

2

Managing the Malaysian Economy in 1997

Macroeconomic Issues — An Overview

The macroeconomic developments leading to the formulation and presentation of the 1997 Budget continued to be favourable. The moderation in growth from 9.5% in 1995 to a more sustainable level of 8.6% in 1996 was accompanied by a significant narrowing of the external payments current account deficit (or the savings-investment gap) from 10.5% of Gross National Product (GNP) in 1995 to 5.2% of GNP in 1996. The deficit in the external payments current account was fully financed by net inflow of long-term foreign corporate investment. The basic balance was in surplus. In addition, the Federal Government budgetary position was in surplus for the fourth consecutive year. Inflation remained low, with the Consumer Price Index (CPI) increasing at 3.5%. Business confidence remained high, as reflected in the strong increases in proposed investment from the manufacturing sector during 1996. All these macroeconomic developments reflected the economy continued to expand at a healthy pace and on an even keel during 1996.

In 1997, growth remains strong, projected at 8.0%. The external payments current account deficit is expected to narrow further as a percentage of GNP and the public sector fiscal position to remain in surplus. At the same time, increases in consumer prices continue to be low. Notwithstanding these strong fundamentals, the Malaysian economy was not spared the contagion effect of the speculative onslaught on the regional currencies and stock markets triggered by developments in Thailand since mid-May. The speculative attacks on the financial markets have led to excessive volatility in the movement of interest rates and sharp depreciation of the local currency and share prices in September 1997, to the extent that the ringgit and share prices no longer reflect underlying

economic fundamentals. Such excessive volatility if protracted for a long period can generate destabilising consequences for the financial system and the economy. The major challenge was to restore stability in the financial markets, as it is only under conditions of stability can the markets perform efficiently and the private sector can have a predictable environment to conduct trade and investment. In this regard, the immediate policy response was to restore confidence in the financial markets and to ensure the level of interest rates was not unduly influenced by external developments to the extent that it stifled domestic economic activities.

The longer term challenge confronting the Government in managing the economy remained one of maintaining a strong but sustainable growth while strengthening further the foundations for macroeconomic stability. Sustaining growth remains critical to the realisation of the nation's vision of achieving the status of a fully developed country by the year 2020, while strengthening macroeconomic stability, especially external payments and price stability as well as the public sector fiscal balance, is crucial in developing the resilience of the economy to external shocks such as those experienced in the third quarter of 1997.

Maintaining a strong growth with macroeconomic stability is increasingly a challenging task as the rapid growth since 1988, averaging 8.9% per annum, has led to resource constraints. The nation increasingly requires a higher rate of investment and, consequently, a higher level of savings rate, to maintain the high growth. However, there is a limit to which domestic savings rate, which at 39.8% of GNP is already high by international standards, can be further raised for the purpose of financing the high rate of capital formation. Raising domestic savings is crucial to financing

growth without recourse to external borrowings as external liabilities would increase the country's exposure to changes in international exchange and interest rate movements. Shortages of labour have also put a constraint to growth. However, the large number of foreign workers, estimated at about 1.7 million, already in the country imposed a limit on the recruitment of foreign workers as a policy option to drive growth. The presence of sizable foreign workers has not only generated social problems and put pressures on social amenities but also exerted strains on the current account position of the balance of payments as a result of large remittances of these workers to their countries of origin.

The strategy for fostering future growth, thus, must continue to be one that is productivity-driven rather than input-driven. Therefore, one of the key objectives of the 1997 Budget that was presented on 25 October 1996 was to achieve sustainable growth through enhanced productivity. The Budget took into cognizance that enhancing productivity was also strategic to the nation's efforts in addressing a number of other challenges, particularly inflationary pressures and prospective loss of international competitiveness caused by rising wages that could translate into higher unit labour costs, if labour productivity gains were to lag behind wage increases.

In the balance of payments, while the deficit in the current account has narrowed significantly in 1996 and had been fully financed by net inflow of long-term foreign direct capital, it has to be further contained to strengthen the resilience of the economy to external shocks. The main source of weakness of the balance of payments has been the persistent deficit in the services account which more than offset the surpluses recorded in the merchandise account. The underlying structural problem has been the lack of capability of the services sector to compete in the international services trade and to substitute imported services, as the sector tended to be inward-looking in terms of market orientation. Increasing net payments on investment income due mainly to the high level of foreign investments in the country has also contributed to the services deficit. In addition, the import content of domestic economic activities continued to be high. Underlying this problem has been the weak inter-industrial linkages which have caused the relatively low value added in domestic manufacturing sector output.

The need to strategically strengthen the export and import substituting capabilities of the merchandise and services sectors has become more urgent as the regional and international trade increasingly move towards a more open and liberalised trading system under Asean Free Trade Area (AFTA), World Trade Organisation (WTO) and General Agreement on Trade in Services (GATS). The emergence of new market economies which have the advantage of an abundant supply of relatively cheap labour provides greater competition to Malaysian exports. Issues affecting the nation's international competitiveness and the liberalisation of the domestic market, therefore, have to be consciously and vigorously addressed in order to propel Malaysia to the forefront of international trade in goods and services and to increasingly reap the benefits of an expanding and a more liberalised world trade system in the medium term.

