Outlook and Policy

Outlook and Policy

WORLD ECONOMIC OUTLOOK

Developments in 2001 and Early 2002

The global economic slowdown that began in late 2000 became more severe than anticipated in 2001. The events following September 11 created further downside risk to an early recovery. In the second half (2H) of 2001, **overall growth in the major economic blocs** declined by 0.5% from a modest growth in the first half of the year (1.5%). Falling confidence amidst disruption in activity after September 11, especially in the United States (US), had adversely affected world growth, which was also reflected in declining global trade. **World growth** halved to 2.4% in 2001, while world trade growth decelerated from a double-digit growth to only 1% in 2001. Growth in the **major industrial countries** as a group weakened to 1.1%.

In early 2001, it was envisaged that only countries with strong trade and investment links with the US, namely Canada, Asia Pacific and Latin America would be affected, while Europe would be fairly insulated. As the year progressed, developments in the US, through more integrated capital markets, resulted in adverse effects becoming more pervasive in all regions.

Table 3.1
World Economy: Key Economic Indicators

	Real GDP growth (%)			Inflation (%)		
	2000	2001e	2002*f*	2000	2001e	2002*f*
World growth	**4.7**	**2.4**	**2.6**	-	-	-
World trade	**12.4**	**1.0**	**2.0~2.5**	-	-	-
Major industrial countries	**3.5**	**1.1**	**1.1**	**2.3**	**2.1**	**1.2**
United States	4.1	1.2	1.4	3.4	2.8	1.6
Japan	2.2	-0.5	-0.5	-0.8	-0.7	-1.0
Euro area	3.4	1.6	1.3	2.3	2.6	1.8
United Kingdom[1]	3.0	2.4	2.0	2.1	2.1	2.4
East Asia	**7.6**	**3.7**	**4.6~4.8**	**1.1**	**2.4**	**2.2~2.3**
Asian NIEs	**8.3**	**0.6**	**2.7~2.9**	**0.8**	**1.1**	**0.8~0.9**
Korea	8.8	3.0*f*	3.9	2.3	4.3	3.0
Taiwan	5.9	-1.9	2.3	1.3	0.0	0.7
Singapore	10.3	-2.0	1.0~3.0	1.3	1.0	-1.0~0.0
Hong Kong SAR[2]	10.5	0.1	1.0	-3.8	-1.6	0.0
People's Republic of China	**8.0**	**7.3**	**7.0**	**0.4**	**0.8**	**1.0**
ASEAN[3]	**6.4**	**1.5**	**2.8~3.6**	**2.9**	**5.9**	**5.0~5.5**
Malaysia	8.3	0.4	3.5	1.6	1.4	1.8
Thailand	4.4	1.5*f*	2.0~3.0	1.6	1.6	0.0~1.0
Indonesia	4.8	3.3	3.5~4.0	3.8	11.5	10.9
Philippines	4.0	3.4	4.0~4.5	4.4	6.1	5.0~6.0

[1] Inflation refers to Retail Price Index excluding mortgage interest.
[2] Inflation refers to composite price.
[3] Includes Singapore.
e Estimate
f Forecast

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

The weakness in the euro area was not caused only by lower external demand, but also the unexpectedly higher inflation arising from the lagged effects of higher oil prices which constrained policy flexibility. In the regional economies, besides the severity of the US slowdown, the deeper and prolonged downturn in the electronics sector had caused growth to slow down more significantly than earlier expectations. Growth in **East Asia** slowed down to 3.7% in 2001. In several countries (Taiwan and Singapore), growth turned negative. To a large extent, the slowdown in all regional economies was contained by stronger fiscal stimulus and easier monetary conditions. Only the People's Republic of China continued to expand at a strong pace of 7.3%, sustained by fiscal spending and strong private investment, mainly in the form of foreign direct investment.

Prompt policy response across the globe during the course of 2001 and immediately after September 11 contained the economic slowdown. In particular, co-ordinated monetary easing and additional fiscal measures by the major industrial countries aided confidence and were effective in sustaining consumer spending.

Concomitant with the weaker global economy, **labour market conditions** deteriorated in many countries as companies reduced their labour force as part of their corporate consolidation process. However, in Europe, the average unemployment rate declined during the year despite announcements of large layoffs by manufacturing companies. The improvement was due to easing of labour market rigidities in the euro area with the introduction of more flexible working conditions and the continued strength in the services sector in the United Kingdom (UK). Meanwhile, **inflationary pressures** were contained during the year against a backdrop of a sharp fall in energy prices, weakening global demand and abating wage pressures.

In 2001, the **US economy** slowed down rapidly as the corporate sector adjusted to the weaker demand.

Table 3.2
Changes in Monetary and Fiscal Measures Undertaken by the Various Countries since 2001

Country	Monetary Policy		Fiscal Stimulus
	Number of interest rate cuts	Changes in policy rate (%)	
United States	11	6.5 → 1.75	Tax cuts and spending
Japan	2	0.25 → zero interest rate policy with quantitative easing	Spending
Euro area	4	4.75 → 3.25	-
United Kingdom	7	6.0 → 4.0	Spending
People's Republic of China	1[1]	5.85 → 5.31[1]	Spending
Korea	4	5.25 → 4.0	Tax measures and spending
Taiwan	11	4.625 → 2.125	Tax measures and spending
Singapore	-	-	Tax measures and spending
Hong Kong SAR	11	8.0 → 3.25	Tax measures
Malaysia	1	5.5 → 5.0	Tax and non-tax measures and spending
Thailand	2	Initially interest rate was increased followed by two rate cuts to 2.0%	Spending
Philippines	15	13.5 → 7.25	-

[1] One-year lending rate on renminbi loans

Corporations consolidated as they reduced capital spending, drew down on their inventories as well as cut back on their workforce. Declines in capital spending was broad-based due to over-capacity, but was more pronounced in the technology sector.

Recent positive developments reinforce optimism for a gradual and modest global recovery in 2002.

However, consumer spending continued to be a source of support. Fourth quarter GDP data showed that the economy turned around to expand during the quarter due to strong demand, particularly for automobiles, spurred by aggressive price cuts and zero interest rate financing.

The **euro area** also weakened as its largest economy, Germany stagnated in the second half-year, reflecting broad-based weakness in both domestic demand and exports. The UK economy was less affected than the other major economies as it was supported by strong domestic demand, particularly consumption. Japan entered its third recession since the correction in the asset markets in the early 1990s, as falling exports compounded the deflation and structural problems in the economy, resulting in sluggish domestic demand.

However, towards year-end, fears of a deep recession in the US abated as markets looked ahead to a recovery. The liquidity impact from the aggressive monetary easing during the year and increased optimism following the early conclusion of the West Asian conflict contributed to the rise in stock markets. The wealth gain from the equity market in the fourth quarter of 2001 and early 2002 was estimated to be around US$1.5 trillion. The optimism was further reinforced by positive data released in December and early 2002 suggesting that the downturn in the US economy was beginning to level off. Markets have also perceived the steepening of the US long-term yields as indicative of an impending recovery.

Prospects for 2002

Going forward, the outlook for the global economy has improved, supported by positive developments in the US. There has also been improvement in other parts of the world. Sentiment indicators in Europe have shown a marked improvement, while in the region there have been further signs of stabilisation in economic activity, mainly a slower pace of decline in exports. Prospects are for the US to lead the recovery, thus supporting an upturn in the other regions, including the euro area and East Asia. However, Japan is expected to experience another year of contraction.

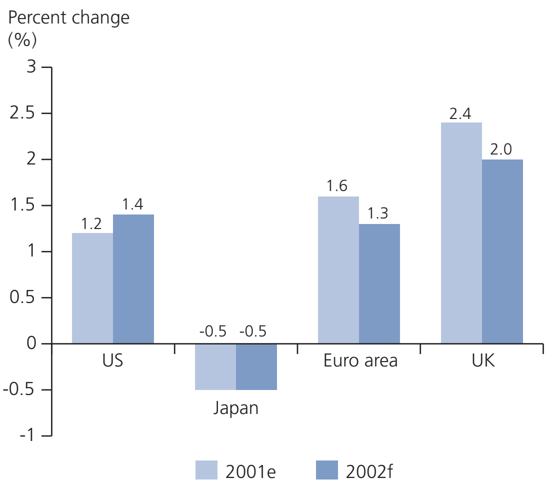
The world economy is expected to recover gradually in line with the slow and modest recovery in the US. Thus, **world growth** is expected to pick up slightly to 2.6%, while **world trade** is forecast to expand between 2% and 2.5%, in tandem with a gradual upturn in the electronics sector. Real output growth in the **major industrial countries** as a group is expected to stabilise at 1.1%, while growth in the **developing countries** is projected to pick up slightly to 4.5%. Growth in the East Asian economies is envisaged to be slightly higher at 4.6 - 4.8%, as impetus to growth is expected to emanate from stronger export demand in the second half of 2002.

Industrial Countries

The **United States** economy entered 2002 in a relatively better position as earlier fears of a recession abated. Consumer confidence and equity markets have rebounded and the fourth quarter 2001 GDP exceeded expectations. The US economy is now expected to recover gradually, gaining momentum from 1.6% in the first half-year to 2.8% in the second half-year. Growth, nevertheless, is expected to be gradual and modest, as investment recovery will lag considerably given the prevailing excess capacity. The recovery in employment will also lag the economic recovery due to ongoing consolidation by corporations as well as the slow recovery in investment. Under these circumstances, growth for 2002 as a whole is estimated at 1.4%.

