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Managing the Malaysian Economy in 1996

An Overview

When the 1996 Budget was formulated in October 1995, it was the eighth consecutive year of strong growth for the economy. While this prolonged period of rapid growth has increased the level of income and standard of living of Malaysians, it was also accompanied by greater price pressures arising from supply constraints and excess demand, tightening of the labour market as the economy reached the level of full employment as well as a widening deficit in the nation's external current payments position. The main challenge to macroeconomic management, therefore, was to ensure a more sustainable growth for the economy with greater price stability and external balance, particularly in the medium and long-term. Thus, the thrust of the 1996 Budget focussed on the objectives of sustaining growth with low inflation and enhancing the capabilities of the services sector with the view to strengthening the balance of payments position as well as to act as a catalyst of growth. In addition, the Budget also focussed on the need to upgrade the development of the nation's human resources and technological capabilities in order to address the problems associated with labour and skills shortages as well as to propel Malaysia into the forefront of technological development. At the same time, the Budget continued to emphasize on the nation's social agenda to address the issues associated with social development.

A major focus of policy adjustments and initiatives continued to be on the nation's balance of payments position which had been recording a widening deficit in the current account since 1992. The growing deficit has been brought about by a narrowing of the surplus in the merchandise account and, at the same time, a widening of the deficit in the services account. The narrowing of

the merchandise account surplus was attributed to an acceleration in imports, particularly capital goods driven by rapid rates of capacity expansion as well as that of new investment, and intermediate goods due to the continued high import content of domestic economic activities. Imports of intermediate goods was 58% of Gross Domestic Product (GDP) in nominal terms, while imported capital goods accounted for 41% of the nation's gross capital formation in 1995. These imports, although for productive purposes, remained high, accounting for 88% of the nation's retained imports. Apart from the merchandise account, addressing the growing services deficit has also been a focus of macroeconomic policies as it does, to a large extent, reflect the continued structural weaknesses of the services sector. The services sector lacks the capacity to adequately meet the expanding needs of the economy and substitute imported services as well as compete in the international services market. While growth in the sector has been strong, its share and contribution to output growth have almost stagnated and its net contribution to the balance of payments remains negative. In the light of this, the nation's external payments position has been closely monitored and appropriate policy measures continued to be put in place with the view to ensuring greater stability in the external account. In essence, these measures focussed on an investment strategy to promote exports and reduce imports, enhance industrial inter-linkages and the entire value chain of the production process as well as strengthen the contribution of the services sector to the nation's output growth and net external earnings.

Reflecting the deficit in the current account of the balance of payments is the widening in the nation's savings-investment gap. Traditionally, national savings together with the inflow of foreign direct investment have generally been more than

sufficient to finance total investment, including foreign and reverse investment, particularly in the last ten years. However, in 1991 and since 1994, gross investment, including reverse investment, exceeded the total amount of national savings and inflows of foreign direct capital. As a result, the basic account of the balance of payments recorded a small deficit which had to be financed through a drawdown of external reserves. While Malaysia has always had a high savings rate by international standards, at 36.5% of Gross National Product (GNP) in 1995, the existence of a widening resource gap necessitates greater efforts at promoting and mobilizing savings. This is to ensure that the nation will not have to depend on external resources to finance domestic investment. Increased recourse to external financing will affect the nation's external balance through higher investment income payments as well as larger debt servicing obligations.

Policy efforts at containing price pressures continued to be accorded priority in the macroeconomic agenda. While the inflation rate remains at below 4% in 1996, potential price pressures still exist, particularly in an environment of strong demand growth that is driven by excess liquidity and strong income and credit growth; supply constraints, particularly with regard to labour and food; as well as market imperfections, particularly in the distribution system. A multitude of policy measures have been implemented to arrest increasing demand pressures on the economy. Monetary policy was further tightened to rein in excess liquidity as well as discourage excessive credit for the purchase of assets and consumption, while fiscal restraints and consolidation continued to be vigorously pursued. In addition, measures to contain asset inflation due to speculation and discourage foreign purchases of real estate were implemented while import duties, particularly on essential items, were either reduced or abolished. At the same time, administrative measures continued to be directed at improving efficiency in the distributive network and curbing unethical trading practices.

Labour shortages, particularly skilled workers, continue to confront the nation's development. The concern with tight labour market has been the upward pressure on wages which could lead to higher unit labour cost and in turn, affect the international competitiveness of Malaysian products, if productivity increases continue to lag

behind wage increases. The presence of unskilled foreign labour in the economy is already large. Malaysian industries, therefore, cannot continue to rely on labour-intensive and inefficient production processes. Instead, these industries must undertake a strategic shift towards a more efficient technology-intensive production process that is labour-saving, and, at the same time, increase the entire value chain of their production process, from manufacturing to Research and Development (R&D), design, distribution and marketing activities. To accelerate this shift, the workforce must be trained and have the technical capabilities to assimilate, adapt and innovate new production processes and technologies. In this context, efforts in human resource development were intensified in the 1996 Budget, with greater emphasis on technical education and training as well as the development of R&D capabilities. At the same time, measures to further broaden the nation's science and technology base, including information technology were also initiated. The employment of unskilled foreign workers was also discouraged through the imposition of a higher levy to encourage the industry to shift towards productivity-driven and capital-intensive production processes.

