Monetary and Fiscal Developments

Monetary and Fiscal Developments

MONETARY POLICY IN 2002

In 2002, monetary policy remained accommodative to support economic recovery. During the course of 2002, monetary policy was effective in sustaining domestic demand. The low interest rates provided the impetus for consumer demand to remain buoyant and for fiscal stimulus to have its desired effects, thereby effectively contributing to the stronger economic expansion in domestic demand in 2002. Growth was achieved with inflation remaining low at 1.8% and core inflation at 0.4%.

Essentially the primary groundwork for monetary policy to support recovery had been laid by monetary measures implemented since August 1998. By early 2002, interest rates were already at historical lows following the aggressive reductions in interest rates by a total of 600 basis points in the period 1998-2001. In September 2001, the policy intervention rate was reduced by 50 basis points as a pre-emptive measure to address the heightened risks of weaker economic growth. In 2002, the policy rate remained unchanged. The positive impact from cumulative monetary easing, the low inflation, the stability accorded by the pegged exchange rate, the positive real rate of return to depositors as well as the positive interest rate differentials favouring Malaysia, allowed monetary policy to achieve its objective of strengthening domestic demand. Given that low interest rates were supportive of promoting growth in domestic demand, efforts in 2002 were biased towards improving access to finance by businesses and small borrowers.

The year 2002 began with cautious optimism that the pace of recovery and growth would strengthen as the year progressed. The outlook for the global economy had improved. The assessment was that policies in the major industrial countries would support global economic recovery, especially in strengthening consumer and business confidence. Pro-growth policies, lower oil prices and ongoing inventory corrections in the global market place were expected to strengthen the economic performance of the major industrial countries.

Against the improving external developments, the Malaysian economy was expected to register a higher rate of growth in 2002, supported by both strengthening domestic demand and recovery in exports. With the recovery cycle in Malaysia in its infancy stage, monetary policy remained accommodative and supportive for growth to be sustained.

As the year progressed, new concerns emerged on whether the expected stronger global recovery in the second half-year would materialise. Confidence was sharply eroded by weak corporate profitability, high profile corporate malpractices in the US and increased geopolitical tensions in the Middle East. Amidst heightened uncertainty in the global recovery and growth prospects, global equity markets continued to slide and registered large losses, while volatility in the international financial markets increased. The Federal Reserve Board and the European Central Bank reduced interest rates by 50 basis points in the fourth quarter to restore confidence and support the recovery process. The coordinated policy measures among major countries and the resilience in consumer spending in the US led to renewed optimism that on balance, the recovery would be intact, although the strength of the recovery would be less than earlier expectations. Within the Asian region, growth continued to gather momentum given the strong domestic demand and increasing importance and stronger growth of intra-regional trade.

Against this background, the 3-month intervention rate, which is the policy rate of Bank Negara Malaysia, remained unchanged in the second half-year. This was supported by several considerations. The prevailing interest rates and ample liquidity as well as measures to improve access to financing were effective in stimulating domestic demand. During the year, demand indicators such as loan applications, loan approvals and loan disbursements showed significant increases. The ample liquidity in the system and competition for new loans also prompted banks to price loans below BLR for certain categories of loans, particularly residential property and consumer

The accommodative monetary policy contributed to expansion in domestic demand.

durables. The maturity of higher cost deposits and more importantly the re-pricing of new loans in a competitive environment with excess liquidity led to progressive declines in the average lending rates of commercial banks and finance companies. This reduced the need for further monetary stimulus to support economic activity.

Reflecting the monetary stance, most interest rates, remained unchanged except for the average lending rates (ALR) of commercial banks and finance companies, which declined during the year. Deposit rates remained virtually unchanged from the level recorded at end-2001 and depositors continued to enjoy positive real rate of returns from their deposits as inflation remained low. In addition, certain groups, individuals and organisations whose income stream was highly dependent on the returns from bank deposits enjoyed a higher return from their savings by holding the Bon Simpanan Malaysia. Bank Negara Malaysia issued the third series of Bon Simpanan Malaysia worth RM1 billion on 2 February 2002 with the maturity of two years, which offered a higher rate of return of 5%.

Recognising the important role of the small businesses as an important source of dynamism and future driving force for a broad-based and resilient economy, special focus was given to improve access to credit by small and medium enterprises (SMEs) and small borrowers in the new growth sectors. In October 2002, additional funds amounting to RM250 million each were allocated to two special funds, the Fund for Small and Medium Industries 2 and the New Entrepreneurs Funds 2. The Central Bank also held regular dialogues with the banking institutions on the potential for the emerging new growth sectors.

As part of the concerted efforts to realise the full potential of the SMEs in meeting the growth objectives, Bank Negara Malaysia through the banking system, conducted a survey of SMEs. The database from the survey formed the basis for the preparation of a comprehensive framework for the development of SMEs. The recommendations focused on addressing not only the issue of access to financing but also initiatives to enhance their technological capabilities, training, access to advisory services, marketing channels and management. An SME Steering Committee chaired by the Governor of Bank Negara Malaysia was set up in October 2002 to oversee the implementation of the first phase of recommendations contained in the framework. Represented in the Committee are the Secretary Generals of Ministries involved in SME development.

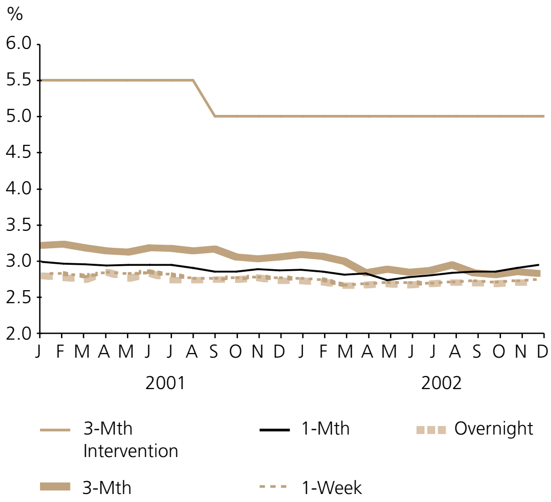
The low borrowing cost and improved access to financing served as an important enabling factor in promoting growth in the economy. It allowed the corporations to refinance their more expensive debt, undertake debt restructuring exercise and lower the debt service burden. Lower cost and longer repayment schedule strongly supported growth in domestic demand in an environment of rising household disposable income. In 2002, total gross financing extended by the banking system and funds raised from the capital market expanded by 9.9%, compared with 5.8% in 2001. Of significance is that small borrowers have been able to maintain access to financing from the banking system. Loans of RM500,000 and below increased at a faster rate of 13.8% in 2002. Outstanding loans below RM100,000, and between RM100,000 and RM500,000 expanded at more rapid rates of 15% and 12% respectively as at end-2002. Small loans of below RM100,000 extended to the businesses grew at an even faster pace of 17.8% during the year.

Notwithstanding the increased demand for credit, liquidity remained ample in the market. Higher trade and investment flows, growth of loans and expansionary Government operations to finance the fiscal stimulus programme contributed to further expansion of M3 by 6.7% at end-2002. To maintain the appropriate level of liquidity to support interest rates at the prevailing low levels, Bank Negara Malaysia absorbed an additional RM18.5 billion of excess liquidity from the banking system during the year. Liquidity operations were conducted mainly through direct borrowing from the market, and to some extent, via the issuance of Bank Negara Malaysia bills. As at the end of 2002, total net funds locked in with Bank Negara Malaysia, amounted to RM64.6 billion.

The monetary framework in 2002 continued to operate under a pegged exchange rate regime. The ringgit remained fixed at RM3.80=US$1, an arrangement that has been in place since September 1998. The exchange rate regime continued to provide an environment of certainty and stability to facilitate planning, investment and pricing decisions to support economic activities. Under the current environment of volatile international financial markets, the exchange rate peg reduced efficiency losses and other costs associated with exchange rate uncertainty, thereby benefiting trade and investments. The stable exchange rate amidst low interest rates also created a conducive environment for the rapid and effective restructuring of the banking system and the corporate sector.

The peg continues to be supported by strong macroeconomic fundamentals. The risk of misalignment is minimal as the exchange rate continues to be supported by low inflation, strong current account surplus, a high level of international reserves, low external debt and a strong banking system.

Graph 2.1
Interbank Rates (average for the month)

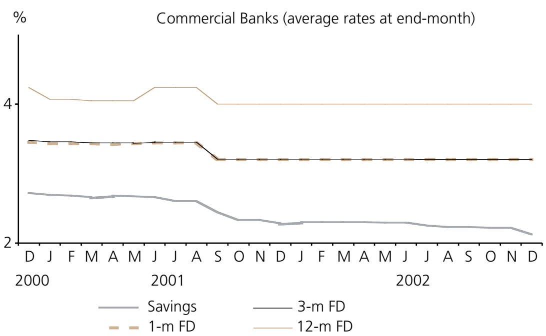


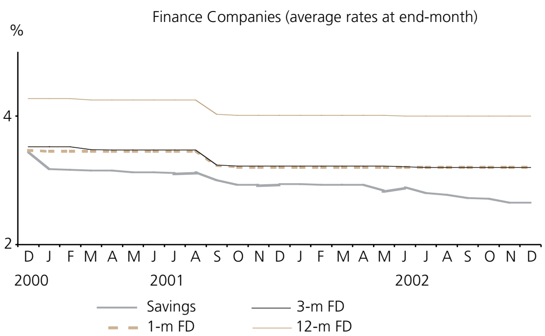
MONETARY DEVELOPMENTS IN 2002

Monetary conditions remained supportive of the stronger economic expansion. Ample liquidity conditions prevailed throughout 2002. The excess liquidity from the previous year was further amplified by new liquidity generated from both external and domestic sources. The Central Bank absorbed a larger quantity of liquidity from the system for the greater part of the year to maintain stable interest rates. Amidst ample liquidity conditions and low interest rates, loan demand and bank lending activities strengthened. The strong growth in household loans, observed since 1999, continued through 2002. More importantly, greater financing by the banking system was reflected in the significant growth in loans disbursed to business enterprises. Reflecting the many pro-active measures to promote lending, especially to the small businesses, loans to this group also expanded strongly during the year. Higher financing for the private sector combined with expansionary Government and external operations contributed to the stronger growth in all monetary aggregates in 2002.

