BANK NEGARA MALAYSIA

Statutory Requirements

In accordance with section 48 of the Central Bank of Malaysia Act 1958, Bank Negara Malaysia hereby publishes and has transmitted to the Minister of Finance a copy of this Annual Report together with a copy of its Annual Accounts for the year ended 31 December 2001, which have been examined and certified by the Auditor-General. The Annual Accounts will also be published in the Gazette.

Zeti Akhtar Aziz
Chairman
Board of Directors

20 March 2002

Board of Directors

Dr. Zeti Akhtar Aziz
P.S.M., D.K. (Johor), D.P.M.J.
Governor and Chairman

Dato' Huang Sin Cheng
D.S.P.N., K.M.N., D.J.N.
Deputy Governor

Dato' Mohd Salleh bin Haji Harun
D.S.D.K.
Deputy Governor

Tan Sri Dato' Dr. Samsudin bin Hitam
P.S.M., D.P.M.T., D.P.M.P., S.M.J., J.S.M., K.M.N., A.M.N.
Secretary General to the Treasury

Datuk Oh Siew Nam
P.J.N.

Tan Sri Datuk Amar Haji Bujang bin Mohd. Nor
D.A., P.S.M., P.N.B.S., J.S.M., J.B.S., A.M.N., P.B.J.

Tan Sri Dato' Dr. Mohd. Noordin bin Md. Sopiee
P.S.M., D.I.M.P., D.M.S.M.

Dato' N. Sadasivan
D.P.M.P., J.S.M., K.M.N.

Tan Sri Dato' Muhammad Ali bin Hashim resigned from the Board with effect from 5 December 2001.

Governor	Dr. Zeti Akhtar Aziz
Deputy Governor	Dato' Huang Sin Cheng
Deputy Governor	Dato' Mohd Salleh bin Haji Harun
Assistant Governor	Datuk Zamani bin Abdul Ghani
Assistant Governor	Dato' Mohamad Daud bin Hj. Dol Moin
Assistant Governor	Datuk Latifah Merican Cheong
Assistant Governor	Mohd Razif bin Abd. Kadir
Secretary to the Board	Mohd Nor bin Mashor
Public Relations Adviser To Governor	Zailah Tun Dr. Ismail
Director/Head of Department	
Monetary and Financial Policy	Ismail bin Alowi
Economics	V. Vijayaledchumy
Bank Regulation	Nor Shamsiah binti Mohd Yunus
Islamic Banking and Takaful	Bakarudin bin Ishak
Investment Operations and Financial Market	Muhammad bin Ibrahim
Bank Supervision I	Azizan bin Haji Abd Rahman
Bank Supervision II	Donald Joshua Jaganathan
Insurance Regulation	Zakaria bin Ismail
Insurance Supervision	Wong Yew Sen
International	Tan Sook Peng
Foreign Exchange Administration	Mahdi bin Mohd. Ariffin
IT Services	Hong Yang Sing
Finance	Abdul Aziz bin Abdul Manaf
Human Resource Management	Mainor bin Awang
Corporate Services	Mohd Nor bin Mashor
Corporate Communication	-
Payment Systems	Ahmad Hizzad bin Baharuddin
Legal	Gopala Krishnan Sundaram
Statistical Services	Chan Yan Kit
Internal Audit	Yahaya bin Haji Besah
Human Resource Development Centre	Lim Lai Hong
Special Investigation	Che Sab bin Ahmad
Information Systems Supervision	Ramli bin Saad
Risk Management	Teo Kee Tian
Currency Management and Operation	Hor Weng Keng
Property and Services	Zulkifli bin Abd Rahman
Strategic Planning	Mior Mohd Zain bin Mior Mohd Tahir
Security	Che Norudin bin Che Alli
DFI Regulation	Che Zakiah binti Che Din
Financial Intelligence	Koid Swee Lian
Manager	
London Representative Office	Lillian Leong Bee Lian
New York Representative Office	Shamsuddin bin Mohd Mahayiddin
Branch Manager	
Pulau Pinang	Ong Boon Teck
Johor Bahru	Ahmad bin Ismail
Kota Kinabalu	Yusoff bin Yahaya
Kuching	Marlene Margaret ak John Nichol
Kuala Terengganu	Md. Daud bin Dahar
Shah Alam	Hamzah bin Abu Bakar

Governor's Statement

BANK NEGARA MALAYSIA

In 2001, the global environment experienced unprecedented events that had widespread implications on the world economy. While Malaysia was affected by these developments, earlier efforts to strengthen the economic base, secure sound macroeconomic fundamentals as well as restructure and reform the financial sector enhanced Malaysia's resilience in weathering the more difficult economic environment. Despite this more challenging environment, Malaysia has avoided a major economic downturn with growth for the year remaining in positive territory at 0.4% and unemployment being contained at below 4%.

Growth was driven by domestic economic activities. Concerted efforts since the financial crisis to promote domestic sources of growth and reduce vulnerabilities to external shocks have shown positive results. Private consumption remained resilient, and together with the strong growth in public sector expenditure, cushioned the adverse impact on the domestic economy of the weaker external sector and the contraction in domestic private investment. These developments contributed to positive growth in the domestic sectors of the economy, thus, mitigating the weaker growth in the export-oriented manufacturing industries.

During the year, the macroeconomic fundamentals have strengthened, with inflation remaining below 2% and the external balance remaining robust with international reserves having increased to more than US$30 billion. Strong macroeconomic fundamentals and strengthened corporate and banking sector balance sheets have made Malaysia well-positioned to tap the emerging global recovery to achieve stronger growth of 3.5% in 2002. Malaysia, nonetheless, is cognisant of the movement towards greater trade and financial liberalisation in the global market place, which would have an impact on Malaysia's economic performance. While nations attempt to ride out the current economic slowdown, they are continuing to strengthen the mechanisms for global integration. The vicissitudes of global competition and technology continue to feature the emergence of new competitors and the easing of protectionist barriers. As economies liberalise and adopt international practices, competition for investments will become more intense. Both foreign direct investments (FDI) and portfolio investments already have increased choices following the opening up of new markets, especially those with large domestic markets and low costs of operation.

The drive to sharpen the nation's competitive edge takes on added importance as we seek to sustain our growth prospects and raise our standard of living. Structural reforms to achieve the most efficient and effective utilisation of our resources have been intensified. Demand management has aimed not only to provide a positive macroeconomic environment but has also focused on structural developments that will improve the enabling environment for businesses. Supply-side policy measures have focused on capacity and institution building. These include raising the efficiency in the provision of public services, lowering the cost of inputs and reducing the cost of doing business. Efforts have also been put in place to raise the capacity of firms through strengthening the knowledge base, narrowing the skills gap in information and communications technology and enhancing technological capabilities. Dislocations arising from these adjustments have been minimal and business competitiveness has shown signs of improvement.

Malaysia has been a recipient of FDI over several decades, contributing to Malaysia's overall development in terms of growth, employment, foreign exchange earnings and transfer of technology. In recent years, FDI flows have become increasingly broad-based across all sectors, with the services sector now receiving a significant part of these flows. The steady inflow of FDI has continued in 2001, in response to the new opportunities that Malaysia offers. There is a distinct shift in the nature of the investments towards higher value-added investments in both the manufacturing and services sectors, which bring new technology and other expertise that contribute towards raising productivity. The Government continues to encourage FDI in all sectors of the economy with attractive incentive packages that are customised to the requirements of the specific industries and investors.

As an open trade-dependent economy, the stability of the exchange rate is important in facilitating international trade and investment. Wide swings in the exchange rate and prolonged periods of misalignment are highly destabilising. The pegged exchange rate regime in Malaysia has provided a stable environment for businesses to plan their investments and to undertake their operations. The stable exchange rate has facilitated a high volume of cross border trade and investment activity. The stability provided by the exchange rate has also allowed for the effective implementation of the pro-growth policies and for the accelerated pace of banking and corporate restructuring and reform. The regime has thus, functioned efficiently and continues to benefit Malaysia.

In the debate on the appropriate exchange rate regime, it needs to be recognised that these current more uncertain and turbulent times impose challenges and pressures on exchange rates, regardless of the exchange rate regime. No regime is insulated from the demands of the current global environment. The global experience has shown that when exchange rates have failed to perform their function, it was not due to the regime itself but due to the weaknesses in the economy and the financial system.

Three elements are important in ensuring that a regime continues to operate effectively. Firstly, it needs to be well supported by the domestic fundamentals. Malaysia's fundamentals have in fact strengthened during the course of the year and are important factors in ensuring the sustainability of the peg. Secondly, the economy needs to have the ability and strength to absorb the external volatility. In terms of external volatility, the strength of the economy, the strength of the banking sector, the strength of the corporate sector and that of the Government will give the country the ability to ride out the difficult period. It is our more diversified economy, enhanced mobility of labour and capital, the growing significance of the domestic economy and the strengthened banking sector that have provided Malaysia the increased resilience to external shocks. Also important is the ability and the flexibility for the authorities to respond with policies to address the situation. While such shocks will continue to affect us, they can be managed and their impact minimised.

Thirdly, competitiveness needs to be achieved through efficiency and productivity gains rather than relying on currency depreciation. As a matter of policy, Malaysia does not rely on the exchange rate to gain competitive advantage. The Malaysian economy has sufficient flexibility to undertake adjustments in all sectors of the economy to remain competitive under these changing circumstances. True competitiveness will be derived not from exchange rate flexibility but more from increasing efficiency, innovation, marketing strategies and providing quality products and services.

Monetary policy will continue to build on gains from the cumulative monetary easing, initiated since 1998, to ensure that the economic recovery process becomes well entrenched. A priority of policy is also to ensure that the pegged exchange rate is well supported by the underlying economic fundamentals. With low inflation and stronger economic fundamentals, Malaysia has the ability to exercise greater policy flexibility to preserve longer-term sustainability and stability.

The strengthened banking system, low interest rates and ample liquidity continued to support the bank intermediation process. Financing to the private sector has been forthcoming, which is evident not only in terms of the increased lending activity but also in terms of financing via the bond market. The greater access to the bond market has enabled corporations to undertake restructuring exercises and allowed greater flexibility in the management of their funding risks. This, in turn, has allowed parallel reforms to take place simultaneously at both the corporate and bank levels. At the same time, financing to the small and medium enterprises (SMEs) has been sustained.

Malaysia remains committed to strengthening the domestic corporate and financial infrastructure. Significant progress has been achieved in financial restructuring undertaken by Danaharta and Danamodal. Progress in corporate debt and non-debt operational restructuring under the arrangement of the Corporate Debt Restructuring Committee (CDRC) progressed at a more rapid pace in 2001 with the implementation of the new framework introduced in August. As part of debt restructuring, a number of large corporations have undertaken rigorous restructuring exercises in terms of management and ownership structure, and the disposal of non-core businesses and assets. Most of the restructuring has been market driven. The Government has been involved in the restructuring of a selected number of companies with a high degree of social and national interests. The successful resolution of the large CDRC cases has contributed towards reducing the NPL in the banking system.

The private sector plays a vital role in the Malaysian economy. While considerable attention has been directed towards strengthening the corporate sector, another area in which special focus is being given is to provide an enabling environment for the development and growth of the SMEs. SMEs are important in providing the linkages between the various sub-sectors within the economy. The SMEs represent a potential source of dynamism and driving force in the economy, having greater agility to adjust and adapt to the changing environment, thereby allowing for further diversification of the economic base. SMEs also represent indigenous enterprises that have the potential to grow and evolve into larger and listed companies with the potential to become regional or global players. To realise this potential, a holistic approach for their development is required. Bank Negara Malaysia has conducted a survey on SMEs through the banking system. It is hoped that this database will form the basis for a comprehensive framework for the development of SMEs across all sectors. The strategy will need to focus on providing the enabling business environment to not only address the issue of access to financing but also to enhance their technological capabilities, access to training, access to advisory services, marketing channels and other enabling infrastructure. This is to enhance their productive efficiency and effectiveness, encouraging production of high quality, differentiated and high value-added products that meet world standards.

Amidst a more challenging economic environment, the banking sector has remained strong and resilient in 2001. The positive results achieved through the restructuring process and enhancements to the regulatory and supervisory framework and process have minimised the impact of the economic slowdown on the banking system. The banking system recorded a pre-tax profit of RM7.5 billion with significant increases in loan disbursements. The significant progress that was achieved in financial reform and restructuring in 2001 has allowed for the focus of attention to now shift from dealing with banking sector problems to the medium and long-term issues on developing a more competitive and resilient banking sector.

The consolidation programme for the domestic banking institutions represents a major structural enhancement to the banking system. The successful completion of the consolidation and integration of banking groups in 2001 has benefited the industry and the banking public. The consolidation process during the year has placed the banking sector on a stronger footing. Customers now have a wider access to banking services and are able to enjoy seamless services from the merged institutions. The merged banking groups are now more well-capitalised to meet future calls for capital expenditure as well as undertake a wider scope of business activities. The operational business integration processes and rationalisation exercises have been an important part of the merger to reduce duplication of resources and to attain higher levels of economies of scale and efficiency in the banking institutions. Strategies of the banking institutions are now directed towards establishing themselves as key players in the financial sector.

The year 2001 marked a significant period for the Islamic banking industry. The encouraging achievement by the industry was a manifestation of the collective efforts of BNM and the industry to realise the potential of the Islamic banking industry in meeting the economic and financial needs of the country. During the year, several of the specific measures in the Financial Sector Masterplan (FSMP) to elevate the performance of the Islamic banking industry were implemented. Today, Islamic banking has proven to be one of the effective financial intermediation channels and has captured an 8.2% market share of the total banking assets. Moving forward, enhancing the institutional capacity of Islamic banking institutions through the envisaged "bank within a bank" concept would not only provide the strategic focus and autonomy, but also achieve the economies of scale, critical mass as well as cost efficiency for the Islamic banking players. On the international front, significant progress was achieved on the two initiatives namely, the International Islamic Finance Market (IIFM) and the international standard-setting body. BNM has participated actively in both initiatives. The IIFM creates a platform for Islamic financial institutions to manage their liquidity as well as facilitate the trading of Islamic capital market instruments. The standard-setting body, to be located in Malaysia, will focus on issuing international best practices governing the supervision and regulation of Islamic financial institutions. These encouraging developments will contribute further to the overall development of the global Islamic financial system.

Bank Negara Malaysia will continue to play an active role in developing the financial sector to be an important enabler of the economic transformation and growth process in Malaysia. Considerable progress has been achieved in the implementation of the FSMP, notably in the areas of enhancing institutional efficiency and competitiveness as well as promoting consumer awareness through a structured consumer education programme. Several banking institutions also moved to offer a broad range of financial services through new distribution channels. This will become increasingly important in securing the competitive edge in the new global environment. New prudential policies were also introduced to enhance risk management practices and corporate governance. The thrust of the banking policies in the coming year will continue to place emphasis on enhancing the capacity of banking institutions, further strengthening the regulatory framework while providing a conducive environment for banking institutions to become more efficient and competitive.

Despite the less favourable environment in 2001, the insurance industry recorded strong growth of 12.4% in premium income. The strengthened capitalisation of the industry since 30 September 2001 has built greater financial resilience among insurers, a key factor in advancing the consolidation of the industry through mergers and acquisitions. Eight M&As have been completed and seven others involving 13 insurers are currently in progress. Going forward, the insurance industry has the potential for a quantum leap in growth, given the low penetration rate and rising incomes. This growth potential is being realised through initiatives under Phase I of the FSMP, which aims at building capacity and efficiency as well as strengthening consumer protection. In the takaful industry, the growth momentum was maintained in the year 2001 with the combined takaful funds reaching RM2.4 billion or 4.6% (2000:2.6%) of the total assets of the insurance funds.

Development financial institutions (DFIs) are expected to continue to play an important role in promoting the development of identified priority sectors in the economy. With the enactment of the Development Financial Institutions Act 2002, a new regulatory and supervisory framework came into force for the DFIs. Bank Negara Malaysia has been empowered to administer the Act. The future focus would be on building the overall financial and structural capacity of DFIs in meeting their mandated roles. Prudential regulations that will improve the management of assets and liabilities, corporate governance as well as risk management practices of DFIs will be introduced to enhance the soundness of their operations and practices.

Efforts are also being directed at improving the efficiency and reliability of the payment system, while keeping abreast with technological developments. In this respect, a National Payments Advisory Council has been established in 2001, with membership including expertise from the Bank of Japan and the Hong Kong Monetary Authority, to formulate developmental policies related to infrastructure needs, new technology and standards on payment systems.

As the process of globalisation intensifies, regional economies have become increasingly inter-dependent and integrated. Being highly open economies, the region has in the recent years been confronted with global economic and financial uncertainty with periodic episodes of turbulence which have tested regional policy makers. In such an environment, national policies alone, while vital and necessary, would not be sufficient to secure the regional financial stability and prosperity we aspire to achieve. Regional co-operation and solidarity can serve as an important anchor during turbulent periods of uncertainty. Critical first steps have been made in strengthening regional financing facilities to promote mutual assistance in maintaining financial stability. Work is also underway to develop an effective regional surveillance mechanism to complement and support the regional financing facilities. Looking forward, the priority would be on the development of regional markets, including a regional bond market to better serve the needs of all regional economies. Closer co-operative efforts in the standardisation of systems and documentation procedures, would also contribute to enhance greater inter-regional financial and economic activity. Effective co-operation in these areas will augment the foundations for translating the tremendous potential that this region possesses for future growth and prosperity.

Although Malaysia has made significant strides on several fronts, much still needs to be done and new challenges are emerging. The challenge to achieve sustainable growth and prosperity requires looking beyond the immediate term, beyond our own immediate interests and beyond our own boundaries. While immediate concerns need to be addressed to preserve confidence and stability, the core of sustainable development is derived from the institutional strength and the fundamental structures and foundations. It is efforts directed towards these goals that will yield the broad-based high quality growth that we aim to achieve.

Zeti Aziz

Zeti Akhtar Aziz
Governor

20 March 2002

The Malaysian Economy in 2001

The Malaysian Economy in 2001

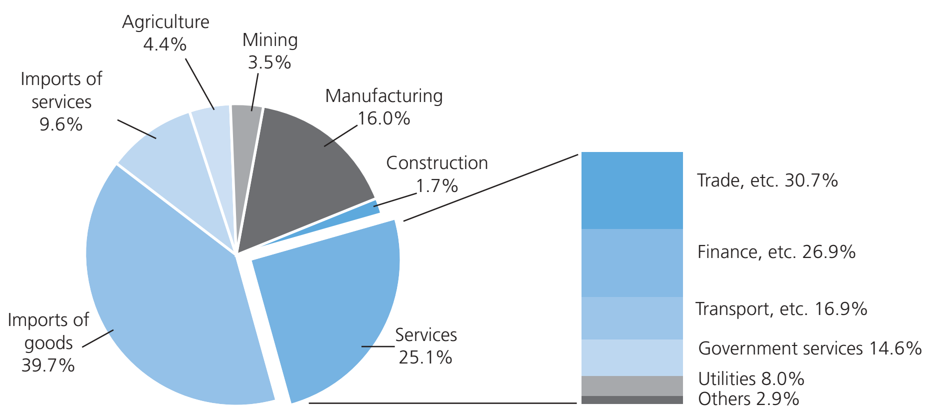
Real GDP growth remained positive in 2001, supported by counter-cyclical measures and diversified economic structure.

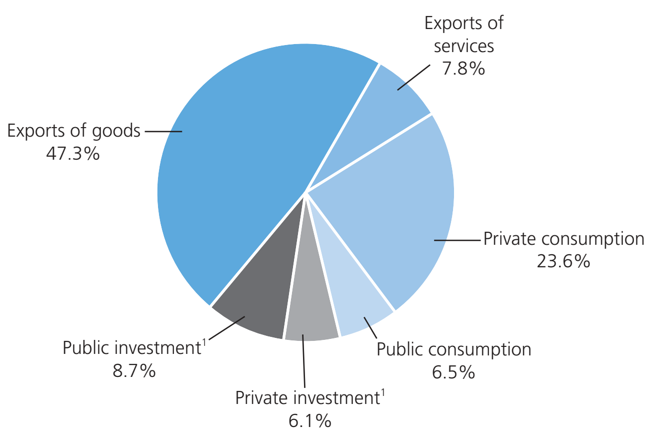
OVERVIEW

The Malaysian economy remained resilient in 2001 in the face of a challenging external environment. While the global economic slowdown in 2001 was more severe than earlier expectations, Malaysia avoided economic contraction and growth for the year remained in positive territory. Unemployment was also contained at a low level.

Given the openness of the Malaysian economy, the negative effects of the US economic slowdown and global electronics downturn was felt as early as March 2001. These were manifested in declining manufacturing production and negative export growth. Concerted efforts since the crisis to promote domestic sources of growth and reduce the over-dependence on exports resulted in real Gross Domestic Product (GDP) expanding by 0.4% in 2001. Fiscal stimulus measures and monetary policy that had remained accommodative led to higher public spending and positive growth in private consumption. During the year, public investment expenditure increased by 15.5%, while public

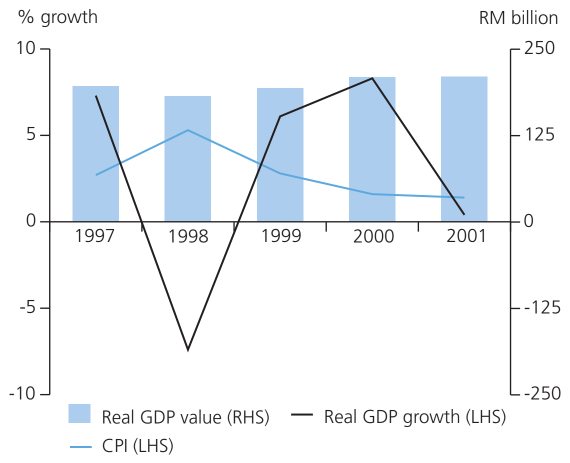
Graph 1.1
The Economy in 2001 (at 1987 Prices)





[1] Include stocks

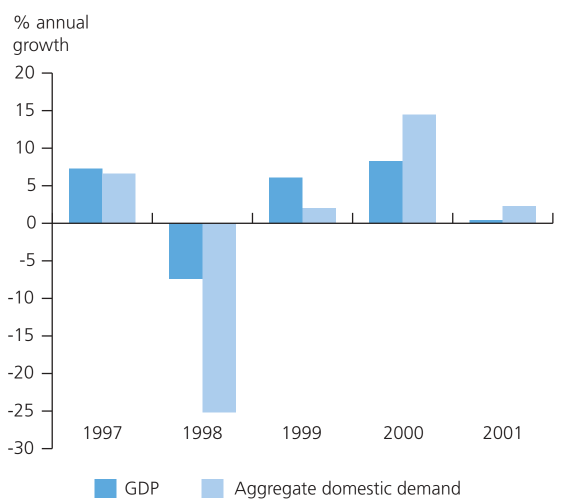
Graph 1.2
Real GDP and Inflation Rate



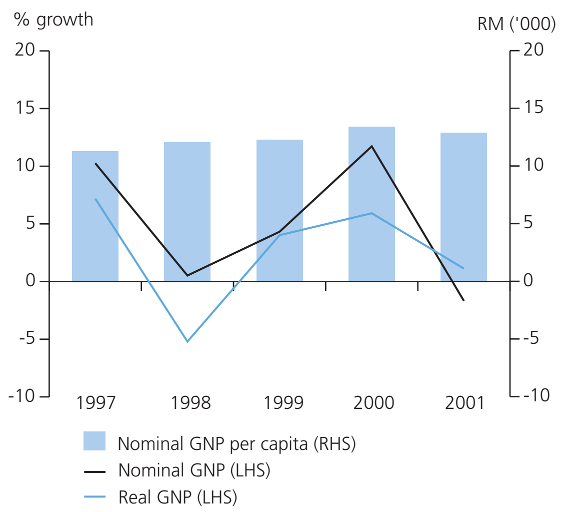
consumption expenditure increased by 11.9%. The direct contribution of the public sector (excluding the non-financial public enterprises) was significant, contributing 3.4 percentage points to GDP growth in 2001.

Through policies on several fronts, consumption has remained resilient despite lower export earnings. While national savings remained high at 34.9% of Gross National Product (GNP), total domestic consumption accounted for more than half of GDP. This resilience in private consumption together with the strong growth in public sector expenditure mitigated the impact of the external sector on the domestic economy and the contraction in domestic private investment, following the consolidation by the corporate sector.

Graph 1.4
Real GDP and Aggregate Domestic Demand



Graph 1.3
GNP Growth and Nominal GNP per Capita



On the supply side, weaker growth in the export-oriented manufacturing industries was mitigated by positive growth in all other sectors, especially the services sector, domestic demand-oriented industries in the manufacturing sector and the construction sector. Overall, the effectiveness of policy measures and the diversified economic structure of the Malaysian economy moderated the impact of the decline faced by the export-oriented industries.

Consequently, the unemployment rate was contained below 4%. Retrenchment was mainly in industries affected by the downturn in the global electronics

Graph 1.5
Contribution to Real GDP Growth:
Domestic Demand and Net Exports

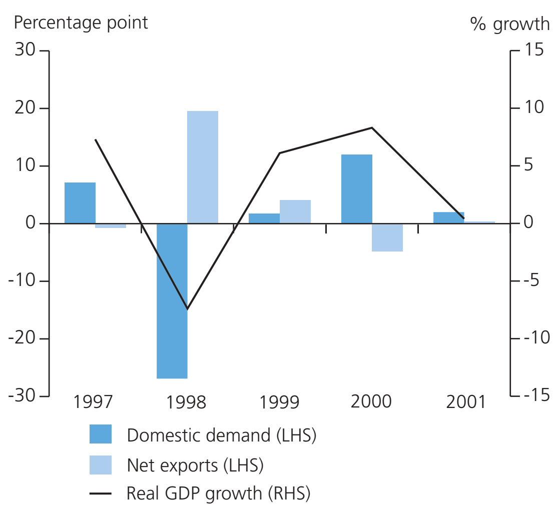


Table 1.1: Malaysia: Key Economic Indicators

	1999	2000	2001*p*	2002*f*
Population (million persons)	22.7	23.3	23.8	24.3
Labour force (million persons)	9.2	9.6	9.9	10.2
Employment (million persons)	8.9	9.3	9.5	9.8
Unemployment (as % of labour force)	3.4	3.1	3.7	3.6
Per capita income (RM)	12,304	13,412	12,889	13,272
(US$)	3,238	3,529	3,392	3,493
NATIONAL PRODUCT (% change)				
Real GDP	6.1	8.3	0.4	3.5
(RM billion)	193.3	209.4	210.2	217.5
Agriculture, forestry and fishery	0.4	0.6	2.5	1.0
Mining and quarrying	-2.6	3.1	0.2	3.0
Manufacturing	13.5	21.0	-5.1	4.2
Construction	-4.4	1.0	2.3	2.4
Services	4.8	4.8	4.9	3.8
Nominal GNP	4.3	11.7	-1.7	5.3
(RM billion)	279.5	312.2	306.7	323.1
Real GNP	4.0	5.9	1.1	3.1
(RM billion)	179.7	190.3	192.4	198.3
Real aggregate demand[1]	2.0	14.5	2.3	2.8
Private expenditure[1]	-3.8	16.0	-2.9	4.2
Consumption	3.3	12.2	2.8	5.0
Investment	-21.8	28.7	-19.7	1.2
Public expenditure[1]	17.1	11.4	13.9	0.0
Consumption	18.5	1.7	11.9	4.1
Investment	15.9	19.9	15.5	-3.0
Gross national savings (as % of GNP)	41.1	39.5	34.9	33.8
BALANCE OF PAYMENTS (RM billion)				
Goods	86.0	79.2	69.9	73.0
Exports (f.o.b.)	319.6	374.0	334.3	349.1
Imports (f.o.b.)	233.5	294.8	264.5	276.1
Services balance	-10.7	-11.2	-8.4	-11.6
(as % of GNP)	-3.8	-3.6	-2.7	-3.6
Income	-20.9	-28.6	-25.9	-27.5
(as % of GNP)	-7.5	-9.1	-8.5	-8.5
Current transfers	-6.6	-7.5	-8.1	-8.4
Current account balance	47.9	32.0	27.4	25.5
(as % of GNP)	17.1	10.2	8.9	7.9
Bank Negara Malaysia reserves, net[2]	117.2	113.5	117.2	-
(as months of retained imports)	5.9	4.5	5.1	-
PRICES (% change)				
CPI (2000=100)	2.8	1.6	1.4	1.8
PPI (1989=100)	-3.3	3.1	-5.0	2.6
Average wages in the manufacturing sector	3.0	5.0	1.5	-

Note: Figures may not necessarily add up due to rounding

[1] Exclude stocks

[2] Arising from the fixing of the ringgit/US dollar exchange rate in September 1998, all assets and liabilities in foreign currencies have been revalued into ringgit at rate of exchange ruling on the balance sheet data and the cumulative gain/loss has been reflected accordingly in the Bank's current year account. The US dollar equivalent of intrenational reserves as at 31 December 1999 was US$30.9 billion.

p Preliminary

f Forecast

Table 1.2: Malaysia: Financial and Monetary Indicators

	1999	2000	2001*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	58.7	61.9	79.6
Operating expenditure	46.7	56.5	63.7
Net Development expenditure	21.5	25.0	34.2
Overall balance	-9.5	-19.7	-18.4
Overall balance (% of GDP)	-3.2	-5.8	-5.5
Public sector net development expenditure	46.4	50.4	68.2
Public sector overal balance (% of GDP)	2.3	0.7	-4.9
EXTERNAL DEBT			
Total debt (RM billion)	161.1	157.7	169.8
Medium and long-term debt	138.7	140.3	146.4
Short-term debt	22.4	17.5	23.3
Debt service ratio (% of exports of goods and services)			
Total debt	6.1	5.3	6.2
Medium and long-term debt	5.7	4.9	5.8

	Change in 1999		Change in 2000		Change in 2001	
	RM billion	%	RM billion	%	RM billion	%
MONEY AND BANKING						
Money supply M1	19.3	35.7	4.8	6.5	2.5	3.2
M2	40.7	13.7	17.6	5.2	7.8	2.2
M3	33.1	8.3	21.9	5.0	13.0	2.8
Banking system deposits	20.4	4.7	14.6	3.2	8.6	1.8
Banking system loans	0.6	0.1	23.6	5.5	16.4	3.6
Manufacturing	0.4	0.6	2.2	3.3	...	0.1
Broad property sector	3.4	2.3	8.6	5.6	12.6	7.7
Fianace, insurance and business services	-4.1	-10.7	0.4	1.3	0.9	2.7
Loan-deposit ratio (end of year)	83.1%		84.3%		85.9%	

	1999 %	2000 %	2001 %
Interest rates (average rates at end of year)	3.18	3.25	3.27
3-month interbank			
Commercial banks			
Fixed deposits 3-month	3.33	3.48	3.21
12-month	3.95	4.24	4.00
Savings deposit	2.76	2.72	2.28
Base lending rate (BLR)	6.79	6.78	6.39
Finance companies			
Fixed deposits 3-month	3.49	3.52	3.22
12-month	4.13	4.27	4.01
Savings deposit	3.50	3.44	2.94
Base lending rate (BLR)	7.95	7.95	7.45
Treasury bill (3-month)	2.71	2.98	2.73
Government securities (1-year)	3.37	3.36	2.93
Government securities (5-year)	5.21	4.80	3.18

	1999 %	2000 %	2001 %
Movement of Ringgit (end-period)			
Change against composite	-1.3	3.2	3.5
Change against SDR	2.7	5.2	3.8
Change against US$[1]	0.0	0.0	0.0

[1] Ringgit was pegged at RM3.80=US$1 on 2 September 1998

p Preliminary

cycle. More flexible labour market practices also helped to moderate the number of retrenchments. An increased number of workers accepted pay cuts and shorter working hours in 2001 as companies rationalised operations to maintain margins. This flexibility in the labour market remains a key fundamental strength of the Malaysian economy. Such flexibility allows for adjustments to adverse developments in the external environment.

Inflationary pressures remained muted with prices, as measured by the Consumer Price Index (CPI), increasing moderately by 1.4% (2000: 1.6%). The moderation in inflation was due mainly to the prevalence of excess capacity in several sectors of the economy, the moderate appreciation of the ringgit vis-a-vis non-US dollar currencies, as well as lower imported inflation. The lower inflation was also consistent with the widening output gap, estimated at 5.6% of the potential output level (details of the potential output estimation are presented in the white box).

The external position remained robust in 2001. The global economic slowdown affected export performance, but imports of goods and services for export production also declined. Hence, the current account remained in surplus, estimated at about 8.9% of GNP. In the financial account, the flows have been relatively stable. Long-term flows continued to dominate. Inward direct foreign investment flows were increasingly channelled to the services sector. These inflows were smaller in average dollar size and low in import content but have brought technology and other expertise that contribute towards raising productivity in Malaysia. Outward investments by Malaysian companies were smaller on a net basis, as Malaysian companies affected by the global slowdown repatriated proceeds of their disinvestment abroad in the second half-year.

The trade surplus and continued inflows of long-term capital resulted in higher international reserves. The reserves level fluctuated in early 2001 following volatility in foreign exchange markets. Reserves which declined in early 2001, reversed to a rising trend from end June following stronger fundamentals and lower interest rates abroad. By end-2001, international reserves of Bank Negara Malaysia (BNM) was higher at RM117.2 billion or US$30.8 billion (US$4.9 billion higher than the lowest level in 2001). Subsequently, reserves increased further to RM119.6 billion or US$31.5 billion as at 28 February 2002. This level is adequate to finance 5.2 months of retained imports and cover 5.1 times the short-term external debt.

While the external debt increased during the year, the outstanding amount remained relatively low, at about 55.4% of GNP (previous peak after the Asian crisis was 64%). The overall debt service ratio continued to remain low at 6.2%, despite the decline in export value. The debt profile also remained healthy with short-term debt accounting for only 13.7% of total debt.

The banking system demonstrated greater resilience despite adverse economic conditions. In 2001, the risk-weighted capital ratio (RWCR) remained above 12% throughout the year, whilst the increase in the levels of non-performing loans (NPLs) during the year was contained within manageable levels. The increase in the level of NPLs of banking institutions during the second half of 2001 was within expectations. As at end-2001, the net NPL ratio on a 6-month basis was 8.1% (11.5% on a 3-month classification basis). Recent measures to accelerate corporate restructuring have improved the balance sheet of the corporate sector, contributing to greater resilience of the banking system. The resolution of the debt restructuring schemes for companies in the transport sector in the final quarter of 2001 reduced the level of NPLs by 0.7 percentage points. As at end-2001, the banks' risk-weighted capital ratio stood at 12.8%, well above the Basel Capital Accord requirement of 8%. The capital position will further strengthen following the strong profits of RM7.4 billion recorded in 2001.

With improvements in the economy, Danamodal, the special purpose vehicle set up in 1998 to recapitalise viable banking institutions, received repayments amounting to RM2.3 billion in 2001 of the RM4.4 billion that was outstanding at the end of 2000. As a result, the outstanding investment in the remaining three recapitalised banking institutions amounted to RM2.1 billion. Since its inception, Danamodal has injected a total of RM7.1 billion into ten banking institutions.

With increases in NPLs remaining within manageable limits, Danaharta, the asset management company set up in 1998 to acquire NPLs from financial institutions, has shifted its focus to asset management and recovery in 2001. As at end-2001, the cumulative amount of NPLs restructured or approved for restructuring amounted to RM47.7 billion or 99.9% of the total

Potential Output of the Malaysian Economy

BNM's latest estimates of potential output indicate that output gap has widened in 2001 as actual output expanded at a slower pace of 0.4%, compared with an increase of 3.3% in potential output. Hence, the output gap increased to 5.6% of potential output in 2001 (peak: 12.3% of potential output in the third and fourth quarters of 1998).

As indicated in the previous studies, potential output has been expanding at a moderate rate since 1999. As shown in Table 1.3, potential output grew by 2.8% in the period 1999 - 2001, as against 4.9% GDP growth recorded in the same period. In 2001, the moderation in growth in potential output to 3.3% was attributed to the marginal decline in investment (-2.1%) and slower growth in labour (2.4%).

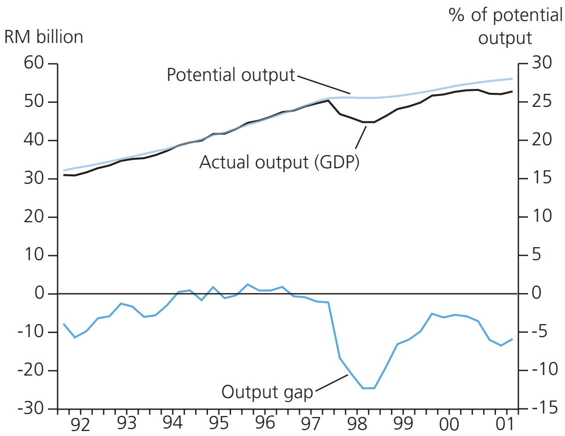
Table 1.3
Actual GDP and Potential Output

Period	Actual GDP	Potential output	Investment	Labour	Output gap
	Annual change in %				(% of potential output)
1992-1997	9.2	8.2	14.1	3.9	-1.3
1998	–7.4	3.2	–43.0	–2.1	–10.9
1999	6.1	1.3	–5.9	3.7	–6.8
2000	8.3	4.0	24.1	4.3	–2.8
2001	0.4	3.3	–2.1	2.4	-5.6

As in the previous studies, the short-run elasticity of labour is still much higher than that of capital; implying changes in employment have greater impact on output. Firms attain higher output in the short run by hiring more labour but not by engaging in capital investment. The low elasticity of capital in the short run could also be explained by the significant investment in infrastructure projects, which have long gestation periods spanning over more than a decade and where the return is realised only after a time period.

However, the long-run elasticity of capital (0.5) is higher compared to 0.4 in the previous study, implying that the return to capital was higher in the year 2001. This could be caused by an increase in utilisation of capital stock put in place previously, as the investments in infrastructure during the 1990s begin to contribute to higher output.

Graph 1.6
Actual Output and Potential Output



NPLs in Danaharta's portfolio. Danaharta expects an average recovery rate of 56%, assuming a zero recovery rate on defaulted cases.

The market-driven corporate restructuring exercises gained momentum in 2001, moving beyond financial restructuring towards greater operational restructuring. Generally, corporate restructuring contributed to the improved financial position of corporates and the overall competitiveness of the economy. During the year, major institutional changes were effected. Institutional changes included a revamp of the CDRC guidelines to hasten the pace of restructuring of companies under its purview. Changes to the restructuring guidelines of the CDRC included improvements in the framework and approach to accelerate restructuring efforts, the establishment of a timeline for restructuring and more comprehensive disclosure and reporting. With the new initiatives, the restructuring of several large and complex cases were completed. The CDRC aims to complete the restructuring of the outstanding debts by July 2002. At the corporate level, the restructuring of debts was accompanied by operational restructuring in the form of disposal of non-core assets. Professional management was put in place by shareholders. The separation of ownership and management can be expected to further enhance corporate governance.

Macroeconomic Management

In 2001, macroeconomic policy was focused on managing the downside risks arising from the slowdown in the major industrial countries. Economic policies were targeted at creating an enabling environment for domestic demand to support growth. Given that there was considerable uncertainty over the severity of the slowdown in 2001, there was greater recognition that economic policies would need to address short-term cyclical risks that emerged during the course of the year, with the objective of minimising the adverse effects on the Malaysian economy.

The initial assessment was for Malaysia's GDP growth to show a moderating trend in the first two quarters of 2001, with a recovery in the second half-year. However, as the downturn in the global economy became more severe during the course of the year, policies turned more expansionary. The strengthened economic fundamentals provided Malaysia the policy flexibility to implement additional pro-growth policies in response to external shocks, without creating imbalances in the economy.

Given the increased prospects that the stimulus from the external sector would be relatively subdued in 2001, the overall budget deficit for 2001 announced in October 2000, was projected to remain large, at RM16.5 billion or –4.7% of GDP. The assessment was that a premature consolidation of the fiscal position in the face of a more challenging external environment would have a damaging impact on the economy. Consequently, as the downside risks facing the world economy increased in early 2001, the Government announced on 27 March, a fiscal stimulus package of RM3 billion. Following the heightened uncertainty after September 11, an additional stimulus package of RM4.3 billion was announced on 25 September.

In the Budget for 2002 announced in October 2001, the overall deficit of the Federal Government for 2001 increased to RM22.4 billion or –6.5% of GDP, an increase of RM5.9 billion from the original allocation announced a year earlier. This additional stimulus was equivalent to 2.2% of GDP. To ensure maximum impact from the increased expenditure, efforts were intensified to improve policy implementation, particularly to reduce project delays and increase efficiency for disbursements.

The 2001 Budget and the two additional fiscal packages announced in March 2001 and after September 11 not only included significant increases in both public consumption and capital outlays but also tax incentives to increase disposable income and reduce business costs. Measures to increase disposable income of households included higher tax rebates, higher allowances for civil servants in specific categories and a temporary reduction in the employees' Employees Provident Fund contribution rate. The announcement effect of the new measures to increase household income in the 2002 Budget also boosted private consumption. These measures included a reduction in personal income tax of between 1-2 percentage points and the 10% salary adjustment for civil servants, effective 1 January 2002.

Monetary conditions during the year also supported the expansion in private sector activities. Interest rates were already at historical lows at the end of 2000 with the aggressive reductions in interest rates by a total of 550 basis points in the period 1998 to 1999. Up to September 2001, the policy rate remained unchanged as the earlier interest rate reductions had been effective in promoting bank lending. Following September 11, BNM reduced its intervention rate on 20 September by 50 basis points to 5% as a pre-emptive measure to address the heightened risks biased towards further weakness. As a result, the average base lending rates (BLR) of the commercial banks and finance companies declined further to 6.39% and 7.45% respectively (6.78% and 7.95% respectively at end-2000).

Low interest rates and the initiatives to improve access to financing resulted in loans outstanding of banking institutions expanding by 3.6%. Together with private debt securities (PDS) issued by the private sector, total financing expanded by 6%. Efforts were also intensified in 2001 to ensure that selected sectors, especially the small and medium enterprises (SMEs), continued to have access to financing. The size and scope of several selected special funds were expanded and lending rates were lowered. As a result, loans extended to the SMEs by the banking system rose by 3.1% in 2001.

In pursuing the more expansionary demand management policies in 2001, care was taken that fiscal and monetary measures would not unduly increase risks of creating imbalances thereby jeopardising the long-term growth potential, price stability as well as the gains made in achieving a robust balance of payments. In particular, strengthening foreign direct investment inflows remained a priority. Incentives addressed the need for foreign direct investment inflows to be more diversified, in terms of location as well as sector. While attracting new investments, it was essential to create a more favourable environment to existing investors to expand operations in Malaysia.

The policy to allow 100% foreign equity ownership in promoted manufacturing industries, irrespective of export levels, was extended to 2003. As a measure to accelerate the development of the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak, Pioneer Status and Investment Tax Allowance that had been granted and expired on 31 December 2000 were extended for another five years. Effective 25 April 2001, the Foreign Investment Committee's guidelines on the acquisition of property by foreigners were also liberalised.

The incentive structure for investors, both domestic and foreign, is designed to attract quality investments that promote technology transfers, and not just expand production capacity. An important change made to the incentive scheme in the 2002 Budget was to extend the period for which the reinvestment allowance would remain in effect. Manufacturing companies and producers of food products would now enjoy the allowance for 15 consecutive years, commencing from the year the first investment is made, instead of the five years given previously.

Overall, the improved macroeconomic fundamentals reduced the risks that inflationary pressure would emerge over the medium term or that a significant misalignment in the exchange rate would occur. While Malaysia has pursued an expansionary fiscal stance for four consecutive years, the Federal Government debt was contained at 43.8% of GDP. The high domestic savings rate gave the flexibility to finance the deficit mainly from non-inflationary domestic sources of growth. The ample liquidity in the system, supported by strong surpluses in the balance of payments, allowed domestic financing of the deficit without crowding out the private sector.

The actual outturn of the financial position of the Government was better than expected. The overall financial position of the Federal Government registered a lower overall deficit of RM18.4 billion or -5.5% of GDP. As the shortfall on both operating and development expenditures was low at less than 5% each, the improvement was largely due to the better-than-expected revenue performance, emanating largely from higher income tax collection.

The thrust of policies introduced in 2001 to address longer-term structural issues focused on increasing domestic capacity, institution building and skills upgrading. The Government launched the Third Outline Perspective Plan (OPP 3) in April 2001, which documented the framework and strategies for economic development over the next ten years, 2001-2010. At the same time, the Government launched the Eighth Malaysia Plan, 2001-2005, which set out the first phase of implementation of OPP 3. Within the new framework for the economy, BNM and the Securities Commission took steps to develop longer-term strategies for the development of the financial sector and the capital market respectively.

The primary objective of the OPP 3 is to build a resilient and competitive nation by strengthening Malaysia's ability to meet the challenges arising from the rapid pace of globalisation and advances in information and communications technology. The Plan also takes into account the need to strengthen Malaysia's economic, financial and social resilience to withstand external shocks. Specifically, the OPP 3 aims to:

- Develop Malaysia into a knowledge-based economy where knowledge, creativity and innovation would increase productivity growth in all sectors;
- Generate domestic sources of growth by strengthening domestic investment in new areas of growth, while continuing to attract foreign direct investment in strategic areas;
- Re-orientate the strategies for human resource development to support a knowledge-based economy.

To advance the policy to increase the knowledge content of the economy, a masterplan for the transition towards a knowledge-based economy was completed in 2001.

Accordingly, the 2001 Budget as well as the 2002 Budget accorded priority to human resource development. Expenditure for education, training and skills development accounted for 23% of the Budget and 6.1% of GDP. Measures were initiated to promote computer literacy amongst students and employees, as well as improve teaching and learning methods. The existing curricula in schools and institutions of higher learning are being reviewed to meet the changing requirements of the economy. The restriction on tax deductions on bonus payments which was limited to two months, was also abolished in order to provide employers the flexibility to offer remuneration which was commensurate with workers' productivity. While emphasis has been placed on intensifying advanced skills development through training, retraining and apprenticeship schemes, efforts to pull the best talents from Malaysia and abroad have also been intensified. Incentives were provided in the 2001 Budget to attract highly skilled Malaysian citizens working abroad to return to Malaysia.

The Financial Sector Masterplan (FSMP), launched in March 2001 outlines the medium and long-term strategies for the development of the financial sector. The objective of the FSMP is to develop a competitive, resilient and dynamic financial system, based on international best practices, which would provide an enabling environment for long-term economic expansion. Phase one of the FSMP, which began in 2001 and covers a period of three years, focuses on enhancing domestic capacity and capabilities. Under the second phase, domestic competition would be intensified and in the third phase, the pace of integration with international markets will be enhanced.

A FSMP Secretariat and a FSMP Steering Committee (FSMP SC) have been set up in BNM, responsible for formulating mechanisms to effectively implement the FSMP recommendations. As at end-2001, out of the total 119 recommendations, nine of the recommendations were fully implemented and another 22 recommendations are being implemented on an ongoing basis.

The Capital Market Masterplan was launched in February 2001 with the objective of setting the strategic position and future direction for the Malaysian capital market. Of the 152 recommendations outlined in the Masterplan, 14 recommendations have been fully implemented, another 24 have been partially completed while 48 more are being addressed. Progress was made in the area of the consolidation of the stockbroking industry and the stock exchange, disclosure-based regulation and corporate bond market development.

Overall, Malaysia concluded the year 2001 in a stronger position with signs of stabilisation in the economy supported by the gradual recovery in export demand, strengthened economic fundamentals and significant progress made in addressing the long-term structural issues. The index of leading indicators which provides an early signal of the direction of the economy, has been rising for five consecutive months since July 2001, supporting the prospects for a recovery in the economy in 2002.

SECTORAL REVIEW

Manufacturing Sector

The overall performance of the manufacturing sector was affected by the slowdown in major industrial countries and the downturn in the global electronics cycle. While production in the export-oriented industries declined, industries that were dependent on domestic demand continued to expand, benefiting from the positive effects of the fiscal stimulus programme and low interest rates. Domestic demand for passenger cars and construction-related materials remained strong throughout the year. As a result, capacity utilisation in the domestic-oriented industries remained high at close to 80%. The strength in the domestic-oriented sector had mitigated, to some extent, the more severe contraction in the export-led manufacturing activities.

The production of export-oriented industries, which was relatively resilient in the first quarter of 2001, was affected more by the pronounced slowdown in external demand in the subsequent quarters. Nevertheless, with the emerging signs of improvements in the external environment towards the end of the year, the declines in manufacturing activities moderated in the fourth quarter of 2001, with both the exports and production of manufactured goods registering smaller declines. Given these developments, the decline in the overall manufacturing production and value added for 2001 as a whole was contained at a single-digit rate of 6.4% and 5.1% respectively (2000: +25% and +21% respectively).

While operating in a slower business environment during the year, some manufacturers had taken the opportunity to consolidate and streamline their operations in order to better position themselves in the increasingly competitive global market. This was evident in the relocation of the labour-intensive industries and lower-end operations from Malaysia to lower cost producing countries such as Thailand. At the same time, some manufacturers also transferred their higher-end operations to Malaysia to take advantage of the existing well-developed manufacturing facilities, competitive incentive structure as well as a workforce that is well-trained and proficient in the English language.

In addition, there were increasing efforts by exporters to explore export opportunities in niche markets. During the year, Malaysia's exports of manufactured goods to the Middle-East increased by 20.4%, with the share of total manufactured exports increasing to 2.4% from 1.8% in 2000. Major products that were exported included electronics, electrical products, wood products and furniture, food products and chemical products. At the same time, Malaysia's manufactured exports to the People's Republic of China have also been on an upward trend, growing significantly by 41.2% to account for a higher share of 3.9% of total manufactured exports in 2001 (2000: 2.5%). The bulk of manufactured goods exported to the People's

Graph 1.7
Manufactured Production and Exports

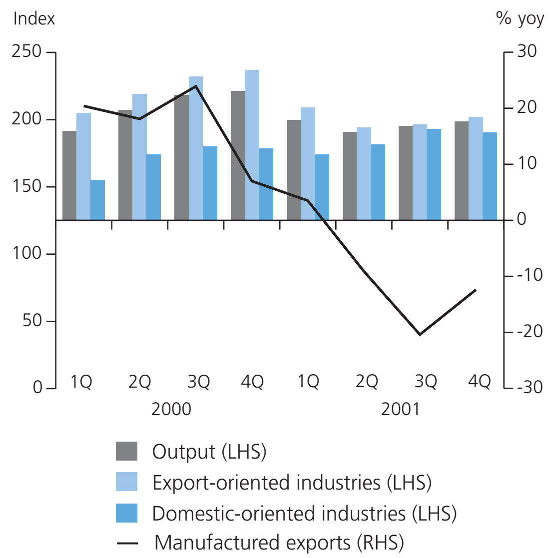
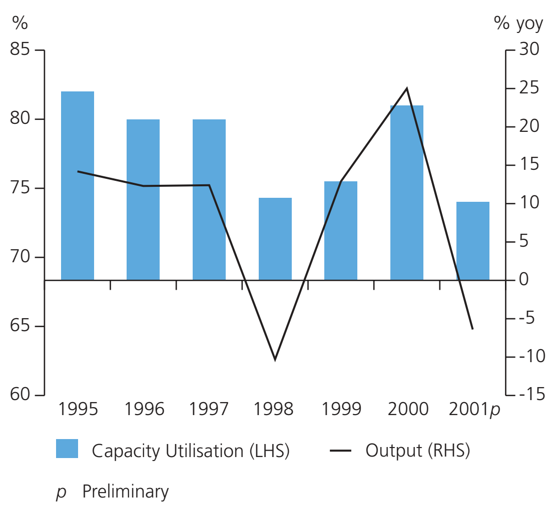


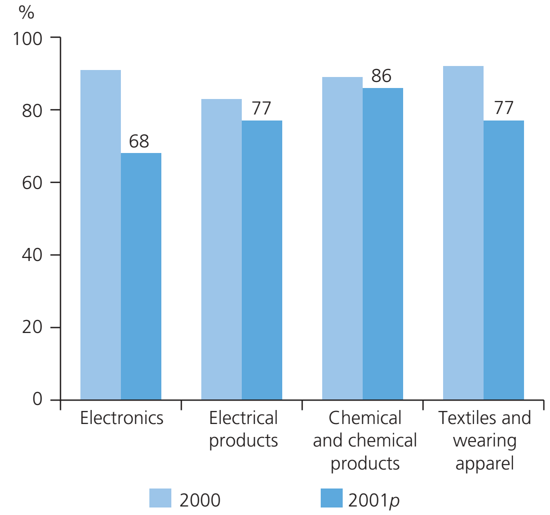
Table 1.4
Manufacturing Sector: Value Added and Production

	2000	2001
	Annual change in %	
Value-added (Constant prices)	**21.0**	**-5.1**
Overall Production	**25.0**	**-6.4**
Export-oriented industries	**25.7**	**-10.2**
of which:		
Electronics	44.8	-20.1
Electrical products	28.7	-1.9
Chemicals and chemical products	15.1	-7.6
Wood and wood products	4.0	1.3
Textiles and wearing apparel	8.7	-8.5
Rubber products	4.0	3.3
Off-estate processing	11.7	7.7
Domestic-oriented industries	**22.1**	**7.4**
of which:		
Transport equipment	19.1	20.6
Petroleum products	19.9	19.3
Construction-related products	18.6	5.0
Fabricated metal products	33.8	4.0
Food products	16.2	4.4

Graph 1.8
Capacity Utilisation in the Manufacturing Sector



Graph 1.9
Capacity Utilisation of Export-Oriented Industries



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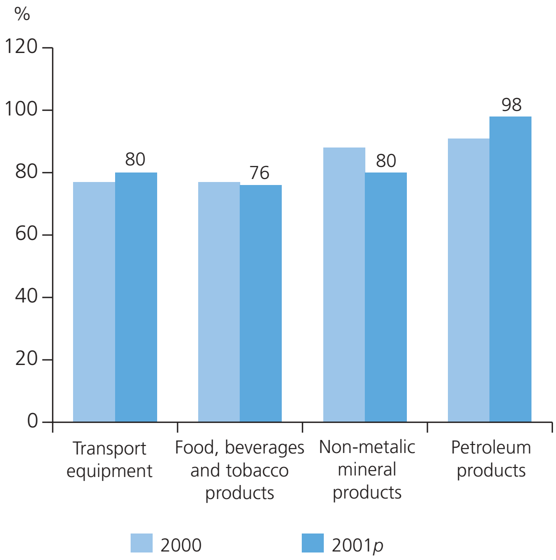
Graph 1.10
Capacity Utilisation of Domestic-Oriented Industries



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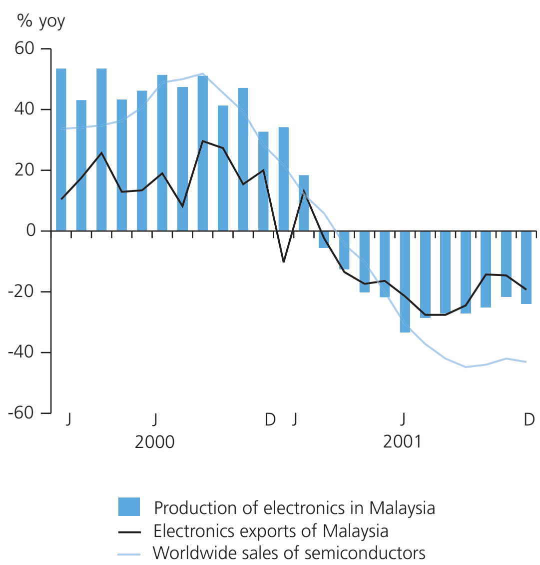
The strength in the domestic-oriented sector mitigated the contraction in the export-oriented industries. Growth was most pronounced in the transport-related industries.

