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Managing The Malaysian Economy in 1998

An Overview

Following the onset of the financial crisis which beset East Asia since mid-1997, the initial focus of macroeconomic management was one of restoring investor confidence to stabilise the financial markets as well as strengthening the resilience of the economy to potential systemic risks that might arise from the contagion effects of the regional crisis. Concerns of the markets especially the continued high credit growth and high exposure of the banking system to the construction sector and share financing, the external payments current account deficit as a result of excessive domestic demand and inadequacy of domestic savings to finance capital formation as well as the issues of corporate governance and transparency had to be addressed. At the same time, there was a need to contain potential inflationary pressures caused by the sharp depreciation of the ringgit as well as to stabilise the ringgit by mitigating the outflow of funds that could be induced by higher interest rates abroad. Thus, the policy packages announced during the fourth quarter of 1997, including during the presentation of 1998 Budget, were directed at maintaining a tight monetary and fiscal policy while instilling investor confidence in the financial markets. The pursuance of tight fiscal and monetary policies then was in the light of the need to address the external payments current account deficit, promote savings, reprioritise investments and conserve the nation's external reserves. The challenge, however, was to judiciously maintain a delicate balance in pursuing a reasonably tight fiscal and monetary policy to restore investor confidence in the financial markets without excessively affecting economic growth which had slowed down to 6.9% in the fourth quarter of 1997.

However, maintaining this delicate balance was made difficult by the volatile external financial environment which continued unabated into 1998. The regional crisis was prolonged by developments in South Korea and Indonesia while deepened by the continued weakening of the Japanese economy and yen, which had generated fear of competitive devaluation of other currencies in the region, particularly the Chinese yuan and Hong Kong dollar. This was subsequently exacerbated by developments in Russia, transforming the financial crisis into a global phenomenon by late August. These developments led to further downward pressures on regional asset prices and currencies, culminating in a sharp deflationary impact on the region's real economy.

Malaysia, being an open economy, was similarly affected by the contagion impact of the financial crisis. Depressed by weakening domestic demand, partly as a result of the pursuance of a tight monetary policy as well as lacklustre exports especially to East Asia, real GDP contracted sharply by 2.8% in the first quarter, followed by a deeper contraction of 6.8% in the second quarter of 1998. This contraction of the real economy was unprecedented and beyond expectation. Nevertheless, the shrinking domestic demand was accompanied by a positive turnaround in the current account position of the balance of payments to record a large surplus of RM15 billion during the first half of 1998, the first surplus since 1989. Inflationary pressures, contained by depressed domestic demand, were also milder than expected earlier.

Given this change of economic circumstances, the focus of macroeconomic management was adjusted during the course of 1998, with the view to revitalise the economy and to prevent it from going into a prolonged recession. This refocussing

of economic management entailed a reversal of the earlier tight monetary and fiscal policy stance. This is necessary as there is a need to speedily invigorate the real economy through easing of monetary policy and provision of fiscal stimulus. This is to prevent the economy from being entrapped into a vicious circle of prolonged and worsening recession that could have severe ramifications on the health of the corporate and the banking sectors as well as to safeguard the socio-economic well-being of the population, particularly the lower income group. At the same time, there is a need to further complement earlier measures that have been put in place to strengthen the fundamentals and resilience of the economy, particularly the systemic stability of the banking sector, to better withstand the crisis.

Consequently, further policy initiatives were introduced during 1998. The major ones included the establishment of National Economic Action Council on 7 January 1998 to act as a consultative body to the Cabinet to deal with the nation's economic problems, specifically to recommend to the Government on how to restore the economy and prevent it from going into recession. In line with its objectives, the National Economic Action Council subsequently submitted A National Economic Recovery Plan on 21 July 1998 which was accepted by the Government for implementation. Other initiatives included the fiscal stimulus as well as measures to address the problem of non-performing loans and to recapitalise the banking system that were announced in July 1998. These initiatives were in line with the recommendations that were put forward by the National Economic Action Council. Further measures were introduced in September 1998 which, among others, were aimed at insulating the economy from the contagion effect of the regional crisis.

Given that the problem confronting the economy is largely due the contagion effect of the financial crisis that has affected the region, the solution to the problem extends beyond domestic policy addressal. In this regard, Malaysia and other members of ASEAN have embarked on a number of cooperative initiatives to deal with the crisis. These included cooperative financing arrangement under the *Manila Framework*. However, the solution to the regional financial crisis requires international cooperation to address the weaknesses of the

present international monetary system which had failed to prevent market distortions caused by speculative activities of highly leveraged funds. Malaysia had, in the various international fora, called for improvement of the architecture of the international monetary system and greater transparency in international currency transactions to address the regional financial crisis.

Unfortunately, action to address the crisis has not been forthcoming from the international community to effectively deal with the risks and challenges associated with a liberalised and globalised financial environment. As a result, the regional financial crisis deepened by end of August 1998 and spread to other continents. A number of economies, such as Hong Kong and Taiwan, had by different means tried to stabilise their financial markets on an individual basis. Malaysia, too, had introduced a variety of measures to stabilise the financial markets, particularly by strengthening the resilience of the financial sector to potential risks and restoring investor confidence, while maintaining a liberal foreign exchange regime. However, these individual efforts had not been able to stabilise the financial markets.

