The Malaysian Economy in 2002

The Malaysian economy strengthened to grow by 4.2% in 2002. Growth was broad based, driven by strong domestic demand and reinforced by improved export performance.

OVERVIEW

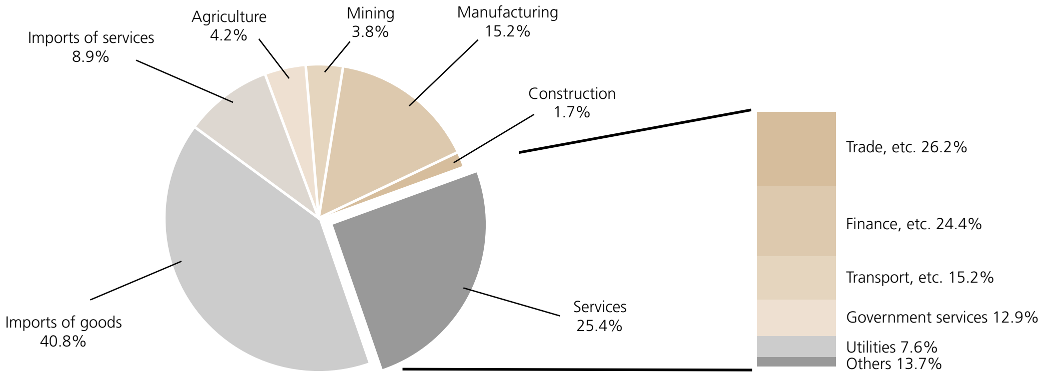
Recovery of the Malaysian economy gained momentum in 2002 amidst a more challenging external environment. Real economic growth turned positive in the first quarter and strengthened to 5.6% in the fourth quarter. For the year as a whole, real gross domestic product (GDP) expanded by 4.2% compared with 0.4% in 2001.

Economic growth was broad based, driven by strong domestic demand and reinforced by improved export performance. While public expenditure was strongly supportive of economic activity, growth was reinforced by sustained strength in consumer spending and external demand. Low interest rates, improved access to financing and the significant improvement in commodity prices provided strong stimuli for private sector expenditure to grow.

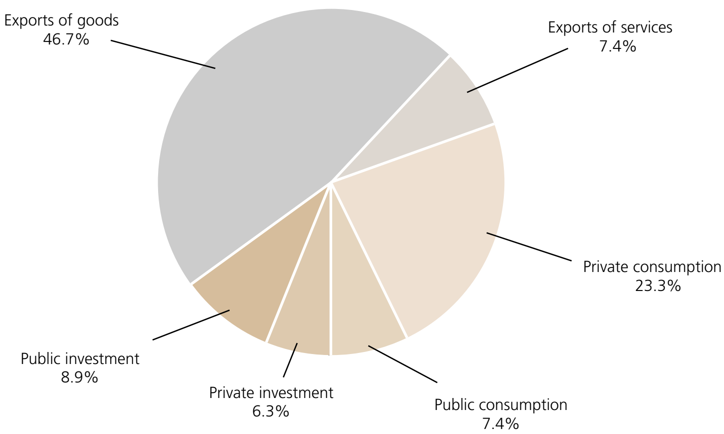
Reflecting the continued expansionary fiscal stance, real public consumption increased substantially by 13.8%, while real public investment rose by 4.6%. In aggregate, public sector expenditure contributed 2.7

Graph 1.1
The Economy in 2002 (at 1987 Prices)

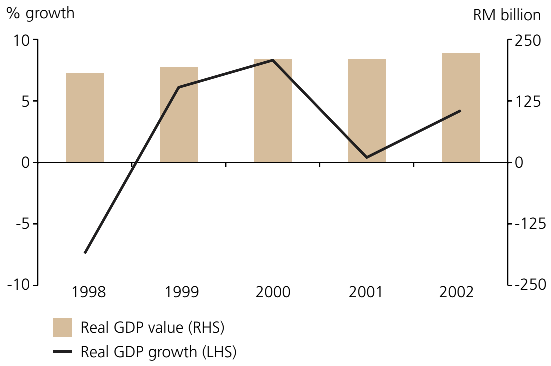
Supply of goods and services (RM435.8 billion)



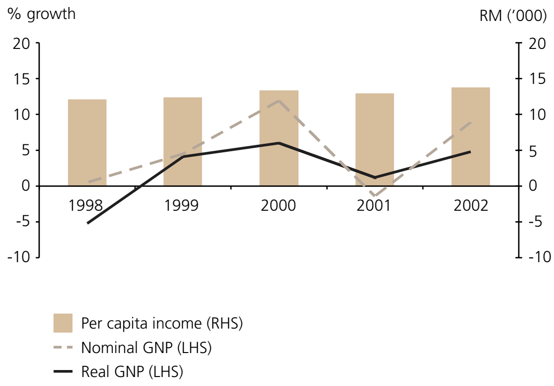
Demand for goods and services (RM435.8 billion)



Graph 1.2
Real GDP



Graph 1.3
GNP Growth and Per Capita Income

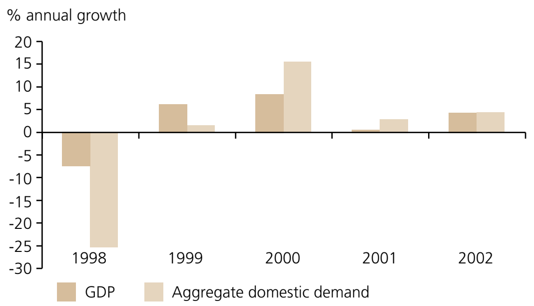


percentage points to total GDP growth. Higher fiscal spending, reduction in income taxes, low interest rates and improved employment and income prospects resulted in private sector expenditure to recover strongly to contribute 1.2 percentage points to overall GDP growth. Real private consumption grew at an encouraging pace of 4.2%, while the more moderate decline in private investment reduced its contractionary impact on growth. In fact, private capital formation turned around to post moderate growth in the second half of 2002 as several industries in the manufacturing sector, such as electronics, chemical products and transport equipment, operated at high rates of capacity utilisation in response to stronger external demand. Reinforcing this development were new investments in high value-added services such as telecommunications and information technology. Malaysia also benefited from some diversion of foreign investment flows, particularly through outsourcing activities and the relocation of design and product development operations by some foreign companies in the electronics industry. The improved investment prospects also extended to domestic businesses, especially smaller enterprises, as reflected in the expansion of loans by the banking system to this sector.

External demand recovered in 2002 and provided an important contribution to overall growth. Real exports of goods and services turned around to increase by 3.6% after contracting by 7.5% in 2001. The main impetus for stronger export performance in 2002 was from the manufacturing and tourism sectors. At the same time, the significant improvement in prices for several primary commodities helped increase rural incomes substantially and, consequently, due to the high multiplier impact, consumption expenditure strengthened.

Inflationary pressures remained subdued during the year. While the consumer price index (CPI) increased at a faster rate of 1.8% in 2002, demand or core

Graph 1.4
Real GDP and Aggregate Domestic Demand



Graph 1.5
Contribution to Real GDP Growth:
Domestic Demand and Net Exports

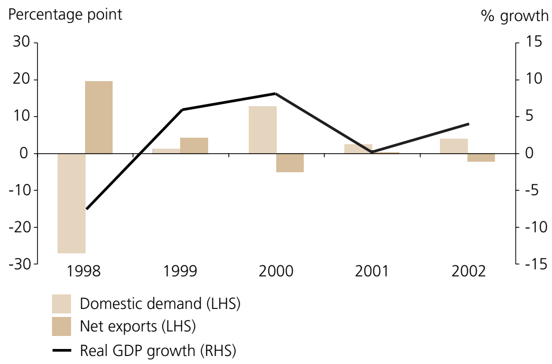


Table 1.1: Malaysia – Key Economic Indicators

	2000	2001	2002*p*	2003*f*
Population (million persons)	23.5	24.0	24.5	25.0
Labour force (million persons)	9.6	9.9	10.2	10.5
Employment (million persons)	9.3	9.5	9.8	10.2
Unemployment (as % of labour force)	3.1	3.6	3.5	3.4
Per Capita Income (RM)	13,333	12,867	13,716	14,098
(US$)	3,509	3,386	3,610	3,710
NATIONAL PRODUCT (% change)				
Real GDP	8.3	0.4	4.2	4.5
(RM billion)	209.5	210.5	219.3	229.2
Agriculture, forestry and fishery	2.0	1.8	0.3	1.5
Mining and quarrying	1.9	1.6	4.5	4.5
Manufacturing	19.1	-6.2	4.1	5.0
Construction	1.0	2.3	2.3	1.9
Services	5.7	5.7	4.5	4.4
Nominal GNP	11.9	-1.4	8.9	5.0
(RM billion)	313.2	309.0	336.4	353.1
Real GNP	6.0	1.2	4.8	3.7
(RM billion)	190.5	192.8	202.1	209.6
Real aggregate demand[1]	15.4	2.8	4.3	5.9
Private expenditure[1]	17.1	-3.0	2.0	7.1
Consumption	12.5	2.8	4.2	6.9
Investment	32.6	-19.9	-6.1	8.1
Public expenditure[1]	11.8	15.9	8.6	3.6
Consumption	3.0	17.6	13.8	3.1
Investment	19.4	14.5	4.6	4.1
Gross national savings (as % of GNP)	39.9	34.8	34.4	33.5
BALANCE OF PAYMENTS (RM billion)				
Goods	79.1	69.9	68.9	72.5
Exports (f.o.b.)	374.0	334.3	354.9	378.5
Imports (f.o.b.)	294.9	264.5	285.9	306.0
Services balance	-10.7	-8.4	-6.0	-6.2
(as % of GNP)	-3.4	-2.7	-1.8	-1.7
Income	-28.9	-25.6	-25.2	-29.0
(as % of GNP)	-9.2	-8.3	-7.5	-8.2
Current tranfers	-7.3	-8.2	-10.4	-9.5
Current account balance	32.3	27.7	27.4	27.9
(as % of GNP)	10.3	9.0	8.1	7.9
Bank Negara Malaysia reserves, net[2]	113.5	117.2	131.4	-
(as months of retained imports)	4.5	5.1	5.4	-
PRICES (% change)				
CPI (2000=100)	1.6	1.4	1.8	1.5
PPI (1989=100)	3.1	-5.0	4.4	-
Real wage per employee in the manufacturing sector	5.0	1.7	2.9	-

Note: Figures may not necessarily add up due to rounding

[1] Exclude stocks

[2] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account.

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Table 1.2: Malaysia – Financial and Monetary Indicators

	2000	2001	2002*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	61.9	79.6	83.5
Operating expenditure	56.5	63.7	68.7
Net development expenditure	25.0	34.2	35.1
Overall balance	-19.7	-18.4	-20.3
Overall balance (% of GDP)	-5.8	-5.5	-5.6
Public sector net development expenditure	50.4	59.7	68.7
Public sector overall balance (% of GDP)	0.7	-0.3	-2.8
EXTERNAL DEBT			
Total debt (RM billion)	160.9	173.8	185.3
Medium and long-term debt	143.4	149.6	153.8
Short-term debt	17.5	24.2	31.6
Debt service ratio (% of exports of goods and services)			
Total debt	5.4	6.1	6.0
Medium and long-term debt	5.1	5.9	5.9

	Change in 2000		Change in 2001		Change in 2002	
	RM billion	%	RM billion	%	RM billion	%
MONEY AND BANKING						
Money Supply M1	4.8	6.5	2.5	3.2	8.3	10.3
M2	17.6	5.2	7.8	2.2	21.0	5.8
M3	21.9	5.0	13.0	2.9	31.6	6.7
Banking system deposits	14.6	3.2	8.6	1.8	25.5	5.3
Banking system loans	23.6	5.5	16.5	3.6	20.1	4.3
Manufacturing	2.2	3.3	0.1	0.2	-1.3	-1.9
Broad property sector	8.6	5.6	12.3	7.6	11.0	6.3
Finance, insurance and business services	0.4	1.3	0.7	2.1	-2.5	-7.1
Loan-deposit ratio (end of year)	84.3%		85.9%		84.9%	

	2000	2001	2002
	%	%	%
Interest rates (average rates as at end of year)	3.25	3.27	3.13
3-month interbank			
Commercial banks			
Fixed Deposit 3-month	3.48	3.21	3.20
12-month	4.24	4.00	4.00
Savings deposit	2.72	2.28	2.12
Base lending rate (BLR)	6.78	6.39	6.39
Finance companies			
Fixed Deposit 3-month	3.52	3.22	3.20
12-month	4.27	4.01	4.00
Savings deposit	3.44	2.94	2.65
Base lending rate (BLR)	7.95	7.45	7.45
Treasury bill (3-month)	2.98	2.73	2.82
Government securities (1-year)	3.36	2.93	2.94
Government securities (5-year)	4.80	3.18	3.15

	2000	2001	2002
	%	%	%
Movement of Ringgit (end-period)			
Change against composite	3.2	3.5	-3.4
Change against SDR	5.2	3.8	-7.3
Change against US$[1]	0.0	0.0	0.0

[1] Ringgit was pegged at RM3.80=US$1 on 2 September 1998

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inflation rose modestly by 0.4%. The increase in headline consumer prices was due mainly to one-off price adjustments for fuel and telecommunication charges, and therefore did not indicate any underlying inflationary pressures. The low inflation was also consistent with the significant output gap, estimated at 5.1% of the potential output level (details of the potential output estimation are presented in the white box). While the gap has narrowed as the recovery gained momentum, there is still significant excess capacity in certain sectors that, in turn, contained demand pressures and thus, price pressures.

In response to the strong domestic and external demand conditions, all sectors in the economy expanded, with the main impetus to growth emanating from the services and manufacturing sectors. The services sector benefited from the recovery in domestic demand, the expansion in trade-related activity and the growth in tourist arrivals. In 2002, the number of tourist arrivals increased by 4% to 13.3 million from the 12.8 million recorded in 2001. As a result, higher net inflows for travel and education helped to reduce the services deficit in the balance of payments. The encouraging performance in the tourism sector reflected the success of the sustained promotional efforts to diversify into new markets, especially the Middle East and regional countries.

The manufacturing sector turned around to expand by 4.1%, due mainly to higher external demand, particularly for electronics. Export demand from traditional markets remains important but Malaysia has increasingly enjoyed the benefits of the growth in intra-regional trade. Malaysia's exports to the region (ex-Japan) have risen from RM43.2 billion in 1992 to RM156.3 billion in 2002, an average annual growth of 14.2% over the period. In particular, Malaysia's exports to the People's Republic of China expanded rapidly at an average annual growth rate of 28.1%. As a result, the share of Malaysia's trade with the region has risen from 41.7% in 1992 to 44.1% in 2002. This growth is a positive trend that has not only increased total export proceeds but has reduced dependence on traditional markets, thereby enhancing Malaysia's resilience.

Growth in the construction sector was sustained at 2.3% in 2002, underpinned by the growth in the civil engineering sub-sector as Government spending on public projects continued. However, the repatriation of illegal foreign workers had a temporary softening impact on the sector. The agriculture sector registered slower growth of 0.3% in 2002 as growth in the production of crude palm oil slowed due to lower yields and the impact of higher replanting activities. However, the production of other major commodities was higher, stimulated by the increase in prices. Value added of the mining sector grew by 4.5% due to increased production from new oil and gas fields, amidst the increase in demand and favourable prices.

For the most part, the trends in the labour market mirrored that of the improving economic conditions. As the recovery gained momentum, the unemployment rate fell to 3.5% at the end of 2002. The decline in unemployment was due to both a significant decline in retrenchments as well as higher demand for labour. However, with excess capacity still affecting selected sectors, the pick-up in economic activity has not exerted undue pressure on wages. The latest indicators showed that increases in wage rates moderated while productivity improved in 2002.

The external position remained robust with stronger exports in 2002. The overall balance of payments improved significantly to record a larger surplus due to the sustained large surplus in the current account (8.1% of gross national product or GNP), larger inflows of long-term capital and a lower net outflow of private short-term capital. In 2002, foreign direct investment (FDI) flows to Malaysia increased significantly and mainly comprised retained earnings following the stronger performance of multinational companies in the electronics industry. There were also some new equity investments, which were channelled mainly into the services, oil and gas and manufacturing sectors. The shift in the overall pattern of FDI inflows to services continued to be evident in 2002. These new investments are in diverse fields such as the retail industry, financial services, telecommunications and software development. The key distinguishing feature of these new investments is that while they are small in dollar value, they enhance productivity and competitiveness, thereby generating higher value added and growth. Outward investment by Malaysian companies also increased, led by some large companies in the oil and gas, manufacturing and utilities sectors. An emerging feature is that overseas investments are now in larger projects in utilities and plantations, compared with previous years when they were concentrated in holding and trading companies.

Potential Output of the Malaysian Economy

Potential output is output derived from full utilisation of available capital and potential employment, which is the labour force in employment that is consistent with the “natural” or “long run” rate of unemployment. As such, the potential output is defined as the level of output in the economy at which there is no inflationary pressures and external imbalances. The output gap is the difference between actual and potential output and the difference, or gap, is calculated as a percentage of potential output. When actual output is lower than its potential, the output gap is negative and output can in principle increase without exerting undue inflationary pressures on the economy.

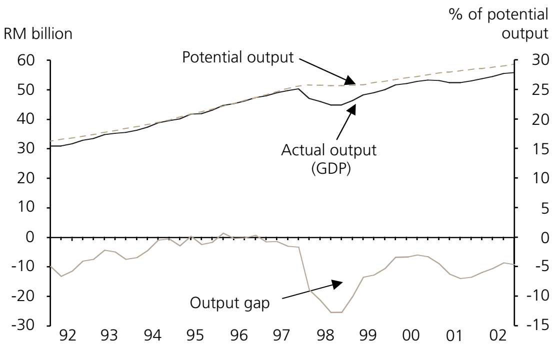
During the years of high growth in the early 1990s, actual output tracked closely its potential, as shown in Table 1.3 and Graph I.6. With the sharp contraction experienced after the Asian crisis, the output gap has widened significantly in 1998 but as the economy recovered, the gap narrowed. In 2001, the output gap widened to 6.2% as real output growth was marginal. However, with the stronger pickup in economic activity compared to the growth in potential output in 2002, the output gap narrowed. Bank Negara Malaysia’s latest estimates of potential output indicated that the output gap narrowed to 5.1% of potential GDP in 2002 (2001: 6.2%) as actual GDP grew more rapidly (4.2%) than potential GDP (3%).

The moderate increase in potential growth rate was due to the slow increase in capital investments (0.2%) as investors remained cautious given global uncertainties in 2002 and the continued excess capacity in selected sectors of the economy.

Table 1.3
Actual GDP and Potential Output

Period	Actual GDP	Potential output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1992-1997	9.2	8.1	14.1	3.9	-1.9
1998	-7.4	3.2	-43.0	-2.1	-11.3
1999	6.1	1.3	-6.5	3.7	-7.1
2000	8.3	4.1	25.7	4.3	-3.3
2001	0.4	3.5	-2.8	3.3	-6.2
2002	4.2	3.0	0.2	3.1	-5.1

Graph 1.6
Actual and Potential Output



The estimated short-run elasticity of capital is slightly higher than the short-run elasticity of labour, implying that changes in capital have had a slightly greater impact on output and returns to capital have improved, even in the short-run. Firms have therefore, managed to increase output without increasing capital investments significantly. This could possibly reflect that capital investments, which were mainly channelled into the upgrading of firms’ technological capabilities, could have had an immediate impact on output.

The long-run elasticity of capital, which is estimated to be 0.49, is slightly higher than its short-run counterpart, in line with previous findings. The higher returns to capital imply more efficient utilisation of capital. Efficiency as measured by the ratio of output to capital has increased at a faster rate compared to the ratio of output to the number of employees. Past supportive infrastructure investments, which have long gestation periods, have begun to show positive returns as they have expanded the productive capacity of the economy and alleviated bottlenecks. In the longer term, with the implementation of the Knowledge-based Economy Master Plan, potential output growth would be further increased.

Reflecting the stronger economic performance, the net international reserves of Bank Negara Malaysia increased by RM14.2 billion (US$3.7 billion) to RM131.4 billion or equivalent to US$34.6 billion in 2002. As at 14 March 2003, the reserves increased further to RM131.7 billion or US$34.7 billion, adequate to finance 5.3 months of retained imports and is about 4.4 times the short-term external debt. The external debt outstanding stabilised at 55.1% of GNP at end-2002 while the debt service ratio remained low at 6%. The nation's debt profile remains healthy with short-term debt accounting for only 17% of total debt. The private sector accounts for a major portion of the debt, with Federal Government borrowing representing only 19.6% of total debt.

The accommodative monetary and fiscal stance and increasing robustness in economic growth resulted in stronger demand for loans by the private sector. Loan applications turned around to increase by 14.1% as both businesses and the household sector displayed greater demand for funds. The financial sector responded to this demand by expanding financing activities. Total funds extended by the banking sector and the capital markets increased by RM40.8 billion or 9.9%. Bank lending rose significantly with disbursements increasing by 10.3%. A notable development has been the increase in lending to small borrowers. Outstanding loans below RM500,000 now constitute the bulk of loans outstanding (53%).

The increase in lending, however, did not create any undue risks in the banking system. Even as loan growth continued to rise, the banking system demonstrated greater resilience as capitalisation increased and non-performing loans (NPLs) declined. The risk-weighted capital ratio (RWCR) was sustained at 12.8%, well above the 8% minimum, while NPLs have declined steadily since May 2002. As at end-2002, the net NPL ratio on a 6-month basis had fallen to 7.4% (10.1% on a 3-month classification basis) compared with 8.1% as at end-2001 (11.4% on a 3-month basis).

The successful and expedient resolution of large corporate debts contributed significantly to the reduction of the NPLs in the banking system. Having successfully restructured the 48 cases referred to it, the Corporate Debt Restructuring Committee (CDRC) officially ceased operations on 15 August 2002. The closure marks a major milestone in the Government's efforts to restructure the banking and corporate sectors.

With NPLs remaining within manageable limits, Danaharta, the asset management company set up in 1998 to acquire NPLs from financial institutions, has been able to deal with the NPLs worth RM47.7 billion in its portfolio and is on course to cease operations in 2005. The corporation achieved an expected average recovery rate of 57% and has already received proceeds amounting to RM18.9 billion out of the total RM30 billion that it expects to recover. On the whole, the cost of financial sector restructuring following the Asian financial crisis accounted for less than 5% of GDP.

Macroeconomic Management

In 2002, macroeconomic policy was focused on mitigating the greater uncertainties emanating from the external environment and enhancing the long-term fundamentals of the economy. The Government played a pivotal role in sustaining growth by providing the necessary support for private and external demand. This support was broadly channelled in two ways: direct expenditure, which had an immediate and forceful impact on private consumption; and secondly, the provision of an enabling environment conducive to improving consumer confidence and facilitating a recovery in investment activities by businesses. The latter was made possible by reducing selected taxes to encourage consumption, implementing policies to improve employment prospects, adopting an accommodative monetary stance and instituting measures to improve access to financing. Given that the international outlook had become more uncertain as the year progressed, economic policies were directed at ensuring balanced growth and diversifying the economic base to strengthen the foundations of the economy. The shift in strategy to supporting private sector-led growth was expected to strengthen these foundations while ensuring that the Government would continue to enjoy flexibilities in fiscal and macroeconomic policies.

More robust growth resulted in higher loan demand. Loans disbursed increased, NPLs declined and RWCR remains high. Financial restructuring is almost complete with the overall cost of restructuring the banking system amounting to less than 5% of GDP.

Monetary policy in 2002 remained accommodative in order to support growth. The Central Bank had moved early by pre-emptively lowering interest rates following the September 11 incident in 2001. Given the time lag of the measures, it was expected that the real effects of the interest rate reduction would be felt in the first half of 2002. As anticipated, economic activity turned around and recorded positive growth in the first quarter and strengthened during the year. Notwithstanding the strengthening of the recovery momentum, the Bank was also cognizant of the fact that the output gap remained substantial and that inflation was not a cause for concern. As such, it was assessed that interest rates were at appropriate levels and the policy rate remained unchanged throughout 2002. Nevertheless, competition among banks and the ample liquidity conditions saw average lending rates trending downwards during the year. Although the economic recovery gathered strength, the increased financing provided by the banks and the capital markets did not create inflationary pressures.

While the monetary policy stance was adjudged to be supportive of growth, for selected sectors of the economy it was apparent that the main issue was not the cost of finance but access to funds. Therefore, several policy initiatives were introduced by the Bank to ensure that there was adequate access to funds for all borrowers. In particular, efforts were directed at ensuring that SMEs continued to have access to funds at reasonable cost. During the year, the special funds set up by the Government and administered by the Bank stepped up the disbursement of funds. The seven funds administered by the Bank, namely Ship Financing Facility, Fund for Food, Rehabilitation Fund for Small and Medium Industries, Bumiputera Entrepreneurs Project Fund, Fund For Small and Medium Industries 2 (FSMIs2), Entrepreneur Rehabilitation and Development Fund, and New Entrepreneurs Fund 2 (NEF2), collectively disbursed RM3 billion as at end-2002. The demand for funds under two of the schemes, the NEF2 and the FSMIs2, was especially significant. By end-August, the funds approved under the NEF2 and FSMIs2 stood at 194% and 196% of their respective total allocations. As a result, the allocations to both funds were increased by RM250 million each in October, bringing their combined size to RM4.35 billion.

In addition to direct financing through the special funds under the Bank's purview, a number of steps were also initiated to ensure that banks were more supportive of lending to SMEs. All financial institutions are also expected to be more transparent and responsive to SMEs by creating a dedicated SME unit to deal with their specific financial needs.

To enhance the contribution of SMEs to the economy and assist in their long-term development, the Bank has proposed a "Comprehensive Framework for the Development of the SMEs". A Steering Committee, chaired by the Governor of Bank Negara Malaysia and comprising the Secretary Generals of Ministries and heads of agencies involved in the development of the SMEs, was established in October 2002 to take this project forward.

Macroeconomic policy was focused on enhancing the long-term fundamentals of the economy while supporting private sector activity.

The pegged exchange rate regime remains an integral part of macroeconomic management. The peg provides stability, thereby facilitating trade and investment. The peg is well supported by strong fundamentals. The inflation rate remains low and stable, the current account continues to record surpluses, long-term capital flows continue to be robust and external reserves continue to grow. The banking sector also remains well capitalised, which provides the financial system with the buffer to absorb external shocks. The peg thus serves as a pillar of stability and remains consistent with economic fundamentals.

The 2002 Budget was tabled amidst expectations of modest growth and the main downside risk envisaged was that consumer spending would not be sustained should labour market conditions become less favourable. Therefore, the main thrust of fiscal policy in 2002 was to enhance the long-term productive capacity of the economy and strengthen economic growth by supporting private sector activity. Accordingly, the Government pursued a moderately expansionary Budget to sustain the growth momentum.

The counter-cyclical fiscal stance was evident both in increased expenditure, especially on education and infrastructure, as well as tax measures to stimulate private consumption. At the same time, personal income tax rates were lowered by between 1–2 percentage points while the chargeable income subject to the highest tax rate was raised from over RM150,000 to RM250,000. In addition, incentives to stimulate private investment activities were also announced in the 2002 Budget. The reinvestment allowance period was extended and incentives were provided to encourage the use of information and communications technology as well as promote tourism and exports. In addition, tax exemptions were provided to firms in the machinery and equipment, food production, rubber, oil palm and timber industries, in order to broaden the economic base and strengthen resilience.

Notwithstanding the need to maintain an expansionary fiscal policy, it was anticipated that the Government would gradually reduce its role in the economy as the private sector recovered. As supportive measures were taken to mitigate the potential adverse impact arising from the uncertainty in the external environment, fiscal spending was higher than earlier estimates. As a result, the Government's overall financial position registered a deficit of 5.6% of GDP. Nevertheless, the Government remains committed to long-term fiscal consolidation, with the pace depending on both global and domestic economic conditions.