Republic of China comprised electronics and electrical products, chemical products, wood products and metal products.

Graph 1.11
Production and Exports of the Electronics Industry



The **electronics industry** was the most affected by the slowdown in global demand in 2001. During the year, most electronics manufacturers drew down inventories accumulated from a year of strong capacity expansion in 2000. As the downturn in the global IT sector became more pronounced since the second quarter of 2001, the electronics manufacturers undertook measures to rationalise operations. These included wage cuts and shorter working hours to improve cost effectiveness as well as retraining of workers to move into higher-end operations. An encouraging development in the second half-year was the increase in demand from niche markets for products such as disk drives for the video game systems and personal video recorders. This supported the operations of disk drive makers based in Malaysia.

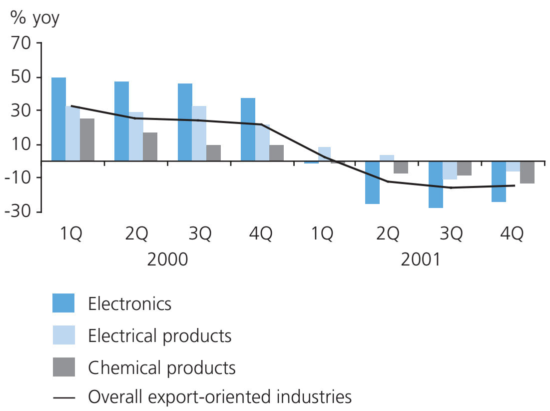
The production of **electrical products** was more resilient in the first half of 2001 and only began to moderate in the second half of the year, as external demand for audio-visual products and communication products declined. Exports to the major markets, especially the US, Japan, Singapore, Hong Kong SAR and Europe declined, due to lower demand for consumer durables, such as digital video disc (DVD) players, video compact discs (VCD) players and flat screen televisions. Nevertheless, exports to some countries in the region such as the People's Republic of China, Thailand, Indonesia and the Middle-East continued to be sustained.

Performance of the **textiles and wearing apparel industry** was adversely affected by the weak external demand conditions. During the year, both the production and exports of textiles and wearing apparel declined due to lower demand from the major buyers, namely, the US, Hong Kong SAR, Singapore and Europe.

About 50% of output of the **chemical products industry** are linked to the production of electronics and electrical products. Consequently, the lower demand for resins and plastic products as well as lower usage of industrial gases in the electronics and electrical products industries affected the production of chemical products. At the same time, slower external demand for resins, toiletries and pharmaceutical products also contributed to the decline in output of this industry. While the production of the more export-oriented chemical products declined, products which have stronger linkages with the domestic-oriented activities continued to experience output growth. These products included paints, varnishes and lacquers for use in car production and construction activities.

During the year, output of **off-estate processed products** increased, in line with the sustained demand and higher production of crude palm oil. The **rubber products industry** benefited from higher

Graph 1.12
Output Performance of Selected Export-Oriented Industries



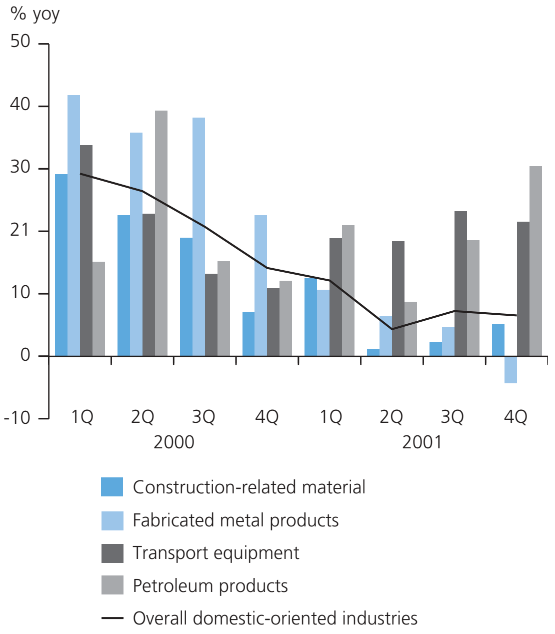
external demand for gloves, especially from the US, following the threat of the anthrax scare. Despite the increased production, export proceeds of rubber products declined further during the year, due to continued low export prices for gloves arising from competition from Thailand. Gloves accounted for about three quarters of total production and exports of rubber products. Output of tyres and tubes was also affected by competition from cheaper imports from Thailand and Indonesia as well as better quality tyres from Japan.

The production of **wood products** was sustained in 2001, reflecting mainly the strong saw milling activities in the early part of the year. Production declined towards the middle of the year when external demand deteriorated further. Like the rubber products industry, the increased volume of wood products did not translate into higher export receipts, as prices of plywood and sawn timber remained low in the global market amidst sluggish demand from Japan and the US. Similarly, lower external demand also resulted in the decline in exports of furniture and parts in 2001.

Supported by the sustained strong domestic demand, most of the industries producing for the domestic market continued to register positive growth in 2001. In particular, output from the **transport equipment** and petroleum products industries continued to record double-digit expansion. The production of transport equipment, including passenger cars as well as motor vehicle parts and accessories expanded by 20.6% during the year. Higher demand was stimulated by measures to raise disposable income and favourable financing conditions. The strong output performance of the transport equipment industry had a favourable impact on domestic demand for **petroleum products**. The export earnings of petroleum products increased further albeit at a slower pace, reflecting mainly the lower crude oil prices towards the middle of the year.

The positive effects of the fiscal stimulus programme were reflected in the continued output expansion of **construction-related materials** to meet demand from the construction sector. The production of iron and steel products as well as non-metallic mineral products, including cement and concrete products, tiles and ceramic products expanded further during the year. Nevertheless, exports of the non-metallic mineral products declined, reflecting to a large extent, the intense price competition,

Graph 1.13
Output Performance of Selected Domestic-Oriented Industries



particularly from Indonesia for tiles and ceramic products as well as other structural clay products in the international markets. These products accounted for about 28% of total exports of the non-metallic mineral products industry.

Output of all sub-sectors in the **fabricated metal products industry** increased, except for the copper and aluminium sub-sector which was affected by lower demand from the electronics industry. Meanwhile, the production of sub-sectors like structural and fabricated metal products, wire products and tin cans was sustained by continued activities in the construction sector and the beverages industry.

Output of the **paper and paper products industry** grew marginally, affected primarily by the decline in the production of containers, paper boxes and paperboard, as packaging activities especially in the export-oriented products industries slowed down. Supported by the strong sustained consumer spending, output of the **food, beverages and tobacco products industries** continued to sustain a positive growth during the year.

Construction Sector

The fiscal stimulus programme, privatisation of infrastructure projects and housing development contributed to a stronger growth of 2.3% in the **construction sector**. Construction activity in the non-residential sub-sector consolidated further due to the large overhang of office and retail space.

The **civil engineering sub-sector** benefited significantly from Federal Government development expenditure on construction-related projects, especially projects in the transportation, education and health sub-sectors. Growth in construction activity also emanated from commencement of four privatised road projects and one independent power plant. The former included the Kajang Ring Road, Ipoh-Lumut Highway, Guthrie Corridor Expressway and the Butterworth Outer Ring Road while the independent power plant was the Technology Tenaga in Perlis. Construction activity was also undertaken for ongoing works related to airports, rail, ports, waste disposal, water and sewerage projects. Among the major ongoing projects during the year were the New Pantai Expressway, Express Rail Link, the Kuala Lumpur Monorail System and the development of Putrajaya. Given the importance of infrastructure project financing to support growth of the civil engineering sub-sector, Bank Pembangunan dan Infrastruktur Malaysia Berhad's loan approvals totalled RM7.4 billion in 2001, compared with RM7.6 billion in 2000. The Bank increased its loan disbursement to RM4.4 billion (2000: RM2.7 billion).

Measures undertaken by the Government to support economic growth and increase disposable income led to a positive growth of the **residential sub-sector** in 2001. Growth was supported by strong underlying demand for residential units, particularly affordable and conventional housing in choice locations with good accessibility. The low interest rate environment with financial institutions offering competitive housing loan packages with lower margin requirements and longer tenure provided additional impetus. Other incentives included withdrawals of EPF funds for the purchase of a second house provided the first house has been sold; exemption from stamp duties; lifting limitations for financial institutions to finance the construction of residential properties priced above RM250,000 each and shop houses within residential areas; and allowing proceeds from private debt securities to be used to finance the development of such properties provided they achieve break-even sales in value terms.

In 2001, demand in choice locations strengthened while sales performance of new launches of housing schemes in poor locations showed a declining trend during the latter half, with the take-up rate declining from 53% in the first quarter to 40% during the third quarter. The value and number of residential property transactions also fell marginally. Nevertheless, government measures to reduce the property overhang by granting stamp duty exemptions for the purchase of completed properties from developers resulted in a total of 6,100 units of properties valued at RM1.7 billion being sold during 2001. This represented about a quarter of the 24,000 units of properties valued at RM7.7 billion that were offered by developers registered with the Real Estate & Housing Developers' Association of Malaysia (REHDA).

Indicators of optimism of rising demand in the residential sub-sector included increase in new developers' licences issued with more units approved for construction in Peninsular Malaysia;

Table 1.5
Residential Property Indicators

	2000	2001
	Number	
Residential property transactions		
Number	170,932	165,309
Value (RMb)	21.9	20.8
Approvals[1]	214,290	227,260
Developers' licences		
New	997	1,095
Renewals	416	413
Sales and advertising permits		
New	969	1,014
Renewals	1,249	1,461
Loans by banking system - value (RMb)		
Outstanding	74.3	87.1
Approvals	24.9	27.1

[1] Units approved for construction by private developers in Peninsular Malaysia

Source: NAPIC, Valuation and Property Services Department, Ministry of Housing and Local Government and Bank Negara Malaysia

Growth in the construction sector was supported by fiscal stimulus programme and low interest rates.

new sales and advertising permits as well as renewals of such permits; and increase in loans for residential properties. Mortgage loans granted by the banking system rose by 17.2% (RM12.8 billion). Similarly, loans approved by other housing credit institutions also increased during the year. In particular, loans by the Treasury Housing Loans Division increased significantly due to higher loan eligibility for civil servants and the ability to utilise the balance of loan eligibility to purchase a second house. In line with higher approvals, total housing loans outstanding increased in 2001.

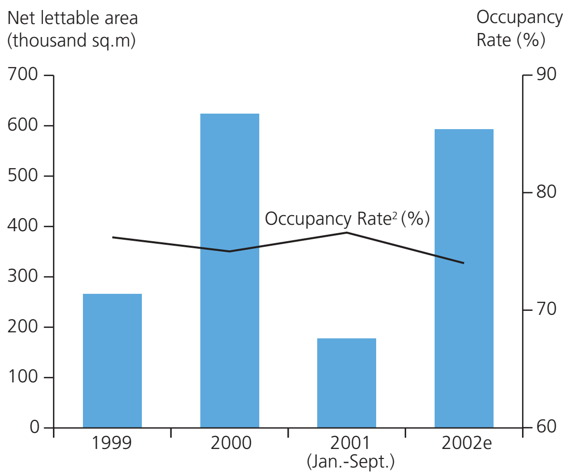
Prices of residential properties rose marginally during 2001 after appreciating by 15.4% since the first half of 1999. The Malaysian House Price Index rose at an annual rate of 0.9% during the first half of 2001. However, prices declined marginally compared with the preceding six months. Prices of terraced and semi-detached houses recorded increases, while the detached and high-rise units registered price declines. Although the index remained below the peak level recorded in 1997, house prices in several states exceeded the pre-crisis levels. Generally, all states registered price

Table 1.6
Property Overhang, Incoming Supply and Planned Supply

	Overhang		In-coming Supply	Planned Supply	In-coming Supply	Planned Supply
	June-01		June-01		Sept-01	
	Units/ '000 s.m.	Value (RMb)	Units/ '000 s.m.		Units/ '000 s.m.	
Residential (units)	35,203	4.9	477,693	342,972	471,835	359,077
Purpose-built office ('000 s.m.)	2,528	8.8	2,540	1,951	2,453	1,917
Shopping complexes ('000 s.m.)	1,449	9.3	1,508	1,718	1,509	1,715
Retail shops (units)	7,817	2.2	25,154	25,351	25,339	26,180
Industrial properties (units)	3,295	1.3	8,254	23,170	8,395	23,017

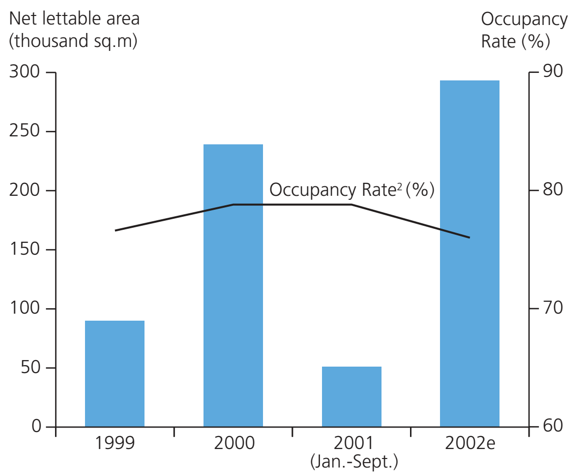
Source : NAPIC, Valuation and Property Services Department

Graph 1.14
New Supply of Purpose-Built Office Space in the Klang Valley[1]: 1999-2002



[1] Refers to Kuala Lumpur and Selangor
[2] Refers to end of period
e Estimates by BNM
Source: NAPIC, Valuation and Property Services Department

Graph 1.15
New Supply of Retail Space in the Klang Valley[1]: 1999-2002



[1] Refers to Kuala Lumpur and Selangor
[2] Refers to end of period
e Estimates by BNM
Source: NAPIC, Valuation and Property Services Department

increases, except for Selangor and Kelantan where prices declined marginally. In particular, terraced houses in Kuala Lumpur recorded the highest price increase of 20.5%.

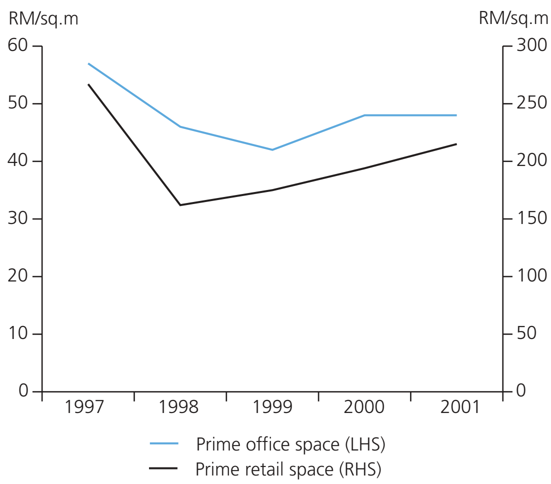
The **property overhang** situation improved primarily due to the sales of residential properties. As at end-June 2001, data compiled by the National Property Information Centre (NAPIC) of the Valuation and Property Services Department showed that the overhang of residential properties improved by 31.4% to 35,203 units, while the improvement in value terms was 26.5% to RM4.9 billion. The remaining unsold units were located mainly in poor locations. Demand for residential units was more resilient in the well-established locations.

Several measures were introduced during the year to reduce the property overhang. With the liberalisation of the FIC guidelines effective 25 April 2001, foreign purchases of commercial properties increased by 14% to RM634 million. However, sale of residential properties to foreigners declined.

The large overhang and low occupancy rates of office and retail space continued to restrain growth of the **non-residential sub-sector**. Construction of **purpose-built office and retail space** during 2001 was supported mainly by ongoing projects. Overall, with the decline in incoming supply, the average occupancy rate for office space and retail complexes in the Klang Valley stabilised in 2001. Commercial property transactions adjusted downwards by 5% in terms of value and 11% in volume terms.

Arising from higher demand, rentals of prime office and retail space edged upwards during the year, although the rental rates remained lower than pre-crisis levels. Rentals for office and retail space in secondary locations were most affected by the excess

Graph 1.16
Average Monthly Rentals for Prime Office and Retail Space in Klang Valley[1]



[1] Refers to Kuala Lumpur and Selangor
Source: BNM, CH Williams Talhar & Wong Sdn. Bhd.

Table 1.7
Office and Retail Space-Unoccupied Space, Incoming Supply and Planned Supply by State (as at end-September 2001)

	Office Space			Retail Space		
	Unoccupied Space	Incoming Supply	Planned Supply	Unoccupied Space	Incoming Supply	Planned Supply
	('000 square metres)					
Kuala Lumpur	1,388	1,376	1,037	320	767	738
Selangor	460	422	164	194	121	0
Johor	230	262	431	272	178	859
Pulau Pinang	189	141	47	277	290	22
Negeri Sembilan	29	62	140	53	60	64
Perak	43	68	6	62	47	0
Melaka	10	15	0	41	0	0
Kedah	16	23	16	72	18	25
Pahang	13	13	56	48	2	6
Terengganu	7	7	0	5	7	0
Kelantan	13	0	20	2	19	0
Perlis	5	34	0	8	0	0
Sabah	224	3	0	44	0	0
Sarawak	64	26	0	34	0	0
Total	**2,692**	**2,453**	**1,917**	**1,432**	**1,509**	**1,715**

Source : NAPIC, Valuation and Property Services Department

supply situation, as tenants became more selective, favouring commercial space in more strategic locations. Although the incoming supply of new office and retail space was on a declining trend, it was estimated that it would take five years to fully utilise existing office space, and 4.4 years for retail space. This was based on the assumption of an average annual take-up rate of 535,000 square metres for office space and 327,000 square metres for retail space as recorded during the period of 1992 to September 2001.

In the development of hotels, new hotels completed during the year increased to 288, which provided 6,344 rooms. The occupancy rate of hotels improved marginally to 59% as tourist arrival for the year rose to a record level of 12.8 million from 10.2 million in 2000.

Agriculture sector

Value added in the **agriculture, forestry and fishery sector** (agriculture) expanded by 2.5% in 2001 due primarily to higher crude palm oil production and, to a lesser extent, higher output of livestock, fruits and vegetables. The latter reflected the initial signs of the positive impact of the Government's measures to increase domestic sources of growth through higher food production. Production of other major agricultural commodities including rubber, saw logs and cocoa declined during the year, reflecting mainly weaker global demand. Consequently, commodity prices, except for cocoa prices, fell in 2001. As a result of the decline in export prices as well as volume, the export earnings of the agriculture sector for 2001 declined by 13.2%.

Production of **crude palm oil**, which accounts for 35% of total value added in the agriculture sector, increased by 8.9% in 2001. The increase was on account of two factors: firstly, the area with newly matured trees particularly in Sabah was higher; and secondly, the volume of oil extracted was higher in line with favourable weather conditions. However, due to ample global supplies of vegetable oils, the export price of Malaysian palm oil remained below RM1,000 per tonne during January-July 2001. Thereafter, the price breached the RM1,000 level in August 2001 and remained above this level for the rest of the year. This turnaround was driven mainly by lower supplies of palm oil, particularly since August 2001, as external demand from Malaysia's traditional buyers was sustained. For 2001 as a whole, palm oil prices averaged RM944 per tonne (2000: RM1,122).

The low palm oil prices in the first half of the year prompted the Government to introduce incentives to reduce the supply of palm oil. This was done by reducing existing stocks and encouraging replanting. To reduce stocks and to promote exports, the Government allowed a full waiver of export duties on one million tonnes of crude palm oil and abolished

Table 1.8
Agriculture Sector: Value Added, Production and Exports

	2000		2001*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value Added (RM million at 1987 prices)	**17,687**	**0.6**	**18,129**	**2.5**
Production [1]				
of which:				
Crude palm oil	10,842	2.7	11,804	8.9
Rubber	615	-20.0	546	-11.2
Saw logs	23,076	5.9	19,554	-15.3
Cocoa beans	70	-16.0	58	-17.9
Exports (RM million)	**23,014**	**-16.8**	**19,966**	**-13.2**
of which:				
Palm oil				
('000 tonnes)	8,863	-1.1	10,466	18.1
(RM/tonne)	1,122	-30.5	944	-15.9
(RM million)	9,948	-31.3	9,876	-0.7
Rubber				
('000 tonnes)	978	-0.6	822	-16.0
(sen/kilogramme)	263	10.4	230	-12.7
(RM million)	2,571	9.7	1,886	-26.6
Saw logs				
('000 cubic metres)	6,484	-3.8	4,834	-25.5
(RM/cubic metre)	384	-2.9	315	-17.9
(RM million)	2,489	-6.5	1,523	-38.8
Sawn timber				
('000 cubic metres)	2,876	2.1	2,411	-16.2
(RM/cubic metre)	1,050	5.4	943	-10.2
(RM million)	3,020	7.6	2,273	-24.7

[1] All in '000 tonnes, except for saw logs in '000 cubic metres.

p Preliminary

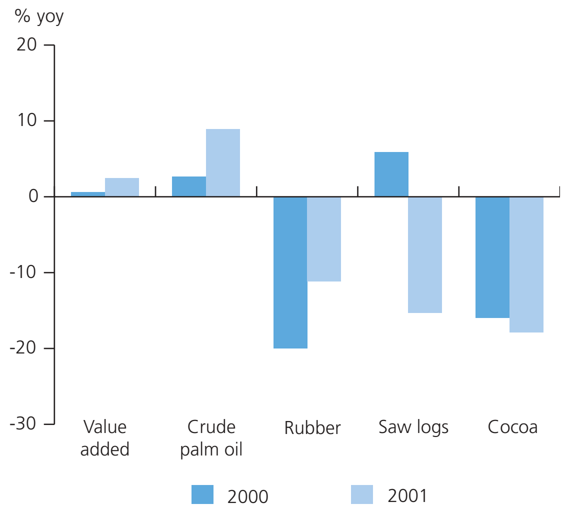
Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board

the 5 percent duty on exports of semi-processed palm oil. To encourage replanting, the oil palm replanting scheme, which aimed to reduce 200,000 hectares of land planted with oil palm trees older than 25 years was introduced in March 2001. A total of RM200 million was allocated for the scheme. However, as palm oil prices improved in the latter half of 2001, the response to the replanting scheme, particularly among the smallholders, was not encouraging. As at end-2001, only 58,600 hectares or almost 30% of the area with old oil palm trees have been replanted. This has prompted the Government to extend the application period for the scheme to the end of June 2002.

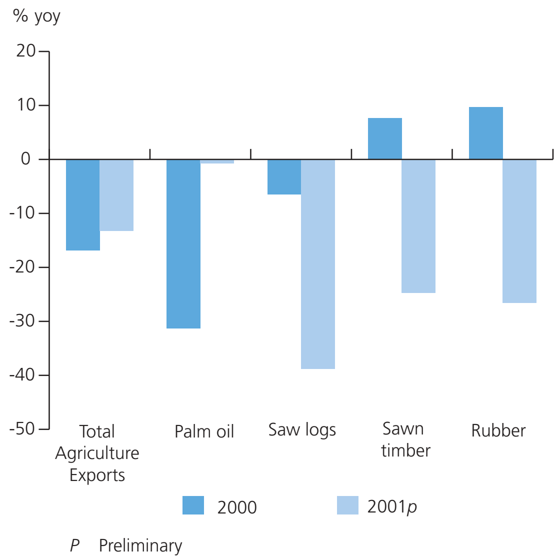
In 2001, the contraction in palm oil exports moderated to 0.7% due to the higher volume of exports (18.1%) and a more moderate decline in export prices (-15.9%). In particular, the higher export volume of palm oil was mainly on account of higher imports from major buyers, namely India, the European Union, the People's Republic of China and Pakistan. These markets accounted for 60% of Malaysia's total palm oil exports. Favourable export demand throughout the year coupled with lower production since September 2001 led to a reduction in total stocks of palm oil to 1.2 million tonnes at the end of the year (end-2000: 1.4 million tonnes).

As part of efforts to further expand and diversify Malaysia's export markets, the Malaysian Palm Oil Promotion Council together with the Technical Advisory Services (TAS) unit of the Malaysian Palm Oil Board undertook promotional activities. The TAS unit focused on market development through the provision of technical support to create greater

Graph 1.17
Agriculture Production

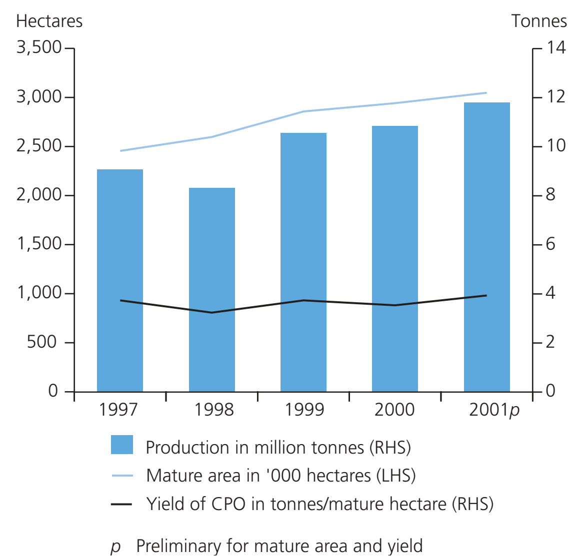


Graph 1.18
Agriculture Exports



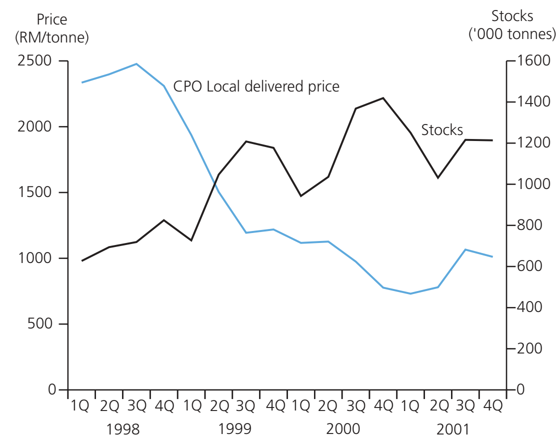
awareness of the technical attributes of the Malaysian palm oil in overseas markets. As a result, several new export markets such as in Ecuador, Liberia, Armenia and Palau were established. Meanwhile, research and development (R&D) activities on palm oil continued in 2001. Generally, such R&D activities can be grouped into innovative products, lipid technology and the oil and fats technology. The Oil and Fats Technology Centre continued to focus its R&D on the formulation of new palm-based food products that have potential for commercialisation by the relevant industrial sectors.

Graph 1.19
Oil Palm: Area, Production and Yield



The stronger growth in the agriculture sector in 2001 was also the result of higher production of the other agriculture group, which comprised mainly the livestock, fishery, fruits and vegetables sub-sectors. This increase was in line with efforts to increase domestic food production. **Livestock** production rose by 7.4% while the production of **fish** remained virtually unchanged from the preceding year's level. To further encourage cultivation of vegetables and fruits, the Ministry of Agriculture has established the Permanent Food Production Parks through the development of lands allocated by State Governments. By end-2001, 800 hectares of such land had been developed. Consequently, production of **fruits** and **vegetables** grew by 10.2% and 15.7% respectively.

Graph 1.20
Palm Oil Prices and Stocks



In 2001, Malaysian **natural rubber** (rubber) production declined to a record low of 546,180 tonnes, or 11.2% lower than in 2000. The decline was due mainly to the low rubber price, which continued to discourage tapping activities, particularly among the rubber smallholders. Smallholders contribute 82% to Malaysia's total rubber output. The production of rubber was also affected by the continuous conversion of areas planted with rubber to other crops or use. During the year, more than 16,000 hectares of rubber smallholdings were replanted with other crops. Taking cognisance that the incomes of most rubber smallholders were adversely affected by the prolonged period of low prices, the Government introduced monetary incentives of 30 sen per kilogramme for latex and 15 sen per kilogramme for cuplumps in the second half of 2001. These incentives were also aimed at encouraging tapping activities. Besides the monetary incentives, smallholders were encouraged to use modern and labour-saving tapping technology known as the Low-Intensity Tapping Systems (LITS) - a gaseous stimulation that can help raise tree productivity. For this purpose, the Government has allocated a total of RM180 million. Generally, LITS are encouraged for use in rubber plantations, primarily to ease the labour shortage and improve productivity.

Reflecting lower export prices and export volume, total earnings from rubber exports (including re-exports), declined by 26.6% in 2001. Rubber prices, which picked up in 2000, were unsustainable in 2001 as global supply exceeded consumption. The average price of rubber (as measured by RRS 1 prices) fell to RM2.27 per kilogramme. Prolonged low international rubber prices amidst an oversupply in the international markets, prompted the three major rubber producing countries, namely Thailand, Indonesia and Malaysia (which together account for 85% of the world's total natural rubber output), to co-operate to revive rubber prices through supply management. This Government-to-Government co-operation culminated in the establishment of the International Tripartite Rubber Organisation (ITRO) in July 2001. ITRO is responsible to a governing council, the International Tripartite Rubber Council. Among the initial arrangements under ITRO endorsed in December 2001, was an annual natural rubber production cutback of 4% and a reduction in exports by 10%, to commence in January 2002.

Arising from poor external demand, production of **saw logs** fell by 15.3% in 2001. In particular, demand from Japan, Taiwan, Hong Kong and Korea was lower in tandem with the global economic slowdown. In 2001, Malaysia's tropical logs continued to face stiff competition from softwoods particularly from Russia, Europe, Chile and New Zealand. As export demand was lower, export prices of saw logs fell to RM315 per cubic metre in 2001. Similarly, **sawn timber** also posted poor export performance with earnings declining by 24.7%. Lower export volume, particularly to major traditional buyers in the Asia-Pacific region, and lower prices contributed to the decline.

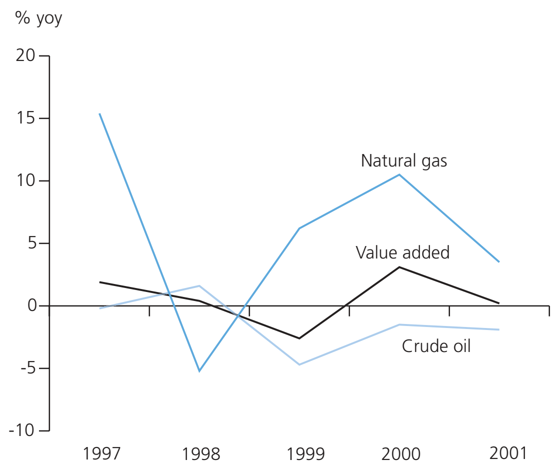
The Malaysian Timber Certification Council (MTCC), which was set up in January 1999 with the objective of operating a voluntary national timber certification scheme for Malaysia, officially launched its certification scheme in January 2002. The certification scheme is to be implemented in two phases. Under the first phase, the Malaysian Criteria, Indicators, Activities and Standards of Performance for forest management Certification (MC & I) would be used as the standard to assess forest management practices in the permanent forest estates at forest management unit levels. The MTCC certification scheme provides buyers of Malaysian timber products the assurance that the products are sourced from sustainably managed forests. In order to ensure a wider market acceptance of its scheme and certified products, MTCC has been working closely with the Forest Stewardship Council (FSC) and local stakeholders through the National Steering Committee to design an FSC-compatible certification standard that can be used under the second phase of the MTCC scheme. Based on the current progress in the implementation of the certification scheme, MTCC-certified timber products are expected to be available in the market by mid-2002.

Production of **cocoa beans** contracted by 17.9% in 2001 as yields were affected by unfavourable weather conditions. In addition, production was affected by continued conversion of cocoa cultivated land to other crops. Nonetheless, the Malaysian Cocoa Board intensified its efforts to increase cocoa productivity through rehabilitation programmes in selected areas. A significant development for the cocoa sector in 2001 was the marked pick up in international cocoa prices. This was brought about mainly by lower global supplies as production in major producing countries declined significantly. Malaysian cocoa prices rose to RM3,494 per tonne in 2001 (2000: RM2,879) leading to a 73.3% increase in total foreign earnings from cocoa exports.

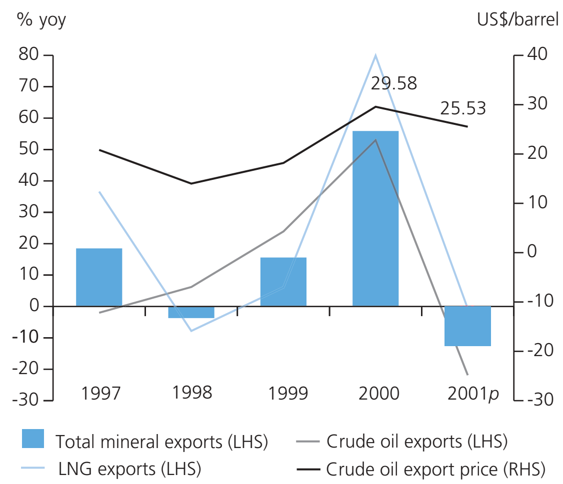
Mining sector

In 2001, the **mining** sector grew moderately by 0.2%. The growth was driven primarily by higher production of natural gas, which increased by 3.2% in response to higher demand, particularly from the domestic power generation sub-sector. In contrast, production of crude oil and tin declined. Total **crude oil** production of 581,000 barrels per day (bpd.) was 2.3% lower than that of the previous year in response to lower external demand particularly by traditional markets in the region. It was also marginally below the 600,000 bpd. production target set for the year under the National Depletion Policy which aims to sustain the exploitation of the nation's crude oil reserves. Malaysia's total earnings from mineral exports were lower by 12.6% (2000: +55.9%) primarily due to weaker crude oil prices.

Graph 1.21
Mining Production



Graph 1.22
Mineral Exports



p Preliminary

In 2001, amidst ample supply and weak global oil demand that worsened further following the September 11 incident, the price of crude oil in the international oil markets trended downwards. International oil prices, benchmarked to Brent price, ranged between US$25-US$28 per barrel in the first nine months of the year, before declining further to US$21.36, US$19.19 and US$18.80 in October, November and December respectively. For 2001 as a whole, the average Brent price was US$25 per barrel, lower by US$4.00 than the average oil price in the previous year. Oil prices declined despite efforts by the Organisation of Petroleum Exporting Countries to support oil prices through three crude oil production cutbacks totalling 3.5 million bpd. In line with the trend in global oil markets, the price of Malaysian crude oil exports was lower at an average of US$25.53 per barrel in 2001 (2000: US$29.58). Combined with lower export volume, export proceeds from crude oil declined by 21.9% (2000: +53%).

Production of **natural gas** increased in 2001. The increase was driven mainly by higher domestic demand, particularly from the power generation sub-sector, accounting for about 72% of the total domestic utilisation of natural gas. The district cooling system sub-sector, another main domestic user which utilises natural gas to produce chilled water for air-conditioning systems and generate electricity for several new business and administration centres in and around Kuala Lumpur, also recorded an increase in demand for gas. External demand for liquefied natural gas (LNG) also increased, albeit marginally by 0.4%. In tandem with lower crude oil prices, LNG prices also declined in 2001. With a marginal increase in export volume and a decline in price, export earnings from LNG declined by 0.7% in 2001.

In December 2001, a new gas field located offshore in Terengganu commenced operations to cater for the projected future increase in demand for gas. A total of 34 exploration wells and 56 development wells were drilled during the year, in addition to the 438,702 line kilometres of seismic data acquired for exploration and development purposes. In 2001, only one new production-sharing contract was signed.

Table 1.9
Mining Sector: Value Added, Production and Exports

	2000		2001*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value Added (RM million at 1987 prices)	**14,416**	**3.1**	**14,444**	**0.2**
Production				
Crude oil and condensates (barrels per day)	681,000	-1.5	668,000	-1.9
of which: *Crude oil (barrels per day)*	*595,000*	*-2.2*	*581,000*	*-2.3*
Natural gas – net (million standard cubic feet)	1,598,325	10.8	1,649,490	3.2
Tin-in-concentrates (tonnes)	6,307	-14.1	4,900	-22.3
Exports (RM million) *of which:*	**26,811**	**55.9**	**23,445**	**-12.6**
Crude oil				
('000 tonnes)	16,672	-5.9	15,077	-9.6
(US$/barrel)	29.58	62.7	25.53	-13.7
(RM million)	14,241	53.0	11,118	-21.9
Liquefied natural gas				
('000 tonnes)	15,430	2.3	15,492	0.4
(RM/tonne)	740	75.9	732	-1.1
(RM million)	11,422	79.9	11,342	-0.7
Tin				
('000 tonnes)	21	-14.2	27	32.3
(RM/tonne)	21,089	3.3	16,900	-19.9
(RM million)	435	-11.4	461	6.0

p Preliminary

Sources: PETRONAS
Department of Statistics, Malaysia
Department of Minerals and Geosience, Malaysia

Table 1.10
Malaysia: Crude Oil and Natural Gas Reserves [1]

	As at 1 January	
	2000	2001
Crude oil		
Reserves (billion barrels)	3.43	3.39
Reserve/Production (year)	16	15
Natural gas		
Reserves (trillion standard cubic feet)	84.4	82.5
Reserve/Production (year)	30-40	30-40

[1] The National Depletion Policy (NDP) was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).

Source: PETRONAS

Services Sector

In a moderating growth environment, pro-growth policies to stimulate domestic activities resulted in growth of the services sector being sustained at a high level of 4.9% in 2001 (2000: 4.8%). Growth continued to be broad-based, with the intermediate services group expanding at a faster rate than the final services group. Supported by the strong growth, the contribution of the services sector to GDP rose to 55.8% (53.4% in 2000 and 51.9% in 1997).

Intermediate services, comprising transport, storage and communication; and finance, insurance, real estate and business services recorded stronger growth of 6.5% in 2001. The strong expansion in the **transport, storage and communication** sub-sector was primarily due to the rapid growth in the mobile phone and Internet services segment of the telecommunications industry and the increase in the local ports' transhipment activities. The market size for fixed telephones increased to 4.7 million as at end-2001 (2000: 4.6 million) while that for cellular telephones was 7.5 million (2000: 5.1 million). The prepaid service of the cellular telephone services also expanded in 2001 as it appealed to the younger generation and casual users. Demand for other value-added services with additional applications and features, such as the Short Messaging Services (SMS), also increased in 2001.

Government initiated programmes to enhance and expand the domestic shipping and ports services sub-sector contributed to the increase in cargo transhipment activities as well as in the handling capacity of cargo at local ports. With the continuous flow of new investment and with improvement in services provided by the port authorities nationwide, the activities of Malaysian ports expanded further in 2001. Container throughputs at six major ports recorded an increase of 43.5%.

The strong performance of the Port of Tanjung Pelepas (PTP) and Port Klang was the result of concerted plans by the Government to promote Malaysian ports as regional trade and shipping hubs. Port Klang has made significant progress in the past few years. In 2000, it was ranked 12th among the world's container ports, up two notches from the 14th position in 1999.

In year 2001, PTP managed a throughput of 2.04 million TEUs (20-ft equivalent units) with a total of 2,283 container vessels, calling at the port. This represented an increase of about five times over the 424,924 TEUs registered in 2000.

In terms of capacity expansion, Westport in Port Klang has increased its capacity from 1.8 million TEUs to 2.5 million TEUs with the construction of an additional 600 metres of berth length and an investment of more than RM100 million on equipment. Northport, in turn, has invested RM1.3 million to develop Phase I of the Wireless Application Protocol service designed for the logistics and transportation industry. Northport also invested in 10

Graph 1.23
Services Sector: Quarterly Annual Growth

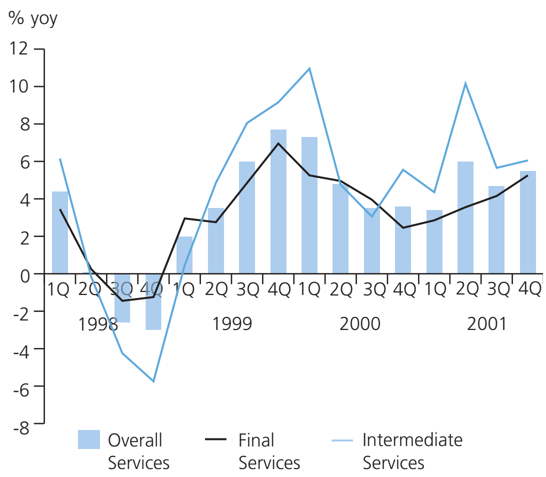


Table 1.11
Growth in the Services Sector at Constant 1987 Prices

	2000	2001*p*	2000	2001*p*
	Annual change %		% share of GDP	
Services	**4.8**	**4.9**	**53.4**	**55.8**
Intermediate services	5.9	6.5	20.5	21.7
Transport, storage and communication	7.3	5.2	8.0	8.4
Finance, insurance, real estate and business services	5.1	7.3	12.5	13.4
Final services	4.1	3.9	32.9	34.1
Electricity, gas and water	7.5	5.6	3.8	4.0
Wholesale and retail trade, hotels and restaurants	5.8	3.3	14.8	15.2
Government services[1]	1.4	5.4	6.9	7.2
Other services[2]	1.5	2.9	7.5	7.7

[1] Include general public services (general public administration, external affairs and public order and safety), defence, health, education, and others.
[2] Include imputed rent from owner-occupied dwellings; community, social and personal services; products of private non-profit services to households; and domestic services of households.
p Preliminary

Source: Department of Statistics, Malaysia new straddle carriers and has ordered another seven carriers to complement the existing fleet.

The performance of the air transport industry was less favourable in 2001, due largely to the slowdown in international trade. Shipment of electronics and other goods from Malaysia were affected by the slowdown in electronics exports. Global passenger traffic also declined, particularly after the September 11 incident when passengers became more risk averse. Current measures to increase flight frequency from KLIA include open sky policy agreements for passenger and cargo services with several developed countries, bilateral agreements and strategic alliances with other airports to allow additional international landing rights, flight frequencies and new destinations.

Rail transport recorded a higher revenue in 2001, attributed mainly to the cargo business sector. The opening of the landbridge linking Thailand and Port Klang by rail has increased KTM Berhad's cargo revenue. In the case of the LRT, the total ridership for the year increased by 16.5% with 85 million passengers.

In the **finance, real estate and business services** sub-sector, value added growth was also higher. The increase reflected mainly higher collection of insurance premium income as well as the stronger performance of the banking institutions. Strong pick-up in activity in the stock market in the second half-year has contained the negative contribution of this sub-sector.

Growth in the services sector was sustained at a high level, with increased activity in new growth sectors.

Growth in the **final services** group, which comprised utilities; wholesale and retail trade, hotels and restaurants; government services and other services was sustained at 3.9% in 2001 (2000: 4.1%). The **utilities** sub-sector recorded a higher growth despite weakening demand from lower manufacturing activities. Value added of electricity generation increased further due to higher demand by the domestic-oriented industry and the commercial sector. Growth in the sub-sector was also supported by an increase in the consumption of water, which rose by 7% in 2001.

The **wholesale and retail trade**, **hotel and restaurants** sub-sector recorded a positive performance in 2001, supported mainly by the fiscal stimulus measures that raised disposable incomes of the household sector. Higher tourist arrivals also contributed to positive performance of this sub-sector. In addition, Malaysia also benefited from the hosting of the South East Asia (SEA) Games in September.

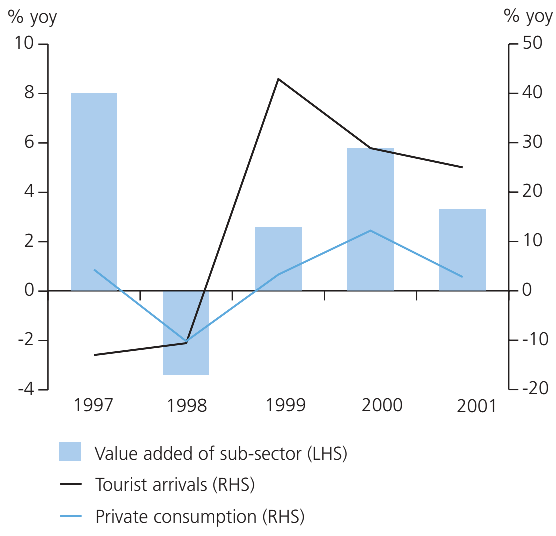
Table 1.12
Selected Indicators for the Services Sector

	2000	2001*p*
	Annual change %	
Cargo throughput at five major ports[1]	14.9	10.4
Container throughput at six major ports[2]	30.3	43.5
KLIA passenger	11.9	-1.3
KLIA cargo	21.6	-13.7
LRT ridership[3]	81.1	16.5
Insurance premiums	28.6	12.4
KLSE (turnover, volume)	–19.7	–27.3
Tourist arrivals	28.9	25.0
Hotel occupancy rate	57.7	58.6
Electricity production index	6.1	8.6

[1] Include Port Klang, Johor Port, Penang Port, Sabah Ports and Bintulu Port.
[2] Include Port Klang, Johor Port, Port of Tanjung Pelepas, Penang Port, Sabah Ports and Bintulu Port.
[3] Include STAR and PUTRA
p Preliminary

Sources: Relevant port authorities; Sistem Transit Aliran Ringan Sdn Bhd (STAR); Projek Usahasama Transit Ringan Automatik Sdn Bhd (PUTRA);
Kuala Lumpur Stock Exchange (KLSE); Bank Negara Malaysia;
Malaysia Tourism Promotion Board;
and Department of Statistic, Malaysia

Graph 1.24
Wholesale and Retail Trade, Hotels and Restaurants, Private Consumption and Tourist Arrivals



In the **Government services** sub-sector, value added was higher in 2001. The increase reflected mainly higher expenditure on emoluments arising from the bonus payment of half month salary or at least RM1,000 to all civil servants.

DOMESTIC DEMAND CONDITIONS

In 2001, measures to promote domestic demand led to a stronger expansion in public sector spending and sustained growth in private consumption. As a result, the slowdown in **real aggregate domestic demand** (excluding stocks) was contained at 2.3% in 2001 (2000: 14.5%).

Public sector expenditure registered a stronger growth of 13.9% in 2001, supported by the expansionary budget and two additional fiscal stimulus packages. Efforts to improve efficiency of project implementation resulted in the implementation shortfall being contained at less than 5%. Consequently, growth in **public investment** expenditure remained strong at 15.5% in 2001 (2000: 19.9%). The higher capital spending allocated in the Budget and the first stimulus package was mainly for education and training, as well as infrastructure and industrial development, with the objective of stimulating economic growth in the immediate term, enhancing human resource development and capacity building in the longer term. The capital spending allocated under the second stimulus package was mainly for small projects for which funds could be disbursed immediately.

During the year, total capital expenditure of the Non-Financial Public Enterprises (NFPEs) was higher, attributed to the modernisation and expansion programmes of several major NFPEs, notably, Petroleum Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB), Putrajaya Holdings Sdn. Bhd., as well as Telekom Malaysia Berhad (TMB). Capital expenditure by PETRONAS included the implementation of the Malaysia Liquefied Natural Gas Tiga (MLNG 3) project, the integrated petrochemical complexes in Kertih and Gebeng as well as acquisition of new LNG tankers. Capital outlays by TNB were mainly for expansion and upgrading of power generation, transmission and distribution networks to ensure adequate supply of electricity to meet longer-term demand. TMB continued to channel its capital spending in information and communication technology. Capital outlays by Putrajaya Holdings Sdn. Bhd. were mainly for the new administrative centre in Putrajaya. Meanwhile, the two wafer fabrication plants, namely, First Silicon in Kuching and Silterra in Kulim, continued to expand their capacity.

The strong growth in **public consumption** expenditure of 11.9% in 2001 was due mainly to procurement of office supplies related to e-Government flagship applications, payments for professional services and bonus payments for the year 2001.

In an environment of low external demand, fiscal stimulus measures played an instrumental role in contributing to the positive growth in private consumption. **Private consumption**, as such, increased by 2.8% during the year. Low interest rates and the Government's measures to increase household disposable income through a temporary reduction in employee's EPF contribution rate, higher tax rebates and the increase in the taxable

Public sector expenditure provided the main impetus to contain the slowdown in domestic demand.

Graph 1.25
Real Domestic Demand Aggerates

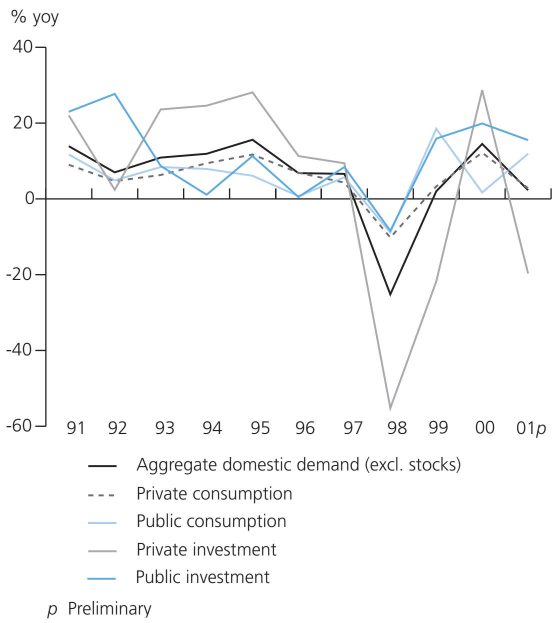


Table 1.13
Private Consumption Indicators

	2000	2001				
		1Q	2Q	3Q	4Q	Year
Sales of passenger cars (incl. 4WD)						
'000 units	296.6	76.5	81.8	91.8	93.2	343.3
Annual change (%)	15.9	16.2	7.8	18.9	19.9	15.7
Imports of consumption goods						
US$ billion	4.5	1.1	1.2	1.1	1.3	4.6
Annual change (%)	14.9	5.0	1.5	–5.8	11.4	3.0
Tax collection (AG)						
Sales tax (RM billion)	6.0	1.1	2.1	1.4	2.8	7.4
Service tax (RM billion)	1.7	0.3	0.6	0.4	0.7	1.9
Loans disbursed by banking system						
Consumption credit (excl. passenger cars) (RM billion)	26.8	7.2	7.7	7.8	8.3	31.0
Wholesale, retail, restaurants & hotels (RM billion)	62.9	16.7	17.0	16.6	15.7	65.9
MRA retail sales						
Annual change (%)	10.6	4.8	-1.6	1.6	0.7	1.7
Credit card operation						
Turnover spending (RM billion)	19.3	5.2	5.6	6.1	6.5	23.4
Annual change (%)	39.5	23.2	20.5	20.9	20.0	21.0
MIER Consumer Sentiments Index	–	105.7	96.2	98.7	93.8	–

income bracket for the low- and medium-income groups contributed positively to growth in consumer spending. Major indicators for consumption, including sales of new passenger cars, sales and service tax collections as well as loans disbursed for both consumption purposes and general commerce, confirmed that consumption spending was sustained in 2001.

Reflecting the effect of lower external demand and excess capacity in selected sectors of the economy, particularly in the export-oriented industries, **private investment** declined by 19.7% in 2001. This trend was also reflected in several key investment indicators, including lower imports of capital goods and lower applications received for investment in the manufacturing sector.