Given the deteriorating global financial crisis could exert further strains on Malaysia's financial system and adversely affect the real economy through contagion effect, there was a need to insulate Malaysia from this destabilising contagion impact. Consequently, the Kuala Lumpur Stock Exchange (KLSE) introduced a number of measures to ensure an orderly and fair market in the trading of Malaysian securities as well as to improve the overall transparency in the Malaysian capital market. These measures, effective 1 September 1998, among others, required all dealings in securities listed on the KLSE to be effected only through the KLSE or through a stock exchange recognised by the KLSE. These measures were in line with the objectives of National Economic Recovery Plan to restore market confidence. Effective on the same day, a number of exchange control measures was imposed by the Government. The overriding objectives of these measures were to insulate the economy from the risks and vulnerabilities that could emerge from a deteriorating global financial markets as well as to gain monetary independence so that the real economy could be invigorated through domestic monetary policy, including that of interest

rate. These measures were largely directed at containing speculation on the ringgit by eliminating the availability of offshore ringgit funds and at minimising the impact of short-term capital flows on the domestic economy.

Monetary Policy Adjustments To Invigorate Economic Growth

The tight monetary policy pursued in 1997 was maintained in the early part of 1998 largely to contain inflationary expectations associated with ringgit depreciation and underlying demand pressures as well as to stabilise the financial markets, including the ringgit exchange rate. In this regard, interest rates were adjusted to contain price pressures and to ensure a positive real rate of return to savers, while, at same time, preventing further instability in the foreign exchange markets by containing the outflow of funds abroad. In pursuing a tight monetary policy, there was also a need to pursue it with flexibility, given the uncertainties on the external front, especially the magnitude and the duration of the regional financial crisis. While credit growth had to be slowed down to 15% by the end of 1998, a level that was considered prudent and consistent with the macroeconomic outlook, it was essential that productive activities continued to receive adequate financing, especially in an environment of economic slowdown. Banking institutions that had the capacity to lend were, therefore, accorded the flexibility to continue to extend financing support and working capital for productive activities, including export-oriented industries. In addition, the statutory reserve requirements (SRR) of commercial banks, merchant banks and finance companies were reduced from 13.5% to 10% of their eligible liabilities, effective 16 February 1998. These measures were aimed at enhancing the efficiency of the intermediation process and improving the distribution of liquidity among individual banking institutions, thereby, enhancing lending capacities of the banking institutions. The reduction in SRR from 13.5% to 10% released about RM14 billion of funds to the banking institutions. This was accompanied by a simultaneous reduction in central bank lending to the inter-bank market, in view of the need to continue to maintain tight monetary policy as the inflation rate was rising steadily during the early part of the year.

However, as more up-to-date macroeconomic data became available, it was evident that the deflationary impact of the regional financial crisis on the Malaysian economy was much more severe than expected. Real GDP contracted by 2.8% during the first quarter of 1998 and by 6.8% in the second quarter. At the same time, money supply and credit growth decelerated faster than desirable. M3 growth slowed down from 21.8% as at end June 1997 to 4.3% at end of August 1998 (against earlier estimated growth of 12%), while credit growth slowed from 30.4% to 7.5% during the same period (against 15% growth earlier targeted by end of 1998). In the absence of demand pressures, inflation rate moderated from 6.2% in June 1998 to 5.6% in August 1998, averaging at 5.2% for the first eight months of 1998, significantly lower than the 7%-8% estimated earlier for the whole of 1998. Given these changes in the macroeconomic environment, an easing of monetary policy was necessary to stimulate the real economy as well as to ensure that it would not be entrapped into a vicious circle of prolonged recession.

Consequently, the SRR was progressively lowered from 10% to 8% on 1 July 1998 and then to 6% on 1 September 1998 and 4% effective 16 September 1998. The reduction in SRR was intended to both reduce the cost of funds to the banking institutions as well as to provide the banking institutions with additional liquidity, thereby, enhancing the capacity of the banking institutions in providing financing for the purpose of invigorating the economy. At the same time, Bank Negara Malaysia (BNM) 3-month intervention rate was reduced from 11% to 10.5% on 3 August, to 10% on 10 August, to 9.50% on 28 August, to 8% on 3 September and further to 7.5% on 5 October. Commercial banks were also no longer required to maintain an amount equivalent to the vostro balances of foreign banking institutions with BNM with effect from 3 September 1998. To ensure changes in monetary policy can have a faster impact on the interest rate level, the framework for calculating the base lending rate (BLR) was revised. The calculation would now be based on the BNM 3-month intervention rate instead of the KLIBOR, while the administrative margins of financial institutions that are allowed in the BLR computation was reduced to 2.25% from 2.50%. This was accompanied by a reduction in the liquid asset ratio requirement of commercial banks from 17% to 15% of eligible liabilities with effect from

3 September 1998. In addition, banking institutions would be required to reduce the maximum margin over the quoted BLR to 2.5 percentage points from 4 percentage points with effect from 1 October 1998. Banking institutions which have been assessed by BNM to be ready to implement the new liquidity framework will be allowed to cross over to the new framework immediately. All these measures have the combined impact of easing liquidity and the holding costs of liquid assets in the banking system, making available more loanable funds to borrowers, and at a lower rate.

At the same time, to ensure that there are sufficient funds to finance economic recovery, banking institutions have been required to achieve a minimum annual loan growth of 8% by the end of 1998. In this regard banking institutions were advised to reinstate credit lines which had been withdrawn towards the end of 1997. Meanwhile, lending for the construction or purchase of residential properties costing RM250,000 and below was exempted from the 20% limit on lending to the broad property sector (infrastructure was exempted from the outset) as part of the efforts to revitalise the construction sector which had contracted sharply. The earlier measure to tighten hire purchase loans for passenger cars was also repealed and relaxed, with no restriction being imposed on repayment period for such loans, while the margin of financing was increased from 70% to 85% of the purchase price of passenger cars. Recognising the need for certain sectors of the economy to have access to financing at below market rates, several funds have been established or enhanced. These include the Small and Medium Industry Fund (RM1.5 billion), Export Credit Refinancing Facility (RM3 billion), Special Scheme for Low and Medium Cost Houses (RM2 billion) and Fund for Food (RM1 billion). In addition, a special unit, known as the Loan Complaints and Monitoring Unit was set up in BNM to receive complaints and assist borrowers facing difficulties in securing financing for their operations; act as the Secretariat for the Corporate Debt Restructuring Committee; and undertake the process of identifying a list of viable projects and subsequently referring these borrowers to the prospective lending institutions.