During 2002, the policy rate, the anchor rate for the computation of Base Lending Rate (BLR), remained unchanged at 5%. Consequently, the BLRs of the commercial banks (CBs) and finance companies (FCs) remained unchanged at 6.39% and 7.45% respectively. Similarly, the weighted interbank market rates remained relatively stable, with the average rates for overnight to 3-month interbank rates ranging between 2.71% – 3.13% at end-2002 (2.76%-3.27% at end-2001). The average quoted fixed deposit (FD) rates offered by the CBs and FCs were also unchanged, ranging between 3.2-4% for deposits with maturity periods of 3 to 12 months. Nevertheless, savings deposit rates of both CBs and FCs eased slightly to 2.12% and 2.65% respectively at end-2002 (2.28% and 2.94% at end-2001). Given the low inflation rate, averaging 1.8% for the year as a whole, depositors continued to enjoy a positive real rate of return, ranging between 1.4%-2.2% for fixed deposits and 0.32% for savings deposits. Consequently, total deposits mobilised by the banking institutions continued to grow and remained

Graph 2.2
Deposit Rates of Banking Institutions





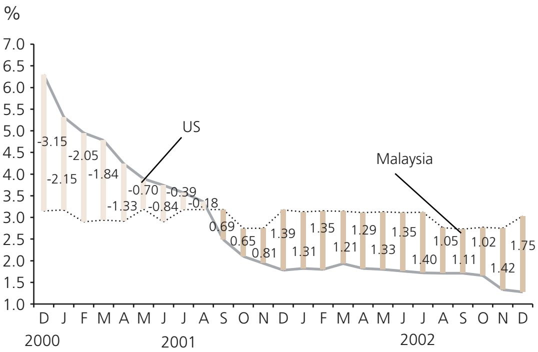
significant, increasing by RM25.5 billion or 5.3% in 2002 (1.8% in 2001).

The international comparison of nominal interest rates showed that the 3-month interbank rate differentials between Malaysia and the US continued to favour Malaysia. The differential, which turned around to favour Malaysia since September 2001, widened further to 175 basis points (+139 basis points at end-2001), following a 50 basis points interest rate reduction by the US in November 2002. Comparison with rates in Singapore also showed that interest rate differentials continued to favour Malaysia, increasing to 238 basis points at end-2002 (+224 basis points at end-2001). Against the United Kingdom and Australia, the rates were in favour of these countries by 89 basis points and 162 basis points respectively at end-2002.

While interbank and deposits rates remained stable, the average lending rates continued to trend downwards. The ample liquidity situation generated intense competition for loans among the CBs and FCs. Under a more competitive environment, banks continued to price their loans lower than the BLR for selected categories of loans, particularly for loans extended for the purchase of houses. Hence, the BLRs represented the upper limit charged by banks rather than indicative of the best rate charged to prime customers. As new loans gradually replaced loans with higher cost, the average lending rates (ALRs) of the CBs and FCs declined further. The ALR of the CBs declined by 17 basis points to 6.5%, while the FCs recorded a more significant decline of 49 basis points to 9.75%. The larger decline in the ALRs of the FCs reflected the higher portion of loans that

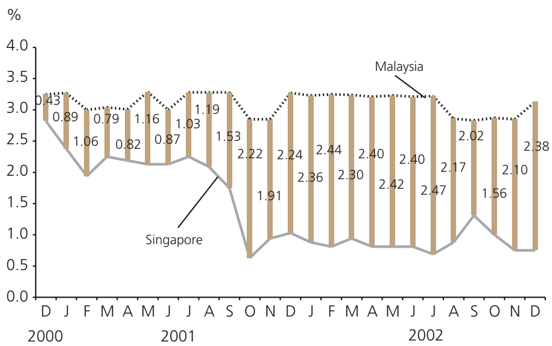
Monetary conditions remained supportive of the stronger economic expansion. Amidst ample liquidity conditions and low interest rates, bank lending activity expanded. In particular, a larger portion of credit was allocated to small businesses.

Graph 2.3
Nominal Interest Rate Differentials*



* 3-month Interbank Rates

Graph 2.4
Nominal Interest Rates Differentials*

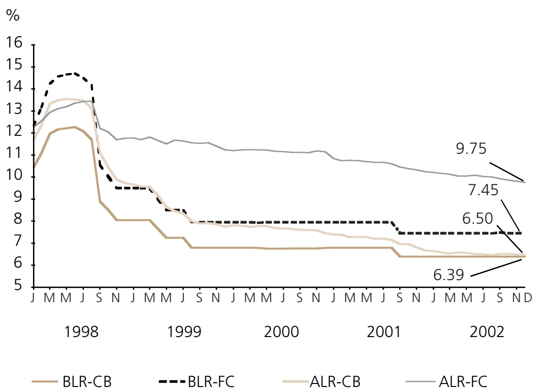


* 3-month Interbank Rates

were pegged to the hire-purchase rates, which declined markedly to around 4% in 2002 compared with 6% to 8% previously. As a result of lower lending rates amidst a stable BLR, the gap between the ALR and BLR narrowed to 11 basis points at end-2002 for the CBs and to 230 basis points in the case of the FCs (2001: 28 basis points for CBs and 279 basis points for FCs).

Reflecting the underlying demand for funds following the improvement in economic activities and the low borrowing costs, gross funds raised through the banking system and the capital market rose

Graph 2.5
Lending Rates: Commercial Banks & Finance Companies

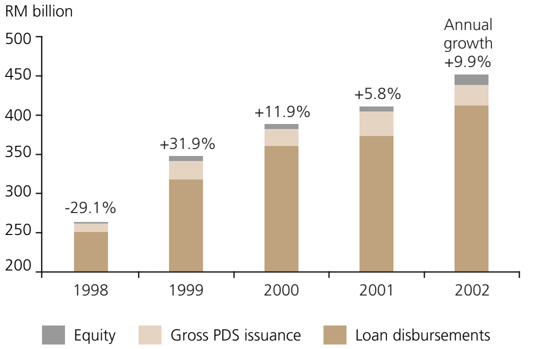


significantly by 9.9% to exceed the average growth of 5.1% recorded in the period 1998-2001. The increase was most pronounced for the banking sector. Loan applications and approvals by the banking institutions turned around in 2002 from negative growth rates of 8.7% and 6.8% respectively in 2001 to increase strongly by 14.1% and 9.7% respectively in 2002. In value terms, loan applications and approvals recorded the highest level in five years. Stronger loan approvals led to a corresponding increase in loan disbursements, which rose by 10.3% in 2002, compared with 3.5% in 2001. In value terms, total loans disbursed in 2002 amounted to RM412 billion, the highest level achieved since 1997.

Indicating an improvement in business activity, loans approved for businesses recovered to increase by 7.9% in 2002, from a negative growth of 19.7% in 2001. Similarly, disbursements increased at a faster rate of 4.3% during the year (0.1% in 2001). An analysis in terms of the direction of bank lending showed that loan disbursements were broad-based, and channelled mainly into the manufacturing (25.6% of total loan disbursements), wholesale and retail trade (15.7%), construction (7.3%) and, finance, insurance and business services (5.8%) sectors.

Of significance, the allocation of credit during the year favoured small businesses. After registering a negative growth of 9.1% during the period 1998-2001, loans of size below RM500,000 extended to businesses increased, by 4.7% in 2002. In particular, business loans below RM100,000 increased at a high double-

Graph 2.6
Private Sector Gross Financing through the Banking System and the Capital Market



Graph 2.7
Loan indicators (RM billion)

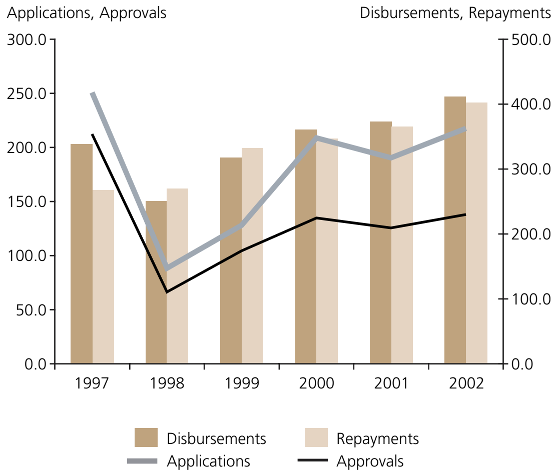


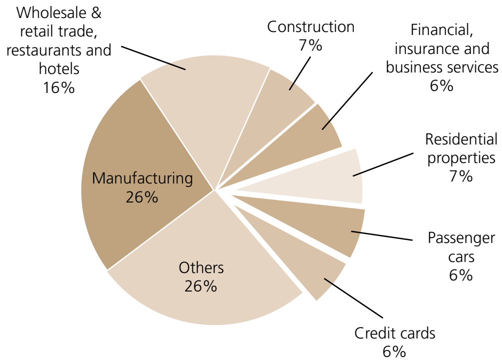
Table 2.1
Banking System: Loan Indicators

	RM billion						Annual growth (%)	
	1997	1998	1999	2000	2001	2002	2001	2002
Total								
Loan applications	250.6	88.3	128.2	208.8	190.6	217.5	-8.7	14.1
Loan approvals	212.5	66.6	104.3	134.8	125.6	137.9	-6.8	9.7
Loan disbursements	338.5	250.9	318.1	360.7	373.5	412.0	3.5	10.3
Loan repayments	267.4	270.3	332.7	347.1	365.4	402.7	5.3	10.2
Loans outstanding	89.2	5.4	0.6	23.6	16.5	20.1	3.6	4.3
of which:								
Business enterprises								
Loan applications	n.a.	n.a.	n.a.	n.a.	n.a.	135.2	n.a.	n.a.
Loan approvals	161.0	46.6	61.4	79.1	63.5	68.5	-19.7	7.9
Loan disbursements	278.3	211.1	256.4	270.2	270.4	282.2	0.1	4.3
Loan repayments	221.9	227.6	269.4	269.4	276.8	275.6	2.8	-0.4
Loans outstanding	50.6	2.9	5.7	4.2	-5.4	-2.9	-2.1	-1.1
Households								
Loan applications	n.a.	n.a.	n.a.	n.a.	n.a.	77.8	n.a.	n.a.
Loan approvals	43.0	16.3	39.8	53.1	59.2	67.2	11.5	13.5
Loan disbursements	46.8	30.8	49.5	76.0	87.0	105.4	14.5	21.1
Loan repayments	35.8	34.1	50.6	65.1	71.5	83.9	9.9	17.3
Loans outstanding	32.0	-5.1	4.1	17.3	23.3	26.3	14.8	14.5

n.a. Not available.