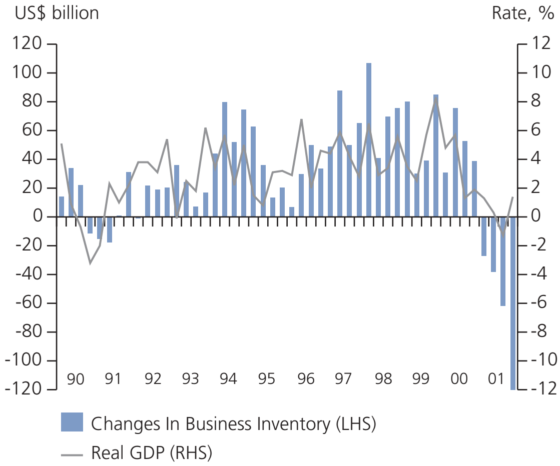
The recovery is premised on four factors. First, while the policies undertaken in 2001 have begun to filter through the economy, the monetary easing has a lag of 6 - 18 months before its full effects are felt on economic activity. The substantial easing of 475 basis points in 2001 is expected to provide a large impetus to growth during the course of 2002. The US$70 billion fiscal stimulus, comprising tax cuts and spending from the emergency package announced after September 11 for reconstruction and defence industries, is also expected to be felt in 2002. In addition, a new fiscal package worth US$51 billion, comprising unemployment benefits and business tax breaks should add further stimulus to growth in 2002. Second, the gradual shift from destocking to inventory accumulation is envisaged to add about 1 - 1.5 percentage points to GDP. Third, softer oil prices would support consumption. The consequent prospects of lower inflation would also allow greater flexibility for the authorities to focus on growth.

Graph 3.1
Major Industrial Countries: Real GDP Growth (2001-2002)



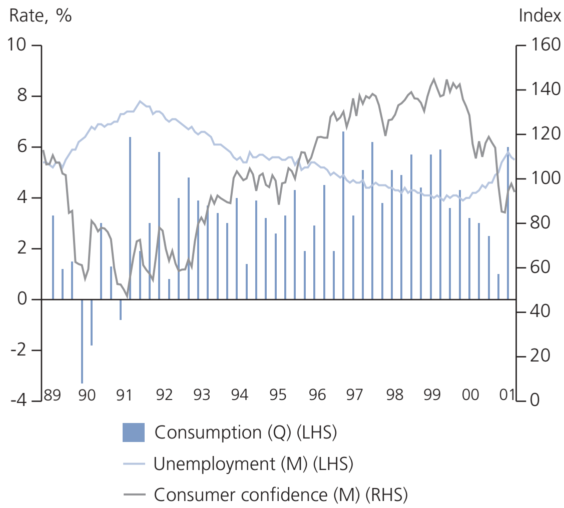
Graph 3.2
Real GDP and Changes in Business Inventory

In 2001, inventory liquidation eroded about 1.1 percentage points from overall GDP growth. A modest build-up of inventory is expected to add about 1 - 1.5 percentage points to GDP growth in 2002.



Graph 3.3
Consumption, Consumer Confidence and Unemployment

Consumption is more related to expectations and lesser to employment conditions. In the 1990s recession, consumption picked up two quarters before unemployment peaked. In the current cycle, unemployment is expected to peak in mid-2002.



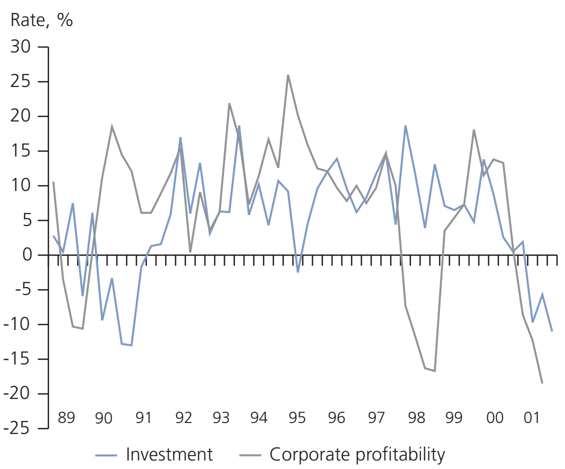
Finally, the resilience in productivity growth seen during the current downturn is expected to further support growth during the year.

Central to the forecast is that consumption growth would continue. While employment and income conditions may weaken in the next few months and restrain consumption to some extent, the positive impact from lower taxes, energy prices and interest rates are likely to cushion part of the impact on disposable income. At the same time, household balance sheets have remained relatively healthy (asset/liability ratio of 5:1), as the negative wealth effect in the past year was confined mainly to losses in equity wealth, while house prices have remained steady. The recent rise in consumer confidence further supports the view that consumption growth would be sustained during the year.

Meanwhile, the corporate sector is expected to continue its consolidation exercise affecting investment and employment prospects. Thus, both investment and employment are expected to lag the recovery cycle and pick up only after clear signs of improvement in corporate earnings and capacity utilisation. In the third quarter of 2001, capacity utilisation declined to the lowest level since 1983 (technology: 61.2, non-technology sector: 77.8). In view of the above, the upside to new investment is somewhat limited except for opportunities in some areas such as the auto industry (upgrading into new models) and the technological upgrading for IT hardware industries.

Graph 3.4
Investment and Corporate Profitability

Corporate profitability registered the largest decline in 10 years of 18.5% in the third quarter of 2001 and is expected to have reached its trough in the fourth quarter of 2001. Corporate profitability is only expected to recover gradually in the second half of 2002, implying that firms are likely to hold back investment plans until they see a stronger upturn in profitability.



Investment would also be supported by fiscal spending worth US$40 billion for the reconstruction and investment in biotechnology and defence industries.

The **euro area** is expected to expand at a slower pace of 1.3% in 2002, given that its recovery would be lagging the US upturn by one to two quarters. Inflationary pressures that had earlier affected domestic demand are expected to diminish progressively following the effects from lower energy prices. A pick-up in production during the second half-year amidst rising demand from the US and inventory accumulation should contribute to growth. Improved exports as well as the lower cost of borrowing (monetary easing of 150 basis points since 2001) are expected to spur investment. In particular, investment in the high-tech sector is also expected to perform better in the euro area during the next phase of growth since the extent of IT spending in the past had been lower than in the US. Given that the bulk of this impact is likely to be seen in late 2002 and 2003, growth is expected to be modest during the year.

In the **United Kingdom**, although growth is expected to moderate slightly to 2% in 2002, the economy would continue to outperform the other major industrial economies. The weakness in the manufacturing sector is expected to dissipate gradually following an upturn in IT-related production and a shift to inventory accumulation, while the strength in the services sector is expected to remain. Lagged impact from the monetary easing in 2001 (200 basis points), the impetus from the expansionary fiscal policy (2001-2003 cumulative spending worth 3% of GDP) and the positive wealth effect from a steady housing market are expected to sustain the underlying strength in consumer spending. These recovery forces are likely to reduce the impact from weaker household incomes and bonuses.

In **Japan**, growth prospects are expected to remain weak in 2002. Real GDP is projected to fall for the second consecutive year by 0.5%. Structural reforms in the financial and corporate sectors are expected to dampen growth prospects in the immediate term. Under these circumstances, employment prospects are likely to deteriorate amidst the deflationary forces. Although the reforms are viewed to contribute positively over the longer term, the short-term impact of the reforms could be fairly significant, especially on the banking system. The two supplementary budgets totalling ¥5.6 trillion as well as the accommodative monetary stance are expected to cushion part of the adverse impact. Growth prospects also remain sensitive to Japan's fiscal sustainability as well as adverse domestic and external developments, including volatility in the financial markets.

Inflation in the major industrial countries as a whole is expected to ease to 1.2% in 2002 due to softer oil prices and a gradual recovery in global demand, especially in the US and euro area. Japan would continue to face deflation in view of the excess capacity, weak demand, lower imported inflation and downward price pressures arising from deregulation and technological innovation. In contrast, inflation in the UK is expected to edge upwards in view of the strength in consumption.

Despite the optimism for a recovery in the US, the **main risk for the global economy is for a "double dip" recession**. The risk is that the US recovery may not be durable in the event that consumer spending, which is key to the recovery, does not hold up. While the corporate sector has taken the necessary adjustments, the household sector remains vulnerable due to the low savings rate (January 2002: 1.8%) and increased indebtedness (ratio of debt to disposable income of 105%). If labour market conditions deteriorate beyond current expectations, consumers may not be able to service their housing mortgages, which in turn could weaken the housing market. Weaker income and negative wealth effects would encourage consumers to become cautious and cut back on consumption and increase their savings.

Higher unemployment could be triggered by stress in the corporate sector resulting in further corporate consolidation. The corporate financing gap (the difference between capital expenditure and cash flows) has remained large, implying that firms would need continued financing from the capital market since banks have already tightened lending to the corporate sector. The recent failure of a large US corporation has made investors and regulators aware of the need to review current accounting standards to ensure better disclosure. Should closer scrutiny reveal more problems, corporations' credit ratings could deteriorate and lead to corrections in both the equity and bond markets, leading to further stress in the corporate sector.

Nevertheless, **structural improvements in the US** in the last decade resulted in lower inflation, high productivity growth and a deep and sophisticated financial system. These developments should help the country weather the current downturn. Events in the past year also showed that the prompt response by the authorities in respect to monetary and fiscal policies effectively shored up business and consumer confidence, thereby reducing the severity of the downturn.