To ensure that Malaysia could independently pursue a monetary policy that could help to stimulate the domestic economy, there was a need to insulate the domestic economy from the

risks arising from a volatile international financial environment and prospects of further deterioration in the world economy. In essence, Malaysia needs to have the freedom to implement domestic policies that are appropriate for the country to ensure that the prospects for economic recovery can be enhanced without any threat of being undermined. Consequently, effective 1 September 1998, the Government introduced selected new exchange control regulations, in order to effect a stable exchange rate regime and, therefore, domestic prices, as well as to insulate the domestic economy from adverse global developments. Essentially, the measures eliminated access to ringgit by speculators by reducing the offshore market in ringgit and bringing the market for ringgit back to Malaysia. The main changes in the exchange control rules were as follows:

- **External Accounts :** Approval is required for transfer of funds between External Accounts. Withdrawals of ringgit from External Accounts other than for permitted purposes, require approval.
- **Authorised Depository :** All purchases and sales of ringgit financial assets can only be transacted through authorised depository institutions.
- **Trade Settlement :** All settlements of exports and imports must be made in foreign currency.
- **Currency held by Travellers :** With effect from 1 October, 1998, travellers are allowed to import or export ringgit currency of not more than RM1,000 per person. There are no limits on the import of foreign currencies by resident and non-resident travellers. The export of foreign currencies by resident travellers is permitted, up to a maximum of RM10,000 equivalent. Amount exceeding the limit requires BNM approval. The export of foreign currencies by non-resident travellers is permitted, up to the amount of foreign exchange brought into Malaysia.

These new measures would not affect the business operations of traders and investors nor the normal conduct of economic activity. Similarly, the general convertibility of current account transactions as well as free flows of direct foreign investment and repatriation of interests, profits, dividends and capital gains were not affected by

the new measures. These exchange controls are targeted mainly at currency manipulators and bringing the ringgit market back to Malaysia. Following the introduction of the new measures, the exchange rate for the ringgit was fixed at RM1=US\$0.2632 for currency transactions effective 2 September 1998. This removed the need for hedging against risks associated with ringgit movements and, thereby, reduced related costs for the corporate sector.

Strengthening The Resilience Of The Banking System

When the financial crisis erupted in the middle of 1997, one of the concerns of the market was the continued strong credit growth of the banking system. At the end of August 1997, for instance, it was 28.6%, which far exceeded the 10.4% annualised growth in the value of goods and services produced locally. This led to outstanding bank credit rising to 160% of nominal GNP, which the market had inferred that the economy was overly leveraged. This coupled with the overexposure of the banking system to the broad property sector and share financing amounting to 40% of total outstanding debt brought into question the systemic stability of the banking system. In an environment of falling asset prices, the expectation was that non-performing loans of the banking system would rise and undermine the strength of the banking system. The banking crises in Thailand, South Korea and Indonesia aggravated this concern, although Malaysia's banking system was at its strongest position when the crisis affected the region. The level of non-performing loans was low, at 3.6% of total loans while risk-weighted capital ratio was 11.8%, exceeding the international standard of 8%, at end June 1997. The strong credit growth, against a sharp depreciation of the ringgit, also gave rise to concerns of potential inflationary pressures. Thus, it was felt then that there was a need to contain the rapid growth of the credit provided by the banking system to a level that was more consistent with the growth of the real economy. This was to be done by reducing the exposure of the banking system to less priority sectors, specifically the non-tradeable construction sector which already experienced excess supply in some segments of the property market, as well as share financing and consumption credit. At the same

time, banking institutions were encouraged to continue to provide financing to the productive sectors.

Consequently, on 20 October 1997 banking institutions were required by BNM to submit their credit plans for the remaining part of 1997 and for 1998, which outlined each banking institution's strategies for its loan growth based on prudent asset-liability management principles. Based on the projections submitted by the banking institutions, the annual loan growth of the banking system was projected to moderate to 25% by the end of 1997, 20% by the end of the first quarter of 1998 and to 15% by the end of 1998.

In addition to the credit plan, a number of measures were also effected in early 1998. These were related to prudential standards governing the domestic banking institutions to ensure that they were comparable with international standards. The changes made to the regulatory, supervisory and monitoring framework of banking institutions were:

- (i) With effect from financial year beginning from 1 January 1998, the default period for classifying a loan as non-performing by banking institutions was reduced from six months to three months. Hence, a credit facility was to be classified as non-performing once the repayment of principal or interest had been in arrears for three months. This was to facilitate early identification and monitoring of problem loans as well as bring the practice in line with international standards.
- (ii) With effect from financial year beginning from 1 January 1998, banking institutions were required to maintain general provisions for bad and doubtful debts of at least 1.5% of total loans net of specific provision and interest-in-suspense.
- (iii) With effect from 17 October 1997, BNM had further increased the level of transparency in the annual financial statements of banking institutions. Details of the additional disclosure requirements were as follows:
 - Disclose the amount of non-performing loans and the ratio of non-performing loans to total loans;