Despite the higher expenditure, the Government's commitment to a policy of fiscal prudence ensures that its financial position remains sustainable. Current revenue continued to exceed operating expenditure, thus allowing development expenditure to be funded firstly through the operating surplus. The high savings rate and ample liquidity in the domestic financial system also made it possible for the bulk of the fiscal deficit to be financed through domestic sources. Favourable external market conditions, especially the low interest rate environment and the demand for emerging market sovereign debt in the international capital markets, allowed the Government to take full advantage of external sources of funds. The Government's external debt issue was not only to register Malaysia's presence, but also helped establish a benchmark for Malaysian corporates seeking financing from international financial markets. In March 2002, the Government reopened Malaysia's Global US Dollar Bond issue due in 2011 and raised an additional US$750 million at 6.8%, 90 basis points lower than the initial issue. In June, the Government issued the first Global Islamic Trust Certificates to provide an impetus for the development of the international Islamic financial market. The issue of debt instruments based on Islamic principles represents an important step in the global development of Islamic finance.

In addition to implementing fiscal measures to support economic activity, non-fiscal measures were also formulated to complement private sector initiatives and enhance confidence. The focus of these policies was to ensure that employment and income prospects remained sound. In this regard, several concrete steps were taken to match job seekers with job vacancies and improve the mobility of workers. Nationwide job fairs and retraining programmes were held throughout the year. A major development during the year was the commencement of operations of the Electronic Labour Exchange (ELX). The ELX, which started operating in May 2002, was designed to effectively match job seekers with vacancies over larger geographical areas. As at end-2002, 11,000 job seekers had registered with the ELX while 720 employers had advertised 2,040 vacancies on it.

While enhancing domestic sources of growth is critical to the establishment of a broader economic base and the strengthening of resilience, foreign direct investment (FDI) will continue to play an important role. FDI not only contributes directly to investment and growth but also helps the Malaysian economy absorb new technology and processes to speed the transition up the value chain. The Government's sustained policy to make Malaysia attractive to different types of FDI reflects the recognition of this dual role. Since the mid-1990s, the Government has given more weight to FDI proposals that encompass high skill, high value-added projects. The flexible and focused approach to attracting FDI is best exemplified by the pre-packaged incentive scheme, under which investors are able to apply for a number of incentives customised to suit their requirements while furthering the Government's objective in raising the quality of investments. This scheme is complemented by various other incentives to encourage foreign investors to locate other complementary activities, especially high value-added activities such as regional training centres, research and development, operational headquarters and international purchasing offices, in Malaysia. These operations provide support services not only to the manufacturing operations in Malaysia but also regionally and have a positive spill-over impact on the services sector. Similarly, companies in the services sector, most notably in finance and insurance, and telecommunications and information technology, have moved backroom operations and other support services to Malaysia.

In order to remain competitive, Malaysian firms have started to move up the value chain in the face of labour cost advantages of regional economies. Malaysian products and services will increasingly carry larger elements of quality and innovation and this process is expected to be supported by the drive towards a knowledge-based economy. Strategies to ensure that skill requirements are met have been incorporated into existing policies and mechanisms, while new approaches in education and industrial training are being formulated.

The banking sector restructuring process is now almost complete and the focus of policy has shifted to capacity building and enhancing the efficiency and quality of services provided by financial institutions. The Financial Sector Master Plan (FSMP) clearly lays out the timetable for achieving these goals. Another ten of the recommendations contained in the Plan were implemented during the year, bringing the number of fully implemented recommendations to 19 as at end- February 2003. These recommendations were directed at enhancing the capacity and capability of domestic financial institutions, promoting stability, developing an efficient and stable payments system infrastructure and putting in place an efficient and market-driven consumer protection framework.

A key tool in this upgrading process is a benchmarking exercise that measures Malaysian financial institutions' performance against international best practice. To complement the benchmarking exercise, the Bank has also initiated a market analysis study to develop a quality service index to assess the service quality of the industry to enhance the qualitative aspect of services offered by the industry. As a first step to enhancing customer service, every financial institution is expected to set up a dedicated Complaints Unit that would function as a focal point for managing complaints received. Any complaint lodged will need to have a response forthcoming within two weeks of its receipt by the institution.

The Bank has also launched a comprehensive consumer education initiative known as "BankingInfo". In the first of three phases, the Bank will concentrate on disseminating information regarding banking products, banking channels available and educational information on aspects of banking and currency. In addition, product approval requirements are being liberalised to encourage the banking institutions to develop new products and services.

A significant development in setting out the direction of future long-term policies was the launch of the Knowledge-based Economy (K-based Economy) Master Plan in September 2002. The Plan provides the pillars needed for a knowledge-based economy and the importance for Malaysia of achieving the transformation from a production-based to a k-based economy. The Plan takes stock of the present position with regard to knowledge-based activities and knowledge intensity in economic activities. It then provides a clear and detailed roadmap on how this transformation is to be achieved by 2020. The ultimate vision espoused in the Plan is to build a strong, resilient, vibrant and competitive economy, driven strongly by an increased intensity in the application of knowledge to production and the development of new industries. To a significant extent, this entails raising the growth rates of total factor productivity and thus many of the strategic thrusts contained in the Plan focus specifically on developing human resources and the enabling environment for innovation to take place.

SECTORAL REVIEW

Manufacturing Sector

Strengthening domestic demand, together with the recovery in exports, led to a turnaround in the manufacturing sector in 2002. Value added in the sector expanded by 4.1%, from a contraction of 6.2% in the previous year. Overall, manufacturing production expanded by 4.5% (2001: -6.6%), due to the stronger performance of the export-oriented industries, while the domestic-oriented industries grew at a moderate pace. In line with the expansion in production, the overall manufacturing capacity utilisation rate increased to 83% in 2002 (2001: 80%), with both the export and domestic-oriented industries operating at higher capacities of 83% and 82% respectively. Overall, the stronger performance of the manufacturing sector in 2002 reflected mainly higher volume, while export prices continued to decline.

The manufacturing sector turned around, supported by strong improvement in external demand and growth in domestic demand.

The Knowledge-Based Economy Master Plan, 2002

Introduction

Malaysia initiated the Knowledge-based Economy (K-based economy) Master Plan following the announcement in Budget 2000. The Plan calls for a paradigm shift from a Production-based Economy (P-based economy) to a K-based economy. A K-based economy is defined in the Master Plan as *"an economy in which knowledge, creativity and innovation play an ever-increasing and important role in generating and sustaining growth"*. The Master Plan was launched in September 2002 after a period of consultation between the private and the public sectors. As a national development plan, the K-based Economy Master Plan charts the strategic thrusts and implementation framework for the transition of the Malaysian economy towards a K-based economy in order to enhance competitiveness and achieve sustainable economic growth.

The Vision of the Master Plan is to build a strong, resilient, vibrant and competitive economy, driven largely by an increase in intensity in the application of knowledge to production and the development of new knowledge-intensive industries. To a significant extent, this entails raising the growth rates of Total Factor Productivity and thus many of the strategic thrusts contained in the Plan reflect this objective. Significant emphasis is therefore placed on capital deepening, improving the utilisation of information and communications technology and revamping the education system. The Master Plan works on a long-term timescale, envisioning the development of a knowledge-intensive economy by 2020. The action agenda in the Plan revolves around seven strategic thrusts and 132 recommendations that will be implemented over three phases during the decade up to 2010.

Seven Strategic Thrusts

A comparison of major knowledge indicators for the ASEAN countries showed that Malaysia was ahead of the others except for Singapore. When compared with developed countries such as Korea, Germany and the US, it was obvious that a concerted effort was needed to close the existing knowledge gap. Toward that end, the Plan put forward seven strategic thrusts as follows:

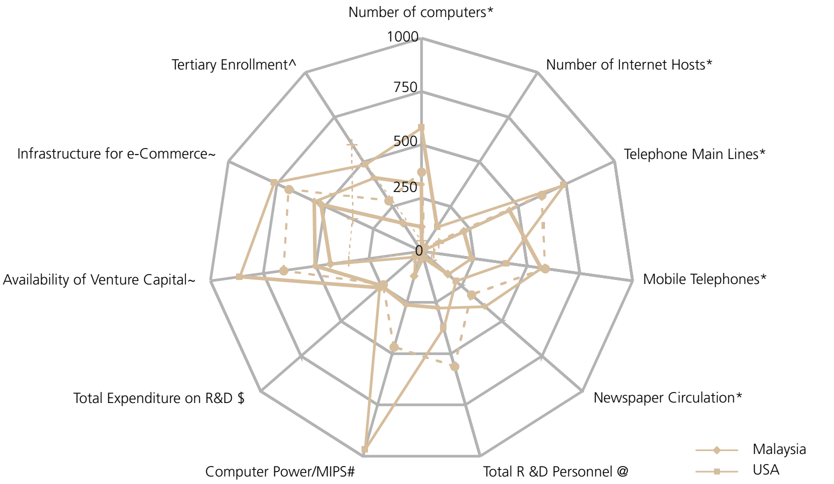
- *Cultivate and secure the necessary human resources*
- *Establish the institutions necessary to champion, mobilise and drive the transition to a K-based economy*
- *Develop an incentive system, infrastructure and infostructure to ensure the optimal and ever-increasing application of knowledge in all sectors of the economy*
- *Dramatically increase capacity for the acquisition and application of science and technology (including information and communications technology) in all areas*
- *Ensure that the private sector is the vanguard of the K-based economy*
- *Develop the public sector into a K-based Civil Service*
- *Bridge the knowledge and digital divides*

The Implementation Stage

The recommendations of the seven strategic thrusts are expected to be implemented over three phases. Phase 1 (2001-2003); Phase 2 (2004-2006) and Phase 3 (2007-2010) during the period 2001-2010. The bulk of the recommendations are expected to be implemented by year 2006, but there are recommendations that are on-going until year 2010.

Thus far, immediate measures have been taken to set up the institutional mechanism for the implementation of the Master Plan, including conducting relevant studies to measure knowledge content and measurement indicators for the K-based economy. In addition, the K-based Economy Strategic Corporations are eligible for Pioneer Status Incentives or Investment Tax Allowance as announced in Budget 2002/2003. In the short term, small and medium scale enterprises (SMEs) are expected to benefit most from a number of key initiatives

Graph 1
K-Indicators - Comparison between Selected Countries



Notes:
* - per 1,000 inhabitans
@- per 1,000 inhabitans x 100
- per 1,000 inhabitans / 100
$ - % of GDP x 100
~ - index points x 100
^ - % of tertiary enrolment x 30

Source: The World Competitiveness Yearbook 2001

unveiled in tandem with the K-economy Master Plan. A venture capital fund amounting to RM500 million was created to provide equity financing for companies in three information and communications technology (ICT) sectors. In addition, another fund totaling RM1.6 billion, established by the Government in collaboration with the Japan Bank for International Co-operation, also targets firms in the ICT sector. Initiatives to foster knowledge-intensive firms have not been limited to financial assistance. The Government also encouraged the setting up of a global supply management network known as RosettaNet Malaysia and provided RM5 million towards its establishment. This facility would allow Malaysian companies, including SMEs, to avail themselves of online real time procurement, production and logistics management, especially for high technology products.

Developing a sufficient supply of labour with appropriate skills is the single most important factor for ensuring the pace and success of the transition towards the K-based economy. The Plan has recommended specific strategies to cultivate and secure a pool of K-based human resources through development in the areas of education, skills training and retraining, lifelong learning and securing global talent. In order to encourage training and retraining, tax deductions in the form of double deduction for training expenses are granted for the training of human capital. The Returning Scientists Programme was revived and took effect from 1 January 2001 to attract Malaysian experts abroad to return and serve in their fields of expertise in IT, science and technology, industry, finance, accounting, and medicine and health. There are also plans to raise the quality of trainers in different fields of education. For example, more recently, the Government announced the upgrade of the entrance qualifications for teachers in primary schools from a diploma or pre-university qualification to a university degree.

Conclusion

The K-based economy Master Plan does not advocate piecemeal transformation with priority being given to knowledge-intensive (or "new" economy) sectors. Rather, it proposes a holistic approach that seeks to nurture these sectors while seeking to infuse greater knowledge content into the production (or "old" economy) sectors. The Plan does not simply provide a blueprint for macroeconomic development but also pays due attention to distributional and empowerment issues. In an environment of intense competition, especially keen competition from existing and newly emerging competitors, the Plan is an essential element in the current stage of restructuring the Malaysian economy to attain growth in line with potential output to achieve Vision 2020. A smooth transformation demands speedy establishment of the institutional infrastructure for monitoring and implementation as well as the readiness and capacity of both the private and the public sectors to make this paradigm shift within a short time span. As for all development plans, the K-based Economy Master Plan will be subject to periodic reviews to revaluate its milestones and realign policies with the changing domestic and international environment.

Table 1.4
Manufacturing Sector: Value Added and Production

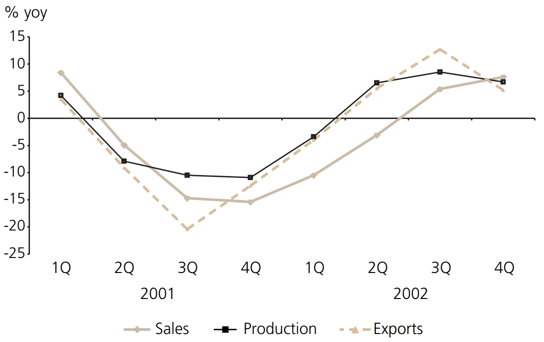
	2001	2002
	Annual change in %	
Value-added		
(Constant at 1987 price)	**-6.2**	**4.1**
Overall Production	**-6.6**	**4.5**
Export-oriented industries	**-10.4**	**5.0**
of which:		
Electronics	-20.2	13.4
Electrical products	-2.8	-5.1
Chemicals and chemical products	-7.7	2.7
Wood and wood products	1.2	-6.0
Textiles and wearing apparel	-8.3	-6.2
Rubber products	3.3	2.0
Off-estate processing	7.7	7.1
Domestic-oriented industries	**7.0**	**3.4**
of which:		
Transport equipment	19.0	6.2
Petroleum products	19.3	-4.1
Construction-related products	4.6	3.8
Fabricated metal products	3.9	0.8
Food products	4.3	8.7

The **export-oriented industries** rebounded from the second quarter of 2002, underpinned by the strong expansion in the electronics industry following the recovery in global demand for semiconductors, particularly from the Asia-Pacific market (excluding Japan). Growth was stronger in the second half-year, when several industries recovered from the lower output in the first half-year. These included the chemical products industry following stronger demand from the US; the off-estate processing industry as production rose in response to both the policy to encourage more downstream activities and higher prices; and the rubber products industry following the recovery in export demand. The US West Coast port lockout in early October did not have a significant impact on Malaysia's manufacturing exports to the US, as a significant share of exports to the US was electronics, which was mainly transported by air.

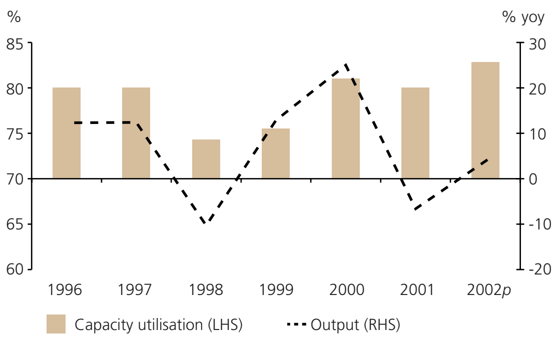
The continued growth in domestic demand led to output expansion in the **domestic-oriented industries**, albeit at a more moderate pace. Expansion in the transport equipment, construction-related materials, paper products and food products industries was supported by growth in public and private expenditure. Growth was stronger in the first half-year due to the strong performance of the construction and automobile industries. Some moderation in output occurred in these industries in the second half-year, due to softer demand for passenger cars and labour disruptions in the construction sector following more stringent administration of regulations on foreign labour.

While the US continued to remain the leading export destination for Malaysia's manufacturing exports, in recent years there has been a discernible increase in share and demand from the regional markets. The trend of a growing share of trade within East Asia was strongly supported by the People's Republic of China's emergence as the largest importer in the region. Strong domestic demand within the People's Republic of China as well as its rapid rise in importance as a production base for multinational companies have generated an additional source of demand for both final and intermediate goods from Malaysia and the other countries in the region. As such, Malaysia's exports of manufactured goods to the People's Republic of China and Hong Kong China expanded strongly by more than 20%, to account for higher shares of 4.7% and 6.4% respectively of Malaysia's total manufactured exports (2001: 3.9% and 5% respectively). The bulk of exports to these two destinations comprised electronics, electrical goods and chemical products. Exports of manufactured goods to the other North-Asian countries, particularly Chinese Taipei and

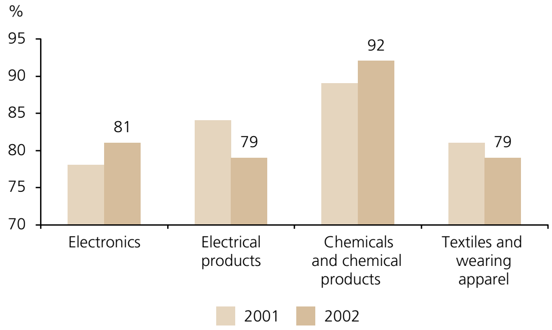
Graph 1.7
Manufacturing Production, Sales and Exports



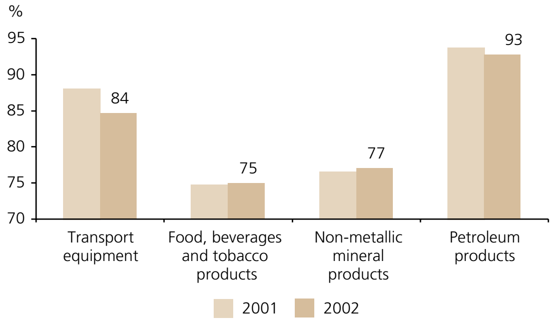
Graph 1.8
Capacity Utilisation in the Manufacturing Sector



Graph 1.9
Capacity Utilisation of Export-Oriented Industries



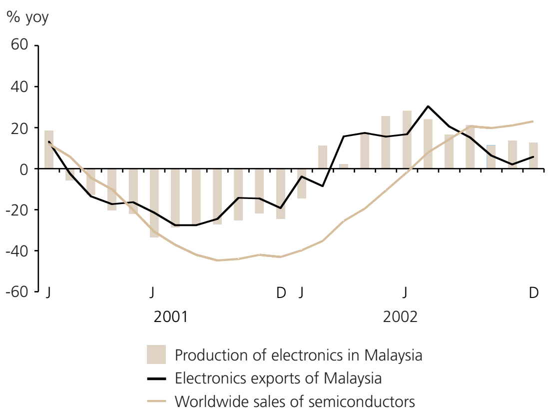
Graph 1.10
Capacity Utilisation of Domestic-Oriented Industries



Korea, also recorded double-digit growth, resulting in their market share increasing to 3.7% and 2.6% respectively (2001: 3.4% and 2.3% respectively). Electronics, electrical goods, chemicals and wood products accounted for the bulk of the manufactured goods exported to these two countries.

The **electronics industry** recovered to register strong increase in both production and exports. The turnaround was driven largely by the improvement in global semiconductor demand, especially from the Asian market. In 2002, the Asia-Pacific region overtook US as the leader in global semiconductor sales. In particular, demand for chips for wireless applications experienced the strongest expansion due to the substantial increase in new mobile phone subscribers and new models of cellular phones. In addition, some Malaysian electronics manufacturers have progressed up the value chain from assembly and packaging activities to full turnkey design and test solutions to attract more outsourcing contracts. As a result, Malaysia has been

Graph 1.11
Production and Exports of the Electronics Industry



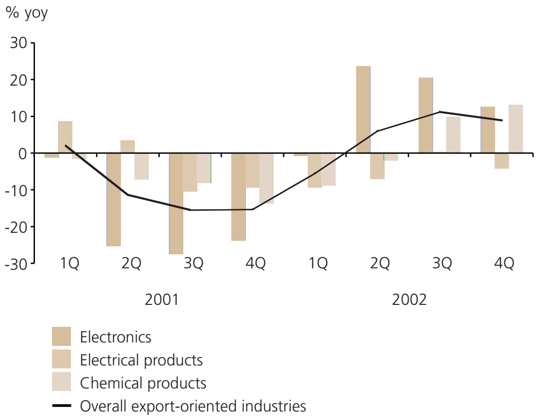
able to maintain its competitive strength and upgrade as a high value-added production centre for many major electronics multinational companies. The restructuring of multinational companies also resulted in Malaysian electronics companies benefiting through transfer of production lines from other high cost production centres to Malaysia.

Output of **electrical products** continued to decline in 2002, as manufacturers faced keen competition from lower cost producing countries, particularly for the audio-visual and communication products segment. Consequently, both export volume and prices of electrical goods declined further. Only the production of air-conditioners continued to expand in response to higher offtake from the US market. Hence, exports to the US, Malaysia's largest market for electrical products, recovered in 2002 to show growth, while exports to the other major countries declined.

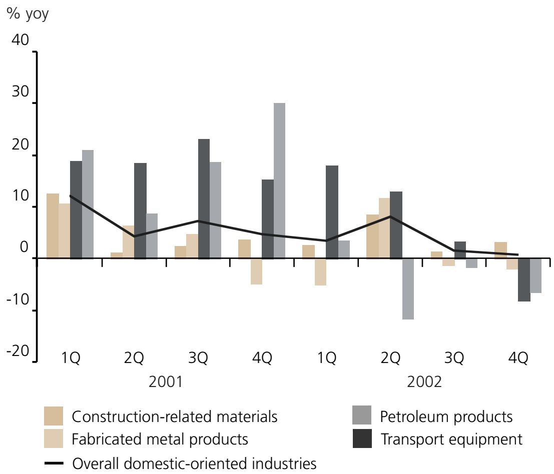
Production of the **chemical products industry** turned around to record a positive growth, mainly benefiting from the recovery in the electronics industry as well as improved demand for organic chemicals, resins and plastic products from the Asia-Pacific region. In 2002, the People's Republic of China had overtaken Singapore as the single largest export market for Malaysia's chemical products. The chemical industry also has strong inter-linkages with domestic economic activity, particularly in the car and construction industries, which has resulted in higher demand for paints, varnishes and lacquers.

The **textiles and wearing apparel industry** continued to face competition from lower cost producing countries resulting in both exports and production declining further during the year. Demand from major buyers, namely, the US, United Kingdom, Japan, Singapore and Hong Kong China declined.

Graph 1.12
Output Performance of Selected Export-Oriented Industries



Graph 1.13
Output Performance of Selected Domestic-Oriented Industries



Output of the **off-estate processing industry** expanded further, sustained largely by higher activity in palm oil processing and rubber remilling. Meanwhile, the **rubber products industry** continued to expand, benefiting from the sustained demand from the US for gloves used in the medical, food processing, manufacturing and household sectors. The domestic gloves industry, which accounts for about 75% of value of exports of rubber products, continued to face keen competition from Thailand and alternative synthetic materials. Output of **petroleum products** declined, reflecting lower production from crude oil refineries, and other derivatives of petroleum and coal. The plant shutdown of a major refinery for maintenance purposes affected refinery activities during the year.

The decline in output of **wood products** during the year reflected lower saw milling activities and plywood production. Nevertheless, exports of wood products rose in 2002 due to improved prices of plywood and sawn timber as well as increased demand from Korea, Canada and Thailand. Exports of furniture also rebounded, driven by the strong housing market in the US, particularly in the first half of the year. Notwithstanding the encouraging export performance, Malaysian wood-based products continued to face competition in the global markets from substitute products like PVC and steel.

Higher assembly of motor vehicles and motor vehicle parts and accessories supported the continued expansion of the **transport equipment industry** in 2002. For a large part of the year, demand for automobiles remained strong due to the low interest rates and attractive incentives offered by the manufacturers. However, car sales moderated towards the end of the year due to the uncertainty over future prices of cars when Malaysia effects tariff reductions for import of cars under AFTA. Consequently, growth in output of transport equipment industry also moderated in the second half of 2002.

Output of **construction-related materials** continued to expand during the year due mainly to higher construction activity, particularly in the first half of 2002, which resulted in increased demand for iron and steel products. For the year as a whole, growth in the sector was broad based. Both non-metallic mineral products, and iron and steel and non-ferrous metal products increased in response to the increase in demand for cement and concrete products as well as structural clay products. Higher export demand for glass, ceramic products, cement and fabricated construction materials from the People's Republic of China, US and Japan also supported growth during the year. However, growth in output of these industries moderated in the second half-year due mainly to labour disruptions in the construction sector, following the repatriation of foreign labour during the year. This development, to some extent, has affected the performance of the overall domestic-oriented industries in the second half-year.

On the other hand, growth in production of the **fabricated metal products industry** moderated during the year. It was mainly affected by lower production of structural metal products, especially in the second half of 2002, amidst the moderation in the construction sector. However, output of brass, copper and aluminium products recovered to record a marginal growth, benefiting from a turnaround in the electronics and telecommunication sectors.

Output of the **paper and paper products industry** expanded significantly during the year, reflecting increases in all its sub-sectors, especially production of pulp, paper and articles. Production of containers, and boxes of paper and paperboard also rebounded to record a double-digit growth due to higher demand for packaging materials, especially from the export-oriented industry. Although strong consumer demand supported the growth in the **food products industry**, the **beverages industry** was adversely affected by high inventory levels, while the **tobacco products industry** declined due to the loss in market share, especially in Hong Kong China.

Construction Sector

In 2002, growth in the **construction sector** was maintained at 2.3%. Growth was supported mainly by higher Government expenditure on infrastructure projects and household demand for residential property. In the non-residential sub-sector, construction activity remained focussed on existing projects given the prevailing large overhang of office and retail space.

In the **civil engineering sub-sector**, growth was stimulated by higher Federal Government development expenditure on construction-related projects, especially for projects related to the transportation, education, housing and public utilities sub-sectors. One of the major ongoing public projects is the electrified double tracking of the railway track between Rawang and Ipoh. Privatised road projects such as the Kajang Ring Road, Butterworth Outer Ring Road, Guthrie Corridor Expressway, New Pantai Highway, Package C of the SPRINT Expressway and the Kajang-Seremban Expressway further supported activity in the construction sector. Ongoing work were related to the construction of power plants, rail, ports and sewerage projects. Among the major ongoing privatised projects during the year were the Kuala Lumpur Monorail System, power plants such as the Teknologi Tenaga Perlis Consortium, TNB Janamanjung, and gas fired Independent Power Producers in Prai, Melaka and Perak. The Express Rail Link project was completed during the year.

Financing for longer-term infrastructure projects shifted away from the banking system to Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB) and the private debt securities (PDS) market. Loans disbursed by BPIMB for infrastructure projects increased to RM3 billion in 2002 (2001: RM2.6 billion), reflecting mainly higher disbursements for Government projects. About 8% of the PDS issued in 2002 was for financing of projects in the construction sector. As a result, loans outstanding of the banking system for infrastructure projects were lower at RM5.2 billion (2001: RM5.8 billion).

Table 1.5
Demand for Residential Property

	1H 2001	2H 2001	1H 2002
		Units	
Total supply	52,243	54,461	73,609
Total demand	73,151	40,925	54,642
of which:			
- Sales from new launches	29,436	23,342	32,089
- Sales from previous launches[1]	43,715	17,583	22,553

[1] Derived from NAPIC's data on overhang.

Source: NAPIC, Valuation and Property Services Department.

While new construction in the **residential sub-sector** remained strong, overall demand for properties moderated. Demand for affordable and landed houses in choice locations with good accessibility, however, was sustained. Several factors lent support to residential development in 2002. The most significant were the promotion of home ownership via the stamp duty waiver in the first half of 2002 and attractive financing packages with very competitive rates offered by financial institutions. For

Growth in the construction sector was maintained, supported by higher Government expenditure. Lower lending rates for mortgages continued to sustain demand for residential houses.

Table 1.6
Residential Property Indicators

	2001	2002
	Number	
Residential property transactions[1]		
Number	176,208	167,567
Value (RMb)	22.2	21.8
Approvals[2]	227,260	198,970
Developers' licences		
New	1,095	1,170
Renewals	413	397
Sales and advertising permits		
New	1,014	1,134
Renewals	1,461	1,666
Loans by banking system - Value (RMb)		
Outstanding	87.1	101.2
Approvals	27.0	29.2

[1] The transactions exclude houses that were exempted from stamp duties.