In essence, the thrust of economic management in 1996 was fostering a sustainable level of growth with low inflation while improving the nation's resource position by strengthening the structure of the economy, particularly the capabilities of the services sector in terms of exporting services and substituting imported services as well as a catalyst of economic growth. To ensure that the economic development is accompanied by social progress and greater social justice, social development continues to receive greater policy attention in 1996.

Maintaining Sustainable Level of Growth with Low Inflation

A major challenge in economic management in 1996 is to steer the Malaysian economy towards a more sustainable growth path, particularly in the medium and long-term, and ensure greater price stability in the domestic economy and improvements in the nation's external position. The policy focus on sustaining the pace of economic growth places importance on productivity and quality-driven growth, in line with the objective

of the Seventh Malaysia Plan, 1996-2000. Traditionally, the nation's economic expansion has been largely driven by large increases in investment, as reflected by the high investment to GNP ratio of 45.5% in 1995. Apart from this, investment as well as output were also characterised by high import content which had adversely affected the merchandise balance. In the light of this, the nation's investment strategy has shifted towards promoting more capital and technology-intensive industries, reducing import content of investment as well as enhancing inter-industry linkages.

Strengthening the Balance of Payments Position

A major task confronting the management of the Malaysian economy in 1996 is strengthening the balance of payments position, in view of the significant widening of the deficit in the current account since 1992. The deterioration has been attributable to rapid growth of imports of capital and intermediate goods, which was driven by strong growth in investment and manufactured exports, as well as the persistent deficit in the services account of the balance of payments. To strengthen the balance of payments position, measures were taken to reduce the pace of import growth and strengthen the capabilities of the services sector to export services and substitute imported services. In this context, the expansion of public sector investment has been reduced to 2.4% per annum during the Seventh Malaysia Plan period from 17.0% per annum in nominal terms during the Sixth Malaysia Plan period, with the view to reducing the pace of imports of capital goods associated with capital formation. The bulk of the projects approved under the Seventh Malaysia Plan are on-going projects. To minimise the impact of on-going big projects on the balance of payments, the Government has continued to ensure that the components used in these projects are not only sourced but produced locally. For example, the aerobridge and the baggage-handling equipment at the Kuala Lumpur International Airport, Sepang are being manufactured locally. As an added effort to reduce imports of construction related capital goods such as bulldozers, excavators, pile-drivers and tower cranes, reconditioning of heavy machineries and equipment has been listed as

one of the promoted activities under the Promotion of Investment Act, 1986 in the 1996 Budget. Companies undertaking such activities are eligible for Pioneer Status or Investment Tax Credit. This fiscal incentive is to promote the development of the domestic machinery and engineering industries, particularly in reconditioning abandoned and unused machineries and equipment.

Lack of inter-industrial linkages has also been a major cause for the acceleration in the import of intermediate and capital goods associated with strong growth in manufacturing output and investment. In 1995, the ratio of the value of imports of intermediate goods to GDP in nominal terms was 58%, indicating the overdependence of domestic economic activities on imported intermediate goods. To reduce imports of intermediate goods, the development of the small and medium-scale industries (SMIs) is being accelerated to enable them to become reliable and cost-effective suppliers of parts and components and related services to the larger industries, including the multinational companies. In this context, the Small and Medium Industries Development Corporation (SMIDEC) was established in May 1996 and an Industrial Linkage Programme has been drawn up to encourage greater integration and linkages between SMIs and large industries, including multinational companies. The number of SMIs that is involved in the Vendor Development Programme, which is aimed at enhancing industrial linkage, has increased to 90 in July 1996. To encourage the growth of SMIs, nine Industrial Parks costing RM55 million are being built, with majority of these parks nearing completion. Soft loans for the modernisation of factories, automation, quality improvement as well as financing of projects are also made available. To facilitate SMIs in securing funding for its product and quality improvement and making in-roads into the export market, the Industrial Technical Assistance Fund continues to provide assistance in the form of matching grant under the Consultancy Service Scheme, Product Development and Design Scheme, Quality and Productivity Improvement Scheme as well as Market Development Scheme. During the first half of 1996, a sum of RM3.6 million was approved bringing the total since 1990 to RM30.2 million.

With respect to the services sector, it continues to be a drag on the services account of the balance of payments. While Malaysia has built a strong trade-oriented production base for goods, its services sector remains weak in its capability to export services as well as to substitute imported services, reflecting the lack of dynamism of the sector. Its share to real GDP has somewhat stagnated at slightly over 40% since the last 15 years. In terms of growth, the sector has expanded at almost the same rate as the overall expansion in GDP, indicating its overdependence on the primary and secondary sectors of the economy. Coupled with the increasing net payments on investment income as a result of a growing foreign investment, the nation is confronted with the persistent deficit in services account which is expected to double from RM9.7 billion in 1990 to RM19.4 billion in 1996. Given the potential of the services sector to provide added stimulus to growth as well as a source of foreign exchange earnings, measures are in place to strengthen the capabilities of the services sector as a catalyst for growth as well as a potential source of export growth that will be able to compete not only in the domestic market but also in the international market. This will not only strengthen the nation's external current payments position but also prepare the services sector for the eventual liberalisation of the sector to global players in line with Malaysia's commitments under the General Agreement on Trade in Services (GATS).