A factor that has contributed to the deficit in the external payments current account in recent years was the build-up of demand pressures, following strong income and investment growth. Although growth in domestic demand had decelerated in 1996, there was still a need to further manage demand so that it would be compatible with output growth. This was essential to ensure that the current account position of the balance of payments remained sustainable and resources were allocated more efficiently for productive use. In managing demand, the focus was towards discouraging excessive consumption, promoting savings and prioritising resource allocation so that more domestic resources be made available for purposes of financing more productive investment, particularly those which could expand the export capacity of the economy.

Although inflation rate, as measured by the Consumer Price Index (CPI), remained moderate, it had accelerated slightly from 3.4% in 1995 to 3.5% in 1996 mainly due to the acceleration in CPI for food from 4.9% to 5.7% during the period as a result of supply bottlenecks. The pressure on domestic prices was also induced by higher wages that had raised labour costs per unit of output as wage increases began to outpace productivity gains in 1996. While the rise in the price of consumer goods and services remained moderate, asset inflation was a cause for concern, as property prices had increased at double digit rates in recent years. Easy access to loanable

funds as well as strong increases in income and prospects of capital gains were factors underpinning gains in property prices. The issues of excessive demand and price pressures, therefore, had to be addressed to prevent the erosion of real income, contain the costs of doing business, minimise the potential risks associated with asset inflation and ensure continued macroeconomic stability.

Given the high rate of investment in recent years, a significantly larger amount of resources needed to be mobilised through the domestic financial markets, so as to reduce the nation's dependence on external financing. Consequently, the effectiveness and the efficiency of the financial markets to mobilise investible funds need to be further enhanced. While Malaysia's stock market was well-capitalised and liquid, the bond market was still relatively underdeveloped. Major constraints to the development of the bond market included the declining supply of tradeable government papers as a result of the Federal Government budgetary surplus, too many "done deals" and an absence of secondary trading. Further initiatives were, therefore, needed to further develop the financial markets, particularly private debt securities, to meet the increasing resource needs of a fast expanding economy, as well as to develop Kuala Lumpur as a regional capital market and services centre.

Economic growth must be accompanied by social development and justice to ensure that all segments of the population benefit from the growth process. Issues related to poverty reduction, rural development, health care, housing as well as youth and women development, therefore, needed further policy addressal. Similarly, the inculcation of a caring culture, the mitigation of social ills, the protection of the environment and the promotion of arts and culture have to be addressed as part of the ongoing social agenda to ensure a balanced development.

Policy Initiatives

The policy measures introduced since the presentation of the 1997 Budget through the first nine months of 1997 were of short and long-term nature. The short-term measures were primarily aimed at restoring stability in the foreign exchange and the equity markets that were subjected to

bouts of speculative attacks, triggered by developments in Thailand since mid-May 1997. These measures reflect the need for flexibility and adaptability in policy stance to deal with unexpected developments that can have destabilising consequences on the economy. The longer term measures which were introduced during the presentation of the 1997 Budget were aimed mainly at:

- (i) achieving sustainable growth through enhanced productivity; and
- (ii) strengthening the balance of payments position through improvements in the services sector and higher domestic production.

Restoring Stability In The Financial Markets

Triggered by developments in Thailand, a number of ASEAN currencies, including the ringgit, has been subjected to bouts of speculative attacks since mid-May through the third quarter of 1997. These bouts of speculative attacks have led to volatility in the movement of interest rates and sharp depreciation of the local currency and share prices to the extent that the value of ringgit and share prices no longer reflect underlying economic fundamentals. On July 10, following a contraction in liquidity resulting from external developments, the interbank rates increased sharply across the board, with the overnight and the 3-month rates reaching 40% and 8.6% respectively, from 7.5% and 7.9% the day before. On 4 September 1997, the Kuala Lumpur Stock Exchange (KLSE) main board index, the Kuala Lumpur Composite Index (KLCI), dropped to a record intra-day low of 675.15 since 20 April 1993, while on 30 September 1997, the ringgit dropped to an intra-day low of RM3.2550=US\$1.

Given that protracted high interest rates could stifle economic activities and the continuous slide in the ringgit value and stock prices could lead to adverse contagion effects on the economy, strategic measures were introduced to restore stability in the financial markets. Consequently on 31 July 1997, Bank Negara Malaysia issued guidelines requiring the financial institutions to cap their base lending rates in August at the July ceiling. Subsequently, on 4 August, Bank Negara Malaysia introduced a US\$2 million limit which

each bank has to observe on non-commercial related ringgit offer side swap transactions with foreign customers. This measure helped to give Bank Negara Malaysia the flexibility to normalise interest rates based on domestic conditions. Following this measure, interbank rates eased and, by mid-August, interest rates returned close to levels prior to the excessive volatility in the currency market. As at 30 September, the overnight and 3-month rates were 7.07% and 8.04% respectively.

A number of measures was also introduced to restore stability in the equity market where prices have fallen due to manipulative short-selling through borrowed shares. These measures included:

- (i) the declaration of all the 100 component stocks of the KLCI as "designated securities" on 28 August 1997. With this designation, any sale of these 100 stocks would be prohibited unless the seller has a free balance of the shares (that is securities which have been given good value and confirmed by the registrar) in the Central Depository Account maintained with the stockbroking company at the time of entering into the sale contract. Dealings in these stocks would be restricted to a "delivery before sale" basis pursuant to the rules of the exchange. A 100% payment was required before the purchase contract was entered into and all contracts done would be due for book entry delivery on the first market day following the date of the contract. Payment to selling clients by stockbroking companies would be due on the second day following the date of the contract. The objective of this ruling was to disallow contra or netting settlement of a purchase against subsequent sale.

