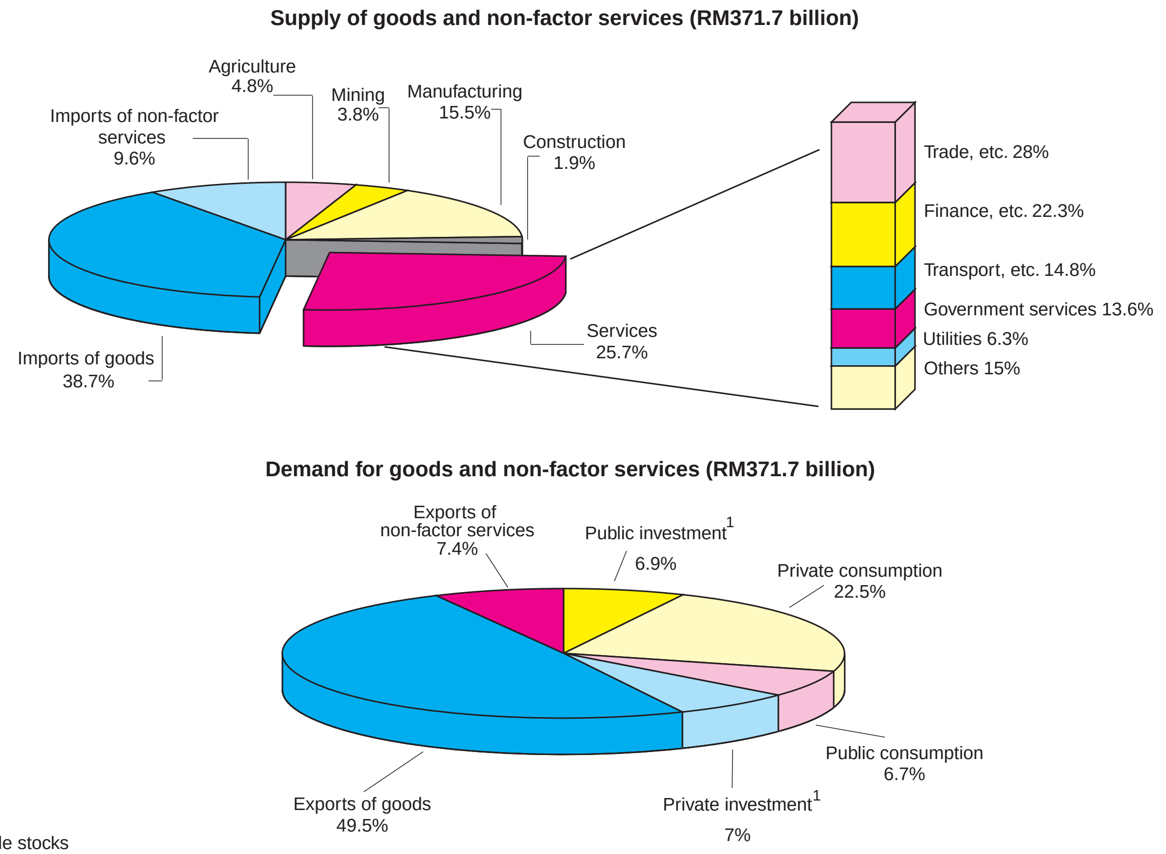
1 The Real Economy

Overview

While GDP growth in 1999 was stronger than forecast, all other developments in the Malaysian economy were in line with expectations. The selective exchange controls implemented in September 1998 allowed Malaysia to emerge from the recession with strengthened macroeconomic fundamentals. In 1999, economic activity in Malaysia rebounded from a contraction of 7.5% in 1998 to record a strong positive growth of 5.4%, higher than the earlier forecast of 4.3% in 1999. The value of GDP has returned to almost the same level as in 1997. Following the increase in nominal gross national income of 4.2%, per capita GNP turned around to register a positive growth of 1.7% to RM12,343 (US$3,248) in 1999 (1998: RM12,134 or US$3,093 and 1997: RM12,314 or US$4,377).

More importantly, overall macroeconomic fundamentals have strengthened. Remaining selective exchange controls and the fixed exchange rate continued to ensure stable financial markets. The policy measures implemented by the Government have been successful in addressing immediate-term issues without undermining medium-term growth potential. Despite a strong rebound in domestic economic activities, inflation moderated further. The balance of payments position strengthened further and the build-up of external reserves reflected the strong net inflows in both the current and long-term capital accounts. Total external debt, which has traditionally remained low, declined further. Further progress was achieved in banking and corporate restructuring. Aided by the economic recovery, the banking sector's balance sheets improved

Graph 1.1: The Economy in 1999
(at 1987 Prices)



[1]Include stocks

Table 1.1: Malaysia – Key Economic Indicators

	1997	1998	1999p	2000f
Population (million persons)	21.6	22.2	22.7	23.3
Labour force (million persons)	9.0	8.9	9.0	9.2
Employment (million persons)	8.8	8.6	8.7	8.9
Unemployment (as % of labour force)	2.4	3.2	3.0	2.9
Per Capita Income (RM)	12,314	12,134	12,343	12,893
(US$)	4,377	3,093	3,248	3,393
NATIONAL PRODUCT (% change)				
Real GDP	7.5	–7.5	5.4	5.8
(RM billion)	197.1	182.3	192.2	203.4
Agriculture, forestry and fishery	0.4	–4.5	3.9	2.0
Mining and quarrying	2.9	1.8	–4.0	2.1
Manufacturing	10.4	–13.7	13.5	10.0
Construction	10.6	–23.0	–5.6	5.0
Services	9.9	–0.8	2.9	5.4
Nominal GNP	10.3	0.9	4.2	7.0
(RM billion)	266.8	269.1	280.3	299.9
Real GNP	7.4	–5.4	4.3	5.4
(RM billion)	182.7	172.9	180.3	190.1
Real aggregate domestic demand[1]	6.8	–25.2	1.6	7.3
Private expenditure[1]	6.5	–30.2	–3.5	8.3
Consumption	4.3	–10.8	2.5	9.5
Investment	9.4	–55.0	–19.0	4.5
Public expenditure[1]	8.1	–8.3	14.8	5.2
Consumption	7.6	–7.8	20.1	0.2
Investment	8.5	–8.7	10.1	10.0
Gross national savings (as % of GNP)	39.4	41.9	40.8	38.4
BALANCE OF PAYMENTS (RM billion)				
Merchandise balance	10.3	69.0	83.5	83.4
Exports (f.o.b.)	217.7	281.9	315.7	350.3
Imports (f.o.b.)	207.4	212.9	232.2	266.9
Services balance	–22.7	–22.3	–28.9	–32.9
(as % of GNP)	(–8.5)	(–8.3)	(–10.3)	(–11.0)
Transfers, net	–3.3	–9.9	–7.2	–7.9
Current account balance	–15.8	36.8	47.4	42.6
(as % of GNP)	(–5.9)	(13.7)	(16.9)	(14.2)
Bank Negara Malaysia reserves, net	59.1[2]	99.4[3]	117.2[3]	–
(as months of retained imports)	(3.4)	(5.7)	(5.9)	–
PRICES (% change)				
CPI (1994=100)	2.7	5.3	2.8	3.2
PPI (1989=100)	2.7	10.7	–3.3	1.0
Average wages in the manufacturing sector	5.9	–2.4	2.7	–

Note: Figures may not necessarily add up due to rounding.

[1] Exclude stocks.
[2] In 1997, the foreign exchange gain on the balance sheet date was not recognised in the Bank's account, in view of the volatility of the exchange rates during that year.
[3] Arising from the fixing of the ringgit/US dollar exchange rate in September 1998, all assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the cumulative gain/loss has been reflected accordingly in the Bank's current year account. The US dollar equivalent of international reserves as at 31 December 1999 was US$30.9 billion.
p Preliminary
f Forecast

Table 1.2: Malaysia – Financial and Monetary Indicators

	1997	1998	1999*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	65.7	56.7	58.7
Operating expenditure	44.7	44.6	46.7
Development expenditure	14.4	17.1	21.5
Overall balance	6.6	–5.0	–9.5
Overall balance (% of GNP)	2.5	–1.9	–3.4
Public sector development expenditure	40.0	46.8	47.4
Public sector overall balance (% of GNP)	6.5	–1.3	0.2
EXTERNAL DEBT			
Total debt (RM billion)	170.8	162.0	159.7
Medium & long-term debt	127.5	129.8	136.8
Short-term debt	43.3	32.2	22.8
Debt service ratio (% of exports of goods & services)			
Total debt	5.5	6.4	5.3
Medium & long-term debt	4.7	5.7	4.8

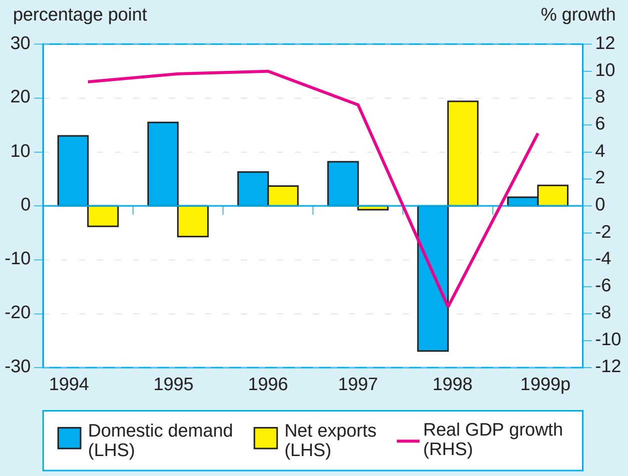
	Change in 1997		**Change in 1998**		**Change in 1999**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
MONEY AND BANKING						
Money supply M1	2.8	4.6	–9.2	–14.6	18.2	33.6
M2 54.0	22.7	4.3	1.5	34.4	11.6	
M3 61.1	18.5	10.6	2.7	33.1	8.2	
Banking system deposits	76.1	21.3	–2.1	–0.5	17.2	4.0
Banking system loans[1]	88.2	26.5	5.4	1.3	1.1	0.3
Manufacturing	9.9	18.5	1.8	2.9	0.9	1.4
Property sector	35.5	34.0	9.7	6.9	4.3	2.9
Finance, insurance and business services	3.4	10.3	1.8	5.0	–4.7	–12.3
Loan-deposit ratio (end of year)	92.7%		91.4%		84.1%	

	1997	**1998**	**1999**
	%	%	%
Interest rates (average rates at end of year)			
3-month interbank	8.70	6.46	3.18
Commercial banks			
Fixed deposits: 3-month	9.06	5.83	3.33
12-month	9.33	5.74	3.95
Savings deposit	4.23	3.87	2.76
Base lending rate (BLR)	10.33	8.04	6.79
Finance companies			
Fixed deposits: 3-month	10.32	6.43	3.49
12-month	10.25	6.57	4.13
Savings deposit	5.49	5.01	3.50
Base lending rate (BLR)	12.22	9.50	7.95
Treasury bill (3-month)	6.76	5.37	2.71
Government securities (1-year)	7.01	5.79	3.37
Government securities (5-year)	7.75	6.66	5.21

	1997	**1998**	**1999**
	%	%	%
Movement of Ringgit (end-period)			
Change against composite	–31.4	– 0.2	–1.3
Change against SDR	–30.8	–1.8	2.7
Change against US$	–35.0	2.3	0.0

[1] Beginning December 1996, loans by sector are classified using a new statistical reporting format.
p Preliminary

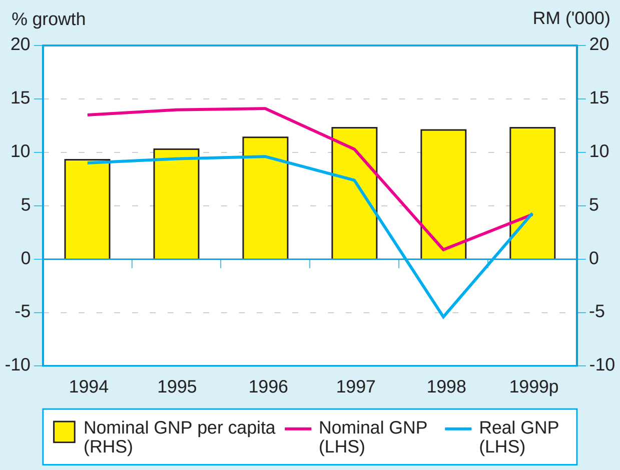
Graph 1.2
Contribution to Real GDP Growth: Domestic Demand and Net Exports



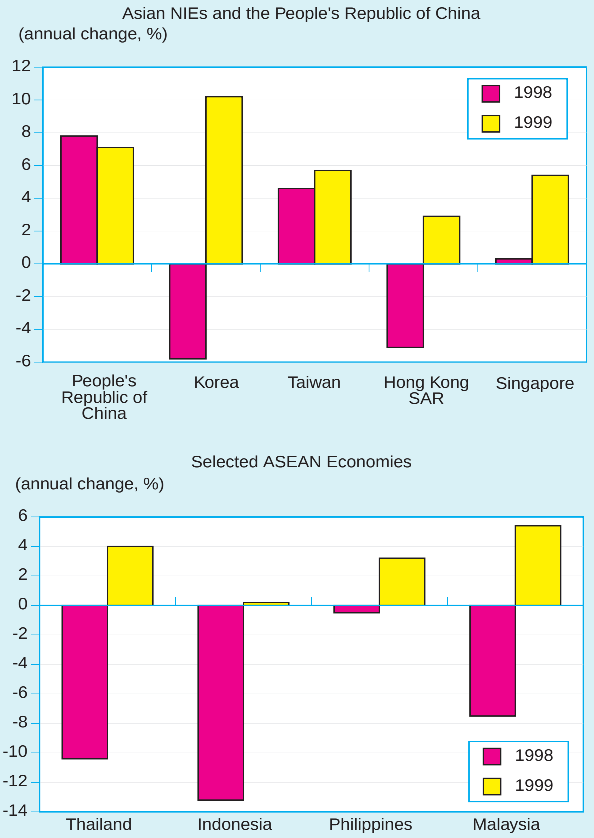
significantly. Consequently, loan disbursements by the banking system have increased, supporting the economic recovery. On the socio-economic front, labour market conditions improved. Macroeconomic adjustments were achieved without serious dislocations in jobs and social unrest.

The nascent signs of improvement seen since the fourth quarter of 1998 strengthened during the course of 1999. In the first half of 1999, the economy expanded by 1.5%. The expansion gathered momentum in the second half-year when expansionary fiscal and monetary operations as well as sustained buoyant external demand raised real output growth to 9.4% in the second half-year.

Graph 1.3
GNP Growth and Nominal GNP per Capita



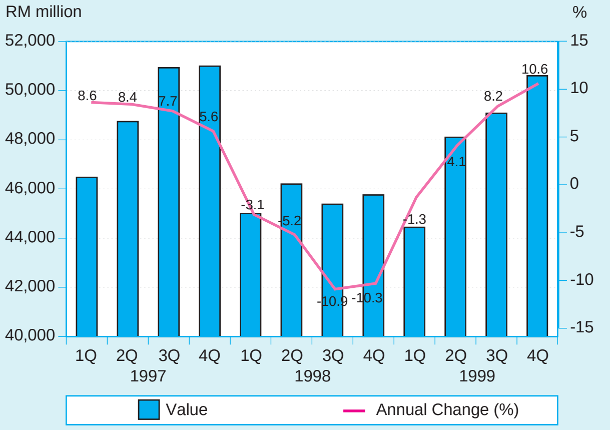
Graph 1.4
Regional Countries: Real GDP Growth



The better-than-expected performance in 1999 was due to both external developments and the prompt policy response to reduce the severity of the impact of the crisis on the Malaysian economy. On the external front, world growth picked up to 3% in 1999 (1998: 2.5%), reflecting higher growth in the industrial countries and stronger-than-expected recovery in Asia. In line with increased economic activity and a strong recovery in global demand, growth of world trade was sustained at 3.7% (1998: 3.6%). The uncertainties in the early part of 1999 of possible risk of deceleration in output growth in the industrial countries did not materialise. Growth in the major industrial countries increased by 2.7% in 1999 (1998: 2.4%). This together with the revival of domestic demand in other regional countries contributed to significant strengthening of demand for exports from Malaysia.

On the domestic front, the stability in the financial markets which emerged after the introduction of selective exchange controls and the fixed exchange rate in September 1998 provided fundamental support to the process of economic recovery. Stability in the financial markets after restrictions were imposed to eliminate the internationalisation of the ringgit enabled the Government to take proactive measures to bring

Graph 1.5
Malaysia's Quarterly GDP: Value and Annual Growth



about an early recovery of the economy. The fixing of the exchange rate provided businesses with some degree of certainty to plan their operations. Stable market conditions were crucial to allow businesses to respond positively to rising export demand. The expansion in the export sector generated increases in income which provided the basis for a significant revival in private consumption. The expansion in domestic economic activity was further reinforced by measures taken to accelerate disbursements for projects under the fiscal stimulus package. At the same time, measures to strengthen the banking sector enabled the banking sector to refocus on lending activities. Although initial expansion in loans was slow, loan approvals and disbursements showed a significant increase in the latter part of the year, lending support to the expansion in economic activities. In terms of capital strength, the risk-weighted capital ratio (RWCR) of the banking system improved further while the ratio of net non-performing loans (NPLs) to total loans of the banking system stabilised. In value terms, the amount of NPLs was lower in 1999.

On the **supply side**, growth was initially driven by the strong performance of the export-oriented industries in the manufacturing sector. The recovery became increasingly more broad-based during the course of the year. Within the manufacturing sector, growth became broad-based from the second quarter onwards as both domestic and export-oriented industries registered positive growth rates. In the second quarter, all sectors except mining and construction recorded positive growth. By the third quarter, the construction sector had also turned around to record positive growth. The decline in value added in the mining sector in all four quarters reflected the deliberate decision under the National Depletion Policy to conserve reserves.

In 1999, value added in the **manufacturing** sector increased at a double-digit rate of 13.5% (–13.7% in 1998), following expansion in output of the manufacturing sector since February 1999. Output in the export-oriented industries increased by 12.9% buoyed by the strong performance of the electronic goods initially and subsequently by higher output in the electrical products, off-estate processing and textiles and wearing apparel industries. The strong growth of the domestic-oriented industries as a group (13.1%) was due mainly to output expansion of the transport equipment (motor vehicles as well as motor vehicle parts and accessories), construction-related products and chemical products industries, with improved performance of most sub-sectors.

In the **agriculture** sector, growth in value added turned around sharply (+3.9%; 1998: –4.5%) mainly on account of the marked increase in crude palm oil production (+26.8%) and to a lesser extent, the growth in saw log production (+1.2%). The upturn in the biological yield cycle for the oil palm trees as well as increased mature area raised output of crude palm oil markedly.

The performance of the **construction** sector improved to record a smaller decline of 5.6% in 1999 (–23% in 1998). The improvement in construction activities was supported by the increase in Government spending in public sector projects such as roads, utilities and housing as well as revival of several critical privatised projects. Policy measures introduced since May 1998 focused mainly on reducing excess stocks (home ownership campaigns) and increasing access to finance (special housing fund for low- and medium-cost houses), while lower interest rates also helped to revive activities in the residential sector. As a result, value added in the construction sector registered a positive growth of 1.8% in the second half-year, after declining at a lower rate of 12.3% in the first half-year.

With the overall improvement in the economy, the **services** sector turned around to increase by 2.9% in 1999. Higher Government operating expenditure accounted for the growth in the government services sub-sector while strong manufacturing activities contributed to the improved performance of the utilities and transport, storage and communications sub-sectors. The increase in disposable income and increased tourist arrivals led to higher growth in the wholesale, retail, restaurants and hotels sub-sector.

Table 1.3
Private Consumption Indicators

	1998	1999				
		Q1	Q2	Q3	Q4	Year
Sales of passenger cars, including 4WD						
Annual change (%)	–54.8	141.3	105.4	76.7	40.1	79.9
’000 units	142.2	55.8	59.8	68.7	71.6	255.9
Imports of consumption goods[1]						
Annual change (%)	–32.9	1.7	16.7	30.6	36.2	21.3
US$ billion	3.4	0.9	1.0	1.0	1.2	4.1
Tax collection						
Sales tax (RM billion)	3.8	1.1	1.0	1.3	1.1	4.5
Service tax (RM billion)	1.4	0.4	0.3	0.5	0.3	1.5
Total loans approved by the banking system						
Consumption credit (excluding passenger cars) (RM billion)	4.1	1.0	1.2	1.8	1.8	5.7
Wholesale, retail, restaurant & hotels (RM billion)	4.9	1.6	1.6	2.7	1.7	7.6
Stock market indicators[2]						
Market capitalisation (RM billion)	374.5	317.9	532.0	457.6	552.7	552.7
KLSE composite index (points)	586.1	502.8	811.1	675.5	812.3	812.3
MIER Consumer Sentiments Index	–	84.0	101.6	111.3	117.7	–

[1] Broad Economic Classification
[2] End-period

Value added in the **mining** sector contracted by 4% due to lower production of crude oil in line with the National Depletion Policy. Crude oil production was lower at 693,200 barrels per day, 4.4% lower than the level recorded in 1998. Production of natural gas increased by 2.1% in response to higher demand from both domestic and external sources.

On the demand side, strong economic growth was sustained by robust export performance, accelerated public sector expenditure and a revival in private

Table 1.4
Private Investment Indicators

	1998	1999				
		Q1	Q2	Q3	Q4	Year
Sales of commercial vehicles, including 4WD						
Annual change (%)	–76.1	35.9	78.4	77.6	27.4	50.8
’000 Units	21.7	6.6	7.5	8.9	9.7	32.7
Imports of capital goods[1]						
Annual change (%)	–40.5	–36.0	–11.6	12.5	21.6	–5.9
US$ billion	9.2	1.8	2.0	2.5	2.4	8.7
Applications to MITI						
No. of projects	726	192	162	198	195	747
Total capital investment (RM billion)	18.9	3.7	3.9	4.2	2.3	14.0
Foreign	*12.6*	*2.0*	*2.6*	*3.0*	*1.4*	*9.0*
Local	*6.3*	*1.6*	*1.3*	*1.2*	*0.9*	*5.0*
Approvals by MITI						
No. of projects	844	171	197	146	194	708
Total capital investment (RM billion)	26.4	6.1	2.4	3.4	4.9	16.9
Foreign	*13.1*	*5.3*	*1.7*	*1.4*	*3.9*	*12.3*
Local	*13.3*	*0.8*	*0.7*	*2.1*	*1.0*	*4.6*
Total loans approved by the banking system						
Manufacturing sector (RM billion)	10.3	2.7	3.8	3.3	4.2	14.0
Construction sector (RM billion)	5.7	1.4	2.0	2.5	2.0	7.9
MIER Business Conditions Index	–	48.2	60.3	62.2	61.0	–

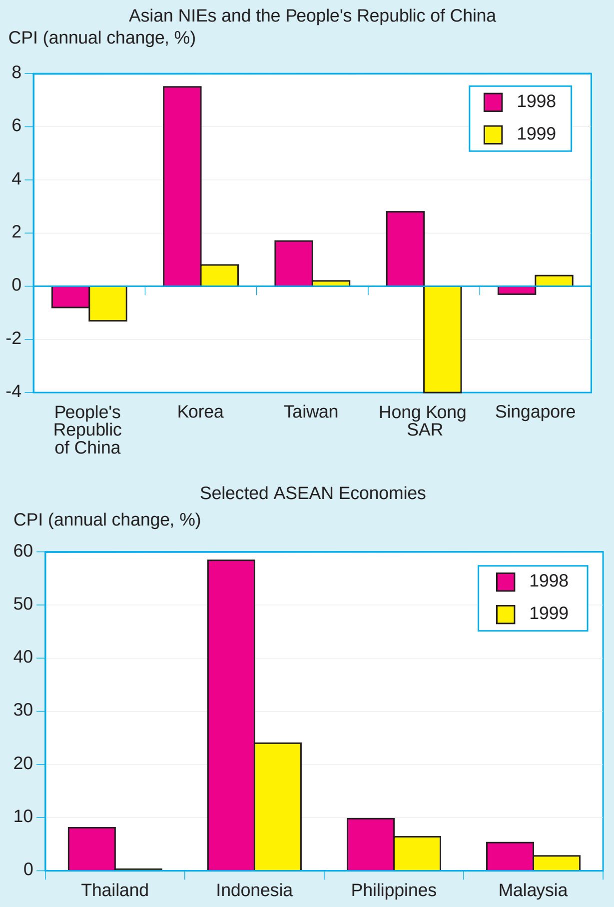
[1] Broad Economic Classification

consumption expenditure. Growth in real aggregate **domestic demand** (excluding stocks) increased by 1.6% in 1999, due mainly to the fiscal stimulus measures implemented by the Government and the revival in private sector consumption expenditure. Public sector expenditure recorded a strong positive growth of 14.8% following the speedier implementation of projects under the fiscal stimulus programme, particularly in the second half-year. Of significance, private consumption turned around to record a positive growth beginning from the second quarter. For the year as a whole, private consumption increased in real terms by 2.5% in 1999, following a decline of 10.8% in 1998. The decline in private investment moderated as lower stock levels and higher capacity utilisation rates became evident in several major industries.

Despite the pick-up in economic activities and increase in capacity utilisation in major sectors, inflationary pressures remained subdued in 1999. Inflation as measured by the **Consumer Price Index (CPI, 1994=100)** moderated to 2.8%, from 5.3% in 1998. The monthly inflation rate moderated to 1.6% in November 1999, representing a significant deceleration from the peak of 6.2% in June 1998. The moderation in the CPI was mainly attributable to the absence of imported inflation from abroad, relative stability of ringgit exchange rate and continued excess capacity in some selected industries in the economy. The decline in non-oil commodity prices was another contributory factor. Growth of most components of the CPI moderated in 1999. The exceptions were beverages and tobacco and transport and communication which recorded higher growth, while the clothing and footwear component recorded a decline. Excluding food, inflation for 1999 was lower at 1.6%, compared with 3.1% in 1998.

The **labour market** situation improved in 1999 following the stronger-than-expected growth in the domestic economy. The unemployment rate is

Graph 1.6
Regional Countries: Inflationary Trends



estimated to have declined to 3%, well below the full employment level of 4% (1998: 3.2%). The improved employment situation was also reflected in key employment indicators including retrenchment, number of job vacancies and job seekers. The Government's counter-cyclical measures and the special attention given to the social agenda have helped to reduce the severity of the economic downturn and contain the deterioration in the overall employment situation. The counter-cyclical measures contained a programme to protect the lower income groups from the adverse effects of the crisis.

On the external front, the overall **balance of payments** position strengthened further to record a surplus of RM17.8 billion or US$4.7 billion, driven by favourable external trade balance and a larger net inflow of long-term capital. In the trade account, gross exports (in US dollar terms) have increased for five consecutive quarters, while import growth has turned positive since the second quarter of 1999. In US dollar terms, exports of manufactured goods rose by 17.6%, benefiting especially from strong global demand for electronic products such as semi-conductors, personal computers and other information and communications-related components. Following the rebound in exports, imports of intermediate goods in US dollar terms have recorded positive growth since March 1999. Imports of capital goods have turned positive since June 1999 reflecting the recovery in private investment activities in the second half-year. Nevertheless, export growth was stronger (12%) relative to import growth (9%) contributing to a record merchandise surplus of RM83.5 billion (US$22 billion) and another year of a large **current account surplus** of RM47.4 billion (US$12.5 billion) or 16.9% of GNP in 1999.

The balance on the **long-term capital account** increased to RM11.7 billion (US$3.1 billion) due mainly to higher inflows of official long-term capital and foreign direct investment. The net private long-term capital account, however, showed a decline due mainly to higher overseas investments by Malaysians. **The overall balance of payments** recorded a surplus of RM17.8 billion, after adjusting for revaluation losses from ringgit appreciation, increased short-term trade credits, further reduction in short-term external debt of commercial banks and the non-bank private sector and some liquidation and repatriation of portfolio investment by foreign investors, following the expiry of the one-year holding period for portfolio investment. Consequently, the **net international reserves of Bank Negara Malaysia** increased to RM117.2 billion (US$30.9 billion) as at end-1999, from RM99.4 billion (US$26.2 billion) at the end of 1998. This level of reserves was sufficient to finance 5.9 months of retained imports (5.7 months in 1998). In addition, the international reserves were 5.1 times the short-term external debt.

Malaysia's external debt position remained at a manageable level in 1999. **The total external debt** outstanding declined by 1.4% to RM159.7 billion or equivalent to US$42 billion as at end-1999. Consequently, the ratio of external debt to GNP improved to 57% from 60% at end-1998, while the debt service ratio improved to 5.3% from 6.4% in 1998. The moderate increase in medium- and long-term external debt of the public sector (mainly reflecting the receipts from the 10-year US$1 billion Malaysian Global Bond issued by the Federal Government and the US dollar denominated bond issue of US$650 million by Petronas) was offset by the net repayment of long-term external loans by the private sector (the first decline since 1989) and the net decline in outstanding short-term debt. Ample liquidity in the domestic market and lower demand for hedging contracts by exporters and importers led to the decline in short-term external debt of commercial banks. Short-term debt of the non-bank private sector, which accounted for about 6% of total external debt, also declined to RM9 billion or US$2.4 billion. With total short-term debt declining to RM22.8 billion or US$6 billion, the ratio of short-term debt to total debt declined to 14% (from 20% in 1998) while the ratio of short-term debt to international reserves improved to 19.5% (1998: 32.4%).

Macroeconomic policy management in 1999 focused on strengthening the recovery process and on expediting measures to address structural issues, both in the economic and financial sectors. To achieve a broad-based recovery that is sustainable over the medium term, the policy strategy adopted was comprehensive, taking into account the potential upside as well as downside risks.

In early 1999, the Malaysian economy was at an initial stage of recovery after one year of economic contraction. Despite some improvements in external demand in the fourth quarter of 1998, there was considerable uncertainty about the prospects for growth in the major industrial countries. In addition, there was an inventory overhang and excess capacity in selected industries in the domestic economy. In such an environment, the broad thrust of policy was directed at strengthening domestic demand through the fiscal stimulus. In the 1999 Budget, the **overall financial position of the Federal Government** was targeted to record a fiscal deficit of 6.1% in 1999. The pace of implementation of Government's projects was initially slow. At the end of the first quarter, only 3.6% of the total development expenditure allocated for 1999 was spent due to implementation constraints. To address this, the Government took measures to expedite spending, which included streamlining the contract tender process, close monitoring of the implementation of projects through regular submissions of progress reports and ensuring more prompt payments to contractors. As a result, Government spending increased in the second quarter of 1999. By end-1999, the Government had utilised 87.5% of the total development expenditure of RM25.8 billion.

Although it was recognised that the public sector stimulus was critical for the economic recovery, the Government remained committed to maintaining the budget deficit at a level that would not jeopardise public sector policies in the longer term. In line with fiscal prudence, the Government targeted for a balanced position in the current account of the Federal Government and an overall deficit of 6.1% of GNP. The actual outturn of the financial position of the Federal Government was, however, better than expected because of the improved performance of the economy. The current account recorded a large surplus of RM12 billion or 4.3% of GNP. The deficit in the overall account was smaller than budgeted in the 1999 Budget, amounting to RM9.5 billion or 3.4% of GNP. Reflecting the improved financial position of the Federal Government as well as the non-financial public enterprises (NFPEs), the **consolidated public sector account** recovered to record a surplus of RM581 million or 0.2% of GNP. With higher crude oil prices, revenue receipts were higher for PETRONAS.

In terms of Government spending, priority was accorded to projects to address structural and socio-economic issues (education and skills training; health services; low-cost housing; and agriculture and rural development), as well as revival of selected infrastructure projects to increase efficiency of the economy. An important criterion of the stimulus package was that it should result in minimal leakage abroad to ensure no build-up of risks in the balance of payments. In addition, the higher expenditure should be financed largely from domestic sources (69%) to contain the nation's external debt and debt service ratio at a manageable level. The Government raised a global bond issue of US$1 billion at end-May 1999 mainly for the purposes of benchmarking. Meanwhile, Malaysia also had obtained funding from multilateral sources such as World Bank (total amount approved in 1999: US$404 million or RM1.5 billion), Islamic Development Bank (total amount approved: US$99 million or RM376 million) and bilateral sources, including loans under the New Miyazawa Initiative amounting to an equivalent of RM4.8 billion or US$1.3 billion (mainly from Overseas Economic Cooperation Fund and Japan Export-Import Bank which have merged and renamed Japan Bank for International Cooperation). In 1999, the Federal Government had only drawn down RM610 million under the Miyazawa Initiative. The remaining amount would be drawn down over the next 3-5 years. The yen credit line offered as bilateral financial assistance to Malaysia under the Miyazawa Initiative are of maturity periods of 5 to 40 years. Such borrowing from official creditors have not adversely affected the overall debt profile. Overall, total debt of the Federal Government remained at about 40% of GNP, of which external debt was 6.6% of GNP.

In the absence of inflationary pressures, monetary policy was accommodative during the course of 1999 to support the expansionary fiscal stance. The easing of monetary policy and ample liquidity in the banking system following the improvement in the balance of payments provided an environment to reduce interest rates to support the economic expansion. The BNM intervention rate was reduced in three steps of 0.5 percentage points to 5.5% in August 1999. Given the moderation in inflation, the objective of ensuring positive real interest rate was achieved. The maturing of high cost deposits and the consequent reduction in the average cost of funds had provided the banking institutions with greater flexibility in reducing lending rates. To ameliorate the adverse impact of the low interest rate environment on the income earned by retirees on their deposits, BNM issued the Malaysia Savings Bond Series 02 in November 1999, with a coupon rate of 5.75% per annum.

Overall, the Central Bank interacted proactively with the banking institutions to ensure that credit remained available to viable activities to support the economic recovery process. Banks were encouraged to channel resources to sectors that were viable, both for new growth sectors and traditional export sectors. Approvals and disbursements of loans by the banking system increased. In 1999, loan approvals averaged RM8.7 billion a month (1998: monthly average of RM5.4 billion a month), while disbursements recorded an average of RM26.9 billion a month (1998: RM20.9 billion a month). The marginal increase in total outstanding loans of the banking system of 0.3% for 1999 (including loans sold to Danaharta) reflected a number of developments, including high repayments (monthly average of RM28 billion in 1999, as against RM22.5 billion in 1998), write-off of loans and conversion of loans to bonds. Including the write-off of loans, conversion of loans to bonds as well as the holdings of private debt securities (PDS), total financing provided by the banking system increased by 2.8%.

