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The Malaysian Economy in 1997 and Prospects for 1998

The Malaysian Economy in 1997

An overview

Malaysia's **real Gross Domestic Product (GDP) growth** is expected to moderate to 8% in 1997 (1996: 8.6%). The moderation in output growth is mainly due to an envisaged slower pace of economic activities in the second half of the year as a result of slower construction starts and output growth of construction-related manufactured materials and services. Output growth of consumption goods, especially durables, is also envisaged to slow down as consumer confidence is expected to be affected by the drop in share prices. Domestic demand (excluding changes in stocks) is also envisaged to expand at a slower pace due to the combined impact of slower growth in export earnings, fiscal prudence, monetary restraint, efforts aimed at promoting and mobilising savings as well as the deferment of spending in response to the depreciation of the value of ringgit and deflation of share prices. The moderation in domestic demand growth against a slower but still robust output growth has enabled inflation to remain low, despite the weaker ringgit. This, coupled with the drop in export prices of manufactured goods, has led to a slower growth in **nominal Gross National Product (GNP)** of 10.2% (1996:14.3%) to RM262.2 billion. Consequently, **per capita income** of the population in current prices is estimated to increase at a slower rate of 7.7% to RM12,102 compared with RM11,239 in 1996 (11.7%). Given the depreciation of the ringgit especially against the US\$ during the third quarter of the year, **nominal per capita income in terms of purchasing power parity** is estimated to decline by 15.4% to US\$10,663, after an increase of 11.6% in 1996, if the exchange rate of RM3.1975=US\$1 on 30 September is used as a basis of calculation.

The current account of the balance of payments is estimated to record a slightly smaller deficit in terms of GNP, that is 5%, in 1997 (1996:5.2% of GNP), underpinned by improvement in the services account of the balance of payments. As in 1996, the basic balance is expected to be in surplus, reflecting the continuing high level of long-term capital inflow. The current account deficit is envisaged to be adequately financed by net inflow of long-term direct foreign corporate investment. Reflecting the fiscal discipline that has been strictly adhered to, the Federal Government financial position records a larger overall surplus in 1997. This is the fifth consecutive year the Federal Government has been able to achieve an overall budgetary surplus.

While Malaysia's economic fundamentals remain strong, the economy, being open, could not insulate itself from the contagion effects of developments in Thailand which have triggered volatility in the region's financial markets since mid-May. In September 1997, the ringgit fell to a record low against the US dollar while the Kuala Lumpur Stock Exchange Composite Index (KLSCI) recorded an intra-day low of 675.15, that is the lowest since 20 April 1993. To further improve the economic fundamentals, the Government announced the deferment of the implementation of several large projects, a cutback in Government expenditure as well as reviewing of the purchase of large foreign goods by Government agencies to strengthen further the current account position of the balance of payments as well as to achieve a larger overall budgetary surplus in 1998.

Sectoral Output Performance

The output performance of most sectors of the economy remains strong, with the manufacturing, construction and some sub-sectors in the services sector continuing to record double-digit rates of

expansion. In the primary sector, agriculture output expanded at a stronger rate while the output growth of the mining sector decelerated. Value added in the **manufacturing sector** is envisaged to increase by 12% in real terms (1996:12.2%), underpinned by a pick-up in the output growth of export-oriented industries and a strong, although slower, output growth of domestic-oriented industries. The export-oriented industries are envisaged to stage a recovery in output growth from 8.3% in 1996 to 10.6% in 1997, largely due to higher output of semiconductors and moderate recovery in textiles output growth. However, output of consumer electrical products such as televisions and radios contracted in the face of global competition while output of wood and rubber products is envisaged to record slower growth due to lack of availability of domestic raw materials. Output growth of the domestic-oriented industries, although still strong, is forecast at a slower rate of 13.7% in 1997 (1996:17%), due to slower output increases of construction-related products, such as non-metallic mineral and glass products and basic metal products, as well as transport equipment. Nevertheless, stronger production increases are expected from industries producing plastics, chemicals and chemical products, food and tobacco while output of paper and paper products is expected to recover due to stronger domestic and external demand. With the output expansion of the manufacturing sector continuing to exceed the average growth of the economy, its share to the real GDP is expected to increase to 35.5% in 1997 (1996:34.2%), accounting for half of the real GDP growth anticipated in 1997.