Graph 2.8
Loan Disbursements in 2002

(RM412 billion)



digit rate of 17.8%, from a negative growth of 12.9% during the period 1998-2001. The improved lending to SMEs reflected a number of measures implemented in recent years to address the financing needs of the SMEs, including the establishment of SME units at banking institutions, enhanced role of CGC in assisting SMEs to obtain financing from banks and increased allocations to special funds, namely the Fund for Food, New Entrepreneurs Fund 2, Fund for Small and Medium Industries 2, Bumiputera Entrepreneurs Project Fund, Rehabilitation Fund for Small and Medium Industries and Entrepreneur Rehabilitation and Development Fund. Total approvals under these funds amounted to RM1.6 billion in 2002, the highest

Table 2.2
Banking System[1]: Outstanding Loans by Sector

	Change		% share of total loans
	2001	2002	
	RM billion		
Banking system loans, of which extended to:			
Business enterprises	-5.4	-2.9	51.4
Households	23.3	26.3	42.2
By sector:			
Agriculture, hunting, forestry and fishing	0.4	-0.1	2.5
Mining and quarrying	-0.2	-0.3	0.3
Manufacturing	0.1	-1.3	13.7
Electricity, gas and water supply	-2.5	1.6	1.4
Wholesale and retail trade, restaurants and hotels	0.4	1.0	8.0
Broad property sector	12.3	11.0	38.0
Construction	*-1.2*	*-1.5*	*7.8*
Purchase of residential property	*12.8*	*14.2*	*20.6*
Purchase of non-residential property	*0.3*	*…*	*6.0*
Real estate	*0.5*	*-1.6*	*3.5*
Transport, storage and communication	-1.7	-0.4	2.4
Financial, insurance and business services	0.7	-2.5	6.7
Consumption credit	9.6	12.1	16.6
Of which:			
Credit cards	*1.4*	*1.8*	*2.2*
Purchase of passenger cars	*8.0*	*9.6*	*11.2*
Purchase of securities	-3.3	0.2	6.2
Purchase of transport vehicles	1.9	-0.5	0.6
Community, social and personal services	…	-0.4	1.2
Others	-1.3	-0.4	2.3
Total loans outstanding[2]	**16.5**	**20.1**	**100.0**

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

Table 2.3
Banking System: Small Loans to Businesses

	Change		Annual growth		% share of total loans	
	2001	2002	2001	2002	2001	2002
	RM billion		%			
Outstanding loans to businesses of size:						
Below RM500,000	**-1.1**	**2.5**	**-10.0**	**4.7**	**12.3**	**12.3**
Below RM100,000	*-3.6*	*3.4*	*-15.7*	*17.8*	*4.4*	*5.0*
RM100,000 - RM500,000	*2.5*	*-0.9*	*7.9*	*-2.7*	*7.9*	*7.3*

Table 2.4
Status of Selected Special Funds

	Approvals				Utilisation rate		Disbursements			
	Total as at end		Change				Total as at end		Change	
	2001	2002	2002		2001	2002	2001	2002	2002	
	RM million		RM million	%	%		RM million		RM million	%
Fund for Food	1,025	1,296	271	26.4	78.8	99.7	923	1,124	202	21.9
New Entrepreneurs Fund 2	176	652	476	270.1	70.5	130.4	66	326	260	396.6
Fund for Small and Medium Industries 2	357	1,049	692	193.6	89.3	161.4	211	510	299	141.5
Bumiputera Entrepreneurs Project Fund	177	317	140	78.4	59.2	105.6	122	257	135	110.6
Rehabilitation Fund for Small and Medium Industries	280	323	43	15.2	56.0	64.5	257	284	27	10.3
Entrepreneurs Rehabilitation & Development Fund	-	2	2	-	-	0.4	-	1	1	-
Total	**2,016**	**3,638**	**1,622**	**80.5**	**62.0**	**97.0**	**1,579**	**2,503**	**924**	**58.5**

level recorded since 1996. The funds' utilisation rate, as measured by approvals over allocations, increased significantly from 62% at end-2001 to 97% at end-2002. In particular, some funds, namely the New Entrepreneurs Fund 2 and Fund for Small and Medium Industries 2 registered a utilisation rate of over 100%.

While the improvement in business activity was evident in higher loan applications, approvals and disbursements, the outstanding loans extended to businesses declined. This was due to several factors. First, the decline was on account of the restructuring and refinancing exercises, which resulted in either loans written off by the banking institutions or refinanced through the bond market or converted into equity. In 2002, the amount of loans written off, conversions into equity and refinancing through bonds remained sizeable, amounting to RM12.4 billion (RM8.3 billion in 2001). Second, a parallel development was the decline in long-term loans raised from banking institutions. The share of long-term loans extended to businesses (with maturity of more than one year) declined from 32% at end-1996 to 27% at end-2002, due partly to the excess capacity situation which also moderated demand for long-term loans. The bulk of the new loans raised by businesses was to meet short-term working capital requirements which contributed to the high disbursements and the correspondingly high repayments. Furthermore, in an environment of low interest rates, the improved cash flow position among businesses provided greater flexibility to trim operating expenses by way of sourcing short-term bank financing at cheaper funding cost. Third, extending the trend observed since 1998, there has been a gradual shift by the private sector to finance long-term projects, particularly infrastructure projects, from funds raised in the bond market and to a lesser extent, from the Infrastructure and Development Bank. Over a period of four years, the share of financing through the bond market to total financing raised from the banking system and the bond market has risen to 17% at end-2002 (10% at end-1996). In terms of GDP, the share has increased to 28%, from 13% in 1996. Given these factors, data on outstanding loans to businesses and other related data including the loans/deposit ratio (84.9 in 2002; 85.9 in 2001) did not adequately reflect the underlying financing activity in the economy to meet the demands of stronger economic growth.

Loan applications and approvals by the banking institutions turned around in 2002 to increase strongly by 14.1% and 9.7% respectively. In value terms, loan applications and approvals recorded the highest level in five years, while total loans disbursed in 2002 amounted to RM412 billion, the highest level achieved since 1997.

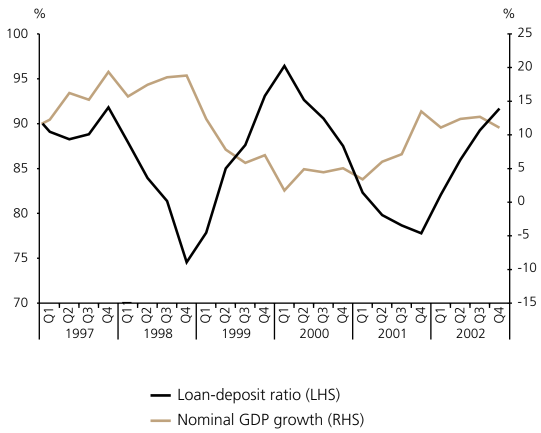
In line with stronger growth in private consumption, financing to the households by the banking system continued to be sustained at a high rate. Loan approvals and disbursements to the household sector continued to increase at double-digit rates of 13.5% and 21.1% respectively (11.5% and 14.5% respectively in 2001). Loan applications from the household sector accounted for 35.8% of the total applications received, the bulk of which was for purchase of houses and cars. Of the total amount

Table 2.5
Adjustments for Outstanding Loans

	During the period		Annual growth
	2001	2002	2002
	RM billion		%
Change in outstanding loans[1]	**16.5**	**20.1**	**4.3**
Add:			
Loan converted into equity	2.7	2.4	
Loans refinanced through the bond market	0.7	1.0	
Loans written off	4.9	9.0	
Total adjusted loans	**24.8**	**32.5**	**5.0**

[1] Include loans sold to Cagamas and Danaharta.

Graph 2.9
Loan-Deposit Ratio and Nominal GDP Growth

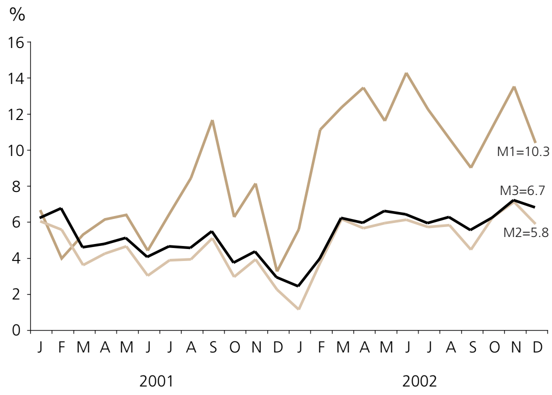


approved for the household sector, 43.5% was for housing loans, 33.7% was for financing of cars, 16.9% for consumption credit. Of significance, disbursements of loans to the household sector rose at a faster rate (21.1%) than repayment of loans (17.3%). The higher level of disbursements compared with repayments resulted in stronger growth in outstanding loans to households of 14.5%. Within this category, outstanding loans for the purchase of houses and cars rose by 16.3% and 21.2% respectively, raising the share of mortgage and car loans to 20.6% of total loans of the banking system and 11.2% respectively at end-2002 (18.5% and 9.7% respectively at end-2001). Including consumption credit, loans outstanding of the household sector accounted for 42.2% of total loans outstanding.