One of the measures introduced to promote the services sector is the provision of tax incentives under the Income Tax Act, 1967 for approved services projects in the communications, public utilities and the transportation sub-sector. These incentives are:

- (i) income tax exemption of between 70% to 100% on statutory income for a period of between five to ten years;
- (ii) investment allowance of between 60% to 100% on qualifying capital expenditure for a period of five years. This allowance is allowed as a deduction of between 70% to 100% of statutory income; and
- (iii) industrial building allowance for the construction of buildings under approved projects.

A major contributor to the rising deficit in the services account is the net payments of freight and insurance which has increased from RM3.8

billion in 1990 to RM9.0 billion in 1995. The increasing net payments on freight and insurance reflects the fast pace of expansion of Malaysia's external trade as well as the relatively limited capacity of the nation's shipping and insurance services industry in relation to Malaysia's ranking as the 17th largest importer and 19th largest exporter in the world. Numerous measures, including the provision of tax and financing incentives, have been instituted to increase Malaysia's shipping fleet, improve shipping and port services as well as expand cargo reinsurance services. As a result, the Malaysian shipping fleet has expanded from 2.7 million dwt in 1994 to 3.9 million dwt in 1995. The improvement was brought about by the acquisition of new vessels, especially by Malaysian International Shipping Corporation Bhd. and the newly established Global Maritime Ventures Bhd. The Shipping Fund initiated by the Government has helped to finance the purchase of 34 vessels, with approved loans amounting to RM398 million as at the end July of 1996. To increase the utilisation of Malaysian vessels, the Government introduced stringent conditions on the Non-Financial Public Enterprises (NFPEs) requiring them to import on a f.o.b. and export on c.i.f. basis. To encourage the use of Port Klang as a transshipment centre, Port Klang's West Port has been made a free commercial zone in 1996, in addition to the Port Klang's North Port which was declared as a free commercial zone since April 1993. As an additional measure to increase the utilisation of domestic ports, the levy on each goods vehicle leaving the country has been increased from RM100 to RM200 in the 1996 Budget. Vehicles transporting perishable goods, however, are given exemption from this measure. For laden vehicles entering Malaysia, a levy of RM100 per vehicle has also been imposed.

To reduce the payment of insurance premiums abroad due to reinsurance, additional efforts have been made in the 1996 Budget to increase the retention capacity of the domestic insurance industry. These efforts included the establishment of Malaysian-Re International Insurance (Labuan) Limited which commenced operation in February 1996 in Labuan Offshore Financial Centre with an authorised capital of US\$200 million to undertake large and specialised insurance in this region. In addition, the Government has approved the establishment of another three foreign reinsurance companies in 1996, bringing the total to six as at end September 1996.

The travel services sub-sector, mainly tourism, has contributed significantly to improving the services account. This sub-sector has been generating net earnings for the nation since 1990, as a result of the vigorous efforts to promote Malaysia as a tourist destination. In 1995, the travel services sub-sector generated a gross receipt of RM9.9 billion and a net receipts of RM4.1 billion, compared with RM4.6 billion and RM0.6 billion, respectively in 1990. To further promote the inflow of foreign tourists as well as domestic tourism, the Malaysian Tourism Promotion Board has undertaken the development of facilities including new resorts and medium-priced accommodation and the diversification of tourism products. Emphasis was also given to the establishment of cultural infrastructure and fine art centres. To promote the fine arts, admissions to stage plays organised by local theatre groups in the Federal Territories of Kuala Lumpur and Labuan have been exempted from entertainment duty in the 1996 Budget. The state governments have been urged to extend the same exemption. In addition, a Fund totalling RM50 million was also set up to finance training as well as the purchase of equipment for the broadcasting and film industry. To promote domestic tourism, the airport tax for international travel has been raised from RM20 to RM40, effective January 1, 1996.

The payments for overseas education have increased from RM1.6 billion in 1990 to RM2.0 billion in 1995. To reduce the outflow of foreign exchange due to Malaysians studying abroad as well as enable the nation to earn foreign exchange from education services, efforts are being vigorously pursued to develop Malaysia into a regional centre of excellence in education. In this context, changes have been made to the legal framework affecting education during 1996, which saw the passing of the Education Act 1996, Private Higher Education Institution Act, 1996, the National Higher Education Council Act, 1996, the National Accreditation Board Act, 1996 and amendments to the University and University Colleges Act, 1971. In line with the objective of making Malaysia as a regional educational centre as well as a focal point in the field of technology, an Industrial Building Allowance of 10% per annum was provided in the 1996 Budget for expenditure on buildings and hostels used for education, including technical and vocational training.

The infrastructure for the financial services sector will be further developed to enhance its efficiency to facilitate the growth process as well increase its competitiveness. To strengthen the competitiveness of financial institutions, the two-tier regulatory system, which was introduced for the commercial banks in December 1994, was extended to finance companies and merchant banks in January 1996. Tier-1 finance companies and merchant banks are allowed to undertake a wider range of activities. The two-tier regulatory system is envisaged to strengthen the capability of domestic financial institutions to compete as Malaysia further liberalises the financial sector in line with its commitments under the GATS.