Credit limits on total exposure of banking institutions to the broad property sector and purchase of shares imposed on 1 April 1997 were maintained to ensure that banking institutions would not be excessively exposed to sectors that are susceptible to economic cycles. In 1999, an additional measure was also put in place to contain further overhang of high-end properties through the restriction on the provision of bridging finance to developers for the development of properties exceeding RM250,000. However, financing to end-buyers for the purchase of properties in both the primary and secondary markets was not affected by the prohibition.

In the course of 1999, Bank Negara Malaysia also **intensified structural adjustment efforts in the banking sector**. Recognising the risks of over reliance on the banking system in financing the economy, the development of the bond market was accelerated to reduce pressures on the banking system, while providing borrowers and investors with alternative instruments. In June 1999 the National Bond Market Committee (NBMC) was established to provide the overall policy direction and to rationalise the regulatory framework for the orderly development of the market.

In 1999, Malaysia also accelerated the pace of restructuring of the banking system and corporate sectors. The period of stability accorded by the selective exchange controls and the fixed exchange rate facilitated significant progress in the restructuring of the banking system during the course of 1999. By 31 December 1999, **Danaharta**, the national asset management company set up in June 1998, had acquired and was managing NPLs with loan rights amounting to RM45.5 billion from the financial system, of which RM35.7 billion was from the banking system. The book value of these NPLs amounted to RM34 billion, representing approximately 42% of total NPLs of the banking system. With the removal of these NPLs from the banking sector, the residual NPL level in the banking sector declined to 6.6% based on 6-month classification as at 31 December 1999 (11.1% based on 3-month classification), from the peak of 9%

based on 6-month classification as at 30 November 1998 (14.9% based on 3-month classification). As consideration for the loans acquired, Danaharta has issued RM10.3 billion nominal value bonds up to December 1999.

As at end-1999, Danaharta has achieved a recovery rate of 80.2% on the loans and assets that it has restructured or disposed. On loan disposals, Danaharta has conducted two successful restricted open tenders to dispose of foreign currency loans and papers in August 1999 and December 1999 involving 43 accounts worth US$394.3 million. The recovery rates of both tender exercises were encouraging, with a recovery rate of 55.3% achieved in the first tender exercise and 71% in the subsequent exercise. With the two tender exercises, Danaharta has successfully disposed a total of US$339.8 million of foreign currency loans and papers. Danaharta has also successfully completed its first open tender exercise on 44 properties with a total indicative value of RM122.6 million. A total of 24 bids were successful, raising a total consideration of RM17.8 million. The amount received on the successful bids represented an 8% surplus over the indicative value of RM16.5 million. The remaining 20 properties with an indicative value of RM106.1 million were transferred to Danaharta's asset subsidiary.

Danamodal, the bank recapitalisation agency set up in August 1998 to recapitalise affected banking institutions has injected RM7.1 billion into 10 banking institutions since its inception. Following repayments by five banking institutions, the amount of capital injected has been reduced to RM5.3 billion as at end-January 2000.

While the pace of corporate debt restructuring to contain the growth of NPLs and complement the restructuring of the financial institutions was slow initially, there was significant improvement in the second half-year. The Corporate Debt Restructuring Committee, **CDRC**, established in August 1998, has received 67 applications with debts totalling RM36.3 billion as at 24 February 2000. Of these, 19 restructuring schemes amounting to RM14.1 billion have been completed and are in various stages of implementation, while 10 cases amounting to RM3.3 billion are being resolved by Danaharta. Thirteen cases involving debts worth RM2.8 billion have been rejected/withdrawn and the debt restructuring schemes for the remaining 25 cases amounting to RM16.2 billion are currently being worked out. In addition, CDRC is also actively looking into the restructuring of three industries, namely transportation, telecommunication and steel.

As at end-January 2000, the RWCR of the banking system remained strong at 12.5%, well above the minimum requirement of 8% and higher than the pre-crisis level of 12% as at end-June 1997. The net NPL ratio, based on a 6-month classification, declined to 6.6% as at end-1999 from the peak of 9% as at end-November 1998. In terms of value, net NPLs amounted to RM24.3 billion (end-1998: RM29.3 billion).

The success of Danaharta and Danamodal in achieving their targets ahead of schedule has enabled BNM to move forward to the next stage of further strengthening the banking sector through mergers and consolidation. Under the merger programme, the banking institutions were given the flexibility to form their own merger groups and to select the lead banks to spearhead the merger process. The banking institutions were given until end-January 2000 to submit to BNM their merger groups. On 14 February 2000, BNM approved the formation of 10 domestic banking groups with the anchor banks as Malayan Banking Berhad, Bumiputra-Commerce Bank Berhad, RHB Bank Berhad, Public Bank Berhad, Arab-Malaysian Bank Berhad, Perwira Affin Bank Berhad, Hong Leong Bank Berhad, Multi-Purpose Bank Berhad, Southern Bank Berhad and EON Bank Berhad. This industry-wide merger exercise is expected to be completed by end-December 2000. The industry consolidation is an important step towards creating a resilient, efficient and competitive banking sector. This industry consolidation needs to be complemented with medium-to long-term measures. In this regard, BNM has embarked on the formulation of a long-term financial master plan to chart the future direction of the banking and insurance sectors.

Efforts to restructure the banking sector were complemented by additional prudential measures introduced in 1999 (for details, please refer to Chapter 4).

With regard to the **selective exchange control measures** that were implemented in September 1998, BNM initiated the liberalisation of these regulations given that the objectives of the measures had been achieved. The one-year minimum holding period of portfolio capital was modified effective 15 February 1999 to allow foreign investors to repatriate principal

Box I

Sustainable Growth: Challenges and Responses

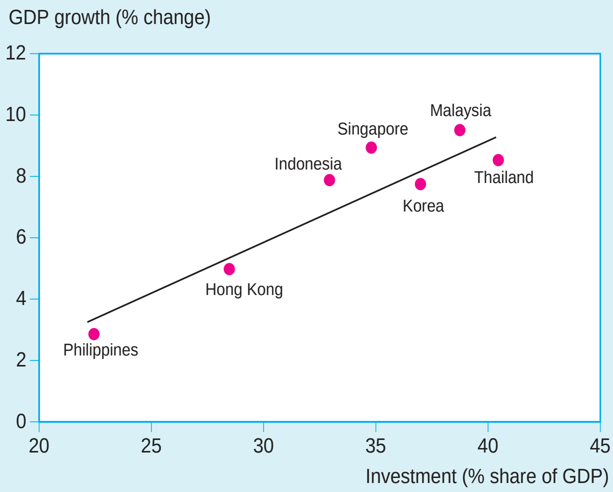
Sustainable economic growth is a situation in which the economy is able to grow at its long-run potential level without experiencing long-term imbalances, particularly price pressures or external imbalances. Essentially, the signs of sustainable growth are a steady rate of growth consistent with low inflation, a manageable balance in the current account, a sustainable fiscal balance with no economy-wide wage pressures and asset price inflation.

In the period following the East Asian financial crisis, the focus of economic policy in Malaysia was to promote economic recovery. To achieve this goal, a comprehensive set of policies consisting of expansionary fiscal and monetary policies, a fixed exchange rate and selective exchange controls and a longer-term programme of restructuring, both for the financial and corporate sector, was implemented. As a result of these policies and strong external demand, Malaysia recorded an expansion of real gross domestic product (GDP) of 5.4% in 1999. With the restoration of growth, the focus of policy has shifted to address medium-term issues of ensuring broad-based and sustainable growth. In a globalised environment of integrated markets and rapid changes in technology, policies that were effective in the past decade may now be less relevant. While the objective of maintaining macroeconomic stability remains unchanged, a paradigm shift is needed to ensure sustainable growth in this new global economy. For Malaysia, this return of focus is particularly timely, given the end of the period of coverage of the Seventh Malaysia Plan (1996-2000) and the work being undertaken to introduce the Eighth Plan. Further, work on the Third Outline Perspective Plan, the Knowledge Economy (K-Economy) Master Plan, the Financial Sector and Capital Markets Master Plans is in progress and industrial policy, as laid out in the Second Industrial Master Plan, 1995-2005 (IMP2), is under review.

Challenges to Sustainable Growth

The development strategy thus far, which has focused on investment- and trade-led growth, has served Malaysia well. In particular, the liberalisation and privatisation programme that was implemented following the economic slowdown in the 1980s saw a structural shift, with manufacturing, especially for exports, becoming the lead sector in the economy. The leap in competitiveness allowed the production for export to be enhanced and was supported by a policy that actively encouraged foreign manufacturers to locate in Malaysia to strengthen the role of the Malaysian private sector to become the engine of growth. As a result, the period between 1987-97 saw the strongest growth in Malaysia's history, with real GDP expanding by a compounded average annual rate of 9.3%. During the same period, real gross fixed capital formation increased by 18.4%. As a result, the share of investment to GDP rose from 22.1% in 1987 to reach 49.1% in 1997. While the rapid increase in investment has provided the base for capacity expansion, the rapid pace of expansion did create some supply-side bottlenecks.

Graph I.1
Growth and Investment-A Regional Comparison



Data for all countries refer to an average for 1990-1996.

Source: International Monetary Fund and Department of Statistics, Malaysia

Firstly, as a consequence of an industrial strategy that focused on non-resource-based industries as the main driver of the development process, there were weak linkages with the rest of the economy. The low level of indigenous capital and intermediate goods manufacturing industries as well as a shortage of labour led to high imports of goods and workers. The consequent impact on the balance of payments was seen in the current account. The surplus that was recorded in 1987 (8.7% of gross national product (GNP)) narrowed and gradually moved to a large deficit equivalent to 10.2% of GNP in 1995, before improving to 4.6% in 1996.

Secondly, the low level of local input in the rest of the value chain was a factor in the low value added contribution of the manufacturing sector given the level of investment. In the case of upstream activities, the lack of research and development resulted in the concentration on assembling components with a relatively low value added content. In the case of downstream activities, manufacturers had limited participation and relied on just a few export destinations. As a result, having moved away from a primary commodity-dominated economy so as to reduce our reliance on uncertain international markets, a large proportion of Malaysia's exports were now manufactured commodities and highly dependent on fewer markets.

There are two main challenges that now face the economy in the post-crisis period. Firstly, investment-driven growth is no longer sufficient to fulfill the development goals envisioned in the longer-term plans. Given the limitations in increasing the supply of other factors of production, investment alone cannot be expected to yield maximum results. Malaysia's incremental capital-output ratio (ICOR), that is, the amount of additional capital required to produce an additional unit of output had been rising throughout this decade. In 1987, the ICOR stood at 2.74 but by 1995, the ICOR had increased to 5.49, implying that while investment had increased, the rate of utilisation of this additional capital stock was lagging. In part, this increase was due to increased capital spending on investments with long gestation periods but which were necessary to ameliorate supply shortages and increase the capacity of the economy. However, it is equally true that efficiency of capital was not as high as it could have been. Additionally, there are limits to the financial resources, both domestic and international, that can be tapped at a reasonable cost to achieve this growth in investment. As such, a more efficient utilisation of resources is the focus for future development and industrial policy. The focus now will be to increase the productivity of labour given that the essential infrastructure has now been put in place.

Secondly, challenges arising from a fast-changing global marketplace also need to be addressed. The events of the last two years have highlighted the risks associated with the reliance on a small range of products or a small group of markets. The electronics industry in particular has been an important element in Malaysia's economic performance over the last decade. However, given the need to diversify the economic structure, new growth areas need to be identified and existing growth areas need to be reviewed to strengthen competitiveness. These include both the higher technology information-communication technology (ICT) sector as well as the resource-based industries. Further, services that support the competitive export structure need to be nurtured. There are also new risks arising from the globalised economy, especially in the case of the financial sector which need to be addressed. Efforts are also being undertaken to promote domestic demand.

Policy Responses to the Challenges

The main components of the policy responses in facing these challenges are to improve competitiveness and efficiency, to manage risks more effectively and to ensure that policy implementation is done in a consistent and efficient manner.

Competitiveness and Efficiency

Competitiveness defines the capacity of industries to provide world class goods and services, both for domestic and external consumption. These goods and services must meet exacting quality standards at reasonable prices. Efficiency is defined as increasing output per unit of input. In this context, this includes improved utilisation of capital, increasing the skill level of the workforce andimproving work processes. Increased efficiency will increase competitiveness while measures that spur competition such as progressive market liberalisation, especially in trade, can contribute to efficiency gains. These, however, need to be achieved in a manner that is not disruptive to the overall functioning of the economy.

- ***Exploring new growth areas***

  Increasing the knowledge content of the economy will be key to moving up the value chain so as to transform Malaysia into a K-economy. The K-economy has been defined as "...one in which the generation and the exploitation of knowledge has come to play the predominant part in the creation of wealth. It is not simply about pushing back the frontiers of knowledge; it is also about the more effective use and exploitation of all types of knowledge in all manner of economic activity."[1] This means not just knowing more but using this knowledge, be it technical, managerial and even networked knowledge to improve design, production, delivery and marketing, effectively. To this end, the Federal Government Budget 2000 has made available, for the first time, funds to identify the key drivers to making the transition to a K-economy.

  A major thrust in development policy will be to identify new growth areas. The services and high-technology manufacturing sectors where knowledge is the key driver have been identified for further development. In these new growth areas, product innovation will be important. The emphasis will also be on productivity-driven growth as much of the essential capital infrastructure is already in place. Identification of these new growth areas will have to correspond with identifying the critical success factors in being able to take advantage of them. This includes the critical role played by industrial clusters, financing, international networks and the education system.

- ***An integrative industrial policy***

  Critical to moving into these new growth areas is a holistic industrial policy. The IMP2 sets out a more integrative approach to industrial development in the use of the cluster-based paradigm. Essentially, instead of industries, eight industrial clusters or groups of related industries have been identified for further development. These clusters are the electrical and electronics industry group, the transportation industry group, the chemicals industry group, the textiles and apparel industry group, the resource-based industry group, the materials and advanced materials industry group and the agro-based and food products industry group.

  Supporting industries are built so as to deepen and widen the industrial base. In the resource-based cluster, for example, the plans include the development of the supporting agricultural base so that supplies of raw materials are maintained. The cluster-based approach also pays attention to the downstream activities such as distribution, packaging and marketing to move industries from original equipment manufacturing (OEM) to higher value-added activities that include indigenous design and branding.

- ***Improving education and human resource development***

  The inadequacy of domestic human resources (HR) is reflected by the estimated 1.2 to 2 million foreign workers who resided in Malaysia in the 1990s. This was partly due to the expansion during the early stage of industrialisation of low skill, labour intensive industries. To address this, the strategy is to improve the skill and productivity level so that higher wages are more than offset by higher output. This will be beneficial both to producers, in that labour costs per unit of output decline despite a higher wage bill, and to workers, in that real wages increase as wage increases are not matched by increases in the price level.

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[1] "Our Competitive Future Building the Knowledge Driven Economy" – White Paper prepared by the UK Department of Trade and Industry, December 1998.

In the case of training and education, the Government accelerated its university-building programme while several new industrial training institutes (ITIs) have been set up. This includes the building of new universities in different parts of the country while upgrading several higher education institutes and training facilities of several large non-financial public enterprises (NFPEs) to full university status and the building of a total of five new ITIs. The private sector has also been encouraged to take on a proactive role in training with the establishment of the Human Resource Development Fund and the introduction of several tax incentives. Between 1996 and 1999, the number of instructors in private higher education institutions increased, on average, by 18.5%. In future, both the private sector and the workers themselves must take on a greater share of the responsibility for training and re-training. In view of the critical importance of human capital to enhance our competitiveness, measures will be taken to reverse the brain drain and to encourage the infusion of talent from abroad.

The education system in Malaysia has performed well thus far. However, in future, a greater premium will be attached to creativity and solution-orientation. The emphasis on a more holistic education has, therefore, become an important part of the curriculum.

While high employment remains a goal of economic policy, high employability is also encouraged to produce a more adaptable labour force. Emphasis is, therefore, given towards constant re-training programmes and the development of a more flexible educational system.

- ***Upgrading the services sector and the knowledge content of traditional economic activity***

As noted earlier, the knowledge content will be an important driver of economic activity. Whereas product innovation will take center stage in the case of the new growth areas, in more traditional areas, equal importance will be place on marketing, product customisation and delivery.

Services, both that are explicitly rendered as well as the intrinsic services embodied in goods, will have an important role. The services sector is the largest part of the productive economy, accounting for 54.2% of real GDP in 1999. However, at the current stage of economic development, the sector is relatively underdeveloped by international standards[2]. Services do more than just support the merchandise sector of the economy but are now seen as necessary inputs into the production process. In the manufacturing sector, only an estimated 25% of the price of goods is for “pure” production costs. The remainder of the payment is for costs linked to services such as product development, storage, distribution, marketing and publicity, financial and insurance services and waste management and disposal systems[3]. The services sector is integral to upgrading the knowledge content in production or shifting to full K-economy status. Services such as transport, design, packaging, marketing and even administrative arrangements are all becoming suffused with a higher knowledge content. For instance, many companies have sites on the worldwide web but relatively few have integrated their links to customers and suppliers and their backroom operations with this new window to the world. Those who are able to do so gain an invaluable competitive edge.

The resource-based industries offer another important avenue to be exploited. Malaysia possesses competitive advantages in this area due to availability of raw materials, a long tradition of research and development, a strong presence in the international market and the strong presence of higher value-added industries that can take advantage of the upstream strengths. The main drawbacks are in product development, design and

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[2] See Box A (pp. 69-73), Annual Report 1995, Bank Negara Malaysia (March 1996) and “Services Sector as an Engine of Growth” by Dr. Zeti Akhtar Aziz (July 1996).

[3] Giarini and Stahel, “The Limits to Certainty: Facing Risks in the New Service Economy” (1989) quoted in “Intermediate Services and Economic Development: The Malaysian Experience” Behuria, Sutanu and Rahul Khullar, Asian Development Bank Occasional Paper (May 1994).

marketing. Attention is, therefore, being directed to equip producers with the necessary knowledge and networks to successfully market their products.

The distribution and logistics system needs to be given prime consideration if all the above developments are to be put in place. The importance of delivering the goods and services consumers want quickly, efficiently and reliably cannot be understated. The widespread containerisation of cargo, more than any other development saw the explosion in global trade and allowed previously untradeable items such as perishable produce to be shipped globally. The new developments in this area will be the improvement in logistics so as to improve multi-modality, that is, greater integration between various modes of transportation. In this regard, an integrated ports policy that hinges on load-centering at Port Klang and the use of an electronic data interchange that brings together the shippers, the port, Customs and insurers has yielded tangible results. While much improvement needs to take place, the increase in the number of mainline operators stopping at Port Klang has been encouraging. Also, faster delivery of services such as banking, brokerage, news, entertainment and even shopping are emerging. As interactive platforms and security systems evolve, internet-based delivery systems can be expected to become more widely accepted as a medium in which transactions are made, making their use more widespread.

- ***Preparing for progressive deregulation and trade liberalisation***

Competition can be an important driver of efficiency and innovation. In general, the Malaysian economy has trended towards greater deregulation with specific rules put in place to ensure safety and fair trade practices. Malaysia's basic philosophy has been to encourage managed competition, particularly in industries where the capital outlay is large, while allowing for progressive entry to foreigners through joint ventures. The gradual deregulation of the telecommunications industry, for example, has culminated with the granting of full access in 1999. However, this deregulation was accompanied with intervention, where necessary. For instance, apart from maintaining its traditional role of ensuring service standards were maintained, the Government intervened directly to expedite connectivity agreements among cellular telephone operators in the mid-1990s.

The other path to increased competition has been trade liberalisation. Malaysia has always been an open economy. Total trade amounted to more than twice gross national product in 1999. Malaysia is a signatory to many major regional and global multilateral free trade agreements. The most important of these are the Uruguay Round agreements including the General Agreement on Trade in Services that formed the World Trade Organisation and the ASEAN Free Trade Area agreement. In addition, bilateral trade agreements have been signed with several developing countries. Local industries have, therefore, been and will be even more progressively subject to international competition.

Risk Management and the Financial Sector

In the new approach towards sustainable growth, the role of the financial system in allocating capital efficiently becomes even more important. It will, therefore, be important to increase the dynamism and efficiency of the sector while ensuring that it is capable of coping with the emerging risks. The critical success factor in achieving these aims is the simultaneous development of both bank and non-bank financial institutions. In the case of banks, the emphasis is being placed not only on capitalisation, but also the implementation of a more innovative and prudent credit culture and improved risk management. While efforts have already moved forward with the initiation of the consolidation programme for domestic banks, further work remains to be done. In the case of non-bank financial institutions, efforts continue to be directed at enhancement of efficiency and the development of the capital markets, in particular, the bond markets, and innovative financiers (e.g. venture capital companies).

Co-ordination of Policies

Due recognition is given to the co-ordination and implementation of policies. Macroeconomic policy, that is fiscal and monetary policies, will continue to play supportive roles to the longer-term developmental policies. The primary aim of macroeconomic policy will be to ensure growth with economic stability. The aim is for high quality growth, led by productivity gains.

Malaysia has always practised prudent fiscal management. This resulted in fiscal surpluses, which provided the stronger base for the implementation of the current counter-cyclical fiscal policy to promote economic recovery. In 1999 and 2000, the Government has increased development spending to provide social services such as health and education to balance the slowdown in private spending. Over the medium term, the conduct of fiscal policy remains unchanged. During periods of strong growth, the Government will aim to achieve a fiscal surplus and allow the private sector to be the main engine of activity. This will reduce competition for resources and prevent imbalances, ensuring stable prices.

The conduct of monetary policy (including exchange rate policy) is mainly targeted at price stability. In this regard, the authorities will implement monetary policy in a flexible manner and adjust these policy responses as circumstances change. Flexible and pragmatic monetary policies will ensure that monetary policy does not become counter-productive to the overall development goals of the nation.

The focus of exchange rate policy will be to ensure that the rate remains consistent with the fundamentals of the Malaysian economy. The peg will not be adjusted in response to any marginal and short-term misalignments that could easily be reversed by subsequent changes in global financial markets. Meanwhile, the overall policy of improving competitiveness will ensure that Malaysia does not depend on the exchange rate to enhance the competitiveness of the economy. The authorities have long maintained that the exchange rate alone cannot guarantee competitiveness but rather it is the fundamental efficiency of the economy that is important. In summary, the overall policy direction in the medium term is to improve efficiency and competitiveness through the use of a market-oriented industrial policy. Macroeconomic policy will play a supportive role to manage emerging risks and ensure the stability of the financial markets while structural reforms continue.

Social and welfare policies such as equitable distribution of wealth and the provision of social safety nets will also continue to receive the attention of economic policy makers to ensure balanced and broad-based growth is achieved.

capital and profits, subject to a graduated levy, depending on when the funds were brought into Malaysia and the duration of the investment. The levy system provided flexibility to investors and was directed at encouraging existing portfolio investors to have a longer-term perspective of their investment in Malaysia. Following the modification, there was a net inflow of funds from non-residents amounting to RM4 billion during the period 15 February 1999 until 31 August 1999. These funds were mainly channelled into the stock market. In response to representation by fund managers to streamline the administrative problems associated with the measures, the Government announced that, effective 21 September 1999, a flat 10% levy on repatriation of profits on portfolio investment would replace the two-tier system.

With improved investor confidence and renewed optimism about the economy, there were continued strong inflows on both the current and capital accounts of the balance of payments. Hence, despite some uncertainty generated by the expiry of the September deadline on repatriation of capital without levy, the net outflows of portfolio funds remained manageable, amounting to about RM8 billion or US$2 billion. In January and February 2000, however, this trend reversed with net inflow amounting to RM8.6 billion or US$2.3 billion in the period January to 8 March 2000.

A number of **tax and non-tax measures** were introduced in Budget 2000 to address longer-term structural issues in the real sector. The crisis has confirmed the need to accelerate efforts to reduce the vulnerability due to over-reliance on exports from the manufacturing sector, particularly electronic products. Recognising that sustained growth with external balance require more balanced and diversified sources of growth for the economy, the new measures included in the Budget (details in Chapter 2) aimed at facilitating the shift towards new growth areas. Within the traditional sectors, policy measures aimed to increase the domestic value added activities to contribute to growth.

Overall, the downside risks envisaged in early 1999 did not occur. On the external front, the strong external demand following the improvements in the Asian economies and robust growth in the US economy spurred production increases in the export sector. This was underpinned by the early upswing in the global electronics cycle, and moved towards a more broad-based export growth in the latter part of 1999.

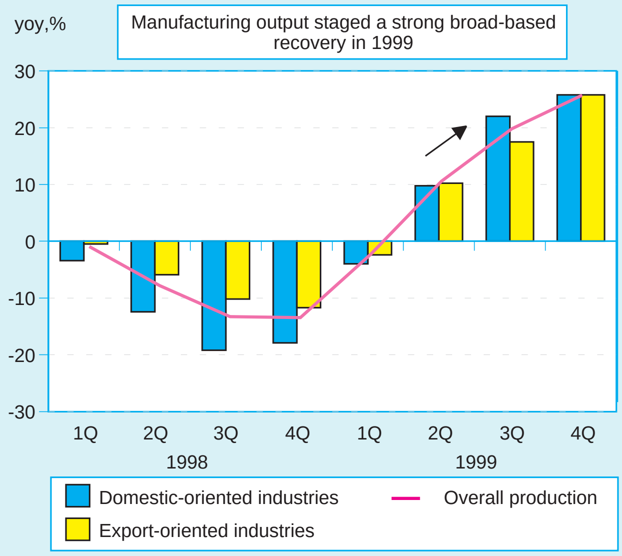
The favourable external environment, the more stable conditions in the domestic financial markets provided by the selective exchange controls and the fixed exchange rate, as well as expansionary fiscal and monetary policy contributed to significant improvement in business and consumer confidence. Consequently, domestic demand recovered as the private sector responded positively to generate a stronger-than-expected recovery for Malaysia.

Sectoral Review

Manufacturing

The overall output performance of the manufacturing sector recovered strongly in 1999. Manufacturing output as measured by the Industrial Production Index (1993=100) turned around to record a strong positive growth of 12.9% (1998: –10.2%). In terms of level, the manufacturing production index exceeded the pre-recession level to register a record high of 167.8 (1997: 165.6), with the better-than-expected recovery in output of both the export- and domestic-oriented industries. In tandem with the strong pick-up in production activities, value added of the manufacturing sector turned around to record a positive growth of 13.5% (1998: –13.7%). Apart from the marked improvement in external demand, the manufacturing sector also benefited from the Government's pragmatic policy responses aimed at expediting economic recovery and promoting sustainable growth. With the favourable performance of the sector during the year,

Graph 1.7
Output Performance of the Manufacturing Sector



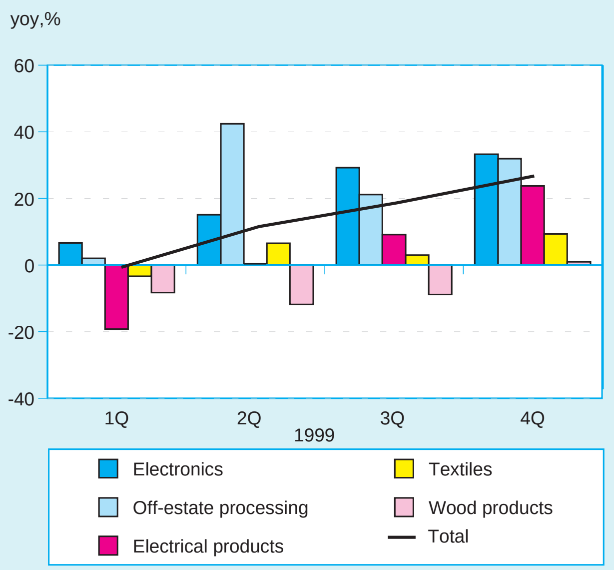
its contribution to GDP growth rose from 27.9% in 1998 to 30.1% in 1999, while its share of total exports and employment rose to 84.6% and 27.1% respectively (1998: 82.9% and 26.5% respectively).

At the initial stage, the turnaround in manufacturing output which began in February 1999 was predominantly export-led, driven mainly by a stronger-than-expected recovery in the electronics industry. Subsequently, as stability returned to financial markets and consumer confidence improved following the implementation of pro-recovery measures by the Government, output growth in the domestic-oriented sector gathered strength during the second quarter of the year. Thereafter, growth in manufacturing production accelerated, recording an annual increase of 22.5% in the second half of the year (first-half: 3.5%). Against the background of an improvement in external and domestic demand conditions, output of both the export- and domestic-oriented industries recorded a growth of 12.9% and 13.1% respectively during the year (1998: –7.3% and –13.4% respectively), thereby contributing to a broad-based recovery in the manufacturing sector.

In the export-oriented sector, growth was spearheaded by the electronics, electrical products and off-estate processing industries.

- The **electronics industry** remained the leading industry with a strong output expansion of 21.2% in 1999 (1998: –4.2%), attributable largely to the increased usage of the Internet and e-commerce, rising demand for communication chips for use in computer modems, networks and cellular phones from major markets in the United States, Europe and Japan, as well as intensified efforts in upgrading facilities to address the Y2K problem. The turnaround of electronic output was in tandem with the recovery in the global semiconductor industry, which expanded by about 18.9% in 1999, the first double-digit growth recorded since 1995.

Graph 1.8
Output Performance of the Export-Oriented Sector



- Output of the **electrical products industry** rebounded to increase marginally by 2.7%, following two consecutive years of decline. This was mainly on account of improved demand for office and computing equipment, consumer durables and air-conditioners from the United States, Japan and the Asia-Pacific region in the latter part of the year. As a group, the **electronics and electrical products industry** registered a substantial increase of 15.6% in output during the year (1998: –7.7%).

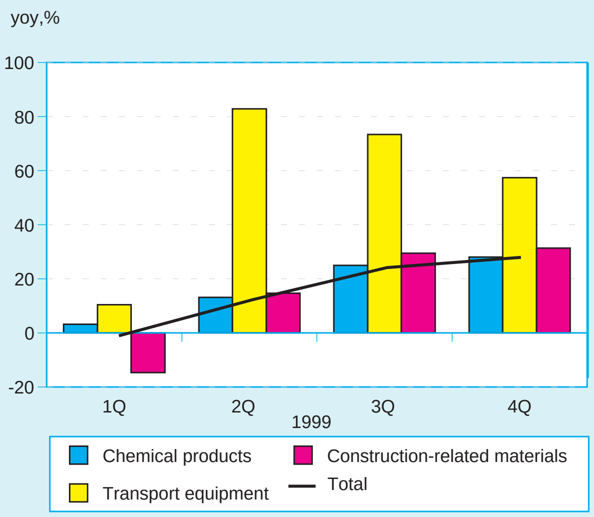
- Output of the **off-estate processing industry** expanded significantly by 24.7% in 1999 (1998: –2.7%), reflecting largely increased palm oil processing activity on account of higher crude palm oil production.

- The **textiles and wearing apparel industry** also performed better with a positive output growth of 4% (1998: –5.3%). Higher expansion of the fibre spinning and weaving, synthetic textiles milling and dyeing, bleaching and finishing activities, as well as improved demand for better-designed and up-market wearing apparel from major overseas buyers such as the United States and Europe contributed to improved output performance.

- On the other hand, production of the **wood and wood products industry** continued to decline for the third consecutive year (–7.3%; 1998: –11.3%). Although production of plywood and particle board improved in response to increased external demand, this was more than offset by the significant contraction in the output of sawn timber as logging activities in the peninsula were disrupted by heavy rain experienced during the year.

In 1999, manufacturing activities of the **domestic-oriented industries** as a group recorded a significant turnaround of 13.1% (1998: –13.4%).

Graph 1.9
Output Performance of the Domestic-Oriented Sector



The impressive output performance reflected mainly increased consumer demand and public investments following the implementation of expansionary fiscal and monetary policies during the year. Growth of the domestic-oriented sector escalated to 23.9% during the second half of the year (first-half: 2.8%), with all industries except the tobacco products industry recording increases in output. Of significance was the strong expansion in the output of the chemical products, transport equipment and construction-related materials industries which together accounted for 61% of total value added of the domestic-oriented sector.

- Output expansion of the **chemicals and chemical products industry** continued throughout the year since its recovery in February. The industry recorded a strong positive growth of 17.1% (1998: –1.8%) as all the sub-sectors, except the soap and cleaning preparation sub-sector, registered higher output growth. In particular, the increased production of resins and plastic products, paints, varnishes and lacquers as well as industrial gases was in response to the strong demand from the electronics, automobile and construction-related materials industries.

- Benefiting from the implementation of the measures to stimulate domestic demand, output of the **transport equipment industry** rebounded significantly to increase by 53.5% in 1999 (1998: –52.2%). During the year, sales of motor vehicles comprising passenger cars and commercial vehicles recorded a strong positive growth of 75.8% to reach a total of 288,547 units, in response to improved domestic demand (1998: 164,116 units). The higher production of motor vehicles created positive spin-off effects on the output of motor vehicle parts and accessories, which turned around to record a strong expansion of 43% in 1999 (1998: –40.1%).

- In tandem with the turnaround in construction activity in the second half of the year, output of the **construction-related materials industries** as a group improved markedly by 14.3% (1998: –27.6%). Higher demand for cement and concrete products, structural clay products as well as iron and steel bars and rods contributed to increased production of the **non-metallic mineral products** and **iron and steel industries**, at 2.6% and 29.5% respectively in 1999 (1998: –26.5% and –29.1% respectively). At the same time, increased exports also supported output growth. This was true especially in the case of ceramic products which benefited from higher external demand particularly from Europe, and selected iron and steel products which gained from the recovery in the ASEAN countries.

- At the same time, the decline in the production of **fabricated metal products** moderated significantly to –1.1% (1998: –17.2%), as output of most of the sub-sectors, including the structural metal products, brass, copper and aluminium as well as tin cans and metal boxes sub-sectors turned around in the second half of the year amidst improved domestic economic activity. In addition, increases in the production of wire and wire products during the year contributed to the improved output performance of the industry.

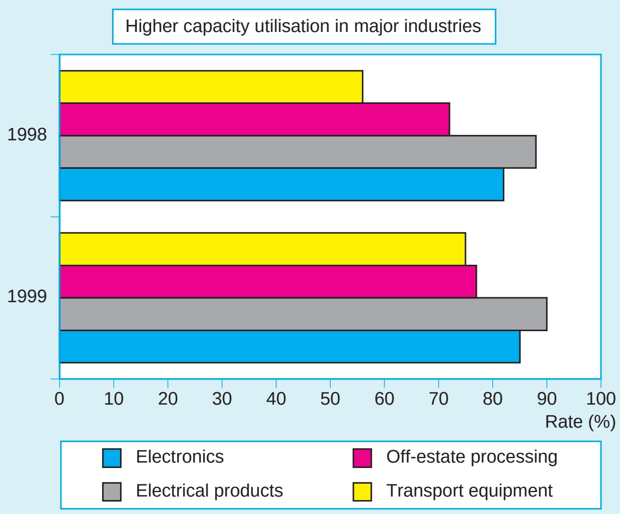
- Output of the **rubber products industry** registered a slower growth of 3.6% in 1999 (1998: 7.8%), as the moderation in the production of gloves amidst intense competition from neighbouring countries more than offset the increase in output of tyres and tubes.