Rising household loans continued to be supported by further gains in the disposable income following the general improvement in economic activities across all sectors as well as the benefit of significantly higher prices of commodities. A high household savings rate and stable employment outlook further reinforced the capacity for the households to take on additional debt without creating risks. Notwithstanding the increase in household loans, the NPLs of households accounted for a lower share of total NPLs (26% compared with 32.7% at end-1997). The delinquency rate for households remained manageable at 9% of total loans. Also, enhancements in the risk management practices and the availability of the credit profile of borrowers in the banking system through the Central Credit Reference Information System (CCRIS) allowed the banking institutions to manage more effectively the expansion of loans in this sector.

The improved economic activity was also reflected in the growth of all monetary aggregates, M1, M2 and M3 expanded at stronger rate of 10.3%, 5.8% and 6.7% respectively at end-2002. Consistent with the higher expansion in output, M3 rose by RM31.6 billion in 2002. The main impetus for monetary expansion came from the increase in financing of private sector activity (RM26.2 billion during the year). Higher financing of the private sector, reflected both higher bank lending and higher holdings of private securities held by the banking institutions. At the same time, the Government and external operations also contributed to M3 growth. In the case of M1, the stronger growth reflected higher demand for transaction balances. Both currency in circulation (RM1.8 billion) and demand deposits (RM6.7 billion) increased significantly, in line with the higher consumption

Graph 2.10
Money Supply: Annual Growth



spending and higher current account balances maintained by businesses following the improved business activity.

Similarly, in tandem with improved economic performance, broad quasi-money increased markedly by RM23.1 billion or 6% (2001: 2.7%; 2000: 4.5%). In terms of component, higher private sector deposits were recorded in fixed and savings deposits, repos and negotiable instruments of deposits (NIDs) while foreign currency deposits, mainly deposits of business enterprises, declined. In response to the new guidelines on NIDs which included the increase in the maximum tenure to 10 years and higher cap on total aggregate outstanding issue of NID (for both conventional and Islamic) at five times approved capital funds, domestic non-bank financial institutions shifted investments into NIDs from repos.

Table 2.6
Broad Money, M3

	Change (RM billion)	
	2001	2002
M3	13.0	31.6
Currency	-0.1	1.8
Demand deposits	2.9	6.7
Broad quasi money	10.2	23.1
Fixed deposits	-0.4	12.6
Savings deposits	4.5	5.6
NIDs	0.6	3.6
Repos	4.2	2.5
FX deposits	1.3	-1.2
Determinants of M3		
Net claims on Government	-1.5	11.7
Claims on private sector	20.3	26.2
Loans	17.1	19.6
Securities	3.3	6.7
Net external operations	6.7	1.2
Bank Negara Malaysia	7.7	7.6
Banking system	-1.0	-6.5
Other influences	-12.5	-7.5

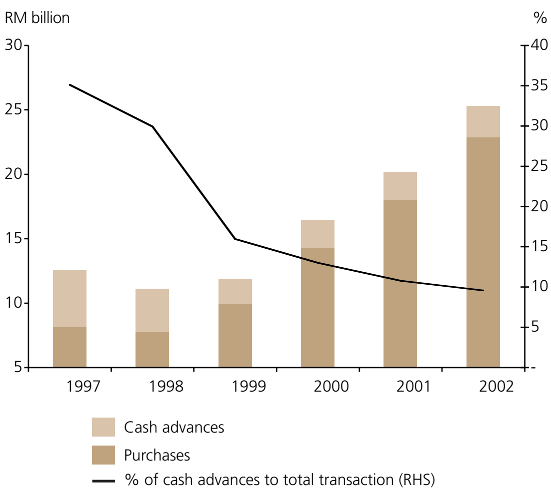
As a result, NIDs issued increased by RM3.6 billion. The increase in repos by RM2.5 billion reflected mainly repos held by the business sector. A development that affected repo transactions during the year was the new ruling allowing banking institutions to undertake repo and reverse repo transactions of less than one month maturity with non-licensed institutions to promote secondary activities and market liquidity. Previously, this activity could only be done by Principal Dealers and discount houses.

In terms of holder, individuals contributed 86% of the total increase in fixed deposits in 2002. In line with the improved economic conditions, deposits from business enterprises turned around to increase by RM0.9 billion in 2002 (-RM4.3 billion in 2001), accounting for 3.7% of the total increase in quasi-money (-42.1% in 2001).

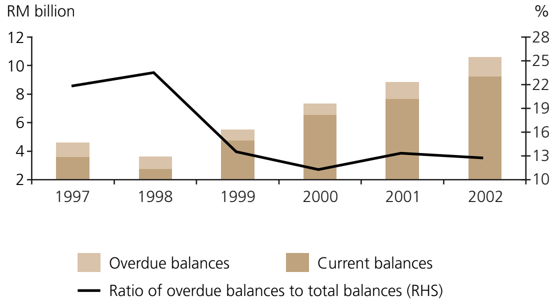
Consistent with M1 growth, spending through credit cards, another indicator of consumption spending, recorded a double-digit growth of 25.8%, extending the sharp increase of 22.3% recorded in 2001. Growth was higher in terms of both the number of credit cards in circulation (both principal and supplementary cards) as well as the value of transactions. The number of cards increased by 27% in 2002 compared with an average growth rate of 18.8% in 1999-2001. At the same time, higher consumption spending was also evident in the rising value of purchases through credit cards by Malaysian cardholders, which increased by 28% from RM16.2 billion in 2001 to RM20.7 billion in 2002.

Notwithstanding the significant expansion in spending through credit cards, higher disposable income has ensured prompt settlement of credit card balances. While there was a sharp increase of 24% in the outstanding balances of credit cards, the overdue balances were lower at 12.8% of outstanding balances at end-2002 compared with 13.3% at end-2001. The bulk of the overdue balances (71%) was in less than 3-month bracket. A positive outturn is that the credit card loan quality remained unaffected. Indeed, the NPLs of credit card transactions continued to decline further to 4.1% of total outstanding loans at end-2002 from 4.6% at end-2001 (a peak of 17.4% at end-1998). This represented 0.7% of total NPLs of the banking system.

Graph 2.11
Banking System: Credit Card Transactions



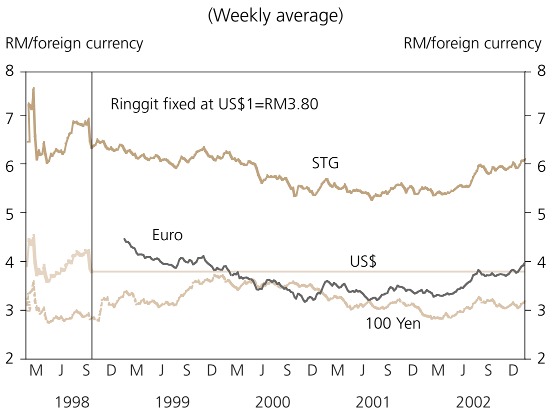
Graph 2.12
Banking System: Oustanding Credit Card Balances (at end period)



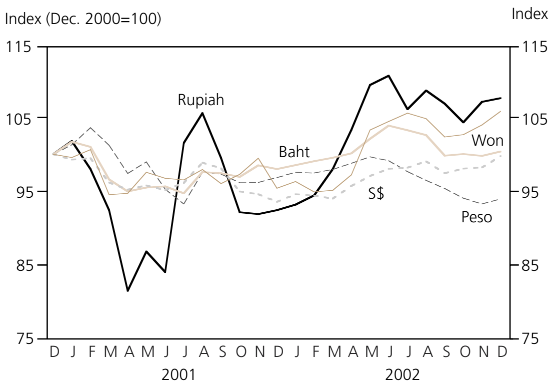
EXCHANGE RATE DEVELOPMENTS

The exchange rate of the Malaysian ringgit remained fixed to the US dollar at the rate of US$1=RM3.80 in 2002. Bilateral exchange rates with other currencies are determined through cross rates based on the movements of the US dollar against these currencies in the foreign exchange markets.

Graph 2.13
Exchange Rate of the Malaysian Ringgit against Major Currencies



Graph 2.14
Exchange Rate of the Malaysian Ringgit against Selected Regional Currencies



Note: An increase in the index represents an appreciation of the currency against the ringgit.

concerns over the uncertain pace of US economic recovery and the widening interest rate differentials in favor of the euro area and the UK towards the end of the year. The US dollar came under pressure and depreciated substantially following heightened risk aversion arising from security threats and geopolitical tensions in the Middle East. These developments culminated in the significant weakening of the dollar against the major currencies for the year. The euro breached parity against the US dollar, and appreciated sharply at the close of 2002. Against the euro, US dollar depreciated by 15.4% during the year. Despite market concerns over the Japanese economy and its financial sector, the yen also ended the year 10.6% stronger against the US dollar.

In tandem with the movements of the US dollar in the foreign exchange markets, the ringgit depreciated against the euro (-15.4%), the Japanese yen (-9.6%) and the pound sterling (-9.5%). However, given that a

The stability accorded by the ringgit peg reduced the element of uncertainty in the decision making process of manufacturers and service providers, thereby facilitating trade and investment.

The appreciation of the US dollar in 2001 continued into early 2002 as it strengthened further against major currencies on market optimism over better economic growth prospects for the US relative to Japan and the euro area. However, as the year progressed, the dollar gradually weakened against major currencies amid revelations of poor corporate governance and accounting malpractices, market

large proportion of Malaysia's external transactions are denominated in US dollars, the Malaysian economy was reasonably insulated from the high volatility in currency movements during the year. The stability accorded by the ringgit peg reduced the element of uncertainty in the decision making process of manufacturers and service providers, thereby facilitating trade and investment.