[2] Units approved for construction by private developers.

Source: NAPIC, Valuation and Property Services Department, Ministry of Housing and Local Government and Bank Negara Malaysia.

Table 1.7
Property Overhang, Incoming Supply and Planned Supply

	Overhang		Incoming Supply[1]	Planned Supply[2]	Incoming Supply[1]	Planned Supply[2]
	June-02		June-02		Sept-02	
	Units/ '000 s.m.	Value (RMb)	Units/'000 sq.m.		Units/'000 sq.m.	
Residential (units)	52,419	7.1	569,283	462,303	574,773	478,477
Purpose-built office ('000 sq.m.)	2,662	9.9	2,415	1,892	2,253	1,884
Shopping complexes ('000 sq.m.)	1,404	8.4	1,479	1,772	1,418	1,768
Retail shops (units)	7,740	2.2	31,143	28,666	29,690	29,727
Industrial properties (units)	2,218	0.8	8,979	22,941	8,874	23,004

[1] Consists of properties that are under construction, including those where certificate of fitness/temporary certificate of fitness has not been issued.
[2] Approved but not started.

Source: NAPIC, Valuation and Property Services Department

low-cost houses, the exemption on stamp duties was extended beyond end-Jun 2002 as part of the measures to reduce the cost of purchasing low-cost houses. According to the Real Estate and Housing Developers' Association Malaysia (REHDA), a total of 86,000 units of properties valued at RM14 billion were exempted from stamp duties.

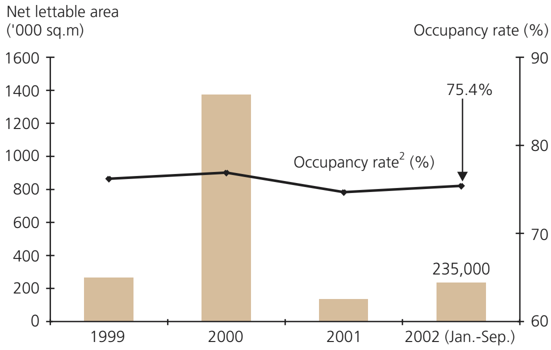
Besides stimulating demand, the waiver on the stamp duties also contributed to an increase in the supply of houses. Several developers brought forward their launches originally planned for later in the year to take advantage of the waiver. While demand for the new launches remained firm, it was not adequate to absorb the increase in units under these new launches. Sales performance or the take-up rate of the newly launched houses was lower at 44% during the first half of 2002 compared with 56% in the first half of 2001. Data provided by the National Property Information Centre (NAPIC) of the Valuation and Property Services Department suggests that total units sold in the first half of 2002 were lower than in the corresponding period of 2001, due mainly to lower sales from previous launches.

New approvals of private housing projects in Peninsular Malaysia by the authorities declined by 12% in 2002, especially in the second half of the year, indicating that developers had become cautious. Despite the lower approvals, new sales and advertising permits as well as renewals of these permits continued to increase. Similarly, loans approved by the banking system for residential properties increased by 8.2% to RM29.2 billion. Also, loans approved by other housing credit institutions as a group increased during the year. In tandem with higher approvals, total housing loans by the banking system as well as other housing credit institutions rose by 16.3% and 11.9% respectively. In the latter half of 2002, there was some slowdown in construction activity, due to labour shortages and large unsold units. The repatriation of foreign workers since the end of the amnesty period for illegal foreign workers on 31 July 2002 resulted in some delays in construction and completion. However, measures have been taken to alleviate the labour shortage problem and the impact is expected to be transitory.

Property overhang is defined by NAPIC as units which remain unsold for a period of at least nine months after their launch. This means that the overhang as at end-June 2002 comprises unsold units from projects launched up to September 2001 and **includes units for which construction work has not yet begun**. As at end-June 2002, data compiled by NAPIC showed that the overhang of residential properties increased by 27.9% to 52,419 units compared with 40,977 units as at end-2001, while in value terms, the increase was 27.8% to RM7.1 billion. The overhang units, however, account for only 1.8% of the total national stock of completed houses.

The higher overhang in residential units as at end-June 2002 was attributable to increases in new launches during the second and third quarters of 2001, amidst the moderate increase in units sold. While the share of units offered for more than 24 months declined to 42% (June 2001: 51%), the share of unsold units offered for 10-18 months

Graph 1.14
New Supply of Purpose-Built Office Space in the Klang Valley[1]: 1999 - 2002



[1] Refers to Kuala Lumpur and Selangor
[2] Refers to end period

Source: NAPIC, Valuation and Property Services Department

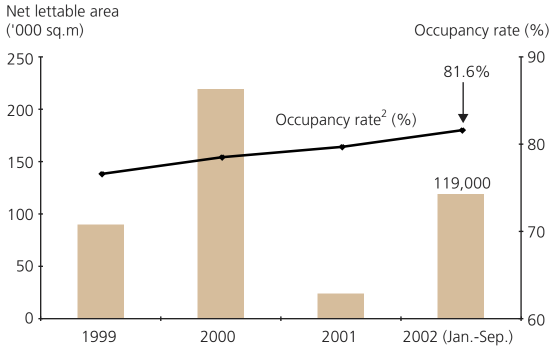
increased substantially (47%; June 2001: 34%). A major share of the unsold units (56%) were houses priced in the range of RM50,000 to RM150,000, while houses priced above RM250,000 accounted for only 6%. Low-cost houses accounted for 12% of total unsold residential property. Two-thirds of the total unsold units are under construction, 12% are completed units, while construction work has not started on the remaining 21%. The overhang is mainly concentrated in Johor, Selangor, Pulau Pinang and Kuala Lumpur.

The lack of demand for the overhang units was due mainly to locational factors. Low take-up rates were mainly for houses outside prime areas or in areas lacking proper infrastructure, such as schools and integrated public transport system. Demand for residential units offered by reputable developers in the well-established locations remained strong. Another factor affecting properties that had been offered for more than 24 months was unresolved certificate of fitness issues.

Following the liberalisation of the Foreign Investment Committee (FIC) guidelines, effective April 2001, foreign purchase of residential properties in Malaysia has increased. In 2002, total foreign purchase rose by 35% to RM590 million. House prices also remained stable in choice locations in the Klang Valley, reflecting continued demand in those locations.

Construction activity in the **non-residential sub-sector** remained subdued, as construction of purpose-built office and retail space during 2002 was supported mainly by on-going projects. Although the overhang of office and retail space improved during the first half of 2002, it continued to account for the bulk of the total overhang (65%; December 2001: 69%). New office projects that started construction during the first nine months of 2002 constituted only 2% of the total office space that was under construction. In the case of shopping complexes, new projects comprised only 1% of the total space under construction. Overall, with the decline in incoming supply, the average occupancy rate for office space and retail complexes stabilised at 78% and 77% respectively as at end-September 2002. In the Klang Valley, despite the increase in new completions of office and retail space in the first nine months of 2002, occupancy rates rose further, indicating demand remained strong, especially for projects located in choice locations. Commercial

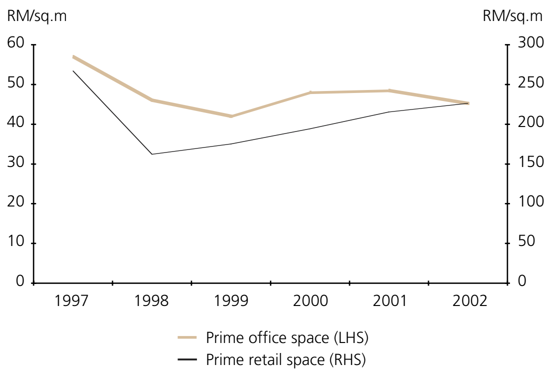
Graph 1.15
New Supply of Retail Space in the Klang Valley[1]: 1999 - 2002



[1] Refers to Kuala Lumpur and Selangor
[2] Refers to end period

Source: NAPIC, Valuation and Property Services Department

Graph 1.16
Average Monthly Rentals for Prime Office and Retail Space in Klang Valley[1]



[1] Refers to Kuala Lumpur & Selangor

Source: CH Williams Talhar & Wong Sdn. Bhd.

Table 1.8
Office and Retail Space - Unoccupied Space, Incoming Supply and Planned Supply by State (as at end-September 2002)

	Office Space			Retail Space		
	Unoccupied Space	Incoming Supply[1]	Planned Supply[2]	Unoccupied Space	Incoming Supply[1]	Planned Supply[2]
	('000 sq.m.)					
WP Kuala Lumpur	1,509	1,170	1,037	321	667	738
Selangor	465	58	0	148	254	63
WP Putrajaya	0	295	155	0	0	0
Johor	208	254	430	289	182	855
Pulau Pinang	253	93	47	270	172	28
Negeri Sembilan	25	31	132	47	72	57
Perak	40	52	6	59	7	0
Melaka	16	12	0	56	9	0
Kedah	22	38	6	72	20	21
Pahang	9	14	51	36	0	6
Terengganu	13	2	0	5	7	0
Kelantan	10	5	20	2	19	0
Perlis	0	34	0	0	0	0
Sabah	155	169	0	28	0	0
WP Labuan	40	0	0	15	0	0
Sarawak	57	26	0	34	9	0
Total	**2,822**	**2,253**	**1,884**	**1,382**	**1,418**	**1,768**

[1] Consists of properties that are under construction, including those where certificate of fitness/temporary certificate of fitness has not been issued.

[2] Approved but not started

Source: NAPIC, Valuation and Property Services Department

property transactions rose by 9% in volume terms and 3% in terms of value.

Rentals for prime office space in the Klang Valley declined during the year to RM45 per square metre per month, as prospective tenants preferred newer buildings. This resulted in lower rentals for older buildings. Meanwhile, the average monthly rental rates of prime retail space in shopping complexes increased to RM226 per square metre (2001: RM215 per square metre) although the rates remained lower than the pre-crisis levels. In the secondary locations, rentals of both office and retail space locations remained low to attract tenants.

During the year, the Government undertook a major revamp of the legislation relating to housing development to protect the interest of house buyers. In particular, amendments were made to the Housing Developers' Act. The new Housing Developers (Control and Licencing) (Amendment) Act 2002, which came into effect on 1 December 2002, and four new related regulations introduced by the Ministry of Housing and Local Government will enhance the authorities' investigation and enforcement powers and enable closer monitoring of the status of any housing development. The Tribunal for Homebuyer Claims was also established to hear claims by homebuyers against errant developers for amounts below RM25,000. Another salient feature of the amendment is the requirement of a minimum deposit of RM200,000 for the application and renewal of a developer's licence.

In the case of **hotels**, a total of 102 new hotels were completed during the year, providing an additional 5,785 rooms. The average occupancy rate remained stable at 58%, but with the increase in tourist arrivals to 13.3 million in 2002, the occupancy rates in the major city areas in Penang, Johor Bahru and Melaka recorded an increase.

Agriculture sector

In 2002, the **agriculture, forestry and fishery** (agriculture) sector benefited significantly from the sharp improvements in the global prices of major agricultural commodities. Export earnings from agriculture rose substantially by 31.9%, following significant increases in prices for all major agricultural commodities, amidst the tight global supplies. Prices of palm oil, rubber, saw logs and cocoa rose by 52.4%, 28.7%, 16.6% and 66.9% respectively. Despite the high prices and strong external demand, value added for the sector only increased marginally by 0.3% in 2002, constrained by supply factors. Nevertheless, the significant increase in prices and incomes had a large multiplier impact on private consumer demand and overall GDP growth during

Table 1.9
Agriculture Sector: Value Added, Production and Exports

	2001		2002*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value Added (RM million at 1987 prices)	**18,269**	**1.8**	**18,330**	**0.3**
Production[1]				
of which:				
Crude palm oil	11,804	8.9	11,908	0.9
Rubber	547	-11.1	588	7.6
Saw logs	18,923	-18.0	19,709	4.2
Cocoa beans	58	-17.9	48	-16.6
Exports (RM million)	**19,966**	**-13.2**	**26,340**	**31.9**
of which:				
Palm oil				
('000 tonnes)	10,466	18.1	10,866	3.8
(RM/tonne)	944	-15.9	1,366	44.7
(RM million)	9,876	-0.7	14,838	50.2
Rubber				
('000 tonnes)	822	-16.0	928	12.9
(sen/kilogramme)	230	-12.7	269	17.0
(RM million)	1,886	-26.6	2,492	32.1
Saw logs				
('000 cubic metres)	4,834	-25.5	4,873	0.8
(RM/cubic metre)	315	-17.9	367	16.6
(RM million)	1,523	-38.8	1,790	17.5
Sawn timber				
('000 cubic metres)	2,411	-16.2	2,335	-3.1
(RM/cubic metre)	943	-10.2	954	1.2
(RM million)	2,273	-24.7	2,228	-2.0

[1] All in '000 tonnes, except for saw logs in '000 cubic metres.

p Preliminary

Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board

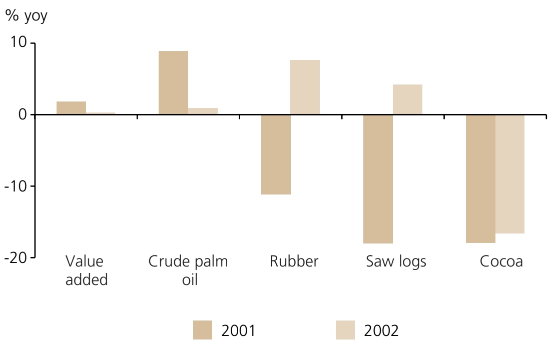
the year. The agriculture sector is an important rural activity and employs about 15% of the total workforce in Malaysia. Higher prices of commodities benefited about 500,000 smallholder families in the rubber, palm oil and cocoa sectors.

The marginal increase in the value added growth in the agriculture sector was due mainly to the almost stagnant output growth of crude palm oil (0.9%, 8.9% in 2001), due largely to transitional lower biological yields. However, rubber and saw log production increased in 2002 in response to the sharp increase in prices and more favourable export demand. Output of other agricultural commodities, namely, vegetables, fruits, livestock and fish also recorded increases during the year.

Production of **crude palm oil** (CPO) remained the single largest contributor to value added in the agriculture sector, accounting for about one-third of the sector. Output growth was however, marginal, due mainly to lower yields. CPO production remained almost unchanged from the previous year's level at 11.9 million tonnes (2001: 11.8 million tonnes). Higher production was seen only in East Malaysia where newly matured oil palm areas expanded by 8.4% to 1.26 million hectares. Production in Peninsular Malaysia, which accounts for almost 60% of total national palm oil production, declined by 6.1%, due to lower biological yields as well as reduced production acreages following replanting activities undertaken largely in the first half of 2002. Against a backdrop of a marginal increase in CPO production and a small increase in export volume, stocks of palm oil closed slightly lower at 1.1 million tonnes as at end-2002 (1.2 million tonnes as at end-2001).

Meanwhile, the recovery in palm oil prices (as measured by local delivered prices) which started in late 2001 continued into 2002, with prices gradually firming from RM1,180 per tonne in January 2002 to RM1,449 in June and RM1,646 in December. For the year as a whole, prices averaged RM1,364 per tonne

Graph 1.17
Agriculture Production



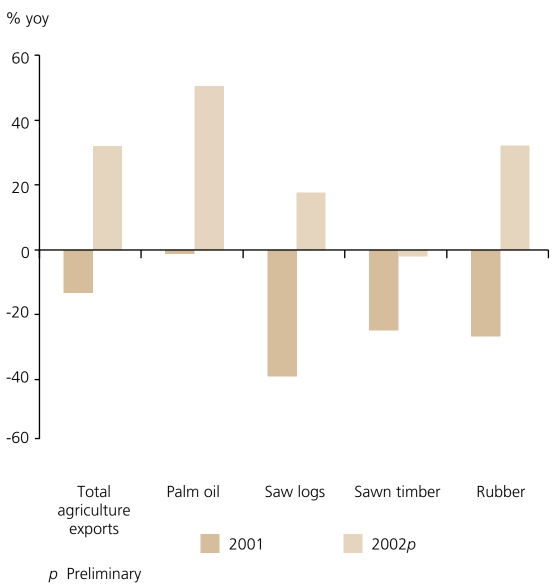
(2001: RM895), representing a sharp improvement of 52.4%. Firm demand for palm oil amidst tight supplies of other major vegetable oils and a marginal increase in palm oil output as well as the very strong prices for soyabean oil, contributed to the significant increase in CPO prices. Stocks of soyabean in the major producing countries were adversely affected by the lower harvest in the United States as well as supply disruptions in Argentina following the economic and political uncertainties. Consumption of palm oil by India, which is one of Malaysia's major buyers, remained high following the shortfall in its domestic oilseed production. Imports by the People's Republic of China, on the other hand, rose substantially overtaking India to become the largest buyer of Malaysia's palm oil during the year. Despite the sharp increase in prices, palm oil products remained the most competitive and attractive vegetable oil in the international markets in 2002. Crude palm oil price in 2002 continued to trade at a discount of US$64, US$203 and US$94 per tonne, against soyabean, sunflower and rapeseed oils respectively.

Given the tight global supplies of oils and fats amidst competitive palm oil prices, export volume of palm oil expanded by 3.8% during the year, with the People's Republic of China emerging as the major buyer, followed by India, the European Union, Pakistan and Egypt. Together, these countries accounted for about 60% of total Malaysian palm oil exports. Following the increase in export price and volume, total receipts from palm oil exports rose sharply by 50.2% to RM14.8 billion. Thus, palm oil retained its position as the single largest contributor to total agricultural export receipts.

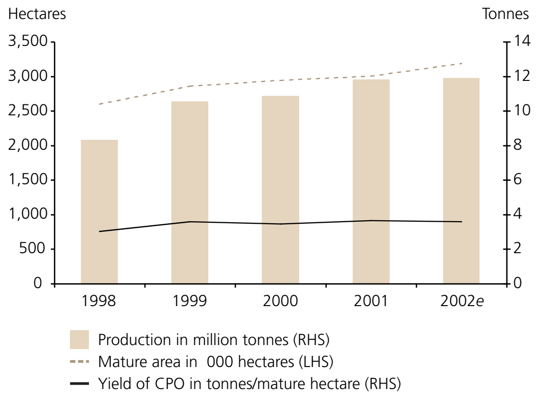
Since CPO production has been rising at an average annual rate of 6.5% in the last decade, efforts have been intensified to ensure sustained external demand. These include increasing the market share of existing export markets, gaining new markets, and increasing the applications of palm oil, in both the edible and non-edible palm-based products. Market promotional efforts continued to be carried out by the Malaysian Palm Oil Promotion Council together with the Malaysian Palm Oil Board Technical Advisory Services (MPOB TAS). Following these promotions, Malaysia succeeded in making inroads into six new markets, namely, Burkina Faso, Niger, Antigua, Suriname, Seychelles and Mongolia. In addition, measures were also undertaken to reduce existing ageing and less productive oil palm areas through the replanting of high yielding hybrids to lower the cost of production.

In the area of research and development (R&D), MPOB continued its efforts to diversify palm oil applications in both the upstream and downstream industries, resulting in a total of 174 technologies/ products being developed by the end of 2002, of which 47 technologies/products were launched during the year. Among products which have been developed for the downstream industries include shortening formulations, protein fortified trans-free margarine, automobile components (boot and door trims, and spare wheel cover), cosmetic products, block board from oil palm trunk, printing ink, and pulp and paper from oil palm fibres. In the upstream sector, the technologies developed include mechanical loose fruits collector, sprayer for young palms and effluent treatment.

Graph 1.18
Agriculture Exports

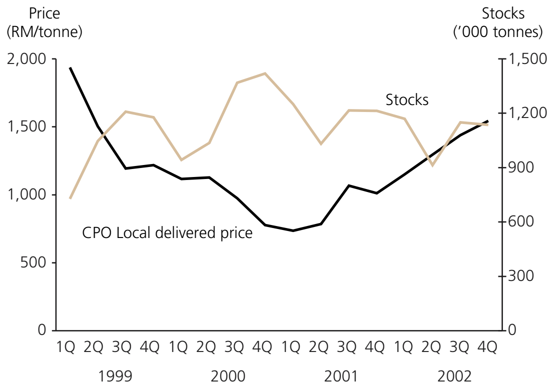


Graph 1.19
Oil Palm: Area, Production and Yield



e Estimates for mature area and yield

Graph 1.20
Palm Oil Prices and Stocks



Similarly, developments in the **natural rubber** sector were also favourable during the year. Of significance, production of natural rubber, which has been declining in the past seven years, turned around to record a growth of 7.6%, driven by the marked improvement in prices, leading to the recovery in export volume for the first time since 1997. Rubber prices also saw a significant increase during the year, with prices strengthening to above 300 sen per kilogramme from mid-2002. The higher rubber prices motivated increased tapping activity, especially among the smallholders, who contribute about 85% of total national rubber production.

The average price of rubber as reflected by RSS1 increased by 28.7% to reach 292 sen per kilogramme, the highest level recorded since 1996. Firmer prices were driven primarily by the tight global supplies following lower production in Thailand, the world's largest rubber producing country as a result of unfavourable weather conditions, as well as an increase in global demand. During the year, efforts by major producers to improve natural rubber prices in the international markets made further progress. Following the formation of the International Tripartite Rubber Organisation (ITRO, comprising Thailand, Indonesia and Malaysia) in July 2001, aimed at ensuring fair and remunerative international rubber prices through sales and stock management, a consortium (under the auspices of ITRO) known as the International Tripartite Rubber Corporation (ITRCo) was established in August 2002. The role of ITRCo is to undertake strategic market operations as and when deemed necessary.

The increase in export volume and much higher rubber prices, both combined to drive export proceeds from rubber significantly higher by 32.1% during the year. Higher rubber shipments were mainly to the People's Republic of China, the United States and France.

While the share of rubber production in GDP growth has declined substantially from 5% in the early 1980's to 0.6% in 2002, its socio-economic importance as a strategic plantation crop in the Malaysian economy remains significant. Maintaining strong output growth is important due to its strong linkages to the domestic downstream rubber-based industry, including rubber gloves, tyres and tubes as well as rubber footwear. The sector still provides employment for about 265,000 families in the smallholdings sector. Measures to strengthen the industry focuses on improving productivity through the consolidation of smallholdings and modernisation of production management. One of the key strategies adopted was to increase private sector investment by encouraging consolidation of uneconomic land size to enhance productivity. Hitherto, the consolidation and management of rubber smallholdings was led by public agencies, while private sector participation remained insignificant. Hence, to promote greater involvement of private companies in the consolidation and management of smallholdings and idle land, the 2003 Budget introduced several incentives. The incentives are in the form of tax deductions on the invested amount for a company investing in a wholly-owned subsidiary company involved in the consolidation exercise, while the wholly-owned subsidiary company is given service tax exemption.

In 2002, output of **other agriculture commodities**, including fruits and vegetables, livestock and fish also registered higher growth. The increase in output of these commodities, which accounts for about 25%

of total value added of the agriculture sector, reflects the positive impact of policies under the Third National Agriculture Policy aimed at increasing domestic food production. Production of vegetables and fruits expanded by 19.9% and 4.2% respectively, mainly attributable to the expansion in the cultivated area, including the Permanent Food Production Parks (PFPP). As at end-2002, more than 1,840 hectares of land have been developed under the PFPP programme. Similarly, production of livestock grew by 6.3% in response to higher demand from both end-consumers and the food-based industries. Higher fish landings, in both the marine and aquaculture sub-sectors led to a 5.1% increase in the production of fish. Given the large potential of the aquaculture sub-sector, the Government has identified a total of 4,472 hectares to be classified as aquaculture industrial zones.

Production of **saw logs** increased by 4.2% in 2002, in response to higher demand from traditional markets, including Japan, the People's Republic of China and India. As a group, these countries accounted for more than 75% of total saw log exports. On the price front, developments were also positive. Besides an improvement in external demand, the shortage in tropical logs in the international markets following the ban on log exports by Indonesia since 2001, contributed to higher prices. As a result, export prices of Malaysian logs were traded 16.6% higher at an average of RM367 per cubic meter in 2002, which lifted export earnings by 17.5%. Exports of sawn timber, however, continued to decline in 2002, as demand from major buyers, particularly in Europe, remained low.

In response to the requirement for certified or "green" timber by major export markets, particularly European countries, the timber certification scheme operated by the Malaysian Timber Certification Council (MTCC) continued to make significant progress in 2002. Thus far, the states of Pahang, Selangor and Terengganu have been awarded the Certificates for Forest Management, while a few other states are awaiting decision on certification. In October 2002, a new national standard for forest management certification, which was developed by the National Steering Committee (comprising multi-stakeholders) based on the Principles and Criteria of the Forest Stewardship Council (FSC) and deliberated at the regional and national levels, was finalised and adopted. MTCC has also become a member of the Pan European Forest Certification Council in November 2002 and has taken the initiative to promote an ASEAN approach in implementing timber certification. MTCC-certified timber has been exported since July 2002, and by the end of December, a total of 732 cubic metres of sawn timber have been exported to the Netherlands and the United Kingdom.

Within the major agriculture commodities group, only the production of **cocoa beans** declined in 2002. The 16.6% decline in cocoa beans production was mainly attributed to a reduction in cultivated area as well as unfavourable weather conditions, particularly during the first half of 2002. The total planted area under cocoa declined by an estimated 8,337 hectares or 14% in 2002. Nonetheless, efforts to rehabilitate cocoa smallholdings, with the aim to increase productivity, continued to be undertaken by the Malaysian Cocoa Board. As at end-2002, a total of 3,073 hectares of cocoa land involving 3,200 smallholders were successfully rehabilitated by the Board under the Smallholders Development Programme. A positive development during the year was the significant increase in cocoa prices since December 2001, driven mainly by the tight global supplies following production constraints in the Ivory Coast, the world's largest producer of cocoa. In particular, cocoa futures prices reached the highest level in 17 years in October 2002. In line with these developments, the export price for Malaysian cocoa beans averaged markedly higher at RM5,222 per tonne (2001: RM3,494). This, together with higher export volume, resulted in significantly higher export proceeds from cocoa.

Mining Sector

Value added in the **mining sector** expanded by 4.5% in 2002, with growth emanating mainly from higher production of crude oil and natural gas. Rising production capacity and the stronger external demand contributed to the higher oil output during the year. Expansion in natural gas production, however, was driven primarily by higher domestic consumption. In line with the declining trend in the past few years, production of tin-in-concentrates declined by 15.2% during the year due to further closure of several tin mines. For the year as a whole, export proceeds from the mining sector declined by 4.4%, with lower earnings from liquefied natural gas (LNG) and tin more than offsetting the increase in crude oil exports. The marginal decline in the average crude oil prices and lower average prices of all other categories of minerals contributed to the weaker export performance of this sector.

Table 1.10
Mining Sector: Value Added, Production and Exports

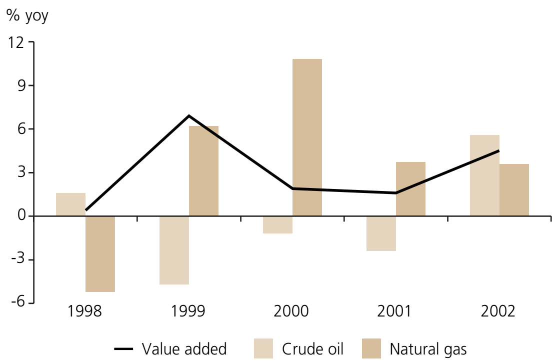
	2001		2002*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value added (RM million at 1987 prices)	**15,892**	**1.6**	**16,603**	**4.5**
Production				
Crude oil and condensates (barrels per day)	666,150	-2.1	700,000	5.1
of which: *Crude oil (barrels per day)*	*579,290*	*-2.6*	*597,000*	*3.1*
Natural gas - net (million standard cubic feet)	1,657,680	3.7	1,708,200	3.0
Tin-in-concentrates (tonnes)	4,972	-21.2	4,216	-15.2
Exports (RM million) *of which:*	**23,445**	**-12.6**	**22,406**	**-4.4**
Crude oil				
('000 tonnes)	15,077	-9.6	16,192	7.4
(US$/barrel)	25.53	-13.7	24.80	-2.9
(RM million)	11,118	-21.9	11,597	4.3
Liquefied natural gas				
('000 tonnes)	15,423	0.0	15,025	-2.6
(RM/tonne)	721	-2.6	661	-8.3
(RM million)	11,119	-2.7	9,932	-10.7
Tin				
('000 tonnes)	27	32.3	27	-0.7
(RM/tonne)	16,900	-19.9	15,713	-7.0
(RM million)	461	6.0	425	-7.7

p Preliminary

Sources: PETRONAS
Department of Statistics, Malaysia
Department of Minerals and Geoscience, Malaysia

Crude oil production (excluding condensates) increased by 3.1% to 597,000 barrels per day (bpd) in 2002, almost close to the production target of 600,000 bpd set for the year under the National Depletion Policy. The increase in production arose from the commencement of five new oil fields during the year, and higher external demand from major buyers, particularly India, Japan and the People's Republic of China. Export volume to this group of countries increased significantly by 60.8% in 2002 (2001: -5.7%).