- Disclose the sectoral concentrations of credit exposure according to industry or economic sector;
 - Disclose movements in specific and general provisions for bad and doubtful debts and movements in interest-in-suspense;
 - Highlight the banking institution's business plan and strategy during the financial year as well as the outlook for the coming financial year in the director's report by external agencies;
 - A statement on whether the banking institution had been rated. If the banking institution was rated, it had to disclose the rating, the name of the rating agency, when the rating was made and together with a description of the rating classifications; and
 - Disclose the components of Tier-I and Tier-II capital and the amount of risk-weighted assets in the various categories of risk-weights.
- (iv) All banking institutions would be subjected to a more intensive and rigorous supervision, including stress testing their positions each month. Banking institutions were also encouraged to perform similar tests on their own and would be required to take corrective actions well before they reached the point where additional capital was required. These included the requirement to build up provisions, limitations on credit growth and restraints on dividend payments. Banking institutions were also required to submit concrete plans to raise additional capital within a specified period if there was a risk that the institution might not be able to comply with the minimum capital adequacy ratio of 8%.
- (v) Banking institutions were required to report and publish key indicators of financial soundness, including capital adequacy and non-performing loans (NPL) every financial quarter not later than six weeks after the close of the financial quarter. The disclosure of such information would complement the monthly publication of aggregate statistics on capital, NPL and provisions of commercial banks, finance companies and merchant banks by BNM.
- (vi) The loan classification and provisioning standards were streamlined to be consistent with international best practices. Specifically, with effect from financial year 1998, the practice of providing 20% specific provisions against the uncollateralised portion of sub-standard loans was made a standard requirement for all banking institutions.
- (vii) Banking institutions were required to comply with the consolidated minimum risk-weighted capital ratio (RWCR) of 8% on a quarterly basis. The minimum RWCR requirement for the finance companies would be gradually raised from the present level of 8% to 10% by the end of 1999, with an interim ratio of 9% to be achieved by end of 1998. This was to ensure adequacy of capital of finance companies to reflect the relatively higher risk profile of their businesses.
- (viii) To expand the current capital adequacy framework to incorporate market risks.
- (ix) The minimum capital funds for finance companies was raised from RM5 million to RM300 million by end-June 1999 and RM600 million by the end of year 2000. Consequently, the minimum RWCR and capital funds of commercial banks and merchant banks would also be reviewed.
- (x) The limit on single customer exposure was reduced from 30% to 25% of total capital funds and banking institutions were required to comply with the single customer limit on a consolidated basis.
- As part of the strategy to strengthen the banking system, BNM initiated the merger of finance companies to accelerate the consolidation of the finance company industry. This was to reduce the number of finance companies, making them larger, stronger and more capable of enjoying economies of scale. The merger programme was implemented in a transparent manner and guided by market principles so that the valuation of assets would be fair to all concerned. In addition, due diligence audits by accredited accounting firms were required to take into account the likelihood of a deterioration in the value of assets for the whole of 1998. The merger exercise will be effected

in the following forms: (i) merger of smaller finance companies with the six identified anchor finance companies; (ii) absorption by parent commercial banks; and (iii) strategic alliances. To-date, the consolidation of the finance company industry is in its final stages of completion. As an added measure to instill confidence in the banking system, the Government also undertook to ensure that the interest of all depositors would not be jeopardised.

However, during the second and early third quarters of 1998, it was evident that credit growth had slowed down faster than envisaged in the credit plan drawn up earlier. The sharp slowdown in credit growth from 30.4% at end of June 1997 to 8.8% by the end of July 1998 was not desirable. It reflected the sharp contraction of the real economy which had affected the liquidity position of some banking institutions, the uncertainties surrounding the economic environment, and high interest rates which had discouraged borrowings, and the reluctance of some banking institutions to extend credit as a result of over-reaction due to concerns over their balance sheets. If the deceleration in credit growth were to continue, the annual loan growth was expected to be only in the region of 3% to 4% by the end of 1998. In the light of these developments and the need to ensure productive activities continue to receive sufficient funding, individual banking institutions with lending capacities were allowed to exceed their respective credit ceiling to lend but within prudent considerations. Relaxations were also given with regard to provision of credit for hire-purchase as well as for the property sector. Banking institutions were also required to achieve an annual credit growth of at least 8% by end of 1998. These flexibilities were provided in the second half of the year to ensure sufficient financing would be available to invigorate economic growth without affecting macroeconomic stability and systemic strength of the banking system.

To strengthen further the banking system as well as to ensure that the banking system can continue to play an effective role in stimulating economic growth and development, the Government established an asset management company, known as Pengurusan Danaharta Nasional Berhad (Danaharta) and a special purpose vehicle, known as Danamodal Nasional Berhad

(Danamodal). Danaharta, with an initial funding of RM2.5 billion from the Government, would purchase, manage and dispose non-performing loans of banking institutions. This was to ensure that the amount of non-performing loans in the banking system remained at manageable levels as well as to unlock funds for the banking institutions to extend more credit to spur economic activities.

In complementing Danaharta, the Government concomitantly established Danamodal with the objective of spearheading the recapitalisation of the banking system. The establishment of Danamodal is crucial as there are a number of banking institutions that require recapitalisation, although the risk-weighted capital ratio of the banking sector as a whole remains high at more than 11%. In addition, the ability of the shareholders of banking institutions to raise capital on their own is limited, given the prevailing economic environment. Apart from strengthening the banking system through recapitalisation, Danamodal will also serve as a catalyst to consolidate and rationalise the banking system as well as to accelerate the formation of a core of strong domestic banks to spearhead the development of the banking system.