- Reflecting the improvement in domestic consumption, the production of **food products** expanded positively by 5.7% in 1999 (1998: –2.1%), with notable increases in the production of other dairy products, biscuits, rice, flour and sugar. In the **beverages and tobacco products industry group**, the production of beverages turned around to increase by 13.2% in the second half of 1999, while the decline in the output of tobacco products moderated significantly to –9% (first-half 1999: –16.8% and –20.9% respecitively) as domestic demand conditions improved further. In 1999, output of the group recorded a slower decline of –9.4% (1998: –10.4%).

- In 1999, the contraction in the output of the **petroleum products industry** slowed down markedly (–0.3%; 1998: –11.5%), as higher oil prices prompted increases in crude oil refining activities. Production of other petroleum products and coal also rose in the second half of the year. Meanwhile, the improvement in output of the manufacturing sector, especially the electronics and electrical products industry had led to increased demand for paper products, in particular, containers and boxes of paper and paperboard. During the year, the **paper products industry** recorded a positive output expansion of 12.8% (1998: –8.7%).

In response to the strong improvement in demand conditions in the international and domestic markets, most industries, especially those producing electronics and motor vehicles, experienced a rapid drawdown in inventory levels. In line with this development, overall capacity utilisation in the manufacturing sector rose significantly. The electronics (mainly semiconductors), electrical products (mainly radio, television and communication equipment), chemical products (mainly paints), transport equipment (mainly motor vehicles), rubber products and paper products were operating above 90% capacity. Meanwhile, improvement in capacity utilisation was also evident in industries producing basic metals and fabricated metal products.

Graph 1.10
Capacity Utilisation of Selected Industries



For the construction-related materials industry, sustained revival of the construction sector is envisaged to absorb the remaining excess capacity.

While the policy response of the Government to the financial crisis was instrumental in revitalising activities in the manufacturing sector, past policies which were implemented to enhance efficiency and productivity, contributed to the resilience of the manufacturing sector. In particular, factors such as well-diversified export markets, strong focus on product quality and design, increased automation and mechanisation, competitive pricing and reliable delivery had enabled the manufacturing sector to bounce back and attain a steady and robust recovery during the year.

During 1999, the main focus of policies has been to improve labour productivity in the manufacturing sector. Given the already full employment situation, recent measures focus on facilitating the process of moving towards a more capital-intensive and hi-tech manufacturing base. The Government has put in place various special incentives to encourage indigenous technological capability and foreign participation in R&D activity, as well as to encourage training and re-training of workers so as to strengthen the quality and skills of the workforce. For instance, in the 2000 Budget, the Government has allocated a total of RM226.85 million for the Intensification of Research in Priority Areas (IRPA), to be shared between the public research and higher education institutions. At the same time, priority was also given to high-technology industries. A total of RM25.17 million was allocated for programmes that promote science and technology, to encourage the use of new technology, upgrade innovative capabilities and commercialise local technology.

Construction

The contraction of the construction sector moderated markedly in 1999, with value added of the sector declining by 5.6%, compared with a sharp decline of 23% in 1998. The improvement was particularly evident in the second half of the year when value added recorded a positive annual growth of 1.8%. Construction activity was supported mainly by the implementation of infrastructure projects under the fiscal stimulus package as well as housing development in response to strong underlying demand and low interest rates. Reflecting improved sentiments on the economic outlook, the value and volume of property transactions increased sharply by 23.1% and 21.1% respectively during the year

(–47.6% and –32.3% respectively in 1998). However, growth of the construction sector continued to be constrained by the stock overhang of commercial buildings and poor demand for higher-priced residential units, particularly those in the suburban areas. Consequently, credit extended for construction activity by the banking system (including loans sold to Danaharta) declined by RM2.3 billion or 5% in 1999.

Recovery was most evident in the **civil engineering sub-sector**. The BNM Survey of the Construction Sector, 1999 showed that most companies surveyed reported an increase in construction activity in the civil engineering sub-sector in 1999. Growth was supported by higher allocation for infrastructure projects and on-going projects related to power plants, roads, rail, water, port, sewerage and waste disposal. The 1999 Budget allocated RM4 billion for development of infrastructure, particularly for the construction of roads, bridges, rail, ports and civil aviation facilities. The resumption of construction work on the New Pantai Expressway as well as rail projects, including the Express Rail Link and the People-Mover Rapid Transit System, provided further impetus to the growth of the sub-sector.

The **non-residential sub-sector** remained weak during the year, due to the continued excess supply of office and retail space. Nevertheless, with some pick-up in demand, the decline in value added moderated. The improved sentiment in the sub-sector was reflected in the increase in the value and number of commercial property transactions by 26.1% and 31.4% respectively in 1999.

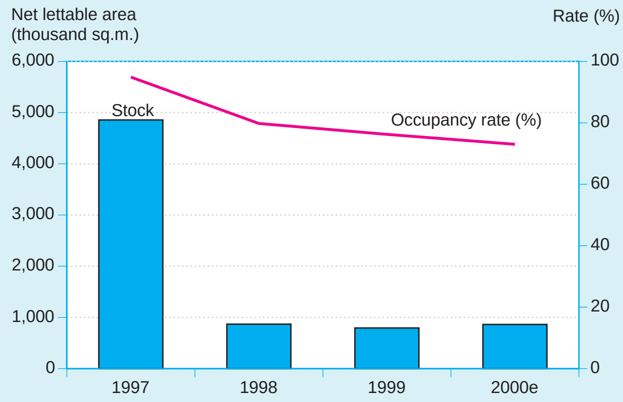
Table 1.5
Supply of Office Space, Retail Space, Condominiums and Apartments in the Klang Valley[1]

	Office Space		Retail Space		Condominiums & Apartments
	Square metres	Occupancy rate (%)	Square metres	Occupancy rate (%)	Units
1991	12,331	96.7	17,502	92.0	13,560
1992	39,825	97.2	58,910	94.2	3,768
1993	332,246	91.5	130,345	97.3	18,232
1994	192,808	94.3	117,340	98.5	9,331
1995	362,851	94.9	341,091	96.1	17,822
1996	296,742	95.5	136,964	92.8	14,568
1997	869,394	94.9	362,574	90.5	5,473
1998	873,346	79.8	395,328	59.5	14,151
1999	795,750	76.2	58,486	76.6	9,547

[1] Refers to Kuala Lumpur & Selangor D.E.

Source: Valuation and Property Services Department

Graph 1.11
Supply of Purpose-Built Office Space in the Klang Valley[1]

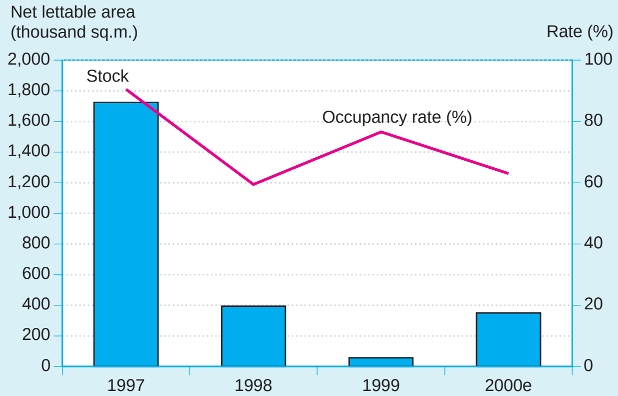


[1] Refers to Kuala Lumpur & Selangor D.E.

In the **purpose-built office space sub-sector**, growth emanated mainly from ongoing projects. A total of 0.8 million square metres of lettable area entered the Klang Valley in 1999, bringing the total supply to 6.5 million square metres at year-end. With the new supply exacerbating the large stock overhang, occupancy rates fell further. The overall occupancy rate for purpose-built office space in the Klang Valley declined from 79.8% in 1998 to 76.2% in 1999. Reflecting the oversupply situation, BNM's estimates showed that the average monthly rental rates of office buildings in the Klang Valley declined further by 4.5% to RM40.60 per square metre (RM3.80 per square foot) in 1999. Compared to the levels in 1997, the average rental rate was lower by 18.5%.

In the **retail space sub-sector**, the delayed completion of several projects resulted in new supply in the Klang Valley totalling 58,500 square metres during 1999, compared with the 205,000 square metres

Graph 1.12
Supply of Retail Space in the Klang Valley[1]



[1] Refers to Kuala Lumpur & Selangor D.E.

scheduled to come on stream. Thus, at 2.2 million square metres at the end of 1999, the total supply of retail space was lower than initially anticipated. With higher demand due to improved business and consumer sentiments and lower new supply, occupancy rates in retail complexes in the Klang Valley improved significantly to 76.6% at end-1999, compared with 59.5% at end-1998. Retail complexes in prime areas of the Klang Valley continued to enjoy relatively high occupancy rates. Meanwhile, retail space under construction remained high at 1.1 million square metres as at end-1999, representing 48% of the existing stock. Many of these projects were those that were near completion and are expected to come on-stream in 2000-2003. The stock overhang of 1.5 million square metres of retail space nationwide as at June 1999 and the expected surge of new supply are expected to influence occupancy rates in the near term.

The number of new **hotels** increased by 6.8% or 97 units, which added 22,662 new rooms to total supply in 1999 (1998: 4% or 54 new hotels with 9,351 rooms), with the bulk of the construction activity carried out prior to 1999. Despite the increase in hotel capacity, the average occupancy rate increased to 53.4% in 1999 from 49.9% in 1998 due to the higher number of tourist arrivals during the year (8 million; 1998: 5.6 million). Latest available data showed that the average occupancy rates for hotels in Penang and Johor Bahru had also increased during the first nine months to 58.7% and 54.6% respectively, compared with 55.7% and 48.8% for the corresponding period of 1998.

Construction activity in the **residential sub-sector** continued to be supported by strong underlying demand, particularly for landed properties in choice locations. Encouraged by lower prices, lower interest rates and improved job opportunities, the value and volume of residential property transactions increased by 32.8% and 27.6% respectively in 1999. Construction activity, especially for low- and medium-cost houses accelerated in the second half of 1999 following the increase in the issue of new developers' licences (+11.7%) in 1999 (1998: –30.3%). Activity in this sub-sector was reflected in the increase in new sales and advertising permits (+13.3%; 1998: –28.3%). The improved performance was also reflected in the number of housing units that were completed by the private sector, which increased by 2.2% to 122,699 units in 1999. On the other hand, a smaller number of units of condominiums and apartments (9,547) were completed in the Klang Valley during the year, compared with 14,151 units in 1998.

Despite the improved performance, the residential sub-sector was still faced with an excess supply situation. As at end-June 1999, the number of unsold units was estimated at 93,599 units, valued at RM14.2 billion. The unsold residential property included 12,021 units of low-cost houses, which were located mainly in the outskirts of towns. New construction activity in the residential sub-sector was, therefore, constrained by the large stock of unsold houses and condominiums. Although more developers' licences were issued during the year, the average size of the projects launched was smaller so that the number of houses approved by the Ministry of Housing and Local Government for construction by private developers declined by 5.7% to 183,041 units during the year. Approvals for low- and medium-cost houses continued to account for the largest share (66%) of total approvals. This reflected that demand was mainly for affordable housing. It also reflected the impact of the BNM guideline, effective 6 January 1999, whereby banking institutions were encouraged to finance development of new residential property and shophouses costing less than RM250,000 each.

Latest available data showed that house prices continued to trend downwards in the first half of 1999. The Malaysian House Price Index declined further by 12% in the first half of 1999 (1998: –9.4%). The decline was broad-based with the price correction being more significant for detached (–13.4%) and semi-detached houses (–10.9%). Following successive price declines since 1996, the high-rise units recorded a smaller decline of 5%. By region, the decline was more pronounced in the Klang Valley (–10.2%), Johor Bahru (–8.7%) and Pulau Pinang (–8.2%) as these areas tended to have a greater supply of higher priced units. In contrast, the Seremban-Sepang and Ipoh-Kinta regions recorded increases in house prices of 1.4% and 7% respectively in the first half of 1999. At the state level, all states experienced lower prices except Kelantan, Perak and Perlis, which registered price increases of 5%, 4.3% and 1% respectively. The decline in house prices was most evident in Selangor (–16.4%), affecting mostly detached houses (–37.7%), followed by semi-detached (–29.6%) and terraced houses (–15.2%). With the strengthening of economic recovery in the second half of the year there were signs of price increases for landed property, particularly terraced houses in selected choice locations in the Klang Valley. Indicators included the high take-up rate of newly launched housing projects as well as higher transaction prices in the secondary market. Price increases were evident in the secondary market for properties in locations such as Bangsar, Bandar Utama and Subang Jaya.

Table 1.6
Home Ownership Campaigns (HOC 1 & 2) - Number and Value of Properties Sold

	Supply		Sales		Sales (% of supply)	
	Units	Value (RMm)	Units	Value (RMm)	Units	Value (RMm)
HOC 1 (12 Dec. '98 - 12 Jan. '99)	53,849	11,778	19,650	3,576	36.5	30.4
HOC 2 (29 Oct. '99 - 7 Dec. '99)	70,135	10,254	17,956	2,795	25.6	27.3

Source: Housing Developers' Association

Meanwhile, house prices in 1999 have remained very attractive to foreigners as they were lower in US dollar terms following the depreciation of the ringgit since 1997. Prices of single-storey and double-storey terraced houses in prime locations were lower by 30-50% in the second quarter of 1999 compared to their pre-crisis levels in the second quarter of 1997. Accordingly, foreign purchases increased significantly. Based on approvals by the Foreign Investment Committee, a total of 1,382 units of residential properties (+18.7%) valued at RM560 million were purchased by foreigners in 1999 (1998: 1,164 units valued at RM434 million). The bulk of the purchases was for condominiums and terraced houses. In the case of commercial property, foreign purchases totalled RM190.9 million (1998: RM44.3 million).

As growth in the construction sector continued to moderate, demand for construction workers declined further, albeit at a marginal rate of –0.7%, to 804,000 workers (1998: –16.8%). However, as the country's employment level increased by 1.7% to 8.7 million workers during the year, the share of construction workers to total employment declined to 9.2% (1998: 9.4%). Nevertheless, skilled foreign workers were in greater demand, resulting in their average daily wages increasing by 6% compared with wages of the other categories of workers, which generally stabilised.

The findings of BNM's Survey of the Construction Sector, 1999 reflected developments in the construction sector in 1999. The performance of the companies surveyed, however, was more favourable, recording a growth of 3.4% in construction activity during 1999. In terms of issues faced, the majority of respondents were still plagued by the problem of excess stocks, declining selling prices and, hence, lower profit margins as well as unfavourable business conditions. Average selling prices of retail and office buildings declined by 20% each while prices of single-storey and double-storey terraced houses declined by 8% and 24% respectively. Meanwhile, one-fifth of the respondents experienced difficulty in obtaining bank financing. Most companies, however, felt that employment conditions were favourable as they continued to rely on the services of foreign labour to fulfill demand in this labour-intensive industry.

During the year, the Government continued with its efforts to revitalise the construction industry in support of economic recovery. To help reduce excess stocks, the Government assisted in the Second Home Ownership Campaign (29 October - 7 December 1999), following the First Home Ownership Campaign (12 December 1998 - 12 January 1999). Incentives offered during the campaign included exemption of stamp duties, and a minimum price discount of 5% for properties costing RM100,000 or less, and 10% for properties costing above RM100,000. Financial institutions also offered incentives such as higher margin of finance (up to 95%), waiver of processing fees and increased loan tenure of up to a maximum of 30 years. Legal fees were also lowered for the Sale and Purchase and loan agreements as well as other charge documents. At the close of the campaign, a total of 17,956 units of residential and commercial properties valued at RM2.8 billion were sold, representing about one-quarter of the total number of units offered for sale.

To assist small- and medium-scale Bumiputera entrepreneurs in the construction sector, a total of RM100 million of the RM300 million Tabung Projek Usahawan Bumiputera, which was established on 10 February 2000, was allocated for the construction sector. This would enable the small- and medium-scale Bumiputera entrepreneurs to have access to financing at a reasonable cost of 5% per annum.

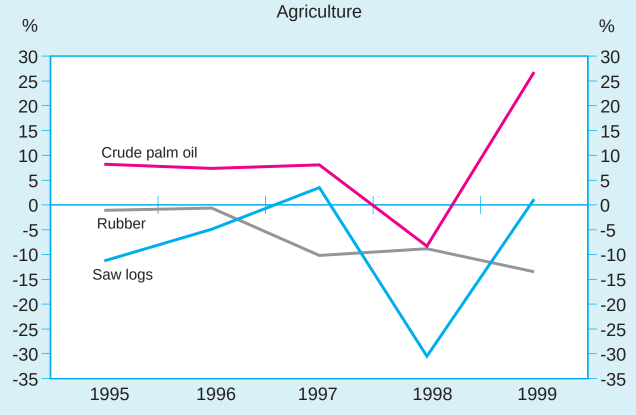
Total loans extended by the banking system to the broad property sector, comprising residential, non-residential, real estate and construction sub-sectors increased by 2.7% or RM4 billion to RM153.6 billion (including loans sold to Cagamas and Danaharta). However, as total loans extended by the banking system increased by only 0.2% in 1999, the share of loans to the broad property sector increased to 36% as at end-1999 (1998: 35.1%). The increase in loans was extended mainly for the purchase of residential property, and for financing real estate activity. Of the total loans extended by the banking system in 1999, purchase of residential property accounted for 14.8%, followed by loans for construction (10%), purchase of non-residential property (6.8%) and real estate activity, 4.3% (1998: 13.2%, 10.6%, 7.3% and 4% respectively). Following the easing of the credit situation, the purchase of housing loans by Cagamas moderated, accounting for 25.6% of total housing loans outstanding (1998: 33.8%).

Reflecting improved sentiments and a pick-up in demand in the latter half-year, the total value of housing loans approved by the various housing credit institutions as a group rose significantly by 106.9% to RM23.5 billion in 1999. In particular, the housing loans approved by the commercial banks and finance companies as a group totalled RM20.6 billion or an increase of 123.5%, accounting for 87.9% of the total value of housing loans approved by the housing credit institutions. However, loans approved by the Malaysia Building Society Berhad, Borneo Housing Mortgage Finance Berhad, Sabah Credit Corporation and Bank Simpanan Nasional declined due to keen competition and the attractive loan packages offered by the banking institutions. In tandem with the higher loan approvals, total housing loans outstanding increased in 1999. Financing of owner-occupied houses costing RM100,000 or less under the prescribed rate provided by the banking system accounted for 30.6% of total financing for residential houses. Effective 1 April 1998, the commercial banks and finance companies had made firm commitments to finance 137,048 and 45,790 of these units respectively as at end-1999.

Agriculture, Forestry and Fishery

Value added in the agriculture, forestry and fishery sector turned around to increase by 3.9% in 1999 (1998: –4.5%) primarily on account of the marked increase in crude palm oil production. The production of saw logs, fish and livestock also increased but this

Graph 1.13
Production Growth Rate



was not sufficient to offset the decline in the production of rubber, cocoa and other agriculture products. Hence, in 1999, the agriculture, forestry and fishery sector accounted for a lower share of GDP (9.3%; 9.4% in 1998), total exports (8.6%; 10.5% in 1998) and employment (16%; 16.3% in 1998).

Within the agriculture sector, **crude palm oil** remained the most important growth-generating commodity in 1999, accounting for 31.9% of the sector's value added. Together with processed palm oil, it contributed 52.5% of export earnings from the agriculture sector. Crude palm oil production increased strongly by 26.8% to 10.6 million tonnes in 1999. The surge in production was mainly due to the upturn in the biological yield cycle of the oil palm trees and to a lesser extent, an expansion in mature area, especially in Sarawak.

On a regional basis, production in the peninsula increased by 23.9% to 7.4 million tonnes, while production in Sabah increased by 31.9% to 2.7 million tonnes and Sarawak by 50.7% to 0.5 million tonnes. As returns from oil palm cultivation were more favourable compared with other industrial crops, the total area under oil palm cultivation expanded further by 4.5% to 3.2 million hectares. Total mature area increased by 7% to 2.8 million hectares as at end-1999. Expansion in mature area under oil palm was most rapid in Sarawak (99%), followed by Sabah (6%) and Peninsular Malaysia (2.2%). During the year, Malaysia remained the world's largest producer of crude palm oil, accounting for more than half (53%) of total world production.

During the year, private estates accounted for the largest share of the total oil palm cultivated area at 58.2% or 1.9 million hectares, followed by the organised smallholders under the Federal Land Development Authority, Federal Land Consolidation and Rehabilitation Authority and the Rubber Industry Smallholders Development Authority schemes (26.2% or 0.8 million hectares) and schemes under the state governments and independent smallholders (combined share of 15.6% or 0.5 million hectares).

With the expansion in area planted with oil palm in Sabah, a total of 33 new licences for mills were granted by the Palm Oil Registration and Licensing Authority in the state in 1999. Five new licences were granted in Sarawak while another 11 new licences were issued in the peninsula. As at end-1999, the number of mills in operation was 333 (1998: 325) with an annual capacity to process 61.5 million tonnes of fresh fruit bunches. Reflecting the higher production of crude palm oil, the average rate of capacity utilisation of the mills rose to 92.5% during the year (1998: 75.1%). In the refining sector, domestic processing of crude palm oil increased sharply by 21.7% to 10.3 million tonnes in 1999. During the year, one new refining licence was issued by the Ministry of International Trade and Industry, bringing the total number of refineries in operation to 46 with a total annual capacity to process 12.9 million tonnes of crude palm oil.

Based on existing acreage under oil palm cultivation and expected continued increase in new planting of oil palm, Malaysia's production of crude

Graph 1.14
Oil Palm: Area, Production and Yield

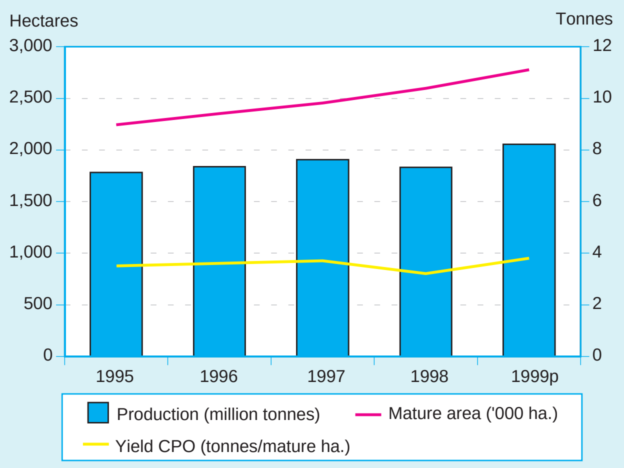


Table 1.7
Oil Palm: Area, Production and Yield

	1998	1999*p*	1998	1999*p*
			Annual change (%)	
Area ('000 hectares)				
Planted	3,078	3,216	9.2	4.5
Mature	2,597	2,780	5.8	7.0
Production ('000 tonnes)				
Crude palm oil	8,320	10,553	–8.3	26.8
Yield (tonnes/mature hectare)				
Crude palm oil	3.2	3.8	–13.5	18.8

p Preliminary

Source: Department of Statistics
PORLA

palm oil will continue to be on a rising trend in the medium and long term. Given the prospect of increasing supply of palm oil, efforts to penetrate new markets as well as R&D to develop new uses of palm oil were further enhanced. During 1999, the Malaysian Palm Oil Promotion Council (MPOPC) held promotional activities in various countries to improve market opportunities and trade. In this regard, MPOPC participated in 20 international exhibitions during the year. Meanwhile, the Palm Oil Research Institute of Malaysia (PORIM) intensified its R&D on new uses of palm oil in both the edible and non-edible products categories. In addition, PORIM continued to undertake research on developing new high-yielding clones and better agronomic practices, including mechanisation of field operations, to increase productivity of the industry. During the year, the Advanced Oleochemical Technology Centre (AOTC) was established to spearhead research in the production and utilisation of palm-based oleochemicals for more value added downstream activities.

Production of **natural rubber** which has been below the one million tonnes production level since 1997, declined further by 13.5% to 766,540 tonnes in 1999. The industry continued to be affected by depressed prices, labour shortages and reduction in cultivated area. During the year, prices for natural rubber fell further due to weak world demand for rubber amidst ample global supplies. Malaysia's RSS 1 price declined by 14.4% to 240 sen per kilogramme. High stocks of rubber, especially latex also led to low farmgate prices for smallholders. The unremunerative level of prices discouraged tapping activity, particularly among the smallholders, which accounted for almost 80% of the country's

Table 1.8
World Elastomer: Production and Consumption

	1998	1999[1]		1998	1999[1]
	'000 tonnes		% share	Annual change (%)	
Production	16,700	12,460	100.0	1.4	0.7
Natural rubber	6,710	4,910	39.4	5.2	–0.6
Thailand	2,216	1,413	11.3	9.0	–14.6
Indonesia	1,714	1,383	11.1	13.9	6.2
Malaysia	886	593	4.8	–8.8	–8.5
India	591	409	3.3	1.9	5.1
The People's Republic of China	450	345	2.8	1.4	2.7
Vietnam	219	177	1.4	9.0	11.3
Sri Lanka	96	75	0.6	–9.4	2.7
Nigeria	93	68	0.5	43.1	–2.9
Others	445	447	3.6	–20.5	44.7
Synthetic rubber	9,990	7,550	60.6	–1.0	1.6
Consumption	16,470	12,380	100.0	–0.2	0.7
Natural rubber	6,590	4,930	39.8	1.4	0.6
Synthetic rubber	9,880	7,450	60.2	–1.2	0.8
Deficit(–)/ surplus(+)	+230	+80			

[1] January - September

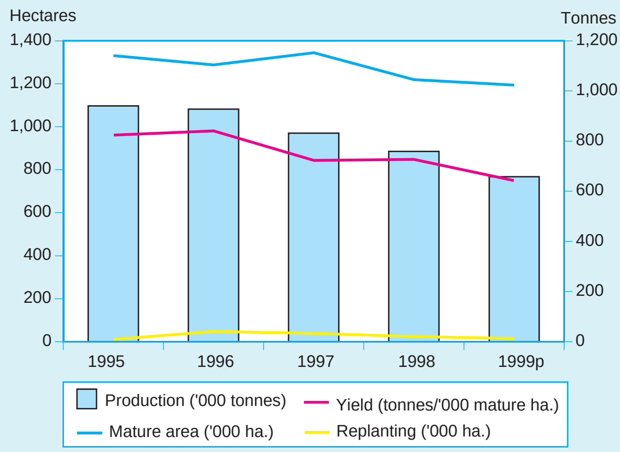
Source: International Rubber Study Group

rubber production. The production of rubber during the year was also affected, to some extent, by the slow rate of replanting over the past decade, contributing to the low level of yields in the smallholder sector.

The prolonged low prices for natural rubber had adversely affected rubber producers, particularly the smallholders. This prompted the Government to introduce in mid-1999, a temporary scheme, whereby the Government purchased rubber directly from the smallholders and rationalised the stock of latex in the country. The scheme was subsequently discontinued in February 2000 when rubber prices improved.

A major problem in the rubber smallholding sector is the low yield. In 1999, a total of 388,000 hectares of rubber cultivated land (26% of total) were due for replanting as the trees were more than 25 years old. During the year, the Rubber Industry Smallholders Development Authority (RISDA) financed the replanting of 13,600 hectares of smallholders' rubber land. To encourage replanting, the Government has, in the 2000 Budget, provided an allocation of RM201 million for replanting purposes, covering 45,000 hectares of

Graph 1.15
Rubber: Area, Production and Yield



rubber cultivated land. In addition, the Government announced in the Budget that it would set up a RM1 billion fund to provide soft loans to RISDA for replanting programmes. In an effort to increase productivity, and given the problem of labour shortages, an allocation of RM80 million was provided in the Budget to encourage rubber smallholders to adopt the low intensity tapping system (LITS). Through LITS, productivity can be increased by 30% compared to the conventional tapping system.

In the international arena, the International Natural Rubber Agreement (INRA) was terminated in October 1999, following the withdrawal of Malaysia and Thailand from the pact. With the termination of INRA, Malaysia and Thailand signed a memorandum of understanding (MoU) with the main purpose of joining efforts and

Table 1.9
Rubber: Area, Production and Yield

	Estates		Smallholdings	
	1998	1999*p*	1998	1999*p*
	'000 hectares			
Planted area	197	192	1,303	1,273
Replanting	3	2	22	14
New planting	1	1	4	2
Production ('000 tonnes)	198	182	687	585
Yield (kg./mature ha.)	1,021	968	670	580

p Preliminary

Source: Department of Statistics
Malaysian Rubber Board
Department of Agriculture, Sarawak
Sabah Rubber Fund Board

sharing resources available in their respective countries to achieve equitable rubber prices for smallholders. At the same time, both countries would develop suitable schemes to minimise stock withholding in order to avoid a market overhang. In addition to co-operation in areas relating to price and trade, the MoU also provided for technical co-operation. Seven broad areas have been identified for technical co-operation, including specification of natural rubber products, exploitation of rubberwood and clone breeding. To avoid a large stock build-up in the international rubber market arising from the release of the International Natural Rubber Organisation's (INRO) rubber stockpile, Malaysia and Thailand had established a US$43 million fund to purchase rubber stocks held by INRO.

Production of **saw logs** turned around to increase by 1.2% to 21.9 million cubic metres in 1999 (1998: –30.5%), due entirely to higher production in Sarawak. Log production in Sarawak accounted for 60% of national production. In response to the recovery in external demand, especially from the Asia-Pacific markets, log production in Sarawak increased strongly by 15.8% to 13.1 million cubic metres. On the other hand, production in Peninsular Malaysia and Sabah declined by 5% and 24% to 4.8 million cubic metres and 4 million cubic metres respectively. During the year, Malaysia's saw log production levels were in line with the Government's forest conservation policy and sustainable forest management as stipulated under the International Tropical Timber Agreement.

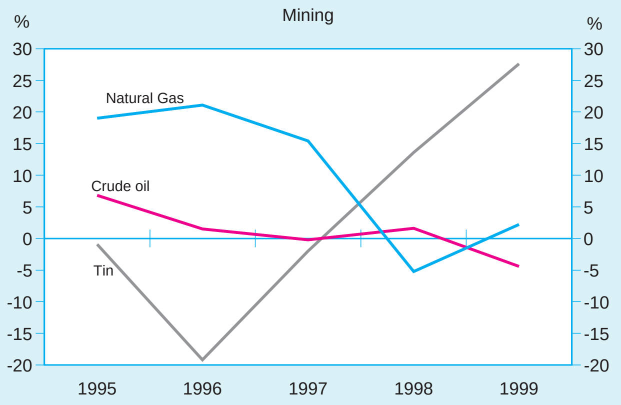
Cocoa production, which had been on a downtrend since 1991, fell by 7.2% to 83,700 tonnes in 1999 (1998: –14.9%) as cultivated area under cocoa declined further following conversion of cocoa cultivated land to other crops, particularly oil palm. Low cocoa prices during the year had also affected production. In addition, rising cost of production as a result of increases in labour costs and prices of agricultural inputs had affected production particularly among the smallholders. In terms of acreage, a total of 1,778 hectares of cocoa cultivated land were converted to other crops during the year. However, in Sabah where production accounted for 70% of the total national output, the total area cultivated with cocoa expanded further by 11.4% during the year. In terms of domestic consumption, demand from cocoa grinders increased further to 110,440 tonnes in 1999 (1998: 100,100 tonnes) in response to higher external demand. As domestic production of cocoa beans was insufficient to meet the demand from the domestic cocoa processing industry, cocoa beans were imported, mainly from Indonesia.

Production in the **fishery** industry increased by 5.1% to 1.4 million tonnes in 1999, reflecting higher production of both marine fish and aquaculture. Marine fish landings, which accounted for almost 90% of total fish production increased by 2.5% to 1.2 million tonnes. As a result of efforts to promote aquaculture activities, production from the sub-sector grew sharply by 28.7% to 172,000 tonnes. During the year, measures were taken to increase fish landings through the construction of a greater number of artificial reefs for breeding fish and through improved fishing technology. With higher production, exports of fish increased by 1.4% to 152,000 tonnes. The main export markets were Thailand, Singapore and Japan. At the same time, imports of fish, mainly from Thailand, declined by 0.6%. During the year, per capita consumption of fish in Malaysia increased to 44 kilogrammes from 43 kilogrammes in 1998.

Mining

Value added in the mining sector contracted by 4% in 1999 (+1.8% in 1998) on account of lower production of crude oil, which accounted for almost 80% of total value added in the sector. On the other hand, natural gas production turned around to grow by 2.1% due to higher domestic and external demand. Tin production also registered a positive growth during the year, in response to favourable prices. In terms of contribution to the economy, the share of the mining sector to GDP growth was lower at 7.3% in 1999 (1998: 8.1%). Its share of total exports was, however, higher at 5.4% (1998: 5.2%) following the sharp increase in prices for crude oil. Meanwhile, the sector's contribution to employment remained unchanged at 0.5% during the year.

Graph 1.16
Production Growth Rate



In 1999, production of **crude oil, including condensates** declined by 4.4% to 693,200 barrels per day (bpd). Excluding condensates, crude oil production was lower by 4% at 614,100 bpd, compared with 639,600 bpd in 1998. The lower level of crude oil production was in line with the National Depletion Policy, which aims to sustain the exploitation of the nation's resources. As at 1 January 1999, Malaysia's crude oil reserves was 3.6 billion barrels and at the current rate of production, this level of reserves could last for another 15 years. Meanwhile, the production of condensates (that is crude oil produced in gas fields) declined by 7.4% to 79,100 bpd (1998: 85,400 bpd) in response to weaker external demand for condensates.

On a regional basis, Peninsular Malaysia accounted for a share of 58% of total production, Sarawak 29% and Sabah 13%. Lower crude oil production was recorded by all regions, namely, Sarawak (–5%), Sabah (–4.3%) and the peninsula (–4.1%). During the year, two new oil fields, one each in the peninsula and Sarawak, commenced operations. In the upstream sector, four new production sharing contracts were signed in 1999. A total of 10 exploration wells and 41 development wells were drilled during the year, while 93,000 line kilometres of seismic data were acquired for exploration and development purposes.

Natural gas production, on the other hand, turned around to increase by 2.1% to 3,802 million standard cubic feet per day (mmscfd) in 1999 following increased domestic demand as well as higher external demand for LNG by Japan and Korea. While the production of associated gas (originating from oil fields) declined by 6.5% in line with the decline in crude oil production, production of gas from gas fields recorded a growth of 3.4%. Based on reserves as at 1 January 1999, it was estimated that Malaysia's gas reserves could be utilised for another 30-45 years.