On 5 September 1997, the authorities lifted the ruling that classified as "designated securities" the 100 blue chip stocks which make up the KLCI, given that the ruling has met its objective. Nevertheless, the ruling disallowing lending of shares and short-selling remained;

- (ii) allowing companies to buy back their own shares in accordance with the new provisions, Section 67A, together with the related regulations, of the Companies Act

1965 which come into force on 1 September 1997. The provisions were aimed at stabilising the supply and demand of securities and consequently their prices;

- (iii) allowing local funds such as Employees Provident Fund (EPF), Permodalan Nasional Berhad and the Pension Trust Fund to buy shares above their previous limits and allow banks to lend them money to buy up shares;
- (iv) abolition of the RM100,000 levy on foreigners buying property in Malaysia costing above RM250,000 on 28 August 1997. This is to boost market sentiments particularly with regard to the property sector whose share prices have been affected by prospects of excess supply in certain property market segments; and
- (v) the setting up of a RM60 billion standby facility to support the local stock market in the event the need arises.

To restore confidence in the financial markets, the Government announced its intention to delay or reschedule a number of infrastructure projects, including the Bakun dam, the northern airport, the Kuala Lumpur Linear City and Putrajaya in order to reduce the nation's external payments current account deficit. In the case of Putrajaya, only phase one of the project will be implemented for the time being. To reduce imports, purchase of large foreign goods by Government agencies will be reviewed and cancelled while Members of the Administration and eligible public officials will be provided with Proton cars instead of imported luxury cars. In the case of privatised projects which are essential for improving the long-term growth prospects and whose import content is acceptable will be allowed to proceed. The Government has also announced a 2% across the board cutback in Government expenditure to achieve a larger overall Budgetary surplus for 1998 as part of the national efforts to promote savings, in order to reduce the reliance on foreign resources, especially debts, for financing growth as well as to ensure price stability. All these measures, coupled with prospective measures to be introduced in the 1998 Budget, should strengthen further the fundamentals of the economy. This should help to restore confidence and improve stability in the financial markets.

Promoting Sustainable Growth Through Enhanced Productivity

Towards productivity-driven growth

To foster productivity-driven growth, the policy focus was towards enhancing efficiency through the use of high technology, improving the quality of investment and accelerating human resource developments with the view to strengthening further the nation's technological and R&D capabilities as well as managerial and entrepreneurial skills. Increasing the value chain of the manufacturing process and improving the efficiency of the financial system in mobilising savings and in allocating funds for more productive use were also strategic towards achieving productivity-driven growth. Consequently, a number of measures was introduced in the 1997 Budget to complement and strengthen past measures to foster productivity-driven growth. One of the measures introduced during the 1997 Budget was the provision of the Reinvestment Allowance of 60% based on 100% exemption of statutory income to encourage manufacturing and agricultural firms to reinvest in equipment which can improve significantly their productivity through changes in production technique. Prior to this, the tax exemption allowed under the Reinvestment Allowance was restricted to 70% of the statutory income in any given year of assessment and was given as an incentive to encourage manufacturing and agricultural firms to expand capacity, diversify output or to modernise operations which may not necessarily lead to increases in productivity.

Towards industries of the future

Developing knowledge-based, technology-intensive and high-technology industries are strategic to propelling future growth and productivity increases. Consequently, there is a need for industries to undertake a strategic shift towards these industries of the future. In this regard, the Government provides special incentives to promote high-technology industries, specifically those producing wafer fabrication products basic to the semi-conductor industry that will strengthen linkages between industries, besides increasing skills. A major strategic policy thrust to raise

productivity and to enhance Malaysia's international competitiveness is in the field of information technology, with strong emphasis on the Multimedia Super Corridor (MSC). Seven special areas or flagship applications have been identified for implementation under the MSC which include telemedicine, smart schools, research and development clusters, and application of multipurpose cards. While the MSC will serve as a catalyst for the development of IT-based industries, it will also facilitate the industrial sector to adopt information and knowledge-driven processes in manufacturing and other related activities, as it will also be geared towards becoming a remote manufacturing coordination and engineering support web. This web will electronically enable companies in high cost countries to access plants across Malaysia and Asia as "virtual" extensions of their domestic operations. Through the MSC, the country will also pioneer the implementation of an electronics government where the multimedia-networked paperless administration centre of Putrajaya will be linked to other government centres nationwide.

To encourage companies to operate in the MSC, the following incentives have been provided in the 1997 Budget:

- (i) granting of Pioneer Status for ten years or Investment Tax Allowance of 100 per cent to a new company or to an existing company, on its additional income;
- (ii) exemption of all taxes on multimedia equipment;
- (iii) a special incentive be given to companies whose presence will attract other companies to establish their operations in the IT City; and
- (iv) a special guideline to regulate foreign currency transactions and loans.

Intensifying human resource development

Malaysia must have a competitive and technologically competent workforce to propel the nation to a higher level of competitiveness in international trade of goods and services. The availability of a well-trained and technologically competent labour force will facilitate the Malaysian

industries to shift towards more efficient and labour-saving, technology-intensive production processes. This shift is critical in raising labour productivity and ensuring cost competitiveness, given that the labour market is expected to remain tight and will continue to exert upward pressures on wages. Therefore, intensifying human resource development, particularly through public-private sector collaboration, continues to be a major public policy thrust. This is with the view of building not only the nation's science and technology manpower to support technology development, but also the intellectual capability in management and entrepreneurship to bring about rational decisions and improvements in efficiency and productivity in all sectors of the economy.