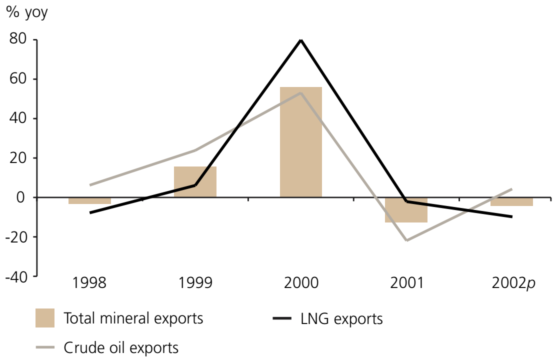
Graph 1.21
Mining Production



The Malaysian crude oil prices were generally in line with trends in the global oil market. In the international market, crude oil prices in 2002 were, to a large extent, influenced by uncertainties in the Middle East. Oil prices remained high amidst fears of a war and possible disruption in oil supplies in the major producing countries. This was further exacerbated by the labour strikes in the Venezuelan oil industry towards year-end.

Oil prices were also restrained by the soft demand in the face of less encouraging economic outlook and greater uncertainties. The Organisation of Petroleum Exporting Countries (OPEC) decided to maintain its production quota at 21.7 million bpd for the year after initially reducing production in

Graph 1.22
Mineral Exports



p Preliminary

Table 1.11
Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at end	
	2001	2002
Crude oil		
Reserves (billion barrels)	3.20	3.61
Reserve/Production (year)	14.8	16.0
Natural gas		
Reserves (trillion standard cubic feet)	87.49	87.76
Reserve/Production (year)	41.7	35.7

[1] The National Depletion Policy was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).

Source: PETRONAS

January by 1.5 million bpd. On the other hand, the non-OPEC countries increased their supplies by 1.3 million bpd. As a result, total global supply of oil was marginally lower at 76.6 million bpd (2001: 76.8 million bpd). Global demand increased slightly to 76.9 million bpd (2001: 76.5 million bpd) amidst the slow economic recovery in the major industrial countries.

Against these developments, the price of Brent, the benchmark grade for international oil trading, firmed slightly to average US$25.05 per barrel (2001: US$24.95). The average export price of Malaysian crude oil, while remaining firm at US$24.80 per barrel, was marginally lower than the price recorded in the previous year (US$25.53 per barrel). However, the increase in export volume contributed to higher export revenue from oil by 4.3% in 2002.

During the year, continued efforts were taken to increase the nation's oil and gas production capacity and reserves. In 2002, five new oil fields, of which four were in Peninsular Malaysia and one in Sabah, and three new gas fields located in Peninsular Malaysia commenced operations. In addition, 94 development wells were drilled and 60 wells were worked-over during the year, while 246,475 line kilometres of seismic data were acquired for exploration and development purposes. Three new production-sharing contracts were also signed during the year.

Services Sector

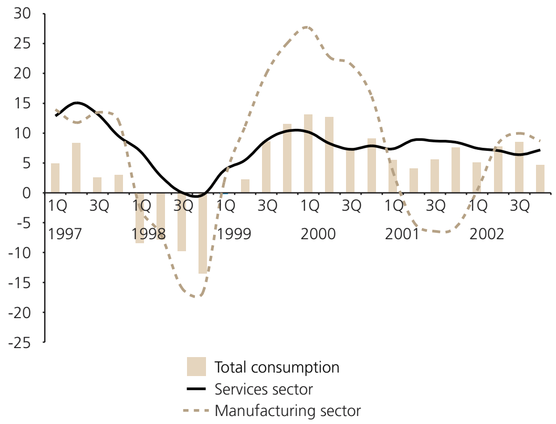
Since the early 1990s, concerted policies have been directed towards promoting the growth of the services sector both as a strategy for containing the services deficit in the balance of payments as well as diversifying the sources of growth. Initially, the focus was on areas such as tourism, education, shipping,

The services sector continued to expand, supported by strengthening domestic demand and improved trade-related activities.

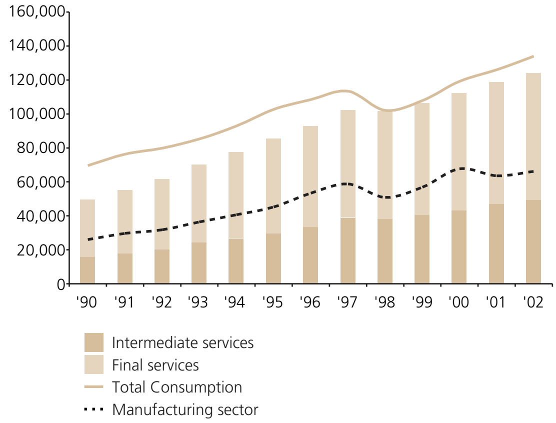
Production of **natural gas** expanded by 3% in 2002, in response to the increase in demand from the power generation industry, which accounts for more than 70% of the total gas consumption in the country. The commencement of three new gas fields also contributed to higher production during the year. Higher consumption of gas by the power generation sector was reflected in the 4.6% increase in the Electricity Production Index. In addition to higher demand from power generation, increased usage of gas was also recorded by the domestic petrochemicals sector, as more projects commenced operations during the year. Meanwhile, export receipts from LNG declined by 10.7% during the year following lower offtake by Malaysia's major buyer, Japan, coupled with the lower average LNG export prices of RM661/tonne (2001: RM721/tonne).

ports and contract and professional services, as the aim was to reduce the services sector deficit in the balance of payments. With the adoption of an integrated or cluster-based approach of the Manufacturing Plus-Plus Strategy of the Second Industrial Master Plan (1996-2005), industries were encouraged to move up the value added chain beyond processing and assembly to incorporating various services, including services for promoting branding, designs, patents, research and development, franchising, marketing, and warehousing and integrated logistics. Toward this end, fiscal and other incentives have been extended to cover the services industries, resulting in an increase in the services content of the manufacturing sector. Consequently, the services sector has gained importance, growing at an average annual rate of

Graph 1.23
Trends in the Growth of the Services and Manufacturing Sectors, and Consumption



Graph 1.24
Trends in Intermediate and Final Services, Manufacturing Sector and Consumption



8.2% during the period 1990 - 2002, faster than the overall GDP growth of 6.5%. Overall contribution of services to GDP increased from 46.8% in 1990 to 56.6% in 2002.

The services sector has also become less vulnerable during an economic downturn. Prior to the Asian crisis, the performance of the services sector was closely correlated with the cycle in the manufacturing sector, which in turn was driven mainly by changes in external demand for manufactured products. However, with the global slowdown in 2001, domestic demand replaced external demand as the main driver of growth. The performance of the services sector, therefore, diverged from the cycle in manufacturing and exports. In 2001, although the manufacturing sector declined and the overall economic activity moderated, growth in the services sector remained resilient, providing the support to overall expansion of GDP growth. Concerted measures to promote services as a new engine of growth and the promotion of domestic consumption have helped the sector to develop on several fronts. Besides supporting trade-related activities, the services sector also provided greater linkages with domestic-oriented sources of growth. Consequently, the services sector has gained dynamism in driving growth.

Reflective of the above developments, during the period 1990 - 2002, the intermediate services sector comprising transport, storage and communication; and finance, insurance, real estate and business services grew, on average, at double-digit growth of 10.1% per annum, faster than the growth in the

Table 1.12
Growth in the Services Sector at Constant 1987 Prices

	1990 - 2002	2001	2002*p*	1990	2002*p*
	Average annual growth, %	Annual change, %		% share of GDP	
Services	**8.2**	**5.7**	**4.5**	**46.8**	**56.6**
Intermediate services	10.1	8.7	4.9	14.9	22.4
Transport, storage and communication	8.7	7.5	2.9	6.7	8.6
Finance, insurance, real estate and business services	11.1	9.5	6.2	8.2	13.8
Final services	7.1	3.8	4.2	31.9	34.2
Electricity, gas and water	10.1	6.9	6.7	2.7	4.3
Wholesale and retail trade, hotels and restaurants	7.9	3.0	2.5	13.2	14.8
Government services[1]	4.4	4.6	6.3	8.8	7.3
Other services[2]	7.3	2.9	4.1	7.2	7.7

[1] Include general public services (general public administration, external affairs and public order and safety), defence, health, education and others.
[2] Include imputed rent from owner-occupied dwellings; community, social and personal services; products of private non-profit services to households and domestic services of households.
p Preliminary

Sources: Department of Statistics, Malaysia final services sector (7.1%). Consequently, the share of intermediate services in GDP increased markedly from 15% to 22%, while the share of final services rose from 32% to 34%. Of significance, the fastest growing sub-sectors during the period were the finance, insurance, real estate and business services sub-sector; followed by the utilities; transport, storage and communication; and wholesale and retail trade, hotels and restaurants sub-sectors.

In 2002, the services sector continued to expand by 4.5%, with the intermediate services group (4.9%) continuing to grow at a faster pace than the final services group (4.2%). Nevertheless, when compared with the previous year, **intermediate services**, expanded more moderately (2001: 8.7%), due mainly to the moderation in the telecommunication sub-sector.

Within the intermediate services sub-sector, the **transport, storage and communication** industries expanded by 2.9% in 2002 (2001: 7.5%). The slower growth reflected the moderation in activity in the telecommunication industry, following the strong expansion in the previous years, while the transport sector continued to expand strongly. In the telecommunication industry, the market size for fixed telephone lines declined marginally to 4.67 million in 2002 (2001: 4.71 million) as cellular phones gained popularity. Total subscribers of cellular phones continued to rise by 23.6% (2001: 46%) to 9.2 million. The number of Internet subscribers rose to 2.6 million at end-2002, representing a growth of 23.6% (2001: 27.5%). As at end-2002, the penetration rates for Internet and cellular phones were 10.5% and 37.3% respectively.

Growth in the transportation segment was supported by higher trade-related and transshipment activities. Activities at the ports remained robust throughout the year. The 11-day closure of the US West Coast ports, Asia's main trade gateway to the US market, in September-October had a minimum impact on Malaysia's trade as the bulk of shipments to the US comprised electronic items, which were mainly transported by air. Installation of state-of-the-art facilities as well as improvement in the quality of services enabled the country's ports to expand their handling and storage capacities to capture a larger share of regional cargo and transshipment of containers. With increased capacity and competitiveness, total container throughput at the six major ports increased further by 20.7% in 2002. Port Klang accounted for the major share, recording a total of 4.5 million TEUs (20-ft equivalent units) in 2002. Port of Tanjung Pelepas (PTP) recorded another marked achievement, with the total TEUs handled increasing sharply by 30% to more than 2.6 million (2001: 2 million TEUs), following the move by another mainline operator to shift their regional transshipment hub to PTP.

Table 1.13
Selected Indicators for the Services Sector

	2001	2002*p*
	Annual change, %	
Cargo throughput at five major ports[1]	3.6	8.8
Container throughput at six major ports[2]	43.5	20.7
KLIA passenger	-1.3	12.8
KLIA cargo	-13.7	19.6
LRT ridership[3]	16.4	3.5
Total internet subscribers	27.5	23.6
Total cellular phone subscribers	46.0	23.6
Total fixed line connections	1.8	-0.8
Insurance premiums	10.8	13.3
KLSE (turnover, volume)	-27.3	12.0
Loans outstanding in the banking system	3.6	4.3
Tourist arrivals	25.0	4.0
Hotel occupancy rate (%)	58.6	57.9
Electricity production index	8.6	4.6

[1] Include Port Klang, Johor Port, Penang Port, Sabah Ports and Bintulu Port.
[2] Include Port Klang, Johor Port, Port of Tanjung Pelepas, Penang Port, Sabah ports and Bintulu Port.
[3] Include STAR and PUTRA.
p Preliminary.

Source:
Department of Statistics; Kuala Lumpur Stock Exchange; Malaysia Airports Holdings Berhad; Malaysian Communications and Multimedia Commission; Ministry of Finance; Relevant port authorities; Syarikat Prasarana Negara Berhad; Malaysia Tourism Promotion Board; and Bank Negara Malaysia.

The air transportation segment also recorded stronger performance in terms of both cargo and passengers. During the year, total air cargo movement increased by 16.3% (2001: -9.3%) due partly to the substitution into air transport for the Christmas orders following the closure of the US West Coast ports. Total passenger traffic at all Malaysian airports increased by 4.2% to 33.7 million (2001: -0.9%). The increase was due to higher number of international passengers (4.7%) amidst the increase in tourists, as well as increase in the number of domestic passengers (3.8%) due mainly to more affordable air travel offered by a local airline company. Accordingly, total passenger traffic at the Kuala Lumpur International Airport grew by 12.8% to reach 16.4 million passengers in 2002.

Value added in the **finance, insurance, real estate and business services sub-sector** grew by 6.2% (2001: 9.5%). Growth was mainly supported by expansion in bank lending activities, particularly for residential property and passenger cars as well as increased collection of insurance premiums. Loans outstanding in the banking system increased at a higher rate of 4.3% in 2002, reflecting increased borrowing by consumers and businesses. Although both bank profitability and loan growth were higher in 2002, the value-added growth in the finance sub-sector was more moderate. While loans expanded, the net interest receipts of the banking system were lower as intensified competition led to declines in lending rates and narrowing of spreads between the lending and deposit rates. Meanwhile, the real estate and business services sub-sectors expanded, supported by higher activity in the first half of 2002 in the real estate business and the Kuala Lumpur Stock Exchange.

In line with strong growth in domestic consumption and tourism, value-added in the **final services** group, comprising utilities; government services; wholesale and retail trade, hotels and restaurants; and other services recorded a higher growth of 4.2% in 2002 (2001: 3.8%). The **Government services sub-sector** expanded at a faster rate of 6.3% (2001: 4.6%) on account of higher expenditure on emoluments arising from the bonus payment of a minimum of RM1,200 or one month's salary to all civil servants and the 10% upward adjustment in salary for all civil servants. Meanwhile, growth in the **utilities sub-sector** was sustained due mainly to increased electricity consumption from all categories of consumers from the industrial, commercial and household sub-sectors.

Also reflecting higher consumer demand, the **wholesale and retail trade, hotels and restaurants** sub-sector remained resilient, registering a growth of 2.5% in 2002 (2001: 3%). Strong consumer spending following the gradual improvement in consumer sentiment over the course of the year and higher tourist arrivals in the second half of 2002, contributed to the expansion in the sector. The wholesale and retail trade industries continued to benefit from the improvement in disposable income arising from the sharp recovery in commodity prices, a reduction in personal income tax and higher salary and year-end bonus for all civil servants. In the retail segment, the increase in sales was also attributable to the rapid expansion of outlets by the large retail chains. The segment also benefited from the increase in tourist spending as the number of tourists from high spending market segments such as the People's Republic of China and West Asia rose during the year.

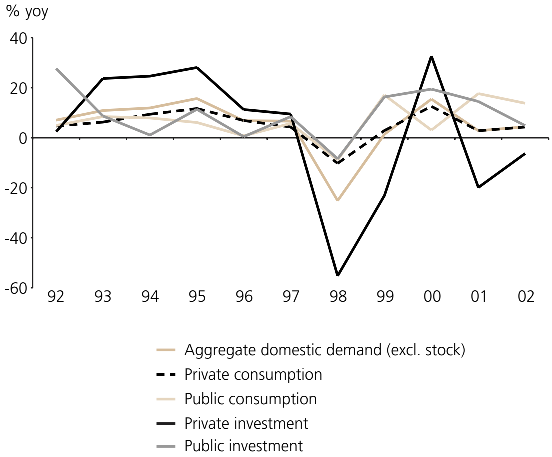
The **other services** sector grew at a faster rate of 4.1% (2001: 2.9%), supported by expansion in the new growth areas such as private higher education and private healthcare industries. As at end-2002, 20 private universities and 516 private colleges have been established in Malaysia, of which the total number of private higher education institutions that have been approved to take in foreign students increased from 231 in 2001 to 238 in 2002. This has helped to augment the existing capacity of public-funded institutions as well as generate foreign exchange earnings by attracting foreign students. The number of foreign students studying in the private higher education institutions in Malaysia rose by 32% to 22,823 (2001: 17,249). Meanwhile, the private healthcare industry has undergone a strategic change, with its focus now on health tourism. Towards this end, a National Committee for the Promotion of Health Tourism was set up to spearhead the growth of this industry. To date, there are 33 participating private hospitals catering to patients from Brunei Darussalam, Indonesia, Vietnam, Singapore, Bangladesh and Saudi Arabia.

DOMESTIC DEMAND CONDITIONS

Aggregate domestic demand strengthened further. Strong growth in private consumption led to higher capacity utilisation, and recovery in private capital formation. Consumption and investment growth was supported by expansionary policies and reinforced by external demand.

Domestic demand conditions strengthened significantly in 2002, sustained by the continued expansion in overall public sector spending and a marked increase in private consumption. Despite greater uncertainties prevailing in the external environment in the second half of the year, consumer confidence remained high throughout the year. Higher disposable incomes and the positive impact of the fiscal stimulus and low interest rates were reinforced by a stronger export performance and the sharp improvement in commodity prices. As domestic

Graph 1.25
Real Domestic Demand Aggregates



economic recovery gained strength, private investment turned around from five consecutive quarters of decline to record a modest recovery in the second half of the year. Overall, growth in **aggregate domestic demand** (excluding stocks) strengthened to 4.3% from 2.8% in 2001.

Public sector expenditure remained the main driver of growth, although the pace of expansion moderated to 8.6%, reflecting mainly on-going fiscal stimulus related spending and higher capital outlays by the non-financial public enterprises (NFPEs).

Public investment expenditure grew moderately by 4.6%. The Federal Government's development expenditure was channelled mainly towards education and training to enhance human resource development and longer-term productive capacity-building projects, and includes infrastructure and information and communication technology, to facilitate the move towards a knowledge-based economy. Higher outlays were also expended on rural development, health services, low-cost public housing projects and housing for essential personnel.

Total capital expenditure of the NFPEs was also higher in 2002, due mainly to the expansion and modernisation programmes of several major NFPEs, notably Petroliam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB), Telekom Malaysia Berhad (TMB) and Putrajaya Holdings Sdn. Bhd. Key investments by PETRONAS during the year included the on-going Malaysian Liquefied Natural Gas Tiga (MLNG 3) project, the phased development of the Universiti Teknologi PETRONAS permanent campus in Tronoh, Perak and the acquisition of new LNG carriers. TNB continued to expand and upgrade power generation, transmission and distribution facilities to meet increasing demand. The capital expenditure of TMB was mainly for the expansion and upgrading of information and communication technology, particularly to widen the coverage areas for Internet Service Provision (ISP) through wireless fixed lines. Capital outlays by Putrajaya Holdings Sdn. Bhd. were mainly for the on-going development of the Federal administrative centre and the construction of residential housing in Putrajaya. In addition, Silterra (Malaysia) Sdn. Bhd. and 1st Silicon (Malaysia) Sdn. Bhd., two NFPEs involved in wafer fabrication activities, continued to expand their plant capacities in 2002.

Public consumption continued to register a strong increase of 13.8%, due mainly to higher expenditure on emoluments and supplies and services. Higher expenditure on emoluments was mainly on account of the 10% salary adjustment and bonus payment to civil servants as well as the implementation of a new salary scheme or *Sistem Saraan Malaysia (SSM)* for employees in the public sector, effective November 2002. Higher expenditure on supplies and services was aimed at upgrading the Government administrative machinery to enhance its delivery system.

Private sector expenditure recovered from the contraction in 2001, with a moderate growth of 2% in 2002. **Private consumption** picked up to expand by 4.2%, reflecting improved consumer confidence in an environment of supportive fiscal operations by the Government, low interest rates, stable employment prospects and a recovery in external demand. The catalysts for the stronger growth in consumer spending during the year were the fiscal measures to increase disposable income, including the reduction in the personal income tax rate by 1-2 percentage points, the widening of the taxable income tax bracket for the low and middle income groups and the upward adjustment in salaries and year-end bonus for public sector employees. The large multiplier effect of higher rural incomes from sharply improved export prices for commodities strongly lifted private consumption. The low interest rate environment and easier access to financing provided strong encouragement for consumers to purchase durable goods and large ticket-items, including cars and houses. Major consumption indicators, such as sales of new passenger cars, imports of consumption goods, sales tax collections and loans disbursed for both consumption purposes and retail trade, restaurants and hotels pointed to a significant improvement in consumption spending in 2002.

Table 1.14
Private Consumption Indicators

	2001	2002 1Q	2Q	3Q	4Q	Year
Sales of passenger cars (incl. 4WD)						
'000 units	343.3	92.0	97.8	99.0	86.6	375.4
Annual change (%)	15.7	20.2	19.6	7.9	-7.1	9.4
Imports of consumption goods						
(RM billion)	16.6	4.3	4.7	5.0	5.3	19.3
Annual change (%)	-2.5	6.7	12.2	22.4	22.1	15.9
Tax collection						
Sales tax (RM billion)	7.4	1.9	2.5	2.0	2.9	9.2
Service tax (RM billion)	1.9	0.4	0.6	0.4	0.8	2.2
Loans disbursed by banking system						
Consumption credit (excl. passenger cars) Annual change (%)	17.3	39.6	39.1	38.6	36.2	38.3
Retail trade, restaurants and hotels Annual change (%)	0.6	0.2	15.6	23.7	31.0	17.0
MRA retail sales						
Annual change (%)	1.7	6.1	0.4	0.6	7.0[e]	2.5-4.0[e]
Credit card operation						
Turnover spending (RM billion)	23.4	6.6	6.9	7.5	8.2	29.1
Annual change (%)	20.8	26.8	22.9	23.9	25.0	24.6
MIER Consumer Sentiments Index	-	104.4	109.0	108.9	112.8	-

e Estimate

The decline in **private investment** moderated significantly in 2002 to 6.1% (2001: -19.9%). With economic activities strengthening steadily in tandem with improving demand, private investment expenditure recovered in the second half of 2002. This was reflected in higher imports of capital goods, an important gauge of investment activities, particularly imports of telecommunication and office equipment as well as construction and mining equipment.

All the major sectors of the economy, with the exception of the manufacturing sector, registered moderate increases in capital spending. This trend in part reflected concerted efforts taken by the Government aimed at developing new domestic sources of growth, mainly in the services sector, including tourism, high value added knowledge-based and resource-based economic activities, and agriculture. Consequently, there has been a noticeable shift in the pattern of investment, with new investment increasingly being channelled towards the new promoted areas in the services sector. This included higher value added and knowledge–based foreign investment in the services sector as evidenced by the setting up of operational headquarters, regional distribution centres and international procurement centres by several MNCs in Malaysia. As a result, the share of private investment in the services sector increased to 20% in 2002, while the share of investment in agriculture remained stable. Although the manufacturing sector continued to account for the largest portion of total private investments, its share had declined to 33%.

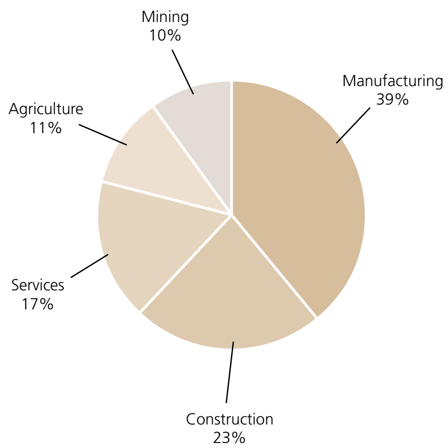
Capital outlays in the **manufacturing sector** remained weak in 2002 (-20.7%), as firms were cautious of committing large capital investments amidst an environment of excess capacity in selected

Table 1.15
Private Investment Indicators

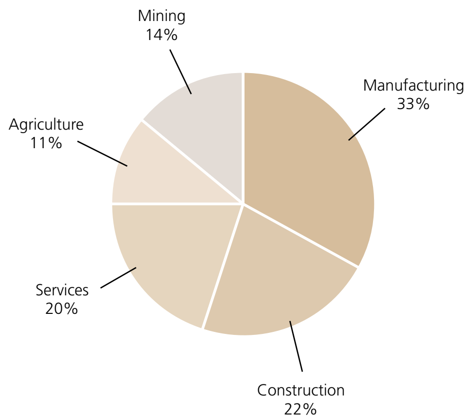
	2001	2002 1Q	2Q	3Q	4Q	Year
Sales of commercial vehicles (incl. 4WD)						
'000 units	53.1	14.3	15.0	15.6	14.6	59.6
Annual change (%)	14.0	28.8	17.3	1.0	6.5	12.2
Imports of capital goods						
(RM billion)	41.3	10.2	12.4	11.8	11.3	45.7
Annual change (%)	-6.5	-9.9	24.4	25.2	6.6	10.6
Applications to MITI						
No. of projects	837	214	220	245	162	841
Capital investment (RM billion)	16.5	3.3	3.0	10.9	1.7	18.8
Foreign	11.3	1.0	1.4	8.6	0.8	11.8
Local	5.2	2.3	1.6	2.2	0.9	7.0
Approvals by MITI						
No. of projects	928	191	195	208	69	663
Capital investment (RM billion)	25.8	3.6	4.0	2.9	5.9	16.5
Foreign	18.9	2.7	1.8	1.3	5.4	11.2
Local	6.9	0.9	2.2	1.6	0.5	5.3
Loans disbursed by banking system						
Manufacturing sector Annual change (%)	11.0	6.6	-5.0	1.8	1.2	1.0
Construction sector Annual change (%)	-10.4	9.4	82.1	42.4	34.7	41.8
Business services Annual change (%)	6.8	-18.5	16.3	-20.8	-6.5	-7.4
Private Debt Securities						
Total funds raised (RM billion)	31.5	2.4	7.4	6.2	10.6	26.6
Initial Public Offerings (KLSE)						
Total funds raised (RM billion)	1.7	0.6	5.6	0.4	0.3	6.8
MIER Business Conditions Survey						
Business Conditions Index	-	51.9	57.5	49.9	43.0	-
Capacity Utilisation Rate	-	78.2	80.4	79.6	78.8	-
MSC-Status Companies						
No. of companies	192	36	47	50	59	192
Approved investment (RM billion)	3.5	0.5	0.6	0.7	0.8	2.7

Graph 1.26
Private Investment by Sector (% share)

1999



2002

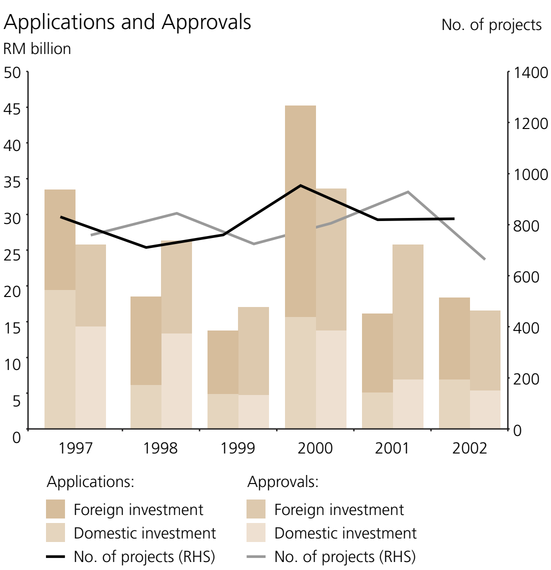


sectors of the economy and slower-than-expected recovery in world growth. Nevertheless, investment activities recovered in the second half of the year, supported by on-going electrical and electronics projects and petrochemical projects and capacity expansion in industries operating at higher capacity levels such as transport equipment and basic metal products industries.