The production of **tin-in-concentrates** continued to record positive growth for the second consecutive year in 1999 as tin prices remained favourable. The firm tin prices resulted in three new mines commencing operations during the year and also induced higher production from existing mines. As a result, production of tin-in-concentrates increased sharply by 27.6% to 7,350 tonnes in 1999.

Services

Supported by the overall improvement in the economy, the services sector rebounded to grow by 2.9% in 1999 (1998: –0.8%). The recovery was broad-based encompassing stronger growth in final services and a turnaround in the growth of intermediate services. Growth picked up slowly by 0.6% in the first half-year and subsequently accelerated to 5.1% in the second half-year, as the recovery strengthened further. Despite a small decline in its share of GDP to 54.2% (1998: 55.6%), the services sector remained the largest sector in the economy.

Intermediate services, comprising transport, storage and communications; and finance, insurance, real estate and business services expanded by 2.2% in 1999 (1998: –2.3%). Growth emanated mainly from the **transport, storage and communications** sub-sector, particularly transportation services, underscoring the strong increase in international trade.

- For **port services**, the volume of cargo handled by the five major ports in Malaysia increased strongly by 9.5% to 132.9 million

Table 1.10
Growth in the Services Sector in 1987 Prices

	1998	1999*p*	1998	1999*p*
	Annual change (%)		% share of GDP	
Services	**–0.8**	**2.9**	**55.6**	**54.2**
Intermediate services	–2.3	2.2	20.8	20.1
Transport, storage and communication	*0.9*	*3.8*	*8.2*	*8.0*
Finance, insurance, real estate and business services	*–4.3*	*1.2*	*12.6*	*12.1*
Final services	0.1	3.3	34.8	34.1
Electricity, gas and water	*3.0*	*4.9*	*3.4*	*3.4*
Wholesale and retail trade, hotels and restaurants	*–3.1*	*2.1*	*15.7*	*15.2*
Government services[1]	*1.8*	*6.6*	*7.3*	*7.4*
Other services[2]	*3.7*	*2.1*	*8.4*	*8.1*

[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; and community, social and personal services, product of private non-profit services to households and domestic services of household.
p Preliminary

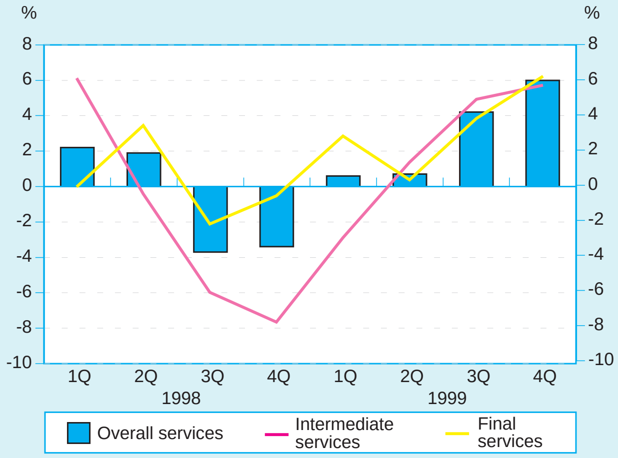
Source: Department of Statistics.

freight weight tonnes (1998: –12.8%), while container throughput surged strongly by 31.7% to a record high of 3.84 million twenty-foot equivalent units (TEUs) in 1999. To meet the increase in container volume, several ports embarked on expansion plans to augment their facilities and services. Westport, for example, began work on the construction of a new 600-metre terminal which would increase the capacity to 1.8 million TEUs annually. Meanwhile, the Kuantan Port Consortium (KPC) has started the construction of 12 new berths to strengthen the port's position as the country's main gateway for the petrochemicals industry. The new berths are expected to raise the port's handling capacity by 9 million tonnes in mixed cargo annually. In the south, the commencement of operations of the Port of Tanjung Pelepas (PTP) at the end of 1999 is expected to enhance port services, particularly in the southern region. The port is envisioned to become an ideal transhipment hub due to its strategic location at the confluence of major international shipping routes.

- In the case of **air transport**, the volume of cargo handled increased marginally by 1.7% in 1999. Growth was affected by diversion of part of the cargo to Singapore due to problems faced by MAS Cargo Advanced Centre since its relocation to KLIA. On the other hand, following the recovery of the Malaysian economy and the efforts taken by MAS to rationalise its flight routes, the number of passengers using the airline increased strongly by 9.1% to 14.8 million passengers. At the same time, MAS was also actively pursuing more code-sharing agreements as a means to increase flight frequencies, capacity and offer a better spread of services to passengers.

- In the **rail transport** segment, lower revenue from cargo and passenger services was recorded in 1999. Revenue declined in the first half-year before increasing in the subsequent half-year, in tandem with the strengthening pace of the economic recovery. The ridership of the Light Rail Transit (LRT) also increased substantially in 1999 due mainly to the opening of the extension route of the Projek Usahasama Transit Ringan Automatik (PUTRA) LRT from Pasar Seni to Gombak in June and the success of the promotion campaign to increase ridership through reduction in fares.

Graph 1.17
Services Sector: Quarterly Annual Growth



- The **communications** sub-sector also benefited from the recovery in domestic demand. The number of telephone (fixed line) subscribers grew by 1.1% in 1999, with increases in both commercial (1.8%) and residential (0.9%) subscribers. At the same time, the increased popularity of mobile phones, particularly the pre-paid service, contributed to a substantial increase in subscriber base.

Value added in the **finance, insurance, real estate and business services** sub-sector recovered to increase by 1.2% in 1999 (1998: –4.3%). The growth in value added of the sub-sector was due in part to improved profitability of financial institutions following measures to strengthen and restructure the banking sector. Meanwhile, the surge in trading activity and higher prices of shares in the Kuala Lumpur Stock Exchange as well as the increase in insurance premium income collections (5.7%) enhanced further the performance of the sub-sector, particularly in the second half-year.

In the **final services** group, comprising utilities; wholesale, retail trade, hotels and restaurants; government services and other services, value added increased by 3.3% in 1999 (1998: 0.1%). Growth emanated mainly from the Government services and utilities sub-sectors.

- Growth in the **Government services** sub-sector was higher at 6.6% in 1999 (1998: 1.8%). The increase reflected mainly higher emoluments arising from the bonus payment and reinstatement of allowances to civil servants as well as the increase in supplies and services provided by the Government.

- With the pick-up in economic activity, particularly in the manufacturing sector, value added in the **utilities** sub-sector expanded by 4.9% in 1999 (1998: 3%). The increase in electricity demand, particularly from the industrial and commercial sectors, led to higher production of electricity, as measured by the Electricity Production Index, which rose by 3.9%. During the year, water consumption increased by 1.5% to 8,754 million litres per day while production increased by 2.4% to 10,382 million litres per day.

- The **wholesale, retail, hotels and restaurants** sub-sector recorded an encouraging growth of 2.1% in 1999 (1998: –3.1%). Following a decline in the first half-year, value added in the sub-sector increased by 5.4% in the second half-year, on account of higher consumer spending and an increase in tourist arrivals. The gradual improvement in consumer confidence was reflected in the Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index, which rose from 84 points in the first quarter of the year to 117.7 points in the fourth quarter. The improved consumer sentiment was mainly on account of the positive wealth effect of the rising equity market, favourable economic outlook and improved employment prospects. Meanwhile, the survey conducted by the Malaysian Retail Association (MRA) showed that retail sales increased by 1% in the first half-year and 6.8% in the third quarter of 1999 (1998: –20%). In the same survey, a stronger growth of 8.7% was expected in the fourth quarter of the year. Reflecting the improvement in the domestic trade sector, the collection of sales tax rose strongly by 16.7% (1998: -37.7%). In the tourism industry, the hosting of international events, in particular the Formula One Grand Prix Championship and the depreciation of ringgit from 1997 onwards had resulted in a significant increase in tourist arrivals, contributing to the favourable performance of the hotels and restaurants sub-sector. During the year, the average hotel occupancy rate rose to 53.4% from 49.9% in 1998.

  The improvement in the wholesale and retail trade sector is corroborated by the results of Bank Negara Malaysia's Annual Survey of the Wholesale and Retail Sector, 1999 which showed a marked increase in sales performance. Sales revenue of the retail sector rose strongly by 10.9% in 1999 (1998: –5.4%) while that of the wholesale sector increased by 1.3% (1998: –4.5%). In the departmental store sub-sector, sales revenue increased by 20.9% in 1999. For the wholesale and retail sector as a whole, sales revenue was higher by 6.6% in 1999 (1998: –5%).

Domestic Demand Conditions

The impact of policy measures to restore consumer and investor confidence was felt in 1999 when domestic demand conditions improved significantly. Growth in real aggregate domestic demand (excluding stocks) turned positive since the third quarter of 1999 due mainly to higher public sector expenditure and revival in private sector consumption. Private investment, however, moderated further in 1999 owing to excess capacity in selected industries. Overall, aggregate domestic demand (excluding stocks) registered a positive growth rate of 1.2% in nominal terms and 1.6% in real terms, a significant turnaround from the decline of 20.3% in nominal terms and 25.2% in real terms recorded in 1998.

Total consumption expenditure increased by 8.4% in nominal terms in 1999, compared with a decline of 7.4% in 1998. In real terms, total consumption spending, which accounted for 68% of total demand, improved by 6.1% (1998: –10.2%). **Public consumption** expenditure, with a share of 23% of total consumption spending, increased significantly by 20% in nominal terms and 20.1% in real terms during the year. While all components of Federal Government consumption expenditure increased, the most pronounced increase was in expenditure on emoluments.

Graph 1.18
Domestic Demand Aggregates

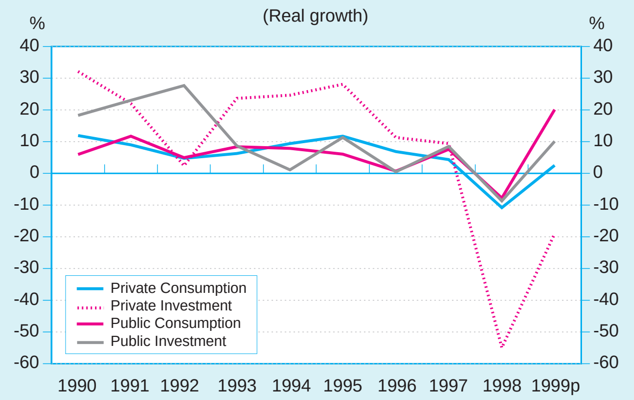


Table 1.11
Quarterly Aggregate Domestic Demand Components at Current and Constant (1987=100) Prices

	1998	1999				
		Q1	Q2	Q3	Q4	Year
	% annual change					
Constant Prices						
Aggregate Domestic Demand (excl. stocks)	–25.2	–9.3	0.2	8.9	7.3	1.6
Total Consumption	–10.2	1.0	6.7	8.1	8.4	6.1
Private Consumption	*–10.8*	*–4.3*	*2.8*	*4.6*	*7.6*	*2.5*
Public Consumption	*–7.8*	*36.0*	*20.8*	*20.2*	*11.0*	*20.1*
Gross Fixed Capital Formation	–42.9	–25.3	–11.2	10.7	5.2	–6.8
Current Prices						
Aggregate Domestic Demand (excl. stocks)	–20.3	–9.2	–0.5	6.2	8.8	1.2
Total Consumption	–7.4	4.7	8.8	8.9	10.9	8.4
Private Consumption	*–7.5*	*–0.4*	*5.6*	*6.5*	*10.8*	*5.6*
Public Consumption	*–7.3*	*37.9*	*21.0*	*18.0*	*10.9*	*20.0*
Gross Fixed Capital Formation	–37.2	–31.3	–17.6	0.2	4.4	–12.7

Private consumption expenditure turned around to record a positive growth of 5.6% in nominal terms and 2.5% in real terms for 1999 (–7.5% and –10.8% respectively in 1998). This reflected the improvement in consumer confidence and consumer spending in an environment of low interest rates and rising wealth following the bullish trend in the stock market and the favourable performance of the export sector. In 1999, the KLSE Composite Index closed the year at 812.3 points, an increase of 38.6%, while export earnings rose by 12.1%. Several major consumption indicators pointed towards an improvement in consumer spending. Sales of passenger cars increased by 79.9% in 1999 to 255,878 units. Imports of consumption goods rose at an annual rate of 21.3% to RM15.5 billion or US$4.1 billion. Improved consumer spending was also indicated by the increases in loans disbursed for consumption credit and general commerce (RM17.1 billion and RM57.7 billion respectively in 1999, from RM11.7 billion and RM35.9 billion respectively recorded in 1998).

Higher budget allocation for development projects by the Government, speedier disbursement of funds and signs of recovery in private investment expenditure in the second half-year led to a slower rate of decline in **gross fixed capital formation**. In 1999, gross fixed capital formation declined at a slower rate of 12.7% in nominal terms and 6.8% in real terms (1998: –37.2% in nominal terms and –42.9% in real terms). With stronger public sector investment activities and a modest recovery in private investment activity especially in the second half-year, gross fixed capital formation posted the first positive growth of 0.2% in nominal terms and 10.7% in real terms in the third quarter of 1999.

Public investment expenditure increased by 3.1% in nominal terms and 10.1% in real terms in 1999. Under the fiscal stimulus programme, allocation for socio-economic projects and selected infrastructure projects were increased. In particular, projects selected were those with greater spill-over effects on the domestic economy and minimal import content. Infrastructure projects funded by the Government included rail, roads, bridges, highways and public utility projects. Capital outlays on the social services sector which accounted for 31% of total development expenditure expanded by 19.9% in 1999. Reflecting the Government's policy of making Malaysia a regional centre of excellence in education as well as promoting a highly skilled labour force to support the strategy of high-technology and productivity-driven growth, allocation for education and training was substantially higher. While several NFPEs increased their capital spending for capacity expansion, particularly PETRONAS and Putrajaya Holdings, other NFPEs particularly Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (Telekom) consolidated their activities to increase the efficiency of their operations. As a result, total investment activities of NFPEs slowed down in 1999. Capacity expansion projects by PETRONAS included the development of several petrochemical complexes in Kertih and Gebeng, central utility facility in Gebeng, and construction of Kuantan Port-Kertih railway link. To provide for the development of the administrative centre in Putrajaya, capital investment by Putrajaya Holdings was also sustained in 1999. Capital expenditure by TNB focused mainly on transmission and distribution projects to ensure reliable and quality supply for its industrial and domestic users. The provision for the construction of the RM2 billion Janamanjung coal-fired plant in Perak accounted for a large part of TNB's capital expenditure in 1999.

Other projects comprised the development of Phase III of the Port Klang Sultan Salahuddin Abdul Aziz Power Station in Kapar and Phase II of the Tenaga Nasional University Complex. Meanwhile, major projects undertaken by Telekom included the development and expansion of the telecommunication network infrastructure, especially to support the development of the Multimedia Super Corridor (MSC).

Latest estimates showed that **private investment** declined at a slower rate of –24.1% in nominal terms and –19% in real terms in 1999 (–50.5% and –55% respectively in 1998) due mainly to the pick-up in activity in the second half-year, following the improvement in consumer and investor sentiment. This trend was also reflected in several indicators of investment activity. Imports of capital goods in US dollar terms, which declined by 40.5% in 1998 and 25.1% in the first half of 1999, turned around to record an increase of 16.7% in the second half of 1999. Sales of commercial vehicles (including 4WD) recovered to 32,669 units or a strong growth of 50.8%, as against a sharp decline of –76.1% in 1998. Loans disbursed by the banking system to the construction and manufacturing sectors were also higher at RM25.6 billion and RM85 billion respectively in 1999, compared with RM21.4 billion and RM68.7 billion in 1998.

The revival of private investment activities differed across sectors. In general, the services, manufacturing and construction sectors continued to experience further consolidation while investment activities were stronger in the agriculture and mining sectors. The 49.3% decline in investment in the services sector reflected mainly lower capital investment in the utilities and finance, insurance and business sub-sectors. The slower rate of investment in the utilities sub-sector was on account of completion of power plant projects by independent power producers. With the completion of LRT II, investment activity in the transport sub-sector was supported mainly by the resumption of construction of the People-Mover Rapid Transit System (Monorail) and Express Rail Link projects. Meanwhile, the property overhang in the supply of office space, hotels and retail space continued to be a drag on the economy, resulting in a substantial reduction in investment in the business sub-sector. Following the continued consolidation of investment activities in the services sector, its share of total private investment declined to 21.1% in 1999 (1998: 31.7%).

Table 1.12
Private Investment by Sector[1]

	1997	1998	1999
	RM billion		
Private investment	89.6	44.3	33.6
Of which:	% share		
Manufacturing	25.7	35.5	36.9
Construction	9.4	15.8	18.9
Services	34.0	31.7	21.1

[1] Estimates

Capital outlay in the construction sector also experienced further adjustment in 1999 due mainly to the deferment and delay in implementation of several privatised road projects as well as commercial buildings. The investment activity in this sector in 1999 was mainly supported by construction activity of low- and medium-cost houses and infrastructure development. The ongoing road projects in 1999 were concentrated in the Klang Valley, such as SPRINT Highway and Elevated Highway. Hence, investment in this sector declined by 9% to account for a share of 18.9% of total private sector investment.

In the manufacturing sector, investment activities were affected by the excess capacity situation faced by selected industries, mainly in the construction-related materials and transport equipment industries. Investment in the manufacturing sector declined by 21% in 1999 (1998: –31.7%). The decline was mainly due to further consolidation in the domestic-oriented industries. Export-oriented industries, particularly the electrical and electronic sector, benefited from the continued strengthening of global demand for electronics and electrical products as well as the stronger expansion of regional trade. New investment activities in the manufacturing sector were mainly sustained by ongoing petrochemical projects approved in 1998 as well as new electrical and electronic projects approved in 1999. Total value of investment approved for electrical and electronic projects exceeded RM7 billion in 1999.

The value of investment approved by the Ministry of International Trade and Industry (MITI) declined to RM16.9 billion in 1999, compared with RM26.4 billion in 1998. Of the total investment approved, four large projects, each with proposed investment exceeding RM1 billion, accounted for approximately 35% of the total investment approved. The electrical and electronic products industry accounted for the largest share of 41.4% of the total value of

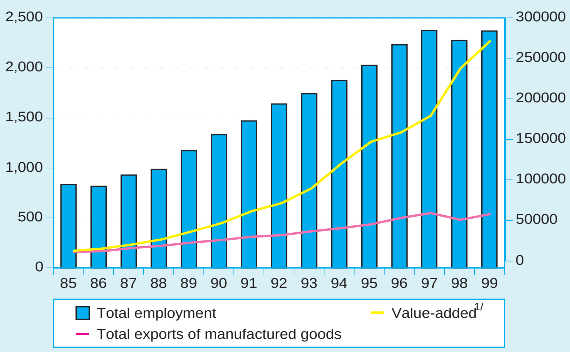
Box II

The Manufacturing Sector in the K-economy - Challenges and Strategies

Introduction

Since Independence, the manufacturing sector has played a progressive role in the economic growth of the country. By 1988, it became the most important source of growth when its share of GDP rose to 21.1%, surpassing for the first time, the traditional mainstay, agriculture. Since then, the sector has been expanding rapidly. During the period 1988-97, both value added and exports of the manufacturing sector grew strongly by 13.9% and 24.3% per year, respectively. Growth, however, was interrupted in 1998 when it contracted by 13.7% before recovering to expand by 13.5% in 1999, with its share of GDP at 30%.

Graph II.1
Trends in the Manufacturing Sector (1985-99)



1/ Value added is based on contribution to real GDP
Source: Department of Statistics
Economic Planning Unit
Bank Negara Malaysia

To a large extent, the impressive growth of the manufacturing sector is attributable to the implementation of deliberate policy measures aimed at achieving an industrialised nation status by the year 2020. Malaysia's industrialisation drive was marked by three distinct phases comprising import substitution (1958-68), selective export-led industrialisation (1969-80) and broad-based export-led industrialisation (1981 onwards). The policy initiatives taken have not only generated employment, expanded exports and further enhanced the value of products, but contributed significantly to the nation's well-being (see Graph II.1 and Chart II.1). An empirical study using the Cobb-Douglas production function in a cointegration model to measure the impact of manufactured and primary exports on GNP per capita for the period 1960-97 suggests that a structural change took place in 1986[1]. The long-run elasticity findings showed that a 1% increase in total primary exports induced a 0.2% increase in GNP per capita during the period 1960-85, but only 0.02% in 1986-97. On the other hand, the long run elasticity of manufactured exports showed that a 1% increase in total manufactured exports resulted in an increase of 1.1% in GNP per capita in 1986-97, significantly higher than the magnitude of 0.2% for the earlier period, 1960-85.

Given the strong positive correlation between the industrialisation process and income per capita, the manufacturing sector needs to be equipped to increase its ability to face the changes that are rapidly shaping the emergence of a new global economic framework. This article, as such, is aimed at identifying the challenges to the manufacturing sector and discussing the strategies to further strengthen the sector.

New Industrialisation Challenges and Strategies

The global landscape for industrial development is fast changing. For a long time, development was viewed as the accretion of both physical

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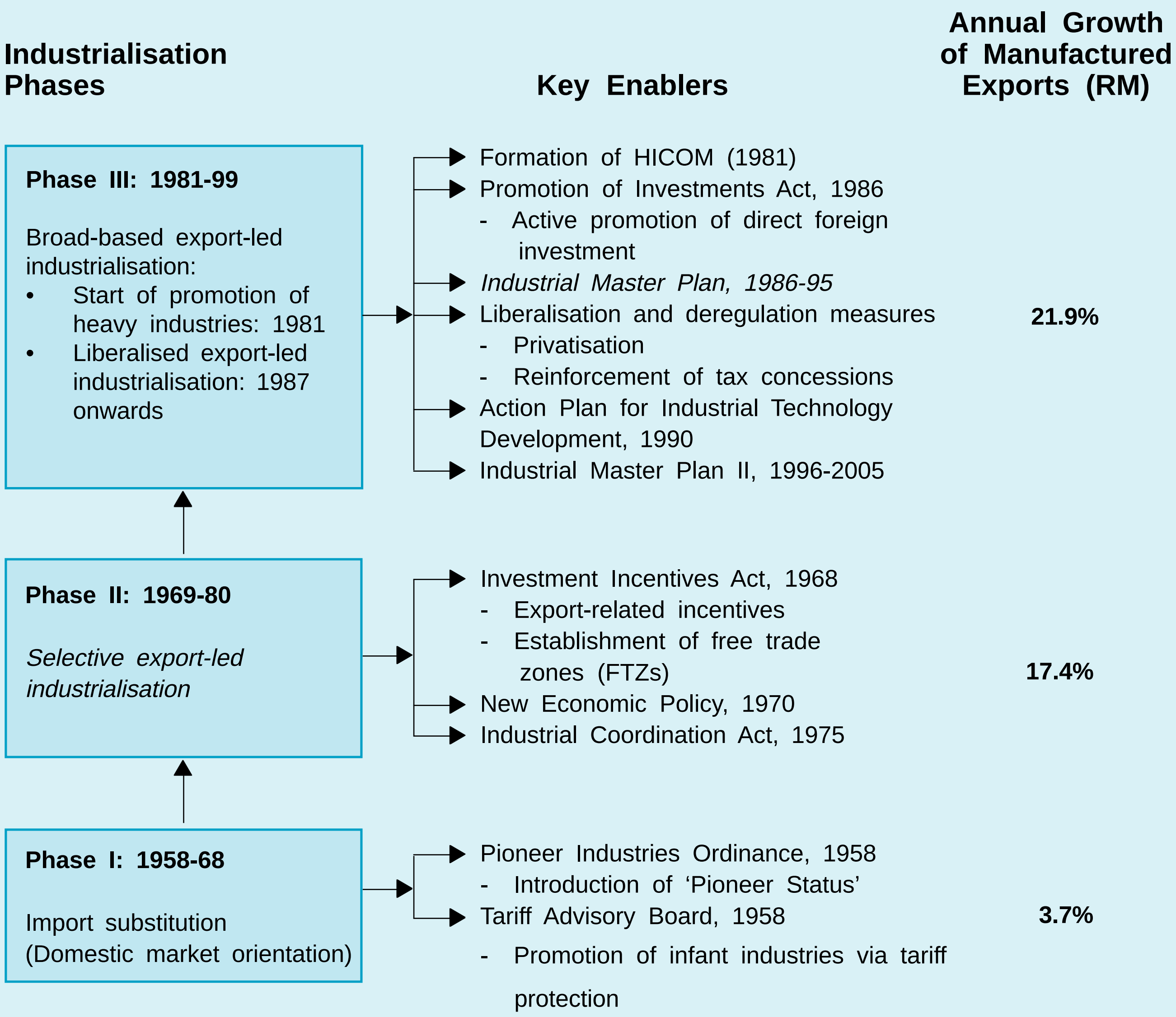
[1] A predictive failure test was used to test for structural changes. Due to its statistical insignificance, the short-run elasticity of manufactured exports was deleted during the testing-down process. Ceteris paribus, primary exports, in the short-run, though positive in sign, had become insignificant during 1986-97 from a strongly significant position in the earlier period (magnitude of 0.3%).

Chart II.1: Industrial Development and Major Policy Initiatives, 1958-99



and human capital. Currently, however, there is growing awareness that successful development should not only entail these factors, but also include the closing of the knowledge gap. A new economy in which knowledge is pervasively recognised as a vital source of economic growth, determinant of wealth and basis of competitive advantage is rapidly developing. Thus, the transition from a production-based economy (P-economy) to a knowledge-based economy (K-economy) implies that manufacturers will be faced with a new set of challenges and success is dependent on their ability to leverage knowledge in the best possible way. These key challenges and strategies are as follows:

(i) Advancements in Information and Communications Technology (ICT)

The world is on the verge of the connected society. Essentially, a new global culture and economy of businesses and individuals connected in a high-speed communications fabric that enables digital transmission of data, voice and video to anyone, anywhere, anytime has surfaced. As such, every business today has to compete in two worlds: a physical world of resources and a virtual world made of information. The latter has given rise to the world of electronic commerce, a new locus of value creation.

Those who understand how to master both can create and extract value in the most efficient and effective manner.

The advancing view, supported by the virtual organisation concept, is 'agile manufacturing', where a company is able to respond quickly to changing circumstances. This requires highly integrated systems between companies to create a fast, flexible, seamless electronic assembly line. In sum, the implications of the virtual value chain for manufacturers are as follows:

- Unlike physical assets, digital assets are not used up in their consumption. As such, manufacturers that create value with digital assets may be able to reharvest them through a potentially infinite number of transactions, thus changing the competitive dynamics of their industries;

- The virtual value chain redefines economies of scale, allowing small companies to achieve low unit costs for products and services in markets dominated by big companies;

- Businesses can redefine scope of operations by drawing on a single set of digital assets to provide value across many different and disparate markets;

- Transaction costs along the virtual value chain are lower than on the physical value chain, hence, allowing companies to control and track information that would have been too costly to capture and process before.

The biggest change in the age of he connected society will be the enhanced driving force of the consumer, so that expansion of the manufacturing sector increasingly demands a ***shift from supply-side to demand-side strategies*** in order to continuously influence consumer tastes and demands.

Given these developments, Malaysian companies need to urgently take steps to enhance their ICT-based competitive edge in order to take advantage of the opportunities of the connected society. A survey conducted by the Malaysian External Trade Development Corporation (MATRADE) in April 1999 revealed that 68.9% of the companies registered with MATRADE have e-mail facilities and 65.8% have Internet connections. However, only 38.3% have websites or homepage applications and 24.3% have on-line product catalogues whilst only 4.1% indicated that they have strategies to participate in e-commerce. In addition, the Asian Executives Poll of the Far Eastern Economic Review and CNBC Asia (February 2000) which targeted top company executives, showed that only 41.2% of Malaysian executives planned to expand their e-commerce activities, the lowest proportion amongst the 10 Asian countries surveyed (in order of ranking, Philippines, Hong Kong SAR, Taiwan, Australia, Japan, Indonesia, Singapore, Thailand, South Korea and Malaysia). Larger companies that are already shifting critical functions to the Internet would expect others who support their operations, such as, vendors and suppliers to also go on board to be electronically linked. As the number of small- and medium-scale enterprises (SMEs) in Malaysia which serve the larger companies as supporting and ancillary service and product providers begins to increase, there is the urgent need for them to adopt the new electronic medium to expand their electronic operations from purely administrative and inventory keeping to actual day-to-day transactions. Given that the SMEs represent more than 90% of the total manufacturing establishments, it is clear that this sector should not be left behind in the shift to e-business. As of January 2000, only 311 of total domestic SMEs have participated and undertaken on-line business. In a global environment of increased competition, failure on the part of Malaysian manufacturers to create value through the virtual value chain will prove costly in terms of lost opportunities.

The Government has provided a number of incentives to encourage IT-related companies to develop their businesses and to spur a higher usage of computer and technology assets. The Multimedia Super Corridor (MSC) which was established in 1996 to provide a high-powered gateway to the latest multimedia and information technology is also aimed at enhancing manufacturing operations in the areas of design, market intelligence, procurement and production control. Within the Electronic Government flagship of the MSC, a world-class electronic procurement infrastructure is being developed in which the Government will play the role of a single buying entity that will procure products and services electronically from about 30,000 suppliers in the country. In educating the SMEs, the Malaysian Electronic Trading Business Environment (MyBiz) Programme, which was introduced in March 1999 by the Small and Medium Industries Development Corporation (SMIDEC) in collaboration with Hitechniaga Sdn. Bhd., is aimed at enhancing awareness among the business community on the opportunities and benefits of conducting business electronically. The Government will continue to provide the necessary conducive environment for the development of e-commerce with the drawing up of a Malaysian Framework for E-Commerce. The framework will lay down a set of guiding principles and policies leading to the development of a National Masterplan for E-Commerce. Manufacturers, on the other hand, need to begin building the capacity to understand the Internet ecosystem and its manifestations.

(ii) Increased competition and globalisation

As market opening by individual countries continues to be the norm, market borders will increasingly become more porous and technically non-existent. In terms of intra-regional trade, the ASEAN Free Trade Area (AFTA) provides a large potential market of 530 million people with an estimated combined GDP of US$838 billion. On 1 January 2000, duties on 89.7% of the products included in the Common Effective Preferential Tariff Scheme for the six original ASEAN members were lowered to between 0-5%. The ASEAN countries have also agreed to eliminate duties on at least 60% of the products by 1 January 2003. The 1999 BNM's Survey of Manufacturing Companies (SMC)[2] indicated that for the year 2000, only 21.5% of the companies anticipated to increase their export market share resulting from the regional tariff liberalisation. The survey also showed that only 28.8% expected to see product price competitiveness. This implies that Malaysian manufacturers would have to step up their production efficiencies in order to fully gain from the benefits of AFTA.

Increased globalisation implies that the domestic industry and trade entities must be able to compete successfully in the Malaysian market with all foreign competitors, while those exporting abroad must be able to meet the challenges in every export market and compete successfully with others that are also in those markets. Those who fail to adjust risk being marginalised or even eliminated in both domestic and export markets. To enhance the competitive advantage of Malaysian manufacturers, the following needs to be considered:

- ***Higher increase of value added/ downstream activities***

  This includes the following four areas:

  Redefining the value chain: Based on BNM's SMC, the value-added content of the manufacturing sector increased from 32.9% in 1998 to 34.2% in 1999, indicating an increase in downstream activities. The survey, however, showed that the electronics and electrical products industries have relatively lower value-added content due to higher concentration on assembly-type activities and less linkages with domestic suppliers. In contrast, the rubber-, wood- and palm oil-based industries registered relatively higher value-added content. In the K-economy, manufacturers would have to look at the value chain from the position of demand by the customer, examining all the activities the customer performs in using and maintaining a product through its life cycle, from sale to disposal. In the car industry, the traditional manufacturer's view of the value chain is relatively compact: assembling the car,

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[2] The results were based on the response from 163 manufacturers. These are preliminary results only.

selling and delivering it and supplying spare parts and upgrades. From the customer's perspective, however, the downstream chain is more complex. It includes financing and leasing, maintenance, servicing, refurbishment and resale.

Innovating value: A five-year study of more than 30 companies around the world in about 30 industries that was conducted by the Harvard Business School (Harvard Business Review, 1998) highlighted a distinct difference in the approach adopted by high growth companies and their less successful competitors in achieving sustained high growth in both revenues and profits. Whilst the approach of less successful companies was dominated by strategies to stay ahead of the competition, the high-growth companies paid little attention to matching or beating their rivals. Instead, high-growth companies sought to make their competitors irrelevant through the strategic approach of value innovation by offering fundamentally new and superior buyer value in existing markets and by enabling a leap in buyer value to create new markets. Essentially, the value innovator does not follow its rivals in offering similar product features, but rather distinguishes factors that engender superior value from all the factors that the industry normally competes on.

The increased brand recognition that comes with value innovation makes imitation costly as the value innovator lowers cost to take advantage of economies of scale. Hence, with value innovation, the focus shifts from restricting output at a high price to a leap in consumer surplus as well as profit and growth for the value innovator. In contrast, in the P-economy, firms with dominant market positions have been associated with two social welfare loss activities. First, to maximise their profits, companies set high prices, which prohibit the mass of customers who, though desiring the product, could not afford it. Second, lacking viable competition, firms with monopolistic positions do not focus on efficiency and hence consume more of society's resources.

Building customer allegiance: In the K-economy, the goal of a manufacturer should not necessarily be to gain the largest share of customers but to gain the strongest relationships with certain target customers. With this, a manufacturer can become the preferred supplier of services throughout the product life span.

Building a customer-based marketing network: As value shifts towards the customer in the K-economy, distribution would become a mainstream activity in the value chain, forcing manufacturers to change from product-based marketing to customer-based marketing. In response to growing competition, businesses are increasingly looking overseas for new opportunities, a trend made easier by the Internet. This in turn brings them into contact with new suppliers, or can bring them new customers. Besides concentrating on the traditional markets, the challenge to Malaysian manufacturers would be to explore the potential of new export markets. In addition, manufacturers should continuously assess the shifts in customers' preferences, as well as new demands. Successful manufacturers will increasingly be characterised by a hands-on involvement with marketing and a focus on identifying and exploiting new products and new channels. According to the BNM's SMC, expenditure on marketing/ advertising by Malaysian manufacturers accounted for only 6.1% of their total expenditure in 1999.

- ***Stronger focus on high technology levels***

Further industrial expansion of Malaysia requires expansion in the scientific and technological infrastructure in the manufacturing industries. The transfer of technology from the multinational corporations has been limited and is confined mainly to assembly-line processes. In fostering K-based transformation, focus needs to be placed on absorbing higher levels of technologies.