Consequently, the 1997 Budget allocated a sum of RM13.2 billion for education and manpower training. Of this, a sum of RM10.0 billion was set aside for schools, the implementation of the Computer In Education Programme and the funding for institutions of higher learning. The allocated sum was also for the construction and upgrading of technical and vocational schools and polytechnics as well as the financing of training programmes in the Industrial Training Institutes, the Institut Kemahiran Belia Negara and at the Giat MARA Centres. A sum of RM1.2 billion was allocated for scholarships and loans. In view of the corporatisation of universities, a launching grant of RM100 million was provided for the Higher Education Fund. This Fund is a loan scheme to assist students given places in local institutions of higher learning facing financial constraints.

To increase the nation's capacity in developing human resources, a number of Government corporations has set up institutions of higher learning, including the PETRONAS Institute of Technology in Perak, the Telekom University (UNITEL) in Melaka and the Tenaga Nasional University in Selangor to supplement private sector initiatives. In addition, more courses have been introduced in Universiti Malaysia Sarawak (UNIMAS). In the pipeline for construction are Universiti Malaysia Sabah and a multimedia university in the MSC. A Design Technology Centre will also be established in the Malaysian Technology Park to train skilled manpower in the field of design that will directly benefit the industrial sector in its efforts to enhance the quality of their products in the international market. In addition, to introduce

and encourage the use of robotic technology, a Flexible Manufacturing Centre will also be established. To complement the expansion of training and education facilities in the country, the Government has permitted the entry of foreign lecturers to overcome the shortage of lecturers. To encourage foreign lecturers to teach in Malaysia, non-resident lecturers who lecture in approved institutions and organisations have been given 50% exemption of their income from income tax during the 1997 Budget. This exemption, however, is only given to lecturers who teach in selected fields, namely, science, engineering and technical skills, information technology, high technology, philosophy and other critical disciplines. In addition, income tax exemption of 50 per cent has been given on income received by any non-resident company or organisation from services rendered by their lecturers in approved training institutions.

Narrowing the savings-investment gap

Productivity can also be increased by ensuring a more efficient utilisation of available resources by both the public and private sectors. Therefore, in the conduct of fiscal and monetary policies, the major thrusts are to promote savings and reduce wastage so that a larger portion of national resources can be channelled for more productive investment. In this context, the Federal Government continues to strive towards maintaining an overall budgetary surplus to supplement national savings, so that the corporate sector can have greater access to domestic funds for financing of productive investment. Stringent control continues to be exercised on operating expenditure to avoid wastage and contain less critical consumption. In the allocation of development expenditure, priority was given to education and training as well as health to upgrade the quality of human capital which is essential in raising productivity. Infrastructural development was also given priority to improve the efficiency in the conduct of economic activities. Although the national savings rate continues to increase, the investment rate has also been high, resulting in a savings-investment gap of estimated 5.2% of GNP in 1996. There was, therefore, a need to step up national savings. In this regard, a Cabinet Committee On the Promotion of Savings has been established to promote the savings habit especially among

students, housewives and workers as well as to reduce the barriers and obstacles to increasing savings and eliminate the habit of waste in the private and public sectors.

To further promote savings and discourage consumption, a number of measures was introduced in the 1997 Budget. These measures included:

- (i) the imposition of a service tax of RM50 a year on all types of credit cards, including those given on a complimentary basis. This is to encourage financial prudence by discouraging the use of credit cards which were already in extensive use and which have led to indebtedness;
- (ii) allowing a cooperative with membership funds of up to RM750,000 to be exempted from income tax, instead of the prevailing RM500,000. This is to encourage cooperatives to mobilise more savings from its members for productive investment; and
- (iii) removing the restriction on relief for life insurance premiums with the view to encourage savings. Prior to the removal of this restriction, the total premium on life insurance and contributions to the EPF allowed as a relief in the computation of individual income tax was up to RM5,000. However, for life insurance premiums, the tax payer was only allowed relief of up to 7 per cent of the value of the life insurance policy. Due to this restriction, the tax payer might not be able to enjoy the maximum relief given. The removal of this restriction will allow low and medium-income groups to enjoy higher relief than previously allowed.

To supplement these measures, an additional measure was introduced during September 1997 to further promote and mobilise savings. This related to the doubling to RM200,000 the limit that Bumiputeras are allowed to invest in Amanah Saham Nasional and Amanah Saham Bumiputera, the country's largest saving schemes. This measure was announced on 7 September 1997 and the effective date for implementation is expected to be November 1997.

Strengthening The Balance of Payments

Improving the services account

The main weakness in the balance of payments has been the persistent deficit in the services account which more than offset the surplus recorded in the merchandise account. The services deficit is a structural problem which requires long-term efforts. Long-term measures to strengthen the services account such as expanding the nation's shipping and airline capacities to export and substitute imported services often generate adverse short-term trade-offs in terms of large imports of ships and aircraft. Similarly, for the nation to earn investment income to neutralise the repatriation of dividends and profits by foreign investors in the country, Malaysian companies have to invest abroad. This inevitably has the immediate impact of reducing the availability of national savings for financing domestic investment and affecting the nation's external reserve position. Nevertheless, past measures to strengthen the services account of the balance of payments have shown encouraging results. Exports of tradeable services (excluding investment income receipts) increased significantly by 25.7% in 1996, while imports of tradeable services (excluding investment income payments) increased at a slower rate of 16.9% 1996. These favourable developments have enabled the deficit in the tradeable services account to narrow not only as a percentage of GNP but also in absolute terms.