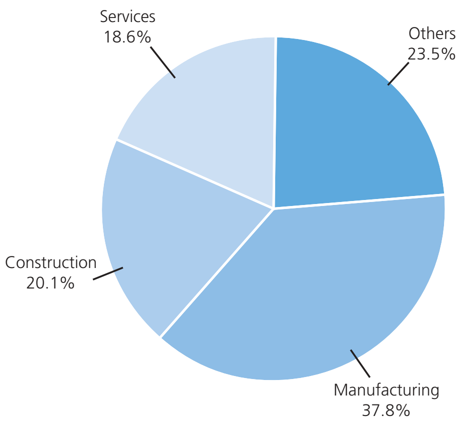
Table 1.14
Private Investment Indicators

	2000	2001				
		1Q	2Q	3Q	4Q	Year
Sales of commercial vehicles (incl. 4WD)						
'000 units	46.6	11.1	12.8	15.4	13.8	53.1
Annual change (%)	42.7	12.9	5.0	20.4	17.1	14.0
Imports of capital goods						
US$ billion	11.6	3.2	2.8	2.6	2.9	11.5
Annual change (%)	38.6	42.4	–5.2	–24.4	–2.6	-1.1
Applications to MITI						
No. of projects	974	168	201	197	146	712
Capital investment (RM billion)	46.2	3.6	4.9	3.9	3..4	15.8
Foreign	30.2	2.4	3.6	2.4	2.4	10.8
Local	16.0	1.2	1.3	1.5	1.0	5.0
Approvals by MITI						
No. of projects	805	240	210	222	141	813
Capital investment (RM billion)	33.6	11.1	5.3	4.6	3.7	24.7
Foreign	19.8	8.1	3.7	3.5	3.0	18.3
Local	13.8	3.0	1.6	1.1	0.7	6.4
Loans disbursed by banking system						
Manufacturing sector (RM billion)	94.1	25.1	27.3	25.6	26.0	103.9
Construction sector (RM billion)	23.6	5.8	5.5	4.6	4.9	20.9
Private Debt Securities						
Total fund raised (RM billion)	22.5	5.2	4.9	7.8	12.6	30.6
MIER Business Conditions Survey						
Business Conditions Index	–	46.3	44.0	42.6	42.3	–
Capacity Utilisation Rate	–	79.2	77.4	79.4	79.6	–

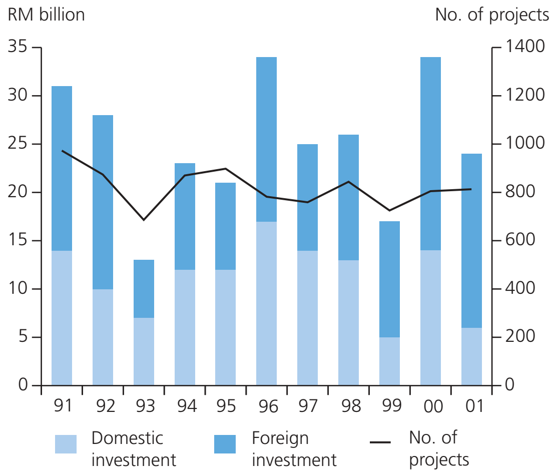
Capital investment in the **manufacturing sector** was estimated to decline by 24.1% in 2001. The overall capacity utilisation in the export-oriented industries in the manufacturing sector was below 80% throughout 2001. New investment activities in the manufacturing sector were mainly sustained by ongoing petrochemical projects, electrical and electronics projects approved in 2000 and 2001, as well as capacity expansion in the non-metallic mineral products industry where producers were already operating at high capacity.

The total value of investment in the manufacturing sector approved by the Ministry of International Trade and Industry (MITI) amounted to RM24.7 billion in 2001 (2000: RM33.6 billion). Of the total investment approved,

Graph 1.26
Private Investment by Sector, 2001 (% share)



Graph 1.27
Approved Investment in the Manufacturing Sector

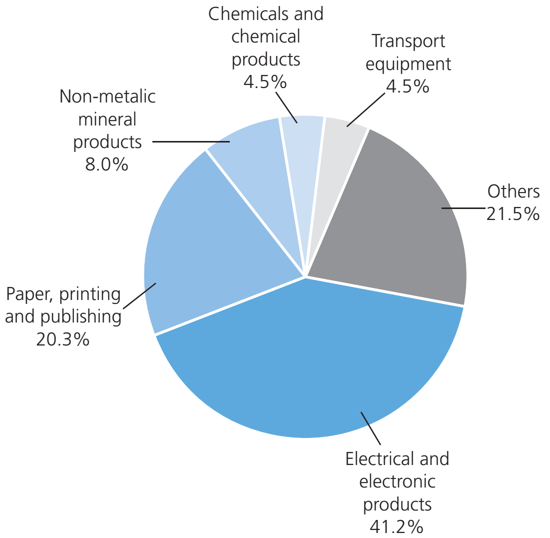


eight large projects, each with capital investment exceeding RM500 million, accounted for RM11.5 billion or 46.4% of the total investment approved. The electrical and electronic products industry continued to account for the highest share of 41.2% of total investment approved in 2001. This was followed by the paper, printing and publishing industry (20.3%); non-metallic mineral products industry (8%) and chemicals and chemical products industry (4.5%).

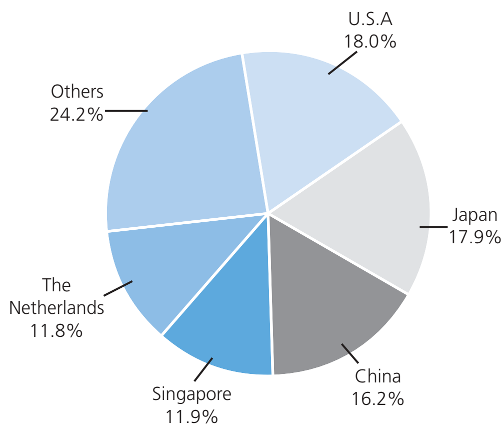
The value of foreign investment approved in the manufacturing sector in 2001 was RM18.3 billion (2000: RM19.8 billion). The bulk of the new projects approved were in the electrical and electronic products industry (51.4%); paper, printing and publishing industry (16.8%) and non-metallic mineral products industry (8.7%). The top five sources of foreign investment during the year were the United States, Japan, China, Singapore and the Netherlands. These countries together accounted for 76% of total foreign investment approved by MITI.

Capital spending in the **construction sector** in 2001 was supported by the construction of several highway projects, including SPRINT Highway and Elevated Highway (completed in 2001) as well as

Graph 1.28
Approved Manufacturing Investment by Industry, 2001 (% share)



Graph 1.29
Foreign Participation in Approved Manufacturing Investment by Country, 2001 (% share)



Kajang Ring Road, SPRINT Highway (Package C), Kajang-Seremban Expressway and Guthrie Corridor Expressway. Investment in the residential sub-sector continued to be high, due mainly to the construction activities for affordable housing and selected high-cost housing in strategic locations.

In the **services sector**, capital investment in the utilities sub-sector was lower, due to the deferment of several power plant projects, including those in Sepang, Jimah and Johor. Nevertheless, investment in this sub-sector continued to be supported by construction of ongoing power plants and water supply projects, including TNB Janamanjung, Nur Generation and Sungai Selangor water supply projects. Capital spending in the transport sub-sector was supported by the ongoing construction of the Express Rail Link and KL Monorail projects. The continuous capacity expansion of Malaysian ports, including the West Port and Port of Tanjung Pelepas, also contributed to the investment in the transport sub-sector. Investment in the telecommunications sub-sector was supported by sustained capital spending in mobile line services, particularly for upgrading of network.

Capital outlays in the mining and agriculture sectors increased in 2001, albeit at a marginal rate. Investment in the **mining sector** was estimated to increase by 2%, due mainly to continuous expansion in the oil and gas sub-sector. Investment in the **agriculture sector** expanded in 2001, attributable to the positive effects of the Government's incentives, which encouraged private sector participation on a bigger scale, modern and integrated mixed farming activities in food production, as well as higher allocation for this sector under the National Agricultural Policy.

In 2001, savings of both the public and private sectors were lower. Public sector savings declined by 15.1%, attributed to the higher growth in public consumption and a slower growth in public sector revenue as a result of lower revenue from the NFPEs. In the private sector, the Government's policies to increase disposable income and lower interest rates were effective in encouraging consumers to draw down on their past high savings to maintain a positive growth in consumption. Overall, the share of **gross national savings** to GNP declined to 34.9%. Nevertheless, given the consolidation in investment activities, the savings-investment balance remained in surplus for the fourth consecutive year, recording a surplus of RM27.4 billion or 8.9% of GNP in 2001 (2000: RM32 billion or 10.2%).

Table 1.15
Savings-Investment Gap

	2000	2001*p*
	(RM million)	
Public gross domestic capital formation	45,686	47,094
Public savings	56,522	47,986
Deficit / surplus	10,836	892
Private gross domestic capital formation	45,569	32,657
Private savings	66,691	59,172
Deficit / surplus	21,122	26,515
Gross domestic capital formation	91,255	79,751
(% of GNP)	29.2	26.0
Gross national savings	123,213	107,158
(% of GNP)	39.5	34.9
Balance on current account	31,958	27,407
(% of GNP)	10.2	8.9

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

PRICES AND EMPLOYMENT

Consumer Prices

Consumer price inflation or headline inflation[1] remained low in 2001. The Consumer Price Index (CPI) moderated further to 1.4% in 2001 (1.6% in 2000). Core inflation[2] or underlying inflation computed by BNM, also displayed a similar trend, moderating to 1% (1.5% in 2000). While consumer spending was sustained, the prevalence of excess capacity in several sectors of the economy led to downward pressure on prices. In addition, the moderate appreciation of the ringgit against non-US dollar currencies during the year, as well as lower inflation abroad, also contributed to lower inflation in 2001.

1 Headline inflation refers to the rate of change in the Consumer Price Index (CPI) for all items in the basket of goods and services published by the Department of Statistics, Malaysia.
2 Core inflation is a measure of the underlying inflation that excludes price-controlled items and price-volatile items, as well as items that are subject to one-off price adjustments from the original CPI basket. There are, however, several alternative measures of core inflation (refer to Box article II in Annual Report 2000).

The moderation in the rate of inflation during the year largely reflected lower increases in the price of food. Food, which accounts for more than a third of the total CPI basket, rose by a slower rate of 0.7% in 2001 (1.9% in 2000). While demand remained moderate, food production and supplies increased during the course of the year following favourable weather conditions and continued Government measures to increase domestic food production. Imported food prices were also lower, concomitant with the moderate appreciation of the ringgit.

Despite the prevalence of excess capacity, prices for beverages and tobacco; transport and communication; as well as medical care and health expenses registered higher rates of increase. These largely reflected the impact of one-off price adjustments arising from:

- Higher bus fares (10-30%) which were introduced in July-October 2000;
- Higher prices for several petroleum products (7.6-9.4%) from October 2000;
- Higher sales tax on alcoholic beverages (5%), and cigarettes and tobacco products (10%) as announced in the 2001 Budget, effective November 2000;
- Higher prices for several pharmaceutical products (10-20%), with effect from March 2001;
- Higher domestic airfares (51.8%) from August 2001; and
- A further price adjustment for petrol prices (8.3%) and higher import and excise duties on cigarettes and tobacco products (20%), which took effect in mid-October 2001, following the 2002 Budget presentation.

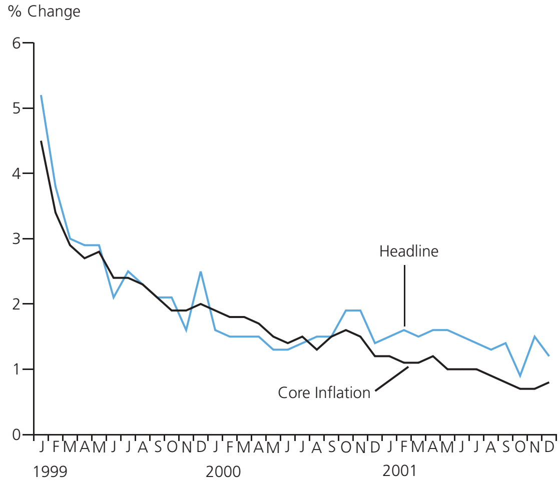
These goods and services accounted for only 9% of the total CPI basket and the higher prices for these goods and services contributed about 0.64% to total CPI inflation in 2001. Meanwhile, price increases for other sub-groups also remained relatively stable,

Table 1.16
One-off Price Adjustments

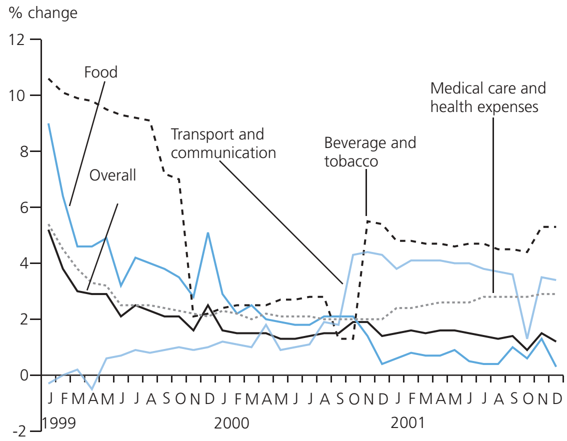
Sub-groups	Weights (%)	Increase (%)	Contribution (%)
Beverages and tobacco			
Alcoholic beverages	0.29	2.45	0.01
Cigarettes and tobacco	1.72	7.11	0.12
Medical care and health expenses			
Medical and pharmaceutical products	0.58	1.79	0.01
Transport and communication			
Bus fares	1.10	6.20	0.07
MAS domestic airfares	0.39	10.75	0.04
Petroleum products	4.96	7.82	0.39
Total	**9.04**		**0.64**

Graph 1.30
Inflation: Annual Rate of Change

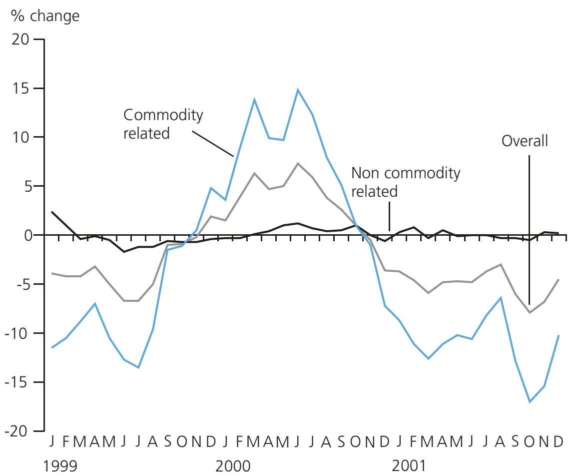
Measures of Consumer Price Inflation



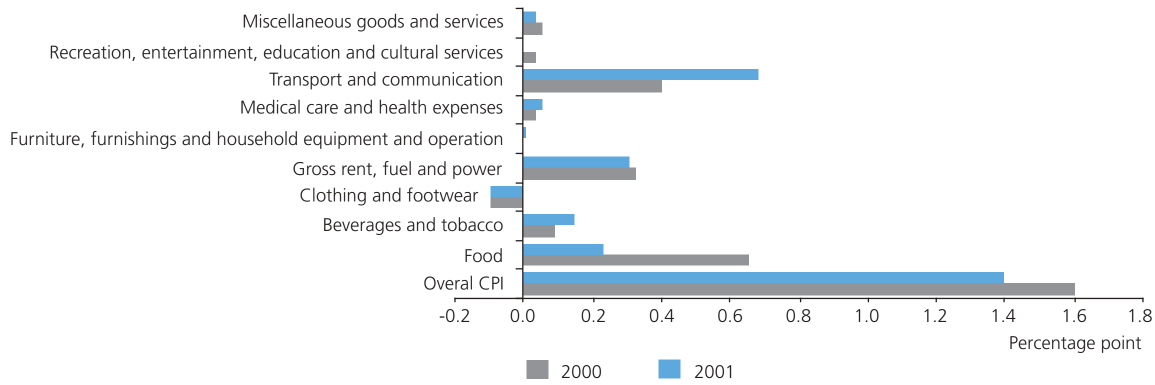
Consumer Price Index



Producer Price Index



Graph 1.31
Contribution to Annual Change in the Consumer Price Index



except for clothing and footwear, where prices continued to decline during the year.

The upward price adjustment for the bus fares, domestic airfares, pharmaceutical products and petroleum products were allowed in order to reflect the underlying market conditions such as higher imported prices, production costs and commodity prices. In particular, crude petroleum prices had increased significantly since early 1999. It was necessary for retail prices for petroleum products to be adjusted as and when the underlying market conditions changed in order to gain long-run economic efficiency and competitiveness. The adjustment to retail prices of petroleum products during a period where inventories and excess capacity in several sectors prevailed had, to some extent, minimised the pass-through effects on prices for other consumer products, in particular, food prices.

Producer Prices

Producer prices declined in 2001 amidst the generally weak commodity prices. The Producer Price Index (PPI) registered a decline of 5% in 2001 compared to an increase of 3.1% in 2000. The decline in producer prices reflected mainly lower prices charged by local producers. This was on account of lower prices for commodity-related products, namely inedible crude materials; mineral fuels, lubricants and related materials; and animal and vegetable oil and fats. Lower prices of these products were concomitant with the generally weak prices of crude palm oil, rubber as well as crude petroleum in 2001. Meanwhile, prices for goods paid by importers were relatively stable throughout the year amidst the stable ringgit exchange rate. Overall, excluding commodity-related products, non-commodity related producer prices were stable in 2001. This, in turn, contributed to stable consumer prices during the year.

Table 1.17
Price Indicators

	Weights	2000	2001
		Annual change (%)	
Consumer Price Index (2000=100)	**100.0**	**1.6**	**1.4**
of which:			
Food	33.8	1.9	0.7
Beverages and tobacco	3.1	2.8	4.8
Clothing and footwear	3.4	-1.7	-2.6
Gross rent, fuel and power	22.4	1.5	1.4
Furniture, furnishings and household equipment and operation	5.3	0.0	0.1
Medical care and health expenses	1.8	2.0	2.9
Transport and communication	18.8	2.1	3.6
Recreation, entertainment, education and cultural services	5.9	0.5	-0.1
Miscellaneous goods and services	5.5	0.9	0.7
Consumer Price Index by Region			
Peninsular Malaysia	81.6	1.7	1.5
Sabah	8.9	0.6	0.6
Sarawak	9.5	1.5	0.8
Producer Price Index (1989=100)	**100.0**	**3.1**	**-5.0**
of which:			
Local Production	79.3	3.6	-6.1
Imports	20.7	1.1	-0.3
House Price Index (1990=100)		**4.7**	**0.9[1]**
of which:			
Klang Valley		12.4	-0.4[1]
Johor Bahru		2.8	-2.3[1]
Penang Island		8.3	-3.7[1]

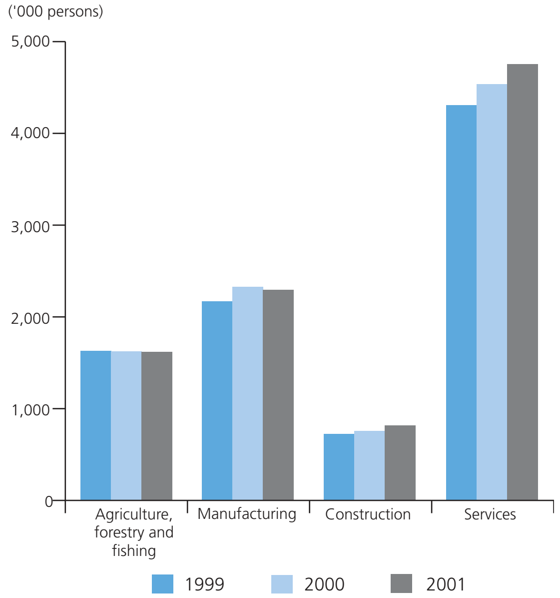
[1] January-June

Source: Department of Statistics, Malaysia
NAPIC, Department of Valuation and Property Services

Labour Market Developments

In 2001, the impact of the slowdown in economic activity was felt by the labour market, particularly in terms of retrenched workers in the manufacturing sector. However, given the flexibility accorded by the labour market, alternative measures that were adopted by employers such as pay cuts and temporary layoffs helped contain the number of workers retrenched. During the year, the slower growth environment resulted in both the total employment and labour force expanding at more moderate rates of 2.6% to 9.5 million workers and 3.2% to 9.9 million persons, respectively. Amidst low inflation and excess capacity, the slack labour market conditions contributed to some moderation in wage increases in 2001.

Graph 1.32
Total Employment by Sector



Source: Economic Planning Unit

Given the labour market conditions during the year, the unemployment rate edged upwards from 3.1% in 2000 to 3.7% in 2001, with the number of unemployed increasing by 63,500 to 364,800 persons. The unemployment rate, however, remained below the 4% deemed as full employment level.

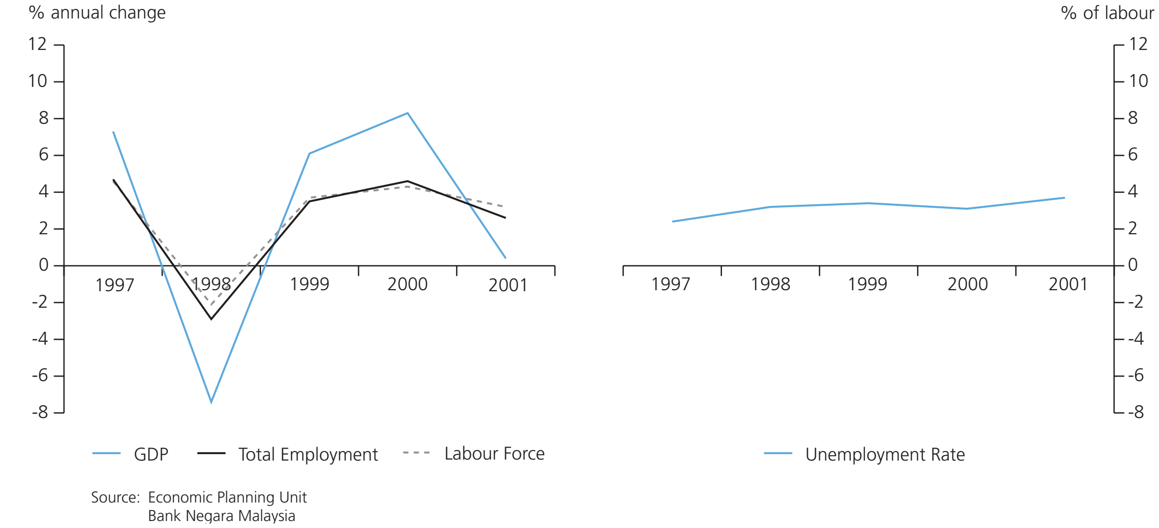
On a sectoral basis, the slower growth in **employment** in 2001 was due mainly to a pronounced decline in employment registered by the *manufacturing* sector, given declining demand for manufactured products, particularly for electronics and electrical products. As such, the manufacturing sector which accounted for a significant number of new jobs in 2000 (156,100) registered the largest contraction in employment (29,900). However, the decline in employment in the manufacturing sector was more than offset by the continued robust employment by the *services* sector which registered the majority of the total number of new workers employed (90.2% or 217,300 persons). Within the services sector, the new jobs created were concentrated mainly in the 'other services' sub-sector which include social services, private services, non-profit services of households and domestic services of households (41.5%) and the wholesale and retail trade, hotels and restaurants sub-sector (24.1%). The banking institutions' merger programme saw minimal disruption as employment in the banking sub-sector declined only marginally by 2% to 93,314 persons as at end-2001. Meanwhile, in the *construction* sector, 55,500 new jobs were generated, consonant with the increase in residential housing and public infrastructure projects.

Table 1.18
Labour Market Indicators

	1997	1998	1999	2000	2001
Labour force ('000)	9,039	8,849	9,178	9,573	9,877
(annual change in %)	4.6	–2.1	3.7	4.3	3.2
Employment (annual change in %)	4.7	–2.9	3.5	4.6	2.6
Unemployment rate (% of labour force)	2.4	3.2	3.4	3.1	3.7
Labour productivity (GDP/Employment)					
(annual change in %)	2.5	–4.6	2.5	3.5	–2.1
Real wage per employee in manufacturing sector					
(annual change in %)	6.0	–2.4	3.0	5.0	1.5

Source: Economic Planning Unit
Department of Statistics, Malaysia
Bank Negara Malaysia

Graph 1.33
Output and Employment

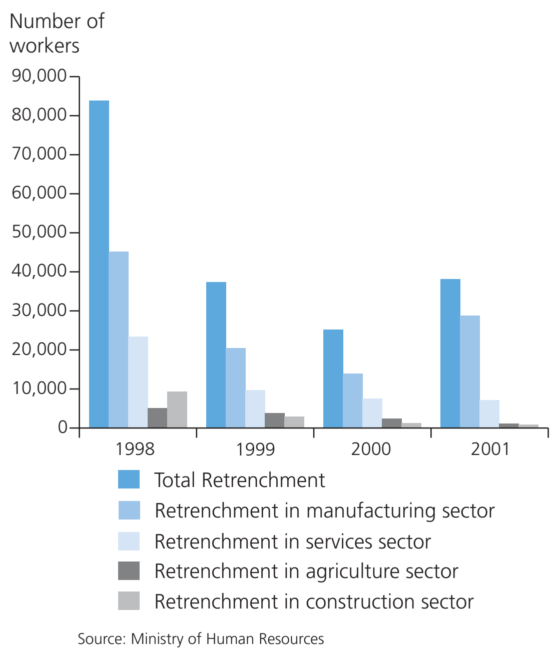


Source: Economic Planning Unit
Bank Negara Malaysia

In order to contain the contraction in earnings, employers reduced their workforce as part of the overall rationalisation process to lower production costs. The following provides an assessment of **retrenchment** in 2001:

- A total of 38,116 workers were retrenched (2000: 25,236), with 75.6% from the manufacturing sector. The electronics and electrical products sub-sector accounted for almost half (45.7%) of the total number of workers retrenched.

Graph 1.34
Retrenchment by Sector



Source: Ministry of Human Resources

- The number of employers involved in retrenchment increased by 55.2% to 1,380.

- Total retrenchment in 2001 accounted for 45.4% of the retrenchment recorded during the financial crisis in 1998.

- Almost half (48%) of the total number of workers retrenched was due to the decline in the demand for products.

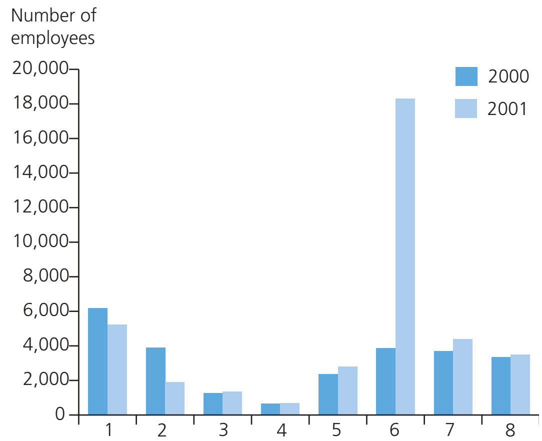
- By job category, production and related workers comprised the majority retrenched (63.6%). The retrenchment of professional, technical and related workers increased significantly by 54.8% in 2001 (2000: -36.2%), indicating that cost cutting measures affected both the high-end and low-end workers.

- Local workers accounted for the majority (86.9%) of the total number of retrenched workers.

- In terms of location, West Malaysia accounted for 96.9% of retrenched workers, with Penang, a major producer of electronics recording 23% of total retrenchment, followed by Johore (20.6%) and Selangor (15.5%).

- BNM's Company Survey findings indicated that the magnitude of layoffs during the year differed based on the type of company ownership. The majority of locally-owned companies that retrenched workers implemented layoffs across all job categories, hence, halting production completely. On the other hand, the majority of

Graph 1.35
Reasons for Retrenchment



1 Closure of companies
2 Sale of companies
3 Relocation to foreign countries
4 Relocation locally
5 High production cost
6 Reduction in demand for products
7 Company reorganisation and automation
8 Others

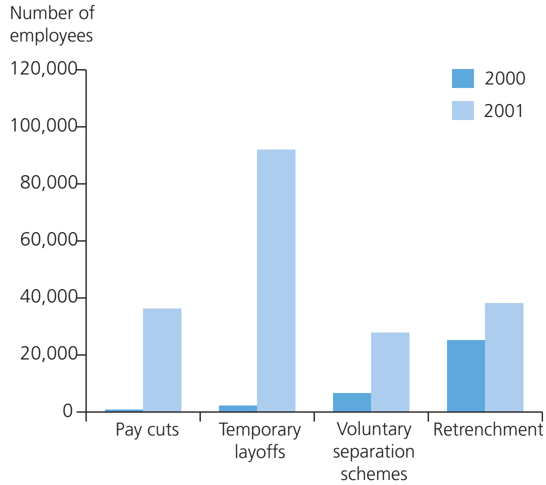
Source: Ministry of Human Resources

foreign-owned companies that retrenched, laid off only a proportion of their production and sales staff, thus, allowing production to continue, subject to shorter working hours. Also, layoffs were found to be higher for companies that export the bulk of their products to the US and Japan, compared to Europe.

- Retrenchment peaked in September 2001 with 5,828 workers laid off. In the fourth quarter of 2001, however, retrenchment declined by 40%, compared with the preceding quarter. The improvement in the labour market situation towards end-2001 indicated that the impact of the US economic slowdown on businesses in Malaysia had somewhat stabilised and that most companies were in the midst of business consolidation.

During the year, an increased number of employers (941; 2000: 144) took alternative measures, rather than retrenchment, to contain the impact of the slowdown on their workers. Hence, salaries of 36,294 workers were cut, while 91,915 workers were temporarily laid off. Also, 27,756 workers accepted the Voluntary Separation Scheme (VSS) during the year. In the banking sector, 4,240 employees had accepted the VSS as at end-December 2001.

Graph 1.36
Retrenchment of Workers vs. Alternative Measures



Source: Ministry of Human Resources

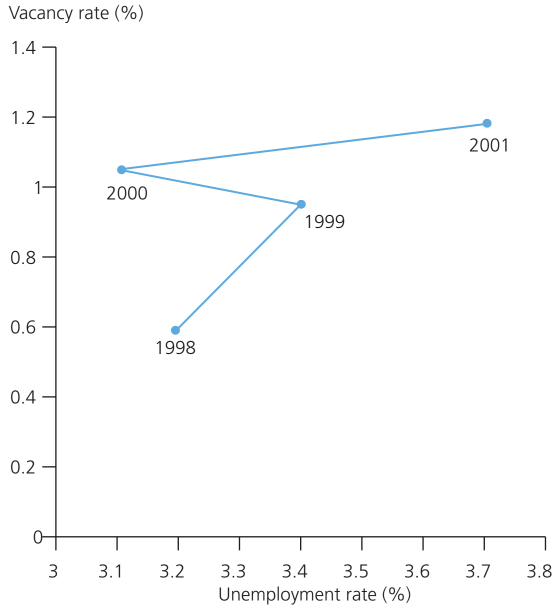
Excluding expatriate workers, the Government approved the recruitment of 258,578 new foreign workers (2000: 230,608), increasing the total number of registered foreign workers by 5% to 769,566. The foreign workers were employed mainly in the manufacturing, agriculture and domestic services sectors. In 2001, the majority (73.7%) originated from Indonesia.

Labour demand as measured by the number of job vacancies increased more moderately by 6.5% to 131,459 in 2001 (2000: 14%). The number of job vacancies could have been under-reported as it is not compulsory for firms to report vacancies to the Manpower Department of the Ministry of Human Resources. The vacancies were concentrated mainly in the manufacturing (46%), agriculture, forestry and fishing (27.6%) and services (15.7%) sectors. Sarawak continued to account for more than half of the job vacancies. Penang registered the largest contraction in vacancies (46.2%), compared with the preceding year.

The total number of active job seekers[1] registered with the Manpower Department increased by 22.9% to 34,200 as at end-2001 (end-2000: -12.6%). Compared with the previous year, the more moderate increase in demand for labour resulted in the widening of the ratio of vacancies to job seekers from 1:0.23 at end-2000 to 1:0.26 at end-2001. In

[1] Data is under-estimated as it is not compulsory for job seekers to register with the Manpower Department.

Graph 1.37
Beveridge Curve for Malaysia (1998-2001)



Source: Economic Planning Unit
Ministry of Human Resources
Department of Statistics, Malaysia

particular, the ratio for the professional and administrative related group widened from 1:1.40 to 1:2.15, whilst that of the clerical related group increased from 1:1.18 to 1:1.72. As at end-2001, the majority of the unemployed[2/] consisted of those with secondary school qualifications (65.7%). Whilst most job vacancies were for production operators (67%), a large part of the jobs sought was clerical related (45%). Although a significant portion of unemployment was cyclical during the year, an analysis using the Beveridge (Unemployment-Vacancy[3/]) Curve illustrates the mismatch between labour supply and demand in 2001, as shown by the upward and rightward shift in the curve from 2000 to 2001.

With the retrenchment of workers and the reduction in salaries experienced by selected sectors during the year, wage pressures generally eased:

- Data from the Monthly Survey of Manufacturing Industries conducted by the Department of Statistics indicated that on an annual basis, real wage per employee increased marginally by 1.5% in 2001 (2000: 4.9%), while labour productivity as measured by real sales value of products (SVP) per employee declined by 2.1% (2000: 16%). Labour productivity, as measured by the ratio of GDP to total employment also declined by the same magnitude. The poor productivity results in 2001 reflected the reduction in output due to the decline in external demand.

- The Malaysian Employers Federation's (MEF) Salary and Fringe Benefits Survey showed that the increase in the average private sector salary had stabilised at 6.9% in 2001 (2000: 7%). The average minimum salary offered to those with a basic degree increased marginally by 0.5% to RM1,671 in 2001. On a sectoral basis, the average salary increase in the non-manufacturing sector was higher (7.1%) than the manufacturing sector (6.7%).

The Government continued to closely monitor the employment situation and adopt pre-emptive measures to address emerging problems arising from the economic slowdown. Amongst others, job fairs were held nationwide to provide a platform for job seekers to obtain information on vacancies available from potential employers. The Electronic Labour Exchange Project which was launched on 19 September 2001 is expected to be operational online in 2002. The project is designed to match job seekers with vacancies beyond geographical boundaries, thus, improving the mobility of human resources. Of significance, the Government had, under the two fiscal stimulus packages announced in March and September 2001 as well as under the 2002 Budget, allocated funds towards the further development of human resources. In this regard, policy measures have been directed mainly at intensifying the application of information technology, upgrading skills of workers, strengthening learning and training programmes, developing various institutions of learning and improving education facilities.

A new wage agreement between the Malayan Agricultural Producers Association (MAPA) and the National Union of Plantation Workers (NUPW) resulted in a guaranteed minimum monthly wage of RM325 to be paid, with effect from 1 January 2001, to oil palm harvesters and oil mill workers.

As a measure to expedite Malaysia's transition to the knowledge-based economy, a programme to encourage Malaysian citizens with special expertise

[2] No. of unemployed at the end of the last quarter does not equal the total no. for the year as nos. for all end-quarters in a year are smoothened out to obtain the yearly no.

[3] Unemployment rate used pertain to the data from the Economic Planning Unit. Vacancy rate= (no. of job offers- no. of placements) / (no. of job offers- no. of placements + no. of employees).

who are employed overseas, to return to Malaysia came into effect on 1 January 2001. On 1 July 2001, amendments to the list of expertise, in terms of the field of expertise, eligibility and years of experience took effect. The revision was done to ensure that the quality of expertise approved under the programme commensurates with the requirements of the country for the identified fields of expertise.

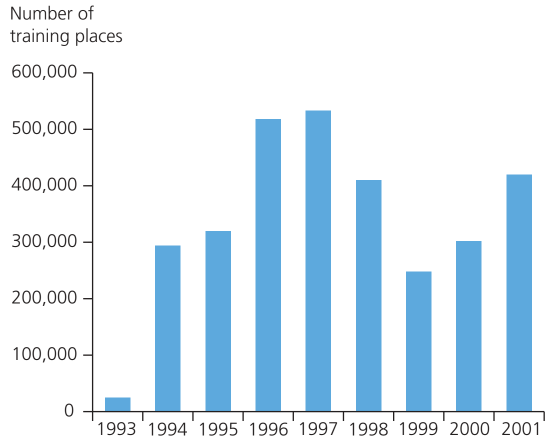
In the financial industry, a 'Staff Re-Skilling Project' or 'StaRs Project' was launched on 23 March 2001 with the objective of enhancing the mobility of staff, particularly those who accepted the VSS. The project, administered by the Institute of Bankers Malaysia and funded by the financial institutions' contributions towards the Staff Training Fund, incorporates a series of training programmes on competencies catering to the needs of a more knowledge-based economy, and a support infrastructure system to assist separating staff to seek new employment. In 2001, a total of 64 programmes was conducted, benefiting about 1,300 trainees.

In order to upgrade the skills of unemployed graduates and school leavers as well as retrenched workers, the RM4.3 billion stimulus package which was introduced in September 2001, included an allocation of RM300 million for the establishment of the Special Scheme that consists of programmes on training in IT, mathematics and languages; commercial agriculture entrepreneurship; further studies; and attachments with government agencies, public universities, private professional firms and small- and medium-scale enterprises.

Since its inception in 1993, the Human Resource Development Council (HRDC) which administers the Human Resource Development Fund (HRDF) for the retraining and skills upgrading of workers has approved a total of 3.1 million training places, involving a total expenditure of RM1 billion. In enhancing the efficiency of services provided, the HRDC which was officially corporatised on 16 May 2001 has been renamed 'Pembangunan Sumber Manusia Berhad (PSMB)'. As at end-December 2001, the number of employers registered with the PSMB increased to 7,690, with the majority (71.6%) from the manufacturing sector and the remainder from the services sector.

Given lower corporate earnings during the year, on 1 November 2001, the levy imposed by the PSMB was reduced by half from 1% of the companies' monthly wage bills to 0.5%. During the year, the HRDF levy

Graph 1.38
Number of Training Places Approved by PSMB



Source: Pembangunan Sumber Manusia Berhad

collection increased further to RM209.1 million from RM188.3 million in 2000. Effective for a year from 1 November 2001, the financial assistance provided to employers was raised from 85% to 100% of the cost of selected training programmes conducted by local trainers, including training on supervision, strategic management, financial management, human resource management and safety and health of workers.

In 2001, a total of 420,057 training places was approved by the PSMB with financial support of RM189.8 million. The PSMB was also appointed as one of the coordinating agencies for two of the nine programmes under the Special Scheme that was set up for retrenched workers and unemployed graduates. These were the 'Training Scheme for Retrenched Workers II' and 'Graduate Training Schemes', which benefited a total of 5,519 trainees with an accumulated financial assistance of RM36.1 million.

A Skills Development Fund (SDF) established by the Ministry of Human Resources with an allocation of RM140 million became operational on 2 January 2001. The Fund aimed to provide soft loans for technical and vocational training offered by institutions that are accredited by the National Vocational Training Council. In 2001, about 20,000 applications were approved and RM24.2 million was disbursed.

Overall, the adjustments observed in the domestic labour market during the year indicated that all parties concerned, including the Government, employers and workers had demonstrated flexibility in a more difficult economic environment. Going forward, productivity improvements will continue to dominate the agenda on transforming the economy to one that is more knowledge-based. In this regard, efforts will include the need to address skill mismatches and the further enhancement of labour mobility.

EXTERNAL SECTOR

Balance of Payments

The overall balance of payments turned around to a surplus position in 2001. The improvement was due to lower outflows in the financial account. The current account surplus narrowed in 2001, but nevertheless the surplus remained large at RM27.4 billion or equivalent to 8.9% of GNP. This reflected a moderate decline in the trade account and improvement in the income and services accounts.

The impact of the global slowdown on exports has been significant as exports of both manufactured goods and commodities declined during the year. At the same time, demand for imports of intermediate inputs used in the production of exports also declined. This contained the decline in the trade surplus. Given the lower export earnings during the year, repatriation of profits and dividends was also lower in 2001, resulting in an improvement in the income account. The services deficit also declined, reflecting not only lower payments related to export activities but also the marked improvement in the travel account surplus.

The improvement in the financial account in 2001 emanated mainly from lower short-term outflows in most major components of the short-term capital account. Net long-term inflows moderated. On balance, inflows were mainly longer-term capital (foreign direct investments and external loans).

Portfolio investors were already underweight in the Malaysian market and hence outflows moderated. Gross inflows of portfolio investment, which was moderate in the first half-year, picked up in the third quarter as market sentiment turned more positive following the accelerated pace of corporate restructuring which strengthened the longer-term outlook for Malaysia. This trend reversed following September 11, with profit-taking activities in the final quarter of 2001. During the year, there was also less incentive for the placement or retention of funds abroad as interest rate differentials shifted in Malaysia's favour since September 2001. This was reflected in the lower trade credits extended to foreign importers and the decline in the net external assets of the banking institutions in the second half of the year following the unwinding of foreign currency inter-bank placements as importers undertook reduced hedging activities.

Table 1.19
Balance of Payments

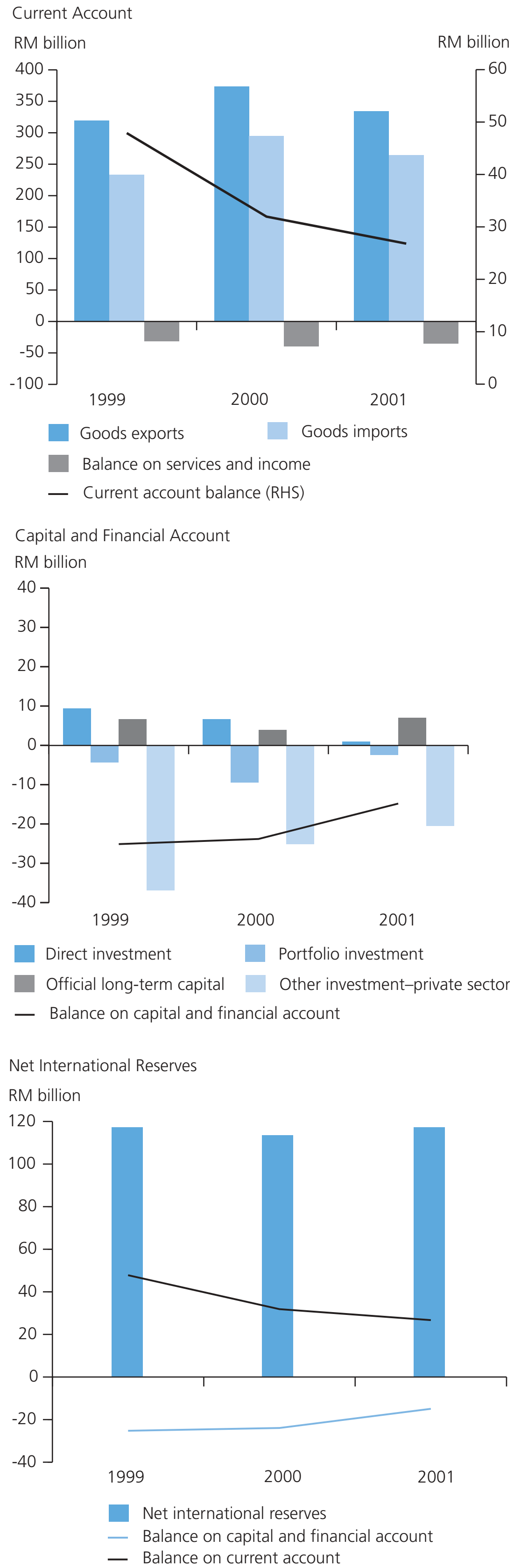
Item	2001e +	2001e -	2001e Net
	RM million		
Goods	334,326	264,472	69,854
Trade account	*334,420*	*280,692*	*53,728*
Services	54,929	63,295	-8,366
Balance on goods and services	389,255	327,767	61,488
Income	6,678	32,626	-25,948
Current transfers	2,059	10,192	-8,133
Balance on current account	397,992	370,585	27,407
% of GNP			8.9
Capital account			–
Financial account			-14,841
Direct investment			1,017
Portfolio investment			-2,489
Other investment			-13,369
Balance on capital and financial account			-14,841
Errors and omissions			-8,904
of which:			
Exchange revaluation loss			-4,061
Overall balance			3,662
Bank Negara Malaysia international reserves, net			117,203
(US$ million)			30,843

e Estimate

Source: Bank Negara Malaysia and Department of Statistics, Malaysia

The external position has remained robust. Large current account surplus and lower short-term outflows led to surplus in the overall balance of payments. Reserves has been on a rising trend.

Graph 1.39
Malaysia: Balance Of Payments



Long-term capital inflows reflected mainly drawdown of long-term external loans by the Federal Government to maintain regular market presence, to establish a benchmark rate for Malaysian corporations and to take advantage of lower interest rate abroad. A significant portion of borrowings by NFPEs was to refinance the more expensive existing offshore loans.

While Malaysia continued to receive inflows of foreign direct investment (FDI) in 2001, FDI for expansion and new investments were lower because of excess capacity, amidst the slowdown in the global economy. The FDI inflows were mainly new equity funds for strategic business alliances in the telecommunications and financial services sector and to a lesser extent in the manufacturing sector. For the year as a whole, the net inflow of FDI was small, mainly due to one large transaction in the private sector involving the acquisition of controlling interests by a Malaysian company from non-resident partners as part of its corporate restructuring exercise. The purchase was financed by the issuance of long-term debt securities to the non-resident investors and an offshore loan. As the outflows were to finance a change in ownership, it had no impact on reserves or total investment activities in Malaysia. Direct investment abroad remained high in the first quarter of 2001 but subsequently declined as companies adopted a cautious approach in their investment plans abroad following the global economic slowdown. Overall, the financial account recorded a substantially lower outflow of RM14.8 billion in 2001.

Errors and omissions amounted to –RM8.9 billion. Of this total, an unrealised exchange loss from revaluation of reserves due to the appreciation of ringgit against selected major currencies amounted to RM4.1 billion. Excluding this book loss, the errors and omissions of RM4.8 billion reflects the normal errors and inconsistencies that occur in the course of compilation of the balance of payments statistics. This represented less than one percent of Malaysia's total trade, well within the accepted norm of 5% of total trade. After adjusting for the errors and omissions, the overall balance of payments recorded a surplus position of RM3.7 billion or US$964 million. Consequently, the net international reserves of Bank Negara Malaysia stood at RM117.2 billion or US$30.8 billion at end-2001 and increased further to RM119.6 billion or US$31.5 billion as at 28 February 2002. This level of reserves represented 5.2 months of retained imports and was 5.1 times larger than the short-term external debt. Including the scheduled amortisation of medium- and long-term debts falling

Compilation of the Balance of Payments based on BPM 5

Since the first quarter of 2001, Malaysia's balance of payments is compiled in conformity with the guidelines set forth in the Fifth Edition of the Balance of Payments Manual (BPM 5) of the International Monetary Fund. The major changes are summarised below:

<table>
<tr><th>Previous format</th><th>BPM 5 format</th></tr>
<tr><td>Merchandise</td><td>Goods</td></tr>
<tr><td>Services
• Freight & insurance
• Other transportation
• Travel and education
• Investment income
• Other services
• Government transactions, nie</td><td>Services
• Transportation
• Travel
• Other services
• Government transactions, nie</td></tr>
<tr><td>Balance on goods and services</td><td>Balance on goods and services</td></tr>
<tr><td>Transfers</td><td>Income
• Compensation of employees
• Investment income

Current transfers</td></tr>
<tr><td>Balance on current account</td><td>Balance on current account</td></tr>
<tr><td rowspan="2">Long-term capital account
• Official sector
Federal Government
NFPEs
Other
• Private sector</td><td>Capital account
• Capital transfers
• Acquisition/disposal of non-produced, non-financial assets

Financial account
• Direct investment
• Portfolio investment
• Other investment
- Official sector
- Private sector</td></tr>
<tr><td>Balance on capital and financial account</td></tr>
<tr><td>Basic balance</td><td rowspan="2">

Errors and omissions</td></tr>
<tr><td>Private short-term capital

Errors and omissions</td></tr>
<tr><td>Overall balance</td><td>Overall balance</td></tr>
</table>

In terms of the **current account**, the major change is the redesignation of investment income (previously a component of the services account) as a new account named the Income account.

Under BPM 5, the former capital account has been expanded and redesignated as the **capital and financial accounts**

- The capital account consists of two categories, i.e. capital transfers and acquisition/disposal of non-produced, non-financial assets.
- The financial account is classified according to type of investment or by functional breakdown i.e. direct investment, portfolio investment and other investment. Under the previous compilation, the capital account was classified according to original contractual maturity of more than one year (long-term) or one year or less (short-term).

The balance of payments data for 1999 and 2000 have been reclassified in accordance with the BPM 5 format.

due in the next 12 months, the reserves level is more than three times the short-term debt. Malaysia's reserves are usable and unencumbered.

The impact on Malaysia of the downturn in the electronics cycle and the slowdown in the global economy was transmitted through the export channel. Growth in gross exports, which had remained positive since 1987, declined by 10.4% in 2001. Exports contracted in all sectors, manufacturing as well as primary commodities. Nevertheless, given the existing structure of high import content in exports, imports also declined by 9.9%. The **trade surplus**, therefore narrowed, but remained large at RM53.7 billion (US$14.1billion). Adjusted for

Table 1.20
External Trade

	2000	2001	2000	2001
	RM billion		US$ billion	
Gross exports (f.o.b)	**373.3**	**334.4**	**98.2**	**88.0**
Annual change (%)	16.1	-10.4	16.1	-10.4
	Annual change (%)			
Volume[1]	11.6	-3.3	11.6	-3.3
Prices [1]	6.2	-7.7	6.2	-7.7
Gross imports (c.i.f)	**311.5**	**280.7**	**82.0**	**73.9**
Annual change (%)	25.3	-9.9	25.3	-9.9
	Annual change (%)			
Volume[1]	15.5	-3.0	15.5	-3.0
Prices[1]	8.5	-7.1	8.5	-7.1
Trade balance	**61.8**	**53.7**	**16.2**	**14.1**

[1] Volume and prices are estimates.

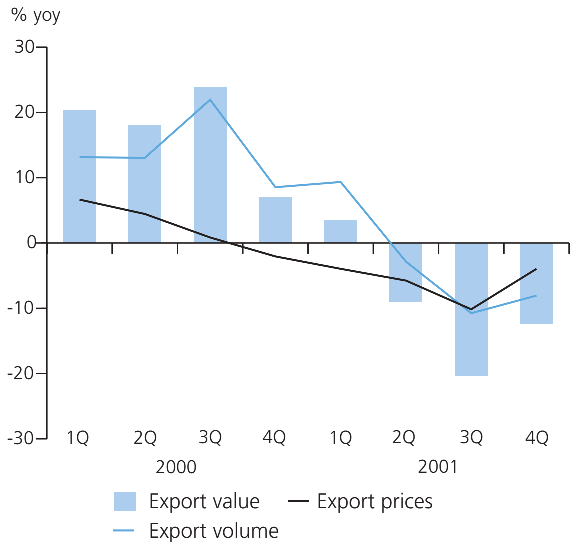
Source : Department of Statistics, Malaysia and Bank Negara Malaysia

valuation and coverage on the balance of payments basis, the goods account recorded a large surplus of RM69.9 billion (US$18.4 billion). The contraction in both exports and imports started in March 2001, reached its peak in September and moderated in the fourth quarter. More moderate declines in exports and sharper improvement in imports supported other indicators that, by the end of 2001, the economy was in the early stages of recovery.

Exports of manufactured goods, which accounted for 85.3% of total exports of Malaysia, declined by 10.3% in 2001. The decline was most pronounced in the electronics sector (-16.3%). Exports of electrical goods were more resilient in the first half-year, and only contracted in the second half-year. For the manufacturing sector as a whole, the decline in prices (-6.1%) was more pronounced than the decline in volume (-4.1%) as firms reduced prices aggressively to retain market share in an environment of weak demand and excess stocks. Reflecting signs of more positive developments in the external environment towards year-end, the rate of decline in earnings from manufactured exports moderated significantly to 12.4% during the fourth quarter from the 20.4% contraction in the third quarter. On a preceding quarter basis, manufactured exports recorded an increase of 2% in the fourth quarter, the first quarterly increase in more than a year.

While manufacturers and exporters were continuing to move up the value chain and improve product quality to enhance their international competitiveness, efforts were also undertaken to explore export market opportunities. In 2001, the Malaysian External Trade Development Corporation (MATRADE) had successfully organised the participation of Malaysian

Graph 1.40
Export Performance of the Manufacturing Sector



Graph 1.41
Export Performance of Electronics and Non-electronics Industries

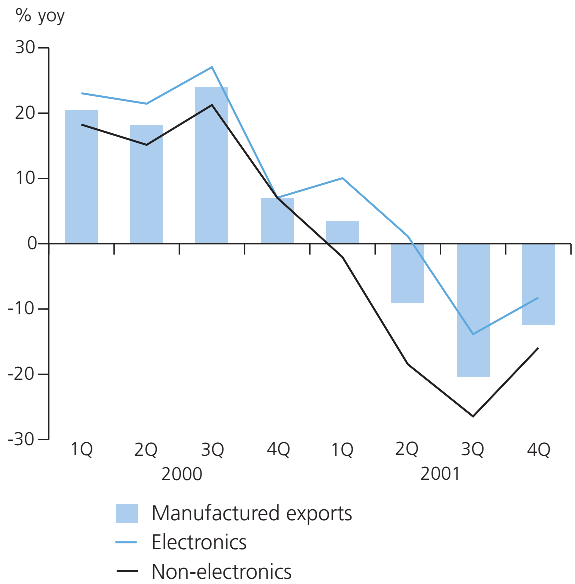


Table: 1.21
Gross Exports

	2001*p*		
	RM million	Annual change (%)	% share
Manufactured goods	**285,316**	**-10.3**	**85.3**
of which:			
Electronics, electrical machinery and appliances	200,307	-13.1	59.9
Electronics	139,632	-16.3	41.8
Semiconductor	*60,530*	*-14.9*	*18.1*
Electronic equipment and parts	*79,102*	*-17.3*	*23.7*
Electrical machinery and appliances	60,675	-4.7	18.1
Consumer electrical products	*23,591*	*-10.9*	*7.1*
Industrial and commercial electrical products	*23,518*	*-0.6*	*7.0*
Electrical industrial machinery and equipment	*12,462*	*-1.0*	*3.7*
Household electrical appliances	*1,104*	*22.3*	*0.3*
Textiles, clothing and footwear	9,054	-13.2	2.7
Chemicals and chemical products	14,879	-0.9	4.4
Wood products	6,017	-11.5	1.8
Manufactures of metal	8,692	0.9	2.6
Transport equipment	2,427	-16.4	0.7
Rubber products	4,466	-4.9	1.3
Optical and scientific equipment	7,802	14.3	2.3
Agricultural commodities	**19,966**	**-13.2**	**6.0**
of which:			
Palm oil	*9,876*	*-0.7*	*3.0*
Sawn timber	*2,273*	*-24.7*	*0.7*
Rubber	*1,886*	*-26.6*	*0.6*
Saw logs	*1,523*	*-38.8*	*0.5*
Minerals	**23,445**	**-12.6**	**7.0**
of which:			
Crude oil	*11,118*	*-21.9*	*3.3*
LNG	*11,342*	*-0.7*	*3.4*
Tin	*461*	*6.0*	*0.1*
Other exports	**5,693**	**2.8**	**1.7**
Total	**334,420**	**-10.4**	**100.0**

p Preliminary

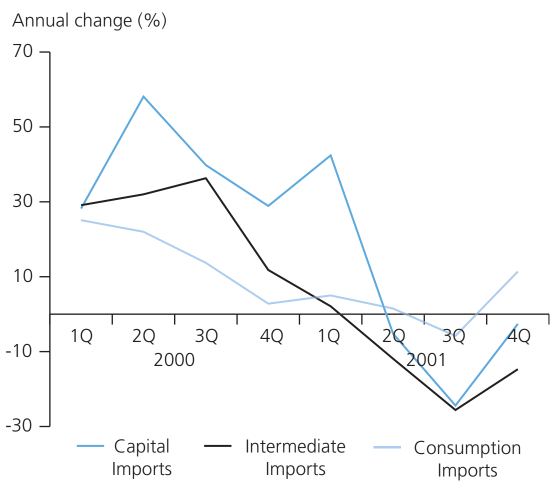
Source : Department of Statistics, Malaysia exporters in 26 international trade fairs in the traditional markets such as the United States, the United Kingdom and Germany, the Asia Pacific destinations such as Australia, Hong Kong, India, Indonesia, Thailand, the Philippines and Brunei and the newer markets of the Middle Eastern countries, South African countries and Vietnam. Reflecting the Government's commitment in promoting Malaysian products in new markets, MATRADE had organised a trade fair in Madagascar. Meanwhile, under the ASEAN Promotion Centre Technical Assistance Programme, Malaysian exporters took part in another six international trade fairs held in Japan.