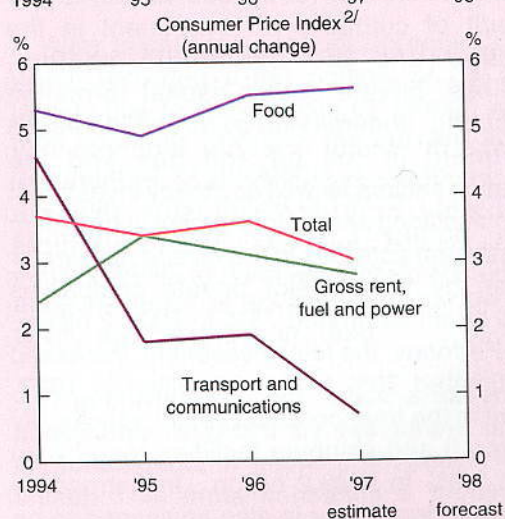
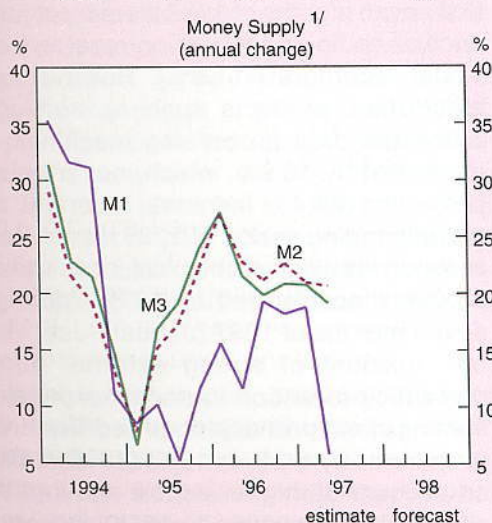
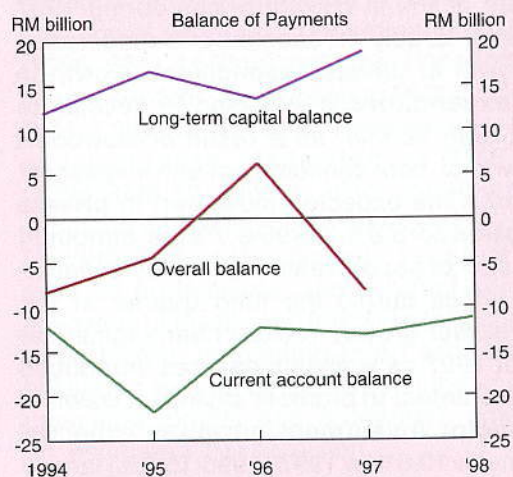
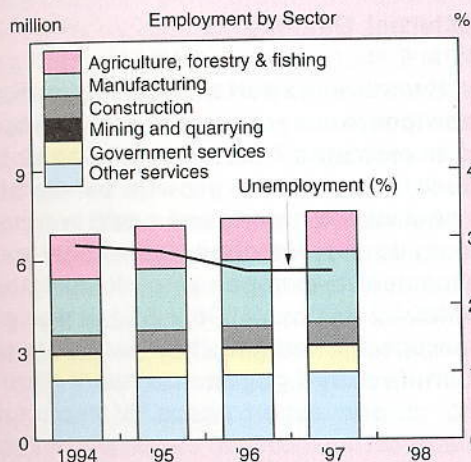
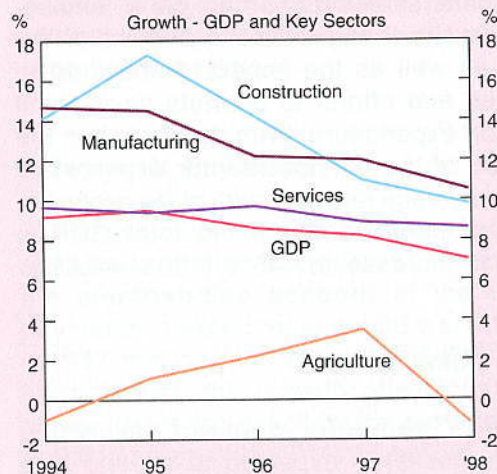
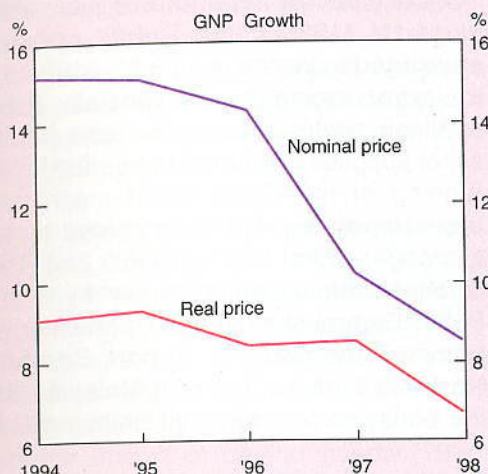
Value-added in the **construction sector** is expected to decelerate to 11% (1996:14.2%). The imposition of the limit on bank lending to the broad property sector and the moderation in demand for properties, in the face of increases in the supply of office space, higher-end condominiums and retail outlets in shopping malls, are expected to discourage new construction starts in some sub-sectors. Nevertheless, on-going projects covering civil engineering works associated with infrastructural projects such as the Kuala Lumpur International Airport, Putrajaya and Cyberjaya, the development of landed residential properties, which still enjoy good demand, as well as strong construction starts in industrial sites continue to provide the impetus for the construction sector to record a double-digit growth. Consequently, the share of the sector to GDP is expected to increase to 4.8% (1996: 4.7%).

Output growth of the **agriculture, forestry, livestock and fishery sector** is envisaged to pick up to 3.5% (1996:2.2%). The stronger growth is attributed mainly to another year of robust increase in palm oil output (7.3%), a recovery in sawlogs production (3.4%) following the clearing of timber for the Bakun Hydroelectric Power Plant project, as well as a steady increase in livestock output (4.6%). However, output of rubber is envisaged to drop by 6.7% and cocoa beans by 6% as a result of conversion of land use and labour shortages. In view of the relatively slower output growth recorded by the agriculture, forestry, livestock and fishery sector, its share to GDP is expected to continue to slide to 12.2% (1996: 12.7%).

Output growth in the **mining sector** is envisaged to slow down to 2.8% (1996:4.5%), largely due to smaller increase in the production of crude oil and gas. Crude oil production is expected to increase by 0.5% to average 720,700 barrels per day (bpd) in 1997 (1996: 717,200 bpd), after taking into account the decision to step up production by 20,000 barrels per day in the last four months of the year to meet higher demand during winter as well as to boost exports. Gas output is expected to continue to expand strongly, at 14.3%, to meet rising external demand, although the rate of output growth is slower compared with the 21.4% recorded in 1996. In the case of tin and copper, the output has continued to decline due to high costs of production and falling reserves. With construction activities expanding at a less rapid pace, output of quarrying industry is expected to record a slower growth. The share of the mining sector to GDP is, therefore, envisaged to decline further to 6.8% in 1997 (1996: 7.2%).

Reflecting the combined impact of a moderation in domestic demand for services by the real sectors of the economy and the expansion of output capacities in some services industries, growth in value-added of the **services sector** is expected to remain strong, although at a slower pace of 8.7% (1996: 9.7%). Services industries that are expected to generate stronger real value-added growth are those in the transportation, storage and communications sub-sector largely as a result of expansion of capacities, as in the case of the airline and shipping as well as rail services industries. On the other hand, services industries

Chart 1.1
Key Economic Indicators



1/ End of March, June, September and December including Repos.
(except for 1997, which represents end of March and July)

2/ Malaysia (1990 - base year)

such as those in the finance, insurance, real estate and business services as well as wholesale and retail trade, hotels and restaurants are expected to record slower output growth. This in part reflects the Government's efforts to cap bank lending, especially to the less productive sectors of the economy, as well as the impact of the drop in share prices and efforts to promote savings on consumption expenditure. With the growth in the value-added of the services sector expected to outpace the average rate of growth of the economy, the share of services sector to total GDP is estimated to increase to 45% (1996: 44.8%).

Domestic Demand

Aggregate domestic demand (excluding changes in stocks) is expected to expand at a slower rate of 9% in current prices during 1997 (1996:9.9%), largely on account of a moderation in the growth of private expenditure. Growth in **private expenditure** is expected to decelerate to 8.4% (1996:12.1%), as a result of slowdown in the growth of both consumption and investment expenditure. The expected slowdown in **private consumption** to 6.9% (1996:9.7%) is attributed to the erosion of paper wealth caused by deflation of share prices during the third quarter of the year, the slower growth in export earnings in the first half of 1997 as well as measures introduced by the Government to promote savings. Likewise, **private sector investment** growth is expected to moderate to 10.6% in 1997 (1996:15.8%) largely as a result of cutbacks in investment in the construction and the agriculture sectors. Nevertheless, private sector capital formation remains strong, underpinned by strong increases in investment in the oil and gas and the transportation sectors as well as steady investment in the manufacturing sector. Investment in upstream and downstream activities in the oil and gas sector undertaken by three major private companies increased by an estimated 75% to RM1.2 billion. Including Petronas, the total investment increased by an estimated 70% to RM 11 billion in 1997. Investment in the transportation sector specifically in rail, aircraft and shipping facilities rose by an estimated 6.9% to RM6.2 billion. Investment in the manufacturing sector is also envisaged to be strong, underpinned by strong increases in the level of investment approved during 1994-1996 which amounted to RM78 billion. Reflecting the

strong capital formation in the first seven months of 1997, imports of capital goods surged by 21.2% (January-July 1996:7.7%).