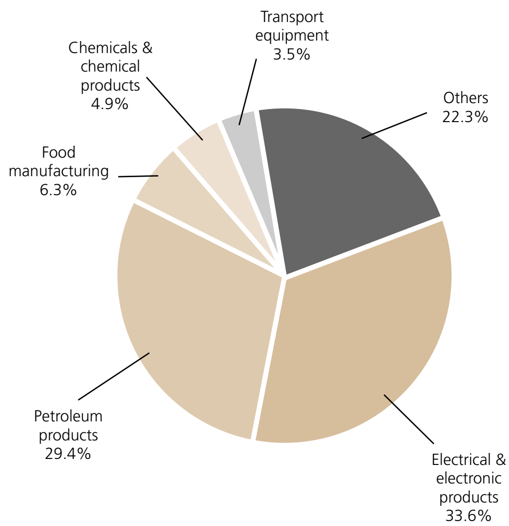
There was a significant revival in the value of applications for new investments received in 2002 to a positive growth of 13.7%, after declining by more than half in 2001 (-64.3%). The bulk of these new applications were received in the second half of the year, as recovery gained momentum. The substantial increase in the value of proposed investment applications for the manufacturing sector followed a rise in business confidence.

The total value of investments in the manufacturing sector approved by the Ministry of International Trade and Industry, however, was lower in 2002, amounting to RM16.5 billion (2001: RM25.8 billion). Of the total investments approved, the electrical and electronics industry accounted for a large share of 33.6%. The high proportion of investments in the electrical and electronics industry was in line with the recovery in global demand as well as the on-going outsourcing and relocation exercises by a number of MNCs. The petroleum products industry, including petrochemicals, was the second largest sector in terms of investment (29.4%). Besides a very large investment for the

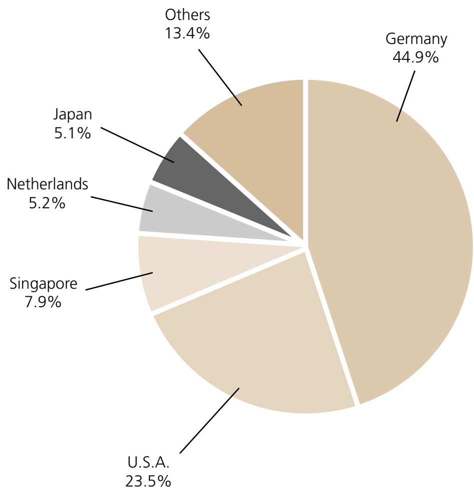
Graph 1.27
Private Investment in the Manufacturing Sector



Graph 1.28
Approved Manufacturing Investment by Industry, 2002 (% share)



Graph 1.29
Foreign Participation in Approved Manufacturing Investment by Country, 2002 (% share)



manufacture of synthetic rubber powder and thermoplastic elastomer from petroleum, capital spending in the industry was sustained by expansion as well as new downstream activities by petroleum companies in line with increased demand for petroleum products. This was followed by the food manufacturing sector (6.3%), the chemical and chemical products sector (4.9%) and transport equipment sector (3.5%).

The foreign share of total investment applications and approvals, both for new activities and expansion by existing concerns, remained high as investors took advantage of the relative robustness in the Asian economies, including Malaysia. Foreign investors accounted for 78.6% of total approved reinvestments during the year. The value of foreign investments approved in the manufacturing sector in 2002 amounted to RM11.2 billion and accounted for 68% of total approved investments. The top five sources of foreign investments during the year were Germany, the United States, Singapore, the Netherlands and Japan, which together accounted for 86.6% of the total foreign investment approved.

Capital spending in the **construction sector** registered a moderate increase in 2002, supported by activities of several privatised road projects, including the ongoing New Pantai Highway, Guthrie Corridor Expressway, Kajang Ring Road, SPRINT Highway (Penchala Link), Kajang-Seremban Expressway and Butterworth Outer Ring Road. The New North Klang Valley Straits Bypass (Shahpadu Highway) was completed in early 2002. The low interest rate environment and the fiscal incentives continued to provide support for investment in the residential sub-sector.

Investment in the **services sector** recovered to record positive growth in 2002. The investment was spread across most sub-sectors, in terms of capital outlay to expand and upgrade infrastructure and technological capabilities to improve the quality of services. In particular, new investments were in high value-added services, including investments in the banking and information, communication and technology sub-sectors. Capital spending in the utilities sub-sector was supported by the ongoing development of power plants and water supply projects. These projects included the Teluk Gong Power Plant in Melaka, Segari Gas Fired Plant in Perak, Teknologi Tenaga Perlis Power Plant, Prai Gas Fired Power Plant, TNB Janamanjung Power Plant and the Sungai Selangor Project Scheme Phase 3 (SSP3). In the telecommunications sub-sector, keen competition had led companies to intensify the upgrading of their technology and expand the mobile network to cater for the additional subscriber capacity and new coverage areas. Ongoing capacity expansion of Malaysian ports including the West Port, Port of Tanjung Pelepas and Kuantan Port supported investment in the transport sub-sector. Nevertheless, overall investment in this sub-sector was lower as two major rail projects, namely the Express Rail Link (ERL) was completed while the KL Monorail was near completion.

Stronger investment activities were also visible in the retail, wholesale and the business sub-sector, mainly reflecting the opening of new outlets as well as continuous expansion and refurbishment activities by existing retailers. Other high valued added investments included research and development activities as well as logistics and support services through the establishment of regional hubs for multinational operations, such as international procurement centres and regional data processing, treasury operations and customer service centres. A major mixed development project included the development of Proton City in Tanjong Malim involving the construction of an assembly plant as well as manufacturing plants for various car components to cater for the increasing demand for the national car.

Capital investment in the **mining sector** has been on an uptrend in recent years. This has resulted in the share of private investment in the sector increasing to 14% in 2002 from 10% in 1999. A large proportion of the investment was in the oil and gas sub-sector. The favourable outlook for global crude oil prices amidst increasing global demand has continued to encourage new investment into activities, such as exploration and surveys for new oil and gas fields, and the expansion of existing production facilities. In the **agriculture sector** the positive effect of the tax incentives provided in the 2001 and 2002 Budgets as well as the higher allocation committed under the National Agricultural Policy has promoted larger private sector participation. These investments included the modernisation and integration of mixed farming activities and food production and diversification into non-traditional activities, such as floriculture and horticulture.

In 2002, the recovery in nominal income led to higher consumption spending and a modest growth in **gross national savings (GNS)** of 7.6%. Public sector savings increased by 3%, reflecting the stronger revenue outturn relative to the increase in operating expenditure of the public sector. In the private sector, with households and the corporate sector enjoying stronger cashflows as a result of fiscal measures, salary increases as well as the recovery in external demand and sharply higher commodity prices, private consumption strengthened in 2002 while private sector savings turned around to register an increase of 12.2% during the year.

Overall, with gross national income increasing at a faster rate of 8.9% relative to gross national savings (7.6%), the share of GNS to GNP was sustained at 34.4%. This rate of savings remained high in comparison with the regional countries and has enabled Malaysia to support and finance its economic growth, mainly from domestic sources. The recovery in private investment in the second half year contributed to the turnaround in gross domestic capital formation (including stocks), which increased by 10.6% in 2002. The fundamental strengthening of the economy was seen in the lower savings-investment balance, as reflected by the smaller surplus in the current account of the balance of payments of RM27.4 billion or 8.1% of GNP (2001: 9% of GNP).

Table 1.16
Savings-Investment Gap

	2001	2002*p*
	(RM million)	
Public gross domestic capital formation	48,817	51,142
Public savings	53,534	55,161
Deficit / surplus	4,717	4,019
Private gross domestic capital formation[1]	30,867	37,026
Private savings	53,839	60,398
Deficit / surplus	22,972	23,372
Gross domestic capital formation	79,684	88,168
(% of GNP)	25.8	26.2
Gross national savings	107,373	115,559
(% of GNP)	34.8	34.4
Balance on current account	27,689	27,391
(% of GNP)	9.0	8.1

p Preliminary

[1] Includes the change in stocks. Previously, the change in stocks was distributed between the public and private sector gross domestic capital formation.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

PRICES AND EMPLOYMENT

Consumer Prices

Inflation rate remained subdued in 2002. The headline inflation, as measured by the annual change in the Consumer Price Index (CPI), was slightly higher at 1.8% in 2002 (2001: 1.4%) but core inflation, a measure of demand-related price pressures, moderated from 1% in 2001 to 0.4% in 2002. Despite the stronger expansion in domestic demand, the excess capacity in several sectors in the domestic economy and low import prices dampened price pressures during the year.

The marginal increase in headline inflation during the year reflected the one-off price adjustments mainly for the transport and communication sub-group. These one-off price adjustments accounted for 10.9% of the CPI basket and contributed to 1.4 percentage points to the headline inflation in 2002. Except for higher import duties for cigarettes and tobacco, the one-off price adjustments for the transport and communication sector; and petroleum-related products reflected the move towards a more market-based pricing mechanism. Overall, these changes were:

- An increase in toll charges by 10%, effective from 1 January 2002;
- Higher domestic telephone charges following a

Table 1.17
Price Adjustments in 2002

Items	Weight	% Increase	Contribution
Cigarettes and tobacco	1.72	7.3	0.13
Toll charges	0.24	10.0	0.02
Petrol	4.86	7.8	0.42
Diesel	0.10	2.1	0.00
LPG	0.49	0.4	0.00
Telephone services	3.47	23.5	0.80
Total one-off impact	10.88	12.6	1.37

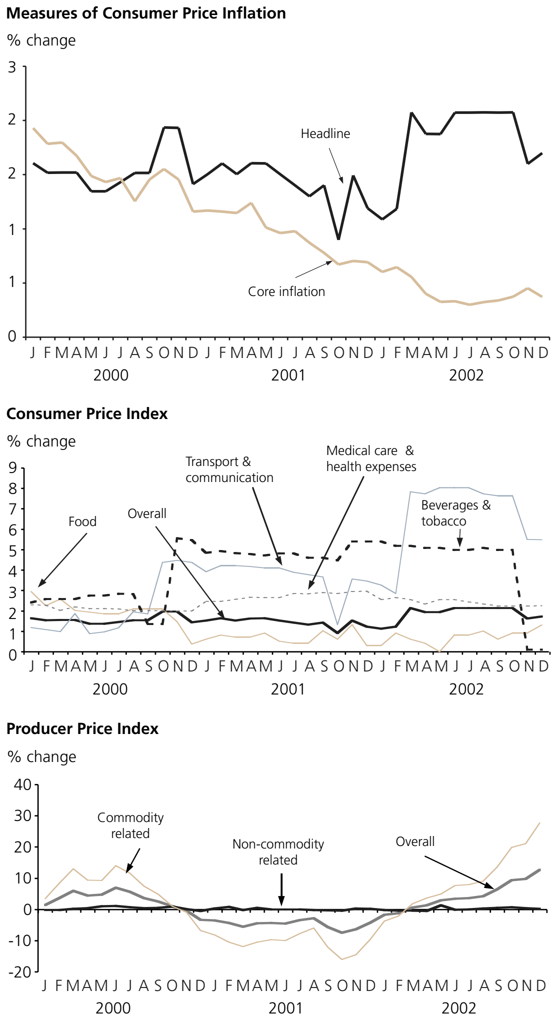
new structure for telephone tariff, implemented with effect from 1 March 2002;

- Increase in retail petrol-pump prices by 10 sen from end of October 2001, a further increase of 2 sen from 1 May 2002 and 1 sen from 1 November 2002; and
- Increase in diesel and LPG prices by 2 sen from 1 May 2002, followed by another increase of 2 sen from 1 November 2002.

The adjustments of these input prices during a period of excess capacity in several sectors had minimum pass-through effect on other goods and services and hence, contained the effect of increases in other consumer products. The upward adjustments in the prices of retail petrol and its related products, and telephone charges reflected higher crude petroleum prices and the change in market conditions of higher production costs. A positive outcome of the increase in domestic telephone charges has been the improvement in the quality of telephone services and an expansion of internet services to the rural areas.

An analysis of the changes in the prices of goods and services showed that the headline inflation rate reflected mainly larger price increases for services (2.9%), particularly transport and communication services. Prices in the goods sector increased at a slower pace of 0.5%. Prices for non-durable goods moderated as growth in prices of food taken at home softened to 0.2% in 2002 (0.4% in 2001) on the back of favourable weather conditions. Prices for durable and semi-durable goods were lower during the year, brought about by the decline in the

Graph 1.30
Inflation: Annual Rate of Change



Graph 1.31
Contribution to Annual Change in the Consumer Price Index

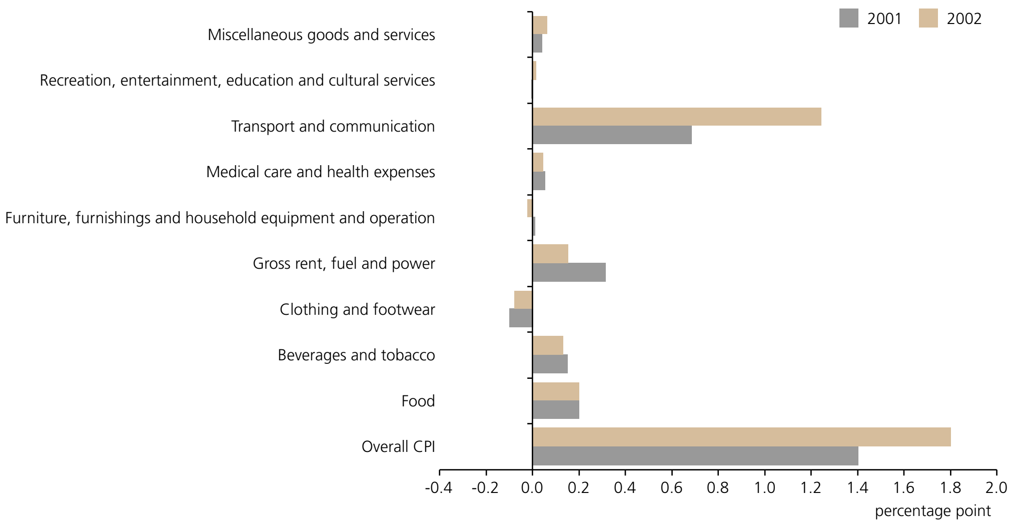


Table 1.18
Price Indicators

	Weight	2001	2002
Consumer Price Index (2000=100)	Annual change %		
	100.0	**1.4**	**1.8**
of which:			
Food	33.8	0.7	0.7
Beverages and tobacco	3.1	4.8	4.2
Clothing and footwear	3.4	-2.6	-2.3
Gross rent, fuel and power	22.4	1.4	0.7
Furniture, furnishings and household equipment and operation	5.3	0.1	-0.4
Medical care and health expenses	1.8	2.9	2.4
Transport and communication	18.8	3.6	6.6
Recreation, entertainment, education and cultural services	5.9	-0.1	0.2
Miscellaneous goods and services	5.5	0.7	1.1
Consumer Price Index by Region			
Peninsular Malaysia	81.6	1.5	2.1
Sabah	8.9	0.6	0.8
Sarawak	9.5	0.8	1.0
Producer Price Index (1989=100)	**100.0**	**-5.0**	**4.4**
of which:			
Local Production	79.3	-6.1	5.7
Imports	20.7	-0.3	-0.7
House Price Index (1990=100)		**-0.6**	**-**
of which:			
Klang Valley		-0.3	-
Johor Bahru		-6.0	-
Penang Island		-5.2	-

Source: Department of Statistics, Malaysia
NAPIC, Department of Valuation and Property Services

prices for clothing and footwear; and furniture, furnishings and household equipment.

Producer Prices

Producer prices were higher during the year in tandem with the sharp recovery in commodity prices. The Producer Price Index (PPI) rose by 4.4% in 2002 compared with a decline of 5% in 2001. The increase was largely contributed by higher prices charged for goods produced locally, which recorded a price increase of 5.7% during the year (2001: -6.1%) and accounted for 79.3% of the total PPI basket. This reflected higher prices for commodity-related products following the sharp increase in prices of crude palm oil, crude petroleum and rubber during the year. Excluding these commodity-related products, producer prices remained relatively stable, increasing only by 0.1%. Meanwhile, prices for goods paid by importers were also stable during the year, as excess global capacities and competition for markets eroded the pricing powers of producers.

Labour Market Developments

Labour market conditions remained favourable in 2002 to support the recovery in economic activity. The latest estimates showed that the total labour force and employment expanded moderately by 3.1% to 10.2 million persons and 3.2% to 9.8 million workers, respectively. Consequently, the unemployment rate declined from 3.6% to 3.5%, and remained close to the full employment level. The improved labour market conditions during the year were also reflected in the significant decline in the number of retrenched workers and higher demand for labour. Measures were taken in 2002 to improve the quality of labour and to address concerns of mismatch of skills with labour demand. Human resource development remained a priority area in continued reforms to strengthen the Malaysian economy.

On a sectoral basis, the majority of the new workers (175,000) was employed by the services sector, raising its share of total **employment** to 52.6%. The new jobs created were concentrated mainly in the "other services" sub-sector (60,000), which included education, health and social work, other community, social and personal service activities and private households with employed persons. Reflecting the

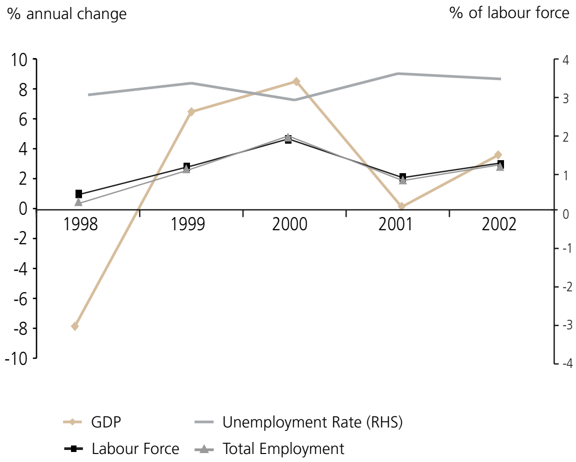
Table 1.19
Labour Market Indicators

	1998	1999	2000	2001	2002e
Labour force ('000)	8,884	9,152	9,616	9,892	10,199
(annual change in %)	1.1	3.0	5.1	2.9	3.1
Employment (annual change in %)	0.4	2.7	5.5	2.3	3.2
Unemployment rate (% of labour force)	3.2	3.4	3.1	3.6	3.5
Labour productivity (GDP/Employment) (annual change in %)	-7.7	3.3	2.7	-1.8	0.9
Real wage per employee in manufacturing sector (annual change in %)	-2.4	3.1	5.0	1.7	2.9

e Estimate

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

Graph 1.32
Output and Employment

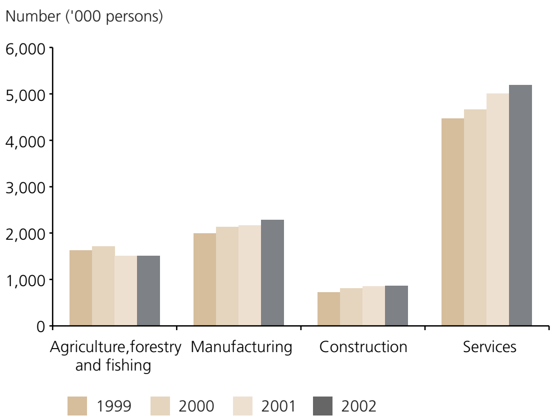


Source: Department of Statistics, Malaysia
Bank Negara Malaysia

pick up in activity in the manufacturing sector in the second half-year, particularly in the electronics sub-sector, employment in the manufacturing sector also increased in 2002, with 124,000 new jobs created.

Reflecting the improved economic environment in 2002, the number of workers retrenched declined significantly by 30.6% to 26,457 while those offered the Voluntary Separation Scheme (VSS) declined by 22.6% to 21,486. In the banking sector, 1,741 employees accepted the VSS in 2002, bringing the total number of employees that have taken VSS as a result of the consolidation programme for domestic banking institutions to 5,981 as at end-December 2002.

Graph 1.33
Total Employment by Sector

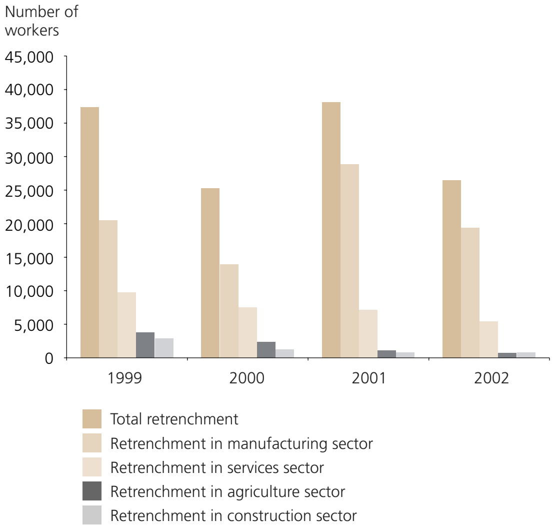


Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Lower **retrenchments** were recorded in all the main sectors of the economy. In particular, the overall decline was attributable to a lower number of workers retrenched in the electronics and electrical products sub-sector (10,496; 2001: 17,413) and agriculture, forestry and fishing sector (733; 2001: 1,129). The number of employers who trimmed their work force also declined by 10.4% to 1,236. More encouraging was the decline by one half to 9,917 in retrenchment that arose from lower product demand and company reorganisation. By job category, production related workers, particularly semi-skilled workers, were the main groups retrenched (58%), indicating that cost cutting measures mainly affected the low-end workers. The retrenchment of professional, technical and related workers declined significantly by 26%. Local workers accounted for the majority (90.8%) of the total number of retrenched workers. In terms of location, West Malaysia accounted for 96% of retrenched workers, with Penang, a major producer of electronics products, continuing to account for the largest share of 24% of total retrenchments, followed by Selangor (21%) and Johor (13%). At the same time, the underemployment of workers was reduced in line with the improved economic performance and favourable prices of palm oil and rubber. This was reflected in a lower number of workers working shorter hours (61,959; 2001: 91,915) as well as accepting pay cuts (17,425; 2001: 36,294).

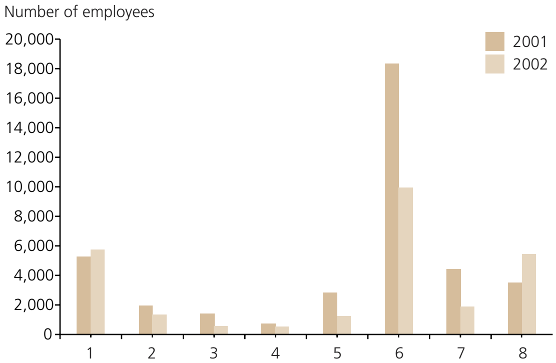
In tandem with the economic recovery, **labour demand** as measured by the number of job vacancies reported to the Manpower Department of the Ministry of Human Resources increased by 23.8% to 162,787 in 2002 (2001: 6.5%). The increase was recorded across the board, with the exception of the transport, storage and communications sub-sector, where vacancies declined by 13.5%. Of significance was the large increase of 25.1% in job vacancies in the manufacturing sector from a decline of 10.4% in 2001. This sector continued to account for nearly half (46.5%) of the vacancies reported during the year. By occupational group, vacancies were reported mostly for production related (63.2%) and agriculture related (21.1%) jobs. During the year, the rising need for high-end skilled workers resulted in more vacancies for professional, technical, administrative and managerial jobs, which increased significantly by 70.8% to 8,575 vacancies. Sarawak continued to account for more than half of the job vacancies. The repatriation of

Graph 1.34
Retrenchment by Sector



Source: Ministry of Human Resources

Graph 1.35
Reasons for Retrenchment



1 Closure of companies
2 Sale of companies
3 Relocation to foreign countries
4 Relocation locally
5 High production cost
6 Reduction in demand for products
7 Company reorganisation and automation
8 Others

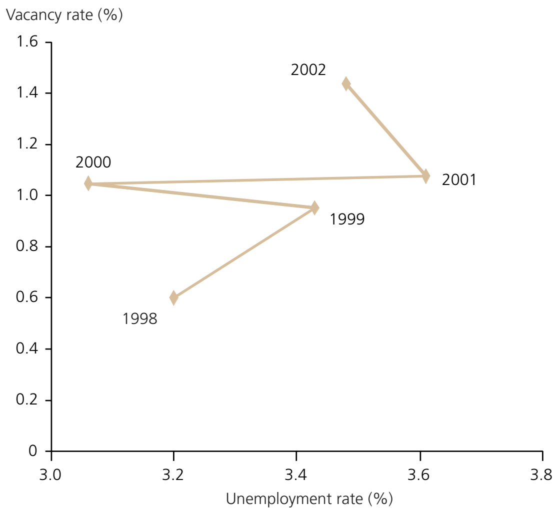
Source: Ministry of Human Resources

illegal foreign workers during the amnesty period also resulted in a large number of vacancies in the construction sector. However, this was not reflected in the number of job vacancies as it was not compulsory for companies to report vacancies to the Manpower Department.

The total number of active **job seekers** registered with the Manpower Department declined by 5.5% to 32,305 as at end-2002. While most job vacancies were for production related and agriculture related jobs, a large part of the jobs sought were related to clerical (49.4%), professional, technical and administrative (21%) and production (20.3%) work. This reflects a continued mismatch of demand and supply of skills in the labour market. In particular, there was a shortage of agriculture and production workers, while professional, technical and administrative related as well as clerical related workers were in excess supply. The continued shortage of production workers despite the large number of job seekers in that category suggested that the Malaysian manufacturers were looking for more skilled workers as they moved production up the value chain.

An analysis of the Beveridge (Unemployment-Vacancy[1]) Curve suggests that although the mismatch between labour supply and demand has persisted into 2002, there are indications of a structural improvement in the labour market. The higher vacancy to unemployment ratio together with a leftward shift in the curve from 2001 to 2002 indicated that an increased number of unemployed persons have filled the vacant positions. This reflected an improvement in job matching due to the continued efforts by the Government to increase the quality and mobility of workers.

Graph 1.36
Beveridge Curve for Malaysia (1998-2002)



Source: Department of Statistics, Malaysia
Ministry of Human Resources
Bank Negara Malaysia

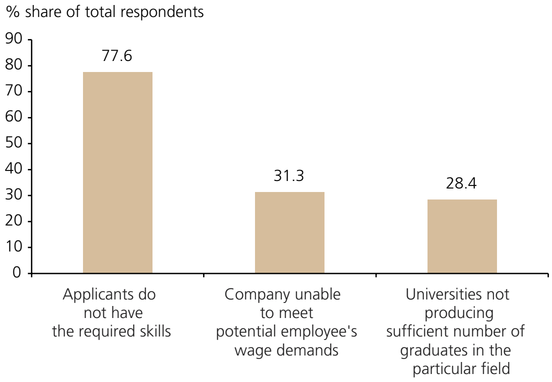
[1] Vacancy rate = $\frac{\text{(No. of job offers – No. of placements)}}{\text{(No. of employees + No. of job offers – No. of placements)}}$

As at end-September 2002, the majority of the active job seekers and unemployed comprised those with secondary school qualifications (80% and 62.9%, respectively). The number of unemployed graduates increased to 45,400 or 0.1% of the total unemployed as at end-September 2002 and accounted for 0.5% of the total labour force (end-2001: 38,800 or 0.4% of total labour force). This increase was due mainly to the increased number of graduates with diploma qualifications (from 18,200 to 26,300) as the number of unemployed graduates with degree qualifications declined from 20,600 to 19,100. Whilst the unemployment situation of graduates is generally cyclical, increasing when economic growth declines, there are also other factors contributing to the increase in graduate unemployment in recent years. A Survey on Employability of Graduates, which was undertaken by Bank Negara Malaysia in July 2002 to identify employer-defined job requirements, indicates that a major problem is the mismatch of skills as most of the respondents considered that a significant proportion of graduates did not meet the skill needs of industries and the problem was more acute for local graduates.