In the field of information technology, the Government will develop the multimedia super corridor in the area between Kuala Lumpur and Sepang, including Putrajaya and KLIA, with the view to attracting international multimedia companies with high technology to locate their operations in Malaysia, whilst making Malaysia a regional centre to channel their services in other countries to this region. The development of the multimedia super corridor will be synergistic with other efforts aimed at enhancing the growth of the information industry in Malaysia, such as the construction of Menara Kuala Lumpur and the upgrading of the nation's telecommunications network, including the launching of the Malaysia East Asia Satellite or MEASAT 1 on 13 January 1996.

Promotion and Mobilisation of Savings

To ensure continued growth can be sustained without further recourse to external resources and a drawdown of external reserves, the level of national savings has to be raised and mobilised to finance investment. Although the nation's gross national savings remained high in 1995, estimated at 36.5% of GNP, it was insufficient to finance the level of investment which was equivalent to 45.5% of GNP, resulting in a resource gap of 9.0% of GNP in 1995. While a large portion of the gap was financed by a net inflow of foreign direct investment, the financing of the gap through external borrowing by the corporate sector had remained large, at RM4.4 billion in 1995 resulting in an increase in the debt servicing burden of the nation from 5.0% of exports in 1994 to 6.2% in 1995. Given the large investment requirements

during the Seventh Malaysia Plan period, estimated at RM536 billion, and the need to further reduce the dependence on foreign resources as a source of financing, national savings will have to be promoted. Towards this end, a number of measures were introduced in the 1996 Budget.

One of these measures was increasing the rate of contribution by employees to the Employees Provident Fund (EPF) from 10% to 11%, effective from January 1996. The one percentage point increase was expected to generate an additional RM335 million in 1996. The rate of contribution of the employers, however, remained the same at 12%, as it was increased from 11% in 1993. In addition, to encourage the corporate sector to establish private pension funds for the benefit of their workers, the maximum deduction allowed for income tax purposes for contribution by employers to the EPF and approved schemes was increased from 16% to 17%, effective from the year of assessment 1996. To encourage savings for education and health, the tax relief provided for contributions to approved pension funds and premiums on life insurance (or Takaful) was increased by RM2,000 from the maximum deduction of RM5,000. In addition, tax exemption on interest income received by individuals on savings and fixed deposit accounts with financial institutions was also provided to encourage savings. The accounts eligible for tax exemption were savings accounts of up to RM100,000, fixed deposits of less than 12 months and up to a maximum of RM100,000 and fixed deposits of 12 months or more. This exemption also covers gains on savings and investment accounts under Interest-free Banking Scheme.

A major effort that was initiated in 1996 to promote and mobilise savings was the launching of the Amanah Saham Wawasan 2020 (ASW 2020). The ASW 2020 is a new unit trust of RM3 billion initiated by the Government and aimed at inculcating the saving habit among the younger generation and pooling of resources for financing of economic development. The units were offered for sale to Malaysians of all races, aged between 12 to 29 years, beginning 2 September 1996. Of the total, 51% or RM1.53 billion was set aside for Bumiputeras and 49% or RM1.47 billion was for non-Bumiputeras. An eligible applicant can apply for a minimum of 100 units or a maximum of 50,000 units at RM1 a unit.

The Government has announced, on 15 August 1996, the formation of a Cabinet Committee on the Promotion of Savings, chaired by the Deputy Prime Minister/Minister of Finance. The success in increasing national savings requires the support and involvement of all levels and sectors of society. The target groups in the promotion of savings, therefore, include students, workers and other members of society such as housewives and youths. The terms of reference of the Cabinet Committee on the Promotion of Savings are:

- (i) to formulate strategies and plan of actions for the promotion of savings among the population, corporate sector and the public sector;
- (ii) to coordinate all activities related to the promotion of savings at the national level; and
- (iii) to act as the driving force in the promotion of savings campaign throughout the nation.

In carrying out its tasks, the Cabinet Committee is assisted by four sub-committees with specific responsibilities:

- (i) The Sub-Committee on Finance, which is given the responsibility of undertaking research and developing new financial products and investment schemes as well as improving existing mechanism to effectively mobilise savings;
- (ii) The Sub-Committee on Education, which is given the task to identify effective means and approaches in inculcating and encouraging savings habit among students;
- (iii) The Sub-Committee on Employees, which is given the responsibility to identify and coordinate efforts aimed at garnering active participation of workers in increasing national savings; and
- (iv) The Information Sub-Committee, which is given the responsibility to coordinate the dissemination of information in relation to the promotion of savings through the mass media and to plan the launching of the National Savings Day.

Overall, the initiatives taken since the 1996 Budget are expected to contribute positively to

national savings, which are expected to increase from 36.5% of GNP in 1995 to 38.8% of GNP in 1996. With investment as a percentage of GNP expected to stabilise at 45.1% of GNP in 1996, the nation's resource position is expected to improve, with the savings-investment gap narrowing to 6.3% in 1996 from a deficit of 9.0% in 1995.