To fund its operations, Danaharta will issue a 5 year bond which will initially be subscribed by all banking institutions. The bonds will generate a yield comparable with the prevailing yield on 5 year Malaysian Government Securities at time of its issue.

The recent reduction in the SRR and BNM intervention rate in an environment of significant slowdown in credit growth would also help to strengthen the banking system. A lowering of the BLR would lead to lowering the financing costs of the corporate sector. This would enhance company profits and the capacity of the corporate sector to pay their debts. As a result, this would lower the level of non-performing loans.

It was recognised that the sharp slowdown in credit growth at a rate faster than desirable during 1998 was partly due to an over-reaction on the part of the banking institutions in containing their lending, as a result of concern over their balance sheets. In part, this was also attributed to the

more stringent but restrictive prudential standards imposed earlier. If allowed to continue, this could exacerbate the contraction of the real economy due to difficulty experienced by the private sector in accessing credit for financing viable economic activities. Since the health of the banking system is highly dependent on a strong and stable economic environment, the role of the banking system in promoting economic activities through their intermediation process is highly critical. To ensure that the banking system would be able to effectively play its role to promote economic recovery, the Government consequently reviewed the conditions imposed earlier on the banking system. As a result, on 23 September 1998, Bank Negara Malaysia implemented the following measures which would be effective from financial year beginning 1 January 1998:

- (i) The default period for classifying a loan as non-performing by banking institutions would be increased from three to six months. This is a reversal of the earlier decision to reduce the default period for classifying a loan as non-performing from six months to three months;
- (ii) Banking institutions would no longer be automatically required to provide a 20% specific provision on sub-standard loans. The quantum of provisioning for the sub-standard loans would be assessed for each banking institution by Bank Negara Malaysia during the approval of half-year and annual accounts. The amount of provisioning required would be dependent on the adequacy of the respective banking institution's loan loss coverage; and
- (iii) For non-performing loans which have been restructured or rescheduled, such loans could be reclassified as performing loans when the repayments under the rescheduled terms are complied with for a continuous period of six months, instead of the current practice which required 12 months of continuous payment.

In addition, effective immediately, the limit on loans for the purchase of shares and units of trust funds was increased from 15% to 20% of total outstanding loans for the commercial banks and finance companies. However, the limit for merchant banks remained at 30%. To ensure continued financing for viable businesses and projects, banking institutions were requested not to withdraw facilities from their customers, based

solely on problems that the customers had with other banking institutions.

The changes introduced on 23 September 1998 would not affect the strength of the banking system, as the net non-performing loans of the banking system were more than adequately covered at 150%. Instead, by promoting economic activity, these measures were expected to strengthen further the banking system in line with the turnaround of the Malaysian economy.

Enhancing Transparency In The Stock Market

In its ongoing efforts to strengthen the security industry, the Kuala Lumpur Stock Exchange instituted a number of new measures to further enhance transparency in the stock market. The new measures were initiated through changes in the rules, regulations and procedures of the Exchange, its clearing houses - the Securities Clearing Automated Network Services Sdn. Bhd. (SCANS) and the central depository - Malaysian Central Depository Sdn. Bhd. (MCD). These changes and amendments which became effective on 1 September 1998 were:

(a) Trading of Listed Securities

- All dealings in securities listed on the Exchange must be effected only through the KLSE or through a stock exchange recognised by the KLSE.
- Except as otherwise permitted, all dealings in KLSE securities must be effected only through the KLSE's trading system.
- A stockbroking company (SBC) shall not deal in securities on behalf of a client if it has reason to believe that the transaction is intended to facilitate the dealing in securities or dealing in interest in securities on a stock exchange not recognised by the KLSE.

(b) New Disclosure Requirements

- Know your client rule - SBCs must take all reasonable steps to obtain all essential particulars and information of their clients.

- A client, in dealing in securities listed on the KLSE on another person's behalf, must disclose the identity of that person to the SBC.
- For the opening of new nominee accounts, the account opening forms shall state the full name and other particulars of the beneficiary.
- For all existing nominee accounts, the name and other particulars of the beneficiary must also be stated in full.
- Each CDS account operated by a nominee can only have one beneficiary. In respect of nominee accounts which are presently shared by more than one beneficiary, new accounts must be opened to comply with the new requirements.
- For pledged security accounts, nominees must state 'PLEDGED SEC A/C' followed by the full name of the beneficiary.

(c) Off-Market Business and its Clearing and Settlement

- SBCs are permitted to engage in off-market dealing only in the form of direct business (i.e. crossings and married deals).
- All direct business must be cleared and settled through SCANS, the recognised clearing house, in accordance with the principles of the Fixed Delivery and Settlement System (e.g. T+5 settlement system)
- A clearing fee of 0.05% of the value of the contract (subject to a minimum of RM25.00 and a maximum of RM250.00) will be imposed for all direct business.
- The commission chargeable by SBCs on direct business is negotiable.

(d) New Issues of Securities

- All new issues of securities by public listed companies (PLCs) must be made by way of crediting the securities into the CDS accounts of the securities

holders. These new securities may arise from rights issues, bonus issues, private placements, special issues, ESOS, conversion of debt securities/warrants/TSRs, share swaps, or any other corporate activities.

- PLCs are not permitted to issue certificates to the securities holders in respect of any new issue of securities.

(e) Mandatory Deposit

- Shareholders of companies which have been approved for listing on the KLSE must deposit their share certificates with MCD within the Prescribed Period.
- Holders of share certificates of companies currently listed on the KLSE must deposit their share certificates with MCD.