To further improve the services account of the balance of payments, a number of measures was introduced in the 1997 Budget:

- (i) to promote the export of professional services, including financial, engineering, legal and accounting, the export of these services would be exempted from service tax. Similarly, the service tax on private hospitals, except for food and accommodation, would be exempted from service tax;
- (ii) to encourage private companies to complement Government's efforts in promoting tourism, tax incentives in the form of Investment Tax Allowance or Pioneer Status would be given for five years to companies constructing tourism projects such as medium and low-cost hotels, holiday camps and recreational projects, convention

centres of specific size and modernisation of existing hotels. In addition, conference promoters bringing in at least 500 foreign participants would be given income tax exemption up to the year 2000. This is to promote Malaysia as a convention centre and to complement the expenditure allocated for the development of the tourism industry. At the same time, the 1997 budget allocated a total of RM294.5 million for the tourism sector, including the provision of budget hotels, upgrading the facilities of rest houses and promotion of tourist activities;

- (iii) to further assist the growth of the nation's shipping industry, an additional RM200 million was provided by the Shipping Fund, raising the total fund available to RM1.3 billion; and
- (iv) to encourage Malaysian investors to remit profits back to Malaysia, the ceiling on the foreign currency accounts which qualified Malaysian exporters could maintain was raised from US\$5 million to US\$10 million. These exporters would also be allowed to maintain more than one foreign currency account as long as they are within the approved limits. These measures complement the tax exemption provided in the 1995 Budget on profits remitted by Malaysian investors to Malaysia.

Improving the merchandise account

While the merchandise account has traditionally been a source of strength of the balance of payments, the size of the surplus has not been large enough to offset the services deficit. Merchandise import remains large, due to the overdependence of domestic economic activities on imported intermediate and capital goods. Reflecting this overdependence is the high ratio of imports of intermediate goods to nominal GDP at 52.4% in 1996. Weak inter-industrial linkages have contributed to the overdependence of domestic economic activities on imported intermediate and capital goods as well as low value added in the manufacturing activities, which tend to focus on assembling and producing simple parts and equipment.

The development of small and medium-scale industries (SMIs) into suppliers capable of producing components and parts of high quality for large firms including multinationals can help to reduce the nation's overdependence on imported intermediate goods. In this regard, the Government has introduced several special programmes to strengthen industrial linkages between large firms and SMIs as suppliers of components. To further strengthen these linkages, the 1997 Budget allowed expenditure incurred by large firms conducting factory audits, training and product testing for SMIs to be deducted for tax purposes. SMIs participating in the industrial linkages programme and producing intermediate goods would also be given full tax exemption for 5 years. In addition, firms that produce goods of quality capable of penetrating the world market would be also given full tax exemption for 10 years.

Specific measures were also introduced to increase domestic production and discourage the import of intermediate and capital goods. These measures included:

- (i) withdrawal of import duty and sales tax exemption on spares and consumables used in manufacturing, such as screws and bolts, filters, valves, gaskets, refractory bricks, grinding stones, sandpaper and catalysts with immediate effect;
- (ii) withdrawal of import duty and sales tax exemption on certain hotel equipment, such as crockery, cutlery, linen and covers with immediate effect. However, tax exemption would continue to be given on selected capital equipment not produced locally;
- (iii) reducing gradually the import duty exemption on components used in the assembly industry. These included adaptors cathode ray tubes, fly back transformers and remote control units for television assembly; motors, compressors, condensers, dryers and evaporators for the air-conditioning industry; and head assembly, cylinders, crank shafts and sprockets for the motorcycle engine assembling industry. As a start, those components which were subjected to an import duty of 5 per cent and more would have to pay an import duty of at least 5 per cent effective immediately; and

- (iv) imposition of import duties of 5% to 20% on imports of heavy machinery such as bulldozers, excavators and pile-drivers. The levy was to supplement the measure introduced in the 1996 Budget which had listed reconditioning of heavy machinery as a promoted activity.

Increased international competition has affected the export prices of Malaysia manufactured goods in 1996. This, coupled with the decline in the value of agriculture exports, has led to a deceleration in the growth of the value of gross exports to 6.5% in 1996 from 20.2% in 1995. In view of this, the competitiveness of the export sector would have to be further strengthened. Acquisition of proprietary rights and promoting Malaysia as an international procurement centre are strategic to efforts in enhancing Malaysia's international competitiveness as well as increasing the value chain of the manufacturing sector. Consistent with these efforts, the 1997 Budget has allowed the relevant expenditure for the purchase of patents, designs, models, plans, trade marks or brands and other similar rights to be deducted in the computation of income tax with effect from the year of assessment 1997. The purchase of these rights would save Malaysian firms time in acquiring the latest technology and in promoting the marketing of its products. At the same time, to attract the multinationals to use Malaysia as a centre of marketing and distribution, the 1997 Budget had introduced a number of incentives to encourage the establishment of International Procurement Centres. These incentives were:

- (i) the flexibility to bring in expatriates according to needs, maintain multiple foreign currency accounts, participate in forward foreign exchange contracts and be exempted from complying with the guidelines with respect to foreign equity ownership on retail trade; and
- (ii) tax exemption for raw materials, components and finished products brought into Free Zones and Licensed Manufacturing Warehouses for the purposes of repacking, cargo consolidation and integration before distribution to final consumers.