In the **primary commodity** sector, export earnings declined by 12.9% to RM43.4 billion following lower exports of all major commodities, except cocoa. Export volume for palm oil expanded as demand from major buyers, namely, India, The People's Republic of China, Pakistan and the European Union increased during the year. However, export earnings for palm oil declined as an oversupply in the global vegetable oils market led to a decline in export prices.

Export earnings from **minerals** declined due to both lower export prices and volume. In particular, crude oil exports declined, reflecting mainly weaker oil prices, given that the price per barrel fell by US$4 to US$25.53 in line with the global trend, as well as lower export volume. Exports of LNG also declined in 2001 as prices fell in tandem with lower oil prices, while export volume increased marginally.

The decline in **gross imports** was reflected in both lower import volume and prices. Imports of **intermediate goods** which account for 72% of total imports declined by 13.3%. The primary source of the decline was the decline in imports of electronic component parts (comprising 65% of imports of parts and accessories of capital goods and 27% of total imports) and industrial supplies which are primarily used as component parts in the production of manufactured exports. The electronics industry experienced a large contraction in output and exports orders in 2001. Most electronics manufacturers drew down on inventories accumulated from the strong capacity expansion in 2000.

Graph 1.42
Imports



A notable development was the continued increase in intermediate imports that were related to the manufacture of goods for the domestic market, supported by the positive effects of the fiscal stimulus programme and low interest rates. Imports of primary and processed materials used by the food and beverages industry increased, reflecting sustained consumer spending on food and beverage items. Imports of parts and accessories of transport equipment also increased significantly by 31.3%, in line with the strong performance of the motor assembly industry and passenger car sales. This contributed to increased domestic demand for fuel and lubricants but the value of these imports declined due to lower crude oil prices.

The postponement of private investment plans following the slowdown in economic growth and excess capacity in the domestic economy led to a 1.1% decline in imports of **capital goods**. While investment in the manufacturing sector moderated, capacity expansion in the services sector mitigated the decline in imports of capital goods. Big value capital imports used mainly in the manufacturing sector which declined included industrial machinery and equipment and generators, electrical motors and turbines for power generation. On the other hand, reflecting the upgrading and modernisation of businesses and the continued strength of the services sector, imports of office equipment increased strongly. Imports of telecommunication equipment also increased substantially, underpinned by ongoing efforts to upgrade and modernise the telecommunications system. With firms producing transport equipment operating at 95% capacity, imports of transport equipment for industrial purposes also increased substantially. Among these were imports of commercial vehicles and buses, as well as railway locomotives and coaches, following completion of the construction of the Express Rail Link connecting KLIA and Kuala Lumpur Sentral.

Table 1.22
Gross Imports by End Use

	2001*p*		
	RM million	Annual change (%)	% share
Capital goods	**43,675**	**–1.1**	**15.6**
Capital goods (except transport equipment)	41,000	–2.1	14.6
Industrial machinery and equipment	*12,253*	*–19.1*	*4.4*
Office equipment	*6,567*	*75.1*	*2.3*
Telecommunication equipment	*4,602*	*33.9*	*1.6*
Transport equipment	2,675	17.7	1.0
Intermediate goods	**201,753**	**–13.3**	**71.9**
Food and beverages, mainly for industry	4,179	8.9	1.5
Industrial supplies, n.e.s.	63,105	–6.5	22.5
Metals and metal products	*17,083*	*–6.5*	*6.1*
Chemicals	*7,043*	*–9.9*	*2.5*
Fuels and lubricants	11,659	–3.6	4.2
Parts and accessories of capital goods (except transport equipment)	117,391	–18.6	41.8
Electronics	*76,341*	*–19.1*	*27.2*
Parts and accessories of telecommunication equipment	*7,239*	*–19.7*	*2.6*
Parts and accessories of transport equipment	5,418	31.3	1.9
Consumption goods	**17,555**	**3.0**	**6.3**
Food and beverages, mainly for household consumption	7,174	11.1	2.6
Transport equipment, non-industrial	121	25.4	0.0
Consumer goods, n.e.s.	10,259	–2.1	3.7
Consumer durables	*2,225*	*10.0*	*0.8*
Consumer semi-durables	*3,604*	*–17.5*	*1.3*
Consumer non-durables	*4,431*	*8.2*	*1.6*
Dual use goods	**5,843**	**–8.6**	**2.1**
Motor spirit	2,462	–0.3	0.9
Passenger motor cars	3,381	–13.8	1.2
Others	**5,074**	**9.1**	**1.8**
Re-exports	**6,791**	**4.2**	**2.4**
Gross Imports	**280,691**	**–9.9**	**100.0**

p Preliminary
n.e.s: Not elsewhere specified

Source: Department of Statistics, Malaysia

In tandem with sustained private consumer spending, imports of **consumption goods** increased further by 3% in 2001. The growth in consumption imports was due mainly to higher imports of food and beverages, namely milk and dairy products, fish, beverages, meat and vegetables. Imports of durable and non-durable consumer goods were also higher during the year. Imports of consumption goods accounted for a small share of 6.3% of total imports.

During the year, the relative importance of Malaysia's major **trade partners**, namely the United States, Japan, Singapore and the European Union remained generally unchanged. These countries accounted for 62.6% of Malaysia's total trade. The **United States** continued to be Malaysia's largest trade partner with a share of 18.3% of total trade. Imports from the US declined by 13.3% while US demand for Malaysian goods also declined by 11.6% in tandem with slow growth in the US economy. The bilateral surplus in Malaysia's favour, although still large, declined further to RM22.8 billion.

Japan maintained its position as the second largest trade partner with a slightly lower share of 16% of total trade. Japan remained Malaysia's most important source of imports, although its market share declined to 19.2% of total imports. This partly reflected the cheaper cost of imports from Japan due to the valuation impact from a weaker yen. Imports from Japan comprised mainly machinery, electronics and electrical components and parts and accessories of transport equipment. Exports to Japan also declined by 8.7%, reflecting to some extent lower

Table 1.23
Direction of External Trade

	2001*p*				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	RM million
Selected South-East-Asian countries	83,107	24.9	63,168	22.5	19,939
Singapore	56,669	16.9	35,313	12.6	21,356
Thailand	12,768	3.8	11,121	4.0	1,647
Indonesia	5,940	1.8	8,517	3.0	-2,577
Philippines	4,893	1.5	6,989	2.5	-2,097
Other ASEAN countries	2,838	0.9	1,228	0.4	1,610
European Union	45,462	13.6	36,075	12.9	9,387
United Kingdom	8,779	2.6	6,872	2.4	1,907
Germany	7,767	2.3	10,415	3.7	-2,648
Netherlands	15,429	4.6	2,466	0.9	12,964
Other EU countries	13,487	4.1	16,322	5.9	-2,836
United States	67,672	20.2	44,841	16.0	22,832
Japan	44,503	13.3	54,002	19.2	-9,499
People's Republic of China	14,520	4.3	14,457	5.2	63
Hong Kong SAR	15,299	4.6	7,191	2.6	8,108
Taiwan	12,117	3.6	15,932	5.7	-3,815
South Korea	11,157	3.3	11,240	4.0	-83
India	5,993	1.8	2,935	1.0	3,058
Australia	7,798	2.3	5,944	2.1	1,854
Rest of the world	26,792	8.1	24,906	8.8	1,885
Total	**334,420**	**100.0**	**280,691**	**100.0**	**53,729**

p Preliminary

Source: Department of Statistics, Malaysia

export receipts from mineral fuels due to lower crude oil prices as well as weaker demand due to the recession in Japan. Consequently, the traditional trade deficit with Japan narrowed by nearly one - half to RM9.5 billion.

Singapore remained Malaysia's third major trade partner, accounting for a lower share of 15% of total trade. Reduced intra regional trade and the increasing importance of Malaysian ports as regional transhipment hubs contributed towards a lower share of exports bound for Singapore. As a result, the trade surplus with Singapore narrowed to RM21.4 billion. Meanwhile, trade with the **European Union** increased to 13.3% of total trade. The trade surplus in Malaysia's favour was substantially reduced to RM9.4 billion as exports to EU declined but the value of imports sourced from EU (mainly Germany) increased in 2001.

Reflecting the slowdown in economic growth in the regional countries, the trade pattern with the **East Asian** countries (except China) displayed a declining trend. Bilateral trade with several Asean countries, except Brunei Darussalam, declined in 2001. Reflecting the substitution of imports from lower cost suppliers, Malaysia continued to experience bilateral trade deficits with the Philippines and Indonesia. Similarly, bilateral trade with several developed Asian countries were also lower during the year, due to significant declines in both exports and imports.

A notable development was the significant increase in trade with the **People's Republic of China**, which has become Malaysia's fourth largest single trading partner with an increased share of 4.7% of total trade. While exports to the major industrial countries, other major destinations in the Far East region (Hong Kong, Taiwan and South Korea) and ASEAN declined in 2001, exports to China increased strongly by 26.2%, reflecting China's sustained strong economic growth.

For the fourth consecutive year, the sustained large surplus in the goods account generated sufficient foreign exchange earnings to finance the deficits in the services, income and current transfers accounts. In 2001, the net outflow in the **current transfers** account increased to RM8.1 billion. The increase reflected higher remittances by foreign workers, including one-time repatriations as some workers

Table 1.24
Services and Income Account

Subsector	2000	2001e		
	RM billion			
	Net	+	-	Net
Services Account				
Transportation	-11.4	10.4	21.8	-11.4
Travel	10.0	26.1	9.9	16.1
Other Services	-9.9	17.9	31.1	-13.2
Government services n.i.e.	0.1	0.5	0.5	…
RM billion	**-11.2**	**54.9**	**63.3**	**-8.4**
US$ billion	**-3.0**	**14.5**	**16.7**	**-2.2**
% of GNP	-3.6			-2.7
Income Account				
Compensation of employees	-0.6	1.4	2.4	-1.0
Investment income	-27.9	5.3	30.2	-24.9
RM billion	**-28.6**	**6.7**	**32.6**	**-25.9**
US$ billion	**-7.5**	**1.8**	**8.6**	**-6.8**
% of GNP	-9.1			-8.5

e Estimate

Source : Department of Statistics, Malaysia and Bank Negara Malaysia

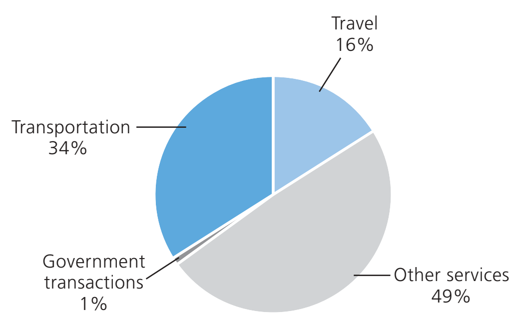
returned to their home countries following consolidation of activities in the export-oriented manufacturing industries. There was a total of 769,566 registered foreign workers in the country in 2001.

The **services account** deficit narrowed significantly by 25.4% to RM8.4 billion or 2.7% of GNP. The improvement reflected the exceptionally strong increase in the travel account surplus and lower payments related to export and import activities.

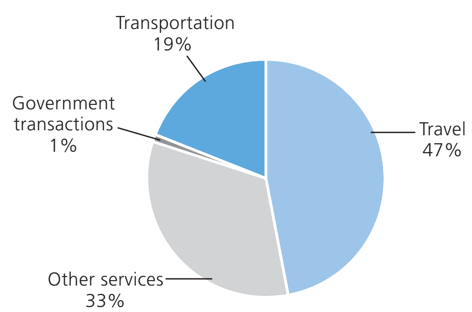
The net surplus in the **travel account** increased by 62% to RM16.1 billion. The exceptionally strong performance of the travel account reflected the marked increase in tourist arrivals (25% to 12.8 million visitors) and excursionists (46.2% to 10.2 million day trippers). Benefiting from the record number of foreign visitors and higher per capita spending (11.8% to RM1,896), tourist (including excursionist) receipts increased to an unprecedented level of RM25.8 billion, representing the second largest source of foreign exchange earnings after electronics and electrical exports. The 47.5% increase in tourist receipts exceeded the Eighth Malaysia Plan target of an average annual growth of 9.5%. The exceptional performance reflected the success of well targeted promotional strategies and policies, in particular the diversification of promotional efforts to niche areas and new markets in Eastern Europe, West Asia, India, and China. The tourism industry also benefited from the strategy to provide a wider variety of products for the tourism market including eco-tourism, agro-tourism and yachting tourism and the hosting of international conventions and major sporting events such as the Formula One Race and Le Tour de Langkawi, and events catering for shoppers such as Mega Sale Carnivals and the Langkawi International Maritime and Aviation (LIMA) exhibition. Mega Sales Carnivals, in particular, contributed towards the significant increase in the number of excursionists.

Meanwhile, efforts to establish Malaysia as an educational regional hub continued. However, in 2001, the uncertainty besetting the regional economies and increased competition from the Philippines, Singapore and Thailand affected the number of foreign students studying in Malaysia. As a result, the total number of foreign students at all levels of education (comprising tertiary, secondary and primary education) in both public and private institutions declined by 23.5% to 20,384 students. This was reflected in a decline in education receipts by 10.1%. Students from Indonesia and China

Graph 1.43
2001: Components of Gross Payments in the Services Account (% share)



Graph 1.44
2001: Components of Gross Receipts in the Services Account (% share)

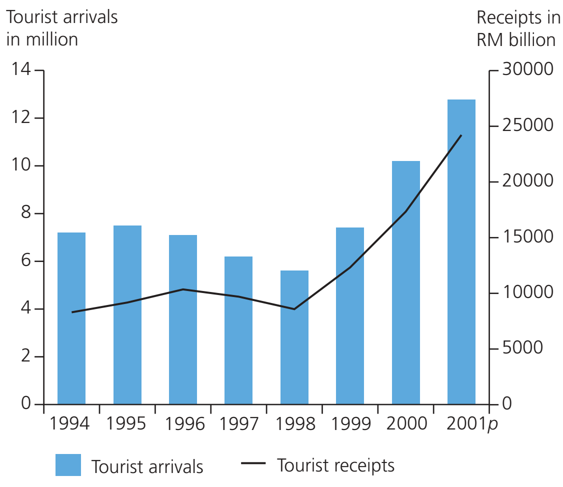


continued to account for the bulk of the foreign students in Malaysia. On the payments front, higher expenditure on travel and education abroad reflected increased business travel and a larger number of students studying abroad.

The **transportation account** deficit was contained at RM11.4 billion as the reduction in receipts was offset by a decline in payments. Gross payments abroad recorded a modest decline associated with lower freight payments on account of the lower volume of trade and freight charges. Gross receipts also declined due mainly to lower earnings on passenger fares and air cargo services provided by the national airline, reflecting lower demand from neighbouring countries. Receipts from charter services were also lower. Despite the decline in external trade, earnings from cargo services provided by major domestic shipping companies and port-related activities continued to register increases during the year. The increase in shipping capacity as well as improvement and expansion of port facilities and services resulted in container throughput of the six major ports increasing by 43.5% to 7.3 million TEUs in 2001. The increase in volume handled was underpinned by the growth in transhipment trade, in particular, transhipment handled by Port Klang and the Port of Tanjung Pelepas (PTP). Strategic business alliances and management expertise provided by foreign partners helped to improve efficiency and handling capacity at the port resulting in a higher volume of activity.

The **other services** account posted a higher net outflow of RM13.2 billion. The deterioration stemmed mainly from a sharp decline in export

Graph 1.45
Tourist Arrivals and Tourist Receipts



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earnings due to lower foreign demand for contract and professional services offered by Malaysian companies. Meanwhile, payments for imported services declined modestly due mainly to lower demand for construction and engineering services during the year. However, payments in areas relating to communication services and computer and information services (ICT enhancement) and mergers and restructuring exercises in the corporate, banking and financial services sectors remained substantial. The payments in other services account also partly reflected the increase in strategic business alliances which usually led to higher imports of other services such as professional, business and technical services.

The **income account** deficit fell by 9.1% to RM25.9 billion or 8.5% of GNP in 2001. The improvement reflected lower repatriation of profits and dividends accruing to foreign direct investors, given lower export earnings of the export-oriented electronics and electrical industries. Repatriation of profits and dividends of foreign direct investors contributed 90% of the net outflow in the income amount. However, the actual outflow of investment income was considerably lower as a significant portion of the profits and dividends were reinvested in the country. Net outflow of profits and dividends accruing to portfolio investments was also significantly lower. However, the other investments component (mainly interest income) of the income account reverted to a deficit position, as lower interest rates abroad led to lower returns from the external assets of BNM and the corporate sector (including commercial banks).

The **financial account** of the balance of payments turned more favourable in 2001, with a lower net outflow of RM14.8 billion. The improvement was attributed mainly to the lower net outflow of short-term capital and, to a lesser extent, higher external borrowings by the Federal Government and the non-bank private sector.

Reflecting the continued commitment by foreign investors to undertake new projects as well as expansion and diversification of existing projects in Malaysia, the value of proposed foreign investments in manufacturing projects approved by the Ministry of International Trade and Industry remained significant in 2001, amounting to RM18.3 billion. In terms of actual **direct investment in Malaysia**, inflows for new and expansion projects were lower in 2001. Lower inflows of direct investment in the manufacturing sector reflected the ongoing

Table 1.25
Balance of Payments: Financial Account

	2000	2001*e*	2000	2001*e*
	RM billion		US$ billion	
Financial Account	**-23.8**	**-14.8**	**-6.3**	**-3.9**
Direct Investment	**6.7**	**1.0**	**1.8**	**0.3**
In Malaysia (foreign direct investment)	14.4	2.1	3.8	0.6
Abroad (overseas investment)	-7.7	-1.1	-2.0	-0.3
Portfolio Investment	**-9.4**	**-2.5**	**-2.5**	**-0.7**
Other Investment	**-21.1**	**-13.4**	**-5.6**	**-3.5**
Official sector	3.9	7.1	1.0	1.9
Federal Government (net)	0.9	6.3	0.2	1.7
Gross borrowing	4.8	7.0	1.3	1.8
Repayment	3.9	0.7	1.0	0.2
NFPEs (net)	3.1	0.9	0.8	0.2
Gross borrowing	6.9	10.7	1.8	2.8
Repayment	3.8	9.8	1.0	2.6
Private sector	-25.1	-20.5	-6.6	-5.4

e Estimates

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

consolidation by major multinational corporations following the decline in global demand and excess capacity. Nevertheless, inflows of new equity for the setting up of strategic alliances with Malaysian partners, particularly in the telecommunications and financial services sectors, were significant in the first three quarters of 2001. These inflows, which are smaller in average dollar size and low in import content, bring technology and other expertise that contribute towards raising productivity in Malaysia.

On a net basis, direct investment in Malaysia amounted to RM5.2 billion in the first three quarters of 2001. The sale of strategic interests in one services company to Malaysian residents in the fourth quarter largely offset this net inflow. As a result, net inflow of direct investment in Malaysia moderated to RM2.1 billion for 2001 as a whole.

The sale of strategic interests by non-resident investors in the fourth quarter of 2001 reflected the decision by a Malaysian company to acquire the stake of its non-resident partners. The move was to enable the Malaysian company to regain control over the subsidiary company, as part of its corporate restructuring exercise. The acquisition was financed by the issuance of long-term debt securities to the non-resident investors as well as by raising an offshore loan. Hence, the transaction, which merely resulted in the change of ownership of the subsidiary, had no impact on international reserves or domestic economic activities as the outflow of direct investment was offset by the inflow of funds from the debt securities issued to non-residents (portfolio investment) and offshore loans.

The Government remains committed to providing a cost-competitive business and investment environment for both foreign and domestic investors. In this regard, the Government continued to provide the Special Pre-Package Incentives that are customised to meet the specific needs of individual investors bringing in quality investment to the promoted sectors of the economy. Several existing incentives were also improved in order to attract the high technology and high value-added investment, consistent with Malaysia's growth strategies. To encourage existing foreign investors to continuously undertake expansion projects or diversify into higher quality investment, the period for the reinvestment allowance was extended from 5 to 15 years in the 2002 Budget. The Foreign Investment Committee (FIC) guidelines on property acquisition by foreigners were further liberalised in April 2001.

Direct investment abroad or overseas investment by Malaysian corporations continued to remain high at RM1.1 billion in the first quarter of 2001, reflecting the strategic business decisions to provide greater synergy to Malaysian corporate activities. A significant share of investment abroad during this period was attributed to the acquisition of palm oil plantations in Indonesia. Towards mid-year, direct investment abroad declined as companies began to adopt a more cautious approach in their investment plans abroad following the severe global economic slowdown. As part of corporate restructuring exercise, some companies also liquidated their businesses overseas, particularly towards the end of 2001, and repatriated the proceeds to Malaysia, thus partly offsetting the large outflows in early 2001. For the year as a whole, direct investment abroad recorded a significantly lower net outflow of RM1.1 billion. The non-financial public enterprises (NFPEs) continued to undertake investments overseas, particularly in the agriculture and oil and gas sectors, mainly in Indonesia and China.

Portfolio investment recorded a significantly lower net outflow of RM2.5 billion in 2001, about one-quarter of the amount recorded in the previous year. Although there were uncertainties in the global financial markets, outflows of portfolio investment were significantly lower as portfolio investors were already underweight in the Malaysian market. In the second half of the year, the accelerated pace of corporate restructuring helped to improve sentiments on the Kuala Lumpur Stock Exchange, thus attracting new inflows of funds, particularly in the third quarter. However, the uncertainty following September 11 led to profit-taking activities that resulted in some net outflows in the fourth quarter, reversing the trend in the third quarter. With the release of more indicators supporting economic recovery, portfolio investments have strengthened to record net inflows in the first two months of 2002.

The **other investment account** recorded a significantly lower net outflow of RM13.4 billion in 2001. The **official sector account** recorded a higher net inflow of RM7.1 billion, comprising mainly drawdown of long-term external loans by the Federal Government. Repayments were lower during the year.

While maintaining the prudent policy of keeping the debt level low, the Federal Government, nevertheless, took advantage of favourable market conditions and low interest rates to access the international capital markets in order to maintain a market presence and to establish a benchmark rate for Malaysian corporations. Proceeds from the issuance of the US$1 billion Notes in July, a syndicated loan of US$540 million in December as well as the drawdown of loans under the Miyazawa Initiative totalled RM7 billion. Although the gross borrowings by NFPEs increased significantly in 2001, a large part of the new borrowings was used to refinance the more expensive existing offshore loans.

The **private sector** recorded a lower net outflow of RM20.5 billion due mainly to lower net outflow of other short-term capital. As interest rates abroad were reduced to support economic activities, there was less incentive for residents to place or retain funds abroad. Interest rate differentials moving in Malaysia's favour since September encouraged the early repatriation of export proceeds, while trade credits extended to foreign importers also declined. The net external assets of the banking institutions also declined in the second half of the year following the unwinding of foreign currency inter-bank placements as importers reduced hedging activities. In addition to lower short-term outflows, there was a net inflow of external borrowings by the non-bank sector, mainly to finance the purchase of non-resident assets as part of a corporate restructuring exercise.

Table 1.26
Outstanding External Debt

	2000		2001*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**157,720**	**41,505**	**169,778**	**44,678**
Medium and long-term	*140,266*	*36,912*	*146,437*	*38,536*
Short-term [1]	*17,454*	*4,593*	*23,341*	*6,142*
As % of total debt	*11*	*11*	*14*	*14*
As % of international reserves	*15.4*	*15.4*	*19.9*	*19.9*
As % of GNP				
Total debt	50.5	50.5	55.4	55.4
Medium and long-term debt	44.9	44.9	47.7	47.7
As % of exports of goods and services				
Total debt	36.4	36.4	42.9	42.9
Medium and long-term debt	32.3	32.3	37.0	37.0
Debt service ratio (%)	**5.3**	**5.3**	**6.2**	**6.2**

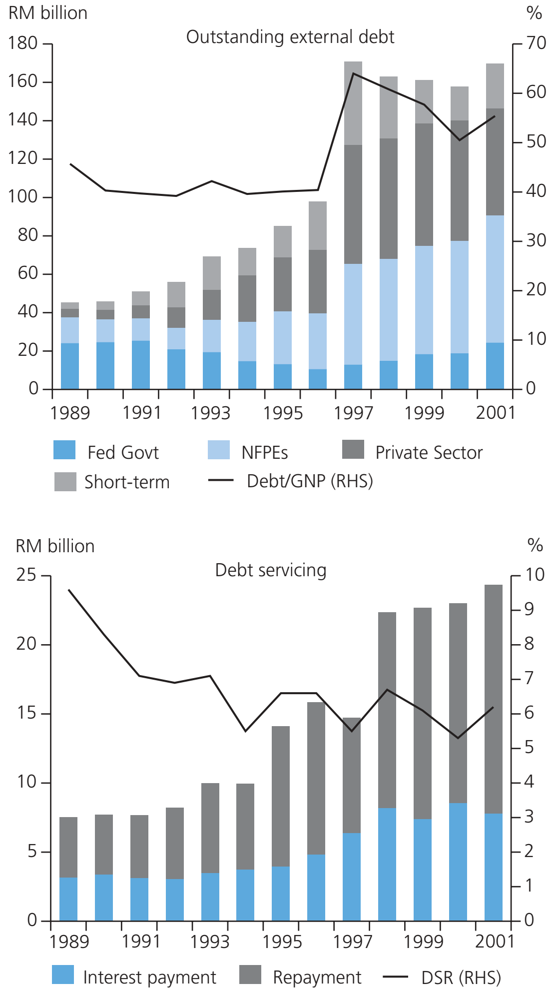
[1] Refers to bank and non-bank private sector short-term debt.
p Preliminary

External Debt

Prudent external debt management remained an integral element of public policy in 2001. In the management of risk and liquidity exposure, Malaysia maintained an external debt management strategy which has already incorporated the international guidelines that were proposed for adoption by emerging market economies for effective debt management following the Asian crisis. Corporations sourcing external funds for operations in Malaysia were required to have foreign exchange income to repay the debt. At the same time, they were encouraged to raise loans with longer maturity, while short-term borrowing by the non-bank private sector to finance long-term investment were not encouraged. The policies were effective in keeping the nation's external debt low with only a small share of short-term debt, and a debt profile that is biased towards the longer end. About two-thirds of the medium and long-term debt have remaining maturities of more than three years. Overall, this active debt management strategy has served Malaysia well in strengthening the underlying fundamentals and reducing vulnerability to external shocks.

As a result of these policies and an efficient debt monitoring system, the nation's external debt position remained contained at a relatively low level. The total external debt outstanding increased moderately by

Graph 1.46
External Debt



7.6% to RM169.8 billion (US$44.7 billion) at the end of 2001. The ratio of external debt to GNP increased to 55.4% (peak of 64% in 1997 following the Asian crisis). The external debt service ratio (excluding prepayments) remained low at 6.2%. The global trend toward lower interest rates has had a positive effect in terms of reduced interest payments on Malaysia's existing external loans. Nevertheless, total debt servicing increased in absolute terms by 6.1% to RM24.4 billion, reflecting the maturity of several bond issues that were raised in the mid-1990s as well as the early retirement of some of the more expensive bonds by the non-financial public enterprises.

The new loan drawdowns were mainly by the public sector (RM7.2 billion) and to a lesser extent the private sector (RM2.8 billion), reflecting lower private investment during the year. An exchange revaluation gain of RM3.8 billion moderated the increase in the external debt level in ringgit terms. As a result, the medium and long-term external debt increased by 4.4% to RM146.4 billion (US$38.5 billion) at the end of 2001.

In terms of currency composition, the bulk of the medium and long-term external debt was denominated in United States dollars with a large share of 77% of debt outstanding at end-2001. The share of yen denominated debt was lower at 15%, reflecting the increased drawdown of US dollar loans, some diversification of borrowing into euro loans, the maturity of yen bonds during the year, as well as the depreciation of the yen. The remaining 8% of the debt was accounted for by other international currencies, including the euro, Singapore dollar and pound sterling. In the case of private sector loans, the currency composition of liabilities generally corresponds closely with the currency composition of earnings, thereby providing a natural hedge against currency risks. As the external debt is diversified in terms of major currencies, the depreciation of the yen and euro has led to an exchange revaluation gain, reducing the external debt in ringgit terms.

Public sector external debt: The Federal Government's external debt increased to RM24.3 billion at the end of 2001. It continued to account for a small share (14%) of total external debt. As in previous years, the Federal Governmentís financing requirements were primarily met from domestic non-inflationary sources. Nevertheless, taking advantage of the favourable market conditions and the nation's low external debt position, the Government tapped the international capital markets, partly to maintain a market presence as well as to take advantage of lower US interest rates to set a benchmark rate to facilitate the corporate sector's access to the US, European and other international markets. In July, the Federal Government issued US$1 billion 10-year Notes due 2011. Reflecting the demand for quality debt papers, these Notes were three times oversubscribed and priced at 228 basis points above the 10-year US Treasuries. In December, it raised a syndicated loan of US$540 million from offshore banks in Labuan. The Government also drew down loans committed under the Miyazawa Initiative as well as project loans from multilateral sources such as the World Bank, Islamic Development Bank and Asian Development Bank. In March 2002, the Federal Government reopened its US$1 billion 7.5% Notes due 2011 by an additional US$750 million. The reopening was priced at the comparable US Treasuries plus 175 basis points to yield 6.8% with a reoffer price of US$104.769.

Based on the US$500 million initially issued, the Notes were oversubscribed by more than seven times.

Reflecting Malaysia's strong fundamentals, the interest **spread** on Malaysia's benchmark securities tightened in 2001. The spread on Malaysian US$1.5 billion Notes due 2009 narrowed to 148 basis points at end-2001, while the spread on the US$1 billion 10-year Notes due 2011 narrowed to 167 basis points. The interest in Malaysia's US dollar bond issues had also increased since May 2001 with the removal of the exit levy and the announcement of a shift in policy by Moody's which could allow companies to be rated higher than the sovereign rating. In a move reflecting the strengthening of the country's external position, Standard & Poor's revised the outlook on Malaysia's long-term sovereign foreign currency debt rating from stable to positive on 4 March 2002, while reaffirming Malaysia's BBB rating.

The **NFPEs** also took advantage of the low interest rate environment to access long-term funds from the international capital markets to refinance their more expensive existing offshore loans. This was reflected in increased gross borrowing of RM10.7 billion in 2001. The new borrowings included the US$600 million 10-year Notes launched by Tenaga Nasional Berhad, and the US$250 million Floating Rate Notes raised by 1st Silicon (Malaysia) Sdn. Bhd. Other major borrowers were Petronas and Silterra Malaysia Sdn. Bhd. In addition, Tenaga Nasional Berhad and Bank Pembangunan continued to draw down loans offered under the Miyazawa Initiative for the development of power plants and transportation infrastructure projects.

The NFPEs as a group recorded a small net inflow of external borrowing of RM0.9 billion as repayments more than doubled, reflecting the refinancing of loans to take advantage of better interest rate spreads as well as the maturity of bonds issued in mid-1990s. Due partly to the reclassification of Malaysia Airline System Berhad (MAS) and its external debt as part of the public sector in 2001, the outstanding debt of the NFPEs increased by 13.3% to RM66.5 billion at the end of 2001.

Private sector external debt: Private sector debt continues to account for the bulk of the Malaysia external debt, at 47% of total debt in 2001. During the year, the private sector recorded net external borrowing of RM2.8 billion in 2001. The higher borrowing reflected mainly the issuance of debt securities to finance the purchase of non-resident assets in Malaysia as part of a corporate restructuring exercise. The non-resident controlled companies continued to account for a large share of the loans, sourcing the borrowing largely from offshore shareholders and parent and associate companies. Such loans were generally provided on flexible terms, including longer maturity and at concessionary interest rates. These loans are also naturally hedged, with foreign currency earnings to service the debt. After taking into account the reclassification of MAS external debt as an NFPE debt and the exchange revaluation gain, private sector external debt outstanding declined by 11.4% to RM55.6 billion at end-2001.

Short-term external debt (maturity of one year or less) comprises mainly short-term borrowing by the banks related to their trade financing activities, revolving credits and inter-company loans. In 2001, short-term external debt increased to RM23.3 billion (US$6.1 billion), largely reflecting the increase in borrowing by the commercial banks. As a prudent measure, the commercial banks are required to observe the external open position limit. As at the end of 2001, the banks' net open position was well below the total approved limit.

The share of short-term debt remained well within prudential limits at 13.7% of total external debt and 19.9% of the international reserves of Bank Negara Malaysia. Including medium and long-term debt falling due within 12 months, short-term debt would amount to RM38.5 billion (US$10.1 billion), less than one third the level of international reserves.

International Reserves

The **net international reserves** held by BNM (comprising gold and foreign exchange holdings, IMF reserve position and holdings of Special Drawing Rights (SDR)) increased by RM3.7 billion or US$964 million in 2001 to RM117.2 billion or US$30.8 billion as at end-2001. The reserves level increased further to RM119.6 billion or US$31.5 billion as at 28 February 2002. This level of reserves is sufficient to finance 5.2 months of retained imports and to cover 5.1 times the short-term external debt. The strengthening of the reserves position reflected the build-up in foreign exchange holdings from trade and long-term capital inflows.

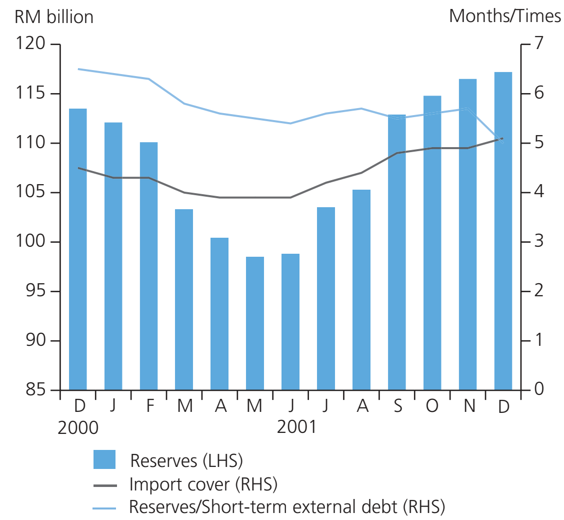
During the course of 2001, there was greater variability in the net international reserves of BNM. Under a fixed exchange rate regime, greater variability in reserves would indeed occur as reserves changes reflect the supply and demand conditions in the foreign exchange market. Between January to mid-April, Malaysia's net international reserves declined to RM99.8 billion (US$26.3 billion) as at 15 April 2001, from RM113.5 billion (US$29.9 billion) at end-2000. Subsequently, the reserves level stabilised and began to steadily increase from end-June. By end-year, the reserves exceeded the level at end-December 2000. At its lowest point, the reserves level had remained high and was equivalent to 3.9 months of retained imports and 5.5 times the short-term external debt. Reserves were at all times unencumbered and usable as Malaysia did not engage in forward contracts.

Table 1.27
Net International Reserves

	As at end			Change
	1999	2000	2001	2001
	RM million			
SDR holdings	330.3	418.7	487.8	69.1
IMF reserve position	3,168.2	3,310.9	3,193.5	-117.4
Gold and foreign exchange	113,766.0	109,835.4	113,542.3	3,706.9
Gross International Reserves	**117,264.5**	**113,565.0**	**117,223.6**	**3,658.6**
Less BNM external liabilities	21.0	23.7	20.7	-3.0
Net International Reserves	**117,243.5**	**113,541.3**	**117,202.9**	**3,661.6**
US$ equivalent	**30,853.6**	**29,879.3**	**30,842.9**	**963.6**
Months of retained imports	5.9	4.5	5.1	
Reserves/Short-term external debt (times)	5.1	6.5	5.0	

In 2001, when the yen depreciated above ¥125 level against the US dollar in late March and early April, there were some sentiment driven outflows during this period of unstable market conditions. A substantial share of the reserves decline, however, reflected trade and investment-related demand for foreign exchange by the Malaysian corporate sector. There was also repayment of external debt to reduce leverage of corporations given the availability of the significantly lower cost of domestic sources of funds. Such repayment of debt reduced Malaysia's external debt and strengthened the external position of Malaysia. This period also saw outflows of overseas investments by Malaysian corporations which reflected strategic business decisions to provide greater synergy to Malaysian corporate activities. These investments also enhanced prospects for future exports of goods and services as well as income and profit repatriation to Malaysia. During the period March-April, the large demand for trade payments reflected 'pre-emptive' outflow as the 'cheaper' US dollar (due to forward discounts arising from interest rate differentials) created incentives to pay forward for imports.

Graph 1.47
Net International Reserves



In March 2001, the exchange revaluation loss from the quarterly revaluation of external reserves holdings also led to an unrealised decline of US$0.9 billion in reserves. As the central bank reserves are diversified in terms of the major currencies, the appreciation of the US dollar led to an unrealised revaluation loss on Euro and yen denominated assets. In the third quarter, a revaluation gain of RM3 billion or US$0.8 billion was recorded as US dollar depreciated against Euro and yen. For 2001 as a whole, the total quarterly revaluation loss amounted to RM4.1 billion or US$1.1 billion.

In 2001, Bank Negara Malaysia stepped up its efforts to enhance transparency and explained in greater detail the nature of the flows. This aimed to increase understanding on the movement of the reserves, in particular that which reflected structural adjustments in the corporate sector that have contributed to Malaysia's long-term economic fundamentals.

Reserves stabilised in the region of RM98.8 billion (US$26 billion) in the period mid-April to end-June 2001. Since end-June, net international reserves increased by RM18.4 billion or US$4.8 billion. Interest rate differentials that moved in Malaysia's favour from September encouraged the early repatriation of export proceeds. While exports declined following the global economic slowdown, this decline was cushioned by a corresponding reduction in imports, resulting in a sustained large trade surplus. The larger trade-related flows was also a reflection of lower import obligations arising from earlier forward payments made in the first half of 2001. There were also continued inflows of foreign direct investment during this period, reflecting inflows from strategic business alliances. Meanwhile, the drawdown of Federal Government external loans, including the US$1 billion 10-year Notes and a syndicated loan of US$540 million from offshore banks in Labuan, more than offset the Government loan repayments during the year. With improved market sentiment, portfolio capital registered a net inflow during a major part of the third quarter. Nevertheless, this trend reversed since the second half of September following the uncertainties associated with September 11 as well as profit-taking activities, resulting in a net outflow of portfolio capital during the fourth quarter. These flows, however, reversed again to show a steady uptrend in January - February 2002.

Malaysia's holdings of reserves in the form of **Special Drawing Rights** (SDR) increased by RM69.1 million to RM487.8 million at the end of 2001. The increase was mainly on account of the receipts of remuneration from the IMF arising from Malaysia's net creditor position with the Fund. During the year, Malaysia's **reserve position with the IMF** remained unchanged. In ringgit terms, however, the reserves with the IMF registered a decline of RM117.4 million to RM3.2 billion at the end of 2001 on account of an exchange revaluation loss during the year.

FLOW OF FUNDS

The economy registered a smaller resource surplus of RM27.4 billion or 8.9% of GNP in 2001 (a surplus of RM31.9 billion or 10.2% of GNP in 2000). In terms of the balance of payments, the smaller resource surplus reflected the larger decline in exports of goods and services relative to imports. Whilst exports declined by 8.8%, imports deteriorated by 8.7% in 2001. From the savings-investment gap perspective, the smaller resource surplus largely reflected the smaller net savings position. Although net savings of the private sector were higher, these were somewhat offset by lower net savings of the public sector. The flow of funds between various sectors of the economy in 2000 and 2001 is summarised in Tables 1.24 and 1.25 respectively.

While the public sector had a lower disposable income during the year, the fiscal stimulus programme by the Government to support economic activity resulted in higher public investment and consumption expenditures. Consequently, the resource surplus of the public sector was significantly lower at RM0.9 billion in 2001 (RM10.8 billion in 2000). The resource surplus reflected entirely the surplus from the NFPEs of RM12.1 billion. This largely offset the resource gap of the general government of RM11.2 billion. The bulk of the resource gap of the

BNM's Reserves Management and Reporting Policy

The objectives of **reserve management** of BNM are to ensure capital preservation and liquidity of reserves whilst optimising returns. BNM has formulated a customised benchmark to serve as a guide for its investment decisions, taking into account the need to ensure the safety of reserves and to meet liquidity requirements as well as the level of tolerance for risk in investment decisions. The benchmark portfolio and BNM's international reserves are made up of the major foreign currencies and gold. The reserves are held in the form of foreign currency deposits or invested in high investment grade sovereign papers. BNM does not engage in options in foreign currencies vis-a-vis ringgit and there are no foreign currency loans with embedded options. There are also no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks and other financial institutions. Reserves are usable and unencumbered.

BNM releases a press statement on international reserves together with the statement of assets and liabilities fortnightly with a one-week lag. As part of the measures to enhance transparency in the international financial system and to facilitate an assessment of the foreign exchange risk exposure, BNM publishes detailed disclosure of international reserves at the end of each month (with a one-month lag) in line with the requirements of the reserves data template under the IMF's Special Data Dissemination Standard (SDDS). This includes the release of forward-looking information on the size, composition and usability of the official reserves and other foreign currency assets and the future and potential (contingent) inflows and outflows of foreign exchange over the next 12 months.

Table 1.28
Flow of Funds: 2000

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-304.5	92.7	211.8			0
Consumption	181.4	-36.2	-145.2			0
Investment	87.1	-43.6	-43.5			0
Change in Stocks	4.1	-2.1	-2.0			0
Exports of Goods and Non-Factor Services	427.5				-427.5	0
Imports of Goods and Non-Factor Services	-359.5				359.5	0
Net Factor Payment Abroad	-28.6				28.6	0
Net Transfers	-7.5				7.5	0
Non-Financial Balance	0.0	10.8	21.1	0.0	-31.9	0
Foreign Financing						
Direct Investment			6.7		-6.7	0
Net Foreign Borrowings		3.9	-28.7		24.8	0
Net Change in Foreign Assets						
BNM				3.7	-3.7	0
Banking System				-5.7	5.7	0
Domestic financing						
Change in Credit		4.4	26.0	-30.4		0
Change in Money Supply, M3			-21.9	21.9		0
Net Borrowings from Non-Bank Sector		-19.1	19.1			0
Net Errors and Omissions			-22.3	10.5	11.8	0
Sum		0	0	0	0	

Table 1.29
Flow of Funds: 2001

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-298.5	88.7	209.8			0
Consumption	191.4	-40.7	-150.7			0
Investment	83.3	-49.2	-34.1			0
Change in Stocks	3.6	2.1	1.5			0
Exports of Goods and Services	389.8				-389.8	0
Imports of Goods and Services	-328.4				328.4	0
Net Factor Payment Abroad	25.9				25.9	0
Net Transfers	8.1				8.1	0
Non-Financial Balance	0.0	0.9	26.5	0.0	-27.4	0
Foreign Financing						
Direct Investment			1.0		-1.0	0
Net Foreign Borrowings		7.1	-23.0		15.9	0
Net Change in Foreign Assets						
BNM				-3.7	3.7	0
Banking System				0.1	-0.1	0
Domestic financing						
Change in Credit		-1.5	20.4	-18.9		0
Change in Money Supply, M3			-13.0	13.0		0
Net Borrowings from Non-Bank Sector		-6.5	6.5			0
Net Errors and Omissions			-18.4	9.5	8.9	0
Sum		0	0	0	0	

general government was financed through net domestic borrowings (RM13.4 billion). Nonetheless, together with net foreign borrowing of RM7.1 billion and the resource surplus of the NFPEs, a total of RM6.5 billion was transferred to the private sector during the year, mainly in the form of loans and grants.

With slower economic growth, private sector disposable income contracted slightly to RM209.8 billion in 2001 (RM211.8 billion in 2000). However, with low interest rates, availability of credit and the Government's policies to encourage domestic consumption spending, private consumption expenditure was higher in 2001. Consequently, private sector savings declined to RM59.2 billion (RM66.7 billion in 2000). However, reflecting the strong decline in private investment expenditure and only a marginal decline in private savings, the resource surplus of the private sector increased to RM26.5 billion (RM21.1 billion in 2000). In addition, part of the investment expenditure in 2001 was financed by inflows of FDI. On the whole, together with net borrowings from the banking system (RM20.4 billion) and transfers from the public sector (RM6.5 billion), the resource available to the private sector amounted to RM54.4 billion (RM72.9 billion in 2000).

The bulk of these excess resources of the private sector were seen in net placements of deposits of RM13 billion with the banking system (including the holdings of currency). Some of the excess also leaked from the domestic economy, mainly in the form of overseas investment (RM20.5 billion) and portfolio outflows (RM2.5 billion). Meanwhile, net external assets of the banking system remained relatively stable. The continued current account surplus and inflows of FDIs were more than sufficient to accommodate these outflows, and net international reserves of BNM rose by RM3.7 billion to RM117.2 billion as at the end of 2001.

Monetary and Fiscal Developments

Monetary and Fiscal Developments

Monetary policy remained accommodative, providing a positive environment for private consumption and investment and overall domestic economic activity. The pegged exchange rate regime which was well supported by economic fundamentals continued to benefit the economy.

MONETARY POLICY IN 2001

The overall objective of monetary policy in 2001 was to create a positive environment to promote domestic activity to mitigate the effects of the global economic slowdown. To achieve this objective, interest rates that had been reduced in 1998 and 1999 were kept unchanged in 2000 and during the first eight months of 2001. The stability provided by the pegged exchange rate regime and the absence of inflationary pressures allowed monetary policy to reinforce the counter-cyclical macroeconomic policy measures implemented to promote domestic economic activity. Nonetheless, the September 11 incident had increased the risks of further weaknesses in the global economic outlook and a delay in the prospects for recovery. On September 20, BNM reduced its Intervention Rate by 50 basis points to 5.00%, as a pre-emptive measure to address the potential for weaker economic growth and to enhance business and consumer confidence. During the year, emphasis was also placed on improving access to financing at reasonable cost to the private sector, in particular SMEs and the agricultural sector.

With the Intervention Rate at 5.50% and 3-month interbank rate at 3.22%, the stance of monetary policy at the beginning of the year was finely balanced between the need to promote consumption and investment without discouraging savings, and avoiding macroeconomic imbalances. As the global economic slowdown was relatively moderate, the full effects of the expansionary fiscal and monetary policies were expected to have their impact on domestic aggregate demand given that the inflation situation was expected to remain subdued.

The easing of monetary policy in several steps in 1998 and 1999 led to ample liquidity and a low level of interest rates. The 3-month BNM Intervention Rate, which is the policy rate, was rapidly reduced by a total of 550 basis points during this period. Given that monetary policy works with a lag, a rapid and significant rate adjustment was initiated in the early part of the recovery cycle. This early easing of monetary policy resulted in lending rates in Malaysia falling to amongst the lowest in the region. With ample liquidity and strengthening competition among banking institutions, interest rates for retail loans in particular, were significantly lower than the quoted BLR. The prevailing low level of interest rates led to strong growth in financing activities, which consequently had positive impact on economic growth, particularly on domestic consumption.

Against this background, monetary policy remained neutral during the first three quarters of 2001. The decision to maintain the prevailing monetary policy stance was supported by several considerations. First, the progressively sharper slowdown experienced in the domestic economy was mainly caused by the weaker performance in the export-oriented industries arising from poor external demand. The benefit of a further lowering of interest rates was therefore expected to be marginal, given that the export sector generally relies on internally-generated funds. Demand indicators also showed that the low level of interest rates resulted in significant increases in new loans, especially for purchases of residential property, motor vehicles and consumer durables. Second, consideration was also given to the need to maintain financial and macroeconomic stability. During this period, deposit rates in Malaysia were generally lower than foreign rates, especially US interest rates. Lowering rates beyond a certain threshold could potentially lead to capital outflows.

Third, in a situation of economic slowdown, where employment and demand prospects remained uncertain and excess capacity was prevalent, fiscal policy would play a crucial role in directly stimulating domestic economic activity. As such, fiscal measures were aimed at enhancing disposable income to boost consumption, and implementing projects with high-spillover effects, low import content and short gestation period. In addition to the Budget 2001 allocation, the pre-emptive package of RM3 billion announced in March, was aimed at further stimulating domestic demand.

An important consideration in the conduct of monetary policy was to maintain a positive real rate of return to depositors, especially individuals and organisations whose income stream was highly dependent on the returns from bank deposits. Unlike other countries, households in Malaysia, being mainly net savers, would be more adversely affected by lower interest rates, in contrast to net debtors. Therefore, interest rates that are too low would have an impact on the income of certain sectors with adverse implications on consumption. In January 2002, BNM launched a third series of Bon Simpanan Malaysia worth RM1 billion as an alternative savings instrument for senior citizens and charity organisations.

During the course of the year, an issue that emerged was the market perception that interest rates were used as a means to sustain financial institutions' profitability. However, this does not figure as an issue in the formulation of monetary policy. Indeed, it is not a policy consideration to sustain banks' profitability at the expense of borrowers, depositors and economic growth. In fact, the prevailing ample liquidity situation and competition for new loans during the first eight months had led banks to lower costs and improve efficiency. Banks' interest rate margins had also narrowed during the period, mainly through the reduction in lending rates. This, had in turn, benefited borrowers without having adverse effects on returns for depositors.

On the whole, the accommodative monetary policy together with the expansionary fiscal policy have contributed to alleviating the impact of the sharp contraction in the export-oriented manufacturing sector on the domestic economy. This outcome was evident in several monetary and real sector indicators. In the first eight months, total banking system loans rose by RM14.4 billion compared to RM13 billion in the corresponding period of high growth in 2000. This loan growth occurred despite the moderation in economic growth in 2001. The increase in outstanding loans was also broad-based and most apparent in the case of interest-sensitive loans such as those for housing and consumption including loans for the purchase of passenger cars and credit card facilities. Other sectors that registered higher loans include transport vehicles; transport, storage and communications; finance, insurance and business services; manufacturing; and wholesale trade. The year also saw continued recourse to the PDS market as a major source of funding. Including loans extended by the banking system and the issuance of PDS, total financing in the first eight months grew by 8.2% at end-August, despite the slowdown in economic growth. In addition, indicators for private consumption such as sales of new passenger cars (+12.7% in the first eight months), sales tax collection (+19.6%) and loans approved and disbursed for consumption credit (+20.3% and +24.7% respectively) also registered continued expansion.

The low inflation environment has provided the flexibility to pursue an accommodative monetary policy. As the year progressed, inflation moderated in line with expectations. The headline inflation moderated to 1.4% in 2001 (1.6% in 2000), while core inflation moderated to 1% from 1.5% during the same period. The lower underlying inflation was attributed to demand remaining relatively weak amidst inventory accumulation and excess capacity in several sectors of the economy. These domestic conditions were further supported by the relatively stable exchange rate and lower imported inflation.

However, the subsequent September 11 incident heightened the macroeconomic risks towards further economic weakness and significantly dampened the global growth outlook. Although Malaysia's economic fundamentals have remained strong, with subdued inflationary conditions and a strong external balance, as an open economy, Malaysia is not insulated from external developments. Following these developments, BNM lowered the Intervention Rate by 50 basis points to 5.00% on 20 September. This, together with further fiscal measures was aimed at promoting domestic demand and mitigating the potential risks of adverse external developments. The average BLRs of commercial banks and finance companies declined to 6.39% and 7.45% respectively. In addition, the lending rates of the special funds for SMEs and Bumiputera entrepreneurs were lowered, while the scope and eligibility criteria for selected funds were liberalised in October.

The reduction in lending rates contributed to providing a positive environment for the private sector. Financing activity in the last four months continued to remain resilient. Total financing through loans extended by the banking system and PDS issued by the private sector rose by a further RM9.8 billion in the last four months or 6% as at end-2001. Similarly, both loan approvals (RM39.7 billion for September to December) and loan disbursements (RM124.7 billion) by the banking system were also sustained.

With the reduction in the Intervention Rate, BNM liquidity operations continued to maintain interbank rates at the prevailing levels, moderating the reduction in the deposit rates. Consequently, depositors continued to earn a positive real rate of return on deposits placed with banking institutions.

During the year, the management of monetary policy continued to focus on managing liquidity flows in order to maintain stable interbank rates. Liquidity operations undertaken by BNM were largely expansionary in the first half of 2001. BNM injected RM15.5 billion into the system through the interbank money market to offset the contractionary impact of net outflow of funds from the domestic economy. During this period, amidst the continued inflow of foreign direct investment and trade surpluses, there were higher payments for imports and repayments of external debt as well as higher overseas investment. In addition, there were also sentiment-driven capital outflows, particularly in March and early April when the financial markets were unstable.

However, liquidity operation turned contractionary in the second half of the year following the net inflow of funds during the period. The inflows exerted an expansionary impact on liquidity and exerted downward pressures on interest rates. To maintain stable interbank rates, BNM mopped up RM12 billion of excess funds from the interbank market in the second half of the year. At the end of 2001, total net funds locked in with BNM amounted to RM46.1 billion (RM49.6 billion at end-2000). This essentially reflects the ample liquidity environment in the financial system.