Public sector expenditure is expected to grow at 11.1% (1996:3.3%). **Public consumption** is envisaged to increase by 9.6% (1996:3.4%), due to larger expenditure especially for essential services such as education and health as well as for supplies and services needed for the smooth running of the Government machinery. **Public investment** likewise is estimated to increase at a stronger rate of 12.7% (1996:3.2%). The increase is attributed to capital outlay by Non-Financial Public Enterprises (NFPEs), particularly the Kuala Lumpur International Airport Berhad, Tenaga Nasional Berhad, Telekom Malaysia Berhad and the Malaysia International Shipping Corporation.

External Demand

Growth in **exports of goods and non-factor services** in current prices is expected to decelerate to an estimated 7.1% in 1997 (1996:10.1%), mainly due to a slower growth in earnings from manufactured exports and a drop in export earnings of crude oil. **Merchandise export** earnings are expected to increase at a slower rate of 6% to RM204.7 billion (1996:7.6%), largely due to a slowdown in the growth of export earnings from **manufactured goods** as a result of an estimated 7% drop in export prices. Manufactured goods that recorded reduced export earnings during the first seven months of 1997 were electrical products such as radio and television receivers and audio-visual recorders (-11.9%). However, exports of electronics products such as semiconductors, automatic data processing machines and parts increased by 10.9%, which, nevertheless, is still below the 29.4% increase recorded during the corresponding period of 1996. In contrast, growth in export earnings of chemical, chemical and plastic products accelerated to 13.8% during the first seven months of 1997 (January-July 1996: 8.4%) on account of strong external demand and domestic production capacity expansion. Export earnings from **primary commodities** are expected to recover by 6.5% in 1997 (1996:-0.6%), mainly on account of higher export earnings from palm oil and gas. However, lower export earnings are expected from rubber, sawlog, sawntimber, tin and crude oil. As a result of higher receipts from exports of services related to freight and insurance,

other transportation, travel, and professional and contract services, **export earnings from non-factor services** are envisaged to increase by 13.2%. The strong increase in export earnings from services reflects the positive returns from past investment in the development of export services industries. As a result, **export earnings from goods and non-factor services** are estimated to expand from RM229.8 billion in 1996 to RM246.3 billion in 1997.

Imports of goods and non-factor services are estimated to increase by 7.1% to RM243.5 billion in 1997 (1996: 4.5%), with **merchandise imports** increasing by 6.6% and **imports of non-factor services** by 9.3%. The expected increase in merchandise imports to RM195 billion (1996:RM183 billion) is largely due to 19.8% increase in the import of capital goods (1996: -5.7%), as a result of 6.9% growth in imports of bulky items such as aircraft, ship and Liquefied Natural Gas Tanker to RM6.2 billion (1996:RM5.8 billion). The import of these bulky items will help to boost future export earnings from services related to freight and air transportation and to substitute the import of related services as well as to facilitate the export of gas. The import growth of intermediate goods which accounts for 63.7% of total gross imports is expected to decelerate further to 2.3% (1996:3.6%), reflecting the moderation in overall economic activities as well as stable import prices. Similarly, imports of consumption goods, which account for 6.3% of total gross imports, are expected to record a slower growth of 4%, reflecting the combined impact of slower growth in disposable income, price deflation in the equity market as well as deferment of spending due to the depreciation of the ringgit in the second half of 1997. Of significance is the sharp deceleration in the import of non-factor services to 9.4% in 1997 from a growth of 16.9% in 1996, reflecting the positive impact of past efforts in substituting imported services such as freight and insurance, air transportation, education as well as port services.

With exports exceeding imports of goods and non-factor services by RM2,789 billion in 1997 (1996: RM2,555 billion), the **external sector** is envisaged to exert a more expansionary impact on the nominal GDP. As a result of a more moderate increase in prices and real output, nominal GDP is estimated to increase at a slower rate of 9.8% compared to 14.2% in 1996. After

taking into account net factor payments (mainly interest payments and repatriation of profits and dividends) of RM12.2 billion in 1997 (1996:RM11.9 billion), Malaysia's GNP, an indicator of national income, is estimated to increase at a slower rate of 10.2% to RM262.2 billion in current prices in 1997 (1996:14.3%).

Balance Of Payments

With merchandise exports envisaged to expand at a slower rate (6%) compared to imports (6.6%), the **merchandise account** of the balance of payments is expected to record a smaller surplus in 1997, that is RM9.7 billion (1996:RM10.2 billion). Nevertheless, this is partly offset by an expected narrowing of the deficit in the **services account** to RM19 billion (1996:RM19.5 billion). The smaller services deficit is attributed to higher net receipts from travel services, amounting to RM5.1 billion (1996: RM4.8 billion) and other transportation and related services, amounting to RM2.4 billion (1996: RM1.5 billion). A smaller net payments for freight and insurance, estimated at RM8.5 billion (1996:RM8.52 billion), also contributes to the expected narrowing of the services deficit in 1997. Nevertheless, net payments on other services such as professional and contract services and payments of royalty and franchise fees are expected to be higher, amounting to an estimated RM6.1 billion, as well as on investment income (interest payments, profits and dividends), amounting to an estimated RM12 billion.

After taking into account unrequited transfers which recorded a net outflow of RM3.7 billion largely due to remittances by foreign workers to their countries of origin, the **current account** of the balance of payments is expected to record a slightly larger deficit of RM13.1 billion in 1997, compared with RM12.3 billion in 1996. Nevertheless, as a percentage of GNP, the current account deficit is envisaged to narrow to 5% of GNP, against 5.2% in 1996.

The current account deficit is expected to be adequately financed by net inflow of foreign corporate direct investment, amounting to RM13.2 billion. This amount reflects a gross inflow of long-term foreign corporate direct investment of RM21.9 billion (1996:RM19.4 billion) and Malaysia's investment abroad of RM8.7 billion (1996:RM6.6 billion). After taking into account net inflow of

long-term official capital of RM5.6 billion, largely as a result of bonds raised by NFPEs abroad, the **basic account** of the balance of payments is expected to record a surplus of RM5.7 billion. Nevertheless, as a result of volatility in the financial markets triggered by developments in Thailand since mid-May 1997, the amount of short-term net capital outflows, including errors and omissions, is envisaged at RM13.9 billion. Consequently, the **overall balance** of payments is projected to record a deficit of RM8.2 billion in 1997. As a result, the net external reserves held by Bank Negara Malaysia is expected to decline from RM70 billion (equivalent to finance 4.6 months of retained imports) as at end of 1996 to RM61.8 billion (equivalent to finance 3.8 months of retained imports) as at end of 1997. However, the envisaged level of reserves as at end of 1997 would be higher if revaluation gains as a result of ringgit depreciation are taken into account.