The impact of these technologies is on long-term cost reductions with simultaneous efficiency and productivity enhancements, and the consequent upgrading of the quality of the industry itself having the trickle-down and spin-off effects on consumers and related industries.

The BNM's SMC showed that only 7.4% of our manufacturers were involved in experimental research. Meanwhile, although 30.7% of respondents were affirmative about undertaking research and development, such expenditure accounted for only about 1.4% of their total expenditure in 1999. A majority of industries were found to be at the low/medium levels of technology, with 62.6% involved in technological support and engineering services, 54.6% in the implementation or installation of new equipment and 45.4% in product innovation or process and prototype development.

Bold steps are being taken to encourage modernisation of the production process of existing industrial units, and the establishment of new industrial units based on the latest technologies. The Government has established a number of funds to provide financing for the acquisition of technology (e.g., Technology Acquisition Fund and Industrial Technical Assistance Fund). In the Budget 2000, the Government also allocated a sum of RM25.2 million for programmes promoting science and technology to encourage the use of new technology and upgrade of innovative capabilities, inventions and commercialisation home grown technology. Furthermore, special allocations were provided to several resource-based agencies to undertake specific research and a RM500 million special fund was announced to support the development of new high technology-based industries. In encouraging companies to undertake high-tech projects that entail high risk, the Budget 2000 announced a full tax exemption incentive for venture capital companies that invest at least 70% of their funds in venture companies in the form of seed capital, start-up or early stage financing (see Table II.1 for the size of selected venture capital funds).

Table II.1: Size of Selected Venture Capital Funds (as at end-1999)

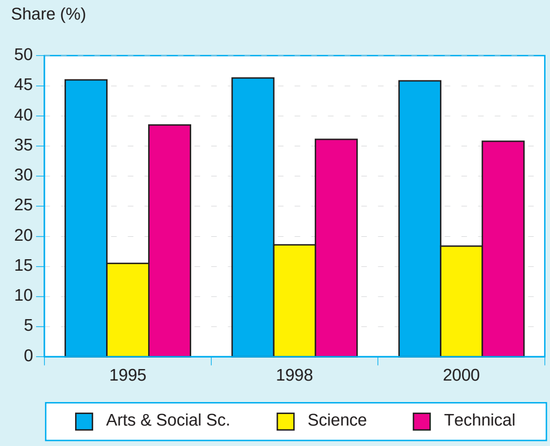
Venture Capital Company / Venture Capital Fund	Amount (RM million)
BNM and two banking institutions (announced in Budget 2000)	300
Government through Bank Industri & Teknologi Malaysia Bhd. (announced in Budget 2000)	200
MSC Venture One Sdn. Bhd.	120

- ***Stronger focus on human resource development***

In the long run, the single greatest K-economy enabler is human capital. Essentially, the K-economy will require a trained labour force that has the capacity and capabilities to optimise the use of new technologies and materials, and to combine them effectively with creativity and innovation. There is, therefore, a need for greater emphasis on creativity and higher order cognitive skills in addition to basic skills, and training in science and technology. In addition, it would be important to meet the training needs of designers and craftsmen who can, in the long-term, create a strong culture of innovation and quality manufacturing. For example, given that the furniture industry is only a step away from producing originally designed pieces, the development of a skilled pool of designers would certainly enable the industry to make greater strides in the export market.

An area of focus is the skilled manpower required to move up the value chain. In 1999, a total of 708 manufacturing projects with total investments of RM16.9 billion were approved by the Government. Of the 65,261 persons that these projects will require, the majority (42%) will comprise skilled workers. While local and tertiary education institutions in Malaysia have expanded to meet the increase in

Graph II.2
Total Intake at Local Institutions of Higher Learning*



* Includes degrees, diplomas, certificates and skills training

Source: Mid-Term Review of the Seventh Malaysia Plan

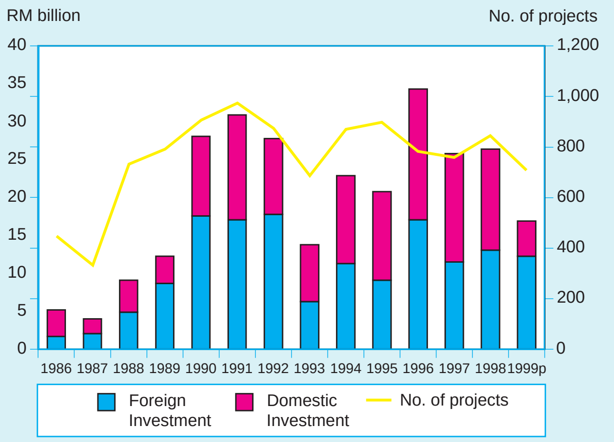
domestic demand and to promote education as an export industry, the general trend continues to favour training in Arts and Social Sciences (see Graph II.2). A World Bank study (1997) highlighted that 80% of firms in Malaysia either did not train or relied exclusively on informal training from co-workers and supervisors, and only 20% provided formal training. Results also showed that formal training improved firm-level productivity. On average, the firms that provided training were 32% more productive than those that did not do so. These firms were also able to pay higher wages out of increased productivity from training. More importantly, the study highlighted that SMEs, which is the group that would most likely benefit from training were under-investing in training.

In order to meet the challenge of producing a skilled labour force, a review of the education policy needs to be undertaken on an ongoing basis. Education needs to continuously raise the general technical competency and increase the ‘trainability’ of workers for lifelong learning, whilst developing creativity and strategic thinking. Also, core training institutions need to be enhanced to cope with demand for more engineers, technical personnel and technological processes. Training sessions for SMEs, in particular, need to be adapted according to their special needs. SMEs must be required to continuously train and retrain their manpower resources for a wide spectrum of administrative and managerial positions, acquire the entrepreneurial know-how, and also acquire the relevant knowledge and capacity to operate information technology as well as the specialised equipment for their respective industries.

Conclusion

In the K-economy, the manufacturing sector will continue to assume an important role. Nonetheless, in order to operate successfully, manufacturers must be able to adjust to the rapid pace of change. Towards this end, it is important that knowledge is diffused throughout all levels of the firm’s value chain. In this era of change, a strong commitment towards the enhancement of knowledge in all aspects of economic activity is needed to achieve a fourth phase of industrial development, namely ‘knowledge-based export-led industrialisation’ to enable the realisation of industrialised nation status by 2020.

Graph 1.19
Malaysia: Investment Approvals



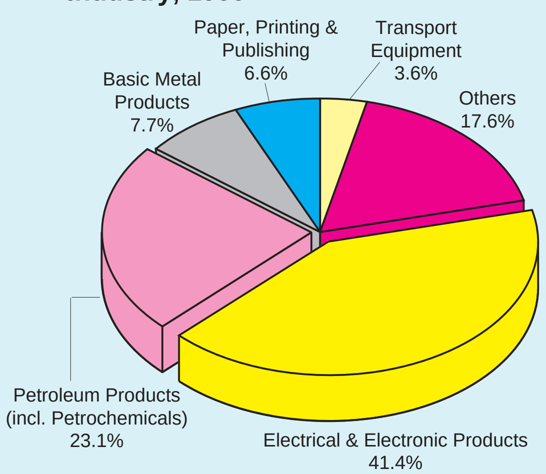
investment approved, followed by petroleum products (including petrochemicals) industry (23.1%), basic metal products (7.7%), paper, printing and publishing (6.6%) and transport equipment (3.6%) industries.

In terms of ownership, approved domestic investment declined to RM4.6 billion (1998: RM13.3 billion) reflecting the ongoing consolidation in domestic investment activities. Meanwhile, foreign investment amounted to RM12.3 billion (1998: RM13.1 billion), reflecting sustained foreign interest in investing in Malaysia. The bulk of the approved investment were for projects in three industries, namely the electrical and electronic products (48.4%), petroleum and petrochemical products (25.7%), and paper, printing and publishing (8.7%) industries. The top five foreign investors in 1999 were the United States (42% of total foreign investment approved in 1999), Japan (8.2%), Pakistan (8%), Singapore (7.4%) and the Netherlands (6.3%). These countries together accounted for 72% of total foreign investment approved by MITI.

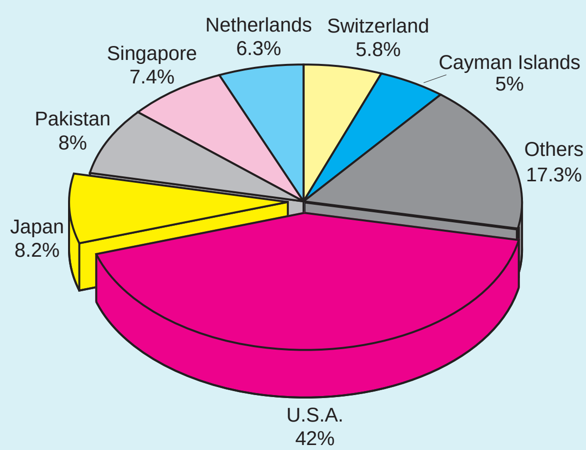
While the major sectors of the economy were still undergoing further consolidation, capital investment in the agriculture and mining sectors increased in 1999. Investment in the mining sector, which accounted for 11.2% of total private investment, increased by 44.2% due mainly to strong expansion in production facilities in the oil and gas sub-sector. The increase in replanted area, especially for oil palm plantations, had contributed to a marginal increase in investment in the agriculture sector in 1999 (10.2% of total investment).

In 1999, the savings-investment gap remained in surplus for the second consecutive year, recording a surplus of RM47.4 billion or 16.9% of GNP in 1999 (1998: RM36.8 billion or 13.7% of GNP). Private savings registered a marginal decline of 0.1% to RM68.6 billion as private consumption recovered in 1999. Nevertheless, the private sector continued to record a bigger resource surplus of RM34.8 billion, as private gross capital formation declined by 23.4% due to the ongoing consolidation of corporate sector activities. Despite higher operating expenditure, public savings increased by 3.8% to RM45.7 billion in 1999 (1998: –22%; RM44 billion), reflecting significantly improved revenue performance of the public sector. The public sector recorded a slightly higher surplus of RM12.6 billion. Overall, **gross national savings (GNS)** increased at a slower rate of 1.4% in 1999 (1998: 7.2% and

Graph 1.20
Approved Manufacturing Investment by Industry, 1999



Graph 1.21
Foreign Participation in Approved Manufacturing Projects by Country, 1999



1997: 11.8%). Consequently, the share of GNS to GNP declined to 40.8% in 1999, from 41.9% recorded in 1998. This rate of savings still remained high by historical standards and in comparison with other countries.

Recognising the need to balance between consumption and savings, the effort of the savings programme in 1999 continued to emphasise on the efficiency of managing household income and expenditure. To achieve this objective, the second edition of the Household Accounts Book for adults and a Pocket Money Book for students were produced in 1999. The main objective of the household accounts book is to encourage households to plan and efficiently manage their income and expenditure and at the same time practise prudent spending habits and avoid wastage. The objective of the students pocket money book is to introduce financial management of personal accounts at a young age and, therefore, introduce a greater awareness in society on financial matters at an early stage.

To strengthen the effort in achieving this objective, the School Finance Club Project was launched in November 1999 by the Minister of Education to establish finance clubs in schools nationwide with participation of the banking industry. To standardise, monitor, guide and streamline the activities of the school finance clubs, Guidebook was produced as part of this exercise. The objective is essentially to outline the relationship between the financial institutions and the schools and the mechanism for the financial institutions to educate the students on banking and financial matters as well as inculcating good expenditure and savings habits and sound management of their personal accounts at a young age. With these mechanisms in place, it is hoped that there will be greater awareness on financial discipline, efficiency and integrity as part of the process of securing a generation that is well informed on these issues in the future.

Table 1.13
Malaysia: Savings-Investment Gap, 1998-99

	1998	1999*p*
	RM million	
Public gross domestic capital formation	31,801	33,126
Public savings	44,027	45,714
Deficit/surplus	12,226	12,588
Private gross domestic capital formation	44,112	33,811
Private savings	68,683	68,604
Deficit/surplus	24,571	34,793
Gross domestic capital formation	75,913	66,937
(as % of GNP)	28.2	23.9
Gross national savings	112,710	114,318
(as % of GNP)	41.9	40.8
Balance on current account	36,797	47,381
(as % of GNP)	13.7	16.9

p Preliminary

Source: Department of Statistics and Bank Negara Malaysia

External Sector

Balance of Payments

The balance of payments position strengthened in 1999 with strong contribution of net exports to GDP and sustained private long-term net capital inflows. Despite the strong recovery in economic growth there was no significant leakage abroad as GDP growth in 1999 was supported by higher productivity and more efficient use of capital invested in previous years. In addition, the surplus in the overall balance of payments was large at RM17.8 billion despite larger outflows of short-term capital. This led to higher BNM external reserves of RM117.2 billion or US$30.9 billion. This level of reserves was sufficient to finance 5.9 months of retained imports and was more than five times larger than the short-term external debt. Malaysia has always ensured that its usable and unencumbered external reserves are adequate to finance the short-term external debt, including the scheduled amortisation of medium- and long-term debts falling due during the following year.

The current account emerged fundamentally stronger in 1999, reflecting an increase in the trade balance that emanated from a stronger export performance, given that imports had begun to increase to service higher export demand. This is in contrast to 1998, when the trade surplus reflected mainly a sharper contraction in imports. The import growth, however, was limited to some extent as the emphasis of the fiscal expansion programme was on projects with low import content. The strength of the external balance was also reflected in a current account surplus that

Table 1.14
Balance of Payments

Item	1999e +	1999e –	1999e Net
	RM million		
Merchandise balance (f.o.b.)	**315,719**	**232,184**	**83,534**
Trade account	*321,181*	*248,870*	*72,311*
Balance on services	**56,057**	**85,000**	**–28,943**
Freight & insurance	4,685	14,416	–9,731
Other transportation	7,258	4,778	2,479
Travel & education	13,326	7,758	5,568
Investment income	7,283	26,073	–18,790
Government transactions n.i.e.	338	385	–46
Other services	23,168	31,590	–8,422
Balance on goods and services	**371,776**	**317,185**	**54,591**
Unrequited transfers	2,732	9,943	–7,210
Balance on current account	**374,508**	**327,127**	**47,381**
% of GNP			**16.9**
Official long-term capital			6,692
Federal Government	4,763	1,840	2,923
Market loans	4,164	1,107	3,057
Project loans	599	733	–134
Non-financial public enterprises	6,080	2,230	3,850
Other assets and liabilities			–81
Private long-term capital			5,025
Balance on long-term capital			11,717
Basic balance			**59,098**
Private short-term capital (net)			–35,958
Errors and omissions			–5,321
Overall balance (surplus +/ deficit –)			**17,819**
Allocation of Special Drawing Rights			–
IMF resources			–
Net change in international reserves of Bank Negara Malaysia (increase – / decrease +)			–17,819
Special Drawing Rights			464
IMF reserve position			–789
Gold and foreign exchange			–17,494
Bank Negara Malaysia international reserves, net [1]			**117,244**

[1] The US dollar equivalent of international reserves as at 31 December 1999 was US$30.9 billion
e Estimate

Source : Bank Negara Malaysia and Department of Statistics

was more than adequate to finance the short-term capital outflows.

The slightly larger balance in the long-term capital account was due to higher inflows of official long-term capital including disbursements under the Miyazawa Initiative. Contrary to market expectations, net inflows of foreign direct investment was higher in 1999, but was partially offset by a significantly larger net outflow of Malaysian investments abroad. Therefore, the surplus balance on long-term capital increased only marginally although net foreign direct investment had increased by 26.8%. Outflows of Malaysian investments abroad doubled to RM6.2 billion from RM3.1 billion in 1998.

The larger outflows of short-term capital in 1999 was due mainly to the improved net external liabilities position of the commercial banks and trade credits to foreign suppliers. Portfolio outflows following the expiration of the 12-month holding period imposed on foreign funds on 1 September 1998 was less than expected. Overall, the large outflows of short-term capital were fully offset by other inflows.

In 1999, the **trade** surplus expanded further, totalling RM72.3 billion, exceeding the previous record of RM58.4 billion set in 1998. In US dollar terms, the surplus amounted to US$19 billion. Overall, the value of Malaysia's total trade increased by 10.8% to RM570 billion and accounted for 203% of GNP compared with 191% in 1998, in tandem with an improved global economic environment and the recovery in the global electronics industry as well as the rebound in domestic demand.

Gross exports (value of exports recorded by the Customs Department) in 1999 increased further by 12.1% to RM321.2 billion (US$84.5 billion). In US

Table 1.15
External Trade

	1998	1999	1998	1999
	RM billion		US$ billion	
Gross exports (f.o.b)	286.6	321.2	73.3	84.5
Annual change (%)	29.7	12.1	–6.9	15.3
Gross imports (c.i.f)	228.1	248.9	58.3	65.5
Annual change (%)	3.3	9.1	–26.2	12.3
Trade balance	**58.4**	**72.3**	**15.0**	**19.0**

Source: Department of Statistics.

Table 1.16
External Trade: Change in Volume and Prices

	Gross exports	Gross imports	Gross exports	Gross imports
	1998		1999	
	Annual change (%)			
Volume[1]	1.1	–19.9	19.3	12.0
Prices (RM)[1]	30.7	28.9	–4.4	–2.6
Prices (US$)[1]	–6.2	–7.9	–2.7	0.3
Total (RM)	**29.7**	**3.3**	**12.1**	**9.1**

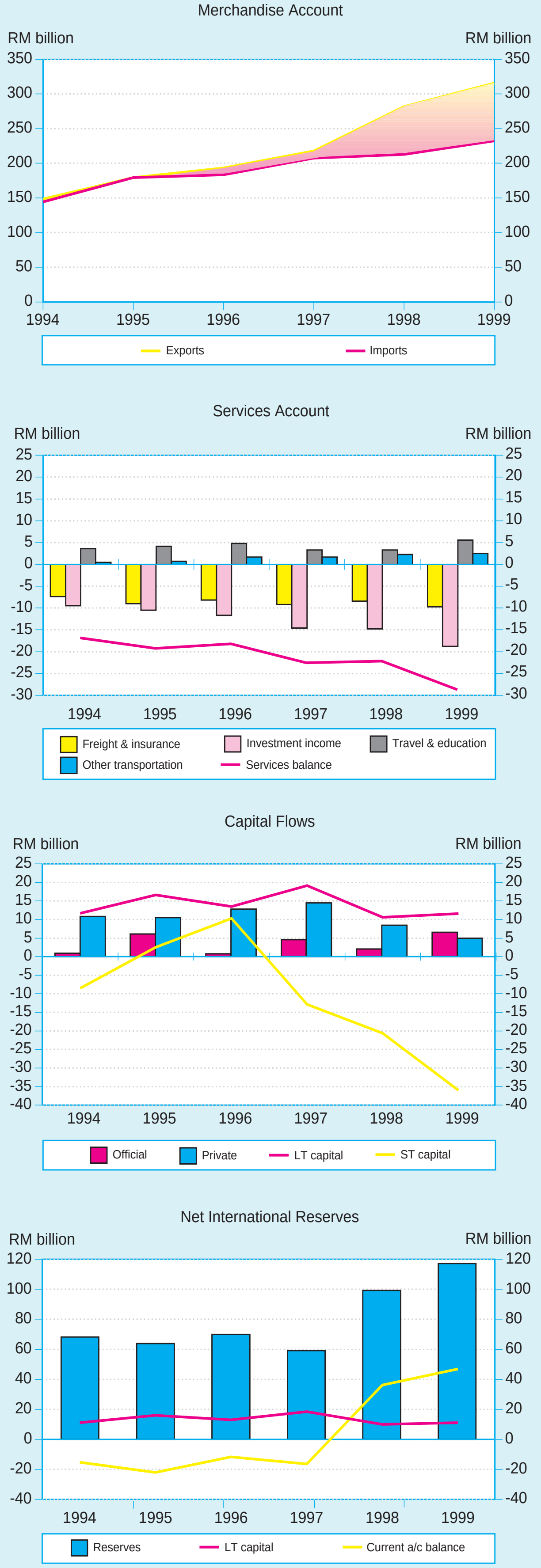
[1] The volume and price estimates for 1999 are preliminary estimates.
Source: Department of Statistics and Bank Negara Malaysia.

dollar terms, export growth recovered to 15.3% following a moderate decline in 1998. The increase in exports was on account of higher volume. Growth emanated mainly from the strong expansion in manufacturing and mineral exports, while agriculture exports declined. Import growth accelerated to 9.1% to reach RM248.9 billion (US$65.5 billion) in 1999. In US dollar terms, the turnaround in imports was stronger, an increase of 12.3% following a large decline in 1998. This was mostly due to an increase in volume as ringgit prices declined slightly. The decline in prices was marginal as ringgit stabilised. In 1998, the sharp increase in prices was mainly due to the depreciation of the ringgit. The increase in volume in 1999 was due mainly to an increase in demand from the manufacturing sector as a result of the strong export performance. However, the recovery in domestic demand, especially private consumption, and a modest pick-up in investment activities, following improved business and consumer confidence especially in the second half of the year also contributed to the higher import growth.

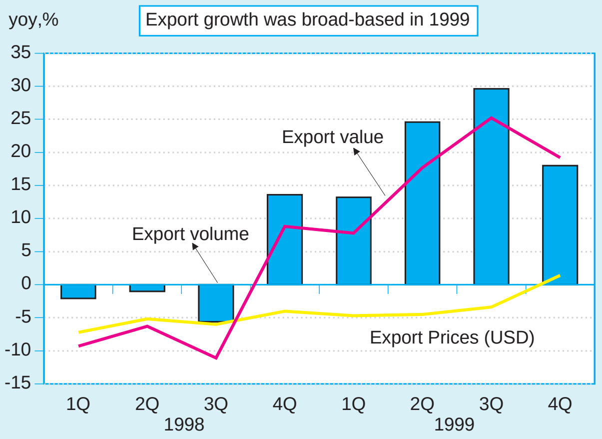
Reflecting the developments in the trade account, the **merchandise account** posted a record surplus of RM83.5 billion (US$22 billion) in 1999.

Increased demand from the industrial countries and the economic recovery in the region led to a strong rebound in exports of **manufactured goods** in 1999. Total exports of manufactured goods in US dollar terms turned around to register an annual growth of 17.6% to US$71.5 billion in 1999 (1998: –4.6%). In US dollar terms, exports of manufactured goods have exceeded export earnings recorded in the years before the regional crisis (1995-1996: average of US$60.9 billion per year). The higher export receipts were mainly on account of a strong pick-up in volume, while export prices measured in US dollar terms continued

Graph 1.22
Malaysia: Balance of Payments



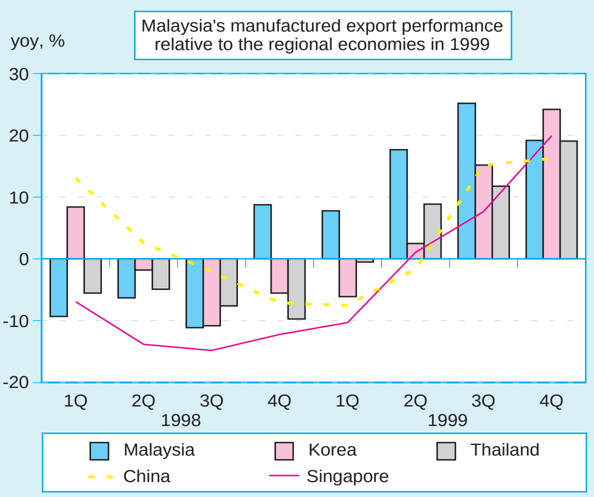
Graph 1.23
Export Performance of Manufactured Goods in 1999



to decline, albeit more moderately. As a result of the improvement in overseas sales, exports of manufactured goods accounted for a higher share of 84.6% of total gross exports in 1999 (1998: 82.9%). In ringgit terms, manufactured exports expanded at a slower rate of 14.3% to RM271.7 million compared with 32.8% in 1998, due to the valuation impact of the exchange rate (1998: US$1=RM3.92; 1999: US$1=RM3.80).

The stability and certainty accorded by the selective exchange controls and fixed exchange rate introduced in September 1998 had facilitated exporters in their costing plans and business operations, thus enabling the Malaysian exporters to retain their export markets. While the Government had implemented policies to provide a more conducive environment for doing business, the track record established by Malaysian exporters in the international markets in terms of product quality, design and range as well as reliable delivery had further strengthened the export recovery. Following a modest recovery in the fourth quarter of 1998, Malaysia's manufactured exports continued on an upward trend, similar to developments in Thailand and Korea, with growth accelerating from 12.8% in the first half of 1999 to 22% in the second half (1998: –7.8% and –1.5% respectively).

Graph 1.24
Export Performance of Selected Countries in the Region



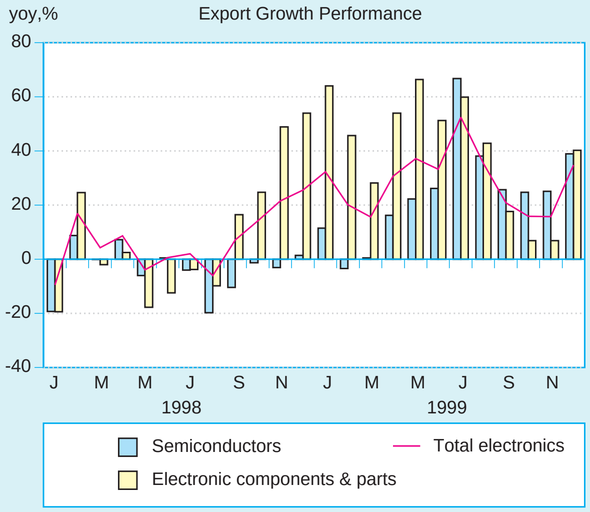
The recovery in export growth was broad-based. Although the electronics industry was a major contributing factor accounting for the growth, exports of the other industries in both the resource- and non-resource based sectors, particularly the electrical products, wood products, furniture and parts as well as chemical products industries also improved, thereby contributing favourably to the growth in manufactured exports.

- Exports of **electronic goods** expanded strongly by 30.4% in 1999 (1998: 1.9%), reflecting the upturn in the global electronics cycle. During the year, exports of both the **semiconductors and electronic equipment sub-sectors** recorded a strong expansion of 23.7% and 36.5% respectively (1998: –4.2% and 8.2% respectively), attributable largely to the more widespread usage of Internet, e-commerce and cellular phones. In addition, intensified efforts to deal with the Y2K problem also boosted demand for computers worldwide. During the year, the United States maintained its position as the largest market for Malaysia's electronic goods, followed by Singapore, Europe, the Asia-Pacific region and Japan.

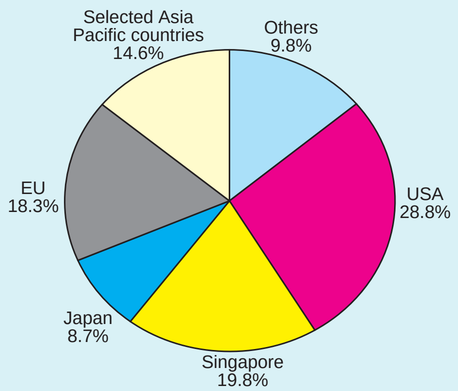
- Exports of the **electrical products industry** rebounded to increase by 8.8% in 1999 (1998: –11.4%), after declining since 1996. The reversal in trend was supported by higher exports to the United States and strengthened demand for consumer durables, air-conditioners and telecommunication products following the economic recovery of major markets in Asia, in particular Japan, Singapore and Hong Kong SAR. As a group, exports of the **electronics and electrical products industries** increased significantly by 24.1% in 1999 (1998: –2.4%), accounting for a higher share of 71.8% of total manufactured exports (1998: 68.1%).

- Following two consecutive years of decline, exports of the **wood products industry** recorded

Graph 1.25
Exports of the Electronics Industry

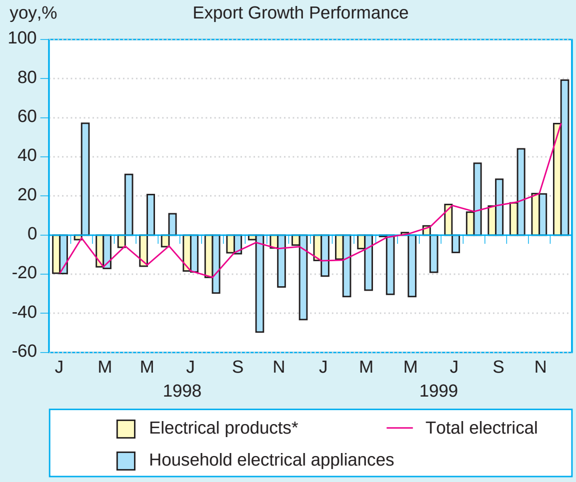


Market Destinations



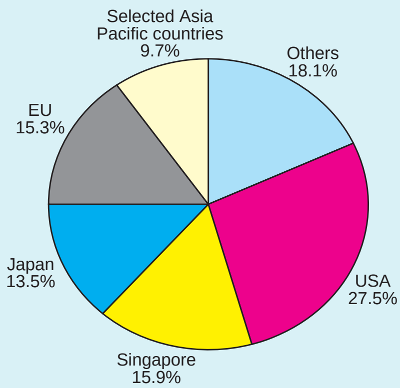
Note: Selected Asia Pacific countries refer to Hong Kong SAR, Taiwan, Korea and Australia

Graph 1.26
Exports of the Electrical Products Industry



* Electrical products refer to consumer electrical products, industrial and commercial electrical products and electrical industrial machinery and equipment

Market Destinations



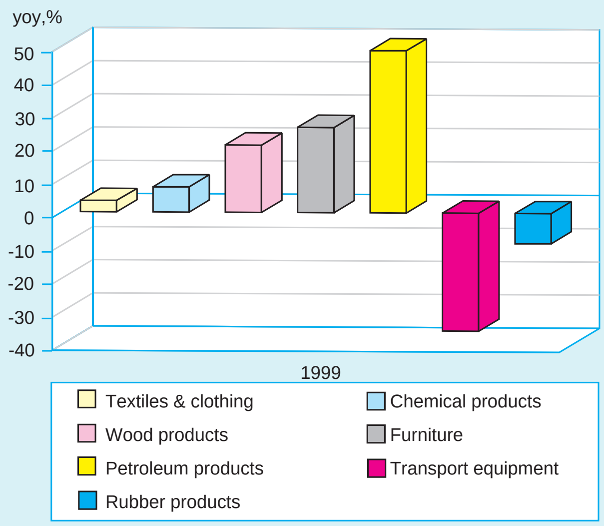
Note: Selected Asia Pacific countries refer to Hong Kong SAR, Taiwan, Korea and Australia.

a strong expansion of 20.3% in 1999 (1998: –34.3%). The recovery in exports was due mainly to the replenishment of plywood stocks in Japan (accounting for almost one-third of total exports of wood products) following the revival of housing starts and sustained demand from the United States and the Asia-Pacific region. In addition, improved export prices of plywood from US$259 per cubic metre in 1998 to US$311 per cubic metre in 1999 also contributed to higher export earnings. Similarly, the turnaround in exports of **furniture and parts** (25.7%; 1998: –7.2%) reflected increased orders from the United States and European Union, as well as the ability of manufacturers to export customized products to meet demand from niche markets in the Middle-Eastern countries.

- Exports of the **chemicals and chemical products** industry recovered to increase by 7.6% in 1999 (1998: –6.6%). The improvement in exports was most evident in the second half of the year due mainly to improved sales of resins and plastic products when the global oversupply situation eased. At the same time, higher exports of organic chemicals, fertilisers as well as perfume materials, essential oils and toiletries to the Asia-Pacific markets and the United States also boosted growth. During the year, the industry maintained its position as the second largest foreign exchange earner, accounting for 4.1% of total manufactured exports. Meanwhile, exports of **petroleum products** increased markedly by 48.9% (1998: –33.4%), reflecting higher crude oil prices and improved industrial demand for both refined and unrefined petroleum products mainly from the Asian countries, in particular, Singapore, Japan, The People's Republic of China and Korea.

- After two consecutive years of decline, exports of the **textiles, clothing and footwear industry**

Graph 1.27
Exports of Other Major Industries



turned around to grow by 3.4% in 1999 (1998: –11%), following increased orders for wearing apparel (accounted for more than half of the total exports of the industry) from the major traditional buyers in the United States and European Union. Since the second quarter of 1999, exports of textiles also picked up in response to higher demand from Taiwan, Hong Kong SAR, Singapore and The People's Republic of China. As export growth was constrained by increased competition from low-cost producers in the region, the industry remained the third largest export earner within the manufacturing sector, having lost its position as the second largest foreign exchange earner to the chemical products industry in 1997.

- On the other hand, exports of the **rubber products industry** declined by 9.1% in 1999 (1998: +3.9%), reflecting lower export earnings from the latex-based products and tyres sub-sectors. During the year, despite increased volume of gloves being exported to the United States and Europe, export earnings continued to decline as a result of persistent weak export prices amidst intense international competition. Meanwhile, the lower exports of tyres were due mainly to reduced overseas sales to cater for increased demand from the domestic automotive industry. Similarly, the **transport equipment industry** registered a contraction in exports (–35.5%; 1998: +17.1%), attributed mainly to lower re-exports of leased aircraft, ships and boats as well as railway vehicles.

- Exports of **iron and steel products** declined by 2.2% in 1999 (1998: +5%), reflecting intense competition among manufacturers in the region who were affected by excess capacity and the imposition of import quotas by the United States. On the other hand, exports of **non-metallic mineral products** rebounded to expand by 10% in 1999 (1998: –13.2%), on account of increased exports of mineral manufactures including ceramic products and tiles, particularly to the European markets. The higher export growth was also attributable to improved external demand for glassware, clay and refractory construction materials during the year.

- Exports of **food products** and **beverages** turned around to grow by 1.4% and 17.4% respectively in 1999 (1998: –10.3% and –11.4% respectively), as demand from the region, especially the ASEAN countries, Korea and Taiwan improved, in tandem with the recovery of these economies.

In terms of market destination, the United States, Singapore, Japan and Europe remained the major trading partners for Malaysia's manufactured goods, accounting for more than two-thirds of the total exports of manufactures. Nevertheless, Malaysian exporters have made considerable progress in penetrating the non-traditional markets in the Asia-Pacific region. The share of manufactured exports to Taiwan, Australia and The People's Republic of China increased from 2.2%, 1.3% and 0.7% respectively in 1991 to 4.7%, 2.2% and 2.1% respectively in 1999.