These measures were also aimed at meeting the objectives of the Second Industrial Master Plan (IMP2) which was launched on 28 November 1996. The strategic thrust of the IMP2 is to orientate the manufacturing sector to be a global player in terms of class and scale. It strives to enhance industrial linkages, increase productivity and competitiveness of the manufacturing sector by emphasizing the full integration of manufacturing operations through the value chain, that is by emphasizing activities beyond production and assembly to include R&D and design capabilities, development of integrated supporting industries particularly the SMIs, packaging and marketing and distribution capacity.

Containing Inflationary Pressures

Increases in food prices had contributed for about half of the increase in the overall CPI during 1996. As part of the on-going efforts to contain pressures on food prices, a total of RM1.7 billion had been allocated in the 1997 Budget for agriculture, fishery and livestock as well as to improve the efficiency of the marketing and distribution system. An allocation of RM92.1 million was set aside for programmes to combat inflation. These included the Zero-inflation campaign and price monitoring on 75 essential items for the low-income groups as well as to curb unethical business practices. Since increasing cost of materials could lead to cost-push inflationary pressures, the 1997 Budget had allowed manufacturers of selected non-taxable goods to obtain raw materials and components free from sales tax. This covered all computer equipment including modems; packaging materials for a variety of products; manufacturing materials for batik and printing industry; tyre-retreading; and agriculture sprayers. In addition to this, import duties and sales tax were abolished or reduced on a number of goods such as canned anchovies, mackerel and tuna; dental alloys, cosmetics, deodorants, paper products and all types of printed paper for the purpose of reducing publishing costs, particularly on items used in schools.

Developing A Dynamic Financial Sector

A well-developed financial and banking services is crucial for the effective and efficient mobilisation

of resources for purpose of financing capital formation. In cognizance of this, the process of reforming the banking and the financial services has been initiated through progressive liberalisation of these services. The introduction of the Two-Tier Regulatory System to encourage the financial institutions to build up their competitiveness and the establishment of the Kuala Lumpur Options and Futures Exchange as well as the Malaysia Monetary Exchange in 1996 to enable trading in financial futures are part of this liberalisation process. To further promote the financial and banking services, a number of measures was announced in the 1997 Budget. These measures included:

(i) Security Broking Services

To enable local brokers to compete with foreign brokers, local security broking firms have been permitted to set up unit trusts, undertake fund management and underwriting activities and issue call warrants. They would also be permitted to manage the listing of companies and undertake electronic share transactions subject to certain conditions. To enable these brokers to obtain expertise from foreign firms, the 1997 Budget allowed foreign firms to have equity in domestic brokerage firms of up to 49 per cent.

(ii) Fund Management Services

To develop the fund management industry, the 1997 Budget rationalised the taxes relating to fund management activities. The rationalisation included:

- (a) extending the concessionary tax rate of 10 per cent enjoyed by foreign fund management companies on income derived from the management of funds sourced from outside Malaysia to local fund managers; and
- (b) exempting gains derived by closed-end funds from investment from tax and granting shareholders income tax exemption on dividends declared out of exempted income.

(iii) Benchmark Bond

The Government introducing a series of bonds aimed at providing a benchmark yield curve in the private debt securities market. These series of bonds are in the form of a zero coupon bond and are issued on a regular basis with short, medium and long term maturities. This benchmark bond also fulfills Islamic principles with murabahah and bai'al-dayn features. In September 1997, Khazanah Holdings Berhad issued the first of a series of its benchmark bonds worth RM1 billion. The RM1.0 billion offering was oversubscribed, attracting bids totalling RM2.262 billion. For the face value of RM100, purchasers paid RM79.44 for the 3 year tenure bonds. The issuance of the benchmark bonds is to further develop the private debt securities market in order to diversify the capital market so that the private sector has an alternative source of raising funds, thus, reducing its over reliance on the equity market.

(iv) Banking system

Under the Two-Tier Regulatory System, adequately capitalised and well-managed financial institutions are allowed to operate in a more liberal environment while the activities of weaker institutions will remain closely supervised. In this regard, Tier-I merchant banks have already been permitted to engage in foreign exchange business and invest in stocks listed on ASEAN stock exchanges. Following the announcement in the 1997 Budget, Tier-I commercial banks will also be permitted to undertake securities and lending business and engage in equity derivatives.

(v) Scriptless Trading of Securities

As an additional instrument to scriptless trading, the system for electronic transfer of funds and securities (SPEEDS) has been enlarged to include unlisted corporate bonds. This step is to increase the liquidity in the bond market since the trading and settlement of bonds can be done electronically through SPEEDS.

(vi) Developing an Islamic Share Index

With the objective of making Kuala Lumpur a regional Islamic financial centre, an Islamic share index will be introduced on the KLSE. This index provided an indicator for companies approved by the Syariah Advisory Council (SAC). On 18 June, the SAC has approved an initial list of 371 companies listed on the KLSE as approved securities. As these companies are listed in both the Main and Second boards of the KLSE, an index has been developed by the KLSE for each of these Boards.