Another important measure included the New Liquidity Framework (NLF), which was implemented in early 1999 and came into full compliance in 2001. The NLF would enable banking institutions to minimise the maturity mismatch in their balance sheets, thereby allowing greater flexibility in managing the investment portfolio. This NLF represents an important step in the ongoing process towards developing a more market-oriented monetary policy framework. A more flexible assets composition will render banks' balance sheets more sensitive to changes in interest rates, making the transmission of monetary policy more effective.

Efforts were also intensified in 2001 to ensure selected sectors, especially the small and medium enterprises and the agriculture sector, continued to have access to financing. These were undertaken in addition to a series of measures implemented including improving the loan approval process in banking institutions, promoting alternative sources of financing including venture capital, setting up of a dedicated unit to monitor loan complaints in each banking institution and to manage problem loans, and the setting up of the Bumiputera Development Unit which provides financial advisory services to Bumiputera entrepreneurs.

In April 2001, the size and scope of selected special funds were expanded, and their lending rates were lowered. In July, the Entrepreneurs Rehabilitation and Development Fund (ERDF) with an allocation of RM500 million was established to assist Bumiputera entrepreneurs to address the problem of NPLs as well as to provide working capital. Following the reduction in the Intervention Rate, the maximum lending rates of selected funds were also reduced in October. Their eligibility criteria and scope were also liberalised (see box on Monetary Measures). As a result of these initiatives, the overall banking system loans extended to the SMEs rose by RM2.2 billion or 3.1% in 2001. The loans were mainly channelled to the broad property, wholesale and retail trade, electricity and transport sectors.

The monetary policy framework in 2001 continued to operate under a pegged exchange rate regime. The ringgit remained fixed at RM3.80=US$1, an arrangement that has been effective since 2 September 1998. Given the volatile environment in the international foreign exchange market in 2001, the fixed exchange rate regime continued to provide positive benefits to the Malaysian economy. The stability accorded by the ringgit peg provided an environment of certainty for decision making, encouraged confidence in the ringgit and discouraged speculation, conferred efficiency gains in the form of lower hedging and transactions costs, while allowing the restructuring of the banking system and the corporate sector to achieve an advanced stage of progress.

Foreign exchange markets, especially regional markets, remained volatile in 2001. Depreciation of yen exchange rate was, from time to time, followed by depreciation of regional currencies. The ringgit in this environment continued to be supported by strong fundamentals of low inflation, strong current account surplus, low external debt, high savings rate, and a

Monetary Measures in 2001

Monetary measures introduced in 2001 were aimed at stimulating domestic demand amid a less favourable external environment. With the global economic slowdown, exacerbated by the September 11 incident in the US, there was further easing of monetary policy, with a reduction in the Intervention Rate, to provide further support for domestic economic activity. Measures were also introduced to improve access to financing, at reasonable cost, to a wider group of small and medium enterprises (SMEs) and the agriculture sector. These measures were as follows:

- In March 2001, together with the unveiling of the fiscal stimulus package, several financial measures were announced and implemented in stages:

  (i) The size and scope of existing special funds were expanded while their lending rates were reduced. The allocations for the Fund for Food (3F) and the New Entrepreneur's Fund (NEF) were raised from RM1 billion and RM1.25 billion to RM1.3 billion and RM1.5 billion respectively. The Fund for Small and Medium Industries 2 (FSMI 2) was doubled to RM400 million while its eligibility criteria was expanded to include the non-export sector. With effect from 16 April 2001, the funding and lending rates of the 3F, NEF and FSMI 2 were reduced as follows:

Funds	Maximum Lending Rates[1/] (% p.a.)			Funding Rates[2/] (% p.a.)		
	Previous	New	Change	Previous	New	Change
3F	4.0	3.75	-0.25	1.0	0.25	-0.75
NEF	6.0	5.5	-0.5	4.0	2.0	-2.0
FSMI 2	6.5	5.5	-1.0	4.0	2.0	-2.0

[1/] Charged by lending institutions to borrowers.
[2/] Charged by Government on lending institutions.

  (ii) The tax of RM50 on credit cards introduced in 1997 was abolished to promote greater use of credit cards.

  (iii) In July 2001, the Entrepreneur Rehabilitation and Development Fund (ERDF) was established with an allocation of RM500 million to assist viable small and medium Bumiputera entrepreneurs. Of this total allocation, RM120 million was set aside for the resolution of NPLs not exceeding RM1 million and the remainder to assist these businesses to continue their activities through the provision of working capital.

- On 20 September 2001, BNM announced the reduction of the 3-month BNM Intervention Rate by 50 basis points to 5.00%. Accordingly, the ceiling base lending rates of commercial banks and finance companies declined to 6.42% and 7.46% respectively. The reduction in the Intervention Rate was aimed at addressing the increased risks biased towards weaker domestic economic growth in the aftermath of the September 11 incident in the US. In particular, the reduction in the Intervention Rate served to contain the implications of the more adverse external environment on domestic business and consumer activity.

- With the reduction in the 3-month Intervention Rate, BNM announced the further reduction in lending rates and liberalization of eligibility criteria of several special funds:

  (i) With effect from 15 October 2001, the lending rates applicable to existing and new borrowers of the Rehabilitation Fund For Small and Medium Industries (RFSMI), FSMI 2 and NEF were reduced by 0.5 percentage points. The funding rates of these funds were also reduced by 0.5 percentage points each. This was the second rate reduction, following the first in April, to further lower the cost of doing business. The changes in the lending and funding rates of RFSMI, FSMI 2 and NEF are as follows:

Funds	Maximum Lending Rates[1/] (% p.a.)			Funding Rates[2/] (% p.a.)		
	Previous	New	Change	Previous	New	Change
RFSMI	5.0	4.5	-0.5	1.0	0.5	-0.5
FSMI 2	5.5	5.0	-0.5	2.0	1.5	-0.5
NEF	5.5	5.0	-0.5	2.0	1.5	-0.5

[1/] Charged by lending institutions to borrowers.
[2/] Charged by Government on lending institutions.

(ii) To further enhance access to the financing schemes, with effect from 15 October 2001, the eligibility criteria and scope of the following special funds were also liberalised:

Fund	Criteria/conditions	Previous	New
Fund for Food (3F)	Maximum financing per customer	90% of total project cost or RM3 million, whichever is lower	90% of total project cost or RM5 million, whichever is lower
	Maximum financing for land cost	20% of the total project cost	30% of the total project cost
	Wages	Not eligible	Eligible
	Financing for food processing and distribution	Not eligible	Eligible, provided the raw materials are from domestic sources
Rehabilitation Fund for Small and Medium Industries (RFSMI)	Maximum limit for loan refinancing/restructuring	30% of the total loan amount approved	40% of the total loan amount approved
Fund for Small and Medium Industries (FSMI 2)	Purpose of financing	Working capital only	Working capital and capacity expansion
	Maximum financing per customer	RM1 million	RM3 million
Bumiputera Entrepreneur Project Fund (BEPF)	Maximum financing	30% of contract amount	60% of contract amount or RM3 million, whichever is lower
	Maximum financing for contract below RM100,000	RM30,000	RM60,000
Entrepreneur Rehabilitation and Development Fund (ERDF)	Borrower's NPL Limit	RM1 million	Exceed RM1 million, provided the total NPL can be reduced to RM1 million within two months after approval of the facility by ERF Sdn. Bhd.
		Turned NPL from 1 January 1998 to 30 June 2001	Extended to 31 December 2001

- On 27 November 2001, BNM announced the removal of the restriction on the provision of bridging finance for development of residential properties above RM250,000 per unit as well as for development of shop houses exceeding RM250,000 per unit located within residential areas. The upliftment of the financing restriction for this specific sub-sector was in response to the reduction in unsold properties in the residential sub-sector. As the overhang (in value and units of unsold properties) still remains large for the other sub-sectors of the property market, the bridging finance restriction for development of commercial properties and projects involving shop houses priced more than RM250,000 per unit, which are not located within residential areas, remained unchanged.

- On 18 December, BNM announced the Bon Simpanan Malaysia Siri 03 (BSM03) issue. A total of RM1 billion of BSM03 was offered for sale during the period 2 - 31 January 2002, of which RM500 million would be issued based on Islamic principles. The bonds have a maturity period of 2 years and a rate of return of 5% per annum. Only senior citizens that are not employed on a full time basis, and charitable organisations registered with the Registrar of Societies are eligible to purchase the bonds. The BSM03 was issued by BNM to mitigate the impact of the current low interest rate environment on incomes of senior citizens and charitable organizations, primarily dependent on income from deposits placed with the banking institutions, thereby sustaining their spending ability.

more resilient financial sector. Reserves also resumed its rising trend in the second half of the year. Malaysia's external liquidity position remained strong as reserves rose to cover more than 6 times short-term external debt.

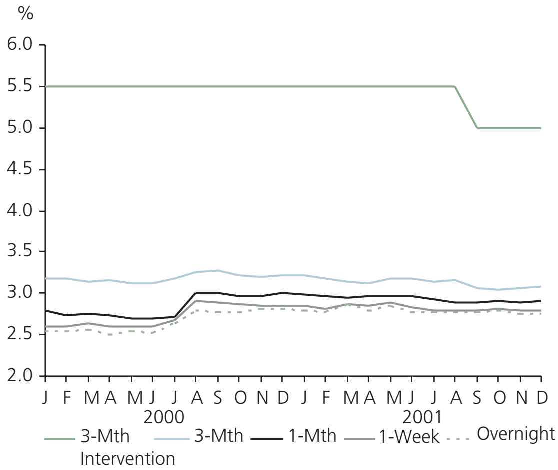
Under these circumstances, the strategy was to put in place policies that will facilitate adjustments in the domestic economy to strengthen the nation's competitive position. These policies aimed to ensure that the Malaysian economy has the flexibility to deliver the necessary internal adjustments to support the exchange rate peg. The Malaysian economy has a relatively diversified economic base and a flexible and mobile labour force. The on-going corporate sector restructuring would also result in further flexibility in price adjustments.

Public perception and confidence are also an important factor in exchange rate sustainability. Through the dissemination of more detailed information, regular dialogues with various segments of the private sector including exporters, manufacturers and members of the media, BNM has sought to highlight issues regarding the exchange rate and factors influencing its sustainability. These have contributed to a greater awareness of the exchange rate developments on private sector balance sheet conditions as well as allowing greater appreciation of the macroeconomic rationale of the exchange rate strategy.

The pegged exchange rate has, for more than three years, effectively and efficiently facilitated international trade and investment without resulting in macro-economic imbalances. As an open economy that is highly dependent on international trade, a stable exchange rate that is consistent with economic fundamentals is of great importance. While it may be tempting to manipulate the exchange rate to gain competitive advantage, it is recognised that such a policy may only provide temporary benefits. Long-term international competitiveness cannot be achieved through exchange rate manipulation. Malaysia has, therefore, chosen to maintain a stable exchange rate, and commit itself to ensuring that policies and domestic economic fundamentals remain consistent with the exchange rate peg. In addition to policies aimed at keeping inflation low, the external balance strong, external debt at low and at prudent levels, reserve levels comfortable and banking sector strong and resilient; efforts are also being directed to continue to build greater flexibility in markets to adjust to external and domestic developments. The stronger macroeconomic fundamentals in a more diversified economy, enhanced mobility of labour and capital, a more resilient banking system and the growing significance of the domestic economy had indeed provided Malaysia with the increased resilience to tolerate and cope with external shocks to the domestic economy.

During the year, the Bank continued to undertake a number of measures that were aimed at enhancing the efficiency and transparency of monetary policy management. A priority of policy was to ensure that adequate information continue to be made available to the public and the market. To achieve this, more frequent statements and dialogues were held with market participants. There were also regular sessions and interviews with both the local and foreign journalists to enable market participants and the media to have a better understanding of monetary policy objectives in Malaysia and its measures. At the same time, there was also a further enhancement of data published through BNM's bulletins. The Bank also hosted a number of international conferences and summits, so that the Malaysian experience and its perspective in managing the economy and financial sector could be better known and appreciated.

Graph 2.1
Interbank Rates (average for the month)



MONETARY DEVELOPMENTS

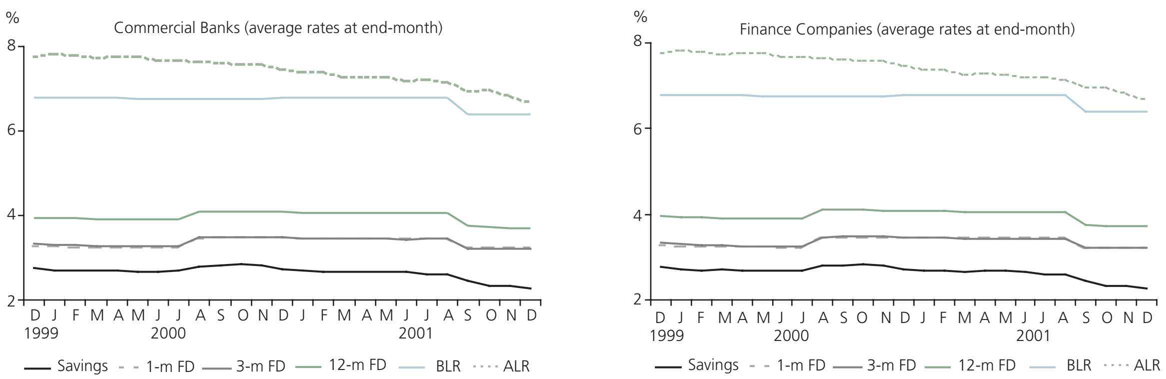
The overall monetary conditions in 2001 were consistent with BNM's monetary policy objectives in promoting domestic economic activity. The low **interest rate** environment together with the ample liquidity situation contributed towards sustained bank lending activity. Higher financing for the private sector coupled with expansionary external operations contributed to the expansion in monetary aggregates during the year. Inflation continued to remain low in this environment.

Monetary conditions remained conducive to support domestic economic activity amidst low inflation. The low interest rate environment, ample liquidity conditions and strengthened banking system contributed to higher financing and expansion in monetary aggregates.

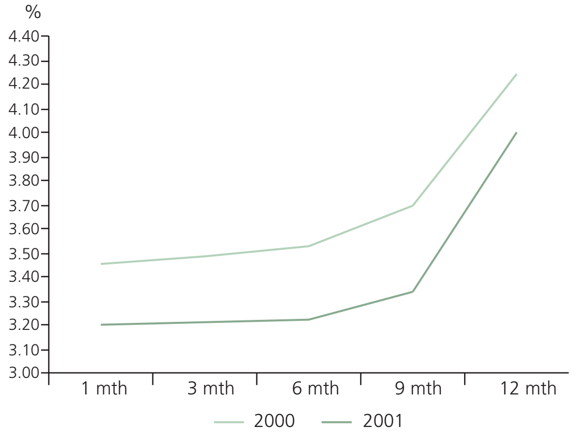
The 3-month BNM Intervention Rate was reduced by 50 basis points to 5.00% on 20 September to address heightened risks biased towards weakness in the domestic economy following the September 11 incident in the US. Meanwhile, the interbank rates remained relatively stable throughout the year. The overnight and 3-month interbank rate stood at 2.76% and 3.27% respectively at the end of 2001 (2.77% and 3.25% respectively at end-2000). Consequently, the divergence between the 3-month interbank rate and the Intervention Rate narrowed to 173 basis points from 225 basis points at the end of 2000.

The retail interest rates offered by the banking institutions were generally stable for the first nine months of the year. The average base lending rate (BLR) of the commercial banks (CBs) and finance

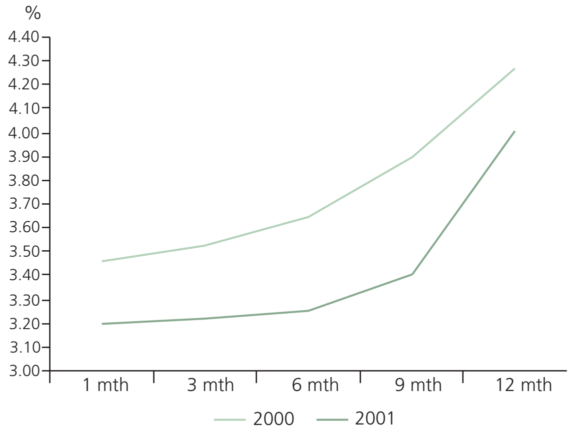
Graph 2.2
Interest Rates of Banking Institutions



Graph 2.3
Fixed Deposit Term Structure of Commercial Banks (average as at end–period)



Graph 2.4
Fixed Deposit Term Structure of Finance Companies (average as at end–period)



companies (FCs) remained at 6.79% and 7.95% respectively, virtually unchanged since August 1999. Following the 50 basis points reduction in the Intervention Rate on 20 September, the BLRs of both groups of banking institutions adjusted downwards by 39 and 50 basis points respectively to a historical low of 6.39% and 7.45% respectively by the end of September 2001. Thereafter, the rates remained unchanged. Lending rates in Malaysia are the second lowest in the region.

Similarly, the average fixed deposit (FD) rates offered by CBs and FCs, which had remained relatively stable in the first nine months of the year, adjusted downwards following the policy rate reduction by BNM. The average quoted FD rates of CBs and FCs, for the one to 12-month maturities fell to 3.20-4.00% and 3.22-4.03% respectively by the end of September (3.45-4.24% and 3.46-4.27% respectively at end-2000). At the same time, BNM continued to direct its liquidity operations to maintain interbank rates at the prevailing levels, resulting in the smaller reduction in the deposits rates. For the CBs, the quoted FD rates with one to 12-month maturities declined by 24-36 basis points, while the rates for FCs declined by 26-50 basis points. Consequently, the term structure of FD rates became steeper than that at end-2000.

Table 2.1
Interest Rates of Banking Institutions (%)

	As at end	2000	2001	Difference
Commercial Banks	3-month FD	3.47	3.21	–0.26
	Savings deposit	2.72	2.28	–0.44
	Base lending rate	6.78	6.39	–0.39
Finance Companies	3-month FD	3.52	3.21	–0.31
	Savings deposit	3.44	2.94	–0.50
	Base lending late	7.95	7.45	–0.50

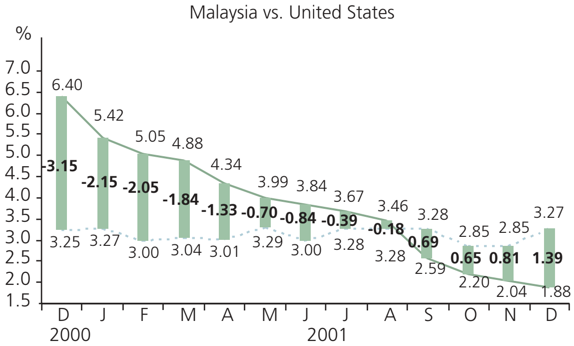
The savings rates of both the CBs and FCs moved in a similar trend as the FD rates. The savings rates were generally unchanged during the first nine months and subsequently declined in October. As at end 2001, the average savings rates of CBs and FCs stood at 2.28% and 2.94% (2.72% and 3.44% respectively at end-2000). Given an inflation rate of only 1.4% in 2001, depositors continued to enjoy a positive real rate of return of 0.88% and 1.54% for deposits with commercial banks and finance companies respectively for savings deposits and 1.81% for 3-month FD for both groups of institutions.

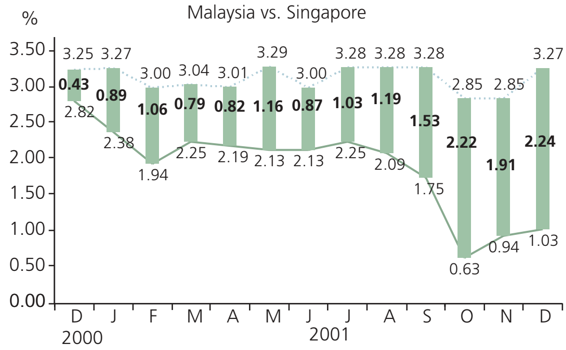
During the year, the gross interest margin of banking institutions narrowed further to 3.86% and 6.31% respectively at the end of 2001. This reflected the larger reduction in the average lending rate (ALR) vis-à-vis the average cost of funds (ACFs). Reflecting the slower declines in FD rates and the relatively stable

Table 2.2
Interest Margins of Banking Institutions (%)

	As at end	2000	2001	Difference
Commercial Banks	Avg. lending rate (ALR)	7.46	6.67	–0.79
	Less Avg. cost of funds (ACF)	3.16	2.81	–0.35
	Interest Margin	**4.30**	**3.86**	**–0.44**
Finance Companies	Avg. lending rate (ALR)	11.14	10.24	0.90
	Less Avg. cost of funds (ACF)	4.06	3.93	0.13
	Interest Margin	**7.08**	**6.31**	**0.77**

Graph 2.5
Nominal Interest Rate Differentials





money market rates, the ACFs of CBs and FCs declined at slower rates of 35 and 13 basis points to 2.81% and 3.93% at the end of 2001. The ALR, on the other hand, declined by 79 basis points and 90 basis points to 6.67% and 10.24% for both CBs and FCs respectively at end-2001, underpinned by the more severe competition among banking institutions to attract borrowers amidst an environment of ample liquidity and moderating economic growth. Competitive interest rates were particularly evident for mortgage and hire purchase loans reflecting the relatively strong demand for credit in these sectors.

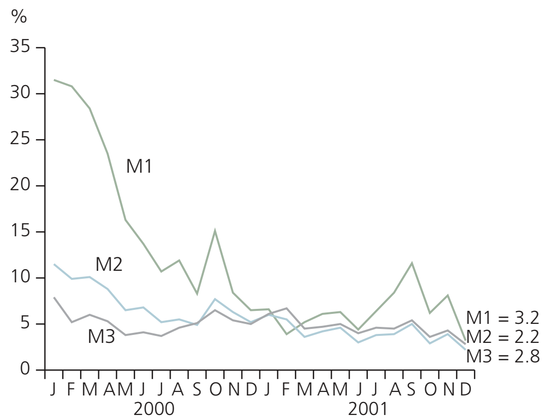
In terms of international comparison of nominal interest rates, the negative differential between Malaysia and the United States (-315 basis points at end-2000) turned positive since September 2001 (+139 basis points at end-2001), following a series of reductions in the US rates throughout the year. The differential widened further in the later part of 2001, following the aggressive cuts in the US rates after the September 11 incident. Comparison with rates in Singapore showed that the interest rates differentials continued to be positive in favour of Malaysia.

Money supply continued to expand in 2001 at a relatively stable pace for the greater part of the year. In the first eleven months, the annual growth in M1, M2 and M3 averaged 6.7%, 4.2% and 4.9% respectively. However, the annual growth rates moderated to 3.2%, 2.2% and 2.8% respectively at end-December due mainly to the high base of December 2000, as well as the build-up in Government deposits in December 2001.

The slower rate of increase in narrow money or M1 (currency in circulation and demand deposits) of 3.2% in 2001 reflected a marginal decline in currency in circulation (-0.5%). Demand deposits also increased at a slower rate of 4.7% (15.0% in 2000). The moderate demand for transaction balances partly reflected the weaker economic activities as well as the optimisation of such balances with the increased utilisation of credit cards. Credit card transactions as a proportion of total private consumption expenditure rose from 8.7% in 2000 to 10.8% in 2001. The slower rate of increase in demand deposits also reflected the performance of the Kuala Lumpur Stock Exchange. As stock market transactions are generally conducted through checking accounts held with banking institutions, the trend in demand deposits tends to be affected by developments on the KLSE.

The continued rise in broad money or M3, albeit at a more moderate pace (2.8%; 5.0% in 2000) generally reflected the overall economic conditions. In terms of components, there were increases in savings deposits, repos and demand deposits. The increase in repos, to

Graph 2.6
Money Supply: Annual Growth



some degree, was indicative of the higher demand for liquidity. Repos provide flexibility for the corporate sector to manage their cash flows. Foreign currency deposits also increased by RM1.3 billion on account of trade-related placements by business enterprises. Despite the large placements by individuals, fixed deposits declined marginally, attributable to the withdrawals by business enterprises and non-bank financial institutions. The latter development partly reflected the shift by these entities to other types of deposits, namely repos and, to a lesser extent, NIDs. While the gap between interest rates on fixed deposits, and NID and repo rates remained relatively stable, the flexibility accorded by NIDs and repos, in terms of tradability and liquidity respectively, were generally more attractive to institutional depositors.

By holder, the higher deposits were almost entirely due to increased deposits by individuals (RM14.3 billion, compared to RM10.7 billion in 2000). This stronger increase in deposits of individuals reflected several factors. The increase in salaries of civil servants, reduction in employees' share of EPF contribution as well as higher tax rebates contributed to higher disposable incomes and, hence, higher deposits. While the propensity to consume was relatively high among those who benefited from tax rebates and higher incomes, there was also some risk aversion amid the weak economic expansion. Consequently, although private sector consumption was sustained, there were some increases in savings and fixed deposits. The higher deposits, to some extent, also reflected the relatively stable and positive real deposit rates amid low inflation.

Meanwhile, the lower deposits by businesses were attributable to a combination of factors. Firstly, it reflected generally lower profitability of some businesses. Secondly, businesses with cash surpluses also repaid their loans amid a situation of excess capacity. Finally, rates on large deposits tended to be lower than quoted rates, which created an incentive among corporations with large deposits to invest their funds in higher yielding papers, such as private debt securities.

While deposits of individuals and businesses accounted for the most significant portion of changes in the components of broad money, deposits by non-bank financial institutions and non-residents contracted during the year (-RM1.5 billion and -RM1.4 billion respectively). The former reflected to some extent, the placement of deposits by a non-bank financial institution with BNM as well as purchases of MGS during the year.

Table 2.3
Broad Money, M3

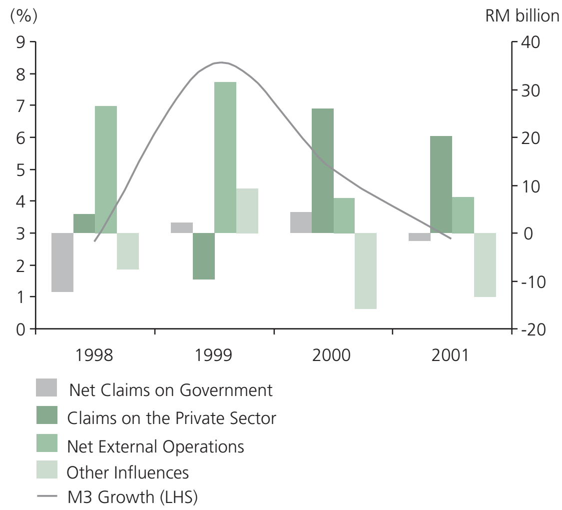
	Change (RM billion)	
	2000	2001
M3	21.9	13.0
Currency[1]	–1.9	–0.1
Demand deposits	7.6	2.9
Broad quasi-money	16.2	10.2
Fixed deposits	8.2	–0.4
Savings deposits	6.4	4.5
NIDs	–0.9	0.6
Repos	–0.3	4.2
Foreign currency deposits	2.9	1.3
Determinants		
Net claims on Government	4.4	–1.5
Claims on private sector	26.0	20.3
Loans	21.6	17.1
Securities	4.4	3.2
Net external operations	7.3	7.6
BNM[2]	1.6	7.7
Banking system	5.7	–0.1
Other influences	–15.8	–13.4

[1] Excludes holdings of banking institutions.
[2] Pre-revaluation.

In terms of determinants, the impetus to growth in M3 emanated from higher claims on the private sector (+RM20.3 billion) and expansionary external operations (+RM7.6 billion). Reflecting the significance of domestic-led economic activity, which is more dependent on domestic sources of financing, bank lending remained resilient (+RM16.8 billion), with loans extended primarily to the household sector, amid a particularly supportive environment of competitive lending rates. In addition, holdings of securities by the banking institutions also increased by RM3.2 billion.

Net external operations (pre-revaluation) also contributed further to the expansion in M3, rising by RM7.6 billion. In the first six months of the year, net external operations of the non-bank sector recorded an increase of RM1.6 billion. Although BNM's international reserves recorded a decline of RM10 billion (excluding net revaluation losses) during this period, the net external assets of the banking system rose by RM11.6 billion. Banking institutions sought to hedge the increase in forward purchases undertaken to cover exchange rate risk on import payments, in the wake of volatility in the foreign exchange markets, especially during March and April 2001. In addition, as foreign interest rates were higher during this period, there were some interest rate arbitrage activities. This situation reversed in the second half-year when net external operations of the non-bank sector recorded an increase of RM6 billion.

Graph 2.7
M3 Determinants



The increase in BNM's international reserves of RM17.7 billion (excluding net revaluation gains) was partly offset by the decline in net external assets of the banking system of RM11.7 billion following the unwinding of forward purchases, as well as the non-rollover of balances previously placed abroad as nominal interest rate differentials had turned in Malaysia's favour beginning September 2001.

Government operations were mildly contractionary on money supply (-RM1.5 billion) as the increase in deposits (+RM5.7 billion) offset higher claims on the Government (+RM4.2 billion). There were large withdrawals of Government deposits from BNM at the beginning of the year. Subsequently, significant increments in deposits were registered at the end of every quarter arising mainly from the receipts of three reopenings and one new issue of MGS, totaling RM21.5 billion for the year as a whole. Two new foreign loans, namely the US$1 billion 10-year Notes issued in June and the US$540 million syndicated loan raised in December also contributed to the increase in deposits with BNM. The increase in Government deposits with BNM also reflected the better-than-expected revenue performance.

Other influences were also contractionary on money supply. These included higher provisions for loan losses; higher profits of the banking institutions during the year; as well as the placement of deposits by a non-bank financial institution with BNM amounting to RM1.5 billion.

Financing activities expanded further in 2001 amid an environment of low interest rates and ample liquidity. In aggregate, **financing through loans extended by the banking system (including Islamic banks) and PDS** issued by the private sector increased by RM33.5 billion or 6% in 2001. Loans extended by the banking institutions (including loans sold to Cagamas and Danaharta) increased by 3.6% for the year as a whole. While loan growth was relatively stronger in the first nine months (+3.5%), it moderated in the remaining months of the year (+0.1%). The slower pace of credit growth in November and December was mainly due to the large loan repayments in connection with the restructuring of non-performing loans as well as the refinancing of banking system loans through the issuance of PDS. Excluding these large repayments, credit would have increased by RM20.6 billion or 4.5% in 2001. Including banking institutions' holdings of PDS, total financing by the banking system increased by 5.2% in 2001.

Financing through the PDS market (excluding Cagamas, Danaharta and Danamodal bonds)

Table 2.4
Financing through Banking System Loans[1] and PDS

	Outstanding		Change		Annual growth	
	2000	2001	2000	2001	2000	2001
	RM bilion				%	
Financing by Banking System	**472.1**	**496.6**	**30.0**	**24.6**	**6.8**	**5.2**
Loan outstanding (1)	454.0	470.4	23.5	16.4	5.5	3.6
Holding of PDS	18.1	26.2	6.5	8.2	56.1	45.1
Total PDS outstanding [2] (2)	**100.8**	**118.0**	**22.4**	**17.1**	**28.6**	**17.0**
Total (1) + (2)	**554.9**	**588.4**	**46.0**	**33.5**	**9.0**	**6.0**

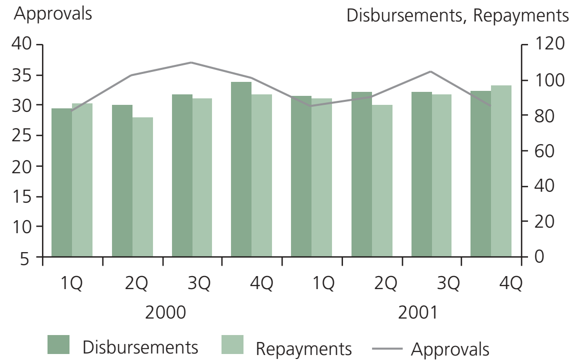
[1] Including Islamic banks
[2/] Refers to total PDS issued by the private sector with original maturity period of more than one year. Exclude debt securities issued by banking institutions, Khazanah, BNM, Cagamas, Danaharta and Danamodal.
Note: Total may not add-up due to rounding

continued to increase strongly, expanding by 17% in 2001. This has been a positive development as it not only reduces the over dependence on the banking system for financing, but also diversifies further the risks associated with long-term financing directly to investors in the PDS market. Of the total gross funds raised from the PDS market, a higher proportion of 41% was to finance new activities, while the remainder was for refinancing (38%) and restructuring (21%). In contrast, in 2000, one-half of the PDS issuance was for restructuring purposes.

During the year, loan approvals were lower, amounting to RM125.6 billion (RM134.8 billion respectively in 2000). Approvals were granted mainly for the purchase of residential properties and passenger cars as well as to the manufacturing sector. Nevertheless, the higher loan disbursements of RM371.8 billion (RM360.7 billion in 2000) were broad-based, channelled mainly to manufacturing; wholesale and retail trade, restaurants and hotels; finance insurance and business services; and construction sectors; as well as for the purchase of residential properties and passenger cars. However, the higher disbursements were almost matched by equally high repayments, amounting to RM364 billion (RM347.1 billion in 2000). As a result, outstanding loans increased by 3.6%.

Overall, credit growth in the banking system reflected the higher loans extended to the household sector for the purchase of residential properties and passenger cars. Loans to business enterprises were lower due mainly to the lower loans for the utilities; transport, storage and communication and construction sectors. However, reflecting the many measures to promote lending to the small and medium enterprises (SMEs), loans to this group expanded further by 3.1% or RM2.2 billion (4.3% in 2000).

Graph 2.8
Loan Approvals, Disbursements and Repayments (RM billion)

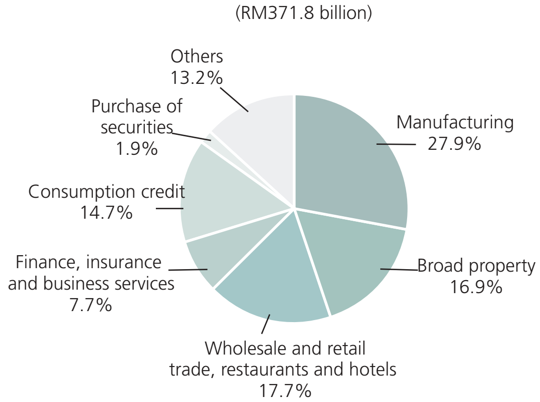


By borrower, loans to the household sector rose markedly by 14% in 2001 (12.4% in 2000). The strong demand for loans by the household sector was attributable to several factors:

- Response to monetary and fiscal measures undertaken to raise domestic demand. The disposable income of households was enhanced through the reduction of the mandatory contribution to the Employees Provident Fund (EPF) and the increase in individual income tax rebates. Other measures also included the reinstatement of incentives offered in the house ownership campaign such as stamp duty exemption and processing fee waivers, as well as the abolition of the RM50 tax on credit cards.

- Amid ample liquidity, banking institutions were more active in promoting consumer loans as reflected by the more competitive interest rates and attractive packages for housing and hire purchase loans as well as credit card facilities. There was also some refinancing of mortgage loans in view of the low interest rate environment.

Graph 2.9
Loan Disbursements in 2001



Loan Approvals in 2001

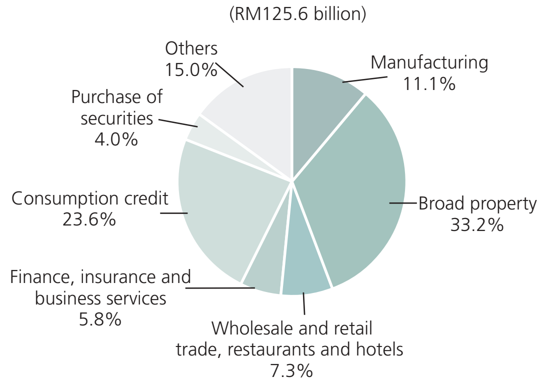


Table 2.5
Banking System[1]: Loans Outstanding by Sector

	As at end		Change	Share of total
	2000	2001	2001	2001
	RM billion			%
Agriculture, hunting, forestry and fishing	12.0	12.4	0.4	2.6
Mining and quarrying	1.7	1.5	–0.2	0.3
Manufacturing	68.4	68.4	…	14.5
Electricity, gas and water supply	7.8	5.3	–2.5	1.1
Wholesale and retail trade, restaurants and hotels	38.1	38.9	0.8	8.3
Broad property sector	163.2	175.8	12.6	37.4
Construction	*41.1*	*40.1*	*–1.1*	*8.5*
Purchase of residential property	*74.3*	*87.1*	*12.8*	*18.5*
Purchase of non-residential property	*29.4*	*29.7*	*0.3*	*6.3*
Real estate	*18.5*	*19.0*	*0.6*	*4.0*
Transport, storage and communication	13.9	12.5	–1.5	2.7
Finance, insurance and business services	34.5	35.4	0.9	7.5
Consumption credit	59.7	69.4	9.7	14.8
of which:				
Credit cards	*7.4*	*8.9*	*1.5*	*1.9*
Purchase of passenger cars	*37.5*	*45.5*	*8.0*	*9.7*
Purchase of securities	33.6	30.4	–3.2	6.5
Purchase of transport vehicles	1.7	2.4	0.7	0.5
Community, social and personal services	6.3	6.2	–0.1	1.3
Others	13.1	11.8	–1.3	2.5
Total loans outstanding [2]	**454.0**	**470.4**	**16.4**	**100.0**
Plus: Holdings of PDS	18.1	26.2	8.2	
Total Financing	**472.1**	**496.6**	**24.6**	

[1] Including Islamic banks
[2] Including loans sold to Cagamas and NPLs sold to Danaharta
Numbers may not add-up due to rounding

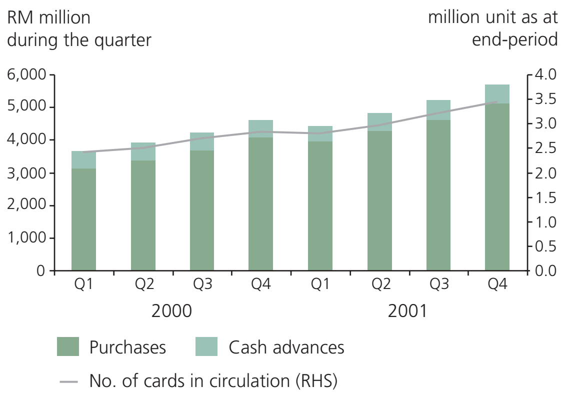
- Banking institutions continued to aggressively promote credit card facilities by selectively offering annual fee waivers and free gifts to widen their customer base. As a result, the number of credit cards in circulation increased by 625,801 or 22.2% to 3.4 million as at end-2001. Correspondingly, the outstanding balance of credit card debt also increased by RM1.5 billion or 21% during the year (+RM1.8 billion or 33.2% in 2000) to RM8.9 billion as at end-2001. The bulk of the credit card transactions was mainly for purchases of goods and services (89.2%) as opposed to cash advances (10.8%).

With the aggressive promotion of credit cards by banking institutions in recent years, BNM has continued to closely monitor credit card developments. In terms of the quality of credit card debt, the overdue balances as a percentage of total outstanding balances remained low at 13.3% in 2001, compared with 23.5% in 1998. In addition, the share of total outstanding balance of credit card debt to total loans outstanding remained low, at 2.1% in 2001 (1.8% in 2000).

Loans outstanding extended to business enterprises were lower (-1.6%) during the period reflecting the high rate of repayments as a result of refinancing, which to some extent was part of the debt restructuring process, and also the more moderate economic expansion in 2001:

- Although loan disbursements to business enterprises remained high in 2001, they were

Graph 2.10
Number of Credit Cards and Volume of Transaction



matched by equally high repayments. This in part reflected refinancing of loans to take advantage of the historical low interest rates and borrowing for short-term working capital requirements as opposed to borrowing for long-term investment purposes.

- The successful completion of the debt restructuring scheme for the light rail transit companies by the Corporate Debt Restructuring Committee (CDRC), also led to some non-performing loans (RM2.9 billion) being taken off the loan books of the banking institutions.

- There were also some refinancing of loans via the PDS market to reduce the operating costs of companies.

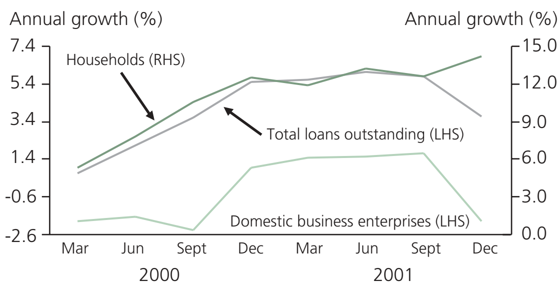
- An increased number of corporations raised funds through the capital market during the year. This was evidenced by the higher gross issuance of private debt securities for financing new activities, amounting to RM13.9 billion or 41% (RM9.2 billion or 32% in 2000) to lock in the low long-term fixed rates.

- There continued to be excess capacity in several industries amid increased uncertainties about the prospects of the global economy and its adverse implications on Malaysia.

Consequently, new loans approved for business enterprises were lower by 12.5% in 2001 and accounted for a smaller share of total new loans approved (50.9%; 54.2% in 2000).

Meanwhile, several measures that were introduced to improve access to credit for the SMEs and the agriculture sector resulted in higher loans to these groups. Loans extended to the SMEs rose further by RM2.2 billion or 3.1% in 2001 (+RM2.9 billion

Graph 2.11
Loans Extended to Households and Business Enterprises



or 4.3% in 2000). The loans to the SMEs were broad based, the bulk of which were channelled to the broad property sector, wholesale and retail trade, as well as the utilities and transport sectors. Loans to the agriculture sector also expanded further by RM435 million or 3.6%. Overall, loans extended to SMEs as a proportion of total loans outstanding remained high at 17.7% at end-2001 (17.8% at end-2000).

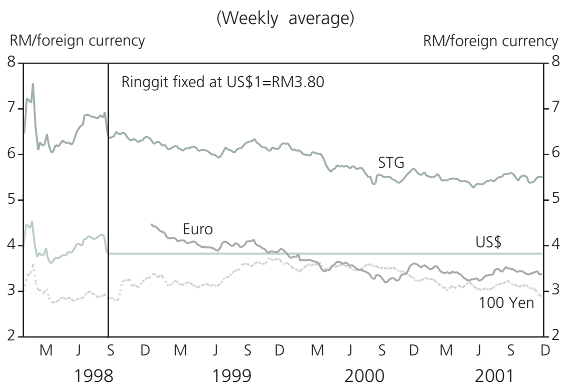
Amongst the many measures implemented to promote SMEs lending were improvement to the loan approval process in banking institutions and promotion of alternative sources of financing including venture capital; establishment of a dedicated unit in BNM to monitor loan complaints and a unit in each banking institution to manage problem loans; and establishment of the Bumiputera Development Unit in BNM which provides financial advisory services to Bumiputera entrepreneurs. The additional measures that were introduced in 2001 included measures on special funds introduced in April, July and October, to expand the scope and size of funds; reduce lending rates, and liberalise the eligibility criteria and conditions of selected special funds (see Box on Monetary Measures in 2001). These measures generated positive results as reflected by the increase in the number of applications approved under the Fund for Food (3F), New Entrepreneur Fund (NEF) and Fund for SMI 2 (FSMI 2) by 26.4%, 23.1% and 291.7% respectively (+5.2% and +13.8% for 3F and NEF respectively in 2000). Disbursements of these funds were also higher, amounting to RM183 million, RM225 million and RM169 million respectively in 2001 (RM81 million, RM132 million and RM43 million respectively in 2000).

EXCHANGE RATE DEVELOPMENTS

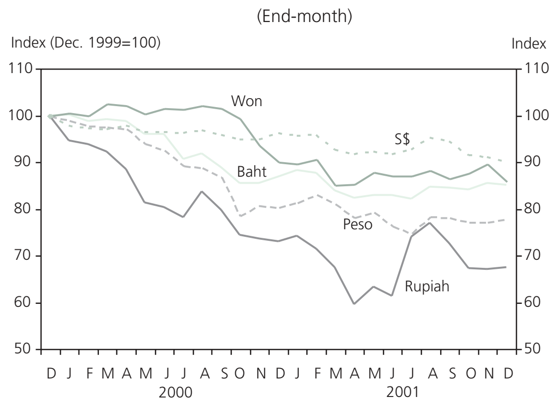
The Malaysian ringgit **exchange rate** remained pegged to the US dollar at the rate of US$1=RM3.80 in 2001. Bilateral exchange rates with other currencies are determined through cross-rates based on the movements of the US dollar against these currencies in the foreign exchange markets.

The international foreign exchange market experienced significant volatility in 2001. The Japanese yen depreciated sharply against the US dollar earlier in the year following increased concerns over growth prospects for the Japanese

Graph 2.12
Exchange Rate of the Malaysian Ringgit against Major Currencies



Graph 2.13
Performance of the Malaysian Ringgit against Selected Regional Currencies



Note: An increase in the index represents an appreciation of the currency against the ringgit.

economy. Subsequently, the Japanese yen appreciated against the US dollar from mid-July due to market concerns over weakness in the US economy, which were further exacerbated by the September 11 incident. Towards the end of the year, the Japanese yen again experienced a weakening trend. Similarly, the euro exchange rate also exhibited volatility during the year.

The ringgit peg continued to provide stability to the domestic foreign exchange market in an environment of volatile international and regional foreign exchange markets.

The ringgit appreciated against the Japanese yen (14.4%), the euro (5.0%) and pound sterling (2.7%) in tandem with the movements of the US dollar in the foreign exchange markets. However, given the fixed exchange rate to the US dollar, the Malaysian economy was reasonably insulated from the extremes in currency movements. Given that the majority of Malaysia's external transactions are conducted in US dollars, the ringgit peg continued to provide stability to the domestic foreign exchange market in an environment of volatile international and regional foreign exchange markets. The stability accorded reduced the element of uncertainty in the decision making process of domestic manufacturers and service providers.

On the regional front, the ringgit appreciated against all regional currencies in the range of 2.1%-8.2% in 2001. Movements were influenced to some extent by market concerns over the impact of the US economic downturn on the region's economic growth prospects. The depreciation of the Japanese yen also led to depreciation of regional currencies through technical and sentiment-driven factors. In addition, domestic political developments exerted downward pressure on the Indonesian rupiah and the Philippine peso.

In terms of its trade-weighted nominal effective exchange rate (NEER), the ringgit appreciated by 5.5% during the year, in line with the appreciation of the US dollar. The appreciation of the US dollar against other currencies in Malaysia's trade-weighted basket was due mainly to higher expected returns on US dollar denominated assets following the better economic growth prospects for the US relative to the other G-7 economies. However, since September 1998, the ringgit's NEER has appreciated by only 3%. Given the relatively small appreciation, the ringgit has essentially maintained a fair valuation. It has also been well supported by the strengthened macroeconomic fundamentals. The low inflation, low external debt levels, strong external balance, higher reserve levels and strong banking sector have created a favourable environment for Malaysia.

Table 2.6
Movement of the Ringgit

	RM to one unit of foreign currency [1]				Annual Change (%)		Change (%)	
	1997 End-June	1998 Sept.2 [2]	2000 End-Dec.	2001 End-Dec.	2000	2001	End-June '97-Dec. 2001	2 Sept. '98-Dec. 2001
Composite	102.47	72.11	70.86	73.34	3.2	3.5	–28.4	1.7
SDR	3.5030	5.1177	4.9511	4.7714	5.2	3.8	–26.6	7.3
US$	2.5235	3.8000	3.8000	3.8000	0.0	0.0	–33.6	0.0
S$	1.7647	2.1998	2.1946	2.0529	3.9	6.9	–14.0	7.2
100 Yen	2.2088	2.7742	3.3121	2.8955	12.1	14.4	–23.7	–4.2
Pound Sterling	4.1989	6.3708	5.6662	5.5161	8.3	2.7	–23.9	15.5
Deutsche Mark	1.4522	2.1743	1.8064	1.7211	8.5	5.0	–15.6	26.3
Swiss franc	1.7368	2.6450	2.3234	2.2757	2.6	2.1	–23.7	16.2
Euro [3]	–	–	3.5331	3.3662	8.5	5.0	–	–
100 Thai baht	9.7470	9.3713	8.7790	8.6022	15.3	2.1	13.3	8.9
100 Indonesian rupiah	0.1038	0.0354	0.0395	0.0365	37.2	8.2	184.4	–3.0
100 Korean won	0.2842	0.2827	0.3022	0.2883	11.0	4.8	-1.4	–1.9
100 Philippine peso	9.5878	8.8302	7.6053	7.3644	24.7	3.3	30.2	19.9

[1] US$ rates are the average of buying and selling rates at noon in the Kuala Lumpur Interbank Foreign Exchange Market. Rates for foreign currencies other than US$ are cross rates derived from rates of these currencies against the US$ and the RM/US$.
[2] Ringgit was fixed to US$1 = RM3.8000 on 2 September 1998.
[3] The Euro began to be traded on 4 January 1999 (EUR 1= RM4.5050).

FISCAL POLICY AND OPERATIONS

The 2001 Budget was formulated at a time when the outlook for the global economy, in terms of the magnitude and duration of the slowdown in the major economies was uncertain. Given the openness of the Malaysian economy, the slowdown in global growth would affect Malaysia's growth prospects. In view of the downside risks, the main thrust of the 2001 Budget was directed at stimulating domestic demand, enhancing the nation's competitiveness and achieving the agenda for a caring society.

Given the uncertainties in global economic prospects, weak private sector activities and prevalence of excess capacity in many sectors, counter-cyclical fiscal policy was crucial to directly stimulate domestic economic activities. Therefore, the Government maintained its expansionary budget through higher allocations for both operating and development expenditures. Nevertheless, the fiscal deficit was budgeted at RM16.5 billion or -4.7% of GDP (October 2000), lower than the fiscal deficit of 5.8% of GDP in 2000. At that time, real GDP for 2001 was forecast to grow moderately with economic recovery in the United States expected in the second-half of 2001. Under this scenario, a lower deficit would be consistent with the Government's commitment to fiscal prudence and discipline in its financial management to preserve long-term fiscal sustainability and flexibility.

The focus of the budget allocation was also to ensure maximum impact on growth and keep leakages abroad to a minimum to preserve the strong balance of payments position. Hence, allocations were accorded to projects and programmes which would stimulate domestic demand and strengthen Malaysia's productivity over the longer term. In terms of strategy, the 2001 Budget adopted a two-pronged approach: stimulate domestic growth through allocation for projects which had strong domestic linkages and low import content; and stimulate domestic demand through raising disposable incomes. The latter was effected through tax and non-tax measures including higher individual tax rebates and higher allowances for civil servants in specific categories. In its expenditure allocation to raise economic activity, the Government focused on projects that not only could be implemented quickly for maximum impact on domestic demand, but would also meet the longer-term objective of increasing

Earlier fiscal discipline, accumulation of assets during favourable periods and low Government debt have accorded the Government the flexibility to pursue expansionary fiscal policy to support growth. The actual outturn of the fiscal deficit for 2001 was much lower than estimated due to stronger revenue.

productivity. Hence, a significant share of budget allocation was allocated for projects related to education, infrastructure and industrial development.

To complement this strategy, incentives were introduced to further strengthen the foundation for long-term sustainable growth. Towards this end, wide ranging fiscal incentives were provided to develop new sources of growth, strengthen the nation's competitiveness and resilience through development of skilled manpower, technological competence and establishing strategic partnerships with international and global players in the services sector. Measures were also undertaken to enhance the ability of the financial markets to be more dynamic, innovative and efficient in supporting growth, particularly as the economy transforms into a knowledge-based economy.

In the early part of 2001, there were increasing signs that the slowdown in the United States economy was becoming more severe with diminishing prospects of an early recovery. The economic outlook for Malaysia in 2001 was revised downwards to 1-2% from 7% announced in October 2000. The impact on the external sector was expected to be more severe due to a stronger deceleration in global growth. Under a more uncertain outlook, the Government implemented several pre-emptive measures to sustain the growth momentum. On 27 March 2001, the Government announced a package of stimulative measures to strengthen domestic demand. These measures included an additional fiscal stimulus of RM3 billion, reduction in employees' share of contribution to the EPF by two percentage points for one year and the removal of tax on credit cards. Projects identified under this package were those with high spill-over effects, low import content and short gestation period. A higher allocation was given to social services, notably for education and training as well as for low-cost housing. At the same time, the Government also undertook several other measures to encourage private investment. These included measures to reduce the property overhang and additional financing for the small- and medium-sized industries through expanding the size and scope as well as lowering the lending rates of special funds.

Subsequently, when there were increased risks biased towards weaker domestic demand following the September 11 incident, a further fiscal stimulus package of RM4.3 billion was announced on 25 September ahead of the 2002 Budget. Apart from containing and minimising the adverse spill-over effects from the deterioration in global demand, the fiscal stimulus also aimed at cushioning the negative impact on the poor and the less fortunate, increasing income opportunities for small enterprises and assisting retail businesses. The new fiscal stimulus package was mainly allocated for small projects for which funds could be disbursed immediately. The projects identified were small development projects in rural and selected urban areas, upgrading of Government buildings and facilities, training of retrenched workers and unemployed graduates and tourism promotion. The early announcement of this fiscal stimulus before the 2002 Budget was aimed at providing enough lead time for higher expenditure to impact economic activities during the remaining months of 2001.

Following the two fiscal stimulus packages, the fiscal deficit was expected to be higher than the deficit of 5.8% recorded in 2000. Efforts were made to contain the estimated budget deficit at about 6.5% of GDP or RM22.4 billion. This level was deemed prudent and within limits that would not create longer-term risks. The actual outturn of the fiscal deficit was however, much lower. Efficiency in tax collection amidst sustained economic activities resulted in the actual tax revenue collection being much higher than projected. Expenditure was on target with the shortfall contained at less than 5% of total allocation. Following the stronger revenue, lower fiscal deficit of RM18.4 billion or -5.5% of GDP was achieved compared to earlier estimates of -6.5% of GDP.