Besides market diversification, manufacturers have also expanded the range of products exported. The major export items comprised mainly electronics, electrical products, textiles and clothing, chemical products, rubber products, wood products, furniture and parts as well as metal products. However, in line with the momentum gained in globalisation and liberalisation, several industries, especially those which are labour-intensive and highly involved in the production of low- to medium-end products such as the electrical products, textiles and rubber products industries, have faced increased competition from low-cost producing and labour-abundant countries. As a result, the contribution of these industries as a group to the overall export earnings has been declining, from 36.8% of total manufactured exports in 1991 to 31.7% in 1996, before declining further to 23.9% in 1999.

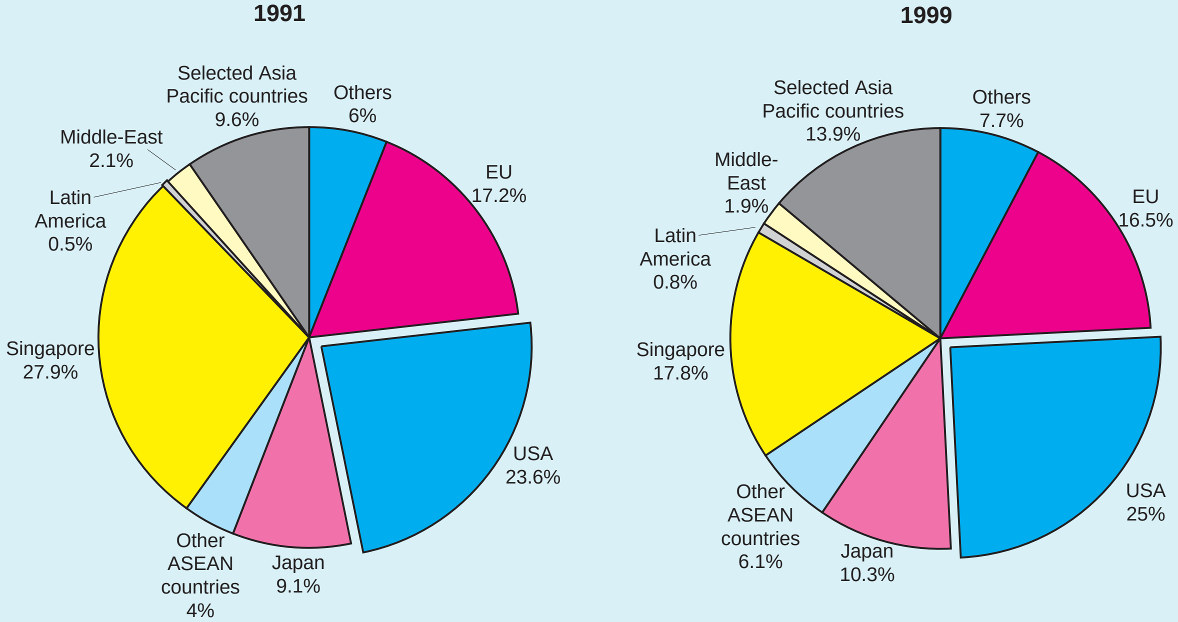
In line with the strategies for industrialisation, Malaysian manufacturers have continuously taken steps to move up the value chain. Several encouraging developments have already taken place in terms of increased exports of higher value-added goods and downstream products. Meanwhile, increased downstream activities in the resource-based sector saw the rapid increase in exports of furniture and parts. During the period 1991-99, exports of these products expanded by an average of 21% per annum, from US$268.7 million in 1991 to US$1.4 billion in 1999. At the same time, manufacturers have also demonstrated their ability to produce customized products to meet demand from niche markets such as the Middle-Eastern countries. To maintain competitiveness in the global market, manufacturers have also moved to producing higher value-added products such as digital video discs and video compact discs in the electrical products industry.

After five consecutive years of growth, export receipts from **commodities** declined by 0.4% to RM44.9 billion in 1999 (1998: +16.8% to RM45.1 billion), due mainly to lower export prices. In United States dollar terms, export earnings from the commodity sector increased by 2.8% to US$11.8 billion. Overall, foreign prices of exports declined by 1.7% as higher prices of crude oil, saw logs and sawn timber were more than offset by the sharp decline in palm oil prices. Export volumes of all major commodities increased, except for rubber and crude oil. As a group, export volume increased by 9.6%.

The contraction in export earnings from the **agriculture** sector in 1999 was due largely to lower proceeds from palm oil, and to a lesser extent, the decline in rubber exports. Nevertheless, exports of saw logs, sawn timber and cocoa turned around to record strong positive growth.

- Exports of **palm oil**, which was the single largest contributor to commodity exports, declined sharply by 18.6% on account of lower export prices. Hence, its contribution to total commodity exports was lower at 32.2% in 1999 (1998: 39.4%). During the year, the export unit value of palm oil fell markedly by 31.8% to RM1,615 per tonne amidst ample global supplies of vegetable oils. Despite the downtrend in prices, crude palm oil production rose substantially during the year, resulting in a corresponding increase in the export volume of palm oil by 19.3% to 9 million tonnes. The increase in exports was in response to higher demand particularly from India (+80.5%) and the European Union (+2%). Demand from India was particularly responsive to prices. Following lower prices, exports to India accounted for 27% of Malaysia's palm oil exports

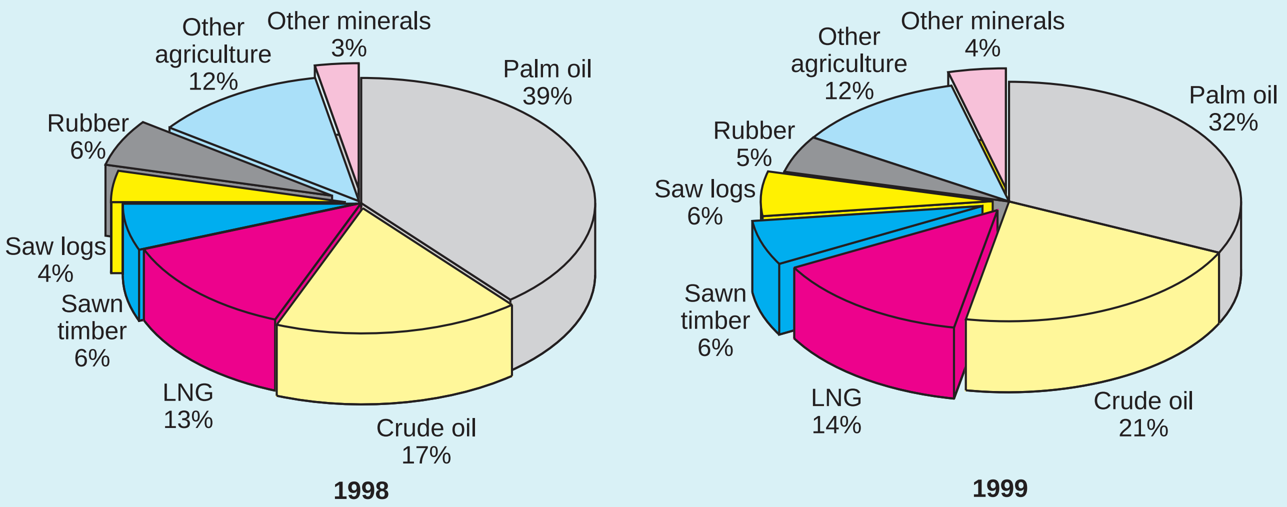
Graph 1.28
Manufactured Exports by Destination



Note: Selected Asia Pacific countries refer to Hong Kong SAR, Taiwan, Korea and Australia.

Graph 1.29
Commodity Exports in 1998-1999

(% share by commodity)



(1998: 18%). On the other hand, demand by Pakistan was slightly lower (–2.5%) while imports by The People's Republic of China fell sharply by 15%, reflecting the reduction in the Republic's import quota for palm oil during the year.

- Export earnings from **rubber** declined further by 17.2% to RM2.3 billion in 1999, the fourth consecutive year of decline, as both prices and external demand remained weak amidst excess global supplies of rubber. In terms of export destination, offtake from the European Union (36% of total rubber exports) in particular, fell by 6% during the year while imports by other buyers remained almost unchanged at the 1998 level.

- Export proceeds from **saw logs** and **sawn timber** turned around to register a sharp increase of 42.7% and 11.1% respectively in response to an improvement in external demand, particularly from the Asia-Pacific markets. The People's Republic of China, which accounted for 25% of Malaysia's total log exports, more than doubled its offtake during the year following increased construction activity in the Republic. Domestic supply constraints due to adverse weather and the Republic's adherence to its forest conservation policy as well as the abolishment of import tariffs on the commodity, encouraged higher exports to China. Meanwhile, Korea, Thailand, The People's Republic of China and Japan accounted for the bulk of the increase in sawn timber exports in 1999.

- Export proceeds from **cocoa**, which mainly consisted of cocoa butter, cocoa beans and cocoa powder, turned positive during the year, growing sharply by 18.6% to RM111.9 million. A higher export volume (+58%) was recorded as external demand improved markedly particularly from the United States, the Netherlands, Singapore, Australia and The People's Republic of China.

Proceeds from **mineral** exports increased in 1999, driven primarily by higher export prices for crude oil and LNG. Export volume increased only marginally.

- Earnings from **crude oil** exports rose sharply by 23.9% to RM9.3 billion in 1999, due entirely to higher export prices as export volume declined during the year. The sharp increase in Malaysia's crude oil prices to an average of US$18.18 per barrel from US$14 per barrel in 1998, was in line with higher international crude oil prices, which had increased substantially on account of tight global supplies following reduced production by OPEC members. On the other hand, the volume of crude oil exports was lower in 1999 due to higher domestic consumption and lower supply as crude oil production was reduced in line with the National Depletion Policy.

- Export receipts from **LNG** were also higher in 1999, increasing by 6.1% on account of increased export volume and higher export prices. The volume of LNG exports expanded

Table 1.17
Gross Exports

	1999				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Manufacturing sector	**271,730**	**14.3**	**84.6**	**71,508**	**17.6**
Of which:					
Electronics, electrical machinery and appliances	195,047	20.6	60.7	51,328	24.1
Electronics	144,885	26.9	45.1	38,128	30.4
• Semiconductor	*65,485*	*20.2*	*20.4*	*17,233*	*23.7*
• Electronic equipment & parts	*79,400*	*33.0*	*24.7*	*20,895*	*36.5*
Electrical machinery & appliances	50,162	5.5	15.7	13,201	8.8
• Consumer electrical products	*21,728*	*5.2*	*6.8*	*5,718*	*8.6*
• Industrial & commercial electrical products	*16,498*	*9.5*	*5.2*	*4,342*	*13.0*
• Electrical industrial machinery and equipment	*11,107*	*1.2*	*3.5*	*2,923*	*4.1*
• Household electrical appliances	*829*	*–4.8*	*0.3*	*218*	*–1.9*
Textiles, clothing and footwear	9,467	0.3	3.0	2,491	3.4
Chemicals & chemical products	11,105	4.5	3.5	2,922	7.6
Wood products	6,984	16.8	2.2	1,838	20.3
Manufactures of metal	7,862	–4.8	2.5	2,069	–2.2
Transport equipment	5,114	–36.6	1.6	1,346	–35.5
Rubber products	5,061	–11.8	1.6	1,332	–9.1
Optical and scientific equipment	4,834	1.5	1.5	1,272	4.5
Agricultural sector	**27,673**	**–8.4**	**8.6**	**7,282**	**–5.5**
Of which:					
Palm oil	14,475	–18.6	4.5	3,809	–16.0
Sawn timber	2,807	11.1	0.9	739	14.6
Saw logs	2,663	42.7	0.8	701	47.4
Rubber	2,344	–17.2	0.7	617	–14.7
Minerals	**17,240**	**15.9**	**5.4**	**4,537**	**19.6**
Of which:					
Crude oil	9,306	23.9	2.9	2,449	27.7
LNG	6,349	6.1	2.0	1,671	9.6
Tin	491	1.3	0.2	129	4.7
Other	**4,538**	**18.2**	**1.4**	**1,194**	**21.6**
Total	**321,181**	**12.1**	**100.0**	**84,521**	**15.3**

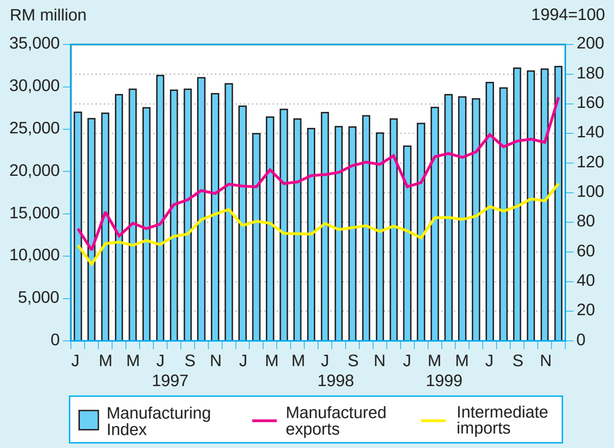
Source: Bank Negara Malaysia and Department of Statistics

by 2.8% (1998: –3.7%), reflecting increased offtake from Malaysia's major buyers, namely Japan and Korea, as economic activity in these economies improved. Meanwhile, the export unit value of LNG recorded an increase of 6.5% in United States dollar terms, in tandem with the increase in crude oil prices.

Gross imports (that is, import payments including cargo, insurance and freight payments or c.i.f.) increased by 9.1% in 1999 in line with output expansion to cater to the recovery in exports and domestic demand. The primary source of the import growth was higher imports of intermediate goods and, to a lesser extent, imports of consumption and dual-use goods. Reflecting the more gradual recovery of private investment and the low import content of public investment, imports of capital goods continued to decline by 6.7%. The significant decline in the first half year was reversed starting in June when a modest recovery in investment fuelled a recovery in imports of capital goods in the second half.

Imports of **intermediate goods** expanded by 13.2% as a result of strong growth in manufacturing production to meet both the higher export and domestic demand.

Graph 1.30
Manufacturing Production, Exports and Intermediate Imports



The main types of goods that contributed to this increase were parts and accessories of capital goods (11.1%) and processed industrial supplies (16.8%), both of which primarily enter into the production of manufactures for export. However, equally important was the strong growth in other types of intermediate imports that were related to the manufacture of goods for the domestic market. In particular, imports of primary fuels and lubricants and parts and accessories of transport equipment contributed significantly to the higher imports of intermediate goods, reflecting the recovery in the motor assembly industry.

The increased imports of parts and accessories of capital goods had a particularly significant impact on import growth, accounting for 4.9 percentage points of the total import growth of 9.1%. This was due mainly to higher imports of thermionic valves and tubes, photocells and parts, items which are crucial inputs for the electronics industry which experienced strong increases in overseas sales orders. These items accounted for about two-thirds of imports of parts and accessories of capital equipment, and 29.3% of total imports, underlining the strength of the industry as the main engine of the recovery.

The weak private investment climate prevailing during the first half of the year accounted for lower imports of **capital goods** by 6.7%. Beginning from the second quarter, the Government launched a concerted programme to speed up the implementation of public sector projects, which resulted in the shortfall in public expenditure narrowing significantly. While most public projects concentrated on infrastructure works that do not have a high import content, higher public investment contributed to the overall recovery in economic activity, especially in the second half of the year. As a result, imports of capital goods turned positive in June 1999 and have since continued to grow strongly.

The primary source of the decline in imports of capital goods continued to be the lower imports of industrial transport equipment. The main cause for this decline was the sharply lower imports of aircraft and ships (–52.4%) as the major transportation companies continued to reduce delivery of new vessels, due partly to the completion of expansion programmes in 1998. On the other hand, imports of commercial vehicles increased by 36.3% while those of trailers and containers increased by 18.8%, in line with the strong recovery in economic activity. In the case of other types of capital goods, higher imports of office equipment (10.3%), construction and mining equipment (39.3%) and agricultural machinery (19.3%) all contributed to the modest 2.5% growth in imports of other capital goods. However, imports of machinery for manufacturing (–7.3%), telecommunication equipment (–17.5%) and machinery for electricity generation and distribution (–10.1%) continued to decline due to the excess capacity in the manufacturing sector and the completion of major utilities expansion programmes.

Imports of **consumption goods** grew strongly by 21.9% as a result of the recovery in private consumption expenditure following improved economic conditions and employment prospects as well as the recovery in share prices. Nevertheless, despite ten consecutive months of positive growth, including nine months of double-digit growth, imports of consumption goods are still below the levels recorded before the onset of the East Asian crisis. Imports of consumption goods have now reached US$425 million in December 1999, lower than the pre-crisis peak of US$461 million in June 1997. Consumption goods accounted for about 6.2% of total imports in 1999, almost unchanged from the pre-crisis level.

The growth in consumption goods imports was due to higher imports of all types of consumer goods, particularly non-durable, durable and semi-durable consumer goods. Some non-durable items that recorded strong growth were medicines (24.6%) and soaps and cosmetics (16.2%). Durable imports which increased significantly included household electrical goods such as washing machines, refrigerators and cookers (151%) and audio and video equipment (46.5%). Semi-durable consumer imports that increased significantly included tapes and records (32%), clothing and footwear (35.8%) and household furnishings such as curtains, cutlery, bed linen, decorative items, mattresses and cushions (16.1%). Similarly, imports of **dual use goods** increased by 29% due to the high imports of passenger motor cars as the import of motor spirit declined due to high oil prices.

Malaysia's trade pattern remained relatively unchanged in 1999, with the major **trade partners** being the United States, Japan, Singapore and the European Union. These four partners alone accounted for 64.9% of Malaysia's total trade. The **United States** maintained a share of 19.9% of the total trade (20.8% in 1998), reflecting the continued strong demand for Malaysian goods. This resulted in a higher trade balance in favour of Malaysia with a bilateral surplus of RM27 billion (RM17.4 billion recorded in 1998). The bulk of the exports made up of manufactured articles, in particular machinery and transport equipment (79.6%). The main commodities imported from the US were also from this category (76.3%), reflecting mainly the importance of the electronics industry.

Japan overtook Singapore and regained its pre-crisis position as the second most important trade partner, accounting for 15.6% of total trade compared with 14.6% in 1998. This was largely due to increased imports (+15.6%) partly on account of valuation impact from a stronger yen. As a result, Japan not only maintained its position as Malaysia's most important source of imports but increased its market share from 19.6% of total imports in 1998 to 20.8% in 1999. However, despite the increase in imports, the trade deficit narrowed marginally to RM14.5

Table 1.18
Gross Imports by End Use

	1999				
	RM million	Annual change (%)	% share	US$ million	Annual change (%)
Capital goods	**33,027**	**-6.7**	**13.3**	**8,691**	**–5.9**
Capital goods (except transport equipment)	29,546	2.5	11.9	7,775	2.8
Industrial machinery	*10,170*	*–7.3*	*4.1*	*2,676*	*–4.0*
Transport equipment	3,482	–47.0	1.4	916	–45.3
Intermediate goods	**182,250**	**13.2**	**73.2**	**47,960**	**17.3**
Food and beverages, mainly for industry	3,998	–4.1	1.6	1,052	–1.2
Industrial supplies, n.e.s.	58,777	16.8	23.6	15,468	20.4
Metals	*14,282*	*20.5*	*5.7*	*3,758*	*24.2*
Fuels and lubricants	5,628	21.7	2.3	1,481	25.2
Parts and accessories of capital goods (except transport equipment)	110,970	11.1	44.6	29,203	15.5
Electronics	74,287	15.7	29.9	19,549	19.1
Parts and accessories of transport equipment	2,878	46.3	1.2	757	43.4
Consumption goods	**15,455**	**21.9**	**6.2**	**4,067**	**21.3**
Food and beverages, mainly for household consumption	6,059	6.6	2.4	1,594	9.7
Transport equipment, non-industrial	91	148.8	0.0	24	152.0
Consumer goods, n.e.s.	9,306	25.8	3.7	2,449	29.6
Consumer durables	*1,710*	*67.3*	*0.7*	*450*	*60.5*
Consumer semi-durables	*3,358*	*25.0*	*1.3*	*884*	*24.9*
Consumer non-durables	*4,238*	*29.9*	*1.7*	*1,115*	*23.7*
Dual use goods	**4,937**	**29.0**	**2.0**	**1,299**	**33.4**
Motor spirit	1,630	–28.8	0.7	429	–26.4
Passenger motor cars	3,307	114.7	1.3	870	122.6
Others	**4,418**	**49.9**	**1.8**	**1,163**	**7.8**
Re-exports	**8,784**	**–19.6**	**3.5**	**2,311**	**–15.9**
Gross Imports	**248,870**	**9.1**	**100.0**	**65,492**	**12.3**

n.e.s: Not elsewhere specified.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.19
Direction of External Trade

	1999				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	RM million
Selected South-East-Asian countries	75,467	23.5	58,072	23.3	17,395
Singapore	53,106	16.5	34,817	14.0	18,289
Thailand	10,481	3.3	9,377	3.8	1,104
Indonesia	4,679	1.5	6,677	2.7	–1,998
Philippines	4,929	1.5	6,213	2.5	–1,284
Brunei Darussalam	809	0.3	46	0.0	763
Vietnam	1,463	0.5	943	0.4	520
European Union	50,522	15.7	28,974	11.6	21,548
United Kingdom	12,067	3.8	5,611	2.3	6,456
Germany	7,692	2.4	7,704	3.1	–12
Netherlands	16,233	5.1	1,805	0.7	14,428
Other EU countries	14,531	4.5	13,855	5.6	676
United States	70,391	21.9	43,318	17.4	27,073
Japan	37,289	11.6	51,803	20.8	–14,514
The People's Republic of China	8,808	2.7	8,125	3.3	682
Hong Kong SAR	13,344	4.2	6,250	2.5	7,094
Taiwan	14,600	4.5	13,259	5.3	1,341
South Korea	9,498	3.0	12,974	5.2	–3,476
India	7,745	2.4	2,014	0.8	5,731
Australia	7,711	2.4	5,670	2.3	2,041
Rest of the world	25,808	8.0	18,411	7.4	7,406
Total	**321,181**	**100.0**	**248,870**	**100.0**	**72,311**

Source: Department of Statistics, Malaysia.

billion compared with RM14.6 billion recorded in 1998. Increased exports to Japan contributed significantly, growing by 23.7% during the year, following the recovery in the Japanese economy. The bulk of the exports consisted of machinery and transport equipment (52.3%) and mineral fuels (17.2%). Malaysia's imports from Japan consisted mainly of machinery and transport equipment (67.1%).

Singapore was Malaysia's third most important trade partner, accounting for a share of 15.4% (15.5% in 1998). This was due to a lower proportion of exports bound for Singapore compared with the previous year. Despite this, the trade surplus with Singapore increased to RM18.3 billion compared with RM17.7 billion in 1998. Similarly, trade with the 15 nations of the **European Union** was slightly lower in relative importance from 14.3% of total trade in 1998 to 13.9% in 1999. This was primarily due to the lower proportion of exports bound for the EU, while its importance as a source of imports also declined slightly.

The trade account with several other East Asian countries showed mixed developments, reflecting mainly the domestic economic conditions in both Malaysia and these partners and to some extent, the shift to source imports from lower cost suppliers. By and large, the bilateral trade balances with several developed Asian countries improved. In these cases, the main reason was faster growth in exports to countries that posted strong economic recovery. In particular, exports to South Korea increased by 45.7%, mirroring the strong recovery there. On the other hand, Malaysia's imports from other Asian countries increased, reflecting some shift to source imports from those countries where prices were lower. In particular, the trade deficit with Indonesia and the Philippines widened further due to the larger increase in imports to meet stronger growth in domestic demand in Malaysia.

For the second successive year, the surplus in the merchandise account was more than sufficient to offset the significantly higher deficit in the services account as well as the continued net outflow in the transfers account. In 1999, the net outflow in the **transfers account** remained large at RM7.2 billion, although lower than the record net outflow of RM9.9 billion experienced in 1998. This reflected lower remittances as a consequence of a lower number of foreign workers in the country following the return of nearly half a million foreign workers to their home countries during the recession in 1998. In addition, the unrequited transfers in the previous year were exceptionally large due to the one-off lump sum repatriation by returning workers.

The deficit in the **services account** deteriorated in 1999 as the recovery in domestic economic activity and buoyant external trade transactions resulted in increased demand for imported support services. The services deficit widened by RM6.6 billion to RM28.9 billion or 10.3% of GNP in 1999 (–8.3% of GNP in 1998). However, in US dollar terms, the deficit of US$7.6 billion remained below the pre-crisis level of US$8.1 billion experienced in 1997. In ringgit terms, the deterioration was due entirely to higher gross payments of RM85 billion, representing an annual increase of 19.8%. Gross receipts also recorded a large increase of 15.3% to RM56.1 billion due to higher demand for Malaysia's exported services reflecting the strong recovery in the regional economies. The weaker performance of the services account was again primarily due to large net payments for investment income due to non-residents, freight and insurance as well as other services, particularly management and professional charges. Meanwhile, the travel and other transportation accounts improved significantly, recording larger net surpluses during the year.

Net payments in the **investment income** account increased further by RM4 billion to RM18.8 billion in 1999, affected primarily by higher payments of profits and dividends. The substantial increase in receipts from Malaysian investment overseas was not sufficient to offset higher profits and dividends accruing to foreign direct investors, especially in the electronic and electrical

Graph 1.31
1999: Components of Gross Payments in the Services Account
(% share)

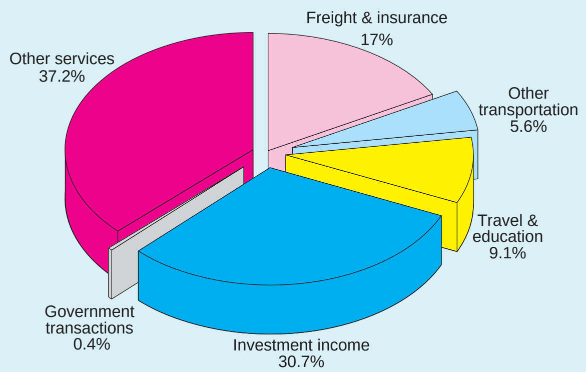


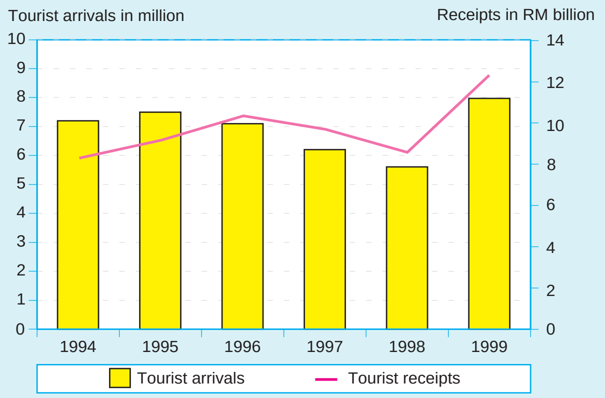
Table 1.20
Services Account

Subsector	1999			
	Net (billion)		Annual change (%)	
	RM	US$	RM	US$
Freight & insurance	–9.7	–2.6	15.4	19.1
Other transportation	2.5	0.7	9.3	12.8
Travel & education	5.6	1.5	81.3	87.1
Investment income	–18.8	–4.9	26.8	30.9
Government transactions n.i.e	…	…	–78.4	–77.8
Other services	–8.4	–2.2	100.1	106.5
Balance on services	**–28.9**	**–7.6**	**29.6**	**33.7**

industries which enjoyed high sales on the back of strong global demand. The interest income component remained in deficit (–RM1.7 billion) for the third consecutive year. However, the deficit has narrowed as the continued large interest payments on the external debt was partially offset by higher returns from the external assets of Bank Negara Malaysia. Meanwhile, higher demand for **other services** in line with the overall improvement in the economy led to a substantially higher net payments position in the **other services** account (–RM8.4 billion). In particular, the restructuring and merger exercises undertaken in both the corporate and financial sectors resulted in higher payments for contract and professional charges as well as salaries and agency fees. The **freight and insurance** account posted a larger deficit of RM9.7 billion (1998: –RM8.4 billion), reflecting higher payments abroad associated with higher trade transactions. The international shipping liners also raised freight rates after two years of consolidation. Nevertheless, higher earnings by major Malaysian shipping companies and the national airline for cargo services helped to reduce the outflow somewhat.

The net surplus in the **travel and education** account increased significantly to RM5.6 billion, benefiting mainly from the marked improvement in tourist receipts. The recovery of the regional economies, intensified promotion of inbound tourism and the hosting of major international conferences and sporting events led to a marked increase in tourist arrivals to 8 million visitors in 1999 compared with 5.6 million visitors a year ago. In particular, the Formula One race event brought in a total of 65,000 foreign visitors contributing more than RM500 million in foreign exchange earnings. Similarly, the number of excursionist arrivals also increased by 12.5% to 6 million. Meanwhile, concerted effort to promote Malaysia as a regional centre for education resulted in an increase in the number of

Graph 1.32
Tourist Arrivals and Tourist Receipts



foreign students pursuing courses in the local universities and colleges. Together, the tourism and educational sectors contributed to a significant increase by 42.6% in travel receipts to an unprecedented level of RM13.3 billion in 1999. On the payments front, the recovery in the economy contributed to an increase in expenditure on travel and education abroad, by 23.2% to RM7.5 billion (US$2 billion). Nevertheless, in terms of US dollars, the outflow was contained below the pre-crisis level of US$2.5 billion in 1997, due largely to active promotion to encourage domestic travel in Malaysia as well as Government measures to increase student intake at local universities and private colleges.

The net surplus in **other transportation** account (comprising mainly passenger fares, charter fees, charges on port and airport-related activities, and bunkers and stores) improved further by 9.3% to RM2.5 billion. This was attributed to improved earnings by Malaysian airline companies from passenger fares and higher receipts from port- and airport-related activities in tandem with improved economic conditions in the regional countries. Reflecting the increase in external trade and positive results of the ongoing effort to promote Port Klang as the main port for Malaysian exporters as well as the regional transhipment hub, throughput handled by Port Klang increased significantly. The container cargo throughput posted a 40% increase to 2.55 million TEUs in 1999, with transhipment cargo accounting for a share of 37.9%. Other major ports also reported increases in cargo handling.

In the **capital account**, the net inflow of long-term capital increased to RM11.7 billion in 1999 (1998: RM10.6 billion), due mainly to higher net inflow of official long-term capital and foreign direct investment. However, the short-term capital account recorded a substantial net outflow for the third successive year, amounting to RM36 billion, due to the reduction in short-term external liabilities of commercial banks and the non-bank private sector, increased trade credits and liquidation and repatriation of portfolio investment by some foreign investors.

The **official long-term capital account** registered a significantly larger net inflow of RM6.7 billion in 1999 (1998: RM2.1 billion) due to both larger borrowings and lower repayments by the Federal Government and the non-financial public enterprises (NFPEs). In contrast to the developments in 1998, the higher net inflow of official long-term capital in 1999 reflected mainly the improvement in access to long-term funds from the international markets. The Federal Government issued a 10-year global bond of US$1 billion in May 1999 and drew down loans offered by the World Bank and bilateral lenders to finance the recovery package and development of infrastructure. The larger borrowings by the NFPEs reflected the higher financing requirements for capital expenditure on both domestic and overseas projects. The new borrowings included the issuance of a 5-year US dollar-denominated bond of US$650 million by PETRONAS as well as loans under the Miyazawa Initiative.

Despite higher net foreign direct investment, **private long-term capital** declined to RM5 billion in 1999 (1998: RM8.5 billion), reflecting mainly a higher net outflow of funds for overseas investment and substantial net repayment of foreign loans by the Malaysian-owned companies. Net **foreign direct investment** increased moderately to RM13.4 billion or 4.8% of GNP (1998: RM10.6 billion or 4% of GNP), with higher inflows of both new investment and reinvestment. The stability and certainty accorded by the selective exchange control rules and the fixed exchange rate together with the Government's commitment to maintain pro-business policies contributed to the continued commitment of several multinational corporations to long-term investment in the country. In addition, higher export earnings on the back of strong external demand also contributed to higher retained earnings in 1999, which accounted for about one-half of net FDI while new equity accounted for a share of 42%. The bulk of the FDI in 1999 continued to be channelled into the manufacturing sector, which accounted for a 47% share, followed by the services sector (27%) and the oil and gas sector (24%). Net external loans from parent and associated companies were substantially lower in 1999 on account of lower new borrowing amidst ample liquidity in the domestic economy and higher interest rates abroad.

In terms of investments in manufacturing projects, the value of proposed foreign investments approved by the Ministry of International Trade and Industry continued to remain significant in 1999, amounting to RM12.3 billion (1998: RM13.1 million). This reflected the confidence and the sustained commitment among the foreign investors, particularly the existing investors in Malaysia, to invest in the country. This was evidenced in the increase in the value of approvals for expansion and diversification projects to RM6.2 billion in 1999 compared with RM3.8 billion in 1998. In terms of sources of investment, the United States of America, Japan, Singapore and the Netherlands had remained as the top investors during the year. Meanwhile, Pakistan has emerged as an important investor in 1999, with the approval to invest in a large project in the paper, printing and publishing sector. Within the oil and gas sector, the United States and the Netherlands continued to remain as major foreign investors in the country.

Gross **overseas investment** increased significantly to RM10.4 billion in 1999 (1998: RM8 billion), due mainly to larger investment by Malaysian companies, particularly the NFPEs, either through acquisitions or joint ventures, in a move to expand their operations worldwide. Reflecting the improved domestic corporate performance in 1999, the liquidation of assets of Malaysian-owned companies abroad and the repayment of loans to parent companies in Malaysia declined during the year. Hence, on a net basis, overseas investment increased significantly to RM6.2 billion (1998: –RM3.1 billion). Based on the Cash BOP Reporting System, the major recipient countries of overseas investment in 1999 were France, which accounted for 24% of the total direct equity investment, followed by Mauritius (16%), Singapore (12%), the United States of America (8%) and the United Kingdom (5%). Investment in France and Mauritius reflected mainly the transfer of funds by PETRONAS to its joint-venture partners in those countries for actual investment in third countries such as Sudan and Iran. Apart from Sudan and Iran, PETRONAS also has interests in exploration ventures in Vietnam, Syria, Pakistan, Turkmenistan, The People's Republic of China, Myanmar, Libya/Tunisia, Algeria and Angola. In addition to the upstream activities, PETRONAS has also formed strategic partnerships with companies in Vietnam, The People's Republic of China, Thailand, Philippines and South Africa to market and distribute LPG and other petroleum products.

Private long-term capital in the form of loans by the resident-controlled companies (RCCs) recorded a significant net repayment of RM2.2 billion in 1999 (1998: +RM1 billion). Gross external borrowings by the RCCs declined in 1999, attributable both to lower investment, especially in the first half-year, as well as higher supply of internally generated funds (due to higher export earnings) to finance capital expenditure. At the same time, the repayment of loans increased significantly during the year, reflecting mainly the maturity of loans committed in the mid-1990s. In addition, some companies took advantage of lower domestic interest rates to restructure their more expensive external debt through refinancing with domestic borrowing, while some companies with foreign exchange earnings opted to repay some foreign loans to reduce their debt servicing burden in view of higher interest rates abroad.