Developing the Capital Market

The amount of funds that has to be mobilised for financing private investment during the Seventh Malaysia Plan period is expected to increase to RM385 billion, an increase of 86% from RM207.4 billion during the Sixth Malaysia Plan period. The magnitude of this financing requirement underscores the need to mobilise savings in the most efficient manner and to rechannel these funds effectively for productive use. The demand on the financial system in resource mobilisation and intermediation will, therefore, increase at a rapid pace. Fund users will continue to look beyond the realms of traditional banking and increase their reliance on the capital market to raise funds to meet their financing requirements. Consequently, measures are being undertaken to ensure the ability of the capital market to increasingly attract investment from households and institutions, including domestic and foreign trust funds managers. In this context, market transparency through a policy of continuous disclosure of material information by corporate leaders, companies and substantial shareholders remains important. In addition, product innovations, such as the introduction of financial derivatives and greater use of private debt securities, will continue to be promoted to provide investment and hedging opportunities for investors. To further develop the capital market, additional measures were initiated in 1996. These measures included:

(i) Developing the Bond Market

To achieve the objective of developing the bond market through the private debt securities market, a system for electronic transfer of funds and securities (SPEEDS) was streamlined. Action was also taken to eliminate the overlapping functions among regulatory authorities involved in the issuance of bonds. As a measure to further encourage the development of the bond market, interest income from specific bonds received by listed closed-

end funds and unit trusts was exempted from tax effective from the year of assessment 1996.

(ii) The Establishment of the Futures Market

Amendments to the Futures Industry Act, 1993 were approved to enable the Securities Commission to regulate more effectively activities in futures trading. Both the Kuala Lumpur Options and Financial Futures Exchange (KLOFFE) and the Malaysian Monetary Exchange (MME) would set up the Malaysian Derivatives Clearing House (MDCH) to enable trading in derivatives to commence by the end of 1996. Consistent with efforts to ensure the success of these new financial industries, income-tax exemptions were approved for KLOFFE and MME. The MME commenced operations and launched the three-month Interbank Offered Rate (KLIBOR) futures contract on 28 May 1996.

(iii) The Establishment of a Malaysian Accounting Standards Board

To ensure a high level of financial reporting and disclosure in the corporate sector, the Financial Reporting Foundation and Malaysian Accounting Standards Board would be set up to formulate accounting standards and identify areas of regulation and enforcement.

(iv) Moving from Merit-Based to Disclosure-Based Regulations for Initial Public Offerings (IPOs)

A move from a merit-based system to a disclosure-based system of regulation would be instituted under a 3-phase approach over a period of 5 years. The move is aimed at fostering a more competitive and transparent market as well as inculcating higher standards of disclosure, due diligence, corporate governance and accountability by companies. The move would also enable Malaysian investors to take a more professional stance in making their investment decisions in addition to ensuring that financial intermediaries such as merchant banks and underwriters

take on an even more effective role in ensuring fair play in the marketplace. The first phase of the move towards disclosure-based regulation commenced in January 1996 with flexibilities given by the Securities Commission (SC) for issuers and underwriters to decide on their own IPO pricing as opposed to intervention by the SC in the past.

(v) Listing of Infrastructure Project Companies

To encourage greater participation of the capital market in helping to meet the financing needs of large infrastructure projects, Malaysian-incorporated or joint-venture infrastructure companies with concessions or licences with a minimum of 18 years are, effective from 19 September 1995, eligible to seek listing on KLSE without the need to meet the normal listing track-record requirements. Powertek Bhd. was the first such company to be approved by the SC and listed on KLSE under the IPC listing guidelines.

(vi) Securities Borrowing and Lending and Regulated Short Selling

To improve the settlement efficiency of the securities market and to facilitate the development of the financial derivative market, guidelines have been issued by the SC on Securities Borrowing and Lending. In line with this, regulations for Regulated Short Selling (Rule 22) have been approved by the SC and implemented through the KLSE rules on 30 September 1996;

(vii) Amendments to the Listing Requirements

The following amendments have been made to KLSE Listing Requirements with the view to improve the regulatory framework and the transparency of the market:

- (a) Majority shareholders of companies seeking a listing can choose to abide by the terms of a moratorium on their shares or they can choose to issue a profit guarantee instead; and

- (b) With effect from 1 January 1996, the paid-up capital requirements have been revised as follows:

- (i) Main Board Companies - minimum of RM40 million (previously RM20 million)
- (ii) Second Board Companies - minimum of RM10 million but less than RM40 million (previously RM5 million but less than RM20 million).

In a further move to develop the capital market and to promote Kuala Lumpur as a regional financial centre, the Minister of Finance announced on 8 August 1996 that foreign companies would be allowed to be listed on the KLSE. In the first phase of the exercise, foreign companies with substantial assets or operations and are owned or controlled by Malaysians will be permitted to list on the Main Board. In addition, the listing of these companies must not be primary listings or these companies are listed elsewhere but intend to shift their primary listings to the KLSE. The shares will be traded in ringgit. The scope of foreign companies qualified to be listed on the KLSE would be widened, at the appropriate time, beyond those allowed under the first phase, with the view to further liberalise the market.

Containing Inflationary Pressures

Containing inflation continues to be an important agenda in macroeconomic management in 1996. To further contain inflationary pressures, the focus of policy attention has been on containing excess aggregate demand, increasing food supplies as food has been the main contributor to the increase in the overall Consumer Price Index (CPI), containing asset inflation as well as reducing the cost of doing business.