In implementing the fiscal stimulus programmes, it became necessary to undertake measures to overcome the slow disbursement of funds, especially in the early months of 2001. Existing procedures were adjusted in order to enhance the efficiency of project implementation, speed up payments to contractors and remove bureaucratic delays. Besides the review of procedures, rules and guidelines on the implementation of development projects and procurements as well as payment to contractors, the implementation of projects was also more closely monitored.

Previous fiscal prudence and accumulation of assets during favourable periods ensured that the Government had substantial resources to finance expansionary fiscal policies. Although the budget deficits were recorded as a result of counter-cyclical measures taken since 1998, these deficits had not led to macroeconomic imbalances. On the contrary, the fiscal stimulus programmes had contributed positively in promoting domestic sources of growth, thereby ensuring economic stability and building resilience against adverse external developments. At the same time, the Government maintained prudent practices and refrained from unsustainable expansion in fiscal policy. In this respect, the Government targeted for at least a balanced position in the current account of the Government budget. This was achieved by ensuring that operating expenditure would not exceed revenue estimates.

The counter-cyclical demand impulse was effective and succeeded in sustaining domestic demand to compensate for the rapid decline in export demand. The positive response of consumer spending to the Government measures sustained total consumption spending, which accounted for 59% of GDP. As a result, domestic demand was the main engine of growth in 2001. The contribution of government expenditure to domestic output was higher at 31% in 2001 compared with 27% in 2000. This expenditure supported investment activities so that the decline in capital formation was contained. Public sector expenditure, as a whole contributed 3.8 percentage points to real GDP growth in 2001. At the same time, public sector expenditure did not erode the gains made in strengthening the balance of payments position. In addition, the benefits of the stimulus programmes would also enhance long-term growth prospects for the Malaysian economy.

While fiscal expansion contributed to GDP growth, it did not exert pressure on domestic consumer prices and interest rates. High savings rate and excess liquidity made it possible for the bulk of the fiscal deficit to be financed through non-inflationary domestic sources in the form of Malaysian Government Securities (MGS). The large issuance of MGS was subscribed mainly by provident, pension and insurance funds. Apart from meeting financing requirements, the domestic borrowing programme was also aimed at providing a benchmark yield curve to facilitate the development of the domestic ringgit bond market. An auction calendar on the issue of government securities also continued to be announced to enhance transparency and assist investors in the formulation of their investment strategies. As there was sufficient liquidity in the banking system to meet the private sector financing needs, the Government requirements did not result in any crowding out effects. In essence, this favourable situation resulted in new issues of MGS being raised at lower coupon rates in line with declining interest rates during the course of 2001.

In 2001, taking advantage of the favourable market conditions and improved overall yields, the Government also tapped external borrowings through the international capital and debt markets. During the year, two new market loans were raised to maintain regular market presence and to provide a benchmark for Malaysian corporations. Meanwhile, no new loans were raised from the bilateral and multilateral sources. The Government continued to draw down from loans committed earlier from both bilateral sources, especially under the New Miyazawa Initiative as well as from multilateral sources.

The higher borrowing raised the Federal Government debt to RM145.7 billion or 43.8% of GDP as at end-2001. At this level, the debt remained low and sustainable. Interest cost accounted for only 15% of operating expenditure in 2001. More importantly, 83% of the total government debt was domestic debt and denominated in ringgit. Hence, the domestic debt will not have exposure to exchange rate risks. As part of a prudent debt policy, the Government will continue to ensure prudence in its recourse to external borrowing to maintain its low external debt level.

Consolidated Public Sector

In 2001, the financial position of the consolidated public sector continued to record a large surplus in the current account. This was due to better revenue

Table 2.7
Consolidated Public Sector Finance

	2000	2001*e*	2002*f*
	RM million		
General government[1]			
Revenue	76,002	92,937	87,692
Operating expenditure	64,445	72,295	74,437
Current surplus of general government	11,556	20,642	13,255
Current surplus of NFPEs [2]	41,204	31,303	33,493
Public sector current surplus	**52,760**	**51,945**	**46,748**
% of GDP	**15.5**	**15.6**	**13.3**
Net development expenditure	50,438	68,161	57,766
General government	*27,078*	*33,934*	*30,028*
NFPEs	*23,360*	*34,227*	*27,737*
Overall balance	**2,322**	**–16,215**	**–11,018**
% of GDP	**0.7**	**–4.9**	**–3.1**

[1] Comprises Federal Government, state governments, statutory bodies and local governments.
[2] Refers to 37 NFPEs.
e Estimate
f Forecast

Source: Ministry of Finance, state governments and non-financial public enterprises performance of the general government. Nevertheless, the significantly higher development expenditure of both the Federal Government and the non-financial public enterprises (NFPEs) to stimulate economic activities, led to an overall deficit of 4.9% of GDP.

Federal Government Finance

The continued weakness in the external environment and its adverse impact on the domestic economy prompted the Government to pursue a more aggressive fiscal stimulus programme. Notwithstanding the additional allocations arising largely from the implementation of two fiscal stimulus packages, the Federal Government recorded a lower fiscal deficit of RM18.4 billion or -5.5% of GDP in 2001. This was significantly lower than the earlier estimated deficit of RM22.4 billion or -6.5% of GDP due mainly to higher revenue.

In 2001, Federal Government **revenue** registered a significant increase of 28.6% or RM17.7 billion to RM79.6 billion or 23.9% of GDP. The better-than-expected revenue collection was attributable largely to improved procedures for income tax collection as well as higher dividend payments from public enterprises. In aggregate, the increase in revenue emanated from all three broad categories of revenue, especially direct taxes.

The higher **tax collection** was attributed to the continued increase in economic activities, collection of delayed payments for taxes for the assessment year 2000 as well as high oil prices in the previous year. It also reflected the success of the widening of the tax base and concerted efforts to strengthen efficiency in tax collection. In particular, tax compliance was enhanced further through creating public awareness in paying taxes and duties as well as ensuring stricter enforcement to reduce tax evasion. Consequently, the ratio of tax receipts to GDP increased to 18.5% from 13.8% in 2000. This was close to the pre-crisis level in 1997.

Of significance, collection from income tax increased sharply, thus increasing its share to one-half of total revenue (44% a year ago). This development

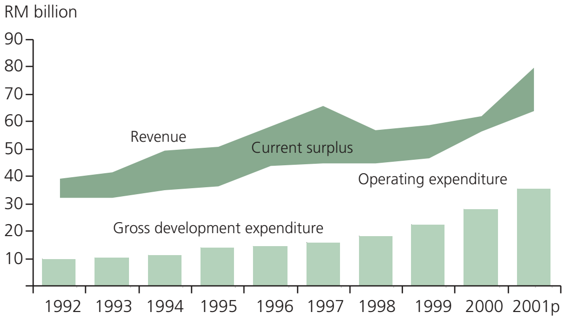
Table 2.8
Federal Government Finance

	2000	2001*p*	2002 Budget
	RM million		
Revenue	61,864	79,567	
Operating expenditure	56,547	63,757	65,342
Current account	**5,317**	**15,810**	**7,825**
% of GDP	**1.6**	**4.8**	**2.1**
Net development expenditure	25,032	34,232	26,689
Gross development expenditure	*27,941*	*35,235*	*28,382*
Less Loan recoveries	*2,909*	*1,003*	*1,700*
Overall balance	**–19,715**	**–18,422**	**–18,857**
% of GDP	**–5.8**	**–5.5**	**–5.1**
Sources of financing			
Net domestic borrowing	12,714	13,381	–
Gross borrowing	*23,182*	*23,500*	–
Less Repayment	*10,468*	*10,119*	–
Net foreign borrowing	864	6,295	–
Gross borrowing	*4,767*	*7,030*	–
Less Repayment	*3,903*	*735*	–
Special receipts	13	6	–
Realisable assets[1] and adjustments	6,123	–1,259	–
Total	**19,715**	**18,422**	**–**

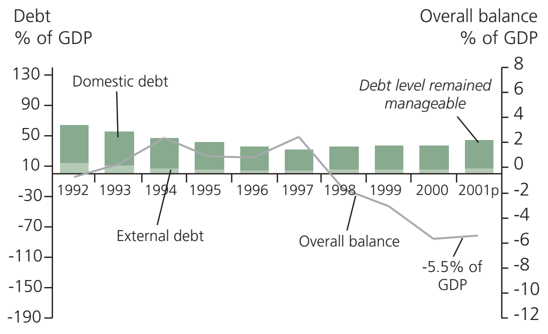
[1] Includes changes in Government's Trust Fund balances. An increase in the accumulated realisable assets is indicated by a negative (–) sign.
[2] Includes a net revenue loss of RM234 million arising from the tax changes for 2002.

p Preliminary
Source: Ministry of Finance

Graph 2.14
Federal Government Finance



Federal Government Debt



reflected the significantly higher petroleum oil prices in 2000 (tax base year for 2001) as well as better performance of the corporate sector, with fewer losses being carried forward from previous year to offset current year profits. In addition, a portion of corporate tax payable in 2000 was collected in 2001 as instalment payment was allowed during the transition period, following the introduction of the current year assessment system in 2000. Collection from individual income tax was also significantly higher, notwithstanding the provision of higher rebates announced in the 2001 Budget to individuals to encourage consumption. The rebate for individuals was increased from RM110 to RM350 and from RM60 to RM350 for wives.

The strong sales of motor vehicles led to higher receipts of excise duties and sales tax. Sales tax collection was also boosted by the increase in sales tax rates on cigarettes and tobacco products and alcoholic beverages. Receipts of service tax were also higher due largely to higher collection from professional services and widened coverage of service tax to all telecommunication services (except the internet), golfing and golf driving range facilities, public houses selling liquor and forwarding agents. Nevertheless, the increase in service tax revenue was moderated to some extent by the abolishment of the RM50 service tax on each credit card, implemented as part of the fiscal stimulus measures to encourage consumption.

Other major components of **indirect taxes**, however, recorded declines in collection. Lower receipts of import duties were seen in all categories of goods especially motor vehicles, tobacco and cigarettes as well as machinery and spare parts. The decline of the latter reflected the tax exemptions on selected machines and spare parts provided in the 2001 Budget to enhance the efficiency and competitiveness of the economy. Receipts of export duties were also lower, attributable to both the decline in export volume and oil prices during the year.

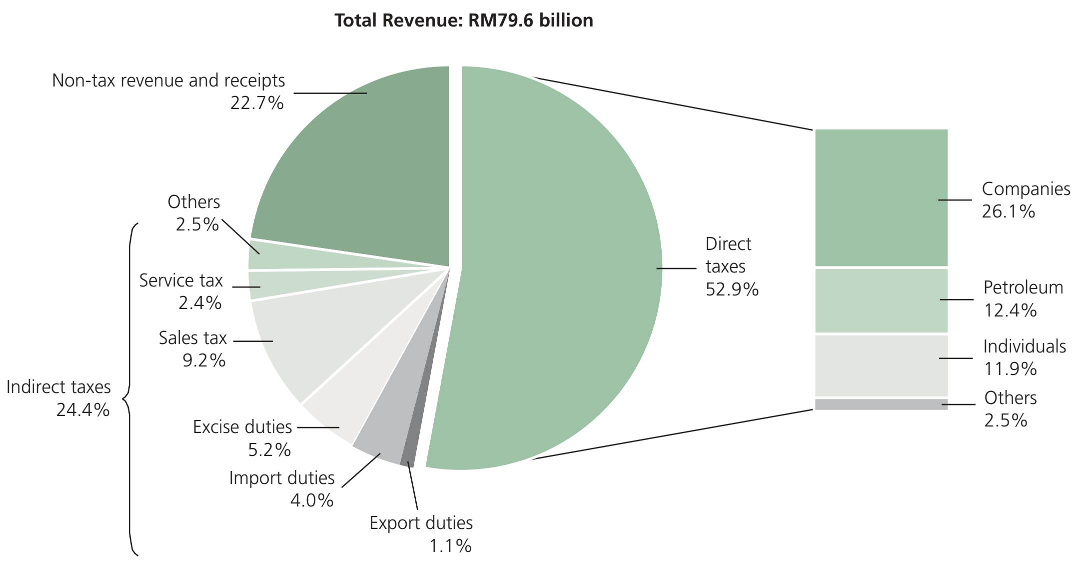
Table 2.9
Federal Government Revenue

	2000	2001*p*	2000	2001*p*
	RM million		Annual Change (%)	
Tax revenue	**47,173**	**61,492**	**4.0**	**30.4**
% of GDP	**13.8**	**18.5**		
Direct taxes	29,156	42,097	7.0	44.4
Income taxes	27,016	40,135	7.4	48.6
Companies	*13,905*	*20,770*	*-11.7*	*49.4*
Petroleum	*6,010*	*9,858*	*110.4*	*64.0*
Individuals	*7,015*	*9,436*	*9.3*	*34.5*
Co-operatives	*87*	*70*	*-39.0*	*-19.2*
Real property gains tax	247	227	-13.9	-8.3
Stamp duties	1,799	1,650	14.9	-8.3
Others	94	85	-59.8	-9.4
Indirect taxes	18,017	19,395	-0.5	7.6
Export duties	1,032	867	53.9	-16.0
Import duties	3,599	3,193	-23.8	-11.3
Excise duties	3,803	4,130	-19.5	8.6
Sales tax	5,968	7,356	33.0	23.3
Service tax	1,701	1,927	16.6	13.3
Others	1,914	1,922	-6.2	0.4
Non-tax revenue and receipts	**14,691**	**18,075**	**10.2**	**23.0**
Total revenue	**61,864**	**79,567**	**5.4**	**28.6**
% of GDP	**18.2**	**23.9**		

p Preliminary

Source: Ministry of Finance

Graph 2.15
Composition of Federal Government Revenue, 2001 (% share)



Overall, tax revenue increased by 30%, leading to a slight increase of its share to 77% of the total revenue. Accordingly, the share of non-tax revenue accounted for 23% with higher receipts from payments of dividend especially from PETRONAS and petroleum royalties.

Total Federal Government expenditure increased by 17.2% to RM99 billion in 2001 due to a stronger expansionary budgetary operation. The additional stimulus packages were effected during the year in March (RM3 billion) and in September (RM4.3 billion). Apart from higher expenditure, the Government stepped up efforts to improve policy implementation, particularly to eliminate bureaucratic delays and accelerate disbursements. The Government also reviewed the procedures, rules and guidelines on the implementation of development projects and payments to contractors (see Box for details). The objective was to ensure that the fiscal stimulus had the intended impact on the economy as well as to improve the delivery of public goods and services. As a result of these measures, the Government's gross expenditure shortfall in 2001 was small, at less than 5%.

In tandem with available resources, **operating expenditure** was raised by 12.8%, mainly to stimulate public and private sector consumption to increase domestic demand. During the year, the total wage bill, the largest component of operating expenditure (27%), increased by 6.6%. The increase in wage bill reflected the increased allowances, particularly for the police and armed forces personnel as well as nurses, doctors and headmasters. The payment for pensions and gratuities was also higher

Measures Undertaken by the Government to Improve Project Implementation

To eliminate bureaucratic delays:

- A task force was established in the Ministry of Finance to monitor the progress as well as identify and address implementation problems to ensure that all measures under the fiscal stimulus programmes are implemented efficiently.
- Established a "Flying Squad" to ensure that the implementation of public and privatised projects proceed as scheduled.
- To ensure that development projects are implemented as scheduled, all implementing agencies are required to submit monthly progress reports to the highest authority.
- For ministries that do not fully utilise their allocations, such allocations would be withdrawn and reallocated to other ministries.

To expedite the implementation of projects:

- Ministries and agencies have been empowered with greater delegated authority in approving tenders.
- To reduce processes, the Government appointed project management consultants (PMCs) to supervise public sector projects and awarded projects based on turnkey and design-and-build basis.
- To facilitate early project start-ups, all contractors implementing government projects were given advance payments of 15%, while for those implementing small projects under the pre-emptive package, advance payments of up to 75% were allowed.

To speed up payments:

- Specific procedures were put in place to expedite payments. In particular, projects undertaken through PMCs were allowed to submit claims for payment directly to the Accountant General's office.

Table 2.10
Federal Government Operating Expenditure by Object

	2000	2001*p*	2000	2001*p*
	RM million		% share	
Emoluments	16,357	17,443	28.9	27.4
Supplies and services	7,360	10,704	13.0	16.8
Asset acquisition	572	1,339	1.0	2.1
Debt service charges	9,055	9,634	16.0	15.1
Pensions and gratuities	4,187	4,711	7.4	7.4
Subsidies	4,824	4,450	8.5	7.0
Other grants and transfers[1]	11,757	13,626	20.8	21.5
Other expenditure[2]	2,435	1,851	4.3	2.9
Total	**56,547**	**63,757**	**100.0**	**100.0**
% of GDP	**16.6**	**19.2**		

[1] Includes grants and transfers to state governments as well as public agencies and enterprises.
[2] Includes grants to international organisations, insurance claims & gratuities and others.
p Preliminary

Source: Ministry of Finance

Table 2.11
Federal Government Development Expenditure by Sector

	2000	2001*p*	2000	2001*p*
	RM million		% share	
Defence and security	2,332	3,287	8.3	9.3
Economic services	11,639	12,724	41.7	36.1
Agriculture and rural development	1,183	1,394	4.2	4.0
Trade and industry	3,667	4,829	13.1	13.7
Transport	4,863	5,042	17.4	14.3
Public utilities	1,517	1,092	5.4	3.1
Others	409	367	1.5	1.0
Social services	11,076	15,385	39.6	43.7
Education	7,099	10,363	25.4	29.4
Health	1,272	1,570	4.6	4.5
Housing	1,194	1,269	4.3	3.6
Others	1,511	2,182	5.4	6.2
General administration	2,894	3,839	10.4	10.9
Total	**27,941**	**35,235**	**100.0**	**100.0**
% of GDP	**8.2**	**10.6**		

p Preliminary

Source: Ministry of Finance

reflecting the higher annual contribution to the Pensions Trust Fund (RM929 million in 2001; RM637 million in 2000) as well as the special payments of RM200 each to pensioners.

Disbursement on supplies and services was significantly higher, mainly for the procurement of office supplies related to e-government flagship applications, repairs and maintenance as well as payments for professional services associated with the Government's initiative to upgrade the quality and efficiency of public services. Domestic debt servicing was higher, reflecting the increased debt level to finance the fiscal stimulus programme. Meanwhile, lower global interest rates contained the servicing of external debt. The share of debt servicing was slightly smaller at 15% of operating expenditure. Expenditure for subsidies was also lower. This reflected the reduced quantum of subsidy payments following two recent price increases for petroleum products and lower oil prices.

Implementation of stronger fiscal impulse during the year led to the sharply higher **development expenditure** (26.1%). Significantly higher expenditure was spent on the social services sector, notably for education and training. The social services sector continued to account for the largest component of the total development spending (44%), reflecting the Government's concerted effort to promote skills development in order to develop a knowledge-based economy. The expenditure was mainly for upgrading of educational facilities, curriculum development, construction of single session schools and building of new community colleges and universities. Priority was also placed on the construction of computer laboratories to narrow the digital divide between the urban and rural areas.

Outlays on health were also higher to ensure better health care and support the increasing demand for public health services. This included the construction and upgrading of hospitals and health clinics. Similarly, the large expenditure on housing was mainly for low-cost public housing projects for the poor as well as housing programmes for the armed forces, police personnel, and teachers in rural areas.

In the economic services sector, emphasis continued to be placed on infrastructure, industrial as well as agriculture and rural development. Expenditure on transport absorbed a sizeable share of the development expenditure reflecting the Government's efforts to increase activities as well as to provide a more efficient and integrated national transportation network. The bulk of the expenditure was for the construction and upgrading of roads (including highways) as well as the development of the rail system, including the dual track from Rawang to Ipoh.

Under the trade and industry sub-sector, the bulk of expenditure was for the development of small- and medium-scale industries, industrial research and development, promotion of tourism and Bumiputera

Commercial and Business Community. Additional expenditure was also incurred in the Government's acquisition of the national airline as part of the corporate restructuring exercise. During the year, the Government also intensified its efforts to increase the income of the poor and enhance rural accessibility to public utilities and amenities. Thus, expenditure for agriculture and rural development (including land development and drainage) as well as investment to improve rural roads, water supply and electrification programmes was higher.

Given the increasing sophistication and challenges faced in combating crimes and ensuring national security, outlays on defence and internal security were higher during the year. Expenditure for general administration was also higher, largely for the construction and maintenance of the new administrative centre at Putrajaya; and the establishment of the ICT infrastructure to support e-government application and computerisation to enhance the efficiency and effectiveness of the Government administrative machinery.

The availability of adequate domestic resources to fund the Federal Government **financing** requirements facilitated fiscal expansion. The bulk of the development expenditure was financed domestically. The issuance of government securities was effected without crowding out private sector's access to financing. In addition, the large issuance continued to facilitate the development of the bond market through regular benchmark issues. Moreover, with the prevailing low domestic interest rate environment, raising funds domestically represented a lower source of financing, and as a result, no unnecessary burden was placed on future Government expenditure. The Government also tapped the international market for continued market presence and established a benchmark for the corporate sector. Recourse to external borrowings, nevertheless, would be prudent in order to maintain the low external debt position.

Overall, the Federal Government recorded a larger **total net borrowing** of RM19.7 billion in 2001. This led the Federal Government outstanding debt to expand by 16% to RM145.7 billion or 43.8% of GDP as at end-2001. This level of debt remained manageable with low debt service charges (15% of the total operating expenditure) and low external debt service ratio (0.5%). While the domestic debt accounted for 83% of total debt, the external debt of the Federal Government accounted for 14% of the nation's external debt.

Net domestic borrowing totalled RM13.4 billion in 2001. The domestic borrowing was financed largely from non-inflationary domestic sources. During the year, the Federal Government floated four issues of Malaysian Government Securities (MGS) totalling RM21.5 billion mainly by way of open tender through the principal dealers. The Government reopened three existing MGS issues to increase their respective issue size and enhance liquidity in the secondary market to further develop the bond market. Meanwhile, on a net basis, there were no new funds raised through Government Investment Issues (GII) and Treasury bills (TB). The Treasury Housing Loans Fund, however, recorded a higher net borrowing of RM1 billion to meet the increased funding requirements following the relaxation of housing loan eligibility in the Budget 2001. The eligibility for housing loans was increased from

Graph 2.16
Federal Government Outstanding Debt as at end–2001*p*

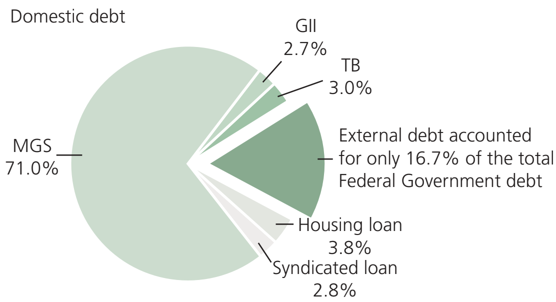


Table 2.12
Federal Government Outstanding Debt

	Annual change 2000	Annual change 2001*p*	At end 2001*p*
	Nominal value in RM million		
Domestic debt	**13,055**	**14,592**	**121,396**
Treasury bills	0	0	4,320
Government Investment Issues	2,000	0	4,000
Malaysian Government Securities	10,714	14,400	103,450
Treasury Housing Loans Fund	341	1,259	5,555
Market loans	0	-1,067	4,071
External debt	**451**	**5,508**	**24,328**
Market loans	965	5,642	17,682
Project loans	-514	-134	6,646
Total	**13,506**	**20,100**	**145,724**
% of GDP			**43.8**

p Preliminary

Source: Ministry of Finance

Table 2.13
Holdings of Federal Government Domestic Debt

	2000	2001*p*	2000	2001*p*
	Nominal value in RM million		% share	
Treasury bills	**4,320**	**4,320**	**100.0**	**100.0**
Insurance companies	76	160	1.8	3.7
Banking sector	4,166	4,014	96.4	92.9
Other	78	146	1.8	3.4
Government Investment Issues	**4,000**	**4,000**	**100.0**	**100.0**
Insurance companies	194	195	4.8	5.0
Banking sector	3,805	3,805	95.1	95.1
Others	1	0	…	0
Malaysian Government Securities	**89,050**	**103,450**	**100.0**	**100.0**
Social security and insurance institutions	71,232	79,154	80.0	76.5
of which:				
Employees Provident Fund	*61,476*	*67,468*	*69.0*	*65.2*
Insurance companies	*6,652*	*8,566*	*7.5*	*8.3*
Banking sector	12,458	18,594	14.0	18.0
Other	5,360	5,702	6.0	5.5

p Preliminary

Table 2.14
Consolidated State Government Finance

	2000	2001*e*	2002 Budget
	RM million		
Revenue	10,314	9,226	9,566
State sources	*8,118*	*7,127*	*7,470*
Federal grants and transfers	*2,196*	*2,099*	*2,096*
Expenditure	5,254	5,874	5,905
Current surplus	**5,059**	**3,351**	**3,661**
% of GDP	**1.5**	**1.0**	**1.0**
Net Development expenditure	5,082	5,673	5,565
Gross development expenditure	*5,348*	*5,878*	*5,757*
Less: Loan recoveries	*266*	*205*	*192*
Overall balance	**–23**	**–2,322**	**–1,904**
% of GDP	**0.0**	**-0.7**	**-0.5**
Sources of financing			
Federal loans	452	592	501
Realisable assets[1]	-430	1,730	1,403
Total	**23**	**2,322**	**1,904**

[1] A positive (+) sign indicated a draw down in the accumulated realisable assets.
e Estimate

Source: State governments

between RM35,000 and RM200,000 to between RM40,000 and RM300,000.

Following the large net borrowings of MGS, the outstanding debt of the MGS rose to RM103.5 billion as at end-2001. It accounted for 85% of the total domestic debt outstanding. In terms of the ownership structure of MGS, the largest holders were mainly the provident, pension and insurance funds. The banking sector raised its holding in 2001.

Gross external borrowings amounted to RM7 billion, reflecting largely the raising of two new loans during the year. Taking advantage of the favourable market conditions and improved overall yields, in July 2001, the Federal Government raised a US$1 billion (RM3.8 billion) global bond due 2011 at a coupon rate of 7.5%. The bond raised was three times over-subscribed and was priced at 228 basis points above the 10-year US Treasuries which reflected foreign investors' confidence in Malaysia's strong fundamentals and its low external debt position. A syndicated loan was also raised in December amounting to US$540 million (RM2.1 billion). The 7-year loan was raised at an attractive interest rate of US$ LIBOR plus 56 basis points, reflecting the high creditworthiness of the Government and confidence in the Malaysian economy. The Government also drew down on loans from both bilateral sources, especially under the New Miyazawa Initiative, and multilateral sources (World Bank, Islamic Development Bank and Asian Development Bank).

State Governments

Based on preliminary estimates, all 13 state governments registered surpluses in their current accounts. The consolidated state governments financial position, however, recorded a smaller current account surplus due to lower revenue receipts from state sources amidst higher operating expenditure. As development expenditure was also higher, the consolidated financial position of the state governments recorded a small overall deficit of 0.7% of GDP in 2001. The overall deficit was financed largely by Federal Government loans and drawdown of accumulated financial assets of the state governments.

During the year, the lower commodity prices including crude petroleum, crude palm oil and saw log had an adverse impact on the states' own sources of revenue. Meanwhile, receipts from Federal sources were sustained to assist the states in providing infrastructure and essential amenities to improve the quality of life and to support the increasing urbanisation in the states. The increased operating expenditure of the state governments reflected largely higher emoluments. A major share of the increased development expenditure was directed to agriculture and rural sector, public utilities, as well as expansion and upgrading of infrastructure.

Non-Financial Public Enterprises (NFPEs)
Preliminary estimates of the consolidated financial position of the 37 non-financial public enterprises (NFPEs) indicated that the overall financial position of the NFPEs as a group recorded a small surplus of RM1.6 billion or 0.5% of GDP in 2001. The small surplus was due to both lower revenue receipts and higher expenditure. The higher development spending of NFPEs was mainly used for quality improvement, capacity expansion and productivity enhancement to ensure efficiency and adequate supply of goods and services.

The consolidated revenue of NFPEs declined by 6.7% to RM107.7 billion. The lower oil prices during the year contributed to the decline in revenue collection. Excluding receipts from oil and gas-related sector, NFPEs revenue recorded a positive growth of 6.5%. This growth was largely attributable to the higher demand for telecommunications and energy services as well as synergy derived from diversification into new business areas. To a lesser extent, extraordinary gains from sales of assets also contributed to the increase in revenue. Meanwhile, the increase in operating expenditure (0.2%) was marginal reflecting largely the efforts to reduce cost as part of prudent financial management. Several public enterprises also implemented organisational restructuring of their business operations through wholly owned subsidiaries of the core business. The objectives were to increase operational efficiency, transparency, accountability and performance to strengthen business earnings.

Table 2.15
Consolidated NFPEs Finance[1]

	1999	2000	2001*e*
	RM million		
Revenue	100,331	115,419	107,689
Expenditure	61,596	71,725	71,898
Current account	**38,735**	**43,694**	**35,790**
% of GDP	**12.9**	**12.8**	**10.8**
Development expenditure	25,458	23,360	34,227
Overall balance	**13,276**	**20,334**	**1,563**
% of GDP	**4.4**	**6.0**	**0.5**

[1] Refers to 37 NFPEs
e Estimate

Source: Ministry of Finance and non-financial public enterprises

Development expenditure was significantly higher at RM34.2 billion (+46.5%), accounting for slightly more than one-half of total public sector development expenditure. All major public enterprises registered increases in development spending. The higher capital spending was for capacity expansion and modernisation programmes. The NFPEs also invested abroad to strengthen their business earnings. In 2001, Petroleum Nasional Bhd. (PETRONAS) continued its domestic and international investments in both upstream and downstream activities. Major projects included the construction of the Malaysia Liquefied Natural Gas Tiga (MLNG 3) and the integrated petrochemical complexes in Kertih and Gebeng. They also included LNG tanker fleet expansion by the Malaysia International Shipping Corporation to accommodate the increase in future exports of LNG. Meanwhile, international projects undertaken by PETRONAS included the exploration and production projects in Indonesia, Vietnam, Niger, Cameroon, Chad, Egypt, Sudan, Turkmenistan and Iran.

A large portion of the capital expenditure of Tenaga Nasional Bhd. (TNB) was channelled towards the expansion and upgrading of power generation, transmission and distribution networks to ensure adequate, reliable supply of electricity. Major projects included the redevelopment of the Tuanku Jaafar Power Station (Phase I and II), Janamanjung coal-fired power plant, Kenyir Hydroelectric project (Phase II), Pasir Gudang Fast Track Plant-up project and the Gelugor combined cycle conversion project. In the case of Telekom Malaysia Bhd. (TMB), expenditure was largely channelled towards capacity building in communications technology. TMB focused on upgrading and expanding the fixed line and mobile network operations, internet service and multimedia activities. The capital outlays by Putrajaya Holdings Sdn. Bhd. were mainly for the new administrative centre in Putrajaya.

The capital outlays of the NFPEs were mainly financed by internally generated funds and domestic borrowings. In 2001, a total of RM7.4 billion was raised from the private debt securities market mainly by enterprises involved in the power, construction and manufacturing sectors. Net external borrowings by public enterprises amounted to RM0.9 billion in 2001. Public enterprises were active in debt management with repayments of higher cost external loans being made to reduce the debt-servicing burden.

Consequently, total outstanding external debt of the public enterprises remained manageable at RM66.5 billion or 20% of GDP to account for 39% of the nation's external debt. Debt servicing remained low with debt service ratio (ratio of debt servicing to exports of goods and services) at 2.9%. Most of the loans were utilised to fund productive investment, including overseas investments of a strategic nature that would strengthen the future income stream of the NFPEs. Investment activities and borrowings of the NFPEs were closely monitored to ensure they would not create risks to the overall economy.

In 2001, the Government continued to pursue its privatisation policy, while strengthening further the regulatory framework for provision of services to the general public. During the year, 11 new privatised projects were approved, mainly in infrastructure and land development. The privatisation was mostly in the form of build-operate-transfer, leasing of assets, land swap and management contracts. The projects included the construction of hostels in Universiti Malaysia Sabah and Universiti Kebangsaan Malaysia.

Outlook and Policy

Outlook and Policy

WORLD ECONOMIC OUTLOOK

Developments in 2001 and Early 2002

The global economic slowdown that began in late 2000 became more severe than anticipated in 2001. The events following September 11 created further downside risk to an early recovery. In the second half (2H) of 2001, **overall growth in the major economic blocs** declined by 0.5% from a modest growth in the first half of the year (1.5%). Falling confidence amidst disruption in activity after September 11, especially in the United States (US), had adversely affected world growth, which was also reflected in declining global trade. **World growth** halved to 2.4% in 2001, while world trade growth decelerated from a double-digit growth to only 1% in 2001. Growth in the **major industrial countries** as a group weakened to 1.1%.

In early 2001, it was envisaged that only countries with strong trade and investment links with the US, namely Canada, Asia Pacific and Latin America would be affected, while Europe would be fairly insulated. As the year progressed, developments in the US, through more integrated capital markets, resulted in adverse effects becoming more pervasive in all regions.

Table 3.1
World Economy: Key Economic Indicators

	Real GDP growth (%)			Inflation (%)		
	2000	2001e	2002*f*	2000	2001e	2002*f*
World growth	**4.7**	**2.4**	**2.6**	-	-	-
World trade	**12.4**	**1.0**	**2.0~2.5**	-	-	-
Major industrial countries	**3.5**	**1.1**	**1.1**	**2.3**	**2.1**	**1.2**
United States	4.1	1.2	1.4	3.4	2.8	1.6
Japan	2.2	-0.5	-0.5	-0.8	-0.7	-1.0
Euro area	3.4	1.6	1.3	2.3	2.6	1.8
United Kingdom[1]	3.0	2.4	2.0	2.1	2.1	2.4
East Asia	**7.6**	**3.7**	**4.6~4.8**	**1.1**	**2.4**	**2.2~2.3**
Asian NIEs	**8.3**	**0.6**	**2.7~2.9**	**0.8**	**1.1**	**0.8~0.9**
Korea	8.8	3.0*f*	3.9	2.3	4.3	3.0
Taiwan	5.9	-1.9	2.3	1.3	0.0	0.7
Singapore	10.3	-2.0	1.0~3.0	1.3	1.0	-1.0~0.0
Hong Kong SAR[2]	10.5	0.1	1.0	-3.8	-1.6	0.0
People's Republic of China	**8.0**	**7.3**	**7.0**	**0.4**	**0.8**	**1.0**
ASEAN[3]	**6.4**	**1.5**	**2.8~3.6**	**2.9**	**5.9**	**5.0~5.5**
Malaysia	8.3	0.4	3.5	1.6	1.4	1.8
Thailand	4.4	1.5*f*	2.0~3.0	1.6	1.6	0.0~1.0
Indonesia	4.8	3.3	3.5~4.0	3.8	11.5	10.9
Philippines	4.0	3.4	4.0~4.5	4.4	6.1	5.0~6.0

[1] Inflation refers to Retail Price Index excluding mortgage interest.
[2] Inflation refers to composite price.
[3] Includes Singapore.
e Estimate
f Forecast

Source: International Monetary Fund, Datastream, OECD Economic Outlook, National sources

The weakness in the euro area was not caused only by lower external demand, but also the unexpectedly higher inflation arising from the lagged effects of higher oil prices which constrained policy flexibility. In the regional economies, besides the severity of the US slowdown, the deeper and prolonged downturn in the electronics sector had caused growth to slow down more significantly than earlier expectations. Growth in **East Asia** slowed down to 3.7% in 2001. In several countries (Taiwan and Singapore), growth turned negative. To a large extent, the slowdown in all regional economies was contained by stronger fiscal stimulus and easier monetary conditions. Only the People's Republic of China continued to expand at a strong pace of 7.3%, sustained by fiscal spending and strong private investment, mainly in the form of foreign direct investment.

Prompt policy response across the globe during the course of 2001 and immediately after September 11 contained the economic slowdown. In particular, co-ordinated monetary easing and additional fiscal measures by the major industrial countries aided confidence and were effective in sustaining consumer spending.

Concomitant with the weaker global economy, **labour market conditions** deteriorated in many countries as companies reduced their labour force as part of their corporate consolidation process. However, in Europe, the average unemployment rate declined during the year despite announcements of large layoffs by manufacturing companies. The improvement was due to easing of labour market rigidities in the euro area with the introduction of more flexible working conditions and the continued strength in the services sector in the United Kingdom (UK). Meanwhile, **inflationary pressures** were contained during the year against a backdrop of a sharp fall in energy prices, weakening global demand and abating wage pressures.

In 2001, the **US economy** slowed down rapidly as the corporate sector adjusted to the weaker demand.

Table 3.2
Changes in Monetary and Fiscal Measures Undertaken by the Various Countries since 2001

Country	Monetary Policy		Fiscal Stimulus
	Number of interest rate cuts	Changes in policy rate (%)	
United States	11	6.5 →1.75	Tax cuts and spending
Japan	2	0.25 → zero interest rate policy with quantitative easing	Spending
Euro area	4	4.75 →3.25	-
United Kingdom	7	6.0 → 4.0	Spending
People's Republic of China	1[1]	5.85 →5.31[1]	Spending
Korea	4	5.25 →4.0	Tax measures and spending
Taiwan	11	4.625 →2.125	Tax measures and spending
Singapore	-	-	Tax measures and spending
Hong Kong SAR	11	8.0 →3.25	Tax measures
Malaysia	1	5.5 →5.0	Tax and non-tax measures and spending
Thailand	2	Initially interest rate was increased followed by two rate cuts to 2.0%	Spending
Philippines	15	13.5 →7.25	-

[1] One-year lending rate on renminbi loans

Corporations consolidated as they reduced capital spending, drew down on their inventories as well as cut back on their workforce. Declines in capital spending was broad-based due to over-capacity, but was more pronounced in the technology sector.

Recent positive developments reinforce optimism for a gradual and modest global recovery in 2002.

However, consumer spending continued to be a source of support. Fourth quarter GDP data showed that the economy turned around to expand during the quarter due to strong demand, particularly for automobiles, spurred by aggressive price cuts and zero interest rate financing.

The **euro area** also weakened as its largest economy, Germany stagnated in the second half-year, reflecting broad-based weakness in both domestic demand and exports. The UK economy was less affected than the other major economies as it was supported by strong domestic demand, particularly consumption. Japan entered its third recession since the correction in the asset markets in the early 1990s, as falling exports compounded the deflation and structural problems in the economy, resulting in sluggish domestic demand.

However, towards year-end, fears of a deep recession in the US abated as markets looked ahead to a recovery. The liquidity impact from the aggressive monetary easing during the year and increased optimism following the early conclusion of the West Asian conflict contributed to the rise in stock markets. The wealth gain from the equity market in the fourth quarter of 2001 and early 2002 was estimated to be around US$1.5 trillion. The optimism was further reinforced by positive data released in December and early 2002 suggesting that the downturn in the US economy was beginning to level off. Markets have also perceived the steepening of the US long-term yields as indicative of an impending recovery.

Prospects for 2002

Going forward, the outlook for the global economy has improved, supported by positive developments in the US. There has also been improvement in other parts of the world. Sentiment indicators in Europe have shown a marked improvement, while in the region there have been further signs of stabilisation in economic activity, mainly a slower pace of decline in exports. Prospects are for the US to lead the recovery, thus supporting an upturn in the other regions, including the euro area and East Asia. However, Japan is expected to experience another year of contraction.

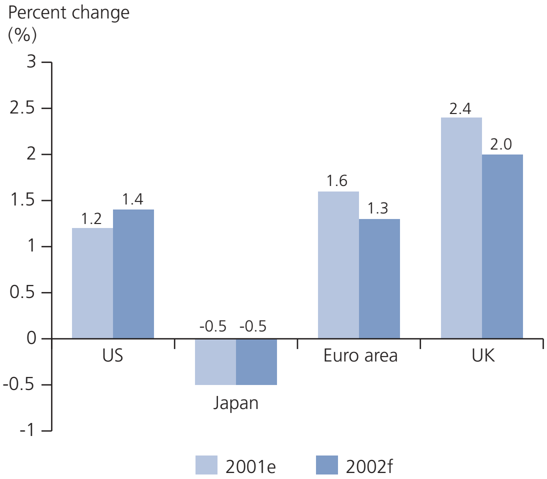
The world economy is expected to recover gradually in line with the slow and modest recovery in the US. Thus, **world growth** is expected to pick up slightly to 2.6%, while **world trade** is forecast to expand between 2% and 2.5%, in tandem with a gradual upturn in the electronics sector. Real output growth in the **major industrial countries** as a group is expected to stabilise at 1.1%, while growth in the **developing countries** is projected to pick up slightly to 4.5%. Growth in the East Asian economies is envisaged to be slightly higher at 4.6 - 4.8%, as impetus to growth is expected to emanate from stronger export demand in the second half of 2002.

Industrial Countries

The **United States** economy entered 2002 in a relatively better position as earlier fears of a recession abated. Consumer confidence and equity markets have rebounded and the fourth quarter 2001 GDP exceeded expectations. The US economy is now expected to recover gradually, gaining momentum from 1.6% in the first half-year to 2.8% in the second half-year. Growth, nevertheless, is expected to be gradual and modest, as investment recovery will lag considerably given the prevailing excess capacity. The recovery in employment will also lag the economic recovery due to ongoing consolidation by corporations as well as the slow recovery in investment. Under these circumstances, growth for 2002 as a whole is estimated at 1.4%.

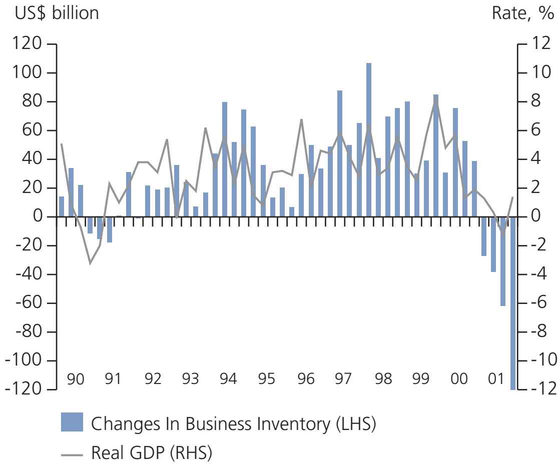
The recovery is premised on four factors. First, while the policies undertaken in 2001 have begun to filter through the economy, the monetary easing has a lag of 6 - 18 months before its full effects are felt on economic activity. The substantial easing of 475 basis points in 2001 is expected to provide a large impetus to growth during the course of 2002. The US$70 billion fiscal stimulus, comprising tax cuts and spending from the emergency package announced after September 11 for reconstruction and defence industries, is also expected to be felt in 2002. In addition, a new fiscal package worth US$51 billion, comprising unemployment benefits and business tax breaks should add further stimulus to growth in 2002. Second, the gradual shift from destocking to inventory accumulation is envisaged to add about 1 - 1.5 percentage points to GDP. Third, softer oil prices would support consumption. The consequent prospects of lower inflation would also allow greater flexibility for the authorities to focus on growth.

Graph 3.1
Major Industrial Countries: Real GDP Growth (2001-2002)



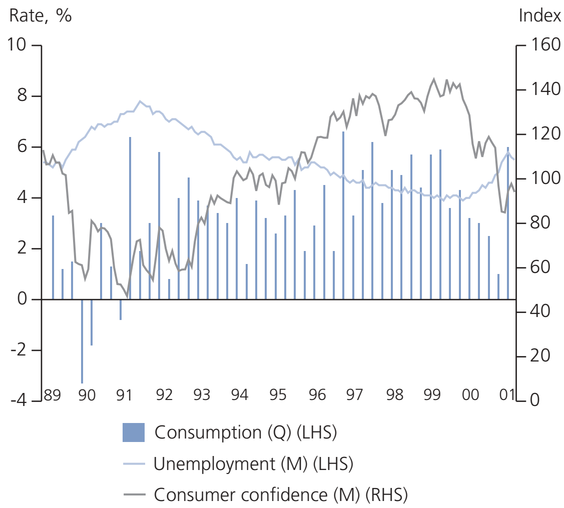
Graph 3.2
Real GDP and Changes in Business Inventory

In 2001, inventory liquidation eroded about 1.1 percentage points from overall GDP growth. A modest build-up of inventory is expected to add about 1 - 1.5 percentage points to GDP growth in 2002.



Graph 3.3
Consumption, Consumer Confidence and Unemployment

Consumption is more related to expectations and lesser to employment conditions. In the 1990s recession, consumption picked up two quarters before unemployment peaked. In the current cycle, unemployment is expected to peak in mid-2002.



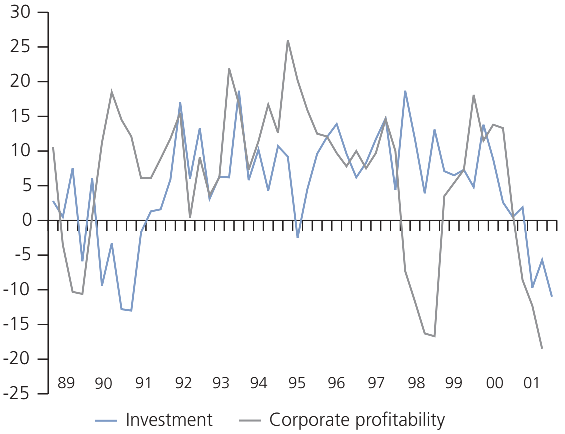
Finally, the resilience in productivity growth seen during the current downturn is expected to further support growth during the year.

Central to the forecast is that consumption growth would continue. While employment and income conditions may weaken in the next few months and restrain consumption to some extent, the positive impact from lower taxes, energy prices and interest rates are likely to cushion part of the impact on disposable income. At the same time, household balance sheets have remained relatively healthy (asset/liability ratio of 5:1), as the negative wealth effect in the past year was confined mainly to losses in equity wealth, while house prices have remained steady. The recent rise in consumer confidence further supports the view that consumption growth would be sustained during the year.

Meanwhile, the corporate sector is expected to continue its consolidation exercise affecting investment and employment prospects. Thus, both investment and employment are expected to lag the recovery cycle and pick up only after clear signs of improvement in corporate earnings and capacity utilisation. In the third quarter of 2001, capacity utilisation declined to the lowest level since 1983 (technology: 61.2, non-technology sector: 77.8). In view of the above, the upside to new investment is somewhat limited except for opportunities in some areas such as the auto industry (upgrading into new models) and the technological upgrading for IT hardware industries.

Graph 3.4
Investment and Corporate Profitability

Corporate profitability registered the largest decline in 10 years of 18.5% in the third quarter of 2001 and is expected to have reached its trough in the fourth quarter of 2001. Corporate profitability is only expected to recover gradually in the second half of 2002, implying that firms are likely to hold back investment plans until they see a stronger upturn in profitability.



Investment would also be supported by fiscal spending worth US$40 billion for the reconstruction and investment in biotechnology and defence industries.

The **euro area** is expected to expand at a slower pace of 1.3% in 2002, given that its recovery would be lagging the US upturn by one to two quarters. Inflationary pressures that had earlier affected domestic demand are expected to diminish progressively following the effects from lower energy prices. A pick-up in production during the second half-year amidst rising demand from the US and inventory accumulation should contribute to growth. Improved exports as well as the lower cost of borrowing (monetary easing of 150 basis points since 2001) are expected to spur investment. In particular, investment in the high-tech sector is also expected to perform better in the euro area during the next phase of growth since the extent of IT spending in the past had been lower than in the US. Given that the bulk of this impact is likely to be seen in late 2002 and 2003, growth is expected to be modest during the year.

In the **United Kingdom**, although growth is expected to moderate slightly to 2% in 2002, the economy would continue to outperform the other major industrial economies. The weakness in the manufacturing sector is expected to dissipate gradually following an upturn in IT-related production and a shift to inventory accumulation, while the strength in the services sector is expected to remain. Lagged impact from the monetary easing in 2001 (200 basis points), the impetus from the expansionary fiscal policy (2001-2003 cumulative spending worth 3% of GDP) and the positive wealth effect from a steady housing market are expected to sustain the underlying strength in consumer spending. These recovery forces are likely to reduce the impact from weaker household incomes and bonuses.

In **Japan**, growth prospects are expected to remain weak in 2002. Real GDP is projected to fall for the second consecutive year by 0.5%. Structural reforms in the financial and corporate sectors are expected to dampen growth prospects in the immediate term. Under these circumstances, employment prospects are likely to deteriorate amidst the deflationary forces. Although the reforms are viewed to contribute positively over the longer term, the short-term impact of the reforms could be fairly significant, especially on the banking system. The two supplementary budgets totalling ¥5.6 trillion as well as the accommodative monetary stance are expected to cushion part of the adverse impact. Growth prospects also remain sensitive to Japan's fiscal sustainability as well as adverse domestic and external developments, including volatility in the financial markets.

Inflation in the major industrial countries as a whole is expected to ease to 1.2% in 2002 due to softer oil prices and a gradual recovery in global demand, especially in the US and euro area. Japan would continue to face deflation in view of the excess capacity, weak demand, lower imported inflation and downward price pressures arising from deregulation and technological innovation. In contrast, inflation in the UK is expected to edge upwards in view of the strength in consumption.

Despite the optimism for a recovery in the US, the **main risk for the global economy is for a "double dip" recession**. The risk is that the US recovery may not be durable in the event that consumer spending, which is key to the recovery, does not hold up. While the corporate sector has taken the necessary adjustments, the household sector remains vulnerable due to the low savings rate (January 2002: 1.8%) and increased indebtedness (ratio of debt to disposable income of 105%). If labour market conditions deteriorate beyond current expectations, consumers may not be able to service their housing mortgages, which in turn could weaken the housing market. Weaker income and negative wealth effects would encourage consumers to become cautious and cut back on consumption and increase their savings.

Higher unemployment could be triggered by stress in the corporate sector resulting in further corporate consolidation. The corporate financing gap (the difference between capital expenditure and cash flows) has remained large, implying that firms would need continued financing from the capital market since banks have already tightened lending to the corporate sector. The recent failure of a large US corporation has made investors and regulators aware of the need to review current accounting standards to ensure better disclosure. Should closer scrutiny reveal more problems, corporations' credit ratings could deteriorate and lead to corrections in both the equity and bond markets, leading to further stress in the corporate sector.

Nevertheless, **structural improvements in the US** in the last decade resulted in lower inflation, high productivity growth and a deep and sophisticated financial system. These developments should help the country weather the current downturn. Events in the past year also showed that the prompt response by the authorities in respect to monetary and fiscal policies effectively shored up business and consumer confidence, thereby reducing the severity of the downturn.

The **other downside risk is a sharp and prolonged depreciation of the yen**. The vulnerability of the Japanese banking system could affect investor sentiment and increase the volatility and heighten the risk on the yen. If the yen depreciates to extremely weak levels for a sustained period, it could further escalate the problems in the Japanese banking system. Empirical evidence showed that there is a positive relationship between the yen and Japanese asset markets. Despite the fact that foreign investors' holdings of outstanding Japanese assets are relatively small, they account for a large share of the active trading, and thus enable to influence the market direction. A combination of a weaker yen, weak Japanese bond and equity markets can have an adverse impact on Japanese banks, given their large exposure to these markets. For the region, a weaker yen could have serious implications, and could be highly destabilising on regional currencies.

East Asian Economies

Against a backdrop of a mild US recovery and a modest rebound in the global electronics sector, the regional countries are envisaged to record an improved growth in 2002. **Growth for the region as a whole** is expected to improve to 4.6 - 4.8%, due mainly to relatively robust growth in the People's Republic of China. Growth in the other regional countries is expected to be more moderate, ranging from 1 - 4.5%. The region is envisaged to recover in the second half of the year as external demand gathers momentum. Given that most regional economies have a large tradable sector and are highly dependent on electronics exports, the acceleration in external demand would create a significant impetus to growth.

Latest available indicators suggest that the downturn in the **global electronics cycle** has bottomed out. The pace of contraction in semiconductor sales has eased and on a month-on-month basis has turned around to record positive growth for two months. In addition, orders received by global chipmakers have picked up, resulting in an improvement in the book-to-bill ratio, prices of selected product segments such as DRAMs have improved and some large companies have indicated a brighter outlook. Despite these positive developments, the upturn in global electronics demand is expected to be modest, Regional countries to recover, supported by expansionary policies and strengthening external demand. Stronger external positions and structural improvements have reduced vulnerability of countries to external shocks.

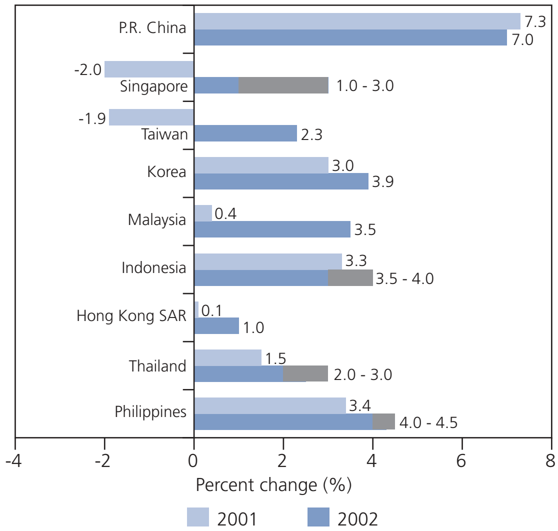
gradual and uneven as there is still significant excess capacity, especially in the communications and network product segments of the industry, amidst the overall weak investment climate. Regional countries producing personal computers and specialised in outsourcing activities are viewed to benefit the most in the latest electronics upcycle.

In the interim, as external demand gathers momentum, expansionary policies already in place are expected to play a key role to support domestic demand, and hence, growth in the first half of 2002. Against a mild inflation backdrop, monetary policy in the regional economies would remain accommodative to ensure sufficient liquidity to facilitate credit growth and stimulate economic activity. In line with the global trend, interest rates in the regional countries had been reduced significantly in 2001 and the cost of borrowing is currently at relatively low levels. In addition, the cumulative effects from the expansionary fiscal policies should also filter through the economies during the year.