The **other downside risk is a sharp and prolonged depreciation of the yen**. The vulnerability of the Japanese banking system could affect investor sentiment and increase the volatility and heighten the risk on the yen. If the yen depreciates to extremely weak levels for a sustained period, it could further escalate the problems in the Japanese banking system. Empirical evidence showed that there is a positive relationship between the yen and Japanese asset markets. Despite the fact that foreign investors' holdings of outstanding Japanese assets are relatively small, they account for a large share of the active trading, and thus enable to influence the market direction. A combination of a weaker yen, weak Japanese bond and equity markets can have an adverse impact on Japanese banks, given their large exposure to these markets. For the region, a weaker yen could have serious implications, and could be highly destabilising on regional currencies.

East Asian Economies

Against a backdrop of a mild US recovery and a modest rebound in the global electronics sector, the regional countries are envisaged to record an improved growth in 2002. **Growth for the region as a whole** is expected to improve to 4.6 - 4.8%, due mainly to relatively robust growth in the People's Republic of China. Growth in the other regional countries is expected to be more moderate, ranging from 1 - 4.5%. The region is envisaged to recover in the second half of the year as external demand gathers momentum. Given that most regional economies have a large tradable sector and are highly dependent on electronics exports, the acceleration in external demand would create a significant impetus to growth.

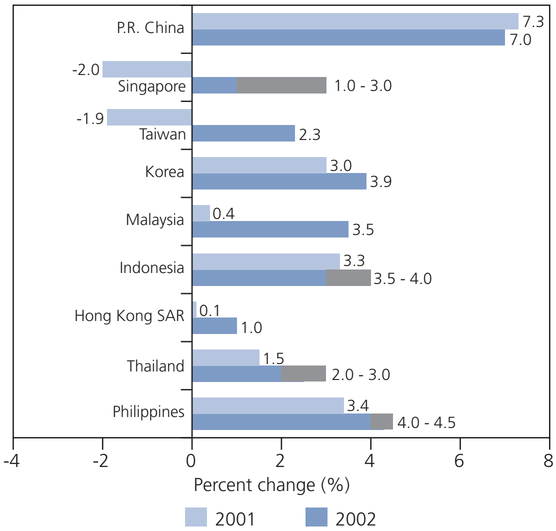
Latest available indicators suggest that the downturn in the **global electronics cycle** has bottomed out. The pace of contraction in semiconductor sales has eased and on a month-on-month basis has turned around to record positive growth for two months. In addition, orders received by global chipmakers have picked up, resulting in an improvement in the book-to-bill ratio, prices of selected product segments such as DRAMs have improved and some large companies have indicated a brighter outlook. Despite these positive developments, the upturn in global electronics demand is expected to be modest, gradual and uneven as there is still significant excess capacity, especially in the communications and network product segments of the industry, amidst the overall weak investment climate. Regional countries producing personal computers and specialised in outsourcing activities are viewed to benefit the most in the latest electronics upcycle.

In the interim, as external demand gathers momentum, expansionary policies already in place are expected to play a key role to support domestic demand, and hence, growth in the first half of 2002. Against a mild inflation backdrop, monetary policy in the regional economies would remain accommodative to ensure sufficient liquidity to facilitate credit growth and stimulate economic activity. In line with the global trend, interest rates in the regional countries had been reduced significantly in 2001 and the cost of borrowing is currently at relatively low levels. In addition, the cumulative effects from the expansionary fiscal policies should also filter through the economies during the year.

In the event of further external shocks, the regional countries are also in a stronger position to absorb these shocks. Their external positions have strengthened. Countries have higher foreign exchange reserves and lower external debt with longer-term maturities. Current account surpluses, although narrowing somewhat, are expected to continue in 2002, which would act as an additional buffer to external shocks. The restructuring in the post-crisis period has also strengthened the financial sectors in the regional countries. Capital adequacy ratios have been raised in most countries to above 10% and their non-performing loan ratios are now lower than the post-crisis levels, due to active measures by asset management companies. Financial institutions in both the banking sector and capital markets in the region have also tightened their prudential measures to be in line with international standards.

In addition, there has been a structural change in the financing pattern in the region, away from banking system loans towards longer maturity and market-based instruments. These changes have helped to diversify the sources of financing in the region that will enhance the resilience against future shocks. In the longer term, the reforms in the financial and corporate sectors should contribute towards enhancing efficiency in production and capital allocation.

Graph 3.5
Regional Countries: Real GDP Growth (%)



In 2002, the **Asian Newly Industrialised Economies (NIEs)** as a group is expected to expand at a stronger rate of 2.7 - 2.9% (2001: 0.6%), reflecting a mild recovery across all the countries on the back of firmer external demand. The forecast is premised on a modest recovery in the electronics sector, on which the NIEs are highly dependent. In **Korea**, growth is expected to rise to 3.9% in 2002, reflecting a pick-up in electronics exports as well as stronger domestic demand, supported by lower oil prices and the positive wealth effects from a rising stock market. Similarly, in **Taiwan**, real GDP is expected to recover to expand by 2.3% in 2002, in line with the expected recovery in the US, which absorbs about one-third of Taiwan's exports. Recovery in asset markets and receding political uncertainties are also expected to support consumer and business confidence.

The **Singapore** economy is projected to recover with a growth of 1-3%. Although growth may be affected by rising unemployment in the first half of the year, the recovery is expected to gather

Regional countries to recover, supported by expansionary policies and strengthening external demand. Stronger external positions and structural improvements have reduced vulnerability of countries to external shocks.

momentum towards the end of the year, following improving demand from the US and better consumer sentiment. In the **Hong Kong Special Administrative Region (SAR)**, growth is expected to pick up to 1% in 2002 but strengthening in domestic demand would be vital to support the recovery. Meanwhile, growth in the **People's Republic of China** is expected to stabilise around 7%, supported by strong domestic demand, increased fiscal spending and investment related to foreign direct investments, especially following its entry into the World Trade Organisation (WTO).

Meanwhile, growth for the **ASEAN** economies as a group is expected to pick up to 2.8 - 3.6% (2001: 1.5%), in view of relatively stable domestic demand in the member countries amidst strengthening exports. Growth in the **Philippines** is expected to rise to 4 - 4.5%, due to improvement in external demand, especially for electronics products, which form the bulk of the country's exports. Effects from the significant monetary easing by 625 basis points since January 2001 as well as improved confidence on the back of receding political uncertainty are likely to support domestic demand.

Growth in **Thailand** is projected to increase slightly by 2 - 3% in 2002 on account of the recovery in the US, its main export partner, and impact from fiscal stimulus measures. In the recent period, **Indonesia** has been less affected among the regional countries as it is a more domestically driven economy and its export sector is less dependent on technology products. Nevertheless, in 2002, Indonesia's real GDP growth is projected to remain moderate at around 3.5 - 4%. Softening oil prices and a weak investment climate are likely to affect the scope for higher growth in Indonesia during the year.

Inflation in the regional countries is expected to remain moderate, easing slightly to 2.2 - 2.3% in 2002, due to mild inflation in the People's Republic of China, ending of deflation in Hong Kong SAR and lower inflation in the other countries. For most countries, lower inflation is largely on account of lower oil prices and general weakness in private consumption, which limits the ability of producers to pass cost increases to consumers. Inflation in the **Asian NIEs** as a group is expected to ease to 0.8 - 0.9%. While inflation is expected to remain mild in Taiwan due to lower tariffs after its entry into the WTO, Singapore is expected to experience a mild deflation attributable to declining rentals, lower oil prices and sluggish demand amidst the high unemployment.

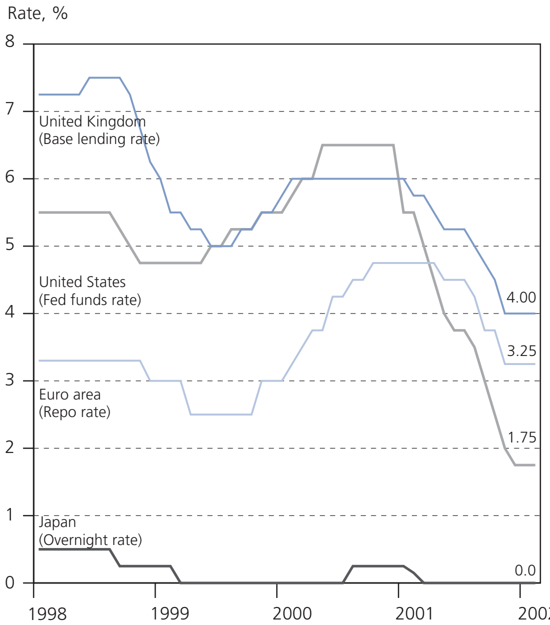
Similarly, inflation in the **ASEAN** countries as a group is expected to moderate slightly to 5 - 5.5%. In both Thailand and the Philippines, price pressures are expected to subside in view of lower oil prices, sluggish domestic demand and relatively stable food prices. In Indonesia, however, inflation is expected to remain relatively high due to the planned fuel and electricity price hikes.

Interest Rates and Exchange Rates

In 2001, **monetary policy** in the major industrial countries shifted towards easing, with the US Federal Reserve Board (Fed) taking the lead. The major industrial countries reduced interest rates aggressively during the year, especially in the US, to counter the sharp economic slowdown amidst a declining inflation trend, especially in the aftermath of September 11. Following September 11, the Fed and the other major central banks conducted co-ordinated interest rate cuts and undertook swap arrangements to minimise potential volatility in the global financial markets.

In the US, the **Fed** reduced the Federal funds rate by a cumulative 475 basis points in 11 steps, a reduction of 300 basis points prior to September 11 and another 175 basis points after September 11. This brought the Federal funds rate to 1.75%, its lowest level in 40 years. The **Bank of England** (BOE) eased its base lending rate (BLR) in seven steps by a

Graph 3.6
Major Industrial Countries: Official Interest Rates



cumulative 200 basis points to a 37-year low of 4% to insulate the economy from the global slowdown, amidst the declining trend of inflation.