Public Sector Financial Position

The Federal Government fiscal position remains strong, with the overall budget expected to record a surplus for the fifth consecutive year. **Revenue** collected by the Federal Government is expected to increase by 8.6% in 1997 to RM63,275 million, underpinned by an increase of 10.5% in tax revenue. Direct tax collection, which includes mainly income taxes and stamp duties, is estimated to increase by 14.4%, while indirect tax collection, which includes export and import duties, excise duties and sales tax, is estimated to increase by 5.8%. **Operating expenditure**, on the other hand, is envisaged to increase at a slower rate of 0.5% to RM44,069 million mainly due to a decline in emolument of 9.1% and in debt service charges of 4.9%. As a result, the **current account** is expected to record a larger surplus of RM19,206 million or 7.3% of GNP in 1997 (1996: RM14,415 million or 6.1% of GNP).

Federal Government **gross development expenditure** is expected to increase by 7.9% to RM15,790 million. The increase is largely for the development of the nation's human resources and improvement of infrastructural facilities as well as for rural development. After taking into account loan recovery of RM1,650 million, the net development expenditure is estimated at RM14,140

million. Given that the current account surplus estimated for 1997 is more than sufficient to finance the net development expenditure, the Federal Government **overall budgetary position** is expected to record a higher surplus of RM5,066 million or 1.9% of GNP in 1997 (1996: RM1,815 million or 0.8% of GNP). The overall budgetary surplus which the Federal Government has successfully achieved for five consecutive years since 1993 reflects the strict adherence to the prudent fiscal policy stance that has been put in place to strengthen macroeconomic stability.

In the case of the financial position of the **general government**, which includes the federal, state and local governments as well as statutory bodies, revenue collection is expected to increase by 8.1% to RM75,559 million, while operating expenditure is anticipated to increase slightly by 1.3% to RM50,692 million. As a result, its current surplus is estimated at RM24,867 million, which is 25.2% larger than the surplus of RM19,863 million recorded in 1996. Operating surplus of the **Non-Financial Public Enterprises (NFPEs)** is also expected to be larger, at RM22,483 million (1996: RM20,416 million), following good profit performance. Meanwhile, public sector development expenditure is expected to increase by 35.3% to RM41,921 million. This is attributed to higher development expenditure by the NFPEs. As such, the public sector overall financial position is expected to record a smaller surplus, amounting to RM5,429 million (2.1% of GNP) in 1997 (1996: RM9,301 million or 3.9% of GNP).

National Resource Position

Growth in **gross national savings** is envisaged to decelerate to 14% or RM104.4 billion in 1997 after surging by 24.8% in 1996, as a result of a slower growth in nominal GNP. Nevertheless, the national savings rate is expected to increase from 38.5% of GNP in 1996 to 39.8% of GNP, due to lower consumption rate. **Private sector savings**, which account for 56.7% of national savings, are expected to increase at a slower rate of 11% (1996:35.9%) to RM59.2 billion (22.6% of GNP). This increase, while reflecting the impact of moderation in income growth, is underpinned by positive real interest rates, the campaign spearheaded by the Government to promote

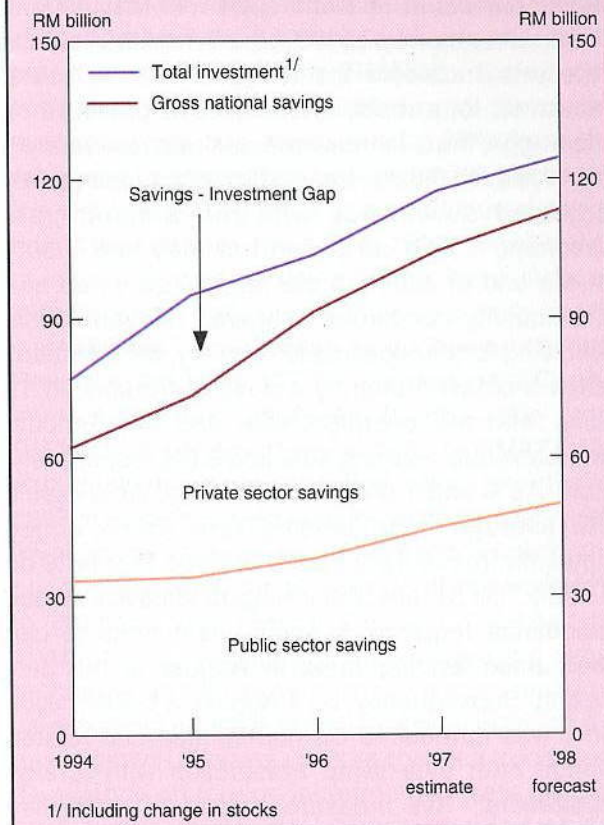
savings, the need to replenish stock of wealth due to the sharp drop in share prices as well as wider avenues of investments made available through the issuance of RM1.0 billion Khazanah benchmark bonds and the doubling to RM200,000 the limit Bumiputeras are allowed to invest in Amanah Saham Nasional and Amanah Saham Bumiputera. About 26% or RM15.5 billion of the private sector savings are envisaged to be mobilised through the Employees Provident Fund in 1997. Due to the large operating surplus of the Federal Government and the NFPEs, total **public sector savings** is envisaged to increase by 18.2% to RM45.2 billion, accounting for 43.3% of gross national savings.

Malaysia's gross national savings rate is high by international standards. This high savings rate has been instrumental in enabling Malaysia to finance high level of capital formation to foster growth. Nevertheless, Malaysia's **gross capital formation**, which includes foreign direct investment, is estimated at 44.8% of GNP in 1997, exceeding gross national savings rate by an estimated 5% of GNP. The savings-investment gap is due to the private sector, where its investment is estimated to exceed private sector savings by 10% in 1997. Public sector savings, on the other hand, are higher than its investment by 5% of GNP, reflecting the prudent fiscal stance that has been put in place. After taking into account the estimated net inflow of foreign corporate direct capital amounting to RM13.2 billion, the total financial resources available, both national savings and long term foreign corporate investment capital, is sufficient to finance the gross investment of RM117.4 billion estimated for 1997.