In the event of further external shocks, the regional countries are also in a stronger position to absorb these shocks. Their external positions have strengthened. Countries have higher foreign exchange reserves and lower external debt with longer-term maturities. Current account surpluses, although narrowing somewhat, are expected to continue in 2002, which would act as an additional buffer to external shocks. The restructuring in the post-crisis period has also strengthened the financial sectors in the regional countries. Capital adequacy ratios have been raised in most countries to above 10% and their non-performing loan ratios are now lower than the post-crisis levels, due to active measures by asset management companies. Financial institutions in both the banking sector and capital markets in the region have also tightened their prudential measures to be in line with international standards.

In addition, there has been a structural change in the financing pattern in the region, away from banking system loans towards longer maturity and market-based instruments. These changes have helped to diversify the

Graph 3.5
Regional Countries: Real GDP Growth (%)



sources of financing in the region that will enhance the resilience against future shocks. In the longer term, the reforms in the financial and corporate sectors should contribute towards enhancing efficiency in production and capital allocation.

In 2002, the **Asian Newly Industrialised Economies (NIEs)** as a group is expected to expand at a stronger rate of 2.7 - 2.9% (2001: 0.6%), reflecting a mild recovery across all the countries on the back of firmer external demand. The forecast is premised on a modest recovery in the electronics sector, on which the NIEs are highly dependent. In **Korea**, growth is expected to rise to 3.9% in 2002, reflecting a pick-up in electronics exports as well as stronger domestic demand, supported by lower oil prices and the positive wealth effects from a rising stock market. Similarly, in **Taiwan**, real GDP is expected to recover to expand by 2.3% in 2002, in line with the expected recovery in the US, which absorbs about one-third of Taiwan's exports. Recovery in asset markets and receding political uncertainties are also expected to support consumer and business confidence.

The **Singapore** economy is projected to recover with a growth of 1-3%. Although growth may be affected by rising unemployment in the first half of the year, the recovery is expected to gather momentum towards the end of the year, following improving demand from the US and better consumer sentiment. In the **Hong Kong Special Administrative Region (SAR)**, growth is expected to pick up to 1% in 2002 but strengthening in domestic demand would be vital to support the recovery. Meanwhile, growth in the **People's Republic of China** is expected to stabilise around 7%, supported by strong domestic demand, increased fiscal spending and investment related to foreign direct investments, especially following its entry into the World Trade Organisation (WTO).

Meanwhile, growth for the **ASEAN** economies as a group is expected to pick up to 2.8 - 3.6% (2001: 1.5%), in view of relatively stable domestic demand in the member countries amidst strengthening exports. Growth in the **Philippines** is expected to rise to 4 - 4.5%, due to improvement in external demand, especially for electronics products, which form the bulk of the country's exports. Effects from the significant monetary easing by 625 basis points since January 2001 as well as improved confidence on the back of receding political uncertainty are likely to support domestic demand.

Growth in **Thailand** is projected to increase slightly by 2 - 3% in 2002 on account of the recovery in the US, its main export partner, and impact from fiscal stimulus measures. In the recent period, **Indonesia** has been less affected among the regional countries as it is a more domestically driven economy and its export sector is less dependent on technology products. Nevertheless, in 2002, Indonesia's real GDP growth is projected to remain moderate at around 3.5 - 4%. Softening oil prices and a weak investment climate are likely to affect the scope for higher growth in Indonesia during the year.

Inflation in the regional countries is expected to remain moderate, easing slightly to 2.2 - 2.3% in 2002, due to mild inflation in the People's Republic of China, ending of deflation in Hong Kong SAR and lower inflation in the other countries. For most countries, lower inflation is largely on account of lower oil prices and general weakness in private consumption, which limits the ability of producers to pass cost increases to consumers. Inflation in the **Asian NIEs** as a group is expected to ease to 0.8 - 0.9%. While inflation is expected to remain mild in Taiwan due to lower tariffs after its entry into the WTO, Singapore is expected to experience a mild deflation attributable to declining rentals, lower oil prices and sluggish demand amidst the high unemployment.

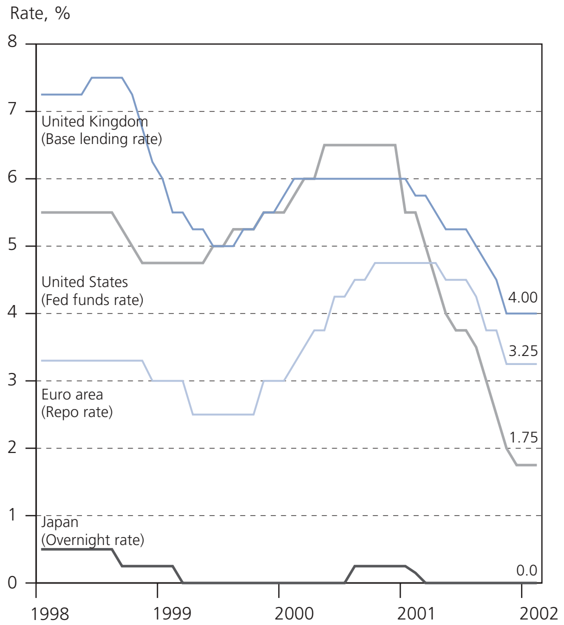
Similarly, inflation in the **ASEAN** countries as a group is expected to moderate slightly to 5 - 5.5%. In both Thailand and the Philippines, price pressures are expected to subside in view of lower oil prices, sluggish domestic demand and relatively stable food prices. In Indonesia, however, inflation is expected to remain relatively high due to the planned fuel and electricity price hikes.

Interest Rates and Exchange Rates

In 2001, **monetary policy** in the major industrial countries shifted towards easing, with the US Federal Reserve Board (Fed) taking the lead. The major industrial countries reduced interest rates aggressively during the year, especially in the US, to counter the sharp economic slowdown amidst a declining inflation trend, especially in the aftermath of September 11. Following September 11, the Fed and the other major central banks conducted co-ordinated interest rate cuts and undertook swap arrangements to minimise potential volatility in the global financial markets.

In the US, the **Fed** reduced the Federal funds rate by a cumulative 475 basis points in 11 steps, a reduction of 300 basis points prior to September 11 and another 175 basis points after September 11. This brought the Federal funds rate to 1.75%, its lowest level in 40 years. The **Bank of England** (BOE) eased its base lending rate (BLR) in seven steps by a

Graph 3.6
Major Industrial Countries: Official Interest Rates



cumulative 200 basis points to a 37-year low of 4% to insulate the economy from the global slowdown, amidst the declining trend of inflation.

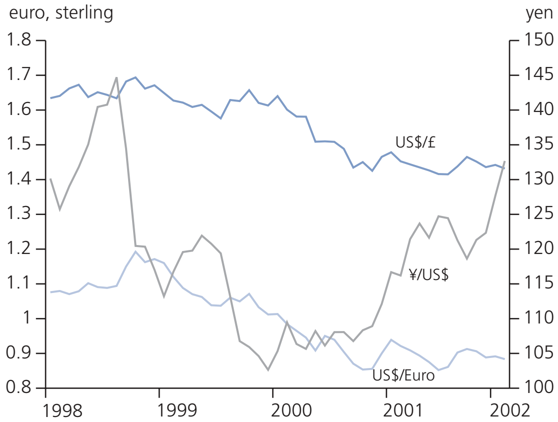
In view of concerns that inflation remained above the target rate of 2%, the **European Central Bank** (ECB) reduced interest rates after a considerable lag, commencing only in May 2001. The repo rate was brought down to 3.25% in four steps by a cumulative 150 basis points to mitigate the sharp slowdown in the euro area. In March, the **Bank of Japan** (BOJ) reverted to its zero interest rate policy to counter the deflation amidst the sharp weakness in its economy. Subsequently, the BOJ engaged in several quantitative easing measures to inject liquidity to the banking system in order to maintain financial stability.

In **early 2002**, except for Japan, monetary policy in the major industrial countries remained unchanged. On 28 February, the BOJ continued further quantitative easing by increasing its direct purchase of Japanese government bonds, while providing ample liquidity to meet market demand.

For the remaining part of 2002, expectations are for interest rates to stabilise given signs of improving economic data, as well as the already significant monetary stimulus that has been put in place to facilitate the recovery. Nonetheless, the central banks are likely to remain vigilant against signs of unexpected softening of economic activity that may require further easing. Equally important, the authorities are likely to assess the strength of the emerging recovery that may result in emerging inflationary pressures and consequently warrant pre-emptive policy responses. The possibility of a shift in the stance, in either direction, would, however, depend on a number of factors, including the strength of the recovery; developments in the IT sector; the movement in the major currencies; and the performance of the financial markets.

In the **foreign exchange** markets, the US dollar strengthened against all major currencies in 2001. The dollar appreciated by 15.2%, 5.9% and 2.8% against the yen, euro and pound sterling respectively. Although the dollar was briefly affected by September 11 due to shifts away from dollar assets to capital-exporting countries, the dollar regained its strength thereafter. Large foreign inflows into the bond market also underpinned the dollar during the year. The sentiment on the dollar was supported by market perception that the US recovery would be ahead of the other major economies.

Graph 3.7
Movement of the US Dollar against Major Currencies



The euro weakened in view of the growth prospects of the euro economies relative to the US. The pound sterling tracked the euro weakness as the currency was seen to be adjusting, taking into account the prospect of UK's entry into the euro area. The weakening of the yen, especially towards the end of the year, was triggered by perceived changes in the Japanese authorities' stance to tolerate a weaker yen.

In the **first two months of 2002**, the dollar remained firm against the major currencies as more positive data in the US reinforced expectations that the US recovery would lead the global upturn. The yen traded in the range of US$1= ¥130 - 135. However, in early March, the yen strengthened to below US$1= ¥130, following an increase in foreign interest in the Japanese stock market.

For the rest of 2002, the movement of the dollar against other major currencies would be influenced by a number of factors. These include investors' perception on the importance of growth differentials vis-à-vis interest rate differentials, performance of stock and bond markets as well as the movement of capital flows during the year. Country-specific issues that are structural and relating to the health of the financial system could also affect the sentiment on the major currencies.

MALAYSIAN ECONOMY IN 2002

The Malaysian economy is expected to strengthen in 2002 following a strengthening of external demand. Past trends show that there is a brief lag between the recovery in the major economies and recovery in Malaysian exports. As such, the timing and magnitude of the recovery would have a significant impact on the Malaysian economy. Current indications suggest that external demand will not pick up as strongly as in the 1999-2000 period, where recovery was mainly led by the internet-boom and the Y2K factor. The current economic upturn is taking place amidst global excess capacity, particularly in the technology sector. External demand is, therefore, expected to strengthen gradually. Against this background, the recovery in the Malaysian economy would be modest, with real GDP expanding by 3.5% in 2002.

front, aggressive policy measures to enhance the role of the services sector, particularly in the education, tourism and information, communication and technology sub-sectors, would benefit these sectors, which in turn could improve further the GDP growth.

Expansionary fiscal policy and accommodative monetary policy already in place are expected to sustain growth in domestic demand. Growth in **private consumption** is expected to pick up to 5% following the improved growth and employment

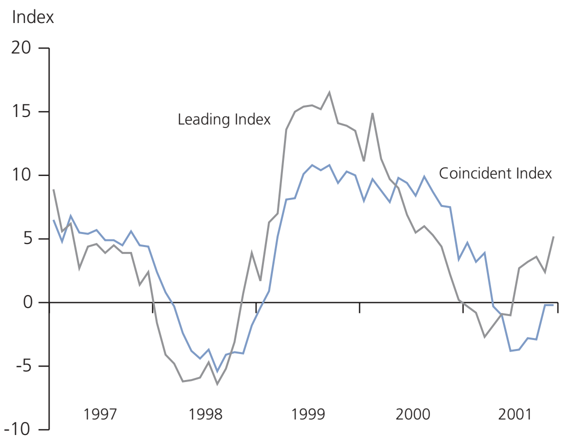
The Malaysian economy is well positioned to benefit from the expected recovery in the global economy.

outlook as well as the cumulative effects from the Government's measures that have raised disposable income. Additional measures announced by the Government in the 2002 Budget such as the 1-2 percentage points across-the-board reduction in individual income tax rates, raising the income threshold before the maximum income tax rate takes effect and an increase in civil servants' salaries should all further increase disposable income. Growth in private consumption is projected to be stronger in the second half-year when export demand gathers momentum.

At this juncture, latest indicators show signs of stabilisation in the Malaysian economy. The index of leading economic indicators compiled by the Department of Statistics, Malaysia, which provides early indications on the direction of economic growth, has already registered five consecutive months of positive growth since July 2001. This suggests that the Malaysian economy would turn around in the first quarter of 2002. Indications, however, are that growth would strengthen in the second half-year when external demand improves more significantly.

The growth projection for 2002 is based on stronger growth in private consumption, a modest recovery in private investment, sustained public sector expenditure and a moderate growth in exports. If the positive trend in the latest indicators for the US economy is sustained, the bias to the growth projection would be on the upside. On the domestic

Graph 3.8
Leading Index Pointed to a Recovery in 2002



Source: Departments of Statistics, Malaysia

Meanwhile, **private investment** is expected to recover in 2002, registering a positive growth of 1.2%. Investment in the manufacturing sector is expected to turn around only in the second half-year when recovery in the global economy becomes more entrenched. The impetus to private investment would, therefore, be coming mainly from continued investments in the ongoing privatised road projects, residential housing, rail projects, development works on ports and power plants as well as investment in the oil and gas sub-sector.

While the 2002 Budget announced a fiscal consolidation, the better-than-expected fiscal outturn in 2001 arising from stronger revenue collections would imply that the consolidation would be less pronounced (fiscal deficit of –5.1% of GDP in 2002 from –5.5% in 2001, compared to earlier estimate of –6.5% of GDP for 2001). **Public investment** spending is projected to decline by 3% after a strong increase of 15.5% in 2001. Despite this, the Federal Government's development expenditure allocation for 2002 remains high at RM28.4 billion, with a large share of expenditure continuing to be accorded to the

Table 3.3
Real GDP by Expenditure (1987=100)

	2001*p*	2002*f*
	Annual change (%)	
Domestic Demand[1]	**2.3**	**2.8**
Private sector expenditure	-2.9	4.2
Consumption	*2.8*	*5.0*
Investment	*-19.7*	*1.2*
Public sector expenditure	13.9	0.0
Consumption	*11.9*	*4.1*
Investment	*15.5*	*-3.0*
Net exports of goods and services	**2.3**	**-0.6**
Exports	-7.6	3.7
Imports	-8.6	4.2
Gross Domestic Product	**0.4**	**3.5**

[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

economic and social sectors. **Public consumption** is projected to increase by 4.1%, reflecting the 10% salary adjustment for civil servants as well as higher expenditure on supplies and services.

On the production side, all major sectors are expected to record positive growth in 2002. The manufacturing sector is anticipated to recover, benefiting from the improvement in global demand

Table 3.4
Contribution of Demand Components to Real GDP Growth

	2001*p*	2002*f*
	% point of contribution	
Domestic Demand[1]	**0.1**	**3.5**
Private sector expenditure	-1.7	2.5
Consumption	*1.3*	*2.3*
Investment	*-3.0*	*0.2*
Public sector expenditure	3.8	0.0
Consumption	*1.4*	*0.5*
Investment	*2.4*	*-0.5*
Changes in stocks	-1.9	1.1
Net exports of goods and services	**0.3**	**-0.1**
Exports	-8.9	4.0
Imports	-9.2	4.1
Gross Domestic Product	**0.4**	**3.5**

Note: Figures may not necessarily add up due to rounding
[1] Include stocks
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 3.5
Real GDP by Sector (1987=100)

	2001*p*	2002*f*
	Annual change (%)	
Agriculture	2.5	1.0
Mining	0.2	3.0
Manufacturing	-5.1	4.2
Construction	2.3	2.4
Services	4.9	3.8
Real GDP	**0.4**	**3.5**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

for electronics. The services and construction sectors are expected to continue to support growth, benefiting from the pro-growth policies already in place.

Value-added growth in the **manufacturing sector** is expected to turn around to register a positive growth of 4.2% in 2002. The anticipated upturn in the US economy and electronics demand is expected to translate into stronger demand for Malaysian manufactured exports and, hence, stronger growth in the production of manufactured goods. Both foreign and domestic manufacturers in Malaysia have indicated increased optimism on the outlook for the manufacturing sector in general, and the electronics sector in particular. The general consensus is that growth in the manufacturing sector would be modest in the first quarter before gathering strength in the subsequent quarters of 2002.

Growth in the electronics industry is expected to be underpinned by several positive factors. First, there was a significant drawdown of inventories by companies in 2001 and, thus, new orders are expected to result in an immediate increase in production, especially for electronics. The personal computer (PC) market is expected to show a stronger recovery relative to the telecommunications sector. Preliminary findings of BNM's study on the export composition of Malaysia's electronics industry showed that exports of computers and peripherals account for about 40% of Malaysia's total electronics exports. Therefore, the impending improvement in the global PC market should benefit the industry in Malaysia. In addition, some manufacturers of

Table 3.6
Malaysia's Electronics Industry: Export Composition

Product Diversification	% share of total electronics exports
Computer and peripherals	**39**
Monitors, keyboards, servers and related hardware	*10*
Parts and accessories for computers	*20*
Data storage devices	*9*
Discrete components	**22**
Integrated circuits	**19**
Others	**20**
Electronics parts	*7*
Display devices	*6*
Electronics apparatus	*3*
Cathode ray tubes and other picture tubes	*2*
Other electronics related equipments	*2*
Total	**100**

Source: Department of Statistics, Malaysia

electrical products have also begun to focus on new products to meet the changing consumer preferences. Second, there is an increasing trend towards outsourcing of activities in the manufacturing sector. As a result, some large manufacturers in the region are expected to transfer some operations to Malaysia following corporate consolidation of plants in the region. Malaysia is expected to benefit from these developments. Finally, demand from niche markets for products such as video games, personal digital assistants and emerging products such as photonics or optoelectronics is expected to continue to contribute to growth.

With the electronics and electrical products industries leading output growth in the export-oriented sector, the production of export-oriented industries as a whole is projected to recover in 2002 with a growth of 4.9% (2001: -10.2%). Output in the domestic-oriented sector is expected to be sustained at a strong rate of 6% in 2002 (2001: 7.4%), supported by the Government's pro-growth policies. In particular, the transport equipment and construction-related materials industries are forecast to continue to contribute to growth.

Growth in the **services sector** is expected to be broad-based, with the intermediate services group expanding at a faster rate than the final services group. Growth, however, is expected to moderate to 3.8% partly due to the strong performance in 2001. Nonetheless, policy measures to raise the potential output of the services sector, particularly in the education, tourism and information, communication and technology sub-sectors, could result in a stronger-than-expected growth in the services sector, which in turn, would improve the GDP growth.

Growth in the **construction sector** is expected to be sustained at 2.4%, with impetus coming from the civil engineering and residential sub-sectors. Low interest rates and various pre-emptive measures implemented by the Government to address the excess supply situation in the property market will continue to support demand for residential housing. The relaxation of the Foreign Investment Committee guidelines on foreign acquisition of properties in April 2001 has helped to reduce the property overhang in the sub-sector. The Government has waived the stamp duty charged for the purchase of residential property from developers registered with the Real Estate and Housing Developers' Association Malaysia, for a period of six months, effective 1 January 2002. On 27 November 2001, BNM lifted the restriction on the provision of bridging finance for the development of residential properties above RM250,000 and shop houses exceeding RM250,000 per unit located within residential areas, provided the projects have achieved break-even sales. Growth in the civil engineering sub-sector is envisaged to be supported by privatised projects as well as fiscal spending on infrastructure development. Meanwhile, activity in the non-residential sub-sector would continue to be constrained by excess capacity with activity focused mainly on ongoing projects.

Growth in the **agriculture sector** is expected to moderate to 1% due largely to lower production of crude palm oil (CPO), rubber and saw logs. In particular, CPO production is expected to decline due to anticipated lower yields arising from cyclical tree stress after three consecutive years of high production, as well as the impact of the replanting programme that will involve 200,000 hectares of old oil palm trees. However, measures taken by the Government to increase food production is expected to result in increased production of fruits, vegetables, livestock and fish, thus contributing to higher activity in the agriculture sector in 2002. Meanwhile, growth in the **mining sector** is expected to pick up to 3% due to higher production of crude oil and natural gas in response to higher domestic demand. For 2002, crude oil production has been targeted at 600,000 barrels per day.

Consumer prices are expected to edge upwards in 2002 in line with the projected recovery in domestic economic activity. As growth is expected to be moderate with excess capacity remaining high for most of the year, the increase in prices is expected to emanate more from price adjustments rather than from demand pressures. Core or underlying inflation, which represents price increases arising from demand pressures, is projected to increase from 1% in 2001 to 1.3% in 2002. A one-off price increase of an additional 0.5 percentage point is anticipated during the year. The increase in the petrol prices and import and excise duties on cigarettes and tobacco products, announced in the 2002 Budget, took effect from mid-October 2001. Toll charges on North-South Expressway and telephone tariffs have also been raised effective January 2002 and March 2002 respectively. While CPI inflation is projected to increase by 1.8% in 2002, it continues to remain low.

The **labour market situation** is expected to improve gradually in 2002 in tandem with the recovery in the export sector. The unemployment rate is forecast to decline to 3.6% in 2002 (2001: 3.7%). The establishment of nine schemes for skills training and higher education with an allocation of RM300 million is envisaged to contribute positively to the development of skills of unemployed graduates and retrenched workers. This is expected to facilitate the absorption of unemployed workers into higher-end job segments. While IT-related areas are expected to create new employment opportunities, the manufacturing sector would still be a major source of new employment opportunities.

As previous experience has shown, a revival of economic activity would result in a narrowing of the **current account surplus of the balance of payments**. The stronger trade surplus from higher exports would be eroded somewhat by higher imports. Similarly, the services and income account deficits are also expected to widen. The current account surplus, nevertheless, is forecast to remain large in 2002, at 7.9% of GNP.

Exports are expected to turn around to record a growth of 4.4% in view of the anticipated recovery in electronic exports and higher revenue from agricultural exports. **Imports** are expected to increase by 4.8% with imports of intermediate goods increasing by 6.4%. Nevertheless, the trade surplus is projected to be large mainly because the import of capital goods is not expected to increase significantly in 2002 due to continued excess capacity and slow buildup in new investment.

Manufactured exports are expected to perform better in 2002, in view of the improving outlook on

Graph 3.9
Consumer Prices

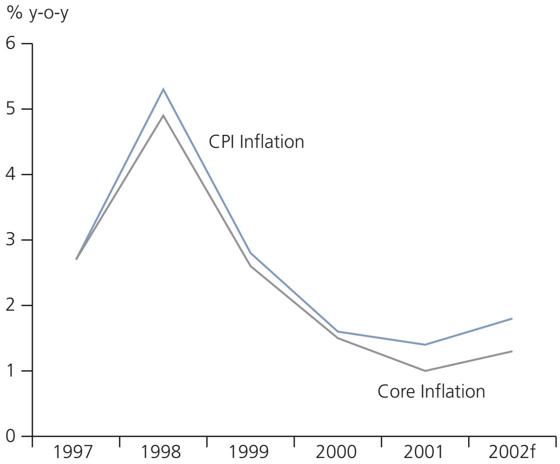


Table 3.7
Balance of Payments

	2001*p*	2002*f*	2001*p*	2002*f*
	RM billion		US$ billion	
Goods	69.9	73.0	18.4	19.2
Trade account	53.7	55.0	14.1	14.5
Exports (% change)	*-10.4*	*4.4*	*-10.4*	*4.4*
Imports (% change)	*-9.9*	*4.8*	*-9.9*	*4.8*
Services	-8.4	-11.6	-2.2	-3.0
Balance on goods and services	**61.5**	**61.4**	**16.2**	**16.1**
Income	-25.9	-27.5	-6.8	-7.2
Current transfers	-8.1	-8.4	-2.1	-2.2
Current account balance	**27.4**	**25.5**	**7.2**	**6.7**
(% of GNP)	***8.9***	***7.9***	***8.9***	***7.9***
Financial account	-14.8		-3.9	
Errors and omissions	-8.9		-2.3	
of which :				
Exchange revaluation loss	*-4.1*		*-1.1*	
Overall balance	**3.7**		**1.0**	

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia.

external demand, especially in the US and the anticipated recovery of the global electronics sector during the year. For the year as a whole, manufactured exports are expected to turn around to register a positive growth of 6.5%, driven by electronics exports, which accounted for about one half of total manufactured exports. With several positive developments already taking place towards the end of 2001, electronics exports are expected to grow by 9.5% (2001: –16.3%). Nevertheless, the growth momentum is expected to pick up in the second half of the year. Similarly, exports of the non-electronics industries are expected to expand by 3.6% (2001: –3.6%), particularly those producing electrical products, chemicals and chemical products, and optical and scientific equipment. Consequently, **export volume** is expected to expand by 8.5% in 2002 (2001: –4.1%). **Export prices**, however, are expected to continue to trend downwards, albeit at a more moderate pace (–2%; 2001: –6.1%). The downward pressure on prices is due mainly to excess capacity amidst a slower expansion in demand. In addition, increased capacity among lower cost producing countries also exert pressure on prices, especially for electronic products.

Table 3.8
Exports and Imports

	2001*p*	2002*f*
	RM billion	
Gross exports	**334.4**	**349.1**
(% change)	***-10.4***	***4.4***
Manufactures	285.3	303.8
(% change)	*-10.3*	*6.5*
Minerals	23.4	15.9
(% change)	*-12.6*	*-32.1*
Agriculture	20.0	23.6
(% change)	*-13.2*	*18.2*
Gross imports	**280.7**	**294.1**
(% change)	***-9.9***	***4.8***
Capital goods	43.7	44.2
(% change)	*-1.1*	*1.2*
Intermediate goods	201.8	214.7
(% change)	*-13.3*	*6.4*
Consumption goods	17.6	18.7
(% change)	*3.0*	*6.3*

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The outlook for Malaysian **commodity prices** is expected to be favourable in 2002, particularly for palm oil. The projected increase of 18.2% in **agriculture exports** would be derived from the higher palm oil price as export volume is only expected to increase marginally, constrained by lower domestic supply. The price of palm oil, which has been trending upwards since November 2001, is projected to strengthen further to RM1,250 per tonne in 2002 in anticipation of rising demand and tight global supplies. Similarly, export prices of saw logs, sawn timber and rubber are forecast to improve as external demand for these commodities is expected to pick up, particularly in the second half of 2002. Meanwhile, the average price for Malaysia's crude oil is forecast to decline to US$18.00 per barrel in 2002 (2001: US$25.53), reflecting primarily conditions in the international oil markets. Globally, the increase in oil demand, which would be dependent largely on the strength of the global economic recovery, is expected to be modest relative to supply. Similarly, export prices of LNG are expected to decline in 2002 in tandem with the downward trend in oil prices. Consequently, **mineral exports** are anticipated to decline by 32.1% in 2002.

The lower current account surplus would reflect entirely the widening of the **services** deficit to 3.6% of GNP and the **income account** deficit to 8.5% of GNP. A recovery in exports would be translated into higher payments for freight and insurance and consultancy services as well as increased outflows related to profits and dividends repatriation by non-resident companies. However, sustained receipts in the travel account as well as higher earnings from port charges and education are expected to support the services account. With the strategy to broaden and diversify the tourism market to new markets such as West Asia, India and China, the number of tourist arrivals is expected to remain high.

The **financial account** is expected to be supported by sustained inflows of long-term capital including higher inflows of foreign direct investment in 2002. In March 2002, the Government tapped the international bond market by issuing US$750 million Notes to take advantage of favourable market conditions and low interest rates. Nevertheless, the **official sector** is expected to record a small net outflow due to high loan repayments by the NFPEs following the maturity of several bonds raised in the 1990s.

In view of the recovery in global economic conditions, inflows of **foreign direct investment** (FDI) are expected to be higher with projected inflows of equity from strategic alliances as well as inflows for expansion and new investment in the manufacturing, services and oil and gas sectors. The investment incentives announced in the 2002 Budget, including the extension of the reinvestment allowance period from 5 to 15 years as well as the Government's commitment to continue to provide the special Pre-Packaged Incentives, are also expected to attract high value-added FDI. The improved prospects for the economy would also encourage greater portfolio inflows. However, it is difficult to forecast the movement of **short-term capital flows**, given that these flows tend to be volatile, responding to specific events and short-term sentiments.

The **external debt outstanding** is expected to decline to RM167.9 billion (US$44.2 billion) as at end-2002, equivalent to 52% of GNP, reflecting the decline in debt of NFPEs and the private sector. The external debt of the NFPEs is expected to decline with the maturity of several bonds raised in the 1990s. Similarly, the external debt of the private sector is also expected to decline, due to prepayments of loans by companies as part of their corporate restructuring exercises. Meanwhile, the Federal Government debt is expected to increase, due to new loans raised in the international capital markets and the drawdown of loans committed under the Miyazawa Initiative. The debt service ratio is expected to improve to 5.3%.

Table 3.9
External Debt

	2001*p*	2002*f*	2001*p*	2002*f*
	RM billion		%share	
Medium and long-term	**146.4**	**144.5**	**86**	**86**
Public sector	90.9	90.4	53	54
Federal Government	*24.3*	*29.9*	*14*	*18*
NFPEs	*66.5*	*60.6*	*39*	*36*
Private sector	55.6	54.1	33	32
Short-term	**23.3**	**23.3**	**14**	**14**
Banking institutions	12.1	12.1	7	7
Non-bank private sector	11.3	11.3	7	7
Total External Debt	**169.8**	**167.9**	**100**	**100**
US$ equivalent	***44.7***	***44.2***		
% of GNP				
Total debt	55.4	52.0		
Medium and long-term debt	47.7	44.7		
Debt service ratio (%)				
Total debt	6.2	5.3		
Medium and long-term debt	5.8	5.0		

Note: With effect from 2001, the external debt of MAS has been reclassified as NFPEs debt. Prior to 2000, it was classified as private sector debt.
p Preliminary
f Forecast

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

MANAGEMENT OF THE ECONOMY IN 2002

As economic recovery is expected to be modest, macroeconomic policies would continue to reinforce the counter-cyclical macroeconomic measures already in place to support domestic sources of growth. In an environment of low inflation, monetary policy can continue to remain accommodative in 2002. Loan growth is expected to expand in tandem with recovery. As the emphasis is on the creation of an environment of stability and predictability, the thrust of policies would be directed at maintaining strong fundamentals to support the fixed exchange rate regime.

In line with the stated intent to consolidate the fiscal deficit in 2002, the fiscal stimulus is expected to be less expansionary at –5.1% of GDP (–5.5% in 2001). Given the high flexibility of fiscal policy, the Government is in the position to further increase expenditure to stimulate economic activity, should the need arise. As consolidation would enhance long-term stability, there is strong commitment to meet the Eighth Malaysia Plan target of fiscal balance by 2005. In managing the fiscal position, appropriate steps would be taken to ensure that the Government's financing requirements would not result in any crowding out effects. Further, priority would continue to be accorded to maintaining the Federal Government debt at a low level (now amounting to 43.8% of GDP).

In an environment of increased liberalisation in the global market place, policy focus in 2002 would essentially centre on ensuring that policy implementation is carried out in a consistent and efficient manner to effectively manage the increased competitive pressures. In this regard, structural adjustment efforts will be intensified as continued commitment to structural policies is envisaged to contribute to building confidence and help in lifting any constraints on macroeconomic policy options and their effectiveness. In line with the broader spectrum of policies outlined in the Eighth Malaysia Plan (2001-2005) and the Third Outline Perspective Plan (2001-2010), measures that will be implemented in 2002 are expected to contribute to improving the business environment through not only demand side measures, but, also supply side initiatives. In this regard, strategies are targeted to realise the full potential of the services sector, promote the development of small- and medium-scale enterprises, further improve productivity levels and ensure that the incentive structure remains favourable to both foreign and domestic investors.

Services sector: In view of its strong linkages with the other sectors of the economy and its strategic importance in supporting the structural transformation of Malaysia to the New Economy, policies also target the acceleration of the development of the services sector as the second engine of growth. In this regard, in 2002, the Government would undertake in-depth studies on maximising the potential of the health, education and tourism sub-sectors as sources of foreign exchange earnings. Specifically, measures would concentrate on boosting health-tourism and further developing the education industry to establish Malaysia as a regional education center of excellence as well as promoting Malaysia as a destination for potential tourists from a wider range of new markets.

Tourism: In further promoting the tourism sub-sector, the 2002 Budget introduced several measures, which include increasing the allocation to the Tourism Fund from RM200 million to RM400 million, extending the existing tax incentives for another five years to tour operators organising domestic tours for foreign and local tourists and granting of excise duty exemption on the purchase of national cars to car rental operators. In developing leisure cruising as a tourism product, the Government has allocated RM5.4 million for the construction of marinas and announced an income tax exemption of 100% for a period of five years on income derived by companies providing charter services of luxury yachts and motorboats. Apart from continuing to host major cultural, sporting and business events in Malaysia, measures are already in place to establish Malaysia as a regional shopping haven by 2003.

Financial sub-sector: As the banking institutions' merger programme has taken place against a backdrop of significant improvements in banking system balance sheets, the focus of financial policy in 2002 will be placed on meeting the objectives set out in the first phase of the Financial Sector Master Plan (FSMP). This involves enhancing the capacity of the banking groups by benchmarking, strengthening skills, strengthening corporate governance, encouraging new delivery channels and promoting greater operational flexibility so as to become more efficient and effective. Also, measures to be taken during the year would include developing minimum standards for the management of market risk for banking institutions; streamlining guidelines, best practices and examination requirements of exempt dealers and stockbroking companies; extending the prudential regulatory framework to include holding companies of banking institutions and their subsidiaries; and strengthening the regulatory framework for investment banks. In the capital market, listed companies with unsatisfactory financial positions or with issued capital below the minimum threshold will be given an extension up to December 2002 to comply with the listing requirements of the Kuala Lumpur Stock Exchange (KLSE) that were issued in 2001.

Macroeconomic policies are in place to support the recovery. The policy focus is to enhance competitiveness to achieve high quality balanced growth.

In further expanding the enabling environment to support economic activity, the Bank will intensify efforts to promote the role of development financial institutions (DFIs) to complement that of the banking system. The Development Financial Institutions Act 2002 (DFI Act), which came into force on 15 February 2002, was formulated to provide a comprehensive and effective regulatory framework for DFIs, with emphasis on the safety and soundness of financial and operational conditions. In this regard, measures for the year will focus on strengthening the regulatory framework and building institutional capacity of the DFIs, as outlined in the FSMP. Overall, measures aim to realign the functions of DFIs so as to enable the institutions to contribute strategically to the economy.

As with the conventional banking sector, the regulatory framework and the operational structure of the Islamic banking institutions will be further strengthened to enhance resilience. The Islamic Banking Act, 1983, and the Banking and Financial Institutions Act, 1989, are being reviewed, whilst focus is placed on enhancing the structure of Islamic banking institutions. Regulatory measures and promotional efforts are expected to support the Islamic banking industry in capturing a more significant market share of approximately 9% (2001: 8.2%) relative to the total assets of the banking system. Moreover, further advancement of Islamic banking and finance on the international front is envisaged. A key development in this regard would be the standardisation and harmonisation of prudential standards for Islamic banking and finance under the Islamic Financial Services Board which will be set up in 2002.

In the insurance industry, the capitalisation of insurers continued to strengthen further following the increase in the minimum statutory requirement to RM100 million with effect from 30 September 2001, which also advanced the consolidation of the industry. As at end-January 2002, seven merger and acquisition proposals involving 13 insurers were at various stages of implementation. The ongoing consolidation of the insurance industry, which is expected to continue into the year 2002, will create progressively stronger and economically viable insurers, and hence, result in the increased resilience of the industry. In protecting consumer interests, specific measures targeted for 2002 entail the adoption of 'best advice' practices and the introduction of independent financial advisers to enable Malaysian consumers to obtain professional independent advice on financial options. Specific performance measures and benchmarks are also being developed by the Bank to assess the progress achieved by the insurance industry in relation to the objectives and recommendations outlined in the FSMP.

Small- and medium-scale enterprises (SMEs): In meeting the challenges of a global environment, a coherent strategy is being developed to enable the SMEs to provide the critical linkages in the development of a broad-based economy. The Bank had, in December 2001, initiated a comprehensive study on local SMEs to identify their needs and thus, match their requirements at each stage of the business cycle, in areas such as financing, training, management, marketing intelligence and IT development. The infrastructure and business support for SMEs will provide a holistic and focused strategy that would make SMEs viable regional and global players that are value-focused, customer-driven, speed-oriented, information-based, cross functional, flexible and networked. The strategy will focus on three main areas: enhancing their production efficiency and effectiveness, encouraging production of high quality, differentiated and high value-added products that meet world standards and promoting innovation and creativity.

Productivity: As competition in the global and regional markets will intensify with increased WTO and AFTA commitments, productivity enhancement becomes central to Malaysia's economic growth and competitiveness, given that Malaysia can no longer offer a cheap labour market. Measures are already in place to transform the economy to a productivity-driven economy that is characterised by knowledge workers. These measures include improving the infrastructure support to promote productivity growth and providing tax incentives to the private sector to reduce the cost of their transition from investment- to productivity-driven strategies.

Overall, the Government would remain committed to ensuring that Malaysia continues to offer a cost-competitive and viable location to both foreign as well as domestic investors. Efforts to constantly evaluate the incentive structure for competitiveness will continue, as with the further upgrading of the physical and administrative infrastructure to meet world-class standards. In order to encourage reinvestments, the Government, in the 2002 Budget, has extended the Reinvestment Allowance period from five to 15 consecutive years, commencing from the year the first reinvestment is made. A number of other key incentives introduced comprised tax measures to benefit, amongst others, the machinery and equipment industry, downstream activity in the resource-based sector (rubber, oil palm, timber and food-based industries) and manufacturing-related services (integrated logistics, marketing support and utility services).

In order to complement the semiconductor and electronics sub-sector, the list of promoted activities and products for high-technology companies has been expanded by the Government to include advanced electronics, biotechnology, electro-optics and non-linear optics, advanced materials, optoelectronics, software engineering, alternative energy sources and aerospace. Increased collaborative programmes between local universities and the Multimedia Super Corridor (MSC) with industries will be encouraged to create a platform for research in the various promoted areas. In essence, the Government will seek to maximise the contribution of both the education system and business sector to develop a more enterprising culture.

As efforts will remain focused on enhancing structural changes in the economy with strong emphasis on knowledge-content activities and product innovation, the economy will continue to present a range of opportunities to both local and foreign investors in traditional as well as new growth sectors. In terms of FDI, higher value-added industries and high quality investments will be encouraged into the country in order to be differentiated in the global market. The Government's stance is that FDI should not only increase the nation's stock of capital, but, also play a role in increasing the nation's competitiveness by raising productivity. Hence, priority will be accorded to the promotion of investments into the MSC and in the manufacturing and services industries that involve specialised technology, high intellectual capital, low import content and increasing returns. In addition, strategic alliances that are mutually beneficial in terms of value creation and delivery will be encouraged, particularly in sectors such as energy, ports, finance, as well as the national airlines and car industry.

Amid increased dynamics of global market integration, Malaysia's export promotion strategy will be to sustain market shares in traditional markets, whilst conscientious efforts are made to match specific Malaysian products and services with the rising and more diversified consumer needs in emerging markets. Tax incentives also favour Malaysian international trading companies and companies engaged in the export of services. Expenses related to the export promotion of goods and services as well as expenses incurred in registering patents overseas are given special tax treatment. Particular attention was also given to the promotion of Malaysian brands in international markets, so that export competitiveness is not based on prices alone, but also on the level of technology and brand recognition.

Given the developments on the external front, economic management in 2002 will focus on a broad comprehensive framework for Malaysia to increase its competitive edge to 'stay ahead of the curve'. In managing the impact of more intense competition, sound macroeconomic policies will be complemented by structural policies to build on existing capacity and raise long-term productivity growth. Besides directing attention to the entire business cycle in terms of its context and perspective, structural changes essentially aim to deliver internal adjustments and focus on core complementarities for sustainable growth.

MONETARY POLICY IN 2002

In 2002, monetary policy will remain accommodative in order to provide a conducive environment to support the economic recovery process. This policy stance is based on the assessment that the balance of risks is biased toward a modest recovery in economic activities in Malaysia. With domestic inflation remaining subdued, monetary policy will continue to build on gains from the cumulative monetary easing, initiated since 1998, to ensure that the economic recovery process becomes well entrenched. On the exchange rate front, the focus of policy is to ensure that economic fundamentals continue to support the pegged exchange rate.

The monetary policy stance in 2002 will continue to be influenced by global and domestic developments. On the external front, indications are that the US-led global recovery would be modest in 2002. The prospects for world trade and the global electronic demand have also improved. It is expected that the US domestic policies would remain supportive of promoting economic recovery, especially in strengthening consumer and business confidence. Notwithstanding these positive signs of imminent stronger recovery, several downside risks remain, including the sustainability of consumption in the US and the significant movement in the major currencies, which could affect the recovery process. Against this external environment, the Malaysian economy is expected to register a modest growth. Inflation, however, is expected to rise only slightly given the excess capacity in several sectors in the economy.

Given the prospects of modest economic growth and low inflation, the basic thrust of monetary policy will continue to be directed at nurturing the recovery in domestic economic activity. Recognising the lags between implementation and effects of policy, there are significant advantages in maintaining the current accommodative stance well into the period of economic expansion. As inflationary expectations do not appear to be a risk in the near term, there would be greater flexibility for this accommodative policy stance.

The conduct of monetary policy in 2002 will, therefore, focus primarily on four key considerations. Firstly, monetary policy will aim to maintain a stable and predictable operating environment in order to facilitate business activity. It is also recognised that the maintenance of macroeconomic stability requires close co-ordination between monetary, fiscal, and structural policies. Monetary policy will continue to leverage on areas of strong complementarity that exists between these policies to ensure an optimal policy mix. In this regard, with the improved prospects for economic recovery, the maintenance of the current accommodative monetary policy stance amid a subdued inflationary outlook allows fiscal consolidation to take effect in 2002. This will help to position the economy to take full advantage of the global recovery when it takes place, and at the same time, enhance our ability to absorb any shocks in the event the actual outturn is weaker than anticipated.

Intervention Rate and the 3-month interbank rate, it did not create any risk that could undermine the long-term objectives of macroeconomic policy.

It should also be emphasized that such an arrangement does not represent a departure from BNM's long-term objective to move toward a market-based approach. Nor does it preclude banks from pricing their loans lower than the computed BLR to remain competitive. By enhancing the effectiveness of the monetary policy mechanism under the current environment, this has allowed banking reforms to proceed smoothly and measures to improve the efficiency of the financial markets to be implemented. As a long-term objective, BNM remains committed to liberalising the BLR framework and interest rate structure as outlined in the Financial Sector Masterplan. This

Monetary policy will remain supportive of economic growth. Low inflation and stronger macroeconomic fundamentals help to sustain the exchange rate regime and allow monetary policy to remain accommodative.

Secondly, the conduct of policy is guided by the need to ensure that the level of interest rates continues to remain supportive of economic activities. Since the Intervention Rate cut on 20 September 2001, external developments have been generally more positive on the prospects for global growth. This, coupled with the fact that the cumulative effects of the previous monetary easing have not been fully manifested, has reduced the need for a further easing of monetary policy at this juncture. BNM, nonetheless, monitors all indicators and developments, both domestic and external, that could heighten the macroeconomic risks towards further economic weakness.

The third consideration is the need to ensure an effective transmission mechanism from the policy rate to retail rates, in order to precipitate a faster response to the counter-cyclical policy measures. In an uncertain environment, the normal market process of adjustment may not always function at the desired level of efficiency, particularly at a time when the banking industry is undergoing consolidation. In this regard, the current BLR framework (implemented in 1998) which is based on the Intervention Rate as the anchor rate, continues to serve its purpose in fostering an effective transition to lower lending rates. Although this arrangement entails some trade-offs, evidenced in the divergence between the 3-month

represents an integral part of the overall shift toward a more market-oriented approach that would further improve efficiency in the transmission mechanism of monetary policy.

A further consideration is to ensure the availability of funds to support the identified priority sectors. Steps have already been taken to improve access to credit by the SMEs, the agriculture sector and other strategic sectors under the special funds. At the same time, efforts to develop alternate modes of financing will be intensified to support the financing requirements of a knowledge-based economy, as part of the overall effort to enhance the long-term competitiveness of the economy.

Success in sustaining the economic recovery, nevertheless, is premised on two critical factors: market response to counter-cyclical policy measures; and the extent of policy flexibility accorded to monetary policy management. The current assessment is that both consumers and corporations have remained responsive to policy measures. There are currently no "trigger" factors that may lead to a structural change in consumer behaviour and render monetary policy less effective. These "trigger" factors include prolonged deflationary tendencies associated with a boom-bust asset market cycle, and falling consumer and producer price indices. Instead, demand for personal loans, notably mortgage and car loans, has remained elastic to interest rates.

Consumption continues to be supported by stable employment and income prospects as well as favourable household balance sheets. Unemployment rates remain low while the net asset position remains strong due to high personal savings and stable property and equity prices. Aided by the CDRC, corporations have also reacted positively, taking advantage of the low interest rates to consolidate, restructure and cut their business costs to stay competitive in a period of reduced business demand. The accommodative policy will therefore continue to provide a positive environment for the restructuring and reform process. Corporations will also be in a better position to take advantage of the economic recovery.

At the same time, BNM continues to have policy flexibility that will enhance the scope for monetary policy to adjust appropriately to changing trends that could potentially undermine the growth momentum. Underpinning this policy flexibility is the strengthening of macroeconomic fundamentals. Notably, low inflation and the wide interest rate differentials with the US in favour of Malaysia will continue to accord policy flexibility. On the whole, improved macroeconomic fundamentals have helped to increase the tolerance of ringgit to higher degrees of volatility in the foreign exchange market. This has allowed BNM to continue to pursue a pragmatic and flexible monetary policy in order to promote domestic demand.

Looking ahead, the most critical challenge lies in anticipating cyclical economic developments and turning points. In the current environment, correct diagnosis of the strength or weakness of recovery would allow BNM to build an appropriate degree of stimulus and pursue front-loading and pre-emptive policy responses. Ensuring monetary policy response that is appropriate in terms of timing and magnitude is important in order to achieve the desired results.

Another challenge is managing potential risks that could emerge in the system. In this regard, BNM will monitor closely the lending and investment activities of the banks to ensure that they do not create risks in the system. BNM will also ensure that the underlying liquidity situation would support the expansion of economic activity without stimulating inflationary pressures. To achieve this, BNM has the option to either release the large pool of funds currently parked with BNM by the financial institutions, or to mop up excess liquidity through its market operations, depending on factors affecting the supply and demand for funds.

On the exchange rate front, policy will focus on ensuring that the pegged exchange rate remains sustainable and continues to benefit trade and investment. For a small open economy, the exchange rate has always been an important price to Malaysia, as it could affect confidence, price stability and long-term international competitiveness. It has, therefore, always been Malaysia's long-held policy not to resort to exchange rate changes to gain competitive advantage, nor to respond to transient and short-term currency movements that could easily be reversed. Policy to maintain international competitiveness has been implemented through efficiency and productivity gains, rather than by relying on the exchange rate. Indeed, the benefits derived from the pegged exchange rate regime have been significant in terms of promoting trade and investment. The stability in the exchange rate itself, has also facilitated corporate restructuring and financial reforms.

Under these circumstances, continuous commitment towards ensuring that fundamentals support the exchange rate will ensure that the exchange rate system will continue to generate significant benefits to the economy. There are no viable alternatives to sound policies and strong macroeconomic fundamentals to sustain the exchange rate. Therefore, macroeconomic policies will continue to be directed towards sustaining underlying economic fundamentals and ensuring that domestic sector remains sufficiently flexible to deliver the necessary internal adjustments to strengthen competitiveness.

FISCAL POLICY IN 2002

The 2002 Budget which was presented to Parliament on 19 October 2001 aimed at strengthening economic growth through increasing domestic demand, strengthening the private sector's resilience and competitiveness, diversifying the sources of growth and ensuring a more equitable distribution of wealth. While the Malaysian economy was expected to register a gradual and modest growth following the gradual recovery in external demand, it was recognised that sustaining domestic demand continued to be necessary given the downside risks to the global economic recovery. In this environment of uncertainty, fiscal policy would remain expansionary in 2002 to strengthen the economic recovery process.

In line with the objective of fiscal prudence, consolidation of the budget deficit would begin in 2002 with a less expansionary fiscal policy. The Government, therefore, budgeted for a lower fiscal deficit of –5.1% of GDP (-RM18.8 billion), compared with the estimated fiscal deficit for 2001 of –6.5% of GDP (-RM22.4 billion). However, due to a stronger revenue performance, the actual outturn for the fiscal deficit in 2001 was lower than budgeted, at –5.5% of GDP (-RM18.4 billion). Based on revenue forecast for 2002 in the 2002 Budget, fiscal consolidation as envisaged in the 2002 Budget is expected to be on track.

The fiscal deficit for 2002 would be kept at a manageable level to strike a balance between the short-term objective of supporting growth and the long-term policy of fiscal sustainability. The fiscal deficit in 2002 is not expected to create risks to the economy, as Malaysia's economic fundamentals continue to remain strong. The fiscal expansion is not anticipated to result in higher inflation given the excess capacity in the economy. Similarly, Government spending is not expected to lead to leakages as most of the expenditure is expected to have minimal import content.

Expenditure allocation would continue to focus on programmes and projects that would have high multiplier effects on domestic activity and raise the long-term productivity of the economy. In terms of development allocation, emphasis continues to be accorded to the social services sector, notably education and training. Higher priority was also placed on agriculture and rural development, reflecting the Government's policy to revitalise the agriculture sector as the third engine of growth. Infrastructure and industrial development focusing on small and medium-scale enterprises and the development of e-commerce were also given special attention.

In addition, the fiscal package also contained both tax and non-tax measures directed at stimulating economic activities. Measures to encourage consumption through increasing disposable incomes included the reduction in personal income tax rates between 1 to 2 percentage points to 0-28% as well as the 10% salary adjustment for civil servants.

Besides addressing the immediate objective of enhancing consumption, the Budget continued to emphasise the longer-term objective of increasing competitiveness to sustain growth. Wide-ranging fiscal incentives were directed at promoting investment in resource-based activities and the services sector, as well as development of skills to meet the needs of a knowledge-based economy. Among others, measures to encourage investment included the extension of reinvestment allowance to 15 years (from 5 years) and tax exemptions for companies involved in machinery and equipment, food production, as well as for reinvestment in the production of rubber, oil palm and timber. Fiscal incentives were also provided to reduce the cost of doing business and improve competitiveness. Import duties were either reduced or abolished on a wide range of products. The industrial building allowance was extended for the purchase of buildings and hotels. Incentives were also directed at encouraging the use of information and communications technology (ICT) in all economic activities. Several incentives were also introduced to strengthen the balance of payments through promotion of tourism and enhancement of exports.

Prudent policies practised earlier have accorded the Government greater flexibility in implementing expansionary measures to support growth. The deficits since 1998 have been financed through non-inflationary sources given the high rate of domestic savings and the ample liquidity situation. As such, higher borrowings by the Federal Government have not crowded out the private sector's access to financing. As in the past, the bulk of the fiscal deficit in 2002 would be financed through the issuance of MGS that would be absorbed mainly by the provident, pension and insurance funds.

Federal Government debt would continue to be contained at manageable and sustainable levels (43.8% of GDP as at end-2001). Debt servicing remains low (15% of operating expenditure or 2.9% of GDP) and has not been a constraint on fiscal flexibility. Furthermore, the Government's exposure to foreign exchange risk would be kept low, as the bulk of the Government's debt would continue to be raised from non-inflationary domestic sources. Currently, 83% of total outstanding debt is in domestic currency. In addition, more than 60% of the debt has a maturity of more than 3 years. The Government has always ensured that debt maturity profiles are of medium- to longer-term maturity and are adequately spaced out to minimise risks. With the economy on the path of recovery and given the Government's target to achieve a balanced budget towards the end of the Eighth Malaysia Plan period, the ratio of debt to GDP is expected to decline over the medium term.

As part of the Government's continuous efforts towards streamlining administrative procedures, reducing red tape and delegating powers, the Budget process was reviewed. Beginning in year 2002, the budget preparation and examination process would be carried out once every two years instead of annually. The forward-looking budgetary process is aimed at making the national Budget a more effective tool in financial management. In particular, the administrative change in the budget process would provide greater fiscal flexibility. It would take into account both the shorter-term annual fiscal policies and the medium-term objectives and policies within the context of the five-year development plans and outline perspective plans. Besides ensuring that all allocations are utilised as scheduled, the new process would also allow for expeditious budgetary reallocations to be effected to take into account unanticipated developments in the domestic and international environment.

The Financial Sector

The Financial Sector

SOURCES AND USES OF FUNDS OF THE FINANCIAL SYSTEM

The total assets of the financial system expanded at a slower pace in 2001, in line with the more moderate economic growth. The bulk of its funds was sourced through deposits placed with financial institutions and contributions to the provident, pension and insurance funds. As in previous years, the resources were mainly invested in loans and advances and securities.

The moderate increase in the total assets of the financial system of 3.5% to RM1,295.2 billion reflected the increases in assets of both the banking system and the non-bank financial intermediaries (NBFIs). As a percentage of GDP, the total assets of the financial system rose to 389.4% of GDP from 367.1% in 2000. Given the higher growth of the assets of the NBFIs (6.7%), relative to that experienced by the banking system (2.1%), the latter's share of the total assets of the Malaysian financial system declined from 67.8% at the end of 2000, to 66.9% at the end of 2001.

Within the banking system, the bulk of the increase in assets was due to the growth in assets of the commercial banks (including Islamic banks), finance companies and merchant banks. This reflected mainly the increase in loans and advances and investment in securities as well as deposits with other financial institutions. Meanwhile, assets of the NBFIs accounted for a higher share of 33.1% of total financial system assets at the end of 2001 (32.2% in 2000). The growth in assets of the NBFIs was driven principally by an expansion in the assets of the provident, pension and insurance funds (+RM25 billion), which accounted for 92.7% of the increase in the total assets of this group.