(vii) Over-The Counter (OTC) Market

To complement Government's efforts to make Kuala Lumpur a regional capital centre, an OTC market will be introduced. This market will allow shares of high-technology companies which have yet to show a profit record to be traded. In this connection, the Malaysian Exchange of Securities Dealing and Automated Quotation (MESDAQ) is expected to be launched by the end of 1997.

(viii) Malaysian Accounting Standards Board and Financial Reporting Foundation.

The development of the capital market requires a high level of financial reporting and disclosure. In this connection, the Government had, in the 1996 Budget, announced its intention to set up a Financial Reporting Foundation and Malaysian Accounting Standards Board to formulate accounting standards and identify areas of regulation and enforcement. Subsequent to the tabling of relevant Bill to the Parliament as indicated in the 1997 Budget, both the Foundation and the Board were operational beginning 1st July 1997.

Promoting Labuan As An Offshore Financial Market

To further promote Labuan as an offshore financial market, securities legislation will be formulated specifically to encourage stock market activities in Labuan. The Offshore Companies Act will be amended to allow Malaysians to own

offshore companies and for non-Malaysians owned offshore companies to undertake portfolio investment in Malaysia. Financial activities based on Syariah principles, including interest-free banking, Takaful, fund management, loan market and private debt securities will be encouraged. Towards this end, the Offshore Banking Act is to be amended to allow merchant banks and Islamic banks to operate in Labuan. As a measure to ensure the further development of Labuan, the 1997 Budget introduced a number of incentives:

- (i) tax exemption of 65 per cent of statutory income of companies providing qualifying professional services to offshore companies. This exemption is effective from year of assessment 1997 to 2000;
- (ii) tax exemption of 50 per cent on gross income of foreign workers at the managerial level serving in offshore companies be extended up to year of assessment 2000;
- (iii) reduction of period of stay in Labuan from 72 hours to 24 hours for purchase of qualified duty-free goods; and
- (iv) reduction of road tax by 50 per cent.

Fiscal Management

As part of the efforts to further improve the balance of payments position as well as to improve the nation's resource position, the Federal Government budgeted for a larger surplus in its overall financial position in 1997, that is for the fifth consecutive year. In the allocation of the development expenditure, priority was given to the development of the nation's human resources, strengthening R&D capabilities, broadening the science and technology base, improving infrastructural facilities, strengthening the services sector, containing inflationary pressures, augmenting the entrepreneur development programmes as well as addressing the social agenda.

In the case of taxation, the measures introduced took into cognizance the need to contribute towards national savings in order to improve the overall nation's resource position. Consequently, the total tax package introduced in the 1997 Budget was envisaged to generate a net tax gain of some RM320 million for the Government. This is in

sharp contrast to the preceding two budgets where the tax loss was about RM2 billion a year. The change in trend also reflects the endeavour needed to moderate demand pressures through the 1997 Budget to ensure macroeconomic stability, particularly to combat inflation. Essentially, the tax measures introduced in the 1997 Budget were aimed at supplementing past measures to address the challenges and issues confronting the economy. Broadly, these measures were aimed at:

- (i) developing the services sector as a catalyst of economic growth as well as a vibrant foreign-exchange generating industry, particularly to address the deficit in the services account of the balance of payments; and
- (ii) increasing domestic production capacity, particularly with the view to reducing the reliance of the economy on imported intermediate and capital goods as well as strengthening inter-industrial linkages.

The tax measures introduced in the 1997 Budget reflected the affirmation of growth-oriented tax policy, while avoiding new taxes that can generate inflationary pressures and stifle growth. While no major adjustments were made to income tax, more incentives and tax exemptions have been provided to supplement past tax measures with the view to sustaining economic growth. Nevertheless, some of the tax exemptions provided in the past were withdrawn during the 1997 Budget, reflecting fine-tuning of past measures that is consistent with the on-going efforts to strengthen the foundation of the economy.

Monetary Policy

1997 was a challenging year for the conduct of monetary policy. The first quarter of the year saw high levels of monetary growth driven by rapid growth in credit, which had also prevailed during the most part of 1996. In addition, loans were increasingly channelled towards less productive activities. Such developments raised several concerns. High levels of monetary expansion, if left unchecked, would have inflationary implications on the economy. Furthermore, the rise in loans to the property sector and to stock

market-related activities increased the exposure of banking institutions to these sectors, raising the potential risk to the soundness of the institutions.

Against this background, the thrust of policy in 1997 had been to contain the growth of credit, particularly to the less productive sectors. Towards this end, monetary policy was progressively tightened throughout the year, resulting in higher interest rates. However, while interest rates would affect the cost of borrowing, it might not influence the desired direction of credit. Furthermore, the momentum of credit growth was very strong, implying that significant interest rate adjustments would be required to achieve the desired objective. This would increase the risk of an over-adjustment of the whole economy. Hence, the firming of interest rates needed to be supplemented by other prudential measures.

Given these considerations, as a pre-emptive measure to curb an escalation of credit to the property sector and for the purchase of stocks and shares, specific prudential measures were announced on 28 March 1997 for implementation effective 1 April 1997:

- (i) All banking institution were required to observe a limit on credit facilities extended to the property sector to not more than 20% of their outstanding loans (excluding the purchase of owner-occupied residential properties, the construction of residential properties costing RM150,000 and below, infrastructure projects and industrial buildings and factories); and
- (ii) The existing limits of 15% imposed on outstanding loans for commercial banks and finance companies and 30% for merchant banks for credit facilities secured by stocks and shares and units of unit trust funds were redefined to cover credit facilities granted for the purchase of stocks and shares and units of unit trust funds, including loans to holding, and investment companies. Loans extended for the purchase of Amanah Saham Nasional, Amanah Saham Bumiputera, Amanah Saham Wawasan 2020 and units of unit trust funds established by the State Governments were exempted from these limits.