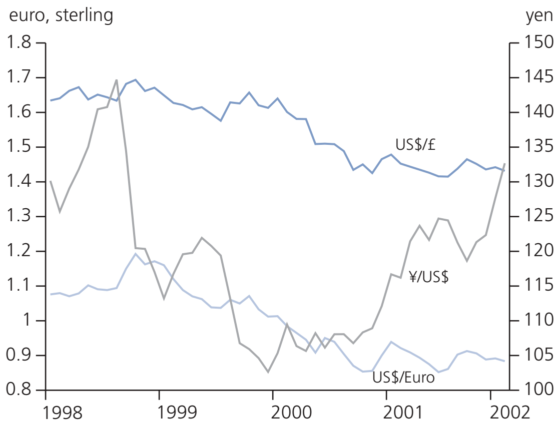
In view of concerns that inflation remained above the target rate of 2%, the **European Central Bank** (ECB) reduced interest rates after a considerable lag, commencing only in May 2001. The repo rate was brought down to 3.25% in four steps by a cumulative 150 basis points to mitigate the sharp slowdown in the euro area. In March, the **Bank of Japan** (BOJ) reverted to its zero interest rate policy to counter the deflation amidst the sharp weakness in its economy. Subsequently, the BOJ engaged in several quantitative easing measures to inject liquidity to the banking system in order to maintain financial stability.

In **early 2002**, except for Japan, monetary policy in the major industrial countries remained unchanged. On 28 February, the BOJ continued further quantitative easing by increasing its direct purchase of Japanese government bonds, while providing ample liquidity to meet market demand.

For the remaining part of 2002, expectations are for interest rates to stabilise given signs of improving economic data, as well as the already significant monetary stimulus that has been put in place to facilitate the recovery. Nonetheless, the central banks are likely to remain vigilant against signs of unexpected softening of economic activity that may require further easing. Equally important, the authorities are likely to assess the strength of the emerging recovery that may result in emerging inflationary pressures and consequently warrant pre-emptive policy responses. The possibility of a shift in the stance, in either direction, would, however, depend on a number of factors, including the strength of the recovery; developments in the IT sector; the movement in the major currencies; and the performance of the financial markets.

In the **foreign exchange** markets, the US dollar strengthened against all major currencies in 2001. The dollar appreciated by 15.2%, 5.9% and 2.8% against the yen, euro and pound sterling respectively. Although the dollar was briefly affected by September 11 due to shifts away from dollar assets to capital-exporting countries, the dollar regained its strength thereafter. Large foreign inflows into the bond market also underpinned the dollar during the year. The sentiment on the dollar was supported by market perception that the US recovery would be ahead of the other major economies.

Graph 3.7
Movement of the US Dollar against Major Currencies



The euro weakened in view of the growth prospects of the euro economies relative to the US. The pound sterling tracked the euro weakness as the currency was seen to be adjusting, taking into account the prospect of UK's entry into the euro area. The weakening of the yen, especially towards the end of the year, was triggered by perceived changes in the Japanese authorities' stance to tolerate a weaker yen.

In the **first two months of 2002**, the dollar remained firm against the major currencies as more positive data in the US reinforced expectations that the US recovery would lead the global upturn. The yen traded in the range of US$1= ¥130 - 135. However, in early March, the yen strengthened to below US$1= ¥130, following an increase in foreign interest in the Japanese stock market.

For the rest of 2002, the movement of the dollar against other major currencies would be influenced by a number of factors. These include investors' perception on the importance of growth differentials vis-à-vis interest rate differentials, performance of stock and bond markets as well as the movement of capital flows during the year. Country-specific issues that are structural and relating to the health of the financial system could also affect the sentiment on the major currencies.

MALAYSIAN ECONOMY IN 2002

The Malaysian economy is expected to strengthen in 2002 following a strengthening of external demand. Past trends show that there is a brief lag between the recovery in the major economies and recovery in Malaysian exports. As such, the timing and magnitude of the recovery would have a significant impact on the Malaysian economy. Current indications suggest that external demand will not pick up as strongly as in the 1999-2000 period, where recovery was mainly led by the internet-boom and the Y2K factor. The current economic upturn is taking place amidst global excess capacity, particularly in the technology sector. External demand is, therefore, expected to strengthen gradually. Against this background, the recovery in the Malaysian economy would be modest, with real GDP expanding by 3.5% in 2002.

front, aggressive policy measures to enhance the role of the services sector, particularly in the education, tourism and information, communication and technology sub-sectors, would benefit these sectors, which in turn could improve further the GDP growth.

Expansionary fiscal policy and accommodative monetary policy already in place are expected to sustain growth in domestic demand. Growth in **private consumption** is expected to pick up to 5% following the improved growth and employment

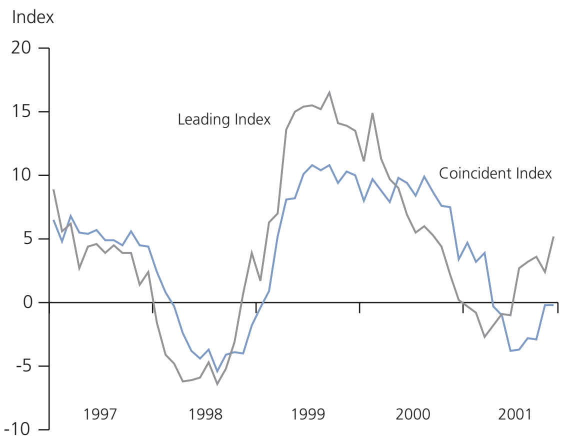
The Malaysian economy is well positioned to benefit from the expected recovery in the global economy.

outlook as well as the cumulative effects from the Government's measures that have raised disposable income. Additional measures announced by the Government in the 2002 Budget such as the 1-2 percentage points across-the-board reduction in individual income tax rates, raising the income threshold before the maximum income tax rate takes effect and an increase in civil servants' salaries should all further increase disposable income. Growth in private consumption is projected to be stronger in the second half-year when export demand gathers momentum.

At this juncture, latest indicators show signs of stabilisation in the Malaysian economy. The index of leading economic indicators compiled by the Department of Statistics, Malaysia, which provides early indications on the direction of economic growth, has already registered five consecutive months of positive growth since July 2001. This suggests that the Malaysian economy would turn around in the first quarter of 2002. Indications, however, are that growth would strengthen in the second half-year when external demand improves more significantly.

The growth projection for 2002 is based on stronger growth in private consumption, a modest recovery in private investment, sustained public sector expenditure and a moderate growth in exports. If the positive trend in the latest indicators for the US economy is sustained, the bias to the growth projection would be on the upside. On the domestic

Graph 3.8
Leading Index Pointed to a Recovery in 2002



Source: Departments of Statistics, Malaysia

Meanwhile, **private investment** is expected to recover in 2002, registering a positive growth of 1.2%. Investment in the manufacturing sector is expected to turn around only in the second half-year when recovery in the global economy becomes more entrenched. The impetus to private investment would, therefore, be coming mainly from continued investments in the ongoing privatised road projects, residential housing, rail projects, development works on ports and power plants as well as investment in the oil and gas sub-sector.

While the 2002 Budget announced a fiscal consolidation, the better-than-expected fiscal outturn in 2001 arising from stronger revenue collections would imply that the consolidation would be less pronounced (fiscal deficit of –5.1% of GDP in 2002 from –5.5% in 2001, compared to earlier estimate of –6.5% of GDP for 2001). **Public investment** spending is projected to decline by 3% after a strong increase of 15.5% in 2001. Despite this, the Federal Government's development expenditure allocation for 2002 remains high at RM28.4 billion, with a large share of expenditure continuing to be accorded to the

Table 3.3
Real GDP by Expenditure (1987=100)

	2001*p*	2002*f*
	Annual change (%)	
Domestic Demand[1]	**2.3**	**2.8**
Private sector expenditure	-2.9	4.2
Consumption	*2.8*	*5.0*
Investment	*-19.7*	*1.2*
Public sector expenditure	13.9	0.0
Consumption	*11.9*	*4.1*
Investment	*15.5*	*-3.0*
Net exports of goods and services	**2.3**	**-0.6**
Exports	-7.6	3.7
Imports	-8.6	4.2
Gross Domestic Product	**0.4**	**3.5**

[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

economic and social sectors. **Public consumption** is projected to increase by 4.1%, reflecting the 10% salary adjustment for civil servants as well as higher expenditure on supplies and services.

On the production side, all major sectors are expected to record positive growth in 2002. The manufacturing sector is anticipated to recover, benefiting from the improvement in global demand

Table 3.4
Contribution of Demand Components to Real GDP Growth

	2001*p*	2002*f*
	% point of contribution	
Domestic Demand[1]	**0.1**	**3.5**
Private sector expenditure	-1.7	2.5
Consumption	*1.3*	*2.3*
Investment	*-3.0*	*0.2*
Public sector expenditure	3.8	0.0
Consumption	*1.4*	*0.5*
Investment	*2.4*	*-0.5*
Changes in stocks	-1.9	1.1
Net exports of goods and services	**0.3**	**-0.1**
Exports	-8.9	4.0
Imports	-9.2	4.1
Gross Domestic Product	**0.4**	**3.5**

Note: Figures may not necessarily add up due to rounding
[1] Include stocks
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 3.5
Real GDP by Sector (1987=100)

	2001*p*	2002*f*
	Annual change (%)	
Agriculture	2.5	1.0
Mining	0.2	3.0
Manufacturing	-5.1	4.2
Construction	2.3	2.4
Services	4.9	3.8
Real GDP	**0.4**	**3.5**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

for electronics. The services and construction sectors are expected to continue to support growth, benefiting from the pro-growth policies already in place.

