis is also placed on industrial development, infrastructure development and agriculture and rural development. At the same time, the Budget continues to accord importance to expenditure to improve the quality of life, especially for the poorer segments of society.

The fiscal package in the 2001 Budget also contains both tax and non-tax measures aimed at stimulating economic activity and strengthening the foundation for long-term sustainable growth. Towards this end, tax incentives are directed at developing new sources of growth, building up a strong and self-enforcing momentum in the growth of domestic demand and strengthening the nation's competitiveness and resilience. Besides this, measures are also directed at enhancing the ability of the financial markets to be more dynamic, innovative and capable of supporting growth, particularly in a more knowledge-based economy. The Budget also announced measures aimed at enhancing alternative sources of financing to provide increased access to an increasingly more diversified economy.

The fiscal deficit will continue to be largely financed from non-inflationary domestic sources.  As Malaysia's savings rate is high at about 37% of GNP, the bulk of the requirements can be financed from domestic resources. The Government will, therefore, finance the fiscal deficit through the issuance of MGS that will be absorbed mainly by provident, pension and insurance funds. The regular issue of the MGS will also continue to provide support for a benchmark yield curve to promote a liquid secondary domestic bond market. In 2001, external financing will mainly be from multilateral and bilateral sources. Given the low external debt position, recourse to international capital markets during periods of favourable market conditions remains an option for Malaysia.