With continued excess capacity experienced by selected sectors, the pick up in economic activity has not exerted undue pressure on **wages** in 2002. Available indicators on wages showed that increases in wage rates had moderated:

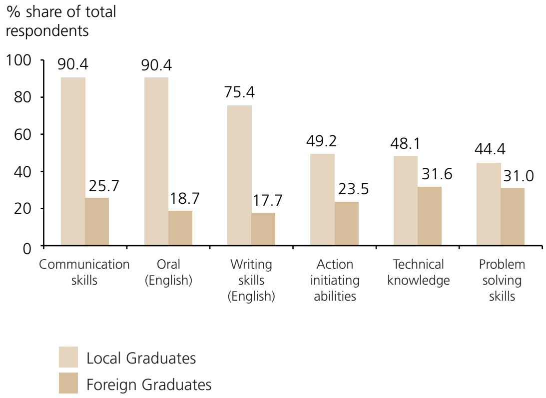
- Data from the Monthly Manufacturing Survey conducted by the Department of Statistics indicated that on an annual basis, real wage per employee increased by 2.9% (2001: 1.7%).
- The Malaysian Employers Federation's (MEF) Salary and Fringe Benefits Survey showed that the increase in the average private sector salary was lower at 6% in 2002 (2001:6.9%). On a sectoral basis, the average salary increase in the non-manufacturing sector was slightly higher (6.1%; 2001: 7.1%) than the manufacturing sector (5.9%; 2001: 6.7%). The average minimum salary offered to those with a basic degree remained stable at RM1,675.
- Only two industrial strikes relating to demand for higher wages were reported in 2002, involving the manufacturing and agriculture sectors.

Graph 1.37
Factors Influencing Employment of Graduates



Note:
In a survey conducted by Bank Negara Malaysia covering 312 companies to identify employer-defined job requirements, 71.7% (134) out of the 187 companies that responded to the survey reported that they have less than sufficient staff for selected graduate level occupations. Out of those that cited staff insufficiency:
- 77.6% indicated that graduates do not have the required skills;
- 31.3% indicated that they were unable to meet the potential employee's wage demands; and
- 28.4% indicated that the universities were not producing the sufficient number of graduates in selected fields.

Graph 1.38
Skills Comparison Between Local Graduates and Foreign Graduates



Note:
Whilst 184 companies cited at least one skill weakness displayed by local graduates, a lower number (147) indicated the same for foreign graduates.
- The most widely reported skills gap pertained to both communication skills and English language oral skills, with 90.4% of respondents indicating that local graduates were lacking in such skills.
- 75.4% indicated that local graduates displayed poor English language writing skills.
- Most respondents across all the sub-sectors surveyed cited poor communication and English language skills among local graduates. There were no distinct variations noted between locally-owned/ foreign-owned companies and public/private companies, implying that the deficiencies were generic amongst all types of companies.
- The proportions of respondents that indicated the same six deficiencies for foreign graduates are consistently lower than that for local graduates.

Labour productivity, as measured by the ratio of GDP to total employment, improved to record a positive growth of 0.9% in 2002 (2001: -1.8%). The productivity growth was attributed mainly to improved productivity in the construction, services and manufacturing sectors. Productivity in the construction sector turned around to register a positive growth of 1.1% (2001: -3.4%), while productivity in the services sector registered a positive growth of 0.8% (2001: -1.6%) due mainly to improved productivity in the finance, insurance, real estate and business services sub-sector as well as the wholesale, retail trade, restaurant and hotel sub-sector. In line with the better performance of the manufacturing sector in 2002, particularly in the export-oriented industries, the rate of decline in productivity in the manufacturing sector moderated to 1.6% in 2002 (2001: -7.6%).

The Government continued to undertake a number of initiatives as part of its efforts to increase the quality of workers and meet the changing demands of employers in line with structural changes in the economy. Measures to increase labour mobility across sectors included holding job fairs nation-wide and conducting retraining programmes for workers who were retrenched. Other initiatives that were taken included the Electronic Labour Exchange Project (ELX). The ELX, which came into operation in May 2002, was designed to effectively match job seekers with vacancies over larger geographical areas to improve labour mobility. As at end-2002, a total of 11,000 active job seekers were registered with the exchange, while 2,040 job vacancies had been advertised on the exchange by 720 employers.

In order to alleviate the shortage of workers in certain sectors, the Government approved the recruitment of 545,725 new **foreign workers** (2001: 258,578). In total, the number of registered foreign workers increased by 111% to 1,057,156 in 2002. The majority of foreign workers were engaged in the manufacturing, agriculture, domestic services and construction sectors. While the recruitment of Indonesians accounted for the largest proportion (71.4%) of total registered foreign workers, the recruitment of workers from Thailand increased significantly to 23,660 in 2002 (2001: 2,240), with the majority being absorbed by the construction sector.

In view of the large number of illegal immigrants in the country, the Government implemented several measures in 2002 to address the security issues. One of the measures included the revision to the Immigration Act. The new Immigration Act 1959/63 (Amendment 2002), which came into effect on 1 August 2002, provides for heavier penalties to be imposed on those found guilty of employing illegal immigrants or entering Malaysia illegally. Employers took advantage of the amnesty programme period during 22 March to 31 July 2002 to repatriate the illegal immigrants. During the amnesty period, 318,272 illegal immigrants were deported, with immigrants from Indonesia (84.7%) accounting for the majority of those deported, followed by India (6.3%) and Bangladesh (5.5%).

In order to have a more regulated inflow of foreign workers, the Government is currently in the process of preparing the Memorandum of Understanding (MoU) with 13 countries (India, Indonesia, Cambodia, Kazakhstan, Laos, Myanmar, Nepal, the Philippines, Sri Lanka, Thailand, Turkmenistan, Uzbekistan and Vietnam), which will supply labour to Malaysia. Among the new terms incorporated in the MoU are that the workers must be able to communicate in either Bahasa Malaysia or English, be free of any criminal record and the host government must be accountable to send these workers back if they violate Malaysian laws. With the MoU, recruitment procedures would be made more systematic and would allow developing a comprehensive data base on foreign workers in the country.

In September, the Government had also revised the policy and guidelines relating to the employment of foreign workers to further alleviate the problem of shortage of skilled workers following the end of the amnesty period, particularly in the manufacturing and construction sectors. Under the new guideline, experienced foreign workers who have been certified by the National Vocational Training Council may extend the duration of their stay for another five years, to a total of 10 years. In 2002, a total of 12,662 foreign workers from the manufacturing (8,974), services (2,215) and agriculture (1,473) sectors have been certified as skilled workers by the National Vocational Training Council.

The Government would continue its efforts to expand the pool of skilled labour and enhance the quality of skilled manpower in preparation for the shift to a knowledge-based economy. In the 2003 Budget, the Government allocated a total sum of RM1.62 billion to the Ministry of Human Resources, Ministry of Youth and Sports and the Ministry of Entrepreneur Development to implement various skills training programmes and to provide infrastructure facilities. In line with the Government's intention to develop more skilled manpower for research and development, a Training Grant of RM100 million would also be established. This would be channelled to private sector companies for financing the training of their R&D personnel.

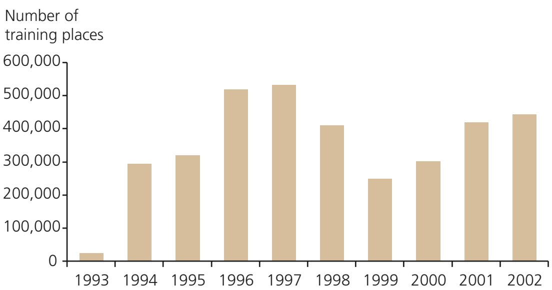
The status of projects that were implemented in 2001 with the objective of upgrading the quality of human resources is as follows:

- **Dual System Project** – This project aims to prepare adolescents to become knowledge-workers through industry-oriented training that will be conducted at the workplace under actual work conditions. The project, which consists of five major components, is presently at the first stage that deals with the creation of a dual Technical Educational and Vocational Training (TEVT) culture and to increase the direct involvement of industry and small- and medium-sized enterprises (SMEs) in TEVT.

- **Brain-Gain Programme** – As at end-2002, a total of 184 out of 506 applications received were approved under this programme, which encourages Malaysian citizens with special expertise working abroad to return to Malaysia for nation building. Out of the approved applications, 47 were in the ICT, research and development and biotechnology fields.

- **Special Scheme for Unemployed Graduates and Retrenched Workers** – A total of 37,033 participated in the various attachments and training schemes for the unemployed graduates, while 9,499 participated in the scheme for retrenched workers and school leavers. As at end-2002, a sum of RM254 million had been utilised for the various programmes under this scheme. All the programmes (except the attachments with government agencies, which ended in October 2002) will continue to be conducted until all the allocated fund of RM300 million has been fully utilised.

Graph 1.39
Number of Training Places Approved by PSMB



Source: Pembangunan Sumber Manusia Berhad

- **Staff Re-Skilling (StaRs) Project** – As at end-2002, nine financial institutions participated in the StaRs Project. The project is aimed at preparing staff of financial institutions who are leaving the industry under the Voluntary Separation Scheme to re-equip themselves with competencies catering to the needs of the knowledge-based economy to facilitate their entry into other industries. During the year, the Institute of Bankers Malaysia conducted a total of 26 programmes, benefiting about 714 trainees.

In 2002, the Pembangunan Sumber Manusia Berhad (PSMB), which administers the Human Resource Development Fund (HRDF) for the retraining and skills upgrading of workers, approved 441,102 training places for the 14 training schemes under the HRDF, with financial assistance of RM319.5 million. Since its inception in 1993, the PSMB has approved a total of 3.5 million training places with a total expenditure of RM1.3 billion. As at end-December 2002, the total number of employers registered with the PSMB increased to 8,172, with the majority (71%) from the manufacturing sector and the remainder from the services sector. Given the lower levy imposed by the PSMB in 2002, the HRDF levy collection declined to RM121.2 million from RM209.1 million in 2001. However, as of 1 November 2002, the levy imposed by the PSMB was reverted from 0.5% to 1% of the companies' monthly wages in 2002.

As a coordinating agency of the retrenched workers and unemployed graduates training schemes, the PSMB also managed, in 2002, the allocation of RM137 million that benefited a total of 20,573 trainees (graduates: 11,787) under the "Training Scheme for the Unemployed and Retrenched Workers" and "Graduate Training Scheme". In addition, the Skills Development Fund (SDF) disbursed a total of RM181.6 million (2001: RM24.2 million) to 36,700 approved applications (2001: 5,000). The SDF was established by the Ministry of Human Resources to provide soft loans for technical and vocational training offered by institutions that are accredited by the National Vocational Training Council.

EXTERNAL SECTOR

Balance of Payments

The **overall balance of payments** strengthened further to record a larger surplus in 2002. The improvement reflects the sustained strong current account surplus and larger long-term capital inflows into Malaysia while short-term outflows by the private sector declined. The current account surplus narrowed marginally but remained large at RM27.4 billion or equivalent to 8.1% of GNP. While the services and income accounts improved, the outflow of current transfers was larger during the year.

The strong recovery in exports led to continuing large surplus in the trade account. At the same time, profits and dividends accruing to Malaysian companies investing abroad turned around to record net inflows, leading to an improvement in the income account. In the services sector, cumulative effects of policies to develop the sector resulted in a significant narrowing of the services account deficit to RM6 billion or 1.8% of GNP.

The financial account showed an improvement with higher inflows of long-term capital, namely, foreign direct investment (FDI) and external loans by the Federal Government. Despite a higher net portfolio outflow amidst general weakening of regional and global stock markets and heightened geopolitical risks, the overall private sector short-term capital outflows have declined, due partly to widening of interest differentials in favour of Malaysia. The overall balance of payments recorded a surplus of RM14.2 billion or US$3.7 billion, after adjusting for errors and omissions of -RM1.2 billion. A significant component of the errors and omissions was the exchange revaluation gain (RM6.6 billion) from revaluation of international reserves of Bank Negara Malaysia due mainly to the appreciation of euro and the yen against the US dollar. Consequently, the net international reserves of Bank Negara Malaysia increased by RM14.2 billion to RM131.4 billion (US$34.6 billion) as at end-2002. Reserves increased further to RM131.7 billion (US$34.7 billion) as at 14 March 2003. This level of reserves represented 5.3 months of retained imports and was 4.4 times the

The external position strengthened further with continued accumulation of international reserves. Current account surplus remained large while the financial account improved due to larger long-term capital inflows.

Table 1.20
Balance of Payments

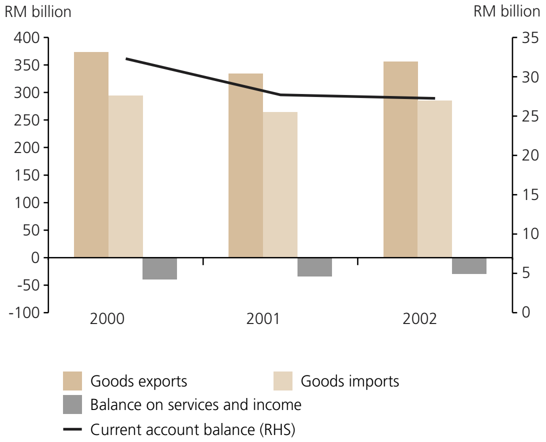
Item	2001 +	2001 -	2001 Net	2002e +	2002e -	2002e Net
			RM million			
Goods	334,326	264,472	69,854	354,855	285,942	68,913
Trade account	*334,284*	*280,229*	*54,055*	*354,475*	*303,508*	*50,967*
Services	54,929	63,295	-8,366	56,536	62,501	-5,965
Balance on goods and services	389,255	327,767	61,488	411,391	348,443	62,948
Income	7,018	32,641	-25,623	8,064	33,253	-25,189
Current transfers	2,040	10,218	-8,178	2,511	12,879	-10,368
Balance on current account	398,313	370,626	27,687	421,966	394,575	27,391
% of GNP			9.0			8.1
Capital account			-			-
Financial account			-14,791			-11,952
Direct investment			1,091			4,667
Portfolio investment			-2,466			-6,718
Other investment			-13,416			-9,901
Balance on capital and financial account			-14,791			-11,952
Errors and omissions			-9,234			-1,248
of which:						
Exchange revaluation gain (+) or loss (-)			*-4,060*			*6,627*
Overall balance			3,662			14,191
Bank Negara Malaysia international reserves, net			117,203			131,394
(US$ million)			30,843			34,577

e Estimate

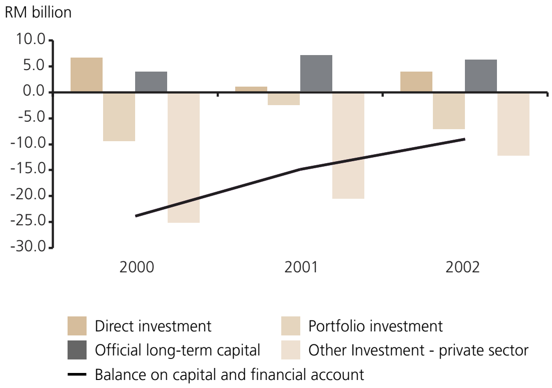
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Graph 1.40
Malaysia: Balance of Payments

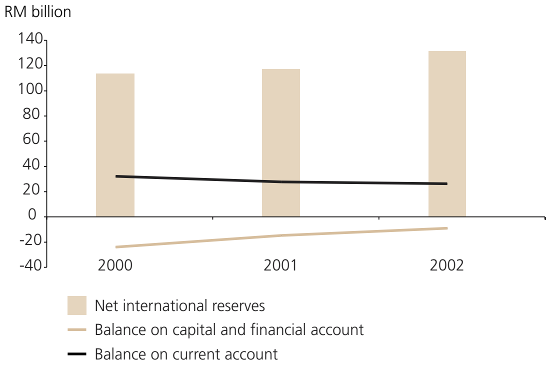
Current Account



Capital and Financial Account



Net International Reserves



short-term external debt. Malaysia's reserves are usable and unencumbered.

The **current account surplus** remained large at RM27.4 billion or equivalent to 8.1% of GNP in 2002, despite the higher growth in imports in line with the pick up in domestic demand. The recovery in export growth emanated from stronger demand for electronics exports and a significant improvement in the terms of trade for commodity exports. The surplus in the goods account was more than sufficient to offset the deficits in the services and income accounts and also net outflows in the current transfers account. The decline in the services deficit reflected sustained improvement in the travel account surplus and lower payments for contract and professional charges. The income account deficit improved, reflecting the turnaround in profits and dividends accruing to Malaysian companies investing abroad. Meanwhile, profits and dividends accruing to foreign investors remained large, in line with the higher export earnings. A factor contributing to the marginal narrowing of the current account surplus was a larger net outflow of current transfers of RM10.4 billion (-RM8.2 billion in 2001). This arose largely from the one-off remittance by illegal foreign workers returning to their country under the Amnesty Program from 22 March to 31 July 2002.

In 2002, **gross exports** turned around to record a growth of 6% due largely to the significant pick-up in the export of semiconductors. The recovery in electronics exports reflected increased external demand particularly from the Asia Pacific region and, to some extent, the US. Agriculture exports was also stronger from the improvements in both prices and volume. Mineral exports, however, declined due to lower revenue from LNG and tin exports which more than offset the increase in earnings from crude oil. The expansion in exports began in March 2002 and peaked in the third quarter. Reflecting the strong expansion in domestic demand and the recovery in exports, imports increased at a faster pace (8.3%) relative to exports. Thus, the trade surplus, while still large, narrowed to RM51 billion (US$13.4 billion). Malaysia's total trade expanded by 7.1% to RM658 billion to account for 196% of GNP in 2002. After adjustments for valuation and coverage on the balance of payments basis, the goods account recorded a large surplus of RM68.9 billion (US$18.1 billion).

Exports of manufactured goods, which accounted for about 84% of gross exports, turned around to increase by 4.8% in 2002 (2001: -10.3%). The recovery was led mainly by strong demand for electronics, particularly semiconductors, exports of which rose sharply by over 40% in the second half of 2002. Exports of chemical products and transport equipment also recorded significant increases during the year, while the export value of electrical goods declined due largely to lower export prices. On a quarter-on-quarter basis, manufacturing exports strengthened gradually to reach

Table :1.21
Gross Exports

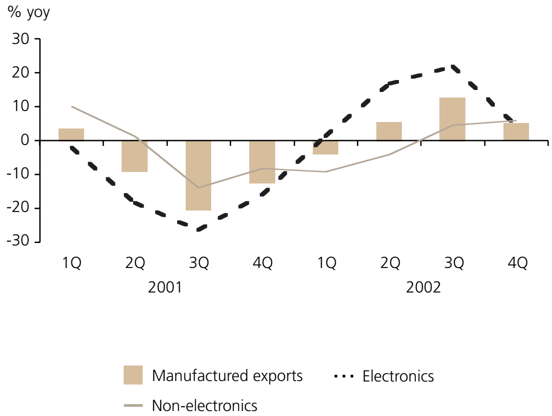
	2002p		
	RM million	Annual change (%)	% share
Manufactured goods	**298,925**	**4.8**	**84.3**
Of which:			
Electronics, electrical machinery and appliances	209,137	4.4	59.0
Electronics	154,386	10.6	43.6
Semiconductor	*72,547*	*19.9*	*20.5*
Electronic equipment & parts	*81,839*	*3.5*	*23.1*
Electrical machinery & appliances	54,751	-9.8	15.4
Consumer electrical products	*21,097*	*-10.6*	*5.9*
Industrial & commercial electrical products	*19,511*	*-17.0*	*5.5*
Electrical industrial machinery and equipment	*12,751*	*2.3*	*3.6*
Household electrical appliances	*1,392*	*26.1*	*0.4*
Chemicals & chemical products	17,285	16.2	4.9
Manufactures of metal	8,827	1.5	2.5
Textiles, clothing and footwear	8,587	-5.2	2.4
Optical and scientific equipment	8,157	4.6	2.3
Wood products	6,314	4.9	1.8
Rubber products	4,512	1.0	1.3
Transport equipment	2,931	20.8	0.8
Agricultural commodities	**26,340**	**31.9**	**7.4**
Of which:			
Palm oil	*14,838*	*50.2*	*4.2*
Rubber	*2,492*	*32.1*	*0.7*
Sawn timber	*2,228*	*-2.0*	*0.6*
Saw logs	*1,790*	*17.5*	*0.5*
Minerals	**22,406**	**-4.4**	**6.3**
Of which:			
Crude oil	*11,597*	*4.3*	*3.3*
LNG	*9,932*	*-10.7*	*2.8*
Tin	*425*	*-7.7*	*0.1*
Other exports	**6,804**	**22.5**	**2.0**
Total	**354,475**	**6.0**	**100.0**

p Preliminary

Source: Department of Statistics, Malaysia

Graph 1.41
Export Performance of the Manufacturing Sector

Graph 1.42
Export Performance of Electronics and Non-electronics Industries



a peak in the third quarter. Overall, the increase in manufacturing exports in 2002 was mainly due to higher volume (7.9%). Export prices declined further as producers reduced prices to remain competitive.

Export proceeds from the **primary commodity sector** turned around to register a strong growth of 12.3% in 2002 due entirely to the significant increase in agriculture exports (31.9%), while mineral exports declined. The marked increase in export prices of Malaysia's major **agriculture commodities** was due to tight global supplies while demand growth remained steady. Export prices of cocoa, palm oil, rubber and saw logs rose sharply by 49.5%, 44.7%, 17% and 16.6% respectively. Despite higher prices, external demand for palm oil remained favourable during the year, reflecting higher imports by the People's Republic of China and the Middle East. Export proceeds from **minerals** declined by 4.4% due to lower earnings from liquefied natural gas (LNG) and tin. Crude oil exports rose, underpinned by higher purchases from Japan, India and the People's Republic of China. During the year, export prices for Malaysia's crude oil averaged slightly lower at US$24.80 per barrel (2001: US$25.53 per barrel). LNG exports, however, were also affected by lower demand from Japan, which is a major importer.

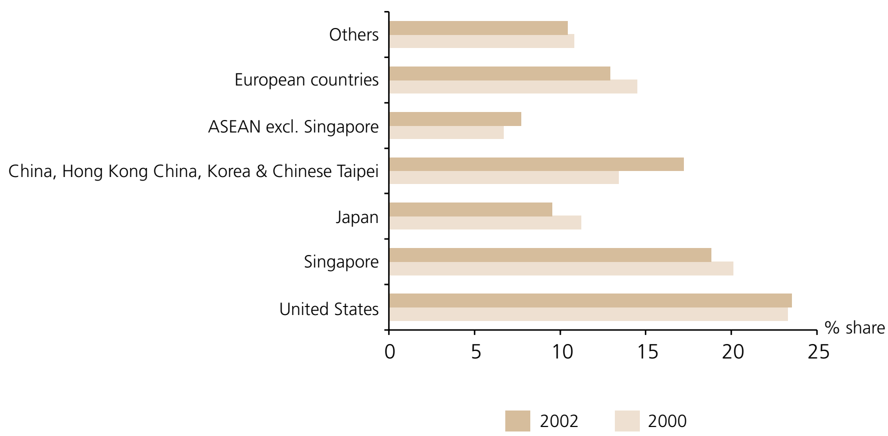
Gross imports turned around to increase by 8.3%, reflecting mainly higher import volume. The strong growth in imports was due to strengthening domestic demand and higher imports of intermediate and capital goods. Imports of intermediate goods were mainly inputs for the manufacture of goods for exports. Imports of capital goods also increased, reflective of higher investment activity, particularly in the services sector.

Imports of intermediate goods, which accounted for 71.3% of total imports, expanded by 6.2%. Increased imports were mainly inputs for the export-oriented electronics industry, which increased by 15.9%. Electronics components accounted for 29.2% of total imports, underlining the high import content of the electronics industry as well as the importance of the electronics industry as the main driver of manufacturing production during the year. Similarly, the value of imports of primary and processed industrial supplies, which are used as components in the production of exports and account for about 21.3% of total imports, also increased.

Another significant development was the continued increase in intermediate imports that were related to the manufacture of goods for the domestic market. Imports of primary and processed materials

The trade surplus remained large. Export earnings growth mainly from increased volume of manufactured exports and higher commodity prices. Prices of manufactured exports declined further.

Graph 1.43
Exports of Manufactured Goods by Destination



used by the food and beverages industry increased in line with sustained consumer spending on food and beverages. Meanwhile, growth of the motor assembly industry arising from robust demand for passenger cars also caused imports of parts and accessories of transport equipment to expand significantly by 28.1%.

Reflecting the recovery of private investment in the second half of the year, **imports of capital goods** increased by 10.6%. The increase in capital goods imports for capacity expansion occurred in the services, construction and mining sectors while capital imports for the manufacturing sector declined due to excess capacity in some sub-sectors. Investment in information and communication technology and capacity expansion in response to rising demand for cellular services and adoption of new technology underpinned the growth in imports of telecommunications equipment. This was reflected in the efforts of the telecommunication industry to roll-out new services and upgrade the mobile telephone network. In addition, in line with the expansion in the services sector, higher capital imports were recorded for office equipment and generators, turbines and electric motors for power generation. Increased exploration and downstream activities in the oil and gas industry in the wake of high prices for petroleum led to the increase in imports of construction and mining equipment. The increase in imports of aircraft and ships by the airlines and shipping companies reflected fleet expansion to service new markets and long-term contractual obligations.

Consonant with sustained private consumer spending, **imports of consumption goods** increased

Table 1.22
External Trade

	2001	2002	2001	2002
	RM billion		US$ billion	
Gross export (f.o.b)	**334.3**	**354.5**	**88.0**	**93.3**
Annual change (%)	-10.4	6.0	-10.4	6.0
	Annual change (%)			
Volume[1]	-4.2	6.8	-4.2	6.8
Prices[1]	-6.2	-1.3	-6.2	-1.3
Gross import (c.i.f)	**280.2**	**303.5**	**73.8**	**79.9**
Annual change (%)	-10.0	8.3	-10.0	8.3
	Annual change (%)			
Volume[1]	-8.6	5.0	-8.6	5.0
Prices[1]	-1.8	2.3	-1.8	2.3
Trade balance	**54.1**	**51.0**	**14.2**	**13.4**

[1] Volume and prices are estimates.

Source: Department of Statistics, Malaysia

significantly by 15.9%. The growth in consumption goods imports reflected mainly higher imports of durable, semi-durable and non-durable consumer goods namely, furniture, cameras and optical equipment, household electrical goods such as washing machines, electric stoves and refrigerators, leather goods and clothing and footwear. In terms of share of imports, consumption goods has remained relatively stable, accounting for 6.3% of total imports.

Malaysia's continuous efforts to diversify markets and enlarge its export share were reflected in the expansion of trade as well as the diversification of markets in 2002. The diversification of markets is measured by the normalised Herfindahl-Hirschmann index where a ratio closer to zero reflects increasing diversification. The index was constructed for 32 of Malaysia's major trading partners which account for 93% of total exports. Reflecting the increasing diversification in export markets, the index declined to 0.16 in 2002 from 0.17 in 2001 (1995: 0.19). As measured by the index, Malaysia's export markets were further diversified by 3% in 2002.

Malaysia's trade with the major **trading partners**, namely, the United States, Singapore, Japan, and the European Union, declined slightly to 59.2% (2001: 62.5%) of Malaysia's total trade, following higher exports to the region, particularly Asean (excluding Singapore) and North East Asia (excluding Japan). On the other hand, trade with the East Asian region (excluding Japan and Singapore) increased to 29.5% of total trade (2001: 25.4%), contributed by the sharp increase in trade with the People's Republic of China.