Value-added growth in the **manufacturing sector** is expected to turn around to register a positive growth of 4.2% in 2002. The anticipated upturn in the US economy and electronics demand is expected to translate into stronger demand for Malaysian manufactured exports and, hence, stronger growth in the production of manufactured goods. Both foreign and domestic manufacturers in Malaysia have indicated increased optimism on the outlook for the manufacturing sector in general, and the electronics sector in particular. The general consensus is that growth in the manufacturing sector would be modest in the first quarter before gathering strength in the subsequent quarters of 2002.

Growth in the electronics industry is expected to be underpinned by several positive factors. First, there was a significant drawdown of inventories by companies in 2001 and, thus, new orders are expected to result in an immediate increase in production, especially for electronics. The personal computer (PC) market is expected to show a stronger recovery relative to the telecommunications sector. Preliminary findings of BNM's study on the export composition of Malaysia's electronics industry showed that exports of computers and peripherals account for about 40% of Malaysia's total electronics exports. Therefore, the impending improvement in the global PC market should benefit the industry in Malaysia. In addition, some manufacturers of

Table 3.6
Malaysia's Electronics Industry: Export Composition

Product Diversification	% share of total electronics exports
Computer and peripherals	**39**
Monitors, keyboards, servers and related hardware	*10*
Parts and accessories for computers	*20*
Data storage devices	*9*
Discrete components	**22**
Integrated circuits	**19**
Others	**20**
Electronics parts	*7*
Display devices	*6*
Electronics apparatus	*3*
Cathode ray tubes and other picture tubes	*2*
Other electronics related equipments	*2*
Total	**100**

Source: Department of Statistics, Malaysia

electrical products have also begun to focus on new products to meet the changing consumer preferences. Second, there is an increasing trend towards outsourcing of activities in the manufacturing sector. As a result, some large manufacturers in the region are expected to transfer some operations to Malaysia following corporate consolidation of plants in the region. Malaysia is expected to benefit from these developments. Finally, demand from niche markets for products such as video games, personal digital assistants and emerging products such as photonics or optoelectronics is expected to continue to contribute to growth.

With the electronics and electrical products industries leading output growth in the export-oriented sector, the production of export-oriented industries as a whole is projected to recover in 2002 with a growth of 4.9% (2001: -10.2%). Output in the domestic-oriented sector is expected to be sustained at a strong rate of 6% in 2002 (2001: 7.4%), supported by the Government's pro-growth policies. In particular, the transport equipment and construction-related materials industries are forecast to continue to contribute to growth.

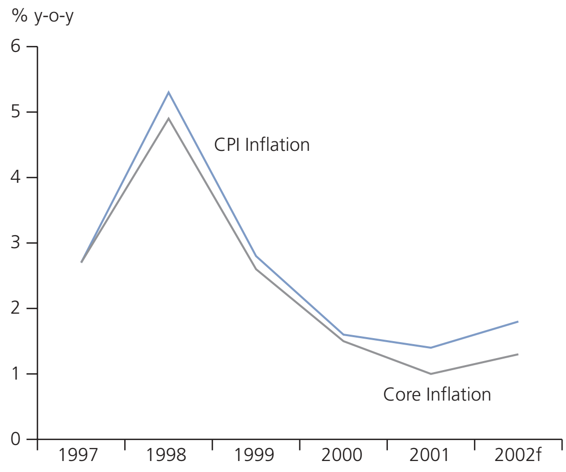
Growth in the **services sector** is expected to be broad-based, with the intermediate services group expanding at a faster rate than the final services group. Growth, however, is expected to moderate to 3.8% partly due to the strong performance in 2001. Nonetheless, policy measures to raise the potential output of the services sector, particularly in the education, tourism and information, communication and technology sub-sectors, could result in a stronger-than-expected growth in the services sector, which in turn, would improve the GDP growth.

Growth in the **construction sector** is expected to be sustained at 2.4%, with impetus coming from the civil engineering and residential sub-sectors. Low interest rates and various pre-emptive measures implemented by the Government to address the excess supply situation in the property market will continue to support demand for residential housing. The relaxation of the Foreign Investment Committee guidelines on foreign acquisition of properties in April 2001 has helped to reduce the property overhang in the sub-sector. The Government has waived the stamp duty charged for the purchase of residential property from developers registered with the Real Estate and Housing Developers' Association Malaysia, for a period of six months, effective 1 January 2002. On 27 November 2001, BNM lifted the restriction on the provision of bridging finance for the development of residential properties above RM250,000 and shop houses exceeding RM250,000 per unit located within residential areas, provided the projects have achieved break-even sales. Growth in the civil engineering sub-sector is envisaged to be supported by privatised projects as well as fiscal spending on infrastructure development. Meanwhile, activity in the non-residential sub-sector would continue to be constrained by excess capacity with activity focused mainly on ongoing projects.

Growth in the **agriculture sector** is expected to moderate to 1% due largely to lower production of crude palm oil (CPO), rubber and saw logs. In particular, CPO production is expected to decline due to anticipated lower yields arising from cyclical tree stress after three consecutive years of high production, as well as the impact of the replanting programme that will involve 200,000 hectares of old oil palm trees. However, measures taken by the Government to increase food production is expected to result in increased production of fruits, vegetables, livestock and fish, thus contributing to higher activity in the agriculture sector in 2002. Meanwhile, growth in the **mining sector** is expected to pick up to 3% due to higher production of crude oil and natural gas in response to higher domestic demand. For 2002, crude oil production has been targeted at 600,000 barrels per day.

Consumer prices are expected to edge upwards in 2002 in line with the projected recovery in domestic economic activity. As growth is expected to be moderate with excess capacity remaining high for most of the year, the increase in prices is expected to emanate more from price adjustments rather than from demand pressures. Core or underlying inflation, which represents price increases arising from demand pressures, is projected to increase from 1% in 2001 to 1.3% in 2002. A one-off price increase of an additional 0.5 percentage point is anticipated during the year. The increase in the petrol prices and import and excise duties on cigarettes and tobacco products, announced in the 2002 Budget, took effect from mid-October 2001. Toll charges on North-South Expressway and telephone tariffs have also been raised effective January 2002 and March 2002 respectively. While CPI inflation is projected to increase by 1.8% in 2002, it continues to remain low.

Graph 3.9
Consumer Prices



The **labour market situation** is expected to improve gradually in 2002 in tandem with the recovery in the export sector. The unemployment rate is forecast to decline to 3.6% in 2002 (2001: 3.7%). The establishment of nine schemes for skills training and higher education with an allocation of RM300 million is envisaged to contribute positively to the development of skills of unemployed graduates and retrenched workers. This is expected to facilitate the absorption of unemployed workers into higher-end job segments. While IT-related areas are expected to create new employment opportunities, the manufacturing sector would still be a major source of new employment opportunities.

As previous experience has shown, a revival of economic activity would result in a narrowing of the **current account surplus of the balance of payments**. The stronger trade surplus from higher exports would be eroded somewhat by higher imports. Similarly, the services and income account deficits are also expected to widen. The current account surplus, nevertheless, is forecast to remain large in 2002, at 7.9% of GNP.

Exports are expected to turn around to record a growth of 4.4% in view of the anticipated recovery in electronic exports and higher revenue from agricultural exports. **Imports** are expected to increase by 4.8% with imports of intermediate goods increasing by 6.4%. Nevertheless, the trade surplus is projected to be large mainly because the import of capital goods is not expected to increase significantly in 2002 due to continued excess capacity and slow buildup in new investment.

Manufactured exports are expected to perform better in 2002, in view of the improving outlook on

Table 3.7
Balance of Payments

	2001*p*	2002*f*	2001*p*	2002*f*
	RM billion		US$ billion	
Goods	69.9	73.0	18.4	19.2
Trade account	53.7	55.0	14.1	14.5
Exports (% change)	*-10.4*	*4.4*	*-10.4*	*4.4*
Imports (% change)	*-9.9*	*4.8*	*-9.9*	*4.8*
Services	-8.4	-11.6	-2.2	-3.0
Balance on goods and services	**61.5**	**61.4**	**16.2**	**16.1**
Income	-25.9	-27.5	-6.8	-7.2
Current transfers	-8.1	-8.4	-2.1	-2.2
Current account balance	**27.4**	**25.5**	**7.2**	**6.7**
(% of GNP)	***8.9***	***7.9***	***8.9***	***7.9***
Financial account	-14.8		-3.9	
Errors and omissions	-8.9		-2.3	
of which :				
Exchange revaluation loss	*-4.1*		*-1.1*	
Overall balance	**3.7**		**1.0**	

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia.

external demand, especially in the US and the anticipated recovery of the global electronics sector during the year. For the year as a whole, manufactured exports are expected to turn around to register a positive growth of 6.5%, driven by electronics exports, which accounted for about one half of total manufactured exports. With several positive developments already taking place towards the end of 2001, electronics exports are expected to grow by 9.5% (2001: –16.3%). Nevertheless, the growth momentum is expected to pick up in the second half of the year. Similarly, exports of the non-electronics industries are expected to expand by 3.6% (2001: –3.6%), particularly those producing electrical products, chemicals and chemical products, and optical and scientific equipment. Consequently, **export volume** is expected to expand by 8.5% in 2002 (2001: –4.1%). **Export prices**, however, are expected to continue to trend downwards, albeit at a more moderate pace (–2%; 2001: –6.1%). The downward pressure on prices is due mainly to excess capacity amidst a slower expansion in demand. In addition, increased capacity among lower cost producing countries also exert pressure on prices, especially for electronic products.