To contain excess aggregate demand, monetary policy was further tightened during 1996. The need for tightening of monetary policy during the first half of 1996 was necessitated by strong growth in money supply which significantly outpaced the growth of the value of the nation's output. As at end of March 1996, the growth of money supply, M3, accelerated with an annualised rate of growth of 27% while the estimated annualised growth rate of GDP was at less than 15% in current

prices. The high growth of money supply was partly attributed to strong credit expansion by the banking system to the private sector, especially for consumption. Excessive lending for consumption was viewed with concern as inflation was trending upward from 3.2% in March 1996 to 3.8% in June and, at the same time, there was a need to increase savings with the view to reduce the nation's resource gap. Consequently, the level of liquidity in the economy had to be actively managed by Bank Negara Malaysia (BNM) in order to ensure price stability as well as to promote savings. This was done through a combination of direct and indirect instruments which included accepting deposits in the interbank market, centralising the excess funds of the Government and EPF with BNM and raising the statutory reserve requirement (SRR). The SRR of the banking institutions was increased by one percentage point from 11.5% to 12.5% on 1 February 1996 and subsequently by another percentage point to 13.5% on 1 June 1996. The SRR increases absorbed a total of RM5.4 billion. Reflecting the impact of the tight monetary policy pursued by the Central Bank, interest rates were generally higher during the first eight months of 1996 when compared to 1995 while the growth of money supply, M3, by the end of August 1996 had decelerated from its peak as at the end of April 1996. The expansion of credit by the banking system to the private sector had also decelerated from 30.1% as at the end of April 1996 to 27.5% as at the end of August 1996.

Specific measures were also introduced in the 1996 Budget to contain inflationary pressures through managing aggregate demand. These included increasing the minimum payment on credit cards to 15% of monthly balances to discourage excessive consumption. Underlying this measure was the rapid increase in the use of credit cards. The number of credit cards had increased significantly from 700,000 in 1990 to 1.6 million as at the end of June 1995, with a total outstanding balances of RM2.5 billion.

Apart from addressing the demand side, efforts aimed at increasing supplies of consumer goods were initiated to reduce inflationary pressures, particularly with regard to food. As a result of shortages in the supplies of food resulting from a decline in the land area for food cultivation,

uneconomic sizes of cultivatable land and increases in the exports of food, prices of food have been increasing at a relatively faster rate than other consumer goods. The CPI for food has increased by 5.7% during the first nine months of 1996, while that of other categories has not exceeded the national average of 3.6%. As a result, more than 50% of the increase in the CPI has been attributed to higher prices of food. To ease the pressures on food prices, the supply of food has to be increased. Past measures that have been taken to increase the supply of food included the setting up of Fund For Food to provide financing for the production of food at reduced interest rate, the liberalisation of import of food and the abolition of import duties on a host of imported food items. In 1996, an additional RM300 million has been allocated to the Fund For Food, increasing the total amount available to RM600 million. As an additional incentive to encourage the production of food, the eligibility of the Reinvestment Allowance has been extended to include the production of essential food such as rice, maize, vegetables, tubers, livestock farming and aquatic products. Prior to the announcement of this extension during the presentation of the 1996 Budget, the Reinvestment Allowance incentive was only enjoyed by manufacturing concerns. The extension of this allowance is to encourage large estates to be involved in the production of food.

As a further measure to contain inflation, import duties and sales tax on raw materials, components and equipment used by manufacturers have been abolished in the 1996 Budget with the view to reducing the cost of production of output. Some 800 items which comprise food preparations from fruits, raw materials for plastics products, iron and steel and a variety of electric motors and generators are covered by this measure. In addition, import duties on more than 700 items which had been given tariff protection for more than 10 years have been reduced. The abolition and reduction of import duties, while helping to contain inflation by reducing the costs of production, have a multi-pronged objectives. These objectives include improving the efficiency and competitiveness of manufacturers, increasing supplies in the domestic market as well as reaffirming Malaysia's commitment to trade liberalisation among member countries of the World Trade Organisation and the ASEAN Free Trade Area (AFTA).

Another issue of concern that was addressed in the 1996 Budget was asset inflation. Prices of properties had increased significantly in recent years, as a result of rising disposable income, significant acquisition of properties by foreigners and speculation. Specific measures, therefore, were introduced in the 1996 Budget to contain asset inflation as acceleration in prices of properties could undermine the objective of providing affordable houses for the nation's lower and medium-income groups. Consequently, the relevant state authorities have been requested to impose a levy of RM100,000 on every purchase of real estate by foreign interests. This is in addition to the tightening of the Foreign Investment Committee guidelines on the acquisition of real estate by foreigners by limiting the purchases of houses to those exceeding RM250,000 a unit. To curb speculation on real properties, the rate of the real property gains tax has been increased from 20% to 30% for disposal within 2 years after acquisition. Tax rates for disposal within the third year after acquisition has been increased from 15% to 20% and within the fourth year from 10% to 15%. The disposal of any real property by non-citizens has been subjected to a flat tax of 30%.