The **short-term capital account** continued to record a substantial net outflow of RM36 billion in 1999, due to a number of factors. Firstly, the outflow reflected both the decline in net external liabilities of the commercial banks due to lower inter-bank borrowings amidst ample liquidity in Malaysia and lower financing requirements for hedging contracts as well as the significant repayment of short-term debt by the non-bank private sector due to rising interest rates abroad. Secondly, the net liquidation and repatriation of portfolio investment by foreign investors following the expiry of the 12-month holding period of portfolio investment from 1 September 1999 amounted to about US$2 billion (RM8 billion). This was, however, significantly lower than earlier market expectation of a significant exodus of funds. Private sector estimates of funds outflow ranged from US$5 billion to US$8 billion. More significantly, some of these foreign funds have since been reinvested in the country in the first two months of 2000. In addition, higher interest rates overseas have prompted an increase in trade credits extended to the foreign importers while the repatriation of export proceeds of some Malaysian exporters, particularly those earned in the later part of the year, have yet to be effected. Exporters are allowed a period of six months from the date of exports to repatriate export earnings to Malaysia.

External Debt

Malaysia's policy of active debt management, guided by prudential safeguards and an efficient debt monitoring system, has enabled the country to keep the overall external debt situation manageable. The nation's **total external debt** outstanding declined further by 1.4% to RM159.7 billion at the end of 1999, reflecting reductions in the short-term debt as well as longer-term private sector external debt. In US dollar terms, the total debt was equivalent to US$42 billion (US$42.6 billion in 1998). The improvement in the debt situation in 1999 was reflected in the decline in the ratio of external debt to GNP and to exports to 57% and 43% respectively. The Federal Government's external debt, although slightly higher in 1999, accounted for only 12% of total external debt, while the NFPEs accounted for a share of 37%. The balance of the debt was private sector debt, with the non-resident controlled companies in Malaysia accounting for a larger share of this debt (54%).

Short-term external debt declined for the second consecutive year, by 29% to RM22.8 billion (US$6 billion) at the end of 1999. Ample liquidity in the domestic banking system, higher external borrowing costs following monetary tightening in the major industrial countries as well as lower financing requirements for hedging contracts resulted in a significant reduction in short-term borrowing by both the commercial banks and the non-bank private sector. Hence, the ratio of short-term debt to total external debt declined to 14% from 20% in 1998. As a share of international reserves, it fell to 19.5% from 32.4% in 1998. Including long-term debt with remaining maturity of less than one year, short-term debt would amount to RM38 billion (US$10 billion), well below BNM's international reserves of US$30.9 billion as at end-1999.

Table 1.21
Outstanding External Debt

	1998		1999*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**162,015**	**42,636**	**159,696**	**42,025**
Medium & long-term debt	*129,778*	*34,152*	*136,848*	*36,013*
Short-term debt[1]	*32,237*	*8,483*	*22,848*	*6,013*
As % of GNP				
Total debt	60.2	62.1	57.0	57.0
Medium & long-term debt	48.2	49.8	48.8	48.8
As % of exports of goods and services				
Total debt	49.0	50.6	43.0	43.0
Medium & long-term debt	39.3	40.5	36.8	36.8
Debt service ratio (%)				
Total debt	6.4	6.4	5.3	5.3
Medium & long-term debt	5.7	5.7	4.8	4.8

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

External borrowing of medium- and long-term loans recorded a slightly lower net inflow of RM5 billion in 1999 (1998: RM5.2 billion). For the first time since 1989, the private sector recorded a net repayment of external loans of RM1.8 billion. However, this was more than offset by higher net external borrowing by the Federal Government and NFPEs totalling RM6.8 billion in 1999, reflecting official borrowing to finance the fiscal deficit and recourse to the international capital markets by Malaysian corporations following an improvement in spreads. Together with an exchange revaluation loss of RM2.1 billion arising from the depreciation of ringgit against the Japanese yen which raised the debt in ringgit terms, the total **medium- and long-term external debt** increased by 5.4% to RM136.8 billion at the end of 1999. In United States dollar terms, the debt amounted to US$36 billion (1998: US$34.2 billion).

In terms of **currency composition**, debt denominated in United States dollars continued to be the largest component of the medium- and long-term external debt, with a share of 72% of debt outstanding at the end of 1999 (74% in 1998). The share of yen-denominated debt increased to 21% (1998:18%), reflecting the drawdown of yen loans under the Miyazawa Initiative as well as an exchange revaluation loss which raised the yen debt in ringgit terms. The remaining 7% of the debt was accounted for by other international currencies, including the French franc, Singapore dollar, Deutsche Mark and pound sterling.

Overall **debt servicing** declined by 8.2% to RM19.5 billion, due both to lower principal repayment and interest payments. In line with higher export growth, the total debt service ratio declined to 5.3% from 6.4% in 1998.

Public sector external debt: The **Federal Government's** external debt increased by 23% to RM18.4 billion at the end of 1999, to account for a larger share of 12% of total external debt. Gross borrowings increased to RM4.8 billion, mainly from the issuance of US$1 billion Global Bond and the drawdown of loans offered by the World Bank and Islamic Development Bank and bilateral lenders especially from Japan under the Miyazawa Initiative (RM610 million). There was no prepayment of Federal

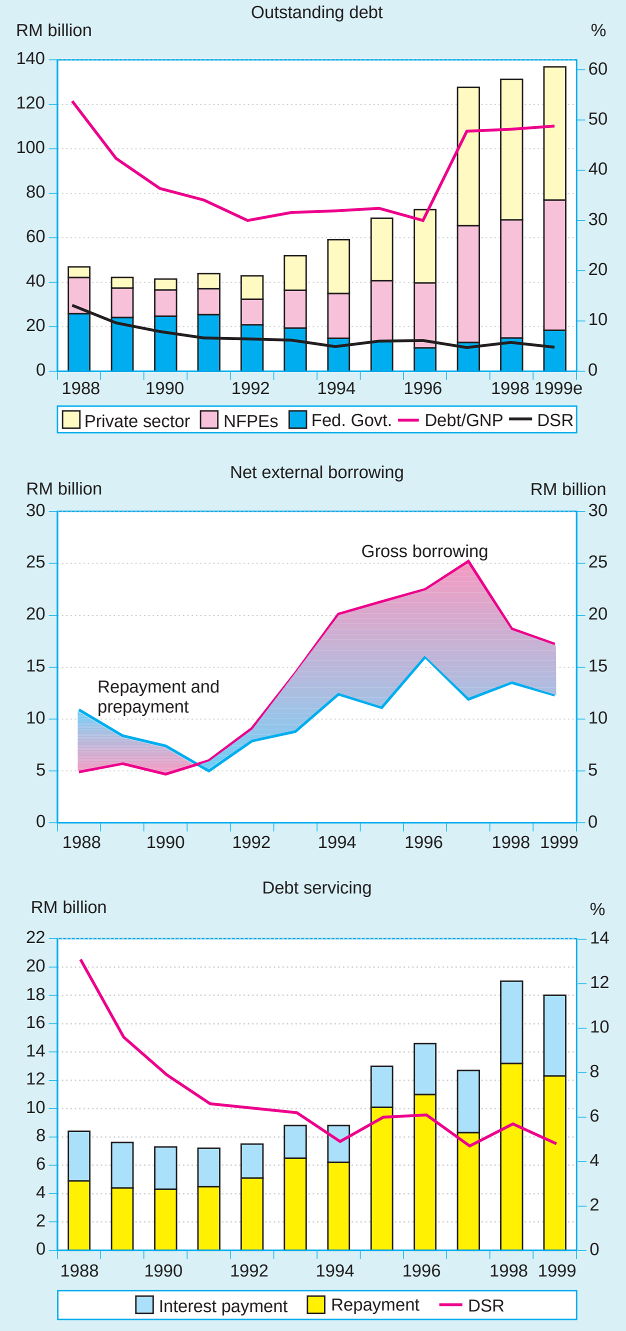
Government loans in 1999 while scheduled repayments totalled RM1.8 billion, including the maturity of a Samurai bond valued at 30 billion yen.

While the funding requirements were primarily met from domestic non-inflationary sources, the Government also tapped the international capital markets in May 1999 to establish market presence and develop an investor base for Malaysian securities, as well as establish a benchmark rate for Malaysian corporations. The 10-year Global Bond with a coupon rate of 8.75% was over subscribed by 300%. With the return of investor confidence and the upgrading of Malaysia's sovereign debt rating, external borrowing costs have declined significantly. Interest rate spreads for Malaysian benchmark securities have narrowed substantially to about 170 basis points at end-1999 (from a peak of about 1200 basis points in September 1998). A large share of loans under the Miyazawa Initiative are for educational projects and infrastructure development. The yen credit lines are offered at concessionary interest rates with maturities of up to 40 years.

The **NFPEs** took advantage of the improvement in access to long-term funds from international capital markets to increase gross borrowing to RM6 billion in 1999 (1998: RM4.7 billion). The new loans were mainly made by PETRONAS and Telekom Malaysia Berhad for funding domestic capital expenditure and investment in projects and joint ventures abroad as well as to refinance the more expensive existing loans. Petronas issued a US$650 million 5-year bond at a coupon rate of 8.875% to finance petrochemical projects. Foreign borrowings to finance overseas projects are naturally hedged, with earnings in foreign currency to service the debt. Loans under the Miyazawa Initiative (RM1.2 billion) were also drawn down by Bank Industri and Bank Pembangunan for promotion of exports and development of infrastructure for transportation. With principal repayments declining substantially to RM2.2 billion, the NFPEs recorded a larger net inflow of new loans of RM3.9 billion (1998: RM361 million). Together with an exchange revaluation loss of RM1.6 billion, the outstanding debt of the NFPEs increased by 10.2% to RM58.6 billion at the end of 1999.

Private sector external debt: The private sector recorded a net repayment of external loans of RM1.8 billion in 1999, reflecting a reduction in new borrowing (RM6.4 billion; RM10 billion in 1998) and significantly higher repayment abroad (RM8.2 billion; RM7 billion in 1998). Demand for external loans was subdued in the face of weak private investment activity, especially in the first half-year, and availability of cheaper sources of domestic funding, including internally generated funds arising from higher export earnings, to finance their capital expenditure. At the same time, higher interest rates abroad induced higher repayments by the private sector. As part of active debt management to reduce the overall debt servicing cost, some companies took the opportunity to restructure their more expensive external debt through refinancing with cheaper domestic bank loans and the issuance of private debt securities. Following these developments,

Graph 1.33
Medium- and Long-Term External Debt



private sector external debt outstanding declined by 3% to RM59.8 billion at end-1999.

Malaysia's framework for external debt management has always been guided by prudential policies designed from a macro perspective to reduce risk exposure to global interest rate shocks, adverse exchange rate movements and shifts in investor sentiment. In the context of these objectives, the debt management strategy will continue to balance the need to ensure that the corporate sector can have access to funding from the most competitive sources to finance productive activities that will generate sufficient foreign earnings to service the debt. In the management of the public debt, the Government will maintain prudence in its recourse to external borrowing to ensure continued long-term access to the international financial markets and low future borrowing costs.

In the management of risk and liquidity exposure, Malaysia already has the experience in practising some simple guidelines which are being put forward to emerging economies on the management of external debt. Corporations are encouraged to raise loans with longer maturity while short-term borrowing by the non-bank private sector to finance long-term investment are not encouraged. Consequently, Malaysia's external debt profile is biased towards the long-end, with about two-thirds of the medium- and long-term debt having remaining maturities of more than three years. Short-term debt forms only a small portion of total external debt. The currency composition of liabilities also corresponds closely with the currency composition of earnings, providing a natural hedge against currency risks. Prudential criteria on managing external loans by both the public and private sectors have helped to reduce Malaysia's vulnerability to external shocks.

International Reserves

The **net international reserves** held by BNM (comprising gold and foreign exchange holdings, IMF reserve position and holdings of Special Drawing Rights (SDR)) increased by RM17.8 billion in 1999 to RM117.2 billion (+US$4.7 billion in 1999 to US$30.9 billion). The level of international reserves is sufficient to cover the short-term external debt by 5.1 times (3.1 times in 1998), and is sufficient to finance 5.9 months of retained imports (5.7 months at end 1998).

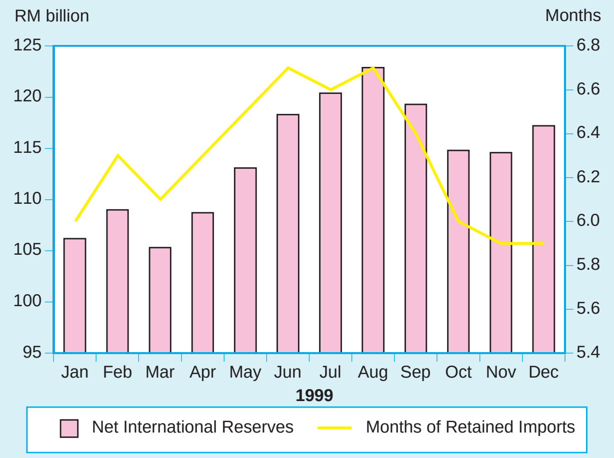
The build-up in international reserves reflected the strong trade surplus during 1999. To a lesser extent, the accumulation in reserves also arose from foreign currency borrowing by the Federal Government, the bulk of which was through the issuance of a global bond. The combined trade inflows and borrowings more than offset net repayment by the private sector and the commercial banks, as well as portfolio outflows.

During the period January-August, reserves increased steadily by RM23.4 billion (US$6.2 billion) or a monthly average of RM2.9 billion. During September-November 1999, however, reserves declined by RM8.3 billion following the expiration of the 12-month minimum holding period on foreign portfolio funds on 1 September 1999. The outflow of portfolio funds amounted to US$1.3 billion in September and subsequently moderated to US$0.8 billion in the period October-December 1999. The decline in reserves in October was also attributed to the repayment of external

Table 1.22
International Reserves

	As at end		
	1997	1998	1999
	RM million		
Net Reserves	**59,122.8**	**99,424.4**	**117,243.5**
SDR holdings	478.9	793.9	330.3
IMF reserves position	1,622.0	2,379.2	3,168.2
Gold and foreign exchange	57,021.9	96,251.3	113,745.0
	US$ billion		
Gross Reserves	**21.7**	**26.2**	**30.9**
Months of retained imports	**3.4**	**5.7**	**5.9**

Graph 1.34
Net International Reserves



loans (US$0.8 billion) by the private sector as part of the corporate debt restructuring process. In December, reserves resumed its uptrend to increase by RM2.7 billion.

Following the 11th general review of quotas, Malaysia's quota with the IMF was raised in January 1999. As a result of the higher quota, there was an increase in the IMF reserve position. Part of the increase in the IMF reserve position, however, came from the decrease in the holdings of SDR. For the year as a whole, the IMF reserve position increased by RM789 million while the holdings of SDR by BNM declined by RM464 million.

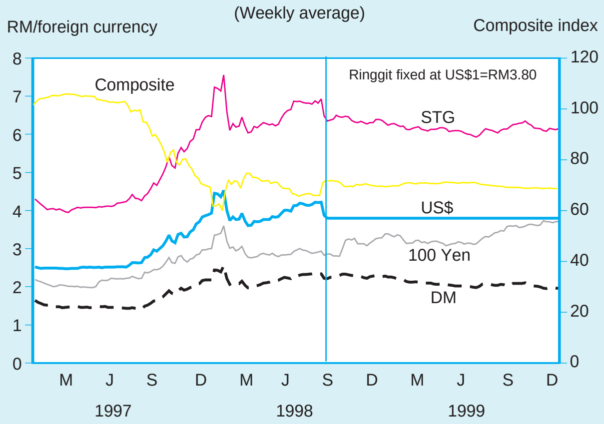
The objective of **reserve management** at BNM is to ensure capital preservation and liquidity of reserves whilst optimising returns. BNM has formulated a customised benchmark to serve as a guide for its investment decisions taking into account the need to ensure safety of reserves and to meet liquidity requirements as well as the level of tolerance for risk in investment decisions. The benchmark portfolio and, hence, BNM's reserves comprises a number of major international currencies, which are held in the form of foreign currency deposits or invested in high investment grade sovereign papers and gold. The composition of foreign currencies in reserves depends on factors such as the country's foreign currency obligations, its trade flows, and the overall assessment of the performance of the currencies concerned. The operational risks of reserve management are closely monitored to ensure full compliance with the investment guidelines.

Exchange Rates

In 1999, **the ringgit remained pegged to the United States** dollar at the rate of RM3.8000. This system of a pegged exchange rate has been effective since 2 September 1998. Under this arrangement, the ringgit exchange rate vis-à-vis other currencies is determined through cross-rates based on the movements of the US dollar against those currencies in the international foreign exchange markets.

The ringgit was relatively stable against most major currencies in 1999. The **volatility of the ringgit** (measured by the standard deviation of the daily rates) against major currencies, with the exception of the Japanese yen, reduced significantly. The standard deviation of the ringgit declined to 0.076 against the Deutsche mark (1998: 0.123) and

Graph 1.35
Exchange Rate of the Malaysian Ringgit against Major Currencies



0.092 against the pound sterling (1998: 0.326). However, the volatility of the ringgit against the yen increased to 0.213 (1998: 0.198).

During the year, the **ringgit appreciated against most major currencies in the world** reflecting the movements of the US dollar in the international foreign exchange markets. In 1999, the strong performance of the US economy supported the performance for the US dollar, leading to an appreciation against the pound sterling and the Euro. The dollar, however, depreciated vis-à-vis the Japanese yen due to the shift in the portfolio preference of global fund managers to yen-denominated assets with the growing investor confidence in the Japanese economic recovery. Following these developments, the ringgit appreciated against the pound sterling (+3.1%) and the Euro (+17.5%), while depreciating against the Japanese yen by 10.7%.

Graph 1.36
Exchange Rate of the Malaysian Ringgit against Selected ASEAN Currencies

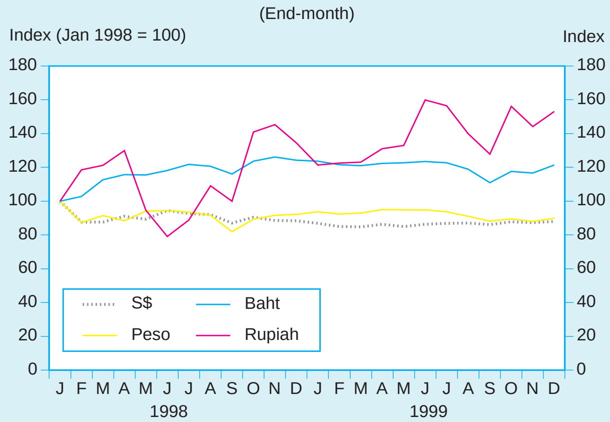


Table 1.23
Movement of the Ringgit

	RM to one unit of foreign currency[1]					Annual change (%)		2 Sept.'98-Dec.'99
	1998		1999			1998	1999	Change (%)
	End-Dec.	Sept. 2 [2]	End-Dec.	Low	High			
Composite	69.57	72.11	68.64	68.53	71.26	–0.2	–1.3	–4.8
SDR	5.3505	5.1177	5.2096	5.0296	5.3819	–1.8	2.7	–1.8
US$	3.8000	3.8000	3.8000	3.8000	3.8000	2.3	0.0	0.0
S$	2.2879	2.1998	2.2809	2.1874	2.2930	1.4	0.3	–3.6
100 Yen	3.3141	2.7742	3.7115	3.0561	3.7442	–9.7	–10.7	–25.3
Pound Sterling	6.3313	6.3708	6.1389	5.8975	6.3694	1.8	3.1	3.8
Deutsche Mark	2.2640	2.1743	1.9599	1.9450	2.3034	–4.0	15.5	10.9
Swiss franc	2.7497	2.6450	2.3836	2.3798	2.7983	–2.7	15.4	11.0
Euro [3]	–	–	3.8333	3.8042	4.5050	–	17.5	–
100 Thai baht	10.3613	9.3713	10.1199	9.1489	10.5337	–20.5	2.4	–7.4
100 Indonesian rupiah	0.0476	0.0354	0.0542	0.0407	0.0575	51.5	–12.2	–34.7
100 Korean won	0.3190	0.2827	0.3355	0.3053	0.3367	–27.7	–4.9	–15.7
100 Philippine peso	9.7064	8.8302	9.4823	9.2356	10.1152	–1.1	2.4	–6.9

[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 such foreign currencies against the US$ and the RM/US$ rate.
[2] Ringgit was fixed to US$1 = RM3.8000 on 2 September 1998.
[3] The Euro began to be traded on 4 January 1999 (EUR 1 = RM4.5050). The annual change for 1999 is calculated against the value as at 4 January 1999.

Meanwhile, the **performance of the ringgit against regional currencies was mixed** in 1999. The ringgit appreciated against the Singapore dollar (+0.3%), the Thai baht (+2.4%) and the Philippine peso (+2.4%), while depreciating against the Indonesian rupiah (–12.2%), Korean won (–4.9%) and the Taiwanese dollar (–2.7%). The Indonesian rupiah continued to remain volatile during the year due mostly to domestic economic and political developments. In other parts of the region, the Thai baht remained subdued for the most part of the year, while strong portfolio inflows into Korea resulted in an appreciation of the won.

Since the fixing of the ringgit exchange rate against the US dollar on 2 September 1998, the ringgit has depreciated against regional currencies and the Japanese yen reflecting the movements of the US dollar. During the period between 2 September 1998 and end-December 1999, the ringgit has weakened against regional currencies in the range of 3.6%–34.7% and 25.3% against the Japanese yen. In terms of the composite, the ringgit depreciated by 4.8% during the same period.

Overall, the pegged exchange rate regime has benefited the economy by offering a period of relative stability, which has aided the recovery of economic activity and allowed the acceleration of financial reforms. The peg has introduced a greater degree of stability and predictability in the operations of trade which has helped manufacturers conduct their pricing and investment decisions in an environment of greater certainty. The peg has been sustainable as it is consistent with the underlying fundamentals of the economy. At the same time, consistent macroeconomic policies have further ensured the viability of the regime.

Flow of Funds

For 1999, the economy registered a larger total resource surplus of RM47.4 billion, which accounted for 16.9% of GNP (+RM36.8 billion or 13.7% of GNP in 1998). The larger resource surplus reflected mainly the favourable export performance amidst a moderate increase in imports. The nation's larger net savings was due mainly to the larger net savings of the private sector of RM34.8 billion, while the resource surplus of the public sector remained stable at RM12.6 billion (both the private and the public sectors also registered resource surpluses of RM24.6 billion and RM12.2 billion respectively in 1998). The inter-sectoral flow of funds between the sectors of the economy in 1998 and 1999 is shown in Tables 1.23 and 1.24 respectively.

Despite the higher public consumption and investment expenditure, which were undertaken as part of the fiscal stimulus package to promote economic recovery, the non-financial balance of the public sector continued to register a net resource surplus of RM12.6 billion in 1999 (a net resource surplus of RM12.2 billion in 1998). Together with official foreign borrowings (RM6.7 billion) and net withdrawals of deposits (RM2.2

Table 1.24
Flow of Funds, 1998

Transactions/Sectors	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	–259.3	72.5	186.8			0
Consumption	146.6	–28.5	–118.1			0
Investment	76.3	–32.0	–44.3			0
Change in Stocks	–0.4	0.2	0.2			0
Exports of Goods and Services	325.3				–325.3	0
Imports of Goods and Services	–263.3				263.3	0
Net Factor Payment Abroad	–15.3				15.3	0
Net Transfers	–9.9				9.9	0
Non-Financial Balance	0.0	12.2	24.6	0.0	–36.8	0
Foreign Financing						
Corporate Investment			8.5		–8.5	0
Net Foreign Borrowings		2.1	–9.8		7.6	0
Net Change in Foreign Assets						
BNM				–40.3	40.3	0
Banking System				–10.9	10.9	0
Domestic financing						
Change in Credit		–12.3	4.1	8.2		0
Change in Money Supply, M3			–10.7	10.7		0
Net Borrowings from Non-Bank Sector		–2.1	2.1			0
Net Errors and Omissions			–18.8	32.3	–13.5	0
Sum	0	0	0	0	0	

Table 1.25
Flow of Funds, 1999

Transactions/Sectors	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	–273.1	79.8	193.3			0
Consumption	158.8	–34.1	–124.7			0
Investment	66.6	–33.0	–33.6			0
Change in Stocks	0.3	–0.2	–0.2			0
Exports of Goods and Services	363.3				–363.3	0
Imports of Goods and Services	–289.3				289.3	0
Net Factor Payment Abroad	–19.4				19.4	0
Net Transfers	–7.2				7.2	0
Non-Financial Balance	0.0	12.6	34.8	0.0	–47.4	0
Foreign Financing						
Corporate Investment			5.0		–5.0	0
Net Foreign Borrowings		6.7	–24.8		18.1	0
Net Change in Foreign Assets						
BNM				–17.8	17.8	0
Banking System				–11.1	11.1	0
Domestic financing						
Change in Credit		2.2	–5.9	3.8		0
Change in Money Supply, M3			–33.1	33.1		0
Net Borrowings from Non-Bank Sector		–21.4	21.4			0
Net Errors and Omissions			2.6	–7.9	5.3	0
Sum	0	0	0	0	0	

billion), a total of RM21.4 billion was extended to the private sector. This largely reflected transfers, in particular by NFPEs to the private sector, mainly in the form of equity participation and purchase of assets.

Meanwhile, the recovery in economic activities enabled the private sector to register higher disposable income of RM193.3 billion in 1999 (RM186.8 billion in 1998). Following a period of higher disposable income and the lower rates of interest, private consumption also increased to RM124.7 billion in 1999 (RM118.1 billion in 1998). Nonetheless, with the continued excess production capacity in the domestic economy, private investment expenditure declined to RM33.6 billion in 1999 (RM44.3 billion in 1998). As a result, the private sector registered a larger net savings-investment surplus of RM34.8 billion (RM24.6 billion in 1998). Together with continued inflows of corporate investment from abroad (+RM5 billion) and net borrowings from the public sector (+RM21.4 billion), the private sector surplus stood at RM61.2 billion.

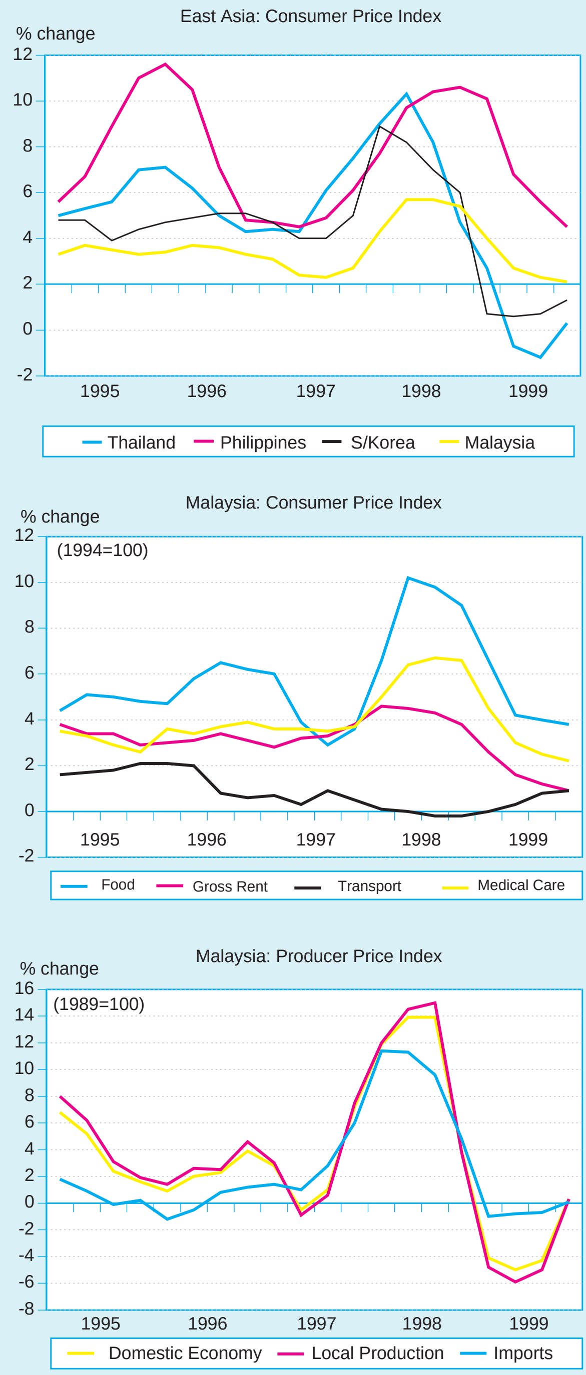
The bulk of the surplus was placed in the form of deposits with the banking system (-RM27.1 billion) and held as currency balances (-RM6.0 billion), which together amounted to RM33.1 billion, as well as net repayment of credit to the banking system (-RM5.9 billion). There was also partial outflow of these funds to abroad. Outflows were mainly in the form of private short-term funds (-RM24.8 billion) as well as reduction in net external liabilities of the banking system (-RM11.1 billion), which together with some net unidentified payments abroad (-RM5.3 billion), amounted to RM41.1 billion. Nonetheless, continued inflows of long-term capital (both official borrowings and corporate investment) together with the large current account surplus, resulted in an accumulation of net international reserves of RM17.8 billion during the year.

Inflation

Inflation moderated in 1999. The relative stability of the ringgit exchange rate, excess capacity in the economy and lower commodity prices led to more moderate price increases in 1999. Inflation as measured by the **Consumer Price Index** (CPI, 1994=100) rose at an annual rate of 2.8% in 1999, lower than the earlier estimate of 3%. The CPI had risen to peak at 6.2% in June 1998 before moderating to record an increase of 5.3% for the year as a whole. Excluding food, growth in CPI was lower and had moderated progressively from 2.8% in January to reach 0.8% in December. For 1999 as a whole, the CPI excluding food rose at an annual rate of 1.6%.

As the ringgit exchange rate against the US dollar was fixed at US$1=RM3.80 effective 2 September 1998, the ringgit appreciated by an average annual rate of 4.8% against the US dollar in the period January-August 1999 and 3.2% for the year as a whole. This marginal appreciation contributed partly to lower consumer prices. In the

Graph 1.37
Inflation: Average Annual Rate of Change



Box III

Towards A Knowledge-Based Economy

Introduction

The rapid development of information technology in recent years has enabled information to be transmitted almost instantaneously to any part of the world. Together with the rapid advancement in technology, this has made the basic production skills increasingly vulnerable to machine substitution. Hence, the need for highly skilled knowledge workers to generate the intangibles that will add value to the product. This is reflected in the shift towards high skill, high technology and service-based growth.

As a small, open economy, Malaysia recognises this global change in which economic growth and success are directly associated with the ability to harvest new ideas and innovation and implement them. To remain competitive, Malaysia needs to transform into a knowledge-driven economy in order to take advantage of the global developments created by the new information and communication technologies. This box article begins by defining the K-economy in simple terms. This is followed by a discussion of the rationale for the transition to the K-economy and the challenges posed by the transition. The article concludes with a discussion of the enabling environment needed for a sustainable K-economy.

K-economy Defined

There is no one standard definition of the K-economy but an acceptable one must place importance on the generation and exploitation of knowledge to create new value in the economy. Indeed, knowledge is information that is put to productive work. Knowledge includes information in any form, know-how and know-why. Knowledge is not only embodied in goods and services, particularly in high technology industries, but also in knowledge as a commodity itself, manifested in forms such as intellectual property rights or in the tacit knowledge of highly mobile key employees. And it involves the way we interact as individuals and as a community. Unlike capital and labour, knowledge is a public good and sharing with others involves zero marginal cost. In addition, technology breakthrough based on knowledge creates technical platforms that support further innovations and drives economic growth.

There are three main aspects of a K-economy that differentiate it from the traditional production-based economy (P-economy).

- Firstly, the K-economy focuses on knowledge as the driver of economic growth, as knowledge can increase the production capacity of the other factors of production and transform them into new products and processes. The K-economy is not confined to information technology (IT). Before the advent of the proliferation of IT, it was knowledge that was embodied in human beings as “human capital” and technology that was embodied in the capital investment undertaken by the Asian economies that brought about the so called Asian miracle. These two types of investments had helped to close the “knowledge gap” between the developed and emerging countries on how to transform inputs into desired outputs. With IT developments, the management of this knowledge gap has become more complex as the globalisation process gains momentum.

- Secondly, K-economy encompasses both qualitative and quantitative changes that transform the structure, mode and the way the economy operates. To compete in a K-economy environment, one needs to focus on the exploitation of intellectual capital, information advantage, a learning culture and more importantly, agile organisations. Knowledge goods and services are customised, less stable and have a shorter life cycle. Moreover, knowledge-based activities will not in most cases generate large volume. Rather,

Chart III.I
Migration to a K-economy

P-economy	K-economy
Structure comprises: manufacturing, agriculture, construction, mining and services sectors.	Merging and blurring of sectors and emergence of K-based sector.
Factors of production: land, labour, capital and decreasing returns to scale.	Intellectual capital, knowledge and increasing returns to scale.
Hierarchical organisations.	Networking and horizontal organisations.
Products: stable and longer life cycle. Output is mass-produced.	Products: less stable and shorter life cycle and customised with K-contents.
Output and resources traded in the market place.	Output and resources traded in the market space through information-based channels.
Competitive advantage: low cost of labour and abundance of raw materials.	Competitive advantage: intellectual capital and exploitation of knowledge.
Based on production work.	Based on K-work and growth of e-commerce.

they will result in the production of intangibles that enhance value through better quality, time saving and increased consumer satisfaction.

- Thirdly, firms in a K-economy focus on investments in intangibles such as human capital, R&D capacity, customers' database, brand names and reputation. As creators of knowledge-based assets, K-firms organise and create intellectual assets, exploit networks and gain access to other clusters of knowledge assets that belong to their suppliers and customers. In this way, the firms will be able to integrate the whole value chain to increase productivity and competitiveness in both domestic and foreign markets.

Rationale for the Transition to the K-Economy

In this era of the Knowledge Revolution we will witness ideas breeding other ideas in a concentric spiral of progress. To remain competitive, Malaysia has to tap the vast opportunities provided by the knowledge revolution. A knowledge-rich and agile environment will facilitate successful competition in an evolving global environment. The ability to shift to this new competitiveness paradigm will enable Malaysia to leapfrog from the industrial era to a post-industrial era that is based on knowledge and R&D. It is clear that in a dynamically evolving environment, a transition to a K-economy where innovation and adaptiveness prevail will be the most prudent and effective strategy for promoting sustainable real economic growth.