Graph 1.44
Imports

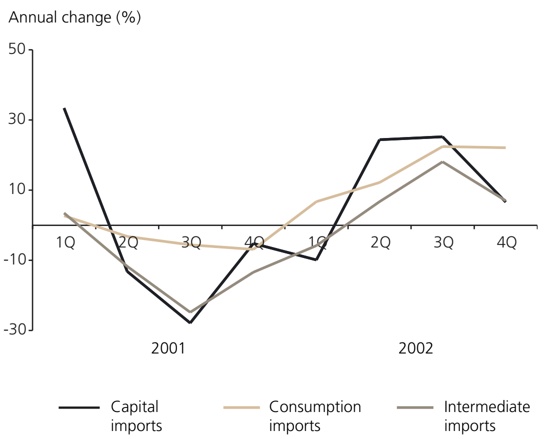


Table 1.23
Gross Imports by End Use

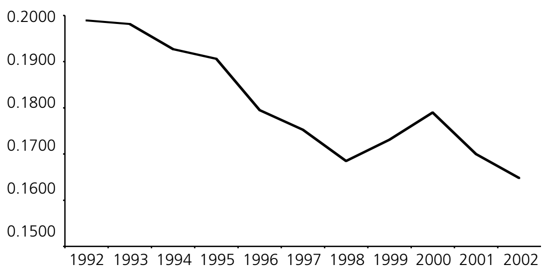
	2002*p*		
	RM million	Annual change (%)	% share
Capital goods	**45,672**	**10.6**	**15.0**
Capital goods (except transport equipment)	40,611	5.2	13.4
Industrial machinery and equipment	*10,281*	*-16.1*	*3.4*
Office equipment	*7,893*	*20.2*	*2.6*
Telecommunication equipment	*5,852*	*27.7*	*1.9*
Transport equipment	5,061	89.6	1.7
Intermediate goods	**216,492**	**6.2**	**71.3**
Food and beverages, mainly for industry	5,153	11.8	1.7
Industrial supplies, n.e.s.	64,695	4.4	21.3
Metals & metal products	*17,856*	*4.5*	*5.9*
Chemicals	*6,938*	*-1.5*	*2.3*
Fuels and lubricants	11,073	0.5	3.6
Parts and accessories of capital goods (except transport equipment)	128,431	7.1	42.3
Electronics	*88,476*	*15.9*	*29.2*
Parts and accessories of telecommunication equipment	*7,049*	*-2.6*	*2.3*
Parts and accessories of transport equipment	7,140	28.1	2.4
Consumption goods	**19,263**	**15.9**	**6.3**
Food and beverages, mainly for household consumption	7,173	0.5	2.4
Transport equipment, non-industrial	173	39.0	0.1
Consumer goods, n.e.s.	11,917	27.4	3.9
Consumer durables	*2,865*	*58.4*	*0.9*
Consumer semi-durables	*4,234*	*23.9*	*1.4*
Consumer non-durables	*4,817*	*16.7*	*1.6*
Dual use goods	**6,105**	**4.5**	**2.0**
Motor spirit	2,544	3.1	0.8
Passenger motor cars	3,561	5.4	1.2
Others	**6,873**	**19.0**	**2.3**
Re-exports	**9,103**	**32.0**	**3.0**
Gross Imports	**303,508**	**8.3**	**100.0**

p Preliminary
n.e.s: Not elsewhere specified

Sources: Department of Statistics, Malaysia

The **United States** continued to be Malaysia's largest trading partner with a share of 18.4% of total trade. Exports to the US turned around to record a growth of 5.7% in tandem with increased demand for semiconductors. Recovery in the electronics sector led to intermediate imports from the US expanding by 10.7%. The US remained the second largest source of imports. Consequently, the bilateral trade surplus of Malaysia with the US, while still large, declined to RM21.8 billion (2001: RM22.7 billion).

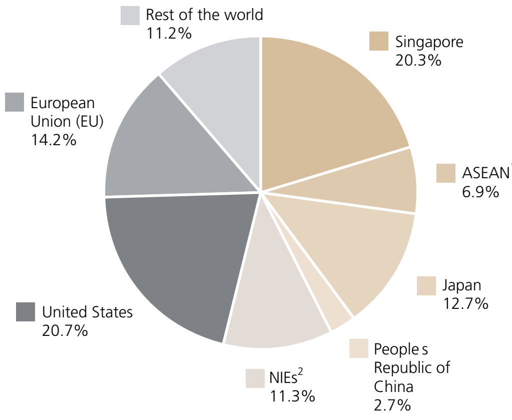
Graph 1.45
Exports Diversification Index



The export diversification index is a modified version of Herfindahl-Hirschmann index. It is normalized to obtain a numeric range from 0 to 1. A lower index signifies higher degree of diversification.

Singapore displaced Japan to become the second most important trading partner although its share of total trade declined marginally to 14.7%. Increased intra-regional trade activities contributed to a higher share of exports bound for Singapore. Exports to Singapore grew by 7.1% and comprised mainly electronics and electrical components, petroleum products as well as paper and pulp products. Imports, comprising mainly machinery and transport equipment, chemicals and manufactured goods, grew by 2.7%. The trade surplus with Singapore increased to RM24.3 billion.

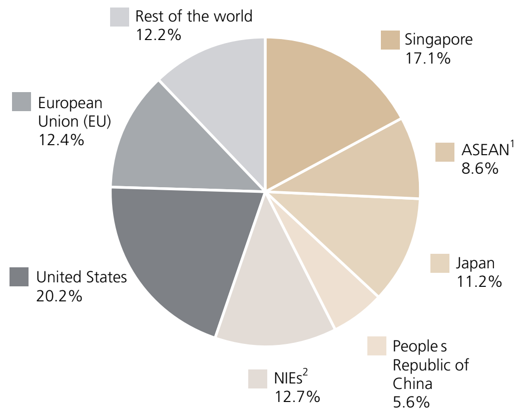
Graph 1.46
Direction of Exports: 1995



[1] ASEAN excluding Singapore

[2] Hong Kong China, South Korea and Chinese Taipei

Direction of Exports: 2002



[1] ASEAN excluding Singapore

[2] Hong Kong China, South Korea and Chinese Taipei

Malaysia's trade with East Asia expanded, supported by strong regional growth, production linkages and outsourcing activity.

Trade with **Japan** declined in relative importance to account for 14.2% of total trade in 2002 (16% in 2001) due to weak demand from Japan. Despite the appreciation of the Japanese yen, imports grew marginally reflecting inelastic demand for imports of machinery and transport equipment. Japan continued to remain the most important source of imports with a market share, albeit smaller, of 17.8% of total imports. Hence, the trade deficit with Japan widened to RM14.1 billion (2001: -RM9.4 billion). Similarly, trade with countries in the **European Union (EU)** declined to 11.9% of total trade in 2002 (2001: 13.2%), reflecting the slowdown in economic activity in the EU countries. The trade surplus in Malaysia's favour increased to RM9.6 billion as the decline in import growth was higher relative to exports.

The strong economic growth in regional economies supported the rapid expansion of intra-regional trade in **East Asia**. The impetus to intra-regional trade stemmed partly from strong economic growth and trade liberalisation in the **People's Republic of China** to comply with the terms of the World Trade Organisation. Reflecting robust growth in both exports and imports, trade with the People's Republic of China expanded by a record 49% in 2002. The People's Republic of China has now emerged as Malaysia's fourth largest trading partner with an increased share of 6.6% of total trade. A second factor underpinning growth of intra-regional trade is the extensive production network and linkages in the region arising from relocation of multinational companies into the People's Republic of China, outsourcing activity and vertical specialisation. Exports to North East Asia as a group, namely Hong Kong China, South Korea and Chinese Taipei expanded, resulting in a higher trade share of 13.2% (2001: 11.9%). The trade pattern was similar for **ASEAN** countries (excluding Singapore) where the trade share rose to 9.7% of total trade (2001: 8.8%). As importers continued to source inputs from lower cost suppliers, Malaysia experienced a trade deficit with the People's Republic of China, Chinese Taipei, South Korea, the Philippines and Indonesia.

The expansion in several sectors of the services industry is mirrored in the progressive improvements in the services deficit in the balance of payments. In terms of GNP, the **services account** deficit declined to 2.9% in the period 1996–2002 from 4.6% in 1991–1995. This improvement was supported by the significant increase in tourism receipts and, to a lesser extent, an improvement in the foreign exchange earnings on airport and port-related services. Policies to promote tourism and more effective coordination of the development and marketing by the public and

Table 1.24
Direction of External Trade

	2002*p*				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	RM million
Selected ASEAN countries	91,177	25.7	69,144	22.8	22,033
Singapore	60,660	17.1	36,317	12.0	24,343
Thailand	15,096	4.3	12,017	4.0	3,079
Indonesia	6,846	1.9	9,689	3.2	-2,843
Philippines	5,073	1.4	9,863	3.2	-4,790
Other ASEAN countries	3,502	1.0	1,258	0.4	2,244
European Union	43,926	12.4	34,368	11.3	9,558
United Kingdom	8,353	2.4	5,970	2.0	2,383
Germany	7,963	2.2	11,163	3.7	-3,200
Netherlands	13,146	3.7	2,450	0.8	10,696
Other EU countries	14,464	4.1	14,785	4.8	-321
United States	71,502	20.2	49,692	16.4	21,810
Japan	39,778	11.2	53,912	17.8	-14,134
The People's Republic of China	19,966	5.6	23,472	7.7	-3,506
Hong Kong China	20,128	5.7	8,837	2.9	11,291
Chinese Taipei	13,224	3.7	16,863	5.6	-3,639
South Korea	11,823	3.3	16,079	5.3	-4,256
India	6,692	1.9	2,445	0.8	4,247
Australia	8,013	2.3	5,411	1.8	2,602
Rest of the world	28,246	8.0	23,285	7.6	4,961
Total	**354,475**	**100.0**	**303,508**	**100.0**	**50,967**

p Preliminary

Source: Department of Statistics, Malaysia

private sectors have led to more than doubling of tourism receipts (1996 - 2002: average RM15.4 billion, 1991 - 1995: average RM6.3 billion). The higher surplus in the **travel account** was also attributable to policies to promote education as an export commodity and development of private

Table 1.25
Services and Income Accounts

	2001	2002e		
	RM billion			
	Net	+	–	Net
Services Account				
Transportation	-11.4	10.8	22.4	-11.5
Travel	16.1	27.0	9.9	17.1
Other Services	-13.2	18.2	29.4	-11.2
Government services n.i.e.	...	0.5	0.8	-0.3
RM billion	**-8.4**	**56.5**	**62.5**	**-6.0**
US$ billion	**-2.2**	**14.9**	**16.4**	**-1.6**
% of GNP	-2.7			-1.8
Income Account				
Compensation of employees	-1.0	1.7	2.8	-1.2
Investment income	-24.6	6.4	30.4	-24.0
RM billion	**-25.6**	**8.1**	**33.3**	**-25.2**
US$ billion	**-6.7**	**2.1**	**8.8**	**-6.6**
% of GNP	-8.3			-7.5

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

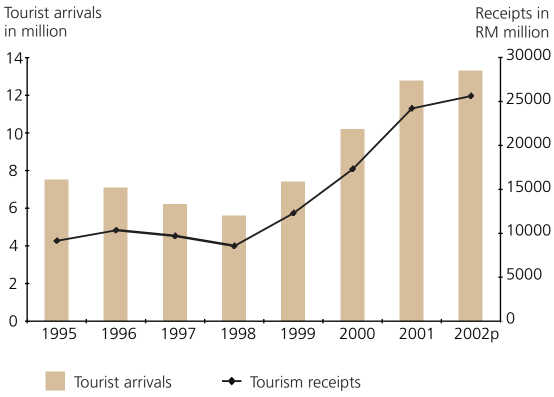
education facilities which attracted foreign students to pursue tertiary education in Malaysia. Similarly, expansion of affordable health care services by the private sector has contributed towards the increase in the number of foreign patients from the regional countries seeking medical treatment locally. The streamlining of processes utilising new technology for the implementation of inter-modal linkages also contributed to improved cargo handling at the airports and ports. These developments, together with increased capacity in the haulage and shipping industry, have supported efforts to stem the outflows in the transportation account.

The cumulative effects of policies to develop the services sector was seen in a significant narrowing of the services account deficit to RM6 billion or 1.8% of GNP in 2002. Gross receipts expanded by 2.9% due largely to the increase in the export of services, particularly in the tourism sector. Overall, the improvement in the services deficit was attributable to higher net inflows in the travel account and lower payments for contract and professional charges with the completion of several large projects. Gross payments declined and services outflow as a percent of GDP fell to 17.3% in 2002 (-18.9% in 2001). Lower payments abroad reflected increasing use of domestic services by manufacturers in line with the Government's efforts to develop the services sector under the cluster-based approach of the Manufacturing Plus-Plus Strategy of the Second Industrial Master Plan.

The net surplus in the travel account increased further in 2002 to RM17.1 billion (RM16.1 billion in 2001), reflecting mainly the 4% growth in tourist arrivals to 13.3 million (2001: 12.8 million) despite the uncertainty faced by the regional tourism industry in the wake of heightened fears of terrorism. The number of excursionist arrivals has also remained high at 7.5 million. As a result, the receipts from foreign visitors (including excursionists) increased by 3.7% to RM26.8 billion. The increase in tourism receipts reflected the successful re-alignment of marketing strategies by the Government and the private sector in three main areas, namely, concentrating on niche markets such as the People's Republic of China, India and West Asian countries, further relaxation of visa requirements, and higher connectivity through increases in flight frequencies (including charter flights) from more points of entry. After September 11, Tourism Malaysia took proactive measures to restore confidence. A programme to attract foreign travel agents, media and convention organisers to the country was effective in raising the average monthly tourist arrivals in 2002 to 1.1 million visitors, compared with 0.8 million visitors in the period October-December 2001. The composition of tourists has changed with tourist arrivals from Asia increasing by 6.5%, with high growth in tourist arrivals from the People's Republic of China (23%), India (27.8%) and West Asia (14.8%). Intra-regional tourism (tourists from East Asia excluding Japan) accounted for about 81% of total tourist arrivals and contributed about 72% of the total tourism receipts. The sustained increase in regional and West Asian tourism earnings more than offset the decline in receipts from long haul tourists.

Expansion of tourism and airport and port services led to progressive improvement in the services deficit.

Graph 1.47
Tourist Arrivals and Tourism Receipts



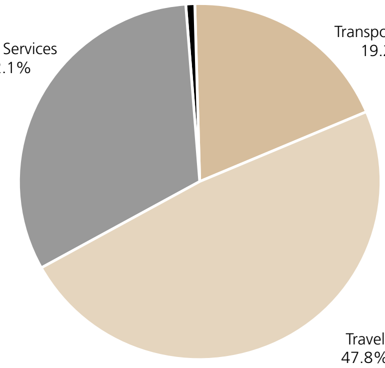
p Preliminary

In the export of education services, efforts to establish Malaysia as a regional centre for education focused on attracting students from the new markets of Vietnam and West Asia as well as existing markets in regional countries. Consequently, the number of foreign students increased markedly by 55.7% to 36,468 students, with students from Indonesia and the People's Republic of China continuing to account for the largest number of foreign students. A notable development in the education sector is the establishment of branch campuses of Malaysian private colleges through franchises in the People's Republic of China, Indonesia and Thailand. While expansion of the sector would result in higher overseas income from education, receipts from education tourism nevertheless is still small, accounting for about 1% of total travel receipts and 0.5% of total services receipts.

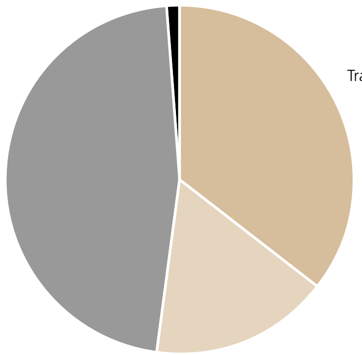
Meanwhile, health tourism emerged as a new growth area with potential to become a major foreign exchange earner, given the growing demand from regional countries for high quality health care services at affordable prices. Accordingly, revenue from foreign patients seeking medical treatment in the country improved significantly to RM150 million in 2002 from RM28 million in 2001. The impetus for this growth stemmed from targeted promotion in regional and West Asian markets, led by Tourism Malaysia in collaboration with MATRADE and the private sector.

On the payments front, travel outflows amounted to RM9.9 billion as higher payments for education abroad and pilgrimage offset the decline in expenditure incurred by Malaysians travelling abroad. Payments for education abroad increased by 17.5% with a higher number of Malaysians studying abroad at all levels of tertiary education. The travel outflows were also due to a 12.6% increase in the number of Malaysians performing the pilgrimage, which resulted in a 54.1% increase in payments for pilgrimage.

Graph 1.48
2002: Components of Gross Receipts in the Services Account (% share)



Graph 1.49
2002: Components of Gross Payments in the Services Account (% share)



Another contributory factor to the lower services deficit was the lower net outflows of RM11.2 billion (2001: -RM13.2 billion) in the **other services account**. The much smaller gross outflow (2002: -RM29.4 billion; 2001: -RM31.1 billion) reflected lower demand for construction and engineering services during the year, following completion of large privatised projects in 2000 and 2001. Payments to foreign services providers in areas related to communication, computer and information services also declined in line with the expansion in the range of services provided by the domestic telecommunication and multimedia sector. Improved export earnings from construction and installation services offered by Malaysians in projects abroad, such as construction of roads and highways, also lent support to the improvement in the other services account. The increased demand for local professional services with the establishment of global or regional hubs providing cross border communication and network support services was seen in higher earnings from professional fees, namely, in technical, business, computer and information services. As a result, receipts in the other services account increased to RM18.2 billion in 2002 (RM17.9 billion in 2001).

The **transportation account** deficit widened to RM11.5 billion (2001: -RM11.4 billion), reflecting largely the increase in freight charges by the international shipping lines arising from higher fuel cost and increased risk premium on some routes. The higher gross payments were also on account of the higher volume of trade. Gross receipts increased as a result of improvements in revenue from air transportation as well as cargo and charter services provided by domestic shipping companies and port related services. Container throughput of six major ports (namely Port Klang, Johor Port, Port Tanjung Pelepas, Penang Port, Sabah Port and Bintulu Port) increased by 20.7% to 8.8 million TEUs in 2002. The increase in volume reflected higher transshipment cargo handled by ports and measures taken to enhance the competitiveness and efficiency of ports and port-related services through improvements in management, increased investment in infrastructure and facilities, and trade facilitation through streamlining of procedures for handling cargo.

The **income account** deficit decreased to RM25.2 billion or 7.5% of GNP (2001: -RM25.6 billion or -8.3% of GNP). The improvement reflected the turnaround in profits and dividends accruing to Malaysian companies from their investments abroad, mainly in agriculture and the services sectors (2002: RM0.7 billion, 2001: -RM0.2 billion). Meanwhile, profits and dividends accruing to foreign direct investors also increased following the improved export performance among the export-oriented industries, especially in the electronics and oil industries. Profits and dividends accruing to foreign direct investors accounted for 68.8% of the gross outflows in the income account. Nevertheless, the actual outflows of investment income were considerably lower as a large portion of the profits was retained in Malaysia. Meanwhile, the portfolio investment income continued to record net outflows following the weaker performance of global and regional equity markets. The other investments component (mainly interest income) registered a net outflow as the interest payments on external debt more than offset the lower interest income from the external assets of the Bank and the corporate sector, including commercial banks.

In 2002, the net outflow in the **current transfers account** increased significantly to RM10.4 billion (2001: -RM8.2 billion). This reflected mainly the one-time lump sum repatriation made by 318,272 illegal foreign workers returning to their home countries under the Amnesty Program conducted by the Immigration Department during 22 March to 31 July 2002. In addition, regular remittances by a total of 1,057,156 registered foreign workers employed mainly in the manufacturing and agriculture sectors, contributed towards the net outflows.

Over the last five years, Malaysia's external financial position has continued to improve in tandem with steps taken to strengthen the external position. Amidst volatility in the global financial markets, short-term capital outflows declined steadily as interest rate differentials widened in favour of Malaysia. At the same time, long-term capital flows, especially foreign direct investment (FDI), was sustained to complement domestic financing to support economic growth.

In 2002, the **financial account** recorded its third consecutive year of improvement to register a lower net outflow of RM12 billion (2001: -RM14.8 billion). The improvement was attributed mainly to higher

Table 1.26
Balance of Payments: Financial Account

	2001	2002e	2001	2002e
	RM billion		US$ billion	
Financial Account	**-14.8**	**-12.0**	**-3.9**	**-3.2**
Direct Investment	**1.1**	**4.7**	**0.3**	**1.2**
In Malaysia				
(foreign direct investment)	2.1	12.0	0.6	3.2
Abroad (overseas investment)	-1.0	-7.3	-0.3	-1.9
Portfolio Investment	**-2.5**	**-6.7**	**-0.7**	**-1.8**
Other Investment	**-13.4**	**-9.9**	**-3.5**	**-2.6**
Official sector	7.1	4.7	1.9	1.2
Federal Government (net)	6.3	8.0	1.7	2.1
Gross borrowing	7.0	10.5	1.9	2.8
Repayment	0.7	2.5	0.2	0.7
NFPEs (net)	0.9	-3.3	0.2	-0.9
Gross borrowing	10.7	3.5	2.8	0.9
Repayment	9.8	6.8	2.6	1.8
Private sector	-20.5	-14.6	-5.4	-3.9

e Estimates

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

flows shifting towards higher value-added activity in the services sector, in addition to sustained inflows into the manufacturing sector. The structural change in FDI flows is consistent with the transformation of the Malaysian economy towards services as a source of growth and the move to a knowledge-based economy.

For the year 2002, net FDI in Malaysia increased substantially to RM12 billion (2001: RM2.1 billion) or 3.6% of GNP. Gross inflows of FDI improved to RM22.4 billion (2001: RM18.8 billion). Outflows reflected partly Malaysian acquisition of foreign

Financial account improved with larger inflows of FDI and lower short-term outflows. FDI was more broad-based in services, manufacturing and oil and gas sectors. Overseas investments have begun to generate repatriation of profits and dividends to Malaysia.

inflows of long-term capital, in particular foreign direct investment and to a lesser extent, external borrowings by the Federal Government. Short-term private capital outflows declined in 2002. As the maturity of external liabilities continued to shift towards a longer-term spectrum, Malaysia's risk profile has improved, enhancing its resilience to external shocks.

The volume of **FDI** inflows into Malaysia has stabilised in recent years notwithstanding global uncertainty and greater competition of FDI into new emerging economies. A notable development has been the changing nature of FDI flows. These flows have become more broad-based with higher shares of new

interests in businesses in Malaysia as well as repayment of loans to related companies.

In terms of gross inflows, a larger share of total FDI inflows of 38% was directed to the services sector. Inflows into manufacturing and oil and gas activities were sustained at 28% and 34% respectively. New investment in the services sector was reflected in the increasing trend towards the formation of strategic alliances between foreign investors and their Malaysian partners in various segments such as the wholesale, retail, business, financial and insurance services. Furthermore, multinational corporations have increased their presence in the country by setting up regional hubs, including operational headquarters, international procurement and distribution centres, regional data processing, financial services and customer support centres. To facilitate the development of this emerging sector, MIDA has created a Promotion of Services Sector Division in April 2002 while the Budget 2003 has provided further incentives for services investments. Foreign investment in the manufacturing sector were seen mainly in the upgrading of equipment as capacity utilisation by manufacturers expanded in response to stronger global demand for electronics. Several multinational companies also upgraded plant facilities in order to move up the value chain to produce higher value-added and technology-oriented products as well as to operate as full turnkey design and test solution providers. During the year, FDI flows into the oil and gas sector were also significant, reflecting mainly the establishment of several new joint ventures in oil and gas exploration projects between Malaysian companies and international oil companies.

Malaysian **direct investment abroad** increased substantially to RM7.3 billion in 2002 (2001: -RM1 billion), led by some large and established Malaysian corporations in the oil and gas, manufacturing and utilities sectors. There were some changes in the pattern of overseas investment, with more funds shifting to developed economies unlike earlier years when they were concentrated in activities in developing economies. The scope of investment was also extended beyond the plantation and manufacturing sectors into other sectors such as utilities and financial services. Most of these investments were undertaken through acquisitions and joint ventures, besides new greenfield investments. Apart from the provision of equity capital financed mainly from internal funds, higher overseas investments were also funded through higher loans extended by the parent companies in Malaysia to their related companies abroad. These investments not only enhanced the export of goods and services from Malaysia, but also have contributed to income growth through repatriation of profits and dividends to Malaysia. In 2002, profits and dividends accruing to Malaysian companies investing abroad turned around to record a net inflow of RM0.7 billion. On balance, FDI inflows into Malaysia were more than adequate to offset increasing overseas investment by Malaysians. As such, the **net direct investment** balance registered a higher net inflow of RM4.7 billion in 2002 (2001: RM1.1 billion).

Portfolio investment recorded a higher net outflow of RM6.7 billion in 2002 (2001: -RM2.5 billion). In the first quarter, portfolio investment recorded a net inflow of RM2.9 billion (1Q 2001: -RM2.4 billion) as investor sentiment improved in line with the recovery of the Malaysian economy. During this period, an international rating agency had also upgraded Malaysia's sovereign rating outlook. However, reflecting the uncertainties in the global financial markets and following the general weakening of regional and global stock markets, portfolio investments recorded a net outflow in the second quarter. The net outflow was also attributed partly to the redemption of debt securities by a Malaysian company, which in turn reduced the external debt of the private sector.

During the second half-year, portfolio investment continued to register net outflows, in line with the prolonged weakening of the global stock market amidst growing uncertainty on the pace of global economic recovery and heightened geopolitical risks. The outflows of portfolio investment in the fourth quarter reflected, to a lesser extent, the purchase of resident-issued redeemable preference shares by residents from non-resident holders.

The **other investment account** recorded significantly lower net outflows of RM9.9 billion in 2002 as long-term capital inflows by the official sector were sustained, while short-term net outflows by the private sector declined. The **official sector** recorded a lower net drawdown of external loans. Inflows from new bond issues raised in 2002 were partially offset by the net repayments of external debt by the NFPEs. Inflows of new official borrowing accrued from the reopening of the global bond due 2011 by an additional US$750 million in March 2002 and the issuance of the 5-year US$600 million Global Islamic Trust Certificates in June 2002. In addition, there were drawdowns of loans from the multilateral financial institutions and bilateral sources, including the Miyazawa Initiative. The NFPEs registered a net repayment of external loans in 2002, reflecting mainly the maturity of several bonds and loans raised earlier.

The **private sector** recorded a lower net outflow of RM14.6 billion in 2002, comprising mainly borrowing and lending as well as placement and withdrawal of deposits by the banking and non-bank private sector with unrelated counterparties. The improvement was due largely to net borrowing of foreign currency by the banking sector to take advantage of the arbitrage opportunities as interest rate differentials were in Malaysia's favour in 2002. These inflows partially offset the higher net outflow of funds by the non-bank private sector, mainly reflecting higher trade credits extended to importers abroad. During the year, there were also large net repayment and prepayment of external loans by the private sector arising from the corporate debt restructuring exercises.

External Debt

Malaysia continued to maintain a prudent external debt management strategy to ensure that the nation's external debt is low and its debt profile is biased towards a longer maturity structure. The relatively low level of external debt is the result of the active debt management by the authorities in accordance with international guidelines on prudential safeguards to ensure the country's sustained capacity to meet the challenges associated with external shocks. The prudential safeguards include conscious efforts to reduce risk exposure to global interest rate shocks, adverse exchange rate movements and shifts in investor sentiment. The core rationale of these safeguards is to ensure the diversification of the external borrowing by the public and private sectors in terms of currencies, debt instruments and creditors in order to spread risks, achieve a longer maturity profile and gain wider access to international capital markets. Furthermore, debt servicing capacity over the medium term, especially by the private sector, is ensured through a guideline requiring external loans to be utilised to finance productive activities that will generate foreign exchange revenue to service the debt. The management of the nation's debt has been adequately supported by an efficient debt monitoring system which has enabled the authorities to monitor the overall changes in the debt level, the structure of the debt as well as the debt servicing obligation of both the public and private sectors.