The task of monetary policy became increasingly difficult in the second half of the year, in an environment of instability and uncertainty in the regional financial markets affected by contagion effect. Following a contraction in liquidity resulting from external developments, interest rates in the interbank market, especially for shorter-term maturities of overnight to one month, rose sharply across the board for a short period in May and a more protracted period in July. On both occasions, external conditions necessitated Bank Negara Malaysia to take firm actions to restore stability in the foreign exchange market, inevitably resulting in a spillover effect into the domestic money market. High levels of interest rates, if allowed to persist over a long period, posed the risk of a major correction of the economy. Furthermore, the wide fluctuations in interest rates would undermine investors' confidence and create a less conducive environment to conduct business and investment. To insulate the domestic interest rates from external developments, Bank Negara Malaysia introduced a temporary measure on 31 July 1997 requiring banking institutions to cap their base lending rate in August at the ceiling for July. This was subsequently lifted in the following month. On 4 August 1997, Bank Negara Malaysia directed the banking institutions to observe a US\$2 million limit on non-commercial related ringgit offer side swap transaction with foreign customers. This was aimed at limiting the supply of ringgit to the speculators. At the same time, liquidity in the money market was judiciously managed.

These measures contributed towards normalising conditions in the domestic money market. Interbank rates eased gradually but remained above the levels before the excessive volatility in the money market, in tandem with tighter policy.

On the measures to contain credit growth, signs of moderation in credit growth had begun to emerge. Loans to the broad property sector moderated to 27.4% of the total loans extended by the banking system during the second quarter of 1997, compared with 30.6% for the whole of 1996. On a quarterly basis, M3 growth decelerated from 5.4% in the first quarter, to 3.2% in the second quarter (7.5% in the fourth quarter of 1996). The growth of M3 credit moderated from 7.5% to 6.9% in the first and second quarter respectively. Nevertheless, despite the increasing signs of a slowdown in credit and monetary growth, Bank Negara Malaysia remained vigilant against any

signs of a further growth in credit. Monetary policy would remain tight to ensure that credit growth would not be excessive.

Addressing the social agenda

The 1997 Budget focused on issues beyond economic management. While Malaysia has made significant progress in promoting economic development and sustaining growth, there is a need to balance this achievement with social development and justice as well as the preservation of the environment and the national heritage. Therefore, in the 1997 Budget, substantial allocation was made to address the social agenda. To narrow the income gap between the urban and rural areas, a sum of RM7.051 billion has been allocated for rural development. Programmes aimed at revitalising the institution of family as well as equipping the welfare institutions for senior citizens, children, youth and the handicapped have also been given allocation to foster the development of a caring society. Allocations to NGOs were increased to RM50 million so that they could participate more actively in community development. Reflecting the nation's resolve to reduce the poverty rate to 5.5% by the year 2000, a large allocation of RM2.4 billion has been set aside to implement programmes aimed at reducing poverty. Similarly, large allocations were provided to accelerate low and medium-cost housing programmes and improve community development while allocations were also provided for youth and women development and the promotion of theatre, arts and culture. A significantly higher allocation of RM265.4 million has also been allocated for the conservation of the environment.

In addressing the social agenda, a number of tax measures has also been introduced. These measures included :

- (i) allowing cash donations to a trust account under the Ministry of National Unity and Community Development for the purpose of undertaking studies and implement activities aimed at overcoming social problems to be tax deductible;
- (ii) extending the special building allowance of 10% to approved services sector for provision of accommodation for their employees. This measure is aimed at addressing the problem of housing;

- (iii) to reduce the costs borne by patients, the service tax to be levied on hospitals would now be confined to the provision of food and accomodation. Tax reliefs of up to RM5,000 would also be given on all medical expenses incurred by the tax-payers, spouse or their children related to the treatment of serious diseases such as cancer, HIV/AIDS, renal failures and leukaemia. These were additional measures consistent with the nation's efforts to promote a caring society; and
- (iv) as part of the effort to address air pollution, tax measures have been introduced to promote the usage of natural gas vehicles.

Conclusion

The policy initiatives introduced since the presentation of the 1997 Budget through the first nine months of 1997 were aimed at complementing past measures to further reinforce the foundations for long-term growth with macroeconomic stability as well as to address the short-term problems

associated with volatility in the financial markets. The impact of recent and past policy initiatives has been very encouraging. Malaysia's real Gross Domestic Product growth remains strong while inflation remains low during 1997. Despite adverse developments in the form of deteriorating terms of trade mainly as a result of lower export prices of manufactured goods, the deficit in the external payments current account as a percentage of GNP is expected to improve in 1997. Of significance is the narrowing of the deficit in the overall services account of the balance of payments for the first time since 1990, indicating past measures to overcome the structural problem associated with the services account have begun to bear some results. Equally important is that the current account deficit is adequately financed by net inflow of long-term foreign direct investment. At the same time, the Federal Government financial position remains strong, recording an overall budgetary surplus for the fifth consecutive year since 1993. This surplus helps to further strengthen the foundations for macroeconomic stability, by boosting national savings and, thereby, reducing the nation's need to resort to external borrowing for purposes of financing growth.