Table 3.8
Exports and Imports

	2001*p*	2002*f*
	RM billion	
Gross exports	**334.4**	**349.1**
(% change)	***-10.4***	***4.4***
Manufactures	285.3	303.8
(% change)	*-10.3*	*6.5*
Minerals	23.4	15.9
(% change)	*-12.6*	*-32.1*
Agriculture	20.0	23.6
(% change)	*-13.2*	*18.2*
Gross imports	**280.7**	**294.1**
(% change)	***-9.9***	***4.8***
Capital goods	43.7	44.2
(% change)	*-1.1*	*1.2*
Intermediate goods	201.8	214.7
(% change)	*-13.3*	*6.4*
Consumption goods	17.6	18.7
(% change)	*3.0*	*6.3*

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The outlook for Malaysian **commodity prices** is expected to be favourable in 2002, particularly for palm oil. The projected increase of 18.2% in **agriculture exports** would be derived from the higher palm oil price as export volume is only expected to increase marginally, constrained by lower domestic supply. The price of palm oil, which has been trending upwards since November 2001, is projected to strengthen further to RM1,250 per tonne in 2002 in anticipation of rising demand and tight global supplies. Similarly, export prices of saw logs, sawn timber and rubber are forecast to improve as external demand for these commodities is expected to pick up, particularly in the second half of 2002. Meanwhile, the average price for Malaysia's crude oil is forecast to decline to US$18.00 per barrel in 2002 (2001: US$25.53), reflecting primarily conditions in the international oil markets. Globally, the increase in oil demand, which would be dependent largely on the strength of the global economic recovery, is expected to be modest relative to supply. Similarly, export prices of LNG are expected to decline in 2002 in tandem with the downward trend in oil prices. Consequently, **mineral exports** are anticipated to decline by 32.1% in 2002.

The lower current account surplus would reflect entirely the widening of the **services** deficit to 3.6% of GNP and the **income account** deficit to 8.5% of GNP. A recovery in exports would be translated into higher payments for freight and insurance and consultancy services as well as increased outflows related to profits and dividends repatriation by non-resident companies. However, sustained receipts in the travel account as well as higher earnings from port charges and education are expected to support the services account. With the strategy to broaden and diversify the tourism market to new markets such as West Asia, India and China, the number of tourist arrivals is expected to remain high.

The **financial account** is expected to be supported by sustained inflows of long-term capital including higher inflows of foreign direct investment in 2002. In March 2002, the Government tapped the international bond market by issuing US$750 million Notes to take advantage of favourable market conditions and low interest rates. Nevertheless, the **official sector** is expected to record a small net outflow due to high loan repayments by the NFPEs following the maturity of several bonds raised in the 1990s.

In view of the recovery in global economic conditions, inflows of **foreign direct investment** (FDI) are expected to be higher with projected inflows of equity from strategic alliances as well as inflows for expansion and new investment in the manufacturing, services and oil and gas sectors. The investment incentives announced in the 2002 Budget, including the extension of the reinvestment allowance period from 5 to 15 years as well as the Government's commitment to continue to provide the special Pre-Packaged Incentives, are also expected to attract high value-added FDI. The improved prospects for the economy would also encourage greater portfolio inflows. However, it is difficult to forecast the movement of **short-term capital flows**, given that these flows tend to be volatile, responding to specific events and short-term sentiments.

The **external debt outstanding** is expected to decline to RM167.9 billion (US$44.2 billion) as at end-2002, equivalent to 52% of GNP, reflecting the decline in debt of NFPEs and the private sector. The external debt of the NFPEs is expected to decline with the maturity of several bonds raised in the 1990s. Similarly, the external debt of the private sector is also expected to decline, due to prepayments of loans by companies as part of their corporate restructuring exercises. Meanwhile, the Federal Government debt is expected to increase, due to new loans raised in the international capital markets and the drawdown of loans committed under the Miyazawa Initiative. The debt service ratio is expected to improve to 5.3%.

Table 3.9
External Debt

	2001*p*	2002*f*	2001*p*	2002*f*
	RM billion		%share	
Medium and long-term	**146.4**	**144.5**	**86**	**86**
Public sector	90.9	90.4	53	54
Federal Government	*24.3*	*29.9*	*14*	*18*
NFPEs	*66.5*	*60.6*	*39*	*36*
Private sector	55.6	54.1	33	32
Short-term	**23.3**	**23.3**	**14**	**14**
Banking institutions	12.1	12.1	7	7
Non-bank private sector	11.3	11.3	7	7
Total External Debt	**169.8**	**167.9**	**100**	**100**
US$ equivalent	***44.7***	***44.2***		
% of GNP				
Total debt	55.4	52.0		
Medium and long-term debt	47.7	44.7		
Debt service ratio (%)				
Total debt	6.2	5.3		
Medium and long-term debt	5.8	5.0		

Note: With effect from 2001, the external debt of MAS has been reclassified as NFPEs debt. Prior to 2000, it was classified as private sector debt.
p Preliminary
f Forecast

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

MANAGEMENT OF THE ECONOMY IN 2002

As economic recovery is expected to be modest, macroeconomic policies would continue to reinforce the counter-cyclical macroeconomic measures already in place to support domestic sources of growth. In an environment of low inflation, monetary policy can continue to remain accommodative in 2002. Loan growth is expected to expand in tandem with recovery. As the emphasis is on the creation of an environment of stability and predictability, the thrust of policies would be directed at maintaining strong fundamentals to support the fixed exchange rate regime.

In line with the stated intent to consolidate the fiscal deficit in 2002, the fiscal stimulus is expected to be less expansionary at –5.1% of GDP (–5.5% in 2001). Given the high flexibility of fiscal policy, the Government is in the position to further increase expenditure to stimulate economic activity, should the need arise. As consolidation would enhance long-term stability, there is strong commitment to meet the Eighth Malaysia Plan target of fiscal balance by 2005. In managing the fiscal position, appropriate steps would be taken to ensure that the Government's financing requirements would not result in any crowding out effects. Further, priority would continue to be accorded to maintaining the Federal Government debt at a low level (now amounting to 43.8% of GDP).

In an environment of increased liberalisation in the global market place, policy focus in 2002 would essentially centre on ensuring that policy implementation is carried out in a consistent and efficient manner to effectively manage the increased competitive pressures. In this regard, structural adjustment efforts will be intensified as continued commitment to structural policies is envisaged to contribute to building confidence and help in lifting any constraints on macroeconomic policy options and their effectiveness. In line with the broader spectrum of policies outlined in the Eighth Malaysia Plan (2001-2005) and the Third Outline Perspective Plan (2001-2010), measures that will be implemented in 2002 are expected to contribute to improving the business environment through not only demand side measures, but, also supply side initiatives. In this regard, strategies are targeted to realise the full potential of the services sector, promote the development of small- and medium-scale enterprises, further improve productivity levels and ensure that the incentive structure remains favourable to both foreign and domestic investors.

Services sector: In view of its strong linkages with the other sectors of the economy and its strategic importance in supporting the structural transformation of Malaysia to the New Economy, policies also target the acceleration of the development of the services sector as the second engine of growth. In this regard, in 2002, the Government would undertake in-depth studies on maximising the potential of the health, education and tourism sub-sectors as sources of foreign exchange earnings. Specifically, measures would concentrate on boosting health-tourism and further developing the education industry to establish Malaysia as a regional education center of excellence as well as promoting Malaysia as a destination for potential tourists from a wider range of new markets.

Tourism: In further promoting the tourism sub-sector, the 2002 Budget introduced several measures, which include increasing the allocation to the Tourism Fund from RM200 million to RM400 million, extending the existing tax incentives for another five years to tour operators organising domestic tours for foreign and local tourists and granting of excise duty exemption on the purchase of national cars to car rental operators. In developing leisure cruising as a tourism product, the Government has allocated RM5.4 million for the construction of marinas and announced an income tax exemption of 100% for a period of five years on income derived by companies providing charter services of luxury yachts and motorboats. Apart from continuing to host major cultural, sporting and business events in Malaysia, measures are already in place to establish Malaysia as a regional shopping haven by 2003.

Financial sub-sector: As the banking institutions' merger programme has taken place against a backdrop of significant improvements in banking system balance sheets, the focus of financial policy in 2002 will be placed on meeting the objectives set out in the first phase of the Financial Sector Master Plan (FSMP). This involves enhancing the capacity of the banking groups by benchmarking, strengthening skills, strengthening corporate governance, encouraging new delivery channels and promoting greater operational flexibility so as to become more efficient and effective. Also, measures to be taken during the year would include developing minimum standards for the management of market risk for banking institutions; streamlining guidelines, best practices and examination requirements of exempt dealers and stockbroking companies; extending the prudential regulatory framework to include holding companies of banking institutions and their subsidiaries; and strengthening the regulatory framework for investment banks. In the capital market, listed companies with unsatisfactory financial positions or with issued capital below the minimum threshold will be given an extension up to December 2002 to comply with the listing requirements of the Kuala Lumpur Stock Exchange (KLSE) that were issued in 2001.