Malaysia's external debt position in 2002 remained within prudential limits. Notwithstanding the increase in total external debt outstanding by RM11.5 billion or 6.6% to RM185.3 billion (US$48.8 billion) at the end of 2002, the ratio of external debt to GNP and external debt to exports of goods and services remained stable at 55.1% and 44.2% respectively. The increase in total external debt reflected mainly higher market loans by the Federal Government and the revaluation loss arising from the weakening of the US dollar. The overall **debt service ratio** (excluding prepayments) remained low at 6% in 2002.

The share of short-term debt to total debt continued to be low, accounting for 17% of total external debt, compared with the end-1997 level of 25.3%. The ratio of short-term debt to international reserves continued to be one of the lowest in the region, accounting for only 24% of reserves (end-1997: 73.2%). In addition, about two-thirds of the medium and long-term debt have remaining maturity of more than three years.

The outstanding **medium and long-term external debt** increased by RM4.1 billion or 2.8% to RM153.8 billion (US$40.5 billion) as at the end of 2002. The increase was due largely to an exchange revaluation loss of RM3.7 billion resulting from the depreciation of ringgit, particularly against the yen and euro. During the year, the public sector, comprising the Federal Government and NFPEs, recorded a lower net drawdown of RM4.7 billion (2001: RM7.2 billion), as the marginally larger net drawdown of external borrowing by the Federal Government was offset partially by the net repayment by the NFPEs. This net inflow was further offset by net repayment of RM4.2 billion by the private sector.

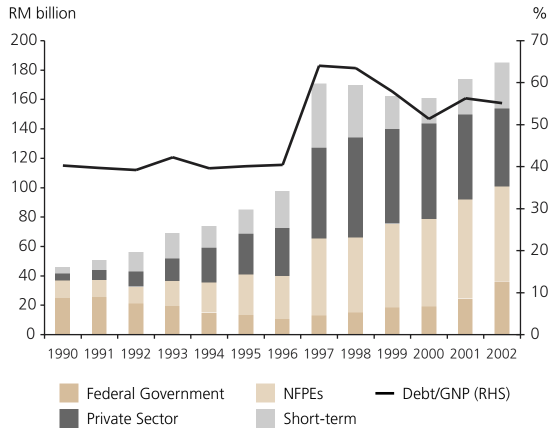
External debt remained within prudential limits and overall debt service ratio was low. Share of short-term debt remained one of the lowest in the region and is only 24% of reserves.

Table 1.27
Outstanding External Debt

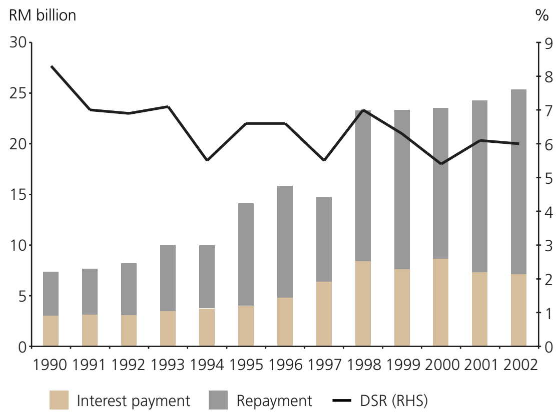
	2001		2002*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**173,830**	**45,745**	**185,348**	**48,776**
Medium and long-term	149,629	39,376	153, 767	40,465
Short-term[1]	24,201	6,369	31,582	8,311
As % of total debt	*13.9*	*13.9*	*17.0*	*17.0*
As % of international reserves	*20.6*	*20.6*	*24.0*	*24.0*
As % of GNP				
Total debt	56.3	56.3	55.1	55.1
Medium and long-term debt	48.4	48.4	45.7	45.7
As % of exports of goods and services				
Total debt	43.9	43.9	44.2	44.2
Medium and long-term debt	37.8	37.8	36.7	36.7
Debt service ratio (%)	**6.1**	**6.1**	**6.0**	**6.0**

[1] Refers to bank and non-bank private sector short-term debt
p Preliminary

Graph 1.50
Outstanding External Debt



Debt Servicing



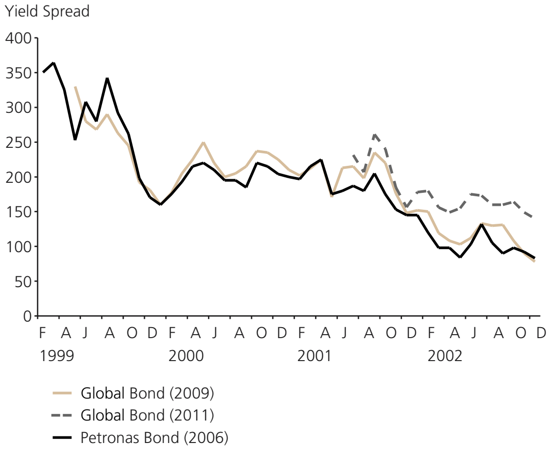
In 2002, **short-term external debt** (maturity of one year or less) rose by RM7.4 billion to RM31.6 billion (US$8.3 billion), reflecting largely the increase in external borrowing by the banking sector. Much of these borrowings occurred in the fourth quarter, when commercial banks took advantage of arbitraging opportunities as interest rate differentials widened in favour of Malaysia. The increase in short-term transactions is transitional and will be reversed upon maturity. Meanwhile, short-term borrowings by the non-bank private sector, comprising mainly revolving credits and inter-company loans, declined in 2002. In particular, there was a large repayment of RM3.1 billion during the second quarter for bridging loans acquired in the fourth quarter of 2001 to finance the acquisition of controlling interests in a telecommunication company from non-resident partners.

The **currency composition** of the medium and long-term debt continued to be largely denominated in United States dollars, with a share of 77% of debt outstanding as at end-2002. The share of yen denominated debt stabilised at 15% while that of the euro increased marginally to 4%. The remaining 4% of the debt was denominated in other international currencies, including the pound sterling, Swiss franc and Singapore dollar. The currency composition of external debt generally corresponds closely with the currency composition of the nation's external earnings, thus, providing a natural hedge against currency risks.

Public sector external debt: The outstanding external debt of the public sector increased to RM100.6 billion (US$26.5 billion), reflecting higher external borrowing by the Federal Government while NFPE debt declined. Although, the Federal Government has maintained its practice to source the funding requirements mainly from domestic non-inflationary sources, it has the flexibility to raise funds in the international capital market, given the nation's low external debt position. In view of the favourable market conditions, in particular the low interest rate environment, the Government raised external financing to maintain a market presence and set benchmark rates to facilitate the corporate sector's access to the US, European and other international capital markets.

Gross borrowings of the **Federal Government** increased to RM10.5 billion (US$2.8 billion), largely accounted for by the reopening of the Global Bond due 2011 and the issuance of the Global Islamic Trust Certificates. In March 2002, the Government reopened its US$1 billion 7.5% Notes due 2011 by an additional US$750 million at a much lower yield of 6.8%, which was 90 basis points lower than the yield at the initial issue of 7.7% in July 2001. The size of the reopening was initially set at US$500 million. However, as it was seven times oversubscribed (twice oversubscribed in the initial offering in July 2001), the issue was raised to US$750 million. These developments reflected investors' confidence in Malaysia's strong economic fundamentals amidst rising uncertainties in the global economy. In June 2002, the Government successfully issued the first international Islamic bond in the international capital market, namely the 5-year US$600 million Global Islamic Trust Certificates. The Shariah-compliant Certificate, also known as Sukuk al-Ijarah or lease-participation trust certificate, has a coupon rate of the six-month US dollar London Inter Bank Offer Rate (LIBOR) plus 95

Graph 1.51
Spread of Sovereign Bonds and Selected NFPE Bond Over US T-bills



basis points. The Sukuk was oversubscribed by more than two times, reflecting worldwide interest and acceptance of the inaugural global Islamic certificate. The success of the Sukuk will provide an impetus for the development of the international Islamic financial market. Apart from creating a benchmark for other similar issues in the future, it has also broadened the investor base and provided a new asset class for Islamic and conventional investors.

Reflecting Malaysia's strong fundamentals and in line with sovereign rating upgrades during the year, the interest spread on Malaysia's benchmark securities narrowed further in 2002. The spread on Malaysia's Global Bond due 2011 narrowed from 228 basis points over US Treasuries in the initial offering on 9 July 2001 to 175 basis points in the reopening on 5 March 2002. The spread has narrowed further to 140 basis points at the end of 2002. Similarly, the spread on the Global Bond due 2009 narrowed steadily in 2002 to 78 basis points at end-2002 (end-2001: 145 basis points). During the year, several credit rating agencies upgraded Malaysia's sovereign rating. In particular, after reaffirming Malaysia's long-term sovereign foreign currency rating at BBB and assigning positive rating to its outlook on 4 March 2002, Standard & Poor's upgraded the rating to BBB+ on 20 August 2002 and assigned a stable outlook to the rating. Meanwhile, Moody's Investor Services reaffirmed Malaysia's Baa2 long-term foreign currency debt rating and revised its outlook to positive from stable on 3 April 2002. Subsequently, on 24 September 2002, the rating was further upgraded to Baa1, with stable outlook.

In 2002, the Government also drew down external loans committed under the Miyazawa Initiative as well as project loans from multilateral sources such as the World Bank, Islamic Development Bank and Asian Development Bank. In February 2002, the Government signed a ¥68 billion (US$420 million) loan with the Japan Bank for International Cooperation to finance projects on the development of information and communication technology (ICT) in Malaysia. After taking into account the repayments, assumption of debt incurred by public and privatised enterprises and exchange revaluation loss during the year, the outstanding external debt of the Federal Government increased to RM36.3 billion or US$9.5 billion (2001: RM24.3 billion). Consequently, the share of Federal Government's debt also increased from 14% of the total debt at the end of 2001 to 19.6% at end-2002.

The outstanding **NFPEs** external debt declined to RM64.3 billion (US$16.9 billion) in 2002 (2001: RM67.4 billion). Although NFPEs continued to draw down long-term external loans from the international financial markets, mainly to finance their capital investment, the amount was significantly lower at RM3.5 billion (US$0.9 billion; 2001: RM10.9 billion). The NFPE loans included the drawdown of the loans under the Miyazawa Initiative by Tenaga Nasional Bhd, Bank Pembangunan dan Infrastruktur Malaysia Bhd and Bank Industri Bhd to finance the development of power plants, transportation infrastructure projects and the export credit facility respectively. Repayment of external loans by NFPEs remained large at RM6.8 billion (US$1.8 billion) in 2002, due mainly to the maturity of several bonds and loans.

Private sector external debt: The private sector medium and long-term external debt outstanding declined by about 8.2% to RM53.2 billion (US$14 billion) as at end-2002. Private sector debt (including short-term debt) continued to account for the bulk of Malaysia's external debt, at 45.7% of total debt in 2002. During the year, the drawdown of longer-term external loans by the private sector was lower at RM8.4 billion (2001: RM12.1 billion). About two-thirds of the external borrowing was incurred by non-resident controlled companies which had sourced their loans largely from offshore shareholders and parent and associate companies. Such loans were generally of longer maturity, with more flexible terms and at concessionary interest rates. These borrowings are naturally hedged, with earnings in foreign currency to service the debt. Repayments of the medium and long-term private sector debt were higher during the year, amounting to RM12.5 billion (2001: RM9.6 billion), reflecting larger prepayments and repayments of loans

Inaugural Global Islamic Trust Certificates

The Government of Malaysia successfully issued the world's first global sovereign Islamic securities on 25 June 2002. The Global Islamic Trust Certificates was oversubscribed by more than two times, reflecting strong worldwide interest and acceptance of the inaugural global Islamic certificate. The issue had attracted a broad investor base, encompassing both conventional investors and Islamic-oriented funds. By geographical distribution, Middle Eastern investors accounted for 51% of the subscription, followed by Asia (30%), Europe (15%) and US (4%). Of significance is that new investors accounted for 65% of the overall issue, indicating the presence of a large new investor base. Middle Eastern investors were drawn more widely from among several Arab countries. In comparison, investors from the US subscribed 48% of the US$750 million reopening of Malaysia's 7.5% US$1 billion 2011 global bond in March 2002, followed by Asia (27%) and Europe (25%).

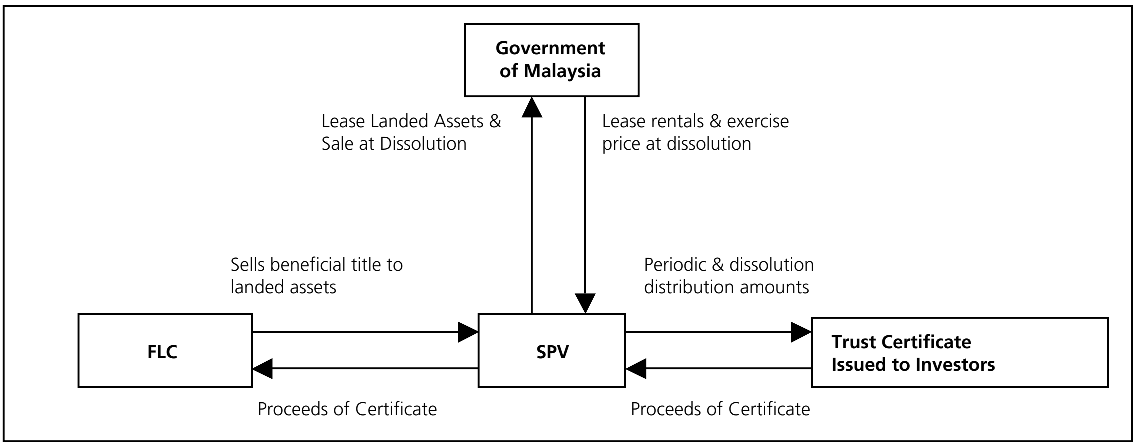
In terms of pricing, the Islamic Trust Certificates was marketed at 95-98 basis points above the six-month US$ LIBOR, but was finally priced at the lower end of the range, namely at 6-month US$ LIBOR +95 basis points. The issue was rated Baa2 and BBB, with a positive outlook, by Moody's and Standard and Poor's respectively, on par with the country's long-term sovereign foreign currency ratings.

The issuance of the Global Islamic Trust Certificates signified Malaysia's continuous and strong commitment to support the development of Islamic banking and finance on the global front. The issue, based on Islamic principles, was in line with the objectives of providing impetus to the growing Islamic financial market, creating a new asset class for both Muslim and conventional investors, diversifying the investor base for Malaysia as well as setting a benchmark for other similar issues.

The 5-year US$600 million Global Islamic Trust Certificates was structured based on the concept of Sukuk al-Ijarah or lease-participation trust certificates. To be Shariah compliant, financing must be asset based and no interest in the conventional sense is paid. Instead, lenders earn a return linked to the performance of an underlying asset. In this case, investors buy a trust certificate evidencing beneficial ownership of an asset which is then leased to the Government of Malaysia. The trust certificates are known as Sukuk in Islamic terminology.

The mechanism for the above trust certificates essentially involves the sale of landed assets by Malaysia's Federal Land Commissioner to a special purpose vehicle (SPV), Malaysia Global Sukuk Inc, incorporated in Labuan. The SPV pays for these assets with cash, funded by the proceeds from the issuance of a floating rate trust certificates sold to investors. The SPV leases the landed assets to the Malaysian Government for five years. The trust certificates, therefore, represent beneficial ownership of the assets and of the lease.

Graph 1: Transaction Structure



FLC – Federal Land Commissioner
SPV – Malaysia Global Sukuk Inc

Over the life of the transaction, the Government of Malaysia will pay six-monthly floating rate lease payments to the SPV, which in turn will pay six-monthly floating rate distributions to investors, both pegged to the 95 basis points spread over the 6-month US$ LIBOR. On maturity, the SPV will sell the landed assets back to the Government of Malaysia at the original purchase price, regardless of the market value of the assets, the proceeds of which will be used to repay the principal to investors.

The inaugural Global Islamic Trust Certificates issuance by the Government of Malaysia has paved the way for similar instruments from a broader spectrum of issuers, including Government-linked agencies and corporations in Malaysia. While corporations are encouraged to consider international Islamic sukuk as a new structure for raising financing, they have the flexibility in selecting the method of financing which best meets their purposes.

The success of the Global Islamic Trust Certificates will also provide an impetus for the development of Islamic financial market on a global basis, especially as a catalyst for accelerating the development of the International Islamic Financial Market launched in early 2002. As the Certificates was also listed in the Labuan Financial Exchange, in addition to the Luxembourg Stock Exchange where the conventional bonds and floating rate notes were listed, this will spur further development of the Labuan International Offshore Financial Centre as an international Islamic financial center.

due partly to corporate debt restructuring. This resulted in a net repayment of RM4.2 billion, compared with a net drawdown of external loan of RM2.5 billion in 2001.

International Reserves

The **net international reserves** held by Bank Negara Malaysia (comprising gold and foreign exchange holdings, IMF reserve position and holdings of Special Drawing Rights (SDR)) increased by RM14.2 billion or US$3.7 billion in 2002 to RM131.4 billion or US$34.6 billion as at end-2002. As at 14 March 2003, reserves increased further to RM131.7 billion or US$34.7 billion. The reserves level is sufficient to finance 5.3 months of retained imports and to cover 4.4 times the short-term external debt.

Higher international reserves in 2002 attributed mainly to strong trade surplus and higher inflow of long-term capital. Reserves of more than 4 times the short-term external debt is unencumbered and usable.

During the year, international reserves increased steadily from RM117.2 billion as at end-2001 to RM131.4 billion as at end-2002. The strengthening of the international reserves position during 2002 reflected the overall strong fundamentals of the economy with foreign exchange inflows generated mainly from the strong trade surplus. To a lesser extent, the accumulation in reserves also arose from the inflows of foreign direct investment and the external borrowing by the Federal Government, the bulk of which was through the reopening of the global bond and the issuance of the Global Islamic Trust Certificates. The increase in reserves had also

Although Malaysia has regularly published detailed information on external debt, Malaysia aims to subscribe to the new **IMF Special Data Dissemination Standard** (SDDS) on external debt. The new SDDS external debt data requirement is consistent with the framework for international investment position statistics in the fifth edition of the Balance of Payments Manual. The SDDS calls for the quarterly dissemination of external debt data by sectors, namely the general government, the monetary authorities, the banking sector, and others. Data also has to be broken down by maturity (short-term and long-term) on an original maturity basis and by instrument. The Bank is in the process of implementing a new statistical system to collate Malaysia's external debt data according to these requirements. The dissemination of these debt data will complement the existing dissemination of external debt information through the Bank's Monthly Statistical Bulletin and the Annual Report. This will further enhance the transparency of Malaysia's external debt data.

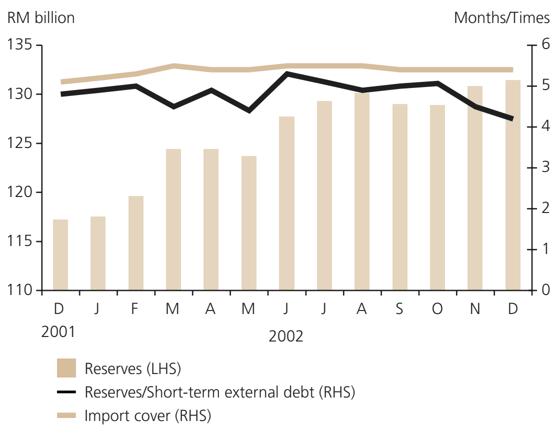
Table 1.28
Net International Reserves

	As at end			Change
	2000	2001	2002	2002
	RM million			
SDR holdings	418.7	487.8	585.0	97.2
IMF reserve position	3,310.9	3,193.5	3,315.5	122.0
Gold and foreign exchange	109,835.4	113,542.3	127,515.1	13,972.8
Gross International Reserves	**113,565.0**	**117,223.6**	**131,415.6**	**14,192.0**
Less Bank Negara Malaysia external liabilities	23.7	20.7	21.9	1.2
Net International Reserves	**113,541.3**	**117,202.9**	**131,393.7**	**14,190.8**
US$ million equivalent	**29,879.3**	**30,842.9**	**34,577.3**	**3,734.4**
Months of retained imports	4.5	5.1	5.4	
Reserves/Short-term external debt (times)	6.5	4.8	4.2	

reflected the net revaluation gains during the year. Amidst rising uncertainties in the world economy, inflows from export earnings remained large and were more than sufficient to cushion rising imports of goods and services that were related to the expansion in domestic demand and exports. This was also reinforced by the interest rate differentials that were in Malaysia's favour in 2002.

In addition to the outflows for financing payments for imports of goods and services, there were also larger overseas investments by the private sector. These investments were mainly to finance operations abroad by both resident and non-resident controlled companies to expand their business opportunities. These operations aim to enhance Malaysian exports of goods and services to the host countries and over time, increase the income and profit inflows into Malaysia.

Graph 1.52
Net International Reserves



The large loan repayments during the year were mainly by the private sector, reflecting both private sector prepayment of the more expensive loans as well as repayments arising from the corporate debt restructuring activities. These repayments had reduced the private sector indebtedness. While there were net inflows of portfolio funds in the earlier part of the year, the second half-year saw outflows following the general weakening of regional and global stock markets amidst rising uncertainties in the global economy.

The diverse currency composition of Malaysia's reserves gave rise to an unrealised revaluation gains during the second and fourth quarters, following the quarterly revaluation of reserves as a result of the appreciation of the euro and the yen against the US dollar during these periods. These gains more than offset the revaluation losses experienced during the first and third quarters. For the year 2002, the total net revaluation gain amounted to RM6.6 billion, or US$1.7 billion, compared with revaluation loss amounting to RM4.1 billion, or US$1.1 billion, in 2001.

The international reserves held by the Bank are usable and unencumbered. There are no foreign currency loans with embedded options, and no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks, and other financial institutions. Bank Negara Malaysia also does not engage in options in foreign currencies vis-á-vis the ringgit.

Malaysia's holdings of reserves in the form of **Special Drawing Rights** (SDR) increased by RM97.2 million to RM585 million at the end of 2002. The increase was mainly on account of the receipts of remuneration from the IMF arising from Malaysia's net creditor position with the Fund as well as exchange revaluation gains on holdings of SDR. During the year, Malaysia's **reserve position with the IMF** declined due to the repurchase of SDR26.9 million (RM134.9 million) following repayments to the ringgit account by three IMF member countries under the Operational Budget of the IMF. No purchases were made in 2002. The obligation to purchase the ringgit was intended by the IMF to facilitate the use of the ringgit by the Fund to meet withdrawals of funds by member countries. The obligation to repurchase would arise whenever a country which had drawn ringgit from the IMF made repayments. Purchases of ringgit from the IMF by a member country would result in an increase in the Bank's reserve position while repurchase of the ringgit by a member would result in a decrease in the Bank's reserves position. In ringgit terms, however, the reserve position with the IMF registered an increase of RM122 million at the end of 2002, partly on account of remuneration from the IMF and an exchange revaluation gain during the year.

In the management of the reserves, a prudent approach is adopted, maintaining the objective of ensuring capital preservation and liquidity of reserves whilst optimising returns. These objectives are embedded in a customised benchmark, which serves to monitor the performance of the reserves portfolios. In addition, all investments are guided by approved investment guidelines to ensure that risks remain within prudent levels. The reserves comprise the major foreign currencies and gold. The foreign currency reserves are held in the form of foreign currency deposits or invested in sovereign papers of high investment grade.

The Bank releases information on the international reserves and the statement of the Bank's assets and liabilities, on a fortnightly basis, with a one-week lag. In addition, the Bank also publishes detailed information on international reserves at the end of each month (with a one-month lag), in line with the requirements of the reserves data template under the IMF's Special Data Dissemination Standard (SDDS). This includes the release of forward-looking information on the size, composition and usability of official reserves and other foreign currency assets, and the future and potential (contingent) inflows and outflows of foreign exchange over the next 12 months.

FLOW OF FUNDS

The stronger economic activity in 2002 resulted in a slightly lower resource surplus of RM27.4 billion or 8.1% of GNP in 2002 (a surplus of RM27.7 billion or 9% of GNP in 2001). In terms of the balance of payments, the smaller resource surplus reflected the larger increase in imports of goods and services relative to exports. While exports recovered and grew by 5.7% (-8.8% in 2001), imports grew faster by 6.3% (-8.6% in 2001). From the perspective of the country's savings-investment gap, the smaller resource surplus reflected a smaller net savings position of the public sector. The flow of funds

Table 1.29
Flow of Funds: 2001

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-300.8	96.4	204.4			0
Consumption	193.5	-42.9	-150.6			0
Investment	83.3	-48.8	-34.5			0
Change in Stocks	-3.7		3.7			0
Exports of Goods and Non-Factor Services	389.3				-389.3	0
Imports of Goods and Non-Factor Services	-327.8				327.8	0
Net Factor Payment Abroad	-25.6				25.6	0
Net Transfers	-8.2				8.2	0
Non-Financial Balance	0.0	4.7	23.0	0.0	-27.7	0
Foreign Financing						
Direct Investment			1.1		-1.1	0
Net Foreign Borrowings		7.1	-24.0		16.9	0
Net Change in Foreign Assets						
Bank Negara Malaysia				-3.7	3.7	0
Banking System				1.0	-1.0	0
Domestic financing						
Change in Credit		-1.5	20.3	-18.8		0
Change in Money Supply, M3			-13.0	13.0		0
Net Borrowings from Non-Bank Sector		-14.3	14.3			0
Net Errors and Omissions		4.0	-21.7	8.5	9.2	0
Sum		0	0	0	0	

Table 1.30
Flow of Funds: 2002

	National Accounts	Domestic Economy: Public Sector	Domestic Economy: Private Sector	Domestic Economy: Banking System	Rest of the World	Sum
	RM billion					
Disposable Income	-326.0	106.5	219.5			0
Consumption	210.5	-51.4	-159.1			0
Investment	83.6	-51.1	-32.5			0
Change in Stocks	4.5		-4.5			0
Exports of Goods and Non-Factor Services	411.4				-411.4	0
Imports of Goods and Non-Factor Services	-348.4				348.4	0
Net Factor Payment Abroad	-25.2				25.2	0
Net Transfers	-10.4				10.4	0
Non-Financial Balance	0.0	4.0	23.4	0.0	-27.4	0
Foreign Financing						
Direct Investment			4.7		-4.7	0
Net Foreign Borrowings		4.7	-27.9		23.1	0
Net Change in Foreign Assets						
Bank Negara Malaysia				-14.2	14.2	0
Banking System				6.5	-6.5	0
Domestic financing						
Change in Credit		11.7	26.2	-37.9		0
Change in Money Supply, M3			-31.6	31.6		0
Net Borrowings from Non-Bank Sector		-11.4	11.4			0
Net Errors and Omissions		-9.0	-6.2	14.0	1.2	0
Sum	0	0	0	0	0	

between various sectors of the economy in 2001 and 2002 is summarised in Tables 1.29 and 1.30 respectively.

The disposable income of the public sector increased by 10.5% to RM106.4 billion in 2002. Nevertheless, the NFPEs recorded a smaller resource surplus of RM16.3 billion due to higher investment for capacity expansion and modernisation programmes. Notwithstanding the higher consumption and investment expenditure, the resource gap of the General Government was smaller at RM12.3 billion due mainly to higher revenue receipts. The bulk of the resource gap of General Government was financed mainly from domestic sources.

The resource surplus of the private sector was virtually unchanged (RM23.4 billion in 2002). Higher disposable income of RM219.5 billion during the year (RM204.4 billion in 2001), amidst stronger economic activity in 2002, enabled the private sector to register higher consumption and savings. The resource surplus together with net inflows of FDI (RM4.7 billion), net borrowings from the banking system (RM26.2 billion) and net transfers from public sector (RM11.4 billion), led to a larger pool of resources being available to private sector of RM65.7 billion (RM58.7 billion in 2001).

The bulk of these resources of the private sector were used for net placement of deposits of RM31.6 billion with the banking system (including the holdings of currency). Some of the funds were also utilised for investment overseas (RM14.6 billion) and portfolio investments (RM6.7 billion). The large current account surplus as well as official borrowings and continued inflows of foreign investments, were more than adequate to accommodate the outflows, and the net international reserves of Bank Negara Malaysia rose by RM14.2 billion to RM131.4 billion as at the end of 2002.