There is no doubt that there has been some gains in productivity in certain sectors in Malaysia. Nevertheless, the concern is that the productivity gains have been facilitated by increased sophistication of production equipment that are imported, and this equipment would also be available to competitors. The problem of productivity has been aggravated in recent years by rising wages. Continuous wage increase that exceed productivity growth will erode Malaysia's advantage as a low cost production centre. In other words, in this millennium, low wages will no longer provide the leverage for competitiveness in Malaysia. Low wages in fact encourages brain drain of skilled labour and managerial talent drawn by higher wages elsewhere. Hence, competitiveness does not depend on low wages. Rather, it requires a critical mass of creativity and innovative potential which is backed by adequate financing, educated labour force with the right skills and positive attitude and a supportive infrastructure and regulatory environment.

Currently there are skill gaps in Malaysia. This is the inherent weakness of the present P-economy with a mismatch of skills. Of more concern is that wages in the P-economy will be determined by the competition with other low-cost P-economies, thus setting the ceiling for any increase in wages. Consequently, earnings in such P-jobs are below the wages for K-jobs, thus widening the income gap between these groups of workers.

The advent of IT has also brought changes through the evolvement of global electronic business, in particular e-commerce as the fundamental element of the emerging digital economy. E-commerce calls for a distinct paradigm shift from our traditional way of doing business, and the growth of e-commerce will have an impact on the domestic economy that could far exceed the ringgit value of e-commerce activity. Indeed, Malaysian businesses will have to harness the forces of e-commerce to break into the international market. At the same time, there is a need to develop new areas of growth such as knowledge-intensive services sector. Reliance on accumulation of manufactured goods, and the export of traditional goods will be insufficient to generate growth in the future. Malaysia needs to become a "knowledge-export" platform to secure future economic prosperity. Exports need to be increasingly based on "knowledge content" that have higher value added and that contribute to higher income levels.

Challenges of the Transition to a K-Economy

In managing the transition to the K-economy, many barriers both cultural and economic will be encountered and many facets of life will be changed. The traditional manner of managing organisations, business models and culture and production process will be challenged in an economy that is knowledge driven. While Malaysia has relatively strong economic fundamentals, it needs to develop the information infrastructure and increase the use of technology. There are also shortages of technical and K-skilled labour and expenditure on R&D needs to increase. A shift towards a knowledge-based economy, therefore, presents significant new challenges to the way the Government, people and organisations think, operate and manage their businesses.

- The first challenge is to design an aggressive and pragmatic architecture that can contribute to building a knowledge rich and agile environment. This is new, and policy makers must realise that if we do not change the way we operate, this will affect the efficiency and success of the migration to the K-economy. Malaysia needs not only to increase the knowledge but also to position itself to increase the exploitation of knowledge. In this endeavour, Malaysian businesses have to close the productivity gap with their competitors and to produce innovative new products and create high value services. Malaysia has, therefore, embarked on the preparation of the K-economy Master Plan to formulate the framework for the successful transformation of the economy. Various aspects such as the pace of transition into the K-economy, the targets and the breakthrough approach will be given careful consideration and study.

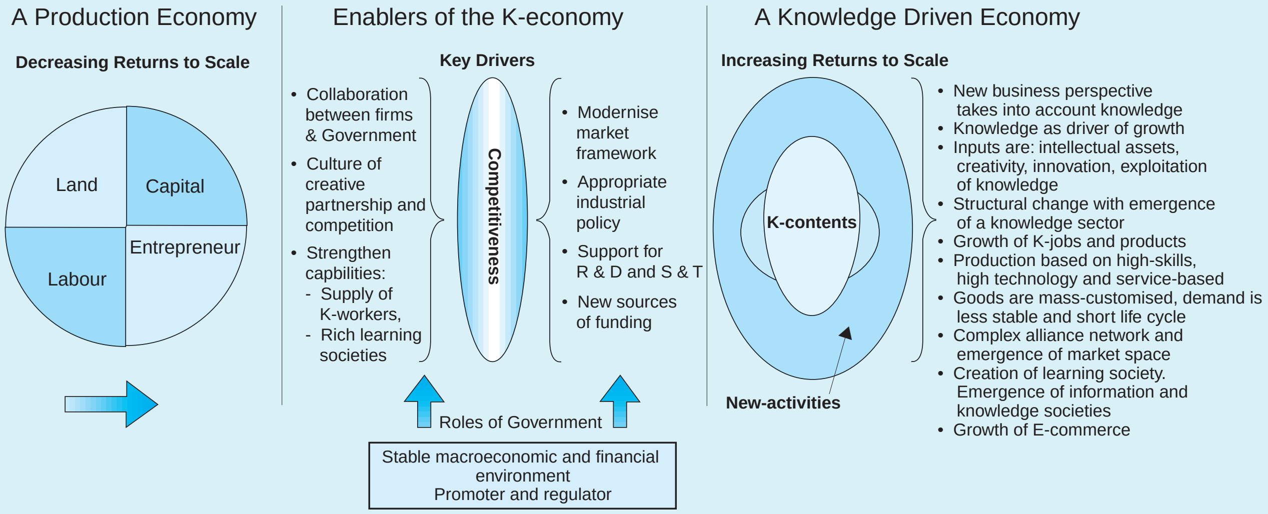
Table III.1
Malaysia vis-à-vis Other Economies

Year 1997	K-skills Workforce (as % of total workforce)	R & D/ GDP (%)	K-skills in R & D (per million population)
Countries			
Malaysia	10.7	0.3	87
Singapore	26.4	1.4	2512
Korea	15.1	2.8	2636
Taiwan	15.5	1.9	3340
Japan	22.9	2.8	5677

Source: NITC

- The second challenge is to close the present "gaps" in the economy that obstruct and are a constraint to the transition to a knowledge driven economy. A critical assessment of the possible rigidities in the economy and obstacles in terms of legislation and policies need to be identified. While there are already "pockets" of K-activities in existence, it is important to establish benchmarks for the performance of these "pockets". When compared with the successful K-economies, statistics show that at present Malaysia has a relatively low share of IT skills to labour force, K-skills in R&D per million of population and R&D investment to GDP. Nevertheless, efforts are being directed to increase the levels of K-labour, private investment in the K-sectors, and innovation capabilities.

Chart III.2 The Knowledge Economy: A Route Map



- The K-economy will make new demands on a conducive business environment and adequate human capital with the right motivation, attitudes, high level of skill and educational attainment as well as high entrepreneurial skills to successfully capitalise on opportunities that arise. The policy makers will be challenged to equip people with K-skills such as problem-solving and cognitive skills, as well as providing the appropriate communication infrastructure and adequate financial capital to sustain knowledge organisations.

- There are also risks that need to be taken into consideration in planning the transition to a K-economy. Policy makers and the public at large must realise that a K-economy does not eliminate the risks of volatility and uncertainty that exists in the international environment. Indeed, declining exports and slower global economic performance will also affect the K-based industries and therefore will continue to be vulnerable to external development.

- Besides the demand for the right fundamentals that support the K-economy, there will also be an impact on society and the quality of life. There will be certain barriers to entry into the K-economy and these may widen the disparity between the urban and rural population. For example, the need to ensure rural access to IT equipment and services. Otherwise, it would reduce their chance to actively participate in the new economy. Therefore, one major challenge is to ensure that the K-economy will not increase the disparity in income distribution between the various segments of society and between the urban and rural populations.

- The final challenge is to change the perception or mindset of the population and the investors towards the knowledge-driven economy. The experience of other countries reveals that people do not fully appreciate the potential economic impact of the transition to a knowledge-driven economy. People do not have the perception that "knowledge work" will hold promise for the economy in the future and thus will continue to place undue importance on the traditional tangible sectors.

Setting the Enabling Environment

Lessons learnt from the national K-economy strategies of other countries point to the need to put in place several key ingredients for setting the right environment for a K-economy. These include establishment of efficient and low cost universal telecommunications network, improved productivity and industrial and commercial competitiveness, support for the information services sectors, focus on investments in education and training, life long learning and upgrading of skills, better-informed populace and support for an innovation culture. Malaysia already has in place the enabling environment for the transition including the ICT policies as part of the broader modernisation programme, and the setting up of the Multimedia Super Corridor infrastructure. There are other important enablers for the successful transition to a K-economy. These include the following:

- In the dynamic and agile knowledge-driven economy, new polices will replace old protectionist policies that protect industries against the tide of globalisation and liberalisation. The trend has been to shift towards market-driven, self-regulatory mechanisms that promote competition, stimulate enterprise and create a culture of creative partnerships.

- Strengthening capabilities in all aspects in the economy:

  – Increase the supply of workers with creativity and higher order cognitive skills through provision of incentives for ensuring a brain gain and for establishing responsive educational and training institutes that cater for continuous work-related training and more knowledge-based courses, particularly IT and multimedia.

  – Nurture a pool of entrepreneurs with the vision to turn ideas and exploit knowledge into winning products and processes.

  – Support for R&D and encourage innovative collaboration, technology dissemination and modernisation of infrastructure to support all forms of research. Science and technology policies that emphasise on the need for innovation and dissemination of technology to a wide range of sectors.

  – To maximise the benefit of a shift from the P-economy to a K-economy, focus R&D on resource-based industries where Malaysia can raise value added capacity.

  – Nurture learning communities and a rich learning society whereby people share and disseminate knowledge.

- Modernise the market framework to facilitate the growth of the K-economy. To this end, priority needs to be accorded to the development of a first-rate National Media System which will include the internet and other IT innovations, as these provide the platform of e-commerce and the central economic strategy for the development of the K-economy.

- Availability of new sources of business funding (such as venture capital and high net worth individuals) for knowledge-based firms to fill the gaps in the early stage of investment funding. Effective strategies will also be needed to unlock the bottlenecks for growth of SMEs through enhancing access to finance, technology capability and innovation, while promoting networking and alliances and diffusion of best practices.

Changing Role of Government

The Government has the role of both a promoter and a regulator to lead and facilitate the development of a K-economy. In this new environment, the Government will also need to manage the risks arising from market deregulation and liberalisation that may be required to promote the K-economy. While moving forward towards a K-economy driven growth, it is necessary to manage the consequent risks that may cause instability in the system and markets. Policies will therefore be clearly articulated to provide the right signals to businesses on the direction that the economy is heading and the strategies to get there. As a manager of emerging risks, the Government will deal with any market failures in a trans parent manner to provide a conducive macroeconomic and financial environment to ensure business confidence.

Conclusion

There are both opportunities and challenges that policy makers will face in the transition towards a knowledge-based economy. Knowledge and ideas in the K-economy are infinite economic goods that can generate increasing returns. Indeed, throughout the world, the national focus has shifted to the intangibles of knowledge as an engine of economic growth. We are in uncharted territories and will have much to learn from the experience of other successful K-economies. However, all changes need to be carefully managed. In the transition to a K-economy, the proven contributions from the traditional economic system should also be managed accordingly. Indeed, the two systems should be managed as complements to economic development and prosperity.

prevailing environment of excess capacity in the economy, firms would have passed on the full impact of this appreciation of the ringgit to consumers in order to maintain market share. To a large extent, low inflation in Malaysia's trading partner countries and lower prices for most agricultural commodities further helped ease increases in domestic prices. On a regional basis, the CPI for Peninsular Malaysia, Sabah and Sarawak rose at an annual rate of 2.9%, 2.4% and 1.6% respectively in 1999. During the first two months of 2000, the annual rate of increase in the CPI moderated further to 1.6%.

In early 1999, CPI was at a monthly annual high of 5.2% in January, but moderated progressively to a low of 2.1% in June 1999. Thereafter, it picked up marginally before stabilising again at 2.1% in September and October and reached the year's monthly annual low of 1.6% in November. The CPI rose by 2.5% in December mainly on account of cyclical supply constraints, resulting from adverse weather conditions as well as an increase in demand due to several festivities during the month.

Reflecting cyclical supply shortages, particularly of essential food items, prices of non-durable goods advanced more rapidly at an annual rate of 4.2%, while prices for services rose more moderately at 2.3%. Higher prices for services reflected increased costs of medical and health care; recreation, entertainment, education and cultural services; and miscellaneous services. On the other hand, as a reflection of weak global prices and relatively lower consumer demand, prices of semi-durable and durable goods declined by 0.9% and 0.5% respectively, as consumers had deferred or reduced consumption of these goods or looked towards cheaper substitutes.

In comparing the different components of the overall CPI, the rise in the three sub-indices, that is, beverages and tobacco; food; and medical care and health expenses exceeded the 2.8% annual increase in the overall CPI in 1999. The index for beverages and tobacco rose by 7.9% on account of higher import and excise duties imposed on cigarettes, tobacco products and alcoholic beverages in the 1999 Budget. However, the group's low weight of 3.6% in the overall CPI basket meant that this group contributed only 0.27 percentage points to the rate of inflation in 1999. On the other hand, the food group accounted for 1.78 percentage points of the year's overall inflation rate due to its largest weight of 34.9% in the CPI basket as well as the high increase of 4.6% in food prices in 1999. The higher prices observed for food consumed at home (4.8%) and food away from home (4.3%) reflected mainly shortages in supplies. These shortages led to stronger increases in prices of most domestic as well as imported essential food items, except sugar and oil and fats, while the price of meat declined. The price increase was most pronounced for fish, at 10.8%.

The medical care and health expenses index increased by 3.1%, but the group's weight in the CPI basket is small (1.9%). More moderate price increases, ranging between 2.6% and 0.5% were recorded for the remaining groups, while prices of clothing and footwear declined by 2%. Prices of gross rent, fuel and power; and transport and communication; the other two sub-groups in the CPI basket with large weights (21.1% and 17.9% respectively), increased by 1.6% and 0.5% respectively. Within the transport and communication category, the increase was on account of increases in prices of transport while charges for all items under the communication category remained stable. The increase in transport charges arose from increases in toll rates effective March 1999, bus and taxi fares and other transportation charges. The impact of these increases were mitigated to some extent by stable prices for railway, ship and airline fares.

The **Producer Price Index** (PPI, 1989=100), which measures prices of both intermediate and final goods charged by domestic producers and paid by importers in the country, declined by 3.3% in 1999, compared with an increase of 10.7% in 1998. The decline was on account of lower import prices (–0.6%) as well as lower local production costs (–3.9%). In 1999, producers paid lower prices for most imported commodities, which more than offset the higher prices paid by producers to import beverages and tobacco; chemicals and related products and other miscellaneous manufactured items. In the case of local production, costs declined for most items, particularly animal and vegetable oils and fats, which more than offset higher costs for mineral fuels, lubricants and related materials; beverages and tobacco; chemicals and related products and other miscellaneous manufactured articles. On a monthly basis, the decline in the PPI was evident in all months of the year except in December, when it rose marginally by 1.9%. Significantly higher increases in prices of mineral fuels, lubricants and related materials, a trend observed since July 1999 due mainly to increases in world oil prices, could no longer offset the lower declines in the prices of animal and vegetable oils,

Table 1.26
Inflation Indicators

	Weights	1997	1998	1999
		Annual change (%)		
Consumer Price Index (1994=100)	**100.0**	**2.7**	**5.3**	**2.8**
Of which:				
Food	34.9	4.1	8.9	4.6
Beverages and tobacco	3.6	1.3	4.3	7.9
Clothing and footwear	3.6	–0.5	0.4	–2.0
Gross rent, fuel and power	21.1	3.2	4.4	1.6
Furniture, furnishings and household equipment and operation	5.6	0.1	3.9	1.3
Medical care and health expenses	1.9	3.6	6.2	3.1
Transport and communication	17.9	0.6	–0.1	0.5
Recreation, entertainment, education and cultural services	5.8	0.4	3.3	2.6
Miscellaneous goods and services	5.6	4.6	7.1	1.5
Consumer Price Index (1989=100) by Region				
Peninsular Malaysia	100.0	2.8	5.5	2.9
Sabah	100.0	2.0	4.3	2.4
Sarawak	100.0	1.7	4.2	1.6
Producer Price Index (1989=100)	100.0	2.7	10.7	–3.3
Of which:				
Local Production	79.3	2.5	11.2	–3.9
Imports	20.7	2.8	9.2	–0.6
House Price Index (1990=100)		1.9	–9.4	–12.0[1]
By region:				
Klang Valley		4.4	–14.5	–10.2
Johor Bahru		0.1	–25.3	–8.7
Penang Island		4.3	–12.9	–8.2

[1] January - June.
Source: Department of Statistics
Valuation and Property Services Department

such as palm oil. If prices of animal and vegetable oils and fats are excluded, the adjusted PPI would show an increase of 2.1% in 1999.

As inflationary pressures arose mainly from supply constraints in the food sector, the Government continued with measures to encourage local food production in addition to diversifying sources of imports for food. In the 2000 Budget, the Government announced that paddy production would be increased through productivity gains derived from a more efficient use of agriculture resources. The Government also undertook to provide new land for agricultural activities, especially for vegetable and fruit cultivation and to encourage greater consumption of local produce. As a short-term measure to increase the supply of food and also to contain the price of food, import duties on 43 categories of food products were abolished, while import duties on another 136 categories of food products were rationalised in the 2000 Budget. Meanwhile, the Ministry of Domestic Trade and Consumer Affairs, using the provisions under the Price Control Act 1946 and Control of Supplies Act 1961, continued with various on-going programmes to ensure adequate supplies of essential goods. Contrary to general perceptions, these programmes were not designed to control prices, but to curb unjustified excessive increases in prices. Of significance is the programme where the Ministry monitors 233 essential items by surveying their prices at 34 centres on a weekly basis. Through this programme, the Ministry is able to anticipate problems and take pre-emptive action.

Asset prices showed mixed trends in 1999. Overall, property prices continued to decline, while share prices increased. The **Malaysian House Price Index** (MPHI) indicated a further decline of 12% in the first half of

1999, after declining by 9.4% in 1998. As part of efforts to clear the existing backlog of properties so as to stimulate new economic activities, various measures were taken both to prevent new supply adding onto the backlog as well as to encourage demand for the existing stock of properties. In this context, effective 6 January 1999, banking institutions were not allowed to finance the development of new residential properties and shop houses where the individual units cost more than RM250,000 each. The guideline, however, did not affect financing for projects already commenced and also new applications for financing of existing projects where construction had already started. The guideline also did not affect end financing for the purchase of both residential and non-residential properties, which have been completed and those already under construction. To clear the backlog of houses not sold, a Second Home Ownership Campaign was held from 29 October to 7 December 1999. Sales under this campaign were exempted from stamp duty on the instruments of transfer, while developers and banks provided discounts and lower lending rates respectively. In addition, in the 2000 Budget, the Government also relaxed various terms of the Treasury Housing Loan Scheme for civil servants.

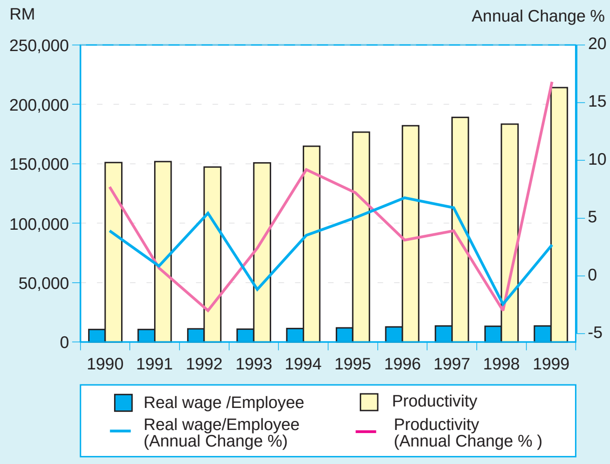
As a result of all these measures, indications are that property prices stabilised in the second half of 1999 but still remained below the pre-crisis levels. In selected choice locations, particularly in the Klang Valley, indications are that property prices increased compared to a year ago. To ensure orderly longer-term planning in the property sector, the Government also established the National Property Information Centre under the Valuation and Property Services Department to set up a database on the property sector. In the stock market, the clear evidence that the economic recovery was gaining momentum led to improved market confidence on the Kuala Lumpur Stock Exchange (KLSE). This was reflected in the strengthened performance of the KLSE, where the KLSE Composite Index gained 226.2 points or 38.6% to end the year at 812.3 points. Compared with the lowest level of 262.7 points on 1 September 1998, the gain was even more significant at 549.6 points or an increase of 209.2%.

Labour Market Developments

The labour market situation improved in 1999 underpinned by the recovery in domestic economic activities. The demand for labour picked up during the year, with the latest estimates showing an increase in employment by 1.7% or 144,000 persons to total 8.7 million workers as at end-1999 (1998: –2.5%). At the same time, the labour force increased at a slower rate of 1.5% to 9 million persons. Consequently, the unemployment rate declined further from 3.2% in 1998 to 3% in 1999, well below the full employment rate of 4%. Although job vacancies were almost three times the number of workers retrenched, wage pressures remained subdued. Overall, labour productivity improved due to rationalisation of operations undertaken during the downturn of the economy. However, unlike the years of high growth during 1995-97, the improvement in wages did not exceed productivity growth.

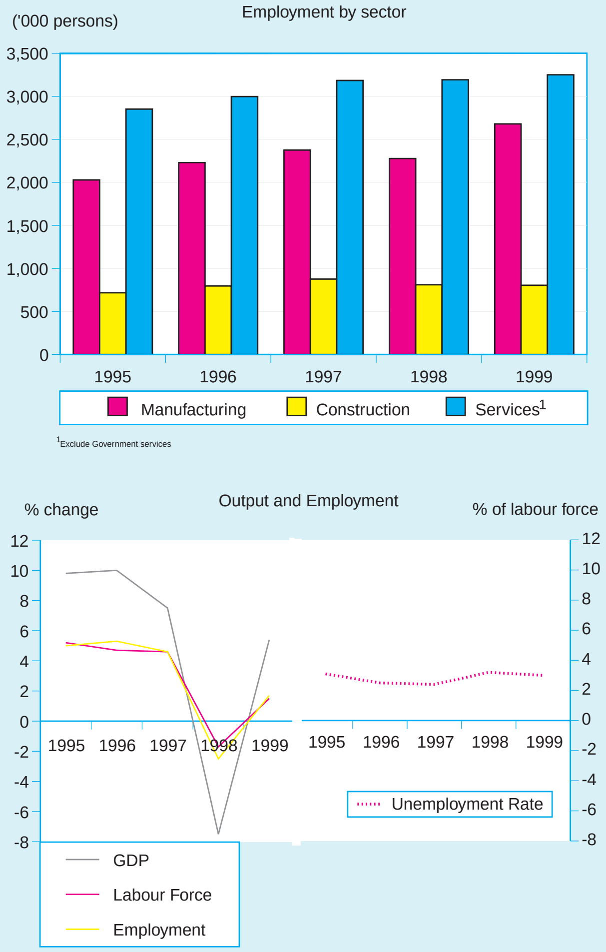
In 1999, the manufacturing sector accounted for the major share of new workers employed (70.8% or 102,000 persons), thus raising its share of total employment to 27.2% from 26.5% in 1998. Within the manufacturing sector, the new jobs created were concentrated mainly in the assembly and labour-intensive industries (such as wood and wood products; electrical machinery; rubber products; and textiles), and to a lesser extent, the crude oil refinery industry. The services sector, which accounted for 47.2% of total employment, recorded a moderate increase in employment by 1.5% or 60,000 workers to 4.1 million persons. The wholesale and retail trade, hotels and restaurants and transport and communication sub-sectors accounted for 21.7% and 11.7% respectively of the increase in employment in the services sector, while the utilities, financial and Government services sub-sectors accounted for about 3% each. More than half of

Graph 1.38
Productivity and Real Wage per Employee in the Manufacturing Sector



Source: Department of Statistics
Bank Negara Malaysia

Graph 1.39
Labour Market Conditions



the increase in total employment in the services sector were provided by the miscellaneous or other services sub-sector. While employment in the finance, insurance and commerce sub-sector remained stable at 420,000 persons, employment in the banking sector declined (–4.5% to 92,360 persons) due partly to the ongoing consolidation exercise, particularly the merger of finance companies. This decline was offset by the increase in employment in business services. Meanwhile, employment in the agriculture and construction sectors continued to decline, albeit at a slower rate of 0.9% and 0.7% respectively (–4.6% and –16.8% respectively in 1998).

With the recovery in both export and domestic activities, demand for labour as reflected by the number of job vacancies reported to the Manpower Department increased during the year. The total number of job vacancies reported throughout the country increased by 45.2% to 108,318 vacancies in 1999 compared with 74,610 in 1998. The number of vacancies could have been higher as it is not compulsory for firms to report job vacancies to the Manpower Department. Job vacancies in the manufacturing sector increased further by 26.9%, accounting for 61.1% of the total number of job vacancies reported in 1999. Of significance, the job vacancies reported in the agriculture sector rose markedly from 5,231 vacancies in 1998 to 24,263 vacancies in 1999, reflecting partly the expansion in agriculture sector activities particularly in Sarawak. However, the number of job vacancies in the services sector declined. This decline prevailed in all the sub-sectors except the finance, insurance, real estate business services and transport, storage and communication sub-sectors. Hence, the services sector's share of total job vacancies declined to 13.6% in 1999 (1998: 20%).

Table 1.27
Job Vacancies and Retrenchment in 1999

	Job Vacancies[1]		Retrenchment	
		Number	% Share	Number
% Share Total	108,318	100.0	37,357	100.0
Agriculture, forestry and fishing	24,263	22.4	3,816	10.2
Mining and quarrying	91	0.1	473	1.3
Manufacturing	66,174	61.1	20,485	54.8
Construction	3,036	2.8	2,869	7.7
Services	14,754	13.6	9,714	26.0
Wholesale and retail trade, hotel and restaurant	*4,864*	*4.5*	*4,320*	*11.6*
Finance, insurance, real estate and business services	*3,595*	*3.3*	*2,789*	*7.5*
Transport, storage and communication	*1,666*	*1.5*	*690*	*1.8*
Electricity, gas and water	*42*	*0.1*	*99*	*0.3*
Social and private services	*–*	*–*	*1,776*	*4.7*
Other services	4,587	4.2	40	0.1

[1] The number of job vacancies could have been under-reported as it is not compulsory for firms to report vacancies to the Manpower Department.

Source: The Ministry of Human Resources
Manpower Department

As selected firms within the agriculture, construction and manufacturing sectors continued to face labour constraints, the Government approved the intake of another 84,150 foreign workers in 1999 to ensure that business expansion is not affected by labour shortages. Nevertheless, Malaysia's dependence on foreign labour was reduced as the number of registered foreign workers continued to decline to 697,219 workers, from 781,548 workers in 1998 (peak of 1.2 million workers in 1997). The number of foreign workers employed in the agriculture sector remained high, increasing by 33.6% to account for 37% of the total foreign workforce (excluding domestic services). In the other major sectors of the economy, the number of foreign workers declined. In terms of origin, 92% of the total foreign workforce were from Indonesia and Bangladesh.

With improving economic and financial conditions, the number of workers retrenched declined during the year. The number of workers retrenched in 1999 declined significantly by 55.5% to 37,357 workers from 83,865 workers in 1998. To some extent, retrenchments were lower because employers were able to implement flexible labour market practices including part-time, flexi-time and pay cuts before resorting to retrenchment. In 1999, about 400 employers implemented pay cuts involving 15,017 workers (August-December 1998: 795 employers involving 22,514 workers). Lower retrenchments were recorded across the board among the major sectors of the economy. In the manufacturing sector, the majority of the workers retrenched were mainly from the fabricated metal, machinery and equipment, chemicals and petroleum products industries, while the wholesale and retail trade, hotel and restaurant sub-sector accounted for the largest share of workers retrenched in the services sector. The main reasons cited for retrenchment were the decline in demand (45%; 1998: 52.2%), closure of company (11%; 1998: 6.4%) and restructuring of companies (12.9%; 1998: 8.1%).

In an environment of excess capacity, wage pressures remained subdued in 1999 despite the pick-up in economic activity. While signs of upward adjustments were observed in the second half-year in the manufacturing sector, real wages rose only moderately for 1999 as a whole:

- The findings of the survey conducted by the Malaysian Employers Federation (MEF) showed that private sector salary increases had slowed down further to 5.9% in 1999, from 6.2% in 1998 and 8.9% in 1997.

- Information collected by the Ministry of Human Resources showed that about 1,195 employers implemented pay cuts involving 37,531 workers in the period August 1998 to end-December 1999.

- The weighted average wage of the three-year collective wage agreements, covering 133,000 workers in the private sector or about 2% of the total workforce in the country, declined by 8.8% in 1999 (1998: +9.6% and 1997: +8.9%). In particular, wages declined significantly by 19.5% in the agriculture sector and 8.5% in the mining sector. The decline was less pronounced in the manufacturing and electricity sectors (–1.1% and –0.8% respectively). The commerce and transport sectors were the only sectors in which wages increased, albeit moderately.

- While most of the indicators on wages pointed to a downward trend in wages, the findings of the Monthly Survey of Manufacturing Industry conducted by DOS showed that wage per employee picked up in the second half-year to increase by 7.5% from a more moderate increase of 3.3% in the first half of 1999 (first half and second half of 1998: 4.8% and 0.7% respectively). Consequently, for the year as a whole, wage per employee increased by 5.5% in 1999, compared with 2.7% in 1998. In real terms, average wages increased by 2.7% in 1999 (1998: –2.4%) compared to the 3.7% increase in labour productivity for the country as a whole.

The number of strikes declined to 11 in 1999 (1998: 12). However, the number of workers involved in strikes doubled to 3,452 workers in 1999 (1998: 1,778 workers), thus raising the number of man-days lost due to industrial actions to 10,555, from 2,685 in 1998. The main causes of strikes were attributable to disputes over terms and conditions of employment (six cases); dismissal, retrenchment and layoffs of workers (one case); and disputes over other issues (four cases). The strikes occurred only in the agriculture and manufacturing sectors. In the agriculture sector, five cases of strikes involving 1,283 workers were recorded, compared with three cases involving only 435 workers in 1998. A higher number of strikes was also recorded in the manufacturing sector with six cases involving 2,169 workers against four cases involving 482 workers a year ago. The 11 strikes that occurred in 1999 were settled mainly through Government intervention and conciliation efforts.

In 1999, the number of workers involved in disputes reported to the Industrial Relations Department declined to 90,278 (1998: 93,530 workers) although the number of industrial disputes increased to 496 cases from 442 cases in 1998. The bulk of the disputes centred on issues relating to terms and conditions of employment (242 cases) and deadlock in the process of collective bargaining (138 cases). On a sectoral basis, the increase in the number of disputes was mainly in the services sector (200 cases), followed by agriculture (73 cases), mining (12 cases) and construction (five cases). The number of industrial disputes in the manufacturing sector declined to 206 cases involving 46,414 workers from 216 cases involving 49,146 workers in 1998.

The supply and demand situation in the labour market over the last two years clearly demonstrate the importance of enhancing the level of productivity. This in turn is influenced by the availability of an adequate supply of workers with appropriate skills and who are willing to move to areas of employment opportunities. Recognising this, the Government introduced several measures during the year, to address the issues of enhancing labour mobility and training. The Ministry of Human Resources had organised labour mobility programmes to increase labour mobility from surplus to deficit areas. In relation to this, work has begun on the implementation of the Electronic Labour Exchange to effectively mobilise workforce and integrate labour market information. The project is expected to be completed by end-2000.

In addition to enhancing labour mobility, the Government also took the lead to promote the use of productivity-linked wages and to encourage training activities through budget allocations as well as through the use of fiscal incentives. The Government launched the implementation of the guidelines on productivity-linked wage system, approved by the National Labour Advisory Council on 1 August 1996. A series of seminars were organised to disseminate information to employers and unions on the implementation of the guidelines. In addition, several fiscal incentives were provided in the 2000 Budget to promote human resource development to enhance productivity of the labour force:

- An allocation of RM14.1 billion was provided to finance education programmes and to develop quality infrastructure for education. With this allocation, the intake of students into local universities is expected to increase to 99,482 students in 2000.

- The Government has also allocated RM1.2 billion to build and equip facilities in existing training institutions.

- Private institutions of higher learning were required to contribute to the Human Resources Development Fund (HRDF). The main aim is to upgrade the quality of the teaching staff. Private institutions of higher learning are given a 95% reimbursement for staff training in the field of medicine, engineering and computer science.

In 1999, the Government continued to emphasise on industrial training to meet the increasing demand for skilled manpower. In this regard, the new intake of trainees in the existing nine Industrial Training Institutes increased further by 22.5% to 3,479 trainees (1998: 2,839 trainees), while the Centre for Instructors and Advance Skill Training (CIAST) provided training for 1,796 new instructors. In addition, the three existing bilateral training centres, namely, the German Malaysian Institute (GMI), Malaysian French Institute (MFI) and British Malaysian Institute (BMI) recruited 1,134 trainees in 1999.

In 1999, a total of 247,785 training places were approved with financial assistance of RM106 million for retraining and skills upgrading of the workers for companies registered with the Human Resources Development Council (HRDC), which administers the HRDF. The HRDF was set up under the Human Resources Development Act 1992, to ensure companies train and retrain and upgrade the skill of their workers through a compulsory contribution of 1% of the monthly wage bills to the Fund. Meanwhile, the Government provided a matching grant of RM2 for each RM1 contributed by small- and medium-scale employers with a workforce of between 10 and 49 people and a paid-up capital of less than RM2.5 million.

Since its inception in 1993, the HRDC has approved a total of 2.3 million training places with total financial assistance of RM706 million. With the onset of the economic crisis, the Government allocated RM5 million for implementing the Training Scheme for Retrenched Workers in May 1998 to retrain retrenched workers. In 1999, 426 participants benefited from this scheme with financial assistance of RM2 million. As at December 1999, 988 participants had benefited from this scheme with financial assistance of RM4.5 million.

During the crisis period, employers facing financial problems were given exemption from contributing to the HRDF. This exemption was extended for the third time, for a period of six months beginning from 11 February to 12 August 1999. The final exemption for the six-month period beginning 12 August 1999 to 11 February 2000 was only extended to the hotel industry and in-bound travel agency sector. The HRDF collection from the levy was higher, amounting to RM83.7 million in 1999 (RM61 million in 1998) despite the exemption given to companies affected by the economic crisis. As at end-December 1999, the number of employers registered with the HRDF rose to 6,352 employers, of which 78% were from the manufacturing sector, while another 22% were from the services sector.

In addition to the existing schemes, the HRDC also plans to introduce four Apprenticeship Schemes in 2000 including apprenticeship schemes for multimodal transport operators, plastic injection moulding, tool and die machining and the wood-based (furniture) industry. As part of an effort to provide quality services, the HRDC will launch the Human Resource Development Network (HRNet) to allow consumers and, in particular, employers registered with the HRDF, to gain direct access to latest information via the internet.