Table 2.7
Movement of the Ringgit

	RM to one unit of foreign currency[1]				Annual change (%)		Change (%)	
	1997	1998	2001	2002	2001	2002	End-June '97-Dec. 2002	2 Sep.'98 - Dec. 2002
	End-June[2]	Sept. 2[3]	End-Dec.					
Composite	102.47	72.11	73.34	70.82	3.5	-3.4	-30.9	-1.8
SDR	3.5030	5.1177	4.7714	5.1474	3.8	-7.3	-31.9	-0.6
US$	2.5235	3.8000	3.8000	3.8000	0.0	0.0	-33.6	0.0
S$	1.7647	2.1998	2.0529	2.1887	6.9	-6.2	-19.4	0.5
100 yen	2.2088	2.7742	2.8955	3.2020	14.4	-9.6	-31.0	-13.4
Pound sterling	4.1989	6.3708	5.5161	6.0924	2.7	-9.5	-31.1	4.6
Swiss franc	1.7368	2.6450	2.2757	2.7386	2.1	-16.9	-36.6	-3.4
Euro[4]	–	–	3.3662	3.9811	5.0	-15.4	–	–
100 Thai Baht	9.7470	9.3713	8.6022	8.8096	2.1	-2.4	10.6	6.4
100 Indonesian rupiah	0.1038	0.0354	0.0365	0.0425	8.2	-14.1	144.2	-16.7
100 Korean won	0.2842	0.2827	0.2883	0.3197	4.8	-9.8	-11.1	-11.6
100 Philippine peso	9.5878	8.8302	7.3644	7.1462	3.3	3.1	34.2	23.6

[1] US$ rates are the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market. Rates for foreign currencies other than US$ are cross rates derived from rates of these currencies against the US$ and the RM/US$.
[2] End-June 1997 represents pre-Asian Financial Crisis levels.
[3] Ringgit was fixed to US$1 = RM3.8000 on 2 September 1998.
[4] The euro began to be traded on 4 January 1999 (EUR 1= RM4.5050).

On the regional front, the ringgit depreciated against most regional currencies in the range of 2.4% - 14.1% in 2002. The exception was the Philippine peso, against which the ringgit appreciated by 3.1%. In addition to the weak US dollar, regional currencies were influenced to some extent by market optimism over the growth prospects of regional economies, a steadier yen, as well as country-specific developments. While several regional currencies were adversely affected by heightened security concerns in the immediate aftermath of the bomb blasts in Bali and Zamboanga in October, the impact, however, was only temporary.

In terms of its trade-weighted nominal effective exchange rate (NEER), the ringgit depreciated by 4.0% during the year, in line with the depreciation of the US dollar against most of the currencies in Malaysia's trade-weighted basket. Since September 1998 when the ringgit was pegged to the dollar, the ringgit NEER has remained stable depreciating by only 1.1%. The small depreciation implies that the ringgit remains fairly valued. The currency continues to be supported by Malaysia's strong macroeconomic fundamentals, namely the low inflation, low external debt levels, strong external balance, higher reserves levels and strong banking sector.

FISCAL POLICY AND OPERATIONS

The thrust of 2002 Budget which was presented to Parliament on 19 October 2001, was aimed at strengthening economic growth through increasing domestic productive capacities and strengthening private sector resilience and competitiveness. The Budget was tabled amidst expectations of a modest growth in the Malaysian economy in 2002 and that the recovery in external demand would be gradual. The main downside risk then was that the pick-up in the momentum of growth in consumer spending would not be sustained should labour market conditions become less favourable. Under these circumstances, the 2002 Budget strategy was aimed at supporting domestic demand and enhancing the long-term productive capacity of the economy.

While the overall budgetary operations would remain expansionary, the Government budgeted for a lower fiscal deficit of RM18.8 billion or 5.1% of GDP in 2002. The actual outturn for revenue collected in 2002 was significantly higher than the initial projections on account of improved economic activities and increased efficiency in tax collection. Nevertheless, higher expenditure resulted in a deficit of RM20.3 billion or 5.6% of GDP for the year 2002, compared with the revised deficit for 2001 of RM18.4 billion or 5.5% of GDP.

In the management of public finances, the Government remains committed to fiscal prudence to preserve long-term fiscal sustainability and flexibility. In this respect, growth in operating expenditure was kept within reasonable bounds, resulting in sustained large current account surplus of RM14.8 billion. Operating expenditure was higher in 2002 arising largely from salary and pension adjustments for civil servants as well as grants and transfers to government agencies, including state governments, for development and maintenance purposes. Higher development expenditure than initially budgeted reflected larger allocation for education and training as well as for infrastructure and industrial development. Concurrently, the Government adopted measures to mitigate increases in expenditure, including a progressive reduction in the subsidy for petrol and petroleum products.

Given the ample savings, the absence of inflationary pressures and the manageable Federal Government debt level, further fiscal expansion in 2002 did not create any structural imbalances in the economy. With the existence of excess capacity in the economy, expansionary policies did not impact inflation which remained low, while higher Federal Government expenditure did not erode the gains made in strengthening the balance of payments position since most of the expenditure was allocated for projects with low import content. The continued high national savings rate and excess liquidity in the banking system allowed the Government's funding requirements to be met without "crowding out" private sector access to financing. At the same time, the cost of new debt issuance has remained low while the size of debt accumulation of the Federal Government was also balanced with financing from the drawdown of accumulated assets.

In the context of greater uncertainties in the global economy during 2002, the counter-cyclical fiscal stance was effective in supporting domestic economic activities. The share of public sector expenditure in aggregate domestic demand was higher at 36% in 2002, compared with 35% in 2001. Against this fiscal expansion, the private sector contributed 1.2 percentage points to economic growth in 2002. The positive response of consumer spending to the stimulus provided by the Government was reflected in higher total consumption spending, which accounted for 61% of GDP. Higher domestic demand supported investment activities, as the capital formation of the private sector turned around to register positive growth in the second half-year. As a result, domestic demand continued to be the main engine of growth in 2002 with public sector expenditure contributing 2.7 percentage points to real GDP growth in 2002.

In terms of direct stimulus, significant increases in allocations for education and infrastructure development were provided during the course of the year. Expenditure in education was utilised for the construction of schools, upgrading of educational infrastructure and support facilities of schools, polytechnics and universities. Infrastructure development was focused on the development of a more efficient transportation network. At the same time, special attention continued to be given to support the more active participation of small businesses in overall economic activity.

The 2002 expansionary fiscal package strengthened the indirect stimulus to support private sector initiatives. The wide range of tax measures encouraged private sector consumption and investment. Personal income tax rates were reduced by between 1 to 2 percentage points to 0–28% while the chargeable income on the maximum tax scale was raised to exceed RM250,000 from RM150,000. These measures were estimated to have increased household disposal income by about RM874 million. Based on historical average marginal propensity to consume, the stimulus given to consumers was estimated to raise GDP growth by about 0.3 percentage points.

The fiscal incentives directed towards promoting private investment activities were focused on expanding the resource-based activities and the services sector. Measures implemented in 2002 included extension of reinvestment allowance to 15 years (from 5 years) and tax exemptions for companies involved in the production of machinery, equipment, and food as well as for reinvestment in the production of rubber, oil palm and timber. The industrial building allowance was further extended for the purchase of buildings and hotels. Incentives were also given for the wider use of information and communications technology (ICT) across all economic activities. Several incentives were also introduced to strengthen the balance of payments, namely, the promotion of tourism and enhancing exports. Other fiscal incentives were aimed at reducing the cost of doing business and improving the nation’s competitiveness. The incentives included the reduction and abolition of import duties on a wide range of intermediate products.

As part of the Government’s efforts to institute more effective planning, budgeting and implementation of public sector programmes, several changes were made to the budgeting process. Beginning in year 2002, the Budget would be prepared for a two-year cycle instead of one year. The forward-looking budgetary process was aimed at making the national Budget a more effective tool in financial management and greater fiscal flexibility. It would take into account both the shorter-term annual fiscal targets and the medium-term objectives and policies within the context of the five-year development plans. Besides ensuring that all allocations are utilised as scheduled, the new process would also allow for expeditious budgetary reallocations to be effected to take into account unanticipated developments in the domestic and the international environment.

Amidst uncertainty in the global economy, the 2002 Budget remained expansionary to support the growth momentum. Fiscal incentives and expenditure allocations were targeted at increasing domestic capacities to enhance long-term growth prospects.

A significant portion of the 2002 Budget deficit was financed from the drawdown of accumulated assets. Consequently, the total debt of the Government, comprising domestic and external debt, was contained at RM165 billion or 45.6% of GDP as at end-2002. During the year, the Government drew down RM6.1 billion from its accumulated assets to finance 17% of its total development expenditure. Financing through issues of MGS was thus reduced in 2002 and domestic debt of the Federal Government was contained at 35.6% of GDP. In an environment of ample liquidity and low interest rates, new issues of MGS were raised at lower coupon rates ranging from 3.07 to 4.053%. The papers were absorbed by the provident, pension and insurance funds (86%) and public enterprises (8%).

Apart from meeting financing requirements, the domestic borrowing programme was also aimed at ensuring the development of a reflective benchmark yield curve to facilitate the development of the domestic ringgit bond market. The auction calendar on the issue of government securities was maintained to enhance transparency and assist investors in asset allocation.

In 2002, the Government continued to tap the international capital markets to retain Malaysia's presence in the market for benchmarking purposes, to take advantage of declining spreads and to diversify and broaden the markets and investor base and to contribute to the global development of Islamic financing. Given the favourable external market conditions, the Government raised two external loans. In March, the Government reopened Malaysia's US$ Global Bond due 2011 (US$750 million) at the lower rate of 6.80%, 90 basis points lower than the initial issue of 7.70%. In June, the Government issued the first Global Islamic Sukuk due 2007 (US$600 million) to tap a broader range of investors and also provide impetus for the development of Islamic financial instruments in the international financial markets. Both issues achieved a positive market response and competitive pricing. After taking into consideration repayments of external loans and debt incurred by public enterprises and privatised entities, the ratio of external debt of the Federal Government to GDP was 10% (7% in 2001).