Monetary Developments and Foreign Exchange

The rate of monetary expansion continued to moderate during the first seven months of 1997. Growth in the **broad monetary aggregate**, M3, decelerated from a peak of 27.0% annualised rate of growth at end of April 1996 to 22.7% at the end of 1996 and 20.8% at end of July 1997. Nevertheless, monetary growth remained strong when viewed against a nominal GNP growth of 10.2% in 1997. Lending to the private sector continued to provide the impetus to monetary growth, increasing by RM61.8 billion during the

Chart 1.2
Savings - Investment Gap



first seven months of 1997 (January-July 1996:RM41.3 billion). Total loans by the banking system increased by an annual rate of 28.7% as at end of July while deposits with the banking system increased by 25.2%. As a result, the banking institutions recorded a resource gap of RM8.4 billion during the first seven months of 1997. Of concern was that the increased lending by the banking system continued to be channelled to the less productive sectors of the economy. In view of the rapid credit and monetary growth and the need to contain inflationary pressures, the stance of monetary policy continued to be one of restraint. Pre-emptive credit measures were introduced effective 1 April 1997 to curb bank lending to broad property sector as well as for share financing.

Although **interest rates** remained relatively stable during the early part of the year, the rates

fluctuated subsequently, as a result of volatility in the region's financial markets triggered by developments in Thailand since mid-May. During the first four months of 1997, the 3-month interbank rate was traded in the range of 7.34%-7.39%. However, as a result of speculative pressure on the ringgit, the 3-month interbank rate rose sharply on 16 May to 8.62%. Interbank rates subsequently adjusted downwards with the 3-month rate recording 7.51% at the end of May and 7.50% at the end of June, as the ringgit recovered and the liquidity conditions improved. Nevertheless, following further speculative activity, the interbank rates increased sharply across the board on 10 July, with the overnight rate and the 3-month interbank rate reaching 40% and 8.6% respectively, from 7.5% and 7.9% the day before. As a result, the average base lending rate (BLR) edged upwards from 9.18% at end of 1996 to 9.56% on 15 July. On 31 July, Bank Negara Malaysia issued guidelines requiring financial institutions to cap their base lending rates in August at the July ceiling. Subsequently, on 4 August, a US\$2 million limit was introduced on non-commercial related ringgit offer side swap transaction with foreign customers. This measure helped to normalise interest rates based on domestic considerations. Following this, interbank rates eased and by mid-August, interest rates returned close to levels before the excessive volatility in the currency market. As at 30 September, the overnight rate was 7.07% and the 3-month rate was 8.04%.

On the **foreign exchange market**, the ringgit appreciated against a composite of major currencies by 4.1% from end of 1996 to end of March 1997. Against the United States (US) dollar, the ringgit appreciated by 2.0% from US\$1=RM2.5279 at end of 1996 to US\$1=RM2.4790 at end of March 1997, despite the US dollar strengthening against most currencies. Nevertheless, the ringgit weakened to US\$1= RM2.5110 at end of April due to the consolidation of the stock market and related outflows of short-term capital. Since mid-May, the ringgit as well as other currencies in the region came under bouts of speculative attacks, triggered by developments in Thailand. As a result, the ringgit declined to close at US\$1=RM3.1975 on 30 September 1997.

Inflation

Inflation, as measured by the increase in the **Consumer Price Index (CPI)**, eased during the first nine months of 1997 to 2.6%, the lowest since 1990, against 3.6% during the corresponding period of 1996. A major factor contributing to the easing of the inflation rate is the moderation in domestic demand growth as a result of slower income growth, erosion of wealth due to drop in share prices, fiscal prudence as well as tight monetary policy. Enforcement of administrative measures to promote healthy and fair business practices as well as stable prices of imports as a result of abolition and reduction of import duties in recent years on a wide range of imports, especially foodstuff, together with low inflation rate in Malaysia's major trading partners have also helped to keep inflation low. Reflecting stable import prices is the 0.9% increase in the Producer Price Index for imports during the first eight months of 1997.

The slower increase in the CPI during the first nine months of 1997 was attributed to lower price increases in all major groups of consumer goods except for medical care and health expenses and miscellaneous goods and services. The sub-CPI for food which has the highest weightage in the overall CPI basket of goods (34.9%) increased at a slower rate of 4.3% during the first nine months of 1997 (January-September 1996:5.7%). Among major food items which recorded significantly lower rate of price increases during the first nine months of 1997 were fish (7.0%), rice, bread and other cereals (4.5%) and fruits and vegetables (1.5%). The availability of larger supply through higher imports as well as domestic production has helped to ease price pressures on these food items. The non-food item that recorded price decline during the period was clothing and footwear (-0.6%) while the sub-CPI for medical care and health services recorded stronger price increase, that is at 3.7%, compared with 3.6% during the corresponding period of 1996. On a regional basis, the CPI for Peninsular Malaysia rose 2.8% (January-September 1996: 3.9%) while the index for Sabah increased 2.1% (January-September 1996: 2.8%) and Sarawak 1.4% (January-September 1996: 2.2%).

For 1997 as a whole, the CPI could increase by an average of about 3%, as the country

replenishes its stocks of supplies for the remaining months of the year with imports at higher prices from countries whose currencies have recently appreciated against the ringgit. Nevertheless, prices of imports from some countries in the region are expected to be lower if the currencies of these countries remain relatively weak compared to the ringgit. This coupled with moderation of demand pressures as the economy adjusts to recent ringgit depreciation and decline in share prices as well as the maintenance of fiscal prudence and monetary restraint should help to neutralise the potential inflationary pressures due to higher prices of imports.

Labour Market

The labour market continues to be tight in 1997. The number of new employment opportunities created during the year is estimated to increase by 2.8% to 229,500 jobs. New employment opportunities in the secondary and the tertiary sectors of the economy are expected to increase by 4.3% to account for 84% of total employment opportunities during the year. However, the number of employment opportunities in the primary sector of the economy is expected to decline by 4.6%. The number of additional job seekers joining the labour force, on the other hand, is expected to increase by 1.4% to 235,200. As a result, the unemployment rate is estimated to remain at 2.5% of the labour force, with the economy continuing to virtually operate under condition of full employment. Reflecting the tight labour market situation, the total number of unfilled vacancies reported to the Manpower Department during the first eight months of 1997 increased by 13.7% to 38,076 vacancies, against 33,483 vacancies reported during the corresponding period of 1996.