In further expanding the enabling environment to support economic activity, the Bank will intensify efforts to promote the role of development financial institutions (DFIs) to complement that of the banking system. The Development Financial Institutions Act 2002 (DFI Act), which came into force on 15 February 2002, was formulated to provide a comprehensive and effective regulatory framework for DFIs, with emphasis on the safety and soundness of financial and operational conditions. In this regard, measures for the year will focus on strengthening the regulatory framework and building institutional capacity of the DFIs, as outlined in the FSMP. Overall, measures aim to realign the functions of DFIs so as to enable the institutions to contribute strategically to the economy.

As with the conventional banking sector, the regulatory framework and the operational structure of the Islamic banking institutions will be further strengthened to enhance resilience. The Islamic Banking Act, 1983, and the Banking and Financial Institutions Act, 1989, are being reviewed, whilst

Macroeconomic policies are in place to support the recovery. The policy focus is to enhance competitiveness to achieve high quality balanced growth.

focus is placed on enhancing the structure of Islamic banking institutions. Regulatory measures and promotional efforts are expected to support the Islamic banking industry in capturing a more significant market share of approximately 9% (2001: 8.2%) relative to the total assets of the banking system. Moreover, further advancement of Islamic banking and finance on the international front is envisaged. A key development in this regard would be the standardisation and harmonisation of prudential standards for Islamic banking and finance under the Islamic Financial Services Board which will be set up in 2002.

In the insurance industry, the capitalisation of insurers continued to strengthen further following the increase in the minimum statutory requirement to RM100 million with effect from 30 September 2001, which also advanced the consolidation of the industry. As at end-January 2002, seven merger and acquisition proposals involving 13 insurers were at various stages of implementation. The ongoing consolidation of the insurance industry, which is expected to continue into the year 2002, will create progressively stronger and economically viable insurers, and hence, result in the increased resilience of the industry. In protecting consumer interests, specific measures targeted for 2002 entail the adoption of 'best advice' practices and the introduction of independent financial advisers to enable Malaysian consumers to obtain professional independent advice on financial options. Specific performance measures and benchmarks are also being developed by the Bank to assess the progress achieved by the insurance industry in relation to the objectives and recommendations outlined in the FSMP.

Small- and medium-scale enterprises (SMEs): In meeting the challenges of a global environment, a coherent strategy is being developed to enable the SMEs to provide the critical linkages in the development of a broad-based economy. The Bank had, in December 2001, initiated a comprehensive study on local SMEs to identify their needs and thus, match their requirements at each stage of the business cycle, in areas such as financing, training, management, marketing intelligence and IT development. The infrastructure and business support for SMEs will provide a holistic and focused strategy that would make SMEs viable regional and global players that are value-focused, customer-driven, speed-oriented, information-based, cross functional, flexible and networked. The strategy will focus on three main areas: enhancing their production efficiency and effectiveness, encouraging production of high quality, differentiated and high value-added products that meet world standards and promoting innovation and creativity.

Productivity: As competition in the global and regional markets will intensify with increased WTO and AFTA commitments, productivity enhancement becomes central to Malaysia's economic growth and competitiveness, given that Malaysia can no longer offer a cheap labour market. Measures are already in place to transform the economy to a productivity-driven economy that is characterised by knowledge workers. These measures include improving the infrastructure support to promote productivity growth and providing tax incentives to the private sector to reduce the cost of their transition from investment- to productivity-driven strategies.

Overall, the Government would remain committed to ensuring that Malaysia continues to offer a cost-competitive and viable location to both foreign as well as domestic investors. Efforts to constantly evaluate the incentive structure for competitiveness will continue, as with the further upgrading of the physical and administrative infrastructure to meet world-class standards. In order to encourage reinvestments, the Government, in the 2002 Budget, has extended the Reinvestment Allowance period from five to 15 consecutive years, commencing from the year the first reinvestment is made. A number of other key incentives introduced comprised tax measures to benefit, amongst others, the machinery and equipment industry, downstream activity in the resource-based sector (rubber, oil palm, timber and food-based industries) and manufacturing-related services (integrated logistics, marketing support and utility services).

In order to complement the semiconductor and electronics sub-sector, the list of promoted activities and products for high-technology companies has been expanded by the Government to include advanced electronics, biotechnology, electro-optics and non-linear optics, advanced materials, optoelectronics, software engineering, alternative energy sources and aerospace. Increased collaborative programmes between local universities and the Multimedia Super Corridor (MSC) with industries will be encouraged to create a platform for research in the various promoted areas. In essence, the Government will seek to maximise the contribution of both the education system and business sector to develop a more enterprising culture.

As efforts will remain focused on enhancing structural changes in the economy with strong emphasis on knowledge-content activities and product innovation, the economy will continue to present a range of opportunities to both local and foreign investors in traditional as well as new growth sectors. In terms of FDI, higher value-added industries and high quality investments will be encouraged into the country in order to be differentiated in the global market. The Government's stance is that FDI should not only increase the nation's stock of capital, but, also play a role in increasing the nation's competitiveness by raising productivity. Hence, priority will be accorded to the promotion of investments into the MSC and in the manufacturing and services industries that involve specialised technology, high intellectual capital, low import content and increasing returns. In addition, strategic alliances that are mutually beneficial in terms of value creation and delivery will be encouraged, particularly in sectors such as energy, ports, finance, as well as the national airlines and car industry.

Amid increased dynamics of global market integration, Malaysia's export promotion strategy will be to sustain market shares in traditional markets, whilst conscientious efforts are made to match specific Malaysian products and services with the rising and more diversified consumer needs in emerging markets. Tax incentives also favour Malaysian international trading companies and companies engaged in the export of services. Expenses related to the export promotion of goods and services as well as expenses incurred in registering patents overseas are given special tax treatment. Particular attention was also given to the promotion of Malaysian brands in international markets, so that export competitiveness is not based on prices alone, but also on the level of technology and brand recognition.

Given the developments on the external front, economic management in 2002 will focus on a broad comprehensive framework for Malaysia to increase its competitive edge to 'stay ahead of the curve'. In managing the impact of more intense competition, sound macroeconomic policies will be complemented by structural policies to build on existing capacity and raise long-term productivity growth. Besides directing attention to the entire business cycle in terms of its context and perspective, structural changes essentially aim to deliver internal adjustments and focus on core complementarities for sustainable growth.

MONETARY POLICY IN 2002

In 2002, monetary policy will remain accommodative in order to provide a conducive environment to support the economic recovery process. This policy stance is based on the assessment that the balance of risks is biased toward a modest recovery in economic activities in Malaysia. With domestic inflation remaining subdued, monetary policy will continue to build on gains from the cumulative monetary easing, initiated since 1998, to ensure that the economic recovery process becomes well entrenched. On the exchange rate front, the focus of policy is to ensure that economic fundamentals continue to support the pegged exchange rate.

The monetary policy stance in 2002 will continue to be influenced by global and domestic developments. On the external front, indications are that the US-led global recovery would be modest in 2002. The prospects for world trade and the global electronic demand have also improved. It is expected that the US domestic policies would remain supportive of promoting economic recovery, especially in strengthening consumer and business confidence. Notwithstanding these positive signs of imminent stronger recovery, several downside risks remain, including the sustainability of consumption in the US and the significant movement in the major currencies, which could affect the recovery process. Against this external environment, the Malaysian economy is expected to register a modest growth. Inflation, however, is expected to rise only slightly given the excess capacity in several sectors in the economy.

Given the prospects of modest economic growth and low inflation, the basic thrust of monetary policy will continue to be directed at nurturing the recovery in domestic economic activity. Recognising the lags between implementation and effects of policy, there are significant advantages in maintaining the current accommodative stance well into the period of economic expansion. As inflationary expectations do not appear to be a risk in the near term, there would be greater flexibility for this accommodative policy stance.

The conduct of monetary policy in 2002 will, therefore, focus primarily on four key considerations. Firstly, monetary policy will aim to maintain a stable and predictable operating environment in order to facilitate business activity. It is also recognised that the maintenance of macroeconomic stability requires close co-ordination between monetary, fiscal, and structural policies. Monetary policy will continue to leverage on areas of strong complementarity that exists between these policies to ensure an optimal policy mix. In this regard, with the improved prospects for economic recovery, the maintenance of the current accommodative monetary policy stance amid a subdued inflationary outlook allows fiscal consolidation to take effect in 2002. This will help to position the economy to take full advantage of the global recovery when it takes place, and at the same time, enhance our ability to absorb any shocks in the event the actual outturn is weaker than anticipated.

Monetary policy will remain supportive of economic growth. Low inflation and stronger macroeconomic fundamentals help to sustain the exchange rate regime and allow monetary policy to remain accommodative.

Secondly, the conduct of policy is guided by the need to ensure that the level of interest rates continues to remain supportive of economic activities. Since the Intervention Rate cut on 20 September 2001, external developments have been generally more positive on the prospects for global growth. This, coupled with the fact that the cumulative effects of the previous monetary easing have not been fully manifested, has reduced the need for a further easing of monetary policy at this juncture. BNM, nonetheless, monitors all indicators and developments, both domestic and external, that could heighten the macroeconomic risks towards further economic weakness.

The third consideration is the need to ensure an effective transmission mechanism from the policy rate to retail rates, in order to precipitate a faster response to the counter-cyclical policy measures. In an uncertain environment, the normal market process of adjustment may not always function at the desired level of efficiency, particularly at a time when the banking industry is undergoing consolidation. In this regard, the current BLR framework (implemented in 1998) which is based on the Intervention Rate as the anchor rate, continues to serve its purpose in fostering an effective transition to lower lending rates. Although this arrangement entails some trade-offs, evidenced in the divergence between the 3-month Intervention Rate and the 3-month interbank rate, it did not create any risk that could undermine the long-term objectives of macroeconomic policy.