Table 2.8
Consolidated Public Sector Finance

	2001	2002*e*	2003*f*
	RM million		
General government[1]			
Revenue	91,633	98,813	105,101
Operating expenditure	72,299	77,794	82,025
Current surplus of general government	19,334	21,019	23,076
Current surplus of NFPEs[2]	39,484	37,551	38,718
Public sector current surplus	**58,818**	**58,570**	**61,794**
% of GDP	**17.6**	**16.2**	**16.2**
Net development expenditure	59,724	68,737	65,282
General government	*35,692*	*41,164*	*39,521*
NFPEs	*24,032*	*27,572*	*25,761*
Overall balance	**-906**	**-10,167**	**-3,488**
% of GDP	**-0.3**	**-2.8**	**-0.9**

[1] Comprises Federal Government, state governments, statutory bodies and local governments.
[2] Refers to 36 NFPEs.
e Estimate
f Forecast

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

High savings and ample liquidity allowed financing of the fiscal deficit from domestic sources. Total Government debt has remained manageable.

As outstanding debt of the Federal Government remained relatively low, the Government's debt servicing capacity continued to remain within prudential limits. Debt servicing as a proportion of the operating expenditure and revenue remained low at 14.1% and 11.6% respectively in 2002. The Government's exposure to exchange rate risks has been kept low as the bulk of its borrowing requirements were met from non-inflationary domestic sources (78% of total outstanding debt). Active debt management also reduced bunching of repayments, with about 60% of the debt having remaining maturity of more than three years. The bulk of the loans are also at fixed interest rates.

Consolidated Public Sector

In 2002, the consolidated public sector continued to record a large surplus in the current account. Notwithstanding the better revenue performance, higher expenditure of both the Federal Government and the NFPEs led to a higher overall deficit of 2.8% of GDP. Given the uncertainty in the global economy in 2002, the Federal Government selectively increased its expenditure during the year to support economic activities. Higher expenditure of the NFPEs reflected mainly capacity expansion undertaken mainly by the oil and gas-related and utility companies.

Federal Government Finance

In 2002, the Federal Government's current account registered a slightly smaller surplus of 4.1% of GDP from 4.7% of GDP in 2001. Revenue increased during the year, with higher receipts being entirely from tax sources. Nevertheless, the outturn of the overall fiscal deficit in 2002 was larger than planned in the 2002 Budget, due to higher allocations to support domestic economic activities and productive capacities. Both operating and development

Table 2.9
Federal Government Finance

	2001	2002*p*	2003 Budget
	RM million		
Revenue	79,567	83,515	89,183[2]
Operating expenditure	63,757	68,699	71,737
Current account	**15,810**	**14,817**	**17,446**
% of GDP	**4.7**	**4.1**	**4.5**
Net development expenditure	34,232	35,069	32,963
Gross development expenditure	*35,235*	*35,977*	*34,963*
Less Loan recoveries	*1,003*	*908*	*2,000*
Overall balance	**-18,422**	**-20,252**	**-15,517**
% of GDP	**-5.5**	**-5.6**	**-4.0**
Sources of financing:			
Net domestic borrowing	13,381	6,076	-
Gross borrowing	*23,500*	*18,000*	-
Less Repayment	*10,119*	*11,924*	-
Net foreign borrowing	6,295	8,019	-
Gross borrowing	*7,030*	*10,465*	-
Less Repayment	*735*	*2,446*	-
Special receipts	6	62	-
Realisable assets[1] and adjustments	-1,259	6,095	-
Total	**18,422**	**20,252**	**-**

[1] Includes changes in Government's Trust Fund balances. A decline in the accumulated realisable assets is indicated by a positive (+) sign.
[2] Includes a net revenue loss of RM610 million arising from the tax changes for 2003.
p Preliminary

Source: Ministry of Finance Malaysia

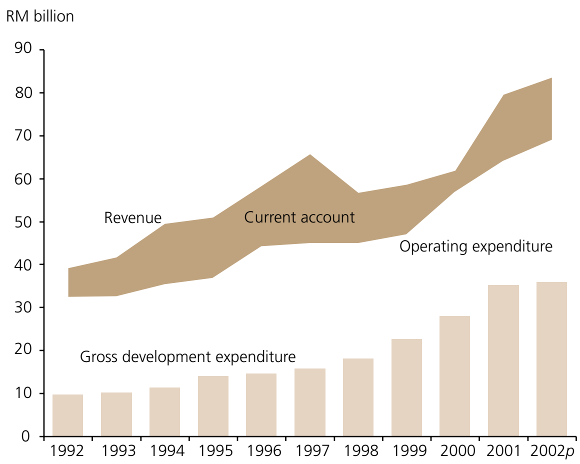
expenditures were higher than budgeted amounts. While the increase in operating expenditure reflected largely higher expenditure for salary adjustments, the increase in development expenditure reflected mainly increases in expenditures related to the fiscal stimulus, a significant portion of which was channelled to the education sector. Consequently, the overall financial position of the Federal Government registered a fiscal deficit of RM20.3 billion or 5.6% of GDP in 2002, compared with the initial estimate of 5.1%.

Federal Government **revenue** increased by 5% to RM83.5 billion in 2002. The increase in revenue emanated entirely from tax sources. Tax revenue rose by 8.7% to account for a higher share of total revenue (80%). Collection from non-tax revenue was lower, attributable mainly to lower receipts of investment income and petroleum royalties.

The higher tax revenue collection was due to the broad overall expansion in economic activities and concerted efforts made by the Government to broaden the tax base, strengthen the efficiency of tax collection, improve compliance and pursue stricter enforcement. On balance, the proportion of total revenue to GDP was sustained at a high level of 23.1% (23.8% a year ago). Of significance, the larger tax collection in 2002 was achieved amidst further reductions in income tax rates and import duties announced in the 2002 Budget and lower contribution from petroleum-based revenue. Crude oil prices were lower in 2001, the income tax base for 2002.

Both categories of tax revenue, direct and indirect taxes, increased in 2002. Of significance, receipts from corporate income tax, which accounted for 55.6% of direct taxes and 29.5% of total revenue, continued to register a double–digit growth of 19%. The higher

Graph 2.15
Federal Government Finance



Federal Government Debt

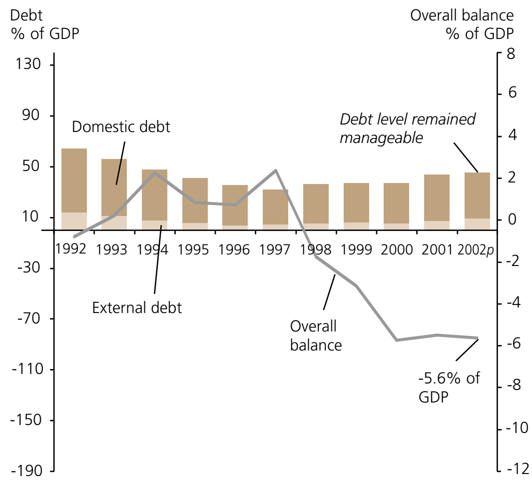


Table 2.10
Federal Government Revenue

	2001	2002*p*	2001	2002*p*
	RM million		Annual change (%)	
Tax revenue	**61,492**	**66,860**	**30.4**	**8.7**
% of GDP	**18.4**	**18.5**		
Direct taxes	42,097	44,351	44.4	5.4
Income taxes	40,135	42,237	48.6	5.2
Companies	*20,770*	*24,642*	*49.4*	*18.6*
Petroleum	*9,858*	*7,636*	*64.0*	*-22.5*
Individuals	*9,436*	*9,889*	*34.5*	*4.8*
Co-operatives	*70*	*69*	*-19.2*	*-1.4*
Real property gains tax	227	319	-8.3	40.7
Stamp duties	1,650	1,732	-8.3	5.0
Others	85	63	-9.4	-26.2
Indirect taxes	19,395	22,509	7.6	16.1
Export duties	867	803	-16.0	-7.3
Import duties	3,193	3,668	-11.3	14.9
Excise duties	4,130	4,745	8.6	14.9
Sales tax	7,356	9,243	23.3	25.7
Service tax	1,927	2,214	13.3	14.9
Others	1,922	1,836	0.4	-4.5
Non-tax revenue and receipts	**18,075**	**16,655**	**23.0**	**-7.9**
Total revenue	**79,567**	**83,515**	**28.6**	**5.0**
% of GDP	**23.8**	**23.1**		

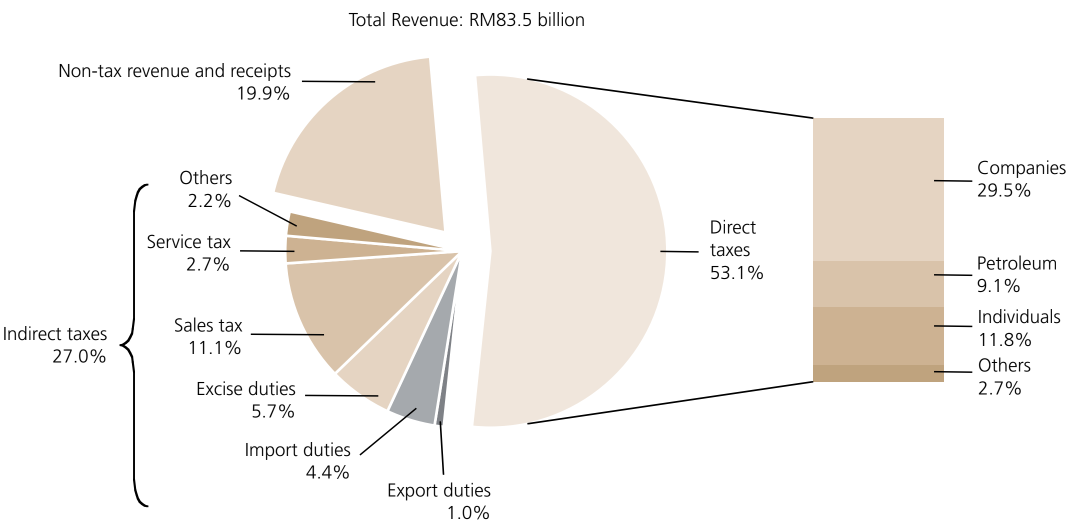
p Preliminary

Source: Ministry of Finance Malaysia

collection from this source reflected improved business earnings. Higher income levels also led to increased personal income tax collection (+4.8%). This was achieved despite the reduction in personal income tax rate of 1-2 percentage points and raising the threshold of taxable income subject to the maximum tax rate to exceeding RM250,000 from RM150,000. Revenue from stamp duties and real property gains tax also increased in 2002 due to higher volume and value of transactions in the stock market and higher value of transactions in the property market. In the direct taxes category, petroleum income tax was lower in 2002. Petroleum income tax declined by 22.5% due mainly to the weakening in crude oil prices, averaging US$25.53 per barrel in 2001, from US$29.58 per barrel in 2000.