The tight labour market situation has put pressure on wages. Average monthly wage in the manufacturing sector has increased by 11.6% to RM1,209 in nominal terms during the first seven months of 1997 from RM1,083 during the corresponding period of 1996. This is higher than the 10.8% increase in labour productivity during the same period. Due to lower selling prices of manufactured goods as a result of worldwide competition, sales value per employee increased by only 3.1%, a much lower rate of increase

when compared to 11.6% increase in nominal average wage. As a result, cost of labour per RM100 of sales in the manufacturing sector increased by 8.3% to RM6.92 during the seven months of 1997 from RM6.39 during the corresponding period of 1996. In real terms, the average wage has increased by 20% from the producers' perspective, in view of 7% decline in the average selling price of manufactured goods during the first seven months of 1997. The shortage of labour as well as rising wages have induced manufacturing firms to shift towards a more capital intensive but labour saving production processes. Reflecting this is the 127.5% increase in the Capital Investment Per Employee (CIPE) ratio from RM165,925 per employee in 1990 to RM377,427 per employee during the first seven months of 1997, based on projects approved by the Malaysian Investment Development Authority during the period. The need for all sectors of the economy to optimise and reduce the use of labour by strategically readjusting and innovating work processes as well as stepping up human resource development efforts is critical to ensure productivity-driven growth. Malaysia cannot continue to increase its reliance on foreign labour to generate growth, as the size of foreign labour estimated at 1.7 million is already large when compared to the country's labour force of 8.6 million. The sizable presence of foreign workers has put pressures on social amenities, generated social problems and led to an increased outflow of foreign exchange in form of remittances by foreign workers to their countries of origin, estimated at RM5.25 billion in 1997.

Prospects for 1998

Being a very open economy, Malaysia's macroeconomic performance is largely influenced by external developments and the capacity of the economy to quickly adapt and adjust to these developments. With the volume of world trade projected to expand at a moderate rate of 6.8% (1997: 7.7%) and with most countries which are Malaysia's trading partners expected to record a moderately slower rate of growth, competition in the global and domestic markets will become more intense. At the same time, there will be greater shifts in capital flows influenced by

prospective changes in relative rate of returns and risks from investments among nations. Under this scenario, Malaysia's economic performance will increasingly depend on its capability to compete in the global market not only in terms of goods and services but also in attracting capital flows. In this regard, more vigorous efforts will be needed to propel Malaysia towards a higher level of competitiveness in international trade and as an investment centre.

On the domestic front, issues associated with the overdependence of domestic economic activities on imports, the lack of inter-industrial linkages, the structural weaknesses of the services sector and the high rate of domestic investment, especially those with long gestation period in non-tradable sector, will be addressed to further improve the external payments current account deficit. The recent decisions by the Government to defer the implementation of several large projects, review the purchase of large foreign goods by Government agencies and to cut back Government expenditure are further efforts to strengthen the balance of payments position. Consistent with these efforts, savings will be more vigorously promoted to reduce the nation's reliance on external resources, especially debt, as a source of financing growth. In this context, a larger fiscal surplus is targeted for 1998 while the capital market will be further developed, including the creation of a liquid bond market, to provide a more diversified avenues of investment for savers and funds managers as well as to enable the private sector to raise funds at reasonable costs for financing capital formation. To promote savings as well as to ensure stability in the financial markets and domestic prices, the stance of monetary policy will continue to be one of restraint. All these efforts should contribute towards further strengthening of Malaysia's external payments and resource position as well as fostering price stability in 1998. Given this scenario, the economy is projected to grow at a moderate rate of 7% in terms of **real GDP**. Reflecting the moderate growth of the real sector of the economy as well as envisaged low rate of price increases, GNP, an indicator of national income, is expected to increase by 8.3% in current prices in 1998. **Per capita income** is, therefore, envisaged to increase by 5.7% to RM12,797.

Sectoral Output Performance

The moderation in real output growth of the economy to 7% in 1998, reflects largely the impact of a moderate expansion in the volume of world trade, slower growth in domestic demand and income, as well as a significant negative turnaround in the output of agriculture sector from a growth of 3.5% in 1997 to a decline of 1.2%. In addition, the projection also takes into consideration the decision to defer several large projects, the cutback in Government expenditure as well as the more cautious stance of developers, in the light of potential mismatches of supply and demand in some segments of the property sector. On the other hand, the expanded production capacities that have been and will be put in place, particularly in the manufacturing and services sector, especially the transportation sub-sector, the moderately higher crude petroleum production, the Commonwealth Games and the efforts taken to step up domestic production to substitute imports as well as to energise exports are expected to offset part of the growth dampening factors that are envisaged to emerge in 1998.

Output expansion in **manufacturing sector** is expected to remain strong, although at a slower rate of 10.5%. Industries that are expected to provide strong impetus to growth are those producing semiconductors, plastics, industrial chemical and synthetic textiles due to capacity expansion and steady external and domestic demand. The output of domestic-oriented industries is expected to record a slower growth of 10.4% (1997:13.7%), mainly as a result of slower output expansion by industries producing construction related materials such as non-metallic mineral and glass products as well as basic iron and steel. Domestic-oriented industries that stand to benefit from recent policy announcements to reduce and substitute imports are those involved in refurbishing and reconditioning of heavy equipment and the fabrication of metal products to be used in privatised infrastructural projects. The Commonwealth Games is expected to generate greater demand and, therefore, induce increased output from industries producing food and beverages as well as souvenirs. Although output growth of export-oriented industries, benefitting from capacity expansion especially in the semiconductors industry, is expected to sustain

at about 1997's level, that is 10.6%, output growth of some industries are expected to be adversely affected by intense global competition and worldwide excess capacities, such as those producing consumer electrical products including radios and televisions, and the relocation of labour intensive operations to surplus labour countries by some industries, such as those producing apparels. With the manufacturing sector envisaged to expand at a rate significantly surpassing that of other sectors of the economy, its share to GDP is expected to increase to 36.6% in 1998.

Construction starts are expected to slow down in 1998, as developers are expected to turn cautious in view of potential lower take-up rate of office space, higher end condominiums and retail outlets in shopping complexes as additional supplies come on stream. The completion of construction of sports facilities and related infrastructure for the Commonwealth Games and the first phase of the Kuala Lumpur International Airport as well as the deferment of several major projects such as Northern Airport, Hill Road, Linear City, the Bakun Hydro Electric Project and the phased implementation of Putrajaya over a longer period are expected to slow down the pace of construction activities. Nevertheless, the construction of landed residential properties, lower end apartments and factories, which are expected to continue to enjoy sustained strong demand, as well as construction activities related to infrastructural projects such as the rail link between the KLIA and city centre, the Multimedia Super Corridor, and the construction of highways such as the East Coast Highway and the Kuala Lumpur Elevated Highway are expected to contribute to a 9% increase in the value added of the construction sector in 1998 (1997: 11.0%).