(f) Withdrawal

- With immediate effect, all withdrawals of securities will be prohibited, except for the circumstances allowed in the notice issued by the KLSE (for example, to facilitate - share buy back; conversion of debt securities; the process of company restructuring; and rectification of errors.)
- This prohibition is pursuant to the directive from the KLSE in exercising its powers under Section 24 of the Securities Industry (Central Depositories) Act 1991.

(I) Transfer

- All transfer requests must state reasons and be supported by relevant documents.

These measures were aimed at ensuring an orderly and fair market in the trading of Malaysian securities as well as to improve the overall transparency in the Malaysian capital market. In this regard, activities which amount to assisting in the establishing, operating or maintaining a stock market that is not the stock market of the Exchange is prohibited. In implementing the measures, stockbroking companies were required

to take the necessary steps to ensure that they are not assisting any persons to create another market for Malaysian securities. The relevant rules and procedures of the central depository, MCD, were amended accordingly to reinforce the achievement of this objective without impinging on the rights of depositors as shareholders.

The security industry, including retail and institutional investors, stockbroking companies and public listed companies are expected to benefit from these new measures, as these measures would lead to enhanced transparency in share trading, investor protection, cost efficiency and overall greater efficiency in the system. As all off-market transactions have to be done as direct business cleared and settled through SCANS, greater accountability and disclosure without compromising client and investor confidentiality could be ensured. The new measures also reduce any possible adverse impact on the local stock market from improper dealings that may be conducted off-market, while moving MCD towards reaching its long-term objective of full immobilisation of shares traded on the KLSE, in line with internationally accepted standard.

Addressing The Balance Of Payments Current Account Deficit

Malaysia's external payments current account position has turned around in 1998 to record an estimated surplus of RM20 billion. This is the first surplus since 1989. During the period between 1990 through 1997, the current account position of the balance of payments was in deficit. This was a area of major concern which the financial markets had attributed to the erosion of investors' confidence following the financial crisis that beset the region since the middle of 1997, even though the size of the deficit had been reduced to 5.4% of GNP in 1997 from 10.4% in 1995. Consequently, additional measures were introduced by the Government during the presentation of the 1998 Budget in October 1997 to strengthen further the balance of payments position. These measures were aimed at enhancing the competitiveness of Malaysia's exports, reducing imports and strengthening the services account of the balance of payments.

To enhance the competitiveness of Malaysia's exports, tax incentives were given effective 1 January 1998 to companies in the manufacturing, agriculture and services sectors based on the increase in export value in the following manner:

- (i) for the manufacturing sector, companies exporting goods having value-added of 30 percent were given exemption from income tax equivalent to 10 percent of the increase in export value, and companies exporting products having value-added of 50 percent were given exemption from income tax equivalent to 15 percent of the increase in export value; and
- (ii) for the agriculture and services sectors, companies were given a one tier income tax exemption equivalent to 10 percent of the increase in export value. For the agriculture sector, fresh fruits and cut flowers would qualify for this incentive. In the case of the services sector, the eligible services include health, education and professional services.

In addition, to assist the private sector in reducing their cost of exports, warehouses which were used for purposes of export and reexport were given a special building allowance of 10 percent. This enabled warehouses to be fully depreciated over a period of 10 years instead of 45 years.

A number of measures were also introduced to reduce imports. These measures included discouraging the import of construction machinery and equipment, given that there were excess supply of used construction machinery and equipment which could be reconditioned and refurbished. Some of the specific measures to reduce imports were:

- (i) all imports of heavy machinery for the construction sector were required to obtain approval to import from the Ministry of International Trade and Industry. The approval would only be given if these machinery were not available locally;
- (ii) import duty on construction materials such as tiles, marble, iron and steel was increased from between 5 percent and 25 percent to between 10 percent and 30 percent;

- (iii) import duty of 5 percent was imposed on heavy machinery and equipment such as tower cranes, forklifts and escalators;
- (iv) import duty on dumpers and multi-purpose vehicles was increased from between zero and 30 percent to 50 percent;
- (v) import duty on special purpose vehicles such as crane lorries and concrete mixer lorries was increased from 35 percent to 50 percent; and
- (vi) the rate of initial capital allowance for imported heavy machinery was reduced from 20 percent to 10 percent, and the annual allowance was reduced from between 12 percent and 20 percent to 10 percent.

At the same time, to encourage import substitution of consumption goods, import duties on a number of consumer durables were increased from 25 percent to 30 percent. Most of these durables were being manufactured locally. Among these were refrigerators, vacuum cleaners, micro wave ovens and floor polishers. To promote the use of local branded goods locally, the expenditure incurred on advertising local goods within the country was given double deduction for income tax purposes. Import duties on motor vehicles especially in luxury categories namely, cars, vans, 4-wheel drivers and motorcycles, whether they were completely built-up (CBU) or completely knocked-down (CKD) were also increased as follows:

- (i) import duty on CBU cars was increased from between 140 percent and 200 percent to between 140 percent and 300 percent, while import duty on CKD was increased from 42 percent to a maximum of 80 percent;
- (ii) import duty on CBU vans was increased from 35 percent to between 42 percent and 140 percent, while import duty on CKD was increased from 5 percent to a maximum of 40 percent;
- (iii) import duty on CBU 4-wheel drivers and multi-purpose vehicles was increased from 50 percent to between 60 percent and 200 percent while import duty on CKD was increased from 5 percent to a maximum of 40 percent; and

- (iv) import duty on CBU motorcycles was increased from 60 percent to between 80 percent and 120 percent while import duty on CKD was increased from 5 percent to a maximum of 30 percent. Excise duty was also increased from a maximum of 20 percent to a maximum of 50 percent. In addition, a sales tax of 10 percent was imposed on motorcycles with an engine capacity of more than 200 c.c. Finally, road tax for motorcycles of engine capacity of 200 c.c. and above was increased from between RM100 and RM130 to between RM150 and RM400 per annum.