Most major sources of indirect taxes recorded double-digit growth as a result of stronger domestic demand, revenue enhancing measures as well as increased efficiency in tax collection. In particular, sales tax collection was higher due largely to the reduction in tax exemption on petrol and petroleum products. The continued high demand for motor vehicles contributed to increases in excise and import duties. Revenue collection was also strengthened by the higher import and excise duties of 20% each for cigarettes and tobacco. The wider coverage for taxable services contributed to higher service tax collection. The annual threshold level for imposing service tax was reduced from an annual sales turnover of RM500,000 to RM300,000 and above for services provided by restaurants, bars, snack-bars, coffee-houses, private clubs and advertising firms; as well as from RM300,000 to RM150,000 and above for professional and consultancy services provided by accounting, legal, engineering, architectural, surveyor, consultancy firms and companies providing management services. Overall, the revenue enhancing measures contributed to a revenue gain of RM0.9 billion. Revenue foregone from abolishment and reduction of import duties on selected goods to reduce costs of doing business was lower, estimated at RM0.3 billion.

Graph 2.16
Composition of Federal Government Revenue, 2002 (% share)



In 2002, several measures were taken to improve the procedures for tax collection. In particular, tax compliance was enhanced through increasing the awareness of income earners and taxpayers on their tax obligations and hence helped identify potential taxpayers. Publicity and education campaigns were mounted during the year to disseminate information to the public. At the same time, additional commercial banks were designated as collection agencies and four additional Inland Revenue Board branches were established, for the convenience of the public. The provision of services was also enhanced through setting up of a processing centre to provide advisory services on tax-related matters. Weekly sessions with taxpayers were organised by the Royal Customs and Excise Department. Enforcement activities were strengthened by conducting internal and field audits to identify businesses liable to taxes. To minimise tax evasion, efficiency at the ports of entry to Malaysia was also improved.

Total Federal Government **gross expenditure** rose by 5.7% to RM104.7 billion in 2002 due to the expansionary fiscal programme to support domestic economic activities and enhance long-term productive capacities. **Operating expenditure** was higher by 7.8%. The total wage bill, which was the largest component of operating expenditure (29.5%), increased by 16% in 2002. The higher wage bill was attributed to the 10% salary and pension adjustment for civil servants, higher payments of bonus, higher expenditure following the extension in pension age from 55 to 56 years, higher rate for overtime allowances for

Table 2.11
Federal Government Operating Expenditure by Object

	2001	2002*p*	2001	2002*p*
	RM million		% share	
Emoluments	17,443	20,242	27.4	29.5
Supplies and services	10,704	11,269	16.8	16.4
Asset acquisition	1,339	968	2.1	1.4
Debt service charges	9,634	9,670	15.1	14.1
Pensions and gratuities	4,711	5,134	7.4	7.5
Subsidies	4,450	3,677	7.0	5.4
Other grants and transfers[1]	13,626	15,948	21.4	23.2
Other expenditure[2]	1,851	1,791	2.9	2.6
Total	**63,757**	**68,699**	**100.0**	**100.0**
% of GDP	**19.1**	**19.0**		

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

Source: Ministry of Finance Malaysia

doctors and increases in gratuities and specialist grants for the armed forces and police personnel. Payments for pensions and gratuities were also higher in line with the salary adjustment for civil servants.

Disbursements on supplies and services increased moderately by 5.3%, mainly on expenditure to upgrade the quality in the Government delivery channels. Increased expenditure was recorded for procurement relating to e-government flagship applications and payments for professional services as well as one-off allowances to graduates under the graduate attachment scheme to improve the skills of unemployed graduates. Servicing of domestic debt was lower, as the new loans were raised at lower interest rates, while higher outstanding external debt led to the increase in interest servicing on external loans. Other transfer payments were higher due mainly to grants and transfers to government agencies, including state governments, for development and maintenance purposes. Meanwhile, payment for subsidies was lower, following two price increases for petroleum products in 2002, and lower oil prices. The Government raised the retail prices of petroleum and petroleum products by two sen with effect from 1 May and by one sen with effect from 1 November.

Gross **development expenditure** was higher by 2.1% to RM36 billion, with the bulk of the outlays (84.8%) extended to social and economic services. Recognising the need to promote skills development and the nation's orientation towards a knowledge-based economy, the thrust of the spending was on human resource development. Consequently, the share of the education sector in total development spending has increased to account for a larger share of 34.6% (17.1% in 1999). The projects were mainly for the construction of single-session school system, smart schools, community colleges, new colleges and universities. In addition, emphasis was given for upgrading of educational infrastructure and support facilities, including provision of facilities for science and computer education and curriculum development. To provide loans for higher learning, the allocation for the Higher Education Fund was increased by RM500 million to RM1.8 billion.

Expenditure on housing was also higher, mainly for public low-cost housing projects for the low income group as well as for housing programmes for the armed forces, police personnel, customs and excise

Table 2.12
Federal Government Development Expenditure by Sector

	2001	2002*p*	2001	2002*p*
	RM million		% share	
Defence and security	3,287	4,333	9.3	12.0
Economic services	12,725	12,433	36.1	34.6
Agriculture and rural development	1,394	1,364	4.0	3.8
Trade and industry	4,830	3,474	13.7	9.7
Transport	5,042	5,401	14.3	15.0
Public utilities	1,092	1,808	3.1	5.0
Others	367	387	1.0	1.1
Social services	15,384	18,043	43.7	50.2
Education	10,363	12,436	29.4	34.6
Health	1,570	1,503	4.5	4.2
Housing	1,269	1,808	3.6	5.0
Others	2,183	2,296	6.2	6.4
General administration	3,839	1,168	10.9	3.2
Total	**35,235**	**35,977**	**100.0**	**100.0**
% of GDP	**10.5**	**9.9**		

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Source: Ministry of Finance Malaysia

officers and teachers. Expenditure for health remained large to improve the quality of health services. The bulk of such expenditure was for the construction and upgrading of hospitals as well as the provision of health services, mainly the installation of health equipment in rural health clinics.

In the economic services sector, capital outlays for the transport sector absorbed the largest share of the development expenditure (15%). Higher expenditure was spent mainly on air, port and road transportation to develop a more efficient and effective integrated transportation system linking air, rail, land and marine transportation networks. Outlays on trade and industry were focused on the provision of infrastructure facilities, industrial research and development, development of small and medium enterprises and promotion of tourism. Reflecting the Government's commitment to upgrade the standard of living in the rural area, expenditure on agriculture and rural development remained high, with higher investment to improve rural roads, water supply and electrification programmes.

Spending for defence and internal security was also higher, mainly for modernisation programme of the armed forces and police. On the other hand, general administration expenditure was substantially lower, largely on account of the gradual completion of the new Government administrative centre in Putrajaya.

In 2002, the Government's **financing** requirements were only to fund the development expenditure, as the operating account continued to register a surplus. Of the fiscal deficit of RM20.3 billion, 30% or RM6.1 billion was funded from the drawdown of its accumulated realisable assets. Hence, new borrowings by the Federal Government declined during the year. **Net borrowing** by the Federal Government declined to RM14.1 billion in 2002 from RM19.7 billion in 2001. Consequently, total debt of the Federal Government was contained at RM165 billion or 45.6% of GDP as at the end of 2002 (43.6% of GDP as at end-2001).

Of the total gross borrowings of RM28.5 billion raised in 2002, 63% was raised from the **domestic** market. The continued high national savings rate and ample liquidity in the banking system allowed funding requirements of the Government to be met without "crowding out" private sector access to financing. In an environment of declining interest rates in the domestic money market, new issues of MGS were raised at lower coupon rates ranging from 3.07 to 4.053%. The low interest rate environment reduced significantly the cost of debt issuance and contained the increase in the Government's future debt servicing burden. Apart from meeting financing requirements, the domestic borrowing programme was also aimed at providing a reflective benchmark yield curve to facilitate the development of the domestic ringgit bond market.

The issuance of government securities in the domestic market amounted to RM18 billion. During the year, the Federal Government floated five issues of

Graph 2.17
Federal Government Outstanding Debt as at end-2002*p* (% share)

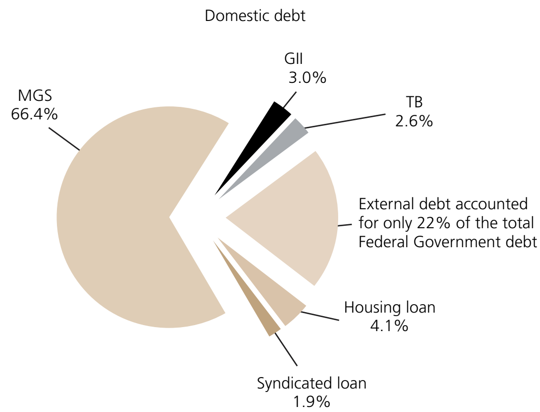

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Table 2.13
Federal Government Outstanding Debt

	Annual change		As at end
	2001	2002*p*	2002*p*
	Nominal value in RM million		
Domestic debt	**14,591**	**7,284**	**128,680**
Treasury bills	0	0	4,320
Government Investment Issues	0	1,000	5,000
Malaysian Government Securities	14,400	6,100	109,550
Treasury Housing Loans Fund	1,259	1,180	6,735
Market loans	-1,068	-996	3,075
External debt	**5,508**	**11,955**	**36,283**
Market loans	5,642	10,992	28,674
Project loans	-134	963	7,609
Total	**20,099**	**19,239**	**164,963**
% of GDP			**45.6**

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Source: Ministry of Finance Malaysia

Malaysian Government Securities (MGS) totalling RM15 billion, by way of open tender through principal dealers, as well as via private placements. A sole issue of the Government Investment Issues (GII) amounting to RM3 billion was also raised. As part of the strategy to develop the domestic bond market, the Government continued to issue securities on a regular basis and with maturities ranging from 3, 5 and 10-years to meet the demands of the market and to generate a benchmark yield curve. The Government also reopened three of its existing MGS issues to increase their respective sizes. The strategy was to develop the secondary market by enhancing market liquidity. The issuance of Treasury bills (TB) was only to meet rollover of maturing bills.