Upgrading Human Resources and Technological Capabilities

Against a background of labour shortages and a global environment that is increasingly moving towards a more open trading system and undergoing rapid technological advancements, Malaysia must continue to undertake strategic adjustments in order to ensure that it remains vibrant and has the capacity to strive and compete under changing environment. It is no longer sustainable for Malaysia to compete by relying on cheap foreign labour, given that the size of foreign labour is already large and the pressures it places on social amenities and other potential problems it may generate. To continue to allow the nation's industrial sector to import cheap and relatively unskilled labour will cause Malaysia to be trapped with an industrial structure that will be relatively labour-intensive and characterised by low productivity. To induce the industrial sector to expedite its strategic industrial adjustments towards a more efficient and technology-intensive production process, the levy on unskilled foreign workers has been increased in 1996 from RM420 to RM840 per year and for semi-skilled workers

from RM600 to RM1,200 per year, except for domestic workers and unskilled workers in the plantation sector.

A technology-intensive industrial structure requires technically competent labour force that can assimilate, adapt and develop new production processes and technologies as well as one that is oriented with a set of industrial values which is essential to maintain a productive and competitive entity. Consequently, there is a need to further upgrade and intensify the development of human resources. Under the Seventh Malaysia Plan, the capacity of existing education and training institutions will be increased while new ones will be established particularly in science, engineering and technical fields. In the 1996 Budget, a sum of RM11.8 billion was allocated for education and training to enable education and training institutions to cater for increased enrolment to produce a larger number of technicians and engineers. Government corporations such as Tenaga Nasional Berhad, Telekom Malaysia Berhad and PETRONAS have been requested to double their efforts to produce a larger number of skilled workers. In addition, distance learning has been introduced in all institutions of higher learning in the academic year 1996. To encourage the private sector to be involved in education and training, an Industrial Allowance of 10% per annum per annum which can be claimed over a period of 10 years has been provided, effective from the year of assessment 1996, for expenditure on buildings and hostels used for education, including technical and vocational training. In addition, companies providing appropriate training for new workers have also been granted tax deduction on expenditure incurred for the purpose of preparing skilled and trained workers before a company commences business.

To sharpen the nation's competitive edge in the global market, vigorous efforts continued to be undertaken to develop its technological and R&D capabilities so that Malaysia can be in the forefront of product and process innovation, capable of designing and producing original parts equipment manufacturing as well as undertake distribution and marketing activities, particularly in the global market place. Through this capability, Malaysian companies can increase their value chain in the manufacturing process and become integrated manufacturing and marketing companies. The Government, while continuing to encourage private companies to undertake R&D activities, will itself

play an active role in technology development, particularly in the development of key and emerging technologies which can yield the highest economic pay-offs. Five key technology areas have been identified for the purpose of building the competency and innovativeness as well as for developing niche areas for domestic industries. These are automated manufacturing technology, advanced materials, biotechnology, electronics and information technology. The development of technological capabilities in these five areas will provide the catalyst for further deepening and broadening of the technology base and competency which are so crucial for the maintenance of Malaysia's competitive position in the global market that is experiencing rapid technological advancements.

To support R&D activities, the Government has allocated a sum of RM471 million in the 1996 Budget for the further development of science and technology. In addition, RM200 million was set aside for Intensification of Research in Priority Areas (IRPA) programmes while a contract-based research system has been introduced to encourage R&D that is client-based as well as to strengthen the linkages between institutions in the public sector and industry. The corporatisation of Standards and Industrial Research Institute of Malaysia (SIRIM) in September 1996 and planned corporatisation of Microelectronic Institute of Malaysia (MIMOS) by late 1996 should also help to generate a more market driven R&D activities. To encourage companies to undertake R&D activities in approved research institutions, including local universities, double tax deduction incentive has been provided for expenses incurred on R&D effective from the year of assessment 1996. To propel Malaysia into a higher plane of technology development in the electronics industry, the development of wafer fabrication industry is being undertaken. This industry will increase the skills associated with the maintenance of sophisticated equipment such as robotics, encourage R&D in the design and fabrication of wafers as well as promote linkages with support industries. In this context, the Government has, in the 1996 Budget, indicated its preparedness to give a number of concessions to investors in this industry including:

- (i) Pioneer Status or Investment Tax Allowance for a period of 10 years or more;
- (ii) special grants for the training of Malaysian engineers and scientists;

- (iii) the provision of special requirements like uninterrupted supply of electricity, clean water, toxic waste storage facilities and the construction of electric substations;
- (iv) recruitment of foreign engineers and scientists as required; and
- (v) other fiscal incentives.

Pursuance of Fiscal Prudence

The broad thrust of fiscal policy and budgetary operations in 1996 continued to focus on fiscal prudence and consolidation. The fiscal restraint, together with further tightening of monetary policy to rein in pressures on price, has not only contributed to a more sustained pace of economic growth with greater price stability and external balance but also contributed to the strong financial position of the Federal Government for the fourth consecutive year in 1996. The Government's revenue performance continues to improve on account of larger receipts from income taxes, despite continued reduction in the tax rates. On the other hand, increases in both operating and development expenditure have been kept to the minimum, with the exception of increases in emolument, pension and gratuities, arising from the recent salary adjustments.