Additional measures specifically to address the deficit in the services account of the balance of payments were also introduced during the presentation of the 1998 Budget. These measures were:

- (i) provision of a concessionary tax rate of 5 percent on income derived from underwriting of foreign inward life reinsurance, in order to encourage the growth of the life reinsurance industry;
- (ii) increasing the fees for an international travel document from RM145 and RM265 to RM300 and RM600, and the fees for restricted travel document from RM60 to RM150. This was to discourage overseas travel; and
- (iii) withdrawal of the additional tax relief given for children studying abroad in institutions of higher learning. Prior to this, the tax relief was twice the amount of the child relief. However, students who had commenced their studies with institutions of higher learning when this measure was introduced were eligible for double tax relief until the completion of their studies. This was to encourage more Malaysian students studying within the country. Parents who sent their children to study at local institutions of higher learning would continue to be given tax relief of 4 times the amount of child relief.

As a result of measures taken as well as the deflationary impact of the financial crisis which had slowed down imports, the current account balance of payments position turned around positively to record a surplus of RM15 billion in the first half of 1998.

Narrowing The Savings-Investment Gap

Increasing the nation's savings is essential to ensure domestic resources are sufficient to finance capital formation in the country without having to increasingly rely on foreign resources, especially external borrowing. Although the nation's savings rate was high by international standard, that is 39.4% of GNP in 1997, the corresponding investment rate was higher, that is 44.8% of GNP. There was, thus, a savings-investment gap of 5.4% of GNP in 1997 which had to be financed through external funds. This savings-investment deficit since 1990 was attributed to the private sector. To reduce the nation's dependence on external resources, there was a need to promote national savings. Consequently, during the presentation of the 1998 Budget, the following additional measures were introduced to promote private sector savings:

- (i) The maximum limit for investment in Amanah Saham Nasional and Amanah Saham Bumiputera was increased to RM200,000 from RM100,000;
- (ii) The tax deduction on the voluntary contribution by employers to the Employees Provident Fund (EPF) was increased from 5% to 7%, increasing the total allowable tax deduction to 19%. This was to take effect from the year of assessment 1998. Prior to this, contributions made by employers to the EPF and approved schemes were allowed as a deduction for purposes of income tax up to a maximum amount of 17%. Of this amount, 12% was for mandatory contribution and the remaining 5% was voluntary contribution; and
- (iii) Reduction in corporate tax by 2 percentage points from 30% to 28% effective from the year assessment of 1998.

As a result of these savings promoting measures as well as lower private investment due prevailing excess production capacity, the level of the nation's savings is expected to exceed the level of investment by an estimated RM20 billion in 1998. This surplus is expected to be generated from the private sector including households, which could be mobilised to part finance the budgetary deficit expected in 1998 and 1999.

Effecting Fiscal Policy Changes With Changing Economic Circumstances

When the 1998 Budget was formulated in October 1997, the economic situation was one of slower but still robust growth, against a background of volatility in the financial markets. A major concern then was the continued deficit in the current account position of the balance of payments, a situation arising from insufficient national savings to finance capital formation. The savings-investment gap during 1990 through 1997 was attributed to private sector resource gap. Against this macroeconomic background, the fiscal stance had to be one of prudence and restraint. This was to contribute strongly towards enlarging the stock of national savings, which the private sector could then mobilise to finance its investments and, thereby, reducing its reliance on external resources for its financing needs. Consistent with this objective, a surplus of 3.2% of GNP was budgeted for 1998. This was to be achieved, among others, by reducing less essential operating expenditure, rightsizing of the civil service, merging of government agencies and privatisation of government activities. Less critical projects were to be deferred with the view of lowering the rate of growth of capital formation, given the resource gap that was experienced at the national level. But the cutbacks and deferments were to be done judiciously without affecting the delivery of essential public services such health and education which were crucial to enhancing the quality of the nation's human resources, poverty eradication programmes and infrastructural development that would facilitate the growth of the economy.

In the light of protracted financial crisis and its associated potential risks, the policy focus immediately after the presentation of the 1998 Budget continued to aim at reducing the balance of payments current account deficit which had been a drain on the nation's external reserves. Strengthening the nation's external reserves position was crucial in enhancing the resilience of the economy to external shocks. This required a cutback in domestic demand, particularly those of high import content. With the revised estimate of Federal Government revenue showing a severe drop in 1998, a sharp cutback in Government expenditure was necessary in order to maintain a budgetary surplus earlier budgeted for 1998 as part of the effort to promote national savings as

well as to contain the external payments current account deficit. Consequently, on 8 December 1997, the Government announced a further cutback in Federal Government expenditure by at least 18% in 1998, beginning with an immediate 10% cutback across the board of both operating and development expenditure and 8% on a more selective basis. To minimise the impact of the economic crisis on those who were vulnerable and those in the lower income categories, the Government, on 24 March 1998, allocated an additional RM1 billion for projects such as food production by small farmers, micro-credit programme for hawkers, education and health facilities, rural infrastructural facilities and poverty eradication programme under Amanah Ikhtiar Malaysia.