The bulk of the new MGS issuance was absorbed by the provident, pension and insurance funds, which continued to be the dominant holders, holding 77% of the outstanding MGS. In terms of ownership structure for GII and TB, the banking sector was the main holder, followed by insurance companies.

While the Government continued to rely on domestic sources to meet its financing requirements, the Government also tapped the international capital markets for benchmarking purposes, to take advantage of low costs, and diversify and make inroads into the broader international financial markets in terms of financing based on Islamic principles. Given the favourable **external** market conditions, the Government raised two external borrowings. In March, the Government reopened Malaysia's US$ Global Bond due 2011 by US$750 million (RM2.9 billion) at a much lower rate of 6.80%, 90 basis points lower than the initial issue of 7.70%. The reopening was seven times oversubscribed, reflecting investors' confidence in Malaysia's strong economic fundamentals. In June, the Government issued the first sovereign Global Islamic Sukuk due 2007 amounting to US$600 million (RM2.2 billion) to provide an impetus for the development of Islamic financial products in the international market. The bond was raised at a coupon rate of the six-month US dollar London Inter Bank Offer Rate (LIBOR) plus 95 basis points. The bond was oversubscribed by more than two times, reflecting worldwide interest and acceptance of the inaugural Global Islamic Bond.

Other sources of external borrowing comprised mainly the draw down of project loans from bilateral sources, especially from Japan under the New Miyazawa Initiative and from multilateral sources such as the World Bank and the International Development Bank. The Government signed a ¥68 billion project loan (RM1.6 billion) in February 2002 with the Japan Bank for International Cooperation. The loan was for the financing of high technology ventures and would be drawn down over several years. After taking into account the exchange rate revaluation loss arising from the strengthening of the yen and euro against the ringgit, as well as assumption of debt incurred by public enterprises and privatised entities, the ratio of external debt of the Federal Government to GDP increased to 10% from 7% in 2001. Nevertheless, external debt of the Federal Government remained low, accounting for 19.6% of the nation's external

Table 2.14
Holdings of Federal Government Domestic Debt

	2001	2002*p*	2001	2002*p*
	Nominal value in RM million		% share	
Treasury bills	**4,320**	**4,320**	**100.0**	**100.0**
Insurance companies	160	65	3.7	1.5
Banking sector	4,014	3,744	92.9	86.7
Other	146	512	3.4	11.8
Government Investment Issues	**4,000**	**5,000**	**100.0**	**100.0**
Insurance companies	195	320	4.9	6.4
Banking sector	3,805	4,680	95.1	93.6
Malaysian Government Securities	**103,450**	**109,550**	**100.0**	**100.0**
Social security and insurance institutions	79,071	84,341	76.4	77.0
of which:				
Employees Provident Fund	*67,415*	*71,995*	*65.2*	*65.7*
Insurance companies	*8,566*	*9,315*	*8.3*	*8.5*
Banking sector	18,594	14,629	18.0	13.4
Other	5,785	10,580	5.6	9.7

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debt. Notwithstanding the increase in external debt in 2002, the bulk of the outstanding debt of the Federal Government was raised from domestic sources (78%).

Total outstanding **debt** of the Federal Government increased moderately by 13.2% to RM165 billion or 45.6% of GDP. Lower net domestic borrowings led to a decline in the proportion of the domestic debt outstanding, from 36.3% of GDP as at end-2001 to 35.6% of GDP as at end-2002. Overall, the Government's debt servicing capacity continued to remain within prudent levels. Debt servicing as a proportion of the operating expenditure and revenue remained low at 14.1% and 11.6% respectively in 2002. External debt service ratio of the Federal Government also remained low at 1%. Active debt management also reduced bunching of repayments, with about 60% of the debt having remaining maturity of more than three years. The bulk of the loans are also at fixed interest rates, reducing exposure to any significant increase in interest rates.

Table 2.15
Consolidated State Government Finance

	2001	2002*e*	2003 Budget
	RM million		
Revenue	8,312	9,477	9,452
State sources	*6,867*	*7,191*	*7,159*
Federal grants and transfers	*1,445*	*2,286*	*2,293*
Expenditure	5,305	5,386	6,478
Current surplus	**3,007**	**4,091**	**2,974**
% of GDP	**0.9**	**1.1**	**0.8**
Net development expenditure	4,704	5,549	5,538
Gross development expenditure	*4,870*	*5,735*	*5,722*
Less: Loan recoveries	*166*	*186*	*184*
Overall balance	**-1,697**	**-1,458**	**-2,565**
% of GDP	**-0.5**	**-0.4**	**-0.7**
Sources of financing:			
Federal loans	549	626	650
Realisable assets[1]	1,148	832	1,914
Total	**1,697**	**1,458**	**2,565**

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

Source: State governments

State Governments

Based on preliminary estimates, the consolidated financial position of the state governments registered a larger current account surplus. Better revenue receipts were recorded, while operating expenditure increased moderately. As development expenditure was also higher, the consolidated financial position of the state governments recorded a smaller overall deficit of 0.4% of GDP in 2002. The overall deficit was financed by Federal Government loans and drawdown of accumulated financial assets of the state governments.

During the year, the higher consolidated state revenue was derived from both state and Federal sources. The sharply higher commodity prices, particularly for crude palm oil and saw logs, had a positive impact on the states' own sources of revenue. Meanwhile, receipts from Federal sources were also higher to assist the states in providing infrastructure and essential amenities to support the increasing urbanisation in the states. Increase in operating expenditure reflected mainly higher payments for emoluments following the salary adjustment for state civil servants as well as payments for supplies and services. A major portion of the higher development expenditure was directed to expansion and upgrading of public utilities, water supply projects, infrastructure, housing, and agricultural and rural development.

Non-Financial Public Enterprises

The non-financial public enterprises (NFPEs) continued to play an important role in the economy, particularly in the development of natural resources and provision of public utilities. Based on preliminary estimates, the overall financial position of the 36 NFPEs continued to record an overall surplus position. The consolidated revenue of the NFPEs rose by 5.3% to RM110.6 billion, as a result of enhanced earnings from telecommunication and utilities and the agriculture-based and construction sectors. Nevertheless, a smaller overall surplus of RM10.3 billion or 2.8% of GDP was recorded attributed to the higher operating and development expenditures. The commencement of several development projects during the year resulted in higher operating expenditure. At the same time, increased disbursement for current expenditure also reflected higher fuel costs, following the use of alternate fuels, as well as the continued organisational restructuring to improve service delivery.

The higher capital outlay of NFPEs was channelled towards the expansion in capacity and productivity enhancement to improve efficiency and quality of services rendered to the public as well as increased investments abroad to enhance their revenue-generating capacity. In particular, higher capital spending was incurred by Petroliam Nasional Berhad

Table 2.16
Consolidated NFPEs Finance[1]

	2000	2001	2002*e*
	RM million		
Revenue	115,419	105,075	110,634
Current expenditure	71,725	65,392	72,811
Current account	**43,694**	**39,683**	**37,823**
% of GDP	**12.8**	**11.9**	**10.5**
Development expenditure[2]	23,360	24,032	27,572
Overall balance	**20,334**	**15,651**	**10,250**
% of GDP	**5.9**	**4.7**	**2.8**

1 Refers to 36 NFPEs.
2 Includes grant from the Federal Government.
e Estimate

Source: Ministry of Finance Malaysia and non-financial public enterprises

(PETRONAS), Telekom Malaysia Berhad (Telekom) and Putrajaya Holdings Sdn. Bhd. During the year, PETRONAS continued to invest in both upstream and downstream activities, including the upgrading of Malaysia Liquefied Natural Gas I and 2 plants in Bintulu. Other major projects undertaken by the company included development of the permanent campus for Universiti Teknologi PETRONAS in Tronoh, Perak and expansion of the tanker fleet by the Malaysia International Shipping Corporation to accommodate the increase in future exports of LNG. PETRONAS also continued to expand its overseas investments during the year, which included the exploration and production projects in Chad, Vietnam, Egypt and Sudan.

A large share of Telekom development expenditure was on upgrading and capacity building to improve the telecommunications infrastructure. During the year, Telekom also diversified its activities to strengthen its core business through the acquisition of Celcom (Malaysia) Berhad. Similarly, Tenaga Nasional Berhad (TNB) continued with its capacity expansion and upgrading of infrastructure namely, generation, transmission and distribution of electricity to meet higher demand by the commercial and industrial sectors as well as residential users. Major projects undertaken included the Janamanjung Coal Fired Power Plant, Gelugor Combined Cycle Conversion Project and East West Grid Interconnection. The capital outlays by Putrajaya Holdings Sdn. Bhd. were mainly for the new administrative centre in Putrajaya.

The capital outlays of the NFPEs were mainly financed by internally generated funds. During the year, net repayments on external debt by public enterprises amounted to RM3.3 billion. Consequently, total outstanding external debt of the public enterprises was lower at RM64.3 billion or 17.8% of GDP to account for a lower share of the nation's external debt (34.7%). Debt servicing remained low with the debt service ratio of 2.4%.

In 2002, the Government pursued its privatisation exercise on a more selective basis. Projects selected were based on their viability and high multiplier effects to stimulate economic growth. Only one new project and one existing project were privatised during the year. The new privatised project was for the construction of logistics complex for the Selangor police head-quarters and police forces' quarters in Ipoh and Shah Alam, while the existing privatised project was the pre-printing, design and marketing activities of Dewan Bahasa dan Pustaka.