After recording a relatively strong output growth of 3.5% in 1997, output from the **agricultural sector** is projected to decline by 1.2% in 1998. The projected contraction in output is largely due to lower palm oil, rubber and sawlog output. Following the four-year crop cycle, where output has been on the increase since 1994, the palm oil output is projected to take a dip in 1998 as a result of "stress" from the last four years of high production. Rubber production is also expected to decline due to prospects of further weakening of prices as well as the continued conversion of

rubber land for other uses. The expected weakening of rubber prices is attributed to projected world natural rubber supply still in significant excess over consumption and the prospects of stockpile release by Thailand. Sawlog output will be lower, consistent with the need to adhere to sustainable forest management. Nevertheless, output of cocoa, pepper and fishery are expected to record moderate growth due to more acreage under harvest as well as more intense fishing activities in response to favourable prices and financial assistance provided by the Government to fishermen for purchases of better equipment.

Output growth in the **mining sector** is expected to increase at a slightly higher rate of 3.8% in 1998 (1997:2.8%), as a result of 2.8% increase in crude oil production to 740,800 barrels per day. Production of gas and quarrying is expected to decelerate to 8% growth, in response to slowdown in the growth of demand while tin output is expected to decline due to higher cost of production.

In line with the moderation in the growth of the primary and secondary sectors of the economy, the pace of value-added in the **services sector** is expected to moderate slightly to 8.6% (1997:8.7%). Services industries that are expected to record slower growth are finance, insurance, real estate and business services as well as the utilities, reflecting in part the anticipated moderation in the growth of bank lending as well as the pace of construction and manufacturing activities. Nevertheless, value added in the transport, storage and communications services sub-sector is expected to record a stronger growth, underpinned by the enhanced delivery capacities of the nation's air transportation and shipping industries following recent acquisitions of aircraft and ships, particularly by MAS and MISC, as well as the wider network of rail transport systems. This sub-sector is expected to benefit from the Commonwealth Games in September 1998 through increased traffic and communications flows. Similarly, the wholesale and retail trade, hotel and restaurant sub-sector is expected to record a higher growth in value-added. With the value-added of the services sector increasing at a pace faster than the average growth of the economy, its share to the GDP is forecast to increase to 45.7%.

Domestic Demand

Aggregate **domestic demand** (excluding accumulation of inventories) is expected to increase at a slower pace of 6.9% to RM290.2 billion in current prices. The slower growth in domestic expenditure is attributed to expected containment of public sector expenditure. Growth in **private sector expenditure** is expected to sustain at 8.9%, with the growth of private sector capital expenditure decelerating to 8%. **Private sector consumption** particularly by households is expected to pick up by 9.5% in current prices, after a slowdown to 6.9% in 1997. The increase in private consumption reflects stronger export earnings, expected recovery in the stock prices which have dropped to recent historical low and adversely discouraged private consumption in 1997, and normal population growth. Nevertheless, the envisaged rate of increase in private consumption in 1998 is still low compared to the average rate of increase of 11.2% recorded during 1993 - 1996 when growth in per capita income was much stronger.

Growth in **private sector capital expenditure** is expected to slow down largely due to a deceleration in investment growth in the manufacturing and construction sectors. The expected slower growth in capital formation in the manufacturing sector is attributed to the enlarged production capacity that has already been put in place in recent years, lower sales orders especially consumer electrical products due to intense worldwide competition, as well as the prospective slowdown in construction activities. Reflecting potential slower capital formation in the manufacturing sector in 1998 is the 19.8% decline in proposed capital investment in manufacturing projects approved by MIDA during the first seven months of 1997. Investment in the construction sector is expected to be affected by the prospective excess supplies of condominiums and office space and retail outlets in shopping complexes. Deferment in the implementation of several large projects will also slow down capital formation in the construction sector. Private sector investment in the transportation sector is expected to be sustained by additional investment by MAS, amounting to RM2.5 billion through the purchase of nine aircraft. Investment in the oil and gas sector is expected to decelerate. Investment in

the upstream activities planned by three private oil companies is expected to increase at slower rate of 30.5% (1997:283.1%) to RM0.9 billion and in the downstream activities at 79.7% to RM 0.8 billion. Including investment by Petronas, investment in the upstream activities is expected to increase by 26.5% to RM7.9 billion and downstream activities by 19.0% to RM5.8 billion in 1998.

Expansion of **public sector expenditure** is expected to be contained at 0.5% in nominal terms to RM63.7 billion, reflecting the fiscal discipline of the Federal Government to generate a larger budgetary surplus in 1998 as well as slower increase in capital expenditure by the NFPEs. Growth in **public consumption** is projected to slow down significantly in 1998 to 2.6%, with the increase in emoluments being capped at 3% and on supplies and services at 3.7%, largely to meet expenditure essential for maintenance of buildings and repair works, payments of rentals and utility charges as well as improving overall public services.

Public sector investment is projected to decline by 1.6% in nominal terms in 1998 to RM31.5 billion. This is attributed to the NFPEs slowing down their capital expenditure within the country from RM16.6 billion in 1997 to RM15.7 billion. The slower growth in the capital expenditure by the NFPEs partly reflects the completion of the first phase of the KLIA project. As a result, the contribution of capital expenditure of the NFPEs to total public investment is expected to decline to 49.8% from 51.7% in 1997. Investment undertaken by the Federal Government is expected to increase by 12.1% to RM8.6 billion, largely for the purpose of developing essential infrastructure, human resources, health services as well as rural and agricultural facilities. However, investment undertaken by other government bodies is expected to decline by 7.2% to RM7.2 billion.

External Demand

The **external sector** is expected to exert a stronger stimulus to economic growth in 1998, as exports of goods and non-factor services are projected to exceed imports of goods and non-factor services by RM6,465 million, against a smaller surplus of RM2,789 million in 1997.

Exports of goods and non-factor services are projected to record a stronger growth of 9.1% to RM268.6 billion, underpinned by the recovery in the export of manufactured goods and the double-digit rate of increase in earnings from exports of services. **Merchandise exports** are anticipated to record a stronger growth of 7.5%, against 6.0% recorded in 1997, with the export of manufactured goods increasing by 9.5% on the back of steady export volume offtake and the expectation of sustained selling prices. However, exports of primary commodities are expected to decline by 2.9%, largely as a result of projected decline of 5.0% in the export of agriculture produce due to lower output as well as significant slowdown in the growth of export earnings from liquified natural gas from 45.9% in 1997 to 1.6%. Meanwhile exports of crude petroleum are also expected to decline by 0.4% due to expected lower export price. **Exports of non-factor services** are, however, projected to increase by 14.4%, underpinned by strong increases in the export of services related to air transportation, tourism, freight and insurance as well as professional and contract services.