However, by the second quarter of 1998 it became clear that the underlying concerns that necessitated earlier fiscal restraint were no longer prevalent. The current account position of the balance of payments has turned around and, for the first time since 1989, recorded a surplus in 1998. This was attributed to a sharp drop in import volume, partly as a result of measures taken by the Government to reduce imports and partly as a result of contracting domestic demand caused by deflationary impact of the financial crisis that affected the region. Given this change of economic circumstances, the priority was to revitalise domestic economic activities through fiscal stimulus. Thus, in July 1998, the Government announced an additional allocation of RM7.0 billion for development expenditure as well as to finance partly Danaharta. To ensure that this additional allocation for development expenditure could provide maximum stimulus to economic growth, the projects to be selected were those with strong linkages with the economy but with minimal leakages in terms of imports. These projects were those with short gestation period as well as those having the capacity to enhance the efficiency of the economy and generate goods and services that could lead to import substitution and increase in exports. Projects which could help to address the social agenda such as poverty eradication were also given priority in expenditure allocation. Among projects selected were those related to agriculture, housing, education, health, infrastructure and public amenities, industrial development, rural development and poverty eradication programmes and cyberview.

In addition, an Infrastructure Development Fund, with an initial allocation of RM5.0 billion, was established to assist in the financing of infrastructure projects and projects involving large public facilities so that their implementation would not be delayed. These projects included mass-transit transportation system, ports, highways, water supply and waste disposal as well as sewerage projects.

With the additional allocation and an expected drop in Government revenue, the Federal Government overall budgetary deficit is expected to record a deficit in 1998, the first since 1993. However, this additional allocation was necessary to prevent the economy from being trapped into a vicious circle of economic doldrums, the socio-economic ramifications of which could be severe. In undertaking the fiscal stimulus, the government will ensure that the fiscal deficit will be kept within prudential limit, in order to ensure that the financing of the deficit will not crowd out the private sector in terms of access to investible funds and the nation's external debt servicing ratio will remain low.

National Economic Recovery Plan

The formation of the National Economic Action Council on 7 January 1998 constituted a major development in the Government effort to deal with the economic problems that were triggered by the contagion effect of the financial crisis affecting the region. Recommendations by the NEAC which were subsequently documented in the National Economic Recovery Plan provided the basis for consequential policy actions to restore the economy and prevent it from going into a prolonged recession. The National Economic Recovery Plan presents six strategic areas of action to address the financial crisis and its pervasive negative effects on the Malaysian economy. These areas of action are aimed at stabilising the ringgit, restoring market confidence, maintaining financial market stability, strengthening economic fundamentals, continuing the equity and socio-economic agenda, and revitalising affected sectors of the economy. Major policy decisions that have been implemented in line with the objectives of the National Economic Recovery Plan include the establishment of Danaharta (Asset Management Company) and Danamodal (for purpose of recapitalisation of the banking system)

as well as recent measures taken by the Kuala Lumpur Stock Exchange to enhance transparency in the local stock market and by Bank Negara Malaysia to stabilise the ringgit. To ensure the speedy implementation of the National Economic Recovery Plan, Government departments and agencies are required to report fortnightly to the Secretariat of the National Economic Action Council on the progress of the implementation of the recommendations contained in the Plan.

Conclusion

The wide ranging policy measures introduced by the Government recently are expected to provide increasing stimulus to domestic demand beginning the fourth quarter of 1998. Complemented by fiscal stimulus to be proposed in the 1999 Budget, these measures are expected to pull the economy out of the recession in 1999. A real GDP growth of 1% is expected, if external demand is sustained.

Some of the measures that have been put in place have already borne the desired results. The reduction in the SRR and the BNM intervention rate, for instance, has increased the liquidity of the banking system, making available more loanable funds to borrowers, and at a lower rate. The BLR of commercial banks has declined from a peak of 12.27% at end-June 1998 to a maximum rate of 8.92% by the end of September, bringing the rate to levels prevailing before the financial crisis (end-June 1996 : 8.93%). By end of October, the maximum BLR is expected to decline to 8.5%. It is estimated that 1 percentage point reduction in lending rates will reduce total financing costs of the corporate sector by 1%-2%. This will encourage them to venture into new investment as more projects become profitable. For households, lower interest rates will reduce their mortgage payments, thereby, enhancing their spending power. This in turn will stimulate domestic demand. On the banks, non-performing loans will become serviceable as lower interest rates enable borrowers to service their debts. This will encourage

banking institutions to increase their loans thereby supporting the economic recovery process.

In response to the relaxation in the hire-purchase guidelines, sales of new passenger cars have improved to 13,658 units in August 1998, more than double the number of units sold in early 1998 (February 1998 : 5,641 units). The improvement in car sales is also due to the reduction in interest rates on hire-purchase from 10% to 8.75%-9%. This should help to revitalise the automobile industry and small and medium-scale enterprises that supply components and part to this industry.

The continued easing of monetary policy as well as the simultaneous imposition of the exchange controls and institution of measures by the KLSE, SCANS and MCD that took effect in September 1998 have already led to an improvement of market sentiments in the local bourse. The Kuala Lumpur Stock Exchange Composite Index rose to 385.45 points on 22 September 1998, after reaching an intra-day low of 261.33 points on 1 September 1998. This recovery, although modest, should have the positive financial wealth effect of restoring consumer and investor confidence. This should lead to some increase in domestic spending and, therefore, economic activities.

The measures taken to stimulate domestic demand and economic activities have not exerted inflationary pressures. In fact, inflation has decelerated since July 1998. The fixing of the ringgit exchange rate at RM1=US\$0.2632 since 2 September 1998 is expected to help contain inflationary pressures further, as imported prices are expected to be stable at this exchange rate in the near term. With inflation expected to remain low and the current account of balance of payments expected to remain in surplus in 1999, easier monetary and fiscal policy stance can continue to be pursued to stimulate growth within the context of maintaining domestic price stability and external payments equilibrium.