It should also be emphasized that such an arrangement does not represent a departure from BNM's long-term objective to move toward a market-based approach. Nor does it preclude banks from pricing their loans lower than the computed BLR to remain competitive. By enhancing the effectiveness of the monetary policy mechanism under the current environment, this has allowed banking reforms to proceed smoothly and measures to improve the efficiency of the financial markets to be implemented. As a long-term objective, BNM remains committed to liberalising the BLR framework and interest rate structure as outlined in the Financial Sector Masterplan. This represents an integral part of the overall shift toward a more market-oriented approach that would further improve efficiency in the transmission mechanism of monetary policy.

A further consideration is to ensure the availability of funds to support the identified priority sectors. Steps have already been taken to improve access to credit by the SMEs, the agriculture sector and other strategic sectors under the special funds. At the same time, efforts to develop alternate modes of financing will be intensified to support the financing requirements of a knowledge-based economy, as part of the overall effort to enhance the long-term competitiveness of the economy.

Success in sustaining the economic recovery, nevertheless, is premised on two critical factors: market response to counter-cyclical policy measures; and the extent of policy flexibility accorded to monetary policy management. The current assessment is that both consumers and corporations have remained responsive to policy measures. There are currently no "trigger" factors that may lead to a structural change in consumer behaviour and render monetary policy less effective. These "trigger" factors include prolonged deflationary tendencies associated with a boom-bust asset market cycle, and falling consumer and producer price indices. Instead, demand for personal loans, notably mortgage and car loans, has remained elastic to interest rates.

Consumption continues to be supported by stable employment and income prospects as well as favourable household balance sheets. Unemployment rates remain low while the net asset position remains strong due to high personal savings and stable property and equity prices. Aided by the CDRC, corporations have also reacted positively, taking advantage of the low interest rates to consolidate, restructure and cut their business costs to stay competitive in a period of reduced business demand. The accommodative policy will therefore continue to provide a positive environment for the restructuring and reform process. Corporations will also be in a better position to take advantage of the economic recovery.

At the same time, BNM continues to have policy flexibility that will enhance the scope for monetary policy to adjust appropriately to changing trends that could potentially undermine the growth momentum. Underpinning this policy flexibility is the strengthening of macroeconomic fundamentals. Notably, low inflation and the wide interest rate differentials with the US in favour of Malaysia will continue to accord policy flexibility. On the whole, improved macroeconomic fundamentals have helped to increase the tolerance of ringgit to higher degrees of volatility in the foreign exchange market. This has allowed BNM to continue to pursue a pragmatic and flexible monetary policy in order to promote domestic demand.

Looking ahead, the most critical challenge lies in anticipating cyclical economic developments and turning points. In the current environment, correct diagnosis of the strength or weakness of recovery would allow BNM to build an appropriate degree of stimulus and pursue front-loading and pre-emptive policy responses. Ensuring monetary policy response that is appropriate in terms of timing and magnitude is important in order to achieve the desired results.

Another challenge is managing potential risks that could emerge in the system. In this regard, BNM will monitor closely the lending and investment activities of the banks to ensure that they do not create risks in the system. BNM will also ensure that the underlying liquidity situation would support the expansion of economic activity without stimulating inflationary pressures. To achieve this, BNM has the option to either release the large pool of funds currently parked with BNM by the financial institutions, or to mop up excess liquidity through its market operations, depending on factors affecting the supply and demand for funds.

On the exchange rate front, policy will focus on ensuring that the pegged exchange rate remains sustainable and continues to benefit trade and investment. For a small open economy, the exchange rate has always been an important price to Malaysia, as it could affect confidence, price stability and long-term international competitiveness. It has, therefore, always been Malaysia's long-held policy not to resort to exchange rate changes to gain competitive advantage, nor to respond to transient and short-term currency movements that could easily be reversed. Policy to maintain international competitiveness has been implemented through efficiency and productivity gains, rather than by relying on the exchange rate. Indeed, the benefits derived from the pegged exchange rate regime have been significant in terms of promoting trade and investment. The stability in the exchange rate itself, has also facilitated corporate restructuring and financial reforms.

Under these circumstances, continuous commitment towards ensuring that fundamentals support the exchange rate will ensure that the exchange rate system will continue to generate significant benefits to the economy. There are no viable alternatives to sound policies and strong macroeconomic fundamentals to sustain the exchange rate. Therefore, macroeconomic policies will continue to be directed towards sustaining underlying economic fundamentals and ensuring that domestic sector remains sufficiently flexible to deliver the necessary internal adjustments to strengthen competitiveness.

FISCAL POLICY IN 2002

The 2002 Budget which was presented to Parliament on 19 October 2001 aimed at strengthening economic growth through increasing domestic demand, strengthening the private sector's resilience and competitiveness, diversifying the sources of growth and ensuring a more equitable distribution of wealth. While the Malaysian economy was expected to register a gradual and modest growth following the gradual recovery in external demand, it was recognised that sustaining domestic demand continued to be necessary given the downside risks to the global economic recovery. In this environment of uncertainty, fiscal policy would remain expansionary in 2002 to strengthen the economic recovery process.

In line with the objective of fiscal prudence, consolidation of the budget deficit would begin in 2002 with a less expansionary fiscal policy. The Government, therefore, budgeted for a lower fiscal deficit of –5.1% of GDP (-RM18.8 billion), compared with the estimated fiscal deficit for 2001 of –6.5% of GDP (-RM22.4 billion). However, due to a stronger revenue performance, the actual outturn for the fiscal deficit in 2001 was lower than budgeted, at –5.5% of GDP (-RM18.4 billion). Based on revenue forecast for 2002 in the 2002 Budget, fiscal consolidation as envisaged in the 2002 Budget is expected to be on track.

The fiscal deficit for 2002 would be kept at a manageable level to strike a balance between the short-term objective of supporting growth and the long-term policy of fiscal sustainability. The fiscal deficit in 2002 is not expected to create risks to the economy, as Malaysia's economic fundamentals continue to remain strong. The fiscal expansion is not anticipated to result in higher inflation given the excess capacity in the economy. Similarly, Government spending is not expected to lead to leakages as most of the expenditure is expected to have minimal import content.

Expenditure allocation would continue to focus on programmes and projects that would have high multiplier effects on domestic activity and raise the long-term productivity of the economy. In terms of development allocation, emphasis continues to be accorded to the social services sector, notably education and training. Higher priority was also placed on agriculture and rural development, reflecting the Government's policy to revitalise the agriculture sector as the third engine of growth. Infrastructure and industrial development focusing on small and medium-scale enterprises and the development of e-commerce were also given special attention.

In addition, the fiscal package also contained both tax and non-tax measures directed at stimulating economic activities. Measures to encourage consumption through increasing disposable incomes included the reduction in personal income tax rates between 1 to 2 percentage points to 0-28% as well as the 10% salary adjustment for civil servants.

Besides addressing the immediate objective of enhancing consumption, the Budget continued to emphasise the longer-term objective of increasing competitiveness to sustain growth. Wide-ranging fiscal incentives were directed at promoting investment in resource-based activities and the services sector, as well as development of skills to meet the needs of a knowledge-based economy. Among others, measures to encourage investment included the extension of reinvestment allowance to 15 years (from 5 years) and tax exemptions for companies involved in machinery and equipment, food production, as well as for reinvestment in the production of rubber, oil palm and timber. Fiscal incentives were also provided to reduce the cost of doing business and improve competitiveness. Import duties were either reduced or abolished on a wide range of products. The industrial building allowance was extended for the purchase of buildings and hotels. Incentives were also directed at encouraging the use of information and communications technology (ICT) in all economic activities. Several incentives were also introduced to strengthen the balance of payments through promotion of tourism and enhancement of exports.

Prudent policies practised earlier have accorded the Government greater flexibility in implementing expansionary measures to support growth. The deficits since 1998 have been financed through non-inflationary sources given the high rate of domestic savings and the ample liquidity situation. As such, higher borrowings by the Federal Government have not crowded out the private sector's access to financing. As in the past, the bulk of the fiscal deficit in 2002 would be financed through the issuance of MGS that would be absorbed mainly by the provident, pension and insurance funds.

Federal Government debt would continue to be contained at manageable and sustainable levels (43.8% of GDP as at end-2001). Debt servicing remains low (15% of operating expenditure or 2.9% of GDP) and has not been a constraint on fiscal flexibility. Furthermore, the Government's exposure to foreign exchange risk would be kept low, as the bulk of the Government's debt would continue to be raised from non-inflationary domestic sources. Currently, 83% of total outstanding debt is in domestic currency. In addition, more than 60% of the debt has a maturity of more than 3 years. The Government has always ensured that debt maturity profiles are of medium- to longer-term maturity and are adequately spaced out to minimise risks. With the economy on the path of recovery and given the Government's target to achieve a balanced budget towards the end of the Eighth Malaysia Plan period, the ratio of debt to GDP is expected to decline over the medium term.

As part of the Government's continuous efforts towards streamlining administrative procedures, reducing red tape and delegating powers, the Budget process was reviewed. Beginning in year 2002, the budget preparation and examination process would be carried out once every two years instead of annually. The forward-looking budgetary process is aimed at making the national Budget a more effective tool in financial management. In particular, the administrative change in the budget process would provide greater fiscal flexibility. It would take into account both the shorter-term annual fiscal policies and the medium-term objectives and policies within the context of the five-year development plans and outline perspective plans. Besides ensuring that all allocations are utilised as scheduled, the new process would also allow for expeditious budgetary reallocations to be effected to take into account unanticipated developments in the domestic and international environment.