The tax policy was aimed at fostering productivity-driven growth, strengthening the services sector, containing inflation, promoting savings, propelling technology development as well as fostering a compassionate society. To foster increased productivity, the income tax rate on individual income was reduced to be in line with that of corporate tax, human resource development was promoted while fiscal measures were introduced to encourage the industrial sector to shift towards a more efficient technology-intensive production process. Tax incentives were also provided to strengthen the services sector as a catalyst of economic growth as well as to export its services and substitute imported services. The sub-sectors within the services sector that were given special attention were the communications, public utilities, transportation, education, port services and insurance sub-sectors. To contain inflation, tax measures were introduced to promote savings, reduce excessive consumption, discourage asset speculation, increased food supply and develop the capital market. Special

tax incentives have been offered to the wafer fabrication industry as a conduit for Malaysia to leapfrog into higher level of technology. To develop information technology, capital allowances related to expenses on computers and other information technology equipment are allowed as deduction in the computation of income tax. Sales tax on computers and software have been abolished to enhance computer literacy among Malaysians. To promote a compassionate society, higher tax reliefs are provided to foster greater care for the handicapped, aged parents and elders.

On the expenditure front, the Federal Government continues to exercise stringent control on operating expenditure, except for essential services such as education and health. In this context, further initiatives have been made to increase the administrative efficiency and productivity of the public sector as well as to discourage wastage. At the same time, the Government continues to exercise prudence in the management of its external debt by exercising restraint on external borrowing and by generating overall budgetary surpluses to avoid future recourse to external borrowing to meet its financing needs. In the case of development expenditure, the thrust of budgetary allocations is to develop the nation's human resources, strengthen the science and technology base of the country, develop low-cost houses for the poor, improve infrastructure in the rural areas and eradicate poverty. Continued attention has been given to alleviating the problem of shortage of skilled and technically-oriented manpower with education and training being provided the largest ever allocation under the 1996 Budget.

Continuing the Agenda for Social Development

Fostering social progress and development continues to be an important part of the nation's development agenda in 1996. Issues related to rural development, eradication of poverty, the plight of the less fortunate, housing for the lower and medium-income groups, *dadah* and the environment were addressed. To ensure a balanced development as well as to enhance the production potential and living standards of the rural community, greater priority has been given to the

development of infrastructure and social amenities in the rural area. For this purpose, 11% of the total 1996 Budget has been allocated for the maintenance and development of rural roads, water supply, electricity supply and clinics. To foster a caring and just society, programmes aimed at eradicating poverty and assisting the less fortunate, including the handicapped, have been given a boost by an additional allocation of RM549 million. To provide shelter for the poor, another RM1 billion has been provided to the Low Cost Housing Fund, increasing the total fund to RM3.4 billion. Reflecting the Government's concern for the environment, allocations have also been provided for the prevention of pollution and soil erosion as well as improvement of the drainage system to avoid flooding. In addition, fiscal incentive in the form of capital allowance related to expenses incurred on environmental equipment is allowed as a deduction in the computation of income tax over a period of three years.

The rapid transformation of Malaysia into a more open, modernised and industrialised nation has affected social and family values both positively and negatively and, at the same time, generated stress and strains associated with modern lifestyles. An issue of increasing concern is the negative impact of this transformation on social order and stability that has degenerated into a variety of social problems such as the breakdown of the family unit, addiction to *dadah* and liquor, gambling, AIDS, child abuses and abandonment of newly born babies. To address these social problems, a Cabinet Committee To Combat Social Problems, chaired by the Deputy Prime Minister, has been set up in March 1996. The terms of reference of the Committee are to identify the extent and the sources of the social problems as well as to formulate policies and strategies to address these social problems. In addition, a National Plan of Action on Family Development is being drawn up which will establish guidelines for the public and private sectors, including non-governmental organisations to take into consideration the family elements in the planning and implementation of socio-economic development programmes. The purpose of the Plan is to develop the institution of family as the foundation for nurturing the creation of a more responsible society. In the 1996 Budget, an amount of RM49.7 million has been allocated for community and family development programmes. Other measures that have been taken

include the promotion of the Rakan Muda programmes to encourage youths to pursue their field of interest, be it in science, technology, sports or culture. Through these programmes, it is hoped that the youth will be exposed to positive influences and, at the same time, enriched culturally which will free them from negative temptations such as dadah, addiction to liquor, gambling and other vices.

Conclusion

The stance of macroeconomic management, which aims at sustaining strong economic growth over the medium and long-term with price stability and improvements in the external position, has contributed to the Malaysian economy expanding at a more sustainable pace of 8.2% in 1996. The growth of the economy is also accompanied by relatively low inflation and a narrowing deficit in the current account of the balance of payments.

At the same time, the Federal Government's overall budgetary position continues to record a surplus for the fourth consecutive year since 1993 while the nation's resource position improves. In essence, economic fundamentals continue to remain strong.

Notwithstanding this, the challenge to macroeconomic management in the years ahead is sustaining these strong foundations and effecting the strategic shift for the economy from largely investment-driven to productivity and quality-driven growth. The competitiveness of the export sector has to be further enhanced through increasing the value chain of the industrialisation process. At the same time, the services sector has to be developed further to provide the added catalyst to growth and making it a vibrant foreign exchange generating industry. In this context, pragmatic and purposeful policies will continue to be pursued so that growth can be sustained over the medium and long-term to achieve the objectives of the Seventh Malaysia Plan and nation's vision by the year 2020.