Imports of goods and non-factor services are projected to increase at a slightly higher rate of 7.7% to RM262.2 billion in 1998. Reflecting the impact of more vigorous efforts to contain the growth of imports, especially through the deferment of several big projects and measures to reduce dependence on imports, but taking into account the prospects of higher prices of imports following the recent depreciation of the ringgit, growth in **merchandise imports** are expected to accelerate marginally from 6.6% in 1997 to 7.3%. Imports of capital goods are expected to slow down to 12.4% (1997:19.8%). Nevertheless, imports of bulky items are expected to remain large due to higher imports of aircraft by Malaysian Airlines (MAS). Growth of imports of intermediate goods is expected to pick up slightly to 7.4%, reflecting higher prices of these imports, against a slowdown in volume intake as a result of slower output growth in domestic-oriented manufacturing industries as well as slowdown in construction starts. Similarly, imports of consumption goods are projected to increase by 5.7%, due to pick up in private consumption. However, imports of luxury items, especially cars, are projected to slow down, largely due to reduced use of these imports by Government agencies. The rate of **imports of non-factor**

services is expected to decelerate slightly to 9.3% (1997:9.4%), due to import substitution effects, following enhanced domestic shipping, air transportation and education capacities as well as slower increase in payments for contract and professional services.

Balance of Payments

With merchandise exports projected to increase by 7.5% to RM220.1 billion, while merchandise imports by 7.3% to RM209.2 billion, the **merchandise account** is expected to record a higher surplus of RM10.9 billion, against RM9.7 billion in 1997. At the same time, the **services account** is expected to record a smaller deficit amounting to RM18.4 billion, against an estimated deficit of RM19 billion in 1997. The anticipated smaller deficit is attributed to larger surpluses of RM6.2 billion recorded in the travel account and RM3.5 billion in other transportation account which is largely air transportation services. However, these surpluses are expected to be more than offset by larger net payments on investment income (RM12.7 billion), freight and insurance services (RM8.6 billion) and other services which cover professional and contract services as well as franchise fees and royalties (RM6.7 billion). After taking into account the deficit in unrequited transfer of RM3.8 billion, largely as a result of repatriation of income by foreign workers to their countries of origin, the **current account** is envisaged to record a smaller deficit of RM11.3 billion. As a percentage of GNP, the current account deficit is forecast to narrow from 5% of GNP in 1997 to 4% of GNP in 1998.

Public Sector Financial Position

The **Federal government financial position** is projected to strengthen further in 1998. Federal Government **revenue** is projected to increase by 7.6% to RM68.1 billion on account of higher receipts from both direct and indirect taxes. **Operating expenditure** is projected to decline by 3% to RM42.8 billion. Of significance is the projected 6.5% decline in Federal Government payment on debt service charges to RM6.2 billion. Interest payments on external loans are expected to decline by 12.8% to RM0.5 billion due to decline in

outstanding external debts, while interest payments on domestic debts are expected to decline by 3.8% to RM5.7 billion. Allocation for emolument is expected to decline by 0.4% to RM14.7 billion. After taking into account loan recovery amounting to RM1,650 million, net development expenditure in 1998 is projected to increase by 15.6% to RM16.3 billion. Consequently, the **overall balance** of the Federal Government is projected to show a larger surplus of RM8,951 million or 3.2% of GNP.

The **consolidated public sector overall financial position** is also projected to improve in 1998. Revenue of the general government is expected to increase by 7.2%, while its operating expenditure is expected to decline by 3.3%. As a result, the general government's current account surplus is forecast to increase by 28.5% to RM31.9 billion (1997: RM24.9 billion). Similarly, the NFPEs are projected to maintain stronger operating surplus in 1998, amounting to RM23.5 billion (1997: RM22.5 billion). Hence, the consolidated public sector current account is anticipated to register a larger surplus of RM55.4 billion in 1998 (1997: RM47.4 billion). Total public sector development expenditure in 1998 is projected to increase by 6.5% to RM44.7 billion, largely due to the larger Federal Government development expenditure. Capital expenditure by NFPEs, including investment abroad, is expected to increase by 2.6% (1997: increase by 49.9%) to RM23.3 billion. Overall, the consolidated public sector financial account is envisaged to record a larger overall surplus of RM10.8 billion or 3.8% of GNP (1997: RM5.4 billion or 2.1%).

National Resource Position

Gross national savings are expected to increase at a slower rate of 8.6% to RM113.4 billion in 1998 (1997:14%), as a result of slower growth in GNP. Nevertheless, as a percentage of GNP, it is projected to increase to 39.9%. The higher saving rate reflects in part the impact of fiscal discipline, tight monetary policy as well as the efforts initiated by the Government to promote savings including the doubling to RM200,000 the limit Bumiputeras are allowed to invest in Amanah Saham Nasional and Amanah Saham Bumiputera. Public sector savings are expected to increase by 14.7% to RM51.8 billion or 45.7% of the gross

national savings while private sector savings are projected to increase by 4% to RM61.5 billion.

Although the level of gross national savings is projected to be insufficient to finance RM124.7 billion of **investment** expected to be undertaken by both domestic and foreign investors, the savings-investment gap of 4% of GNP is expected to be adequately financed by net inflow of foreign corporate direct investment. The anticipated resource gap of RM11.3 billion is attributed to private sector investment exceeding its savings by RM31.3 billion which is expected to be fully financed by net inflow of long-term foreign private capital as well as surplus funds mobilised from the public sector through financial intermediaries. The public sector is expected to record a surplus in its resource position, with its savings projected to exceed its investment by RM20 billion or 7% of GNP.

Inflation

With projected slower growth in domestic demand as well as the pursuance of fiscal discipline and monetary restraint, **inflation** is likely to remain low. The depreciation of the ringgit is not expected to push up the price of imports significantly, as slower growth in the volume of world trade against a steady increase in world output especially manufactured goods is expected to force producers worldwide to cut prices in order to get a greater market share, as evidenced in the recent decline in the prices of electrical and electronics products. More conscious efforts in procuring imports from cheaper sources as well as to generate local substitutes to alleviate the impact of ringgit depreciation would also contribute to keep imported inflation in check.

Conclusion

1997 has been an eventful year, marked by volatility in the financial markets that was triggered by developments in Thailand. Notwithstanding the instability generated by the markets, the fundamentals of the economy remain strong. The external payments current account deficit is expected to narrow as a percentage of GNP. The basic balance is expected to remain in surplus. The capital formation undertaken by both domestic

and foreign investors has been adequately financed by domestic savings as well as retained profits and new funds from foreign investors in the real sector of the economy. The Federal Government overall budgetary position remains in surplus. Nevertheless, more vigorous efforts have to be taken to strengthen further the fundamentals of the economy. Adjustments have also to be made to reduce the negative impact of a significantly weaker ringgit on the economy, particularly on imports, while savings have to be promoted in

order to strengthen the resilience of the economy to external shocks. At the same time, the private debt securities market will be further developed, in order to diversify the capital market, in part to provide the private sector an additional alternative source of raising funds at reasonable costs. Commitments to all these adjustments have been made through recent policy pronouncements. With further measures to be announced in the 1998 Budget, the fundamentals of the economy should strengthen further.