During the year, the bulk of new resources was contributed by deposits placed with financial institutions and contributions to the provident, pension and insurance funds. Though recording a slower growth of 2.9% in 2001 (4.3% in 2000), deposits mobilised by the financial institutions continued to account for the largest share (45.8%) of the total sources of funds at the end of 2001 (46% in 2000). Similarly, the banking institutions (comprising commercial banks, finance companies, merchant banks, and discount houses) continued to be the largest mobiliser of deposits, accounting for 83.4% of total deposits of the financial system (84.1% in 2000).

Graph 4.1
Assets of the Financial System as at end 2001*p* (% share)

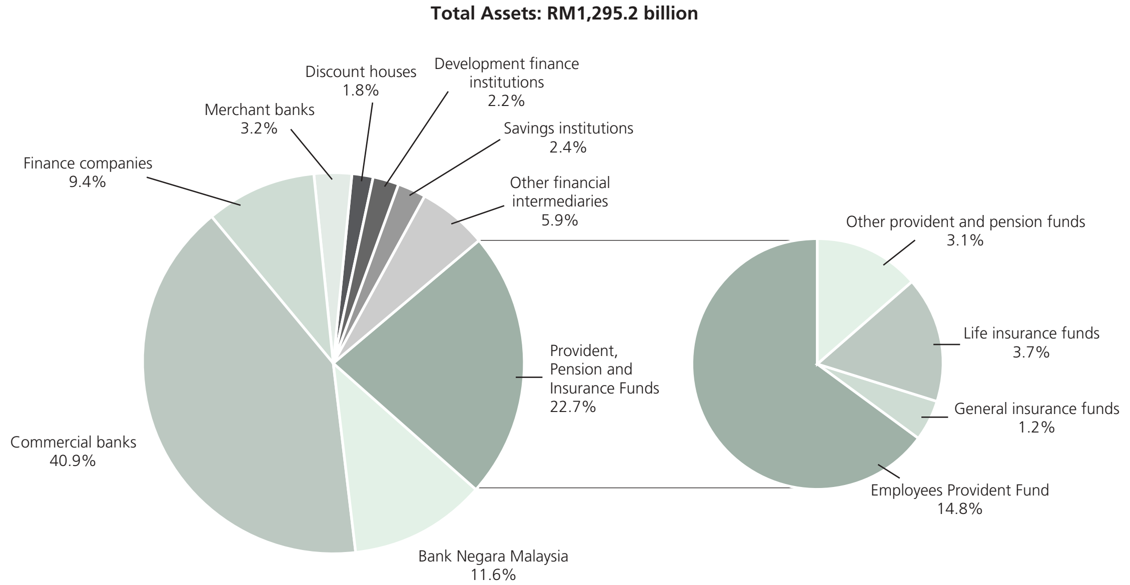


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Table 4.1
Assets of the Financial System

	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Banking system	**27.5**	**17.5**	**865.9**
Bank Negara Malaysia	1.9	0.8	149.7
Commercial banks[1]	29.8	5.6	529.5
Finance companies	-4.4	4.2	121.7
Merchant banks	-2.3	4.2	41.1
Discount houses	2.6	2.7	23.8
Non-bank financial intermediaries	**42.6**	**26.9**	**429.3**
Provident, pension and insurance funds	27.8	25.0	294.3
Employees Provident Fund	*18.1*	*6.0*	*191.1*
Other provident & pension funds	*3.1*	*8.6*	*40.3*
Life insurance funds	*6.1*	*9.2*	*47.6*
General insurance funds	*0.6*	*1.2*	*15.3*
Development finance institutions[2]	3.4	2.8	27.9
Savings institutions[3]	7.0	-1.5	30.7
Other financial intermediaries[4]	4.4	0.7	76.3
Total	**70.1**	**44.4**	**1295.2**

[1] Includes Bank Islam Malaysia Berhad and Bank Muamalat Malaysia Berhad (since 1999).
[2] Includes Malaysian Industrial Development Finance Berhad (MIDF), Bank Pertanian Malaysia, Borneo Development Corporation, Sabah Development Bank Berhad, Sabah Credit Corporation, Export-Import Bank Malaysia Berhad, Bank Pembangunan dan Infrastruktur Malaysia Berhad and Bank Industri dan Teknologi Malaysia Berhad.
[3] Includes National Savings Bank, Bank Kerjasama Rakyat and co-operative societies.
[4] Includes unit trust (ASN, ASB, ASW2020, ASN2, ASM (Malaysia) and ASM Mara), building societies, Credit Guarantee Corporation, Cagamas Berhad, leasing companies, factoring companies and venture capital companies.
p Preliminary

Table 4.2
Sources and Uses of Funds of the Financial System

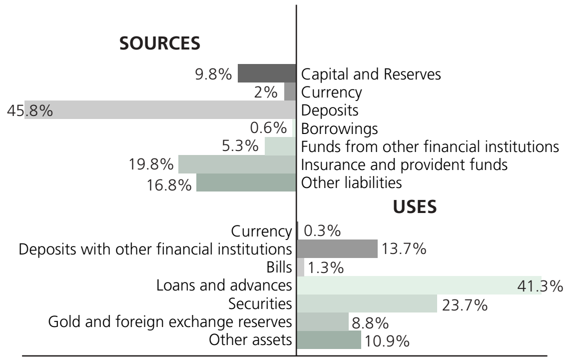
	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Sources:			
Capital and reserves	7.1	4.7	126.7
Currency	-3.8	-1.3	25.4
Deposits[1]	23.9	16.8	592.6
Borrowings	-0.4	-0.2	7.3
Funds from other financial institutions[1]	-3.3	0.5	68.9
Insurance and provident funds	23.1	20.0	257.1
Other liabilities	23.5	3.9	217.2
Total	**70.1**	**44.4**	**1295.2**
Uses:			
Currency	-2.4	-2.1	4.5
Deposits with other financial institutions	5.3	-6.3	178.0
Bills	0.1	-0.3	16.3
Treasury	*0.6*	*-0.2*	*4.0*
Commercial	*-0.4*	*-0.1*	*12.2*
Loans and advances[2]	24.6	20.5	534.7
Securities	35.4	36.7	306.8
Malaysian government	*12.6*	*14.1*	*101.6*
Foreign	*0.3*	*0.9*	*2.7*
Corporate	*19.9*	*22.3*	*195.7*
Others	*2.6*	*-0.7*	*6.9*
Gold and foreign exchange reserves	-3.9	3.7	113.5
Other assets	11.2	-7.9	141.3

[1] Effective 1998, the statutory reserves of banking institutions have been reclassified as "Funds from other financial institutions" rather than "Deposits". In this regard, data from prior years have also been revised accordingly.
[2] Excludes loans sold to Danaharta.
p Preliminary

In terms of holders, deposits were mainly held by the non-financial private sector (comprising individuals and business enterprises), which accounted for 68.6% of the outstanding deposits at the end of 2001. The deposits of this group grew by 4.4% in 2001, mainly as a result of an increase in deposits by individuals. As in previous years, fixed deposits continued to account for the bulk of the increase in deposits placed by the non-financial private sector. By maturity, fixed deposits continued to be concentrated at the shorter-end.

Graph 4.2
Sources and Uses of Funds of the Financial System as at end 2001*p* (% share)

Total: RM1,295.2 billion



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Contractual savings with provident and pension funds as well as contributions to insurance funds continued to be the major sources of funds for the financial system, expanding by 8.4% to account for 19.8% of the total funds mobilised by the financial system in 2001. Meanwhile, capital and reserves of the financial system increased by 3.9% (+6.1% in 2000), reflecting mainly the strengthened capital position of the banking institutions.

The increase in the total resources of the financial system in 2001 was mainly invested in loans and advances and securities. The growth of total loans and

Table 4.3
Non-Financial Private Sector Deposits[1] with the Financial System[2]

	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Deposits[3] with:			
Commercial banks	37.5	14.3	301.8
Finance companies	-0.9	2.6	60.8
Merchant banks	2.9	-2.4	11.3
Discount houses	1.3	0.0	5.3
National Savings Bank	3.4	0.1	10.6
Others	3.1	2.3	16.6
Total	**47.3**	**17.0**	**406.5**
Demand deposits	14.8	2.1	58.1
Fixed deposits	21.9	9.2	269.1
Savings deposits	10.2	4.0	58.6
NIDs[4]	0.0	-1.1	1.8
Repos[5]	0.4	2.8	18.8
Fixed deposits			
of which:			
Up to 1 year	*10.6*	*6.6*	*237.0*
More than 1 year	*11.4*	*2.6*	*32.2*

[1] Refers to deposits of the business enterprises (excluding NFPEs) and individuals.
[2] Excludes provident, pension and insurance funds, and other financial intermediaries.
[3] Refers to demand, savings and fixed deposits, negotiable instruments of deposits and repos.
[4] Refers to negotiable instruments of deposit.
[5] Refers to repurchase agreements.
p Preliminary

advances was sustained at RM20.5 billion or 4% in 2001 (+RM24.6 billion or 5% in 2000) despite the lower real GDP growth. The sustained loan growth was due mainly to increased demand from the household sector.

Table 4.4
Direction of Credit[1] to the Non-Financial Private Sector

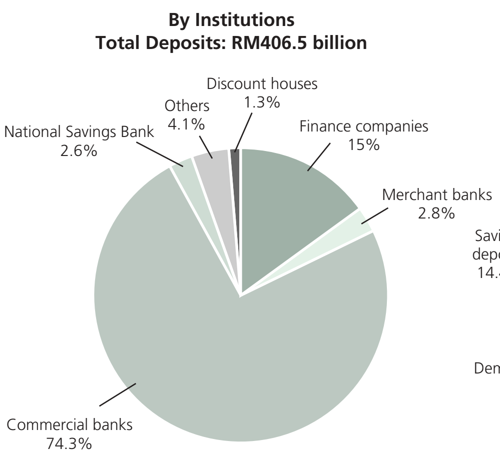
	Annual change		As at end 2001*p*
	2000	2001*p*	
	RM billion		
Loans and advances	**22.9**	**21.6**	**501.1**
Agriculture	2.7	0.3	13.7
Mining and quarrying	0.0	-0.1	1.3
Manufacturing	1.6	-1.2	55.8
Housing	13.2	12.8	111.1
Construction[2]	-3.3	1.8	84.1
Business services	-0.9	1.4	21.8
General commerce	0.9	0.8	19.4
Transport and storage	0.1	-0.9	13.4
Purchase of shares	0.0	-2.4	20.5
Consumption credit	7.4	9.6	68.3
Others	1.0	-0.4	91.7
Investments in corporate securities	**16.0**	**22.3**	**195.7**
Total	**38.9**	**44.0**	**696.8**

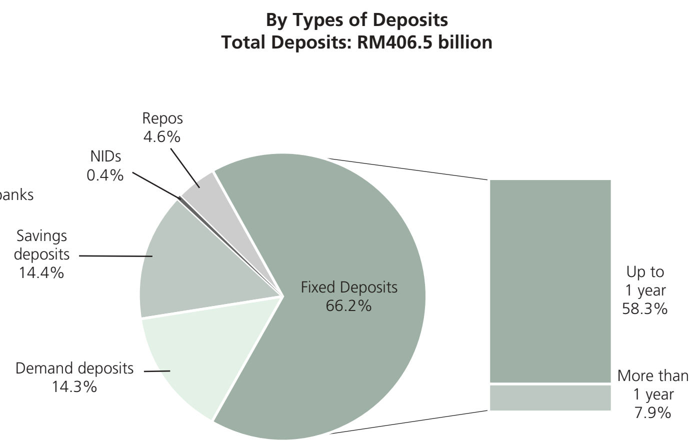
[1] Excludes credit to non-financial public enterprises.
[2] Includes loans for real estate.
p Preliminary

This was reflected in the higher loans extended for the purchase of residential property and passenger cars.

Investment in securities by the financial system continued to expand in 2001, recording an increase of 13.6%. In particular, there were marked increases in investments in corporate (+RM22.3 billion) and government securities (+RM14.1 billion), in line with the increase in the issuance of both PDS and MGS as well as market expectations of lower interest rates which encouraged investors to acquire debt securities.

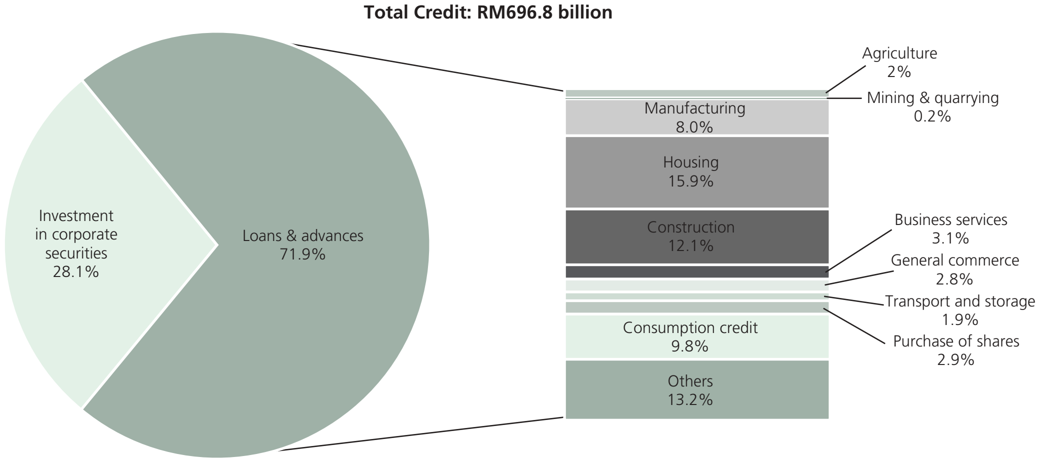
Graph 4.3
Non-Financial Private Sector Deposits with the Financial System as at end 2001*p* (% share)





p Preliminary

Graph 4.4
Direction of Credit to the Non-Financial Private Sector as at end 2001*p* (% share)



p Preliminary

Provident and pension funds continued to be the main investors in securities, accounting for 41% of the increase in investments in securities. Having declined in the previous year (-RM3.9 billion), gross holdings of gold and foreign exchange reserves turned around to record a marginal increase of RM3.7 billion in 2001, mainly on account of the repatriation of export proceeds from abroad and inflows of foreign direct investment.

MANAGEMENT OF BANKING SYSTEM

The strategies implemented in 1999 and 2000 to strengthen the banking sector continued to be pursued in 2001 aimed at strengthening the ability of the banking sector to operate in a more competitive and increasingly difficult economic environment. In particular, efforts to restructure the large corporate sector debts were intensified during the year. The positive results achieved through the institutional arrangements put in place by the Government during the financial crisis have also succeeded in minimising the impact of the economic slowdown on the overall health of the banking system. Despite the adverse impact of the events on September 11 on the world economy and its consequent impact on the Malaysian economy, the Malaysian banking sector remained resilient and was able to play its intermediation role efficiently and effectively throughout the year. Total outstanding loans of the banking system continued to record positive growth of 3.4%, whilst the preliminary unaudited pre-tax profit of RM7.5 billion for the calendar year 2001 can be expected to further strengthen the capital base of the banking system, thus enhancing further its capacity to meet future challenges. The thrust of the banking policies throughout the year were therefore aimed at preserving the integrity and maintaining the resilience of the banking system amidst a more challenging environment as well as building the necessary foundations for the long term development of the banking system to effectively meet the needs of a changing economy as envisaged in the Financial Sector Masterplan. With the increased resilience of the banking sector, BNM has shifted its focus from managing banking sector problems to medium and longer term efforts towards developing a more robust financial system.

Despite the adverse impact of the events on September 11 on the world economy and its consequent impact on the Malaysian economy, the Malaysian banking sector remained resilient and was able to play its intermediation role efficiently and effectively throughout the year.

Developments in 2001

The restructuring efforts undertaken since the financial crisis have placed the banking sector on a stronger footing to withstand further pressures and to contribute towards macroeconomic stability. The various prudential and developmental measures introduced earlier have also helped to enhance the business and risk management practices within banking institutions. Close regulatory and supervisory oversight on the banking institutions will nevertheless continue to be maintained. Banking institutions are now subjected to more rigorous stress testing and are required to submit more detailed statistics to identify areas of potential vulnerabilities. BNM also conducts regular dialogues with banking institutions to facilitate the formulation of pre-emptive policies that would contribute towards minimising the impact of the economic slowdown on the banking system and to preserve the soundness of the banking sector. One potential area of vulnerability that needed to be addressed was the resolution of the large corporate debts and its impact on the health of the banking sector. To facilitate this process, the corporate debt restructuring framework under the Corporate Debt Restructuring Committee (CDRC) was revamped to accelerate the pace of corporate debt restructuring in Malaysia. Borrowers and creditors were subject to more stringent and definitive timelines in the debt restructuring process to ensure that they complete the resolution process within the shortest timeframe. The membership of the Steering Committee was also expanded to include representatives from Pengurusan Danaharta Nasional Berhad and the Federation of Public Listed Companies. Operational restructuring was undertaken together with financial restructuring to ensure the viability of the debt restructuring scheme. Significant progress has been achieved following this revised framework, with the resolution of a number of debt restructuring cases, including the debts of three large corporates. CDRC had targeted to resolve 10 cases with total debts of RM10.2 billion between 1 August 2001 and 31 December 2001. As at 31 December 2001, CDRC has successfully resolved eight of these cases, with debts accounting for 83.5% of the total targeted amount of debts to be addressed. In total, CDRC has successfully resolved 11 cases in the year 2001, involving debts amounting to RM11.9 billion. With stronger economic recovery envisaged in 2002, CDRC is well placed to meet its target to complete the restructuring of the remaining cases by July 2002.

The merger programme for domestic banking institutions that was initiated in 1999 and concluded in 2000 succeeded in consolidating the fragmented domestic banking sector without causing disruptions to the provision of banking services. In 2001, the focus of the domestic banking groups was to complete the business integration processes and rationalisation exercises. This formed the most critical aspect of the mergers. The banking groups would not be able to reap the benefits of mergers and attain higher levels of economies of scale, synergies and efficiency without rationalising their business operations and removing duplications in resources. Therefore, all banking groups capitalised on the opportunity to reorganise, rationalise and restructure their business operations, including their branch network and staff requirements, in line with their future business strategies. By the end of 2001, all banking groups had conducted their branch rationalisation exercise and five banking groups had rationalised their workforce. All the staff rationalisation exercises were conducted on a voluntary basis. Affected staff were granted the opportunity for various options of redeployment to other suitable business divisions, or to opt for the voluntary separation schemes. For those who opted for the latter, they were adequately compensated. The compensation schemes were relatively consistent across banking groups. Staff were also given the opportunity to participate in a re-skilling programme, aimed towards enhancing their skills in alternative areas of businesses, thereby facilitating their smooth transition into other segments of the economy. As a result of the rationalisation exercises during the year, 187 branches were closed, whilst 55 branches were relocated and a total of 4,240 staff left the banking industry.

All banking groups completed their business system integration during the year with minimal disruption to the provision of banking services to customers, thus enabling customers to enjoy seamless services from the merged institutions. Customers now have access to a wider scope of banking services through cross-selling of banking products between institutions within the same banking groups. The merged banking groups are now more well-capitalised to meet future calls for capital expenditure as well as able to undertake higher levels of risk arising from wider scope of business activities. Domestic banking institutions have already started on aggressive branding campaigns to establish themselves as key players within the Malaysian banking industry.

The merger programme and the structural reforms undertaken by the banking sector since 1998 have enhanced the ability of the banking sector to adjust and cope with a more difficult environment. As an important enabler of the economic transformation and growth process in Malaysia, it was important that the development of the financial sector is aligned

Table 4.5
Merger Programme for Domestic Banking Institutions

Original Anchor Banking Group	Merged with	Resultant Entity After Merger
1 Affin Bank Berhad Group Perwira Affin Bank Berhad Asia Commercial Finance Berhad Perwira Affin Merchant Bank Berhad	BSN Commercial Bank (M) Berhad BSN Finance Berhad BSN Merchant Bankers Berhad	Affin Bank Berhad AFFIN ACF Finance Berhad Affin Merchant Bank Berhad
2 Alliance Bank Berhad Group Multi-Purpose Bank Berhad	International Bank Malaysia Berhad Sabah Bank Berhad Sabah Finance Berhad Bolton Finance Berhad Amanah Merchant Bank Berhad Bumiputra Merchant Bankers Berhad	Alliance Bank Berhad Alliance Finance Berhad Alliance Merchant Bank Berhad
3 Arab-Malaysian Bank Berhad Group Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad Arab-Malaysian Merchant Bank Berhad	MBf Finance Berhad	Arab-Malaysian Bank Berhad Arab-Malaysian Finance Berhad[1] Arab-Malaysian Merchant Bank Berhad
4 Bumiputra Commerce Bank Berhad Group Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad		Bumiputra Commerce Bank Berhad Bumiputra Commerce Finance Berhad Commerce International Merchant Bankers Berhad
5 EON Bank Berhad Group EON Bank Berhad EON Finance Berhad	Oriental Bank Berhad City Finance Berhad Perkasa Finance Berhad Malaysian International Merchant Bankers Berhad	EON Bank Berhad EON Finance Berhad Malaysian International Merchant Bankers Berhad
6 Hong Leong Bank Berhad Group Hong Leong Bank Berhad Hong Leong Finance Berhad	Wah Tat Bank Berhad Credit Corporation (Malaysia) Berhad	Hong Leong Bank Berhad Hong Leong Finance Berhad
7 Malayan Banking Berhad Group Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad	The Pacific Bank Berhad PhileoAllied Bank (M) Berhad Sime Finance Berhad Kewangan Bersatu Berhad[2]	Malayan Banking Berhad Mayban Finance Berhad Aseambankers Malaysia Berhad
8 Public Bank Berhad Group Public Bank Berhad Public Finance Berhad	Hock Hua Bank Berhad Advance Finance Berhad Sime Merchant Bankers Berhad	Public Bank Berhad Public Finance Berhad Public Merchant Bank Berhad
9 RHB Bank Berhad Group RHB Bank Berhad RHB Sakura Merchant Bankers Berhad	Delta Finance Berhad Interfinance Berhad	RHB Bank Berhad RHB Delta Finance Berhad RHB Sakura Merchant Bankers Berhad
10 Southern Bank Berhad Group Southern Bank Berhad	Ban Hin Lee Bank Berhad United Merchant Finance Berhad Perdana Finance Berhad Cempaka Finance Berhad Perdana Merchant Bankers Berhad	Southern Bank Berhad Southern Finance Berhad Southern Investment Bank Berhad

Note: [1] Pending completion of business merger with MBf Finance Berhad.
[2] To be absorbed into Mayban Finance Berhad.

with the envisaged direction for the development of the economy. This is an important element behind the formulation of the Financial Sector Masterplan (FSMP) by BNM that was launched in March 2001, which outlines the broad strategies for the development of the Malaysian financial sector over the next 10 years.

The FSMP outlines the medium and longer term agenda to build a financial sector that is responsive to the changing economic requirements and that is resilient, efficient and competitive. In achieving the end-game, the respective building blocks needs to be put in place to form the foundation on which further progress can be built upon. The recommendations that were outlined in the FSMP were therefore focused on enhancing domestic capacity and capability before progressing towards a more competitive environment in the second phase and finally towards greater international integration. The FSMP identified three key objectives in its implementation phases: firstly, to ***enhance domestic capacity*** by building the capabilities of domestic banking institutions and increased deregulation in certain areas to increase competition; secondly, to ***promote financial stability*** through strong, risk-adjusted prudential regulations and supervision; and finally, to ***meet the socio-economic objectives*** of Malaysia, which includes increasing the level of consumer activism. The thrust of the policy measures and initiatives undertaken during 2001 were therefore aimed towards meeting the objectives in these areas.

Enhancing Domestic Capacity

One of the most significant developments during the year was the introduction of internet banking by domestic banking institutions. Eight domestic banking groups are now offering the full range of banking services through the internet. This is a significant milestone for the Malaysian banking sector, not only in terms of a new delivery channel but also marked the beginning of the liberalisation process. It is planned under the FSMP that the liberalisation of the operating environment for the incumbent foreign-owned banking institutions would start in Phase 2, that is after 2003. However, given the progress that has been achieved by the domestic banking institutions to compete, foreign-owned commercial banks have been allowed to offer transactional internet banking services with effect from 1 January 2002. As at 1 March 2002, three foreign-owned commercial banks have taken advantage of this and are offering transactional internet banking services.

The completion of the consolidation programme for the domestic banking sector represented the initial step towards enhancing the capacity of the domestic players to compete in the new business environment. Following this, the domestic banking groups would need to continuously assess their positions, not only within the domestic market but also within the presence of other regional and international players, and develop strategies to enhance their competitive presence in their targeted market segment. Benchmarking their position vis-à-vis their peers within the domestic banking sector as well as the foreign banks operating in Malaysia, would be an important step for the domestic players to gain this competitive edge, whilst setting realistic targets for improvement.

The benchmarking programme that started in 2000 continued to be one of the main agenda pursued by BNM to enhance the capacity of banking institutions. The benchmarking programme provides a powerful tool for banking institutions to see where their strengths lie and identify the opportunities that can be capitalised in enhancing returns in areas in which they have comparative advantage. As consumers grow in sophistication, the ability for banking institutions to provide wide range of financial services at competitive prices becomes increasingly important. Financial products would need to be personalised and customised to the individual needs of corporate and retail clients. Banking institutions would therefore need to be more proactive and innovative in identifying their niche areas and packaging and marketing their products to cater for the needs of their niche markets. Recognising these challenges ahead, it is important for banking institutions to formulate their plans with clearly defined milestones and the necessary resources required to achieve these goals. Baselines for future comparison would need to be established. Therefore, banking institutions must allocate adequate resources and implement capacity building measures to achieve this strategic objective.

In this regard, BNM has developed a set of general benchmarks in consultation with the banking industry, that has served as an initial framework to measure the position of banking institutions vis-à-vis their peers and help drive performance improvement within each banking institution. These benchmarks include indicators on operating and financing ratios, broad indicators on customer service and ratios to gauge operational efficiency within banking institutions. BNM will continue to provide statistics on industry averages to banking institutions on a quarterly basis to facilitate their internal monitoring process. Efforts are currently ongoing to further refine the general performance indicators to allow banking institutions to better assess their competitive position, particularly in identifying gaps and opportunities relating to different customer and product segments. By monitoring detailed ratios on cost and returns of different products, transactions, customer segments and delivery channels, banking institutions would be in a position to evaluate their key strengths and capabilities. This understanding will help banking institutions to re-examine existing business models, define future focus and leverage on their respective strengths to enhance shareholders' value.

Tracking the progress is an important part of the process. Board of directors of banking institutions are certainly expected to show commitment to drive this process. Towards this end, BNM has implemented the first of a series of awareness programmes for directors and senior management of banking institutions to raise their awareness of best practices on core areas of banking and emerging issues facing the banking industry. The first seminar was on benchmarking aimed to enhance the understanding of the board of directors and senior management of banking institutions on the related issues. Strategies to be undertaken in implementing a benchmarking exercise, how benchmarking could aid an institution in formulating their business plans and drive performance, as well as how benchmarking could be incorporated in risk management practices were discussed. In line with the strategy of the FSMP, further seminars would be conducted, emphasising on areas relating to the capacity enhancement of banking institutions.

As recommended in the FSMP, BNM has also developed a broad framework for the establishment of full-fledged investment banks in Malaysia. The functions of an investment bank are currently performed by different entities within a banking group: that is the merchant bank, stockbroking firm and discount house. The more competitive and challenging environment has made it imperative for these different entities to attain higher levels of efficiency and economies of scale, by facilitating mergers between these different entities. With the creation of investment banks, the consumers would benefit by being able to obtain a wide range of banking and securities related products and services from the merged entity. Towards this end, BNM has undertaken a study to determine the scope of business, desired structure and regulatory framework for the investment banks. As the scope of activities of investment banks would focus on banking-related as well as capital market and securities-related activities, the merged entity would need to be supervised by both BNM and the Securities Commission (SC). As part of this process, efforts are therefore being directed towards harmonising the legal and regulatory framework for the merchant banks and stockbroking companies. This would be essential to minimise regulatory gaps and to ensure that there would not be excessive regulatory burden on investment banks arising from the dual regulatory environment. Efforts are also being undertaken to streamline guidelines, best practices and examination requirements imposed on the stockbroking companies and the exempt dealers, which are the commercial banks and merchant banks. With the standardisation of the operational requirements and continuous collaboration between BNM and the SC, the banking sector and capital market would stand to benefit from the efforts to develop a more robust capital market as envisaged by the Capital Market Masterplan.

BNM continued to place emphasis on preserving the strength and resilience of the banking sector, whilst promoting an environment where innovation and competition amongst players in the financial market were encouraged. The challenge was therefore, to balance the trade-offs between encouraging innovation between players in the financial system and preserving overall financial stability.

Promoting Financial Stability

The initiatives to strengthen the capacity of domestic banking institutions were complemented with continuous enhancements to the prudential regulations in order to maintain stability in the banking sector and to enable the banking sector to adapt to the changes evolving within the industry. BNM continued to place emphasis on preserving the strength and resilience of the banking sector, whilst promoting an environment where innovation and competition amongst players in the financial market were encouraged. The challenge was therefore, to balance the trade-offs between encouraging innovation between players in the financial system and preserving overall financial stability.

Banking institutions are very much involved in the business of managing risks. To ensure that the safety and soundness of the banking system is preserved at all times and to safeguard the interest of depositors, it is critical to have an effective risk-focused and risk-adjusted prudential regulation and supervisory framework in place to govern the conduct of banking institutions. In the past, guidelines relating to the management of risk on derivatives trading were issued to inculcate the practice of sound risk management among banking institutions in the area of derivatives trading. Recognising the need to enhance the overall risk management framework and to align the practices of banking institutions with international best practices, BNM has issued a guideline on best practices for credit risk management and is currently developing a more comprehensive market risk management framework to address the risk exposures that are inherent in the banking business.

The continued emphasis on sound credit risk management clearly strengthens the point that credit risk forms the largest source of risk faced by banking institutions as their core business is in lending activities. The recent Asian financial crisis has highlighted that poor credit risk management is a source of vulnerability in banking institutions and the absence of sound credit risk practices and strong credit culture may result in significant or even crippling losses. Therefore, the Guidelines on Best Practices for the Management of Credit Risk formed the foundation towards upgrading the practices by banking institutions with regard to credit management and administration. The guidelines prescribed the specific requirements that banking institutions have to comply with, as well as best practices which banking institutions are encouraged to observe. The establishment of sound credit risk management practices and culture as envisaged in the guidelines rests on four pillars: enhanced responsibility on the part of the board of directors and management of banking institutions in the credit risk management process, having in place adequate infrastructure for effective credit risk management, the development of an integrated risk management process and the establishment of comprehensive internal controls and audit procedures for credit risk management.

The responsibilities of the board of directors of banking institutions to be aware and ensure that proper oversight on credit risk management is established within banking institutions is one of the key requirements emphasised in the guidelines. Board members are expected to focus on supervisory oversight to ensure that adequate credit risk management processes are put in place and that the credit risk policy is consistent with the banking institutions' capital strength, management expertise and risk appetite. The board of directors need to be kept informed in a timely manner on the performance of the credit portfolio and banking institutions are required to set up an independent credit risk management committee, which does not have any credit approval authority, to assist the board in overseeing the overall credit risk management process. The functions of the credit risk management committee would include, among others, evaluating and assessing the adequacy of strategies and policies to manage the overall credit risk associated with their activities; monitor, assess and advise on credit risk portfolio composition; and evaluate risks under stress scenarios and the capacity of the banking institution to sustain such risk.

The level of risk exposure that a banking institution assumes on a credit facility is determined when the decision is made to grant the facility. Thus, it is important for the credit assessment and evaluation process to be properly conducted by competent personnel using all relevant information and appropriate risk assessment tools to perform the evaluation process. The credit management process should include regular reviews on the financial position and the repayment capacity of the borrower, as well as taking into account the developments facing the economic sector in which the borrower operates. As such, having competent personnel in the credit granting and review process is essential towards enhancing the quality of credit. Recognising this, the guidelines require that all personnel involved in the credit appraisal, approval and review process to undergo an accreditation programme. This programme would enhance the understanding on the risks associated and the factors and market conditions that may subsequently affect the quality of the credit granted.

The upgrading in the level of skills amongst credit personnel alone would not be sufficient. It has to be complemented with an effective credit risk management information system to help banking institutions identify potential areas of vulnerabilities among borrowers, thus enabling them to take

Banking Measures Issued in 2001

The regulatory framework was further strengthened in 2001 with the introduction of several new policy measures and further refinement to the existing prudential guidelines. In addition, liberalisation measures were also instituted as part of the continuing effort to improve the competitiveness and efficiency of the financial sector. Several recommendations outlined in the Financial Sector Masterplan (FSMP) were also implemented during the year.

Enhancing Resilience and Capacity of Banking Industry

Revision of Corporate Debt Restructuring Committee (CDRC) Framework

In previous years, the size and complexity of the cases referred to the Corporate Debt Restructuring Committee (CDRC) contributed to the slow progress of debt restructuring efforts. The unfavourable market conditions and sentiments have also affected the smooth implementation of some of the restructured schemes which had obtained all the necessary approvals from the authorities, including those involving disposal of assets and raising of new equity capital. In certain instances, several cases had to be revised to review aspects of the previously agreed and approved terms and conditions, thus delaying the implementation of the restructuring process.

To expedite efforts to strengthen the corporate sector and to enable the restructuring exercises to be conducted effectively to place the corporate sector in a position to continue to participate in the economic growth process, a number of changes were introduced to the CDRC framework to facilitate and expedite the restructuring efforts under its purview. These initiatives are as follows:

(i) Inclusion of representatives from Danaharta and the Federation of Public Listed Companies in the CDRC Steering Committee;

(ii) Revision to the CDRC framework and approach with a specific timeline set to ensure effective implementation of the restructuring schemes (CDRC has set a timeline of one year for the completion of the restructuring of key corporate groups);

(iii) Enhance greater discipline among borrowers and creditors where borrowers would be required to undertake operational restructuring, where necessary, and for creditor banking institutions to be more realistic in their recovery expectations; and

(iv) Enhance disclosure and reporting through the issuance of a quarterly update on the progress of debt restructuring to ensure a more comprehensive reporting of the corporate borrowers and the progress of the restructuring to allow for greater transparency of the restructuring process.

The criteria for acceptance of loans to participate in a restructuring exercise under the CDRC was also changed to be eligible only to cases which involved an aggregate borrowing of RM100 million by the borrower as compared to RM50 million previously, and for the borrower to have exposure to at least five creditor banks as opposed to two creditor banks previously. The guiding principles to be adhered by all parties concerned, the formulation and implementation of workout proposal for the CDRC cases and the conditions to be abided during standstill periods remain unchanged.

Industry Wide Benchmarking Project

One of the key recommendations outlined in the FSMP to drive improvements and enhance the capacity of the banking industry is the benchmarking exercise. BNM in discussions with the Association of Banks in Malaysia has embarked on an industry wide benchmarking project to provide banking institutions with a means to elevate the performance of the banking sector. This is essential in equipping banking institutions with the necessary knowledge to leverage and reap the potential opportunities and to effectively address emerging challenges.

While indicators and benchmarks have been used previously, this is the first time that a wide ranging set of indicators has been formulated to form a basis for a periodical and systematic assessment.
A committee comprising a number of industry players, the Association of Banks in Malaysia and BNM

was set up to drive the benchmarking project. The group is responsible for developing the quantitative and qualitative benchmarks that would serve as 'drivers' of performance improvement. To initiate this process, BNM has begun to disseminate reports to banking institutions, benchmarking each bank's performance against that of the industry. Currently, there is a proposed set of minimum general benchmarks that are being adopted by all the banking institutions. These include benchmarks for capital adequacy, profitability, asset quality, liquidity, loan performance, productivity, customer service and operational efficiency. This set of indicators will be further refined with additional and more detailed indicators so as to enhance understanding of the factors driving the banking institutions' performance. The results from the benchmarking exercise will provide valuable input to banking institutions to guide them in implementing capacity building initiatives. The monitoring of comprehensive ratios and indicators will facilitate banking institutions to better evaluate their key strengths and capabilities and use this understanding to examine existing business models and strategies, and define future focus in the face of a constantly changing financial landscape.

Prudential Measures

Guidelines on Directorship in Banking Institutions

As part of the overall effort to improve the quality of corporate governance in the banking sector, the Guidelines on Directorship in Banking Institutions (BNM/GP1) was revised on 24 July 2001.

The main revisions cover:

- *Restricting directorships by the CEOs of banking institutions to the holding company, sister company or subsidiary of the sister company, all of which must be financial institutions and limiting the number of directorships held by a CEO at any one time to five.*
  This aims to ensure that CEOs of banking institutions are able to concentrate and dedicate their full attention on the management of the respective banking institution. Directorship in related companies would allow the CEOs to streamline the activities of the banking institutions with the financial companies in the group, thus enabling the group to maximise both its synergistic value and profitability. Directorships in organisations that represent the interests of the banking industry, non-profit organisations and statutory bodies or Government-owned companies, are however permitted and would not be part of the limit.

- *Accord full discretion and responsibility to the Board of Directors of individual banking institutions in determining the remuneration of CEOs.*
  The bonus, salary, increment and remuneration package of CEOs would be determined by the Board based on objective, measurable and transparent criteria. The total remuneration of the directors and the CEOs must be disclosed in the annual financial statements of the banking institutions.

Best Practices for the Management of Credit Risk

Following a series of discussions with the banking industry, the Best Practices for the Management of Credit Risk (Best Practices) was implemented on 1 September 2001. The Best Practices stipulates the minimum standards on best practices and mandatory requirements to be observed by all banking institutions in all aspects of their credit activities. The issuance of the Best Practices is one of the recommendations outlined in the FSMP.

Reflecting the nature of banking business, credit risk remains the largest source of risk for banking institutions. Effective credit risk management is therefore vital to minimise the risk of insolvency emanating from poor and weak credit processes and risk management. In tandem with this objective, the Best Practices aims to lay the foundation for the progressive development of higher standards in the management of credit risk and to inculcate strong credit culture in banking institutions.

Among the major requirements stipulated in the Best Practices are:

(i) *Appropriate overview by the Board of Directors and management*

- The Board of Directors is entrusted with the supervisory role and is responsible for ensuring that adequate risk management processes are in place. Therefore, the Board of Directors will no longer approve loans so as to enable them to undertake their supervisory role more effectively. However, the Board of Directors can reject loans or modify the terms of the loan that have been approved by the banking institution's executive body/credit personnel, should the majority of the Board be of the opinion that the loan would expose the banking institution to undue excessive risk.

(ii) *Existence of adequate infrastructure for credit risk management*
- An independent committee comprising of personnel experienced in credit and risk management must be formed and be chaired by a director (without the executive powers to approve credit) to assist the Board in overseeing the credit risk management processes;
- Personnel involved in credit-granting activities must be accreditated by reputable bodies or individuals acknowledged by the Board, after undergoing a common training programme and passing a common test, before being eligible to approve a credit proposal;
- A product evaluation programme must be carried out where all new credit products must be signed off by all relevant departments affected by the product and approved by the committee/the Board before its introduction; and
- An effective management information system must be put in place to enable management to be aware of, measure, monitor and control the credit risk inherent in its activities.

(iii) *Existence of an integrated risk management process*
- The credit approving function must be performed by full-time executive personnel or a committee comprising of such personnel;
- An internal credit grading system must be developed to systematically grade the credit risk of the banking institution's loan accounts;
- Credit assessment must be based on repayment capacity rather than on collateral, with specific reference and comprehensive assessment of the identified source of repayment;
- An independent credit review department or unit to review (audit) the quality of loan appraisals done by the mainstream credit officers and the approval process in accordance with standards set; and
- Biannual stress analysis, or at more frequent intervals as may be prescribed by BNM, must be performed, the results of which must be tabled to the Board.

(iv) *Comprehensive internal controls and audit procedures*
- An audit evaluation must be performed to assess the independence, adequacy and overall effectiveness of the credit risk management systems.

Accounting Treatment for Loans Sold to Cagamas with Recourse

With effect from 1 September 2001, the accounting treatment for loans sold to Cagamas on a recourse basis was revised to reflect the essence of the transaction (including under the back-to-back arrangement). Following the revision:
- loans sold to Cagamas on a recourse basis will no longer be deducted from gross loans. Proceeds from the "sale" transaction is reclassified to the "liability side" of the balance sheet; and
- interest income received from the loans and subsequently paid to Cagamas would be recognised on a gross basis as "interest income" and "interest expense" respectively, instead of on a net basis as "non-interest income".

The sale of loans to Cagamas Berhad on a recourse basis effectively entails a secured financing as any defaulted loans would be returned and replaced by the selling banking institutions. Thus, from a risk point of view, the credit exposure remains with the selling institutions, even after the loans have been "sold". The revision attempts to ensure that the books of a reporting entity reflect the substance of the transaction, rather than its form, the main principle underlying the generally accepted accounting principle.

Anti-Money Laundering Act 2001

The Anti-Money Laundering Act 2001 (AMLA) was gazetted on 5 July 2001. The enactment of AMLA signifies a concerted and comprehensive effort to combat illegal transfer of financial resources as a mean to legitimise such assets. AMLA provides comprehensive new laws for the prevention, detection and prosecution of money laundering, the forfeiture of property derived from, or involvement in money laundering and the requirements for record keeping and reporting of suspicious transactions for reporting institutions.

In recognition of the importance of a co-ordinated national effort in the fight against money laundering, the National Co-ordination Committee to Counter Money Laundering (NCC) was formed involving the various ministries and government agencies as its members. One of the major outcomes of the various initiatives undertaken by the NCC is the enactment of AMLA in 2001.

AMLA addresses the following broad issues:

(i) *Money Laundering Offences*

Stipulates monetary penalty of up to RM5 million or imprisonment not exceeding five years, or both, on any person found to be engaged or abetted in money laundering. The Second Schedule sets out the criminal activities that are illegal activities for the purpose of money laundering which include among others, serious crimes of drug trafficking, corruption and certain offences under the Penal Code such as kidnapping, robbery, human trafficking, gambling, vice and fraud.

In the civil or criminal proceedings ensuing the offence, no witness shall reveal the identity of the person who discloses the offence unless required by the court. No publications or broadcasting of the proceedings are allowed on the disclosure, or person who does the disclosure, except if the person is charged with the offence.

(ii) *Financial Intelligence Unit (FIU)*

Empowers the Minister of Finance (MoF) to appoint a competent authority, who will be empowered to act in accordance with this Act. In this regard, the MoF has appointed BNM as the competent authority and a 'Financial Intelligence Unit' (FIU) has been set up in BNM. Its responsibilities include:

- receiving and analysing reports issued by the reporting institutions;
- sending any report received or information derived from any such report to an enforcement agency;
- sending any information derived from an examination to an enforcement agency;
- compiling statistics and records;
- making recommendations to the relevant supervisory authority, enforcement agency and reporting institutions;
- developing training requirements and providing training for any reporting institutions; and
- communicating relevant information to a corresponding authority of a foreign state.

(iii) *Reporting Obligations*

The obligations of the reporting institutions cover:

- record keeping by the reporting institutions;
- immediate reporting on transactions exceeding an amount specified by the FIU or any suspicious transaction, either to the FIU or the supervisory authority;
- maintenance of records for a period of not less than six years, even after the closure of the account;
- verification of the identity of the account holder using official or private documents for any banking service to be offered. In the case of an account opened on behalf of another person, reasonable measures must be undertaken to obtain the true identity of the person; and

- adoption, development and implementation of internal programmes, policies, procedures and controls in order to guard against and detect any offence. The aforesaid programme needs to address the integrity of employees; conduct training programmes to enable the employees to disclose their responsibilities effectively, designate compliance officers at the management level and develop audit functions to test compliance. Compliance shall cover all branches and subsidiaries inside and outside Malaysia.

Provisions stipulated under AMLA overrides the secrecy obligation imposed by any written law.

(iv) *Powers of investigation, search and seizure*
This is to be undertaken by a competent authority and enforcement agencies (EA) upon having reason to suspect an offence under AMLA. The powers include:
- power to enter and search the premises for any property, record, report or document;
- make copies of, take extracts from, take possession of or remove from the premises, any of the records, reports or documents that were seized; and
- power to search and detain any person found on such premises until the search is completed.

(v) *Powers of freezing, seizure and forfeiture of property*
The EA may issue an order to freeze any property and seize any movable property suspected to be the subject matter of an offence or evidence relating to such an offence, except those in the possession, custody or control of a financial institution. Where the movable property seized comprising money, shares, securities, stocks, debentures etc, belonging to a person other than the person being prosecuted, the seizure shall prohibit the using, transferring or dealing with such property; or require the surrender of the property.

Liberalisation Measures

Negotiable Instruments of Deposits

With effect from 22 January 2001, the maximum tenor for the issuance of negotiable instruments of deposit (NIDs) was lengthened to ten years from five years.

The NIDs were first introduced in 1979 as an alternative avenue for banking institutions to source funds. When the NIDs were first issued, the maximum tenor was restricted to three years. Over the years, the maximum tenor was lengthened to five years in tandem with developments in the local debt market. Reflecting the need to further deepen the capital market, efforts were intensified in recent years to expand the range and tenor of debt instruments. Consistent with this effort, the current extension of the maximum tenor to up to 10 years would increase the supply of longer dated debt papers as well as lengthening the yield curve in the pricing of long-term bonds, thus contributing positively towards the development of the longer end of the debt market. In addition, it also adds variety and diversity to the longer dated papers available in the debt market to cater to the specific needs of the various groups of investors and permit the banking institutions to source longer term funds for hedging purposes.

Upliftment of the RM150,000 Limit on Sale of Housing Loans with Recourse Basis to Cagamas Berhad

The restriction on sale of housing loans costing more than RM150,000 on a recourse basis to Cagamas Berhad (Cagamas) was uplifted on 29 May 2001. The liberalisation took place after a temporary relaxation of the selling restriction during the period 17 April 2000 to end-March 2001.

The securitisation market in Malaysia began in late 1980s with the establishment of Cagamas which purchases housing loans of RM150,000 and below from banking institutions on a recourse basis. As the market at that time lacked the infrastructure required for a full-fledged securitisation activity, sale of housing loans to Cagamas were made on a full recourse basis, with a longer-term objective of developing a full-fledged securitisation market through outright sale of loans to Cagamas, i.e. on a non-recourse basis. Bearing in mind this long-term agenda, the range of housing loans eligible for sale on a recourse basis to Cagamas has been restricted to those costing less than RM150,000.

In 2001, Cagamas expanded its operations to include the purchase of housing loans on a non-recourse basis. Nevertheless, the volume of loans sold by banking institutions under the scheme remains low as the financial institutions are flooded with liquidity under prevailing market conditions and hence do not see the need to seek refinancing from Cagamas. Furthermore, the yield spread of banking loans has increased in view of the low interest rate environment. Even though the response to this new facility is not encouraging in view of the present liquidity situation, this new avenue provides the financial institutions with greater flexibility in managing their assets and liabilities more efficiently and effectively. Once market conditions return to normal, financial institutions would use this avenue as an effective tool to reduce their credit exposure and hence, increase their ability to grant credit facilities. Therefore, in the meantime, banking institutions were permitted to sell housing loans above RM150,000 on a recourse basis for a temporary period. However, as at end-March 2001, the market remained liquid whilst compliance with the data requirement by Cagamas for the non-recourse sale remained insufficient. In view of these developments, banking institutions are now allowed to sell all types of housing loans to Cagamas including those for the purchase of houses costing above RM150,000. This would give Cagamas greater flexibility to extend its business scope, thus providing a catalyst to the further development of the securitisation industry. Notwithstanding this, the role of Cagamas in developing a true securitisation market would continue to be pursued.

Upliftment of Restriction on the Provision of Bridging Finance for Residential Property Development Exceeding RM250,000 Per Unit

With effect from 27 November 2001, the restriction on the provision of bridging finance facility for the development of residential properties priced above RM250,000 per unit as well as the development of shop houses exceeding RM250,000 per unit located within residential areas was uplifted as the stock of unsold residential units had declined. The bridging finance restriction for the development of shop houses priced above RM250,000 per unit, which are not located within residential areas as well as for the development of commercial properties, remains unchanged. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

Consumer-related Measures

Guidelines for Lending Institutions Accepting Guarantee for a Credit Facility

With effect from 1 June 2001, the Guideline for Lending Institutions Accepting Guarantee for a Credit Facility was amended to further safeguard the interest of guarantors. Under the revised framework, banking institutions may no longer obtain a waiver of guarantor's rights whether voluntarily or involuntarily. In addition, the maximum coverage of credit facility secured by a guarantor was raised to RM250,000 from RM200,000.

In the course of their lending activities, banking institutions often require a guarantor, who in the event of default by the borrower, is equally and severally liable to the lending banking institution. The issuance of this guideline, back in 1995, aims to provide certain safeguards to the guarantor of a credit facility. This includes the requirement for banking institutions to ensure that the guarantor is fully aware of his liability beforehand and is prepared to undertake it, and that he is kept informed of the latest status of the credit facility to enable him to monitor the repayment by the borrower. In dealing with defaults, the lending institutions are required to use their best endeavour to execute the judgement to recover the sum in default from the borrower first, before any action can be taken against the guarantor. These safeguards are however, not applicable in cases where the guarantor voluntarily waives his rights, thus reducing the effectiveness of the safeguards stipulated in the guideline. With the revision, banking institutions would still be required to perform the steps as stipulated in the guideline, hence ensuring that the rights of the guarantors remain protected.

Establishment of Complaints Unit in Banking Institutions

In order to promote greater customer awareness of the existence of a structured and formal mechanism for banking institutions to address public enquiries, all commercial banks and finance companies have been required to set up a dedicated Complaints Unit within their organisation by end-2001. Banking institutions are also encouraged to establish complaints booth within their branch premises. The Unit will function as the focal point for managing all complaints received by the banking institutions (via correspondence, e-mails, telephones etc) consistent with the long-term objective to improve the services provided by the banking institutions to the banking public.

To ensure that all complaints are being attended to, banking institutions are required to put in place a central tracking system to record and monitor the status of each complaint received by the institution. In addition, all complaints lodged must be processed and responded to within a period of two weeks from its receipt, with the exception of complex cases whereby complainants would be informed of the timeframe to resolve the matter. For certain cases, if the complainant is unsatisfied with the response given or the cases remain unresolved, the complainant may subsequently forward his/her dissatisfaction or complaints to the Banking Mediation Bureau (BMB) or BNM.

The BMB was established to provide an avenue for consumers aggrieved with the services provided by the banking institutions to seek redress. The present scope of BMB operations is limited to claims involving monetary losses not exceeding RM250,000 arising from unfair practices relating to charges and fees as well as against guarantors, ATM-related matters and unauthorised use of credit cards. In order to foster a more market-oriented banking system as envisaged in the FSMP, the power and scope of operations of BMB would be expanded to cover the full range of retail banking-related consumer complaints. This would ensure that BMB would be effective and proactive in protecting the rights of the banking consumers. The setting up of the Unit is therefore an initial step towards the achievement of this vision.

Improving Access to Financing for Priority Sector

Measures implemented in 2001 were also focused at enhancing the accessibility of the small- and medium-sized enterprises (SMEs) and specific industries to financing at reasonable cost to fund their working capital needs in order to meet demands of the domestic economy.

Reduction of Interest Rates and Financing of Loans under Special Funds

With effect from 16 April 2001, the funding rates (rates charged by the Government on lending institutions) and lending rates (maximum rates charged by lending institutions on borrowers) for the Fund for Food (3F), New Entrepreneurs Fund (NEF) and Fund for Small and Medium Industries 2 (FSMI2) were reduced. The reduction in funding rates ranged between 0.75 and 2.0 percentage points, whilst the lending rates were reduced within the range of 0.25 and 1.0 percentage points. In addition, the allocation for these funds was also increased, which in aggregate amounted to RM0.75 billion. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

Reduction in Lending Rates and Liberalisation of Eligibility Criteria of Special Funds

Effective 15 October 2001, the funding and lending rates for the Rehabilitation Fund for Small and Medium Industries (RFSMI), FSMI2 and NEF2 were further reduced by 0.5 percentage points. The revision in the rates was aimed at further lowering the cost of doing business, thus promoting higher domestic economic activities as impetus for growth in investment.

The eligibility criteria and conditions of 3F, RFSMI, Fund for Small and Medium Industries, Bumiputera Entrepreneur Project Fund and Entrepreneur Rehabilitation and Development Fund were also liberalised to further enhance access to such financing schemes. Details of this measure can be found in the *Monetary Measures in 2001* section in *Chapter 2: Monetary and Fiscal Developments* of the BNM Annual Report.

The Entrepreneur Rehabilitation and Development Fund

The Entrepreneur Rehabilitation and Development Fund (ERDF) was established on 3 July 2001 with a total allocation of RM500 million. It has two objectives, namely to assist the resolution of existing non-performing loans (NPLs) and to provide working capital to Bumiputera SMEs. Out of the RM500 million allocation, RM120 million is allocated to assist the SMEs in resolving their existing NPLs, whilst the remaining RM380 million is allocated to provide working capital support to enable the SMEs to continue in their business operations. The ERF Sdn Bhd (ERF) has been entrusted to act as the administrator and secretariat of the ERDF.

The primary objective of the ERDF is to provide distressed companies that are still fundamentally viable and being capably run, with financial assistance in the form of working capital to eligible borrowers with existing NPLs not exceeding RM1 million. Features of the financing terms include:

- amount of financing sought is limited to the borrower's actual working capital requirement or RM3 million, whichever is lower. The new financing would be extended by the ERF and financial institutions in the ratio of 80%:20%;
- maximum lending rate of 5% per annum for a maximum tenure of 5 years; and
- all conduct of the new financing is made through non-checking accounts with close monitoring on the disbursements by the financial institutions and ERF.

The new financing would be complemented by a scheme to restructure the existing NPLs through debt reduction and moratorium as follows:

- Unsecured loans: all outstanding and penalty interests would be waived, whilst the unsecured principal amount would be reduced by 40%. The Government will contribute financial assistance on 30% of the principal amount, while the entrepreneur must settle the remaining 30% of the NPLs by not more than 18 monthly instalments; and
- Secured loans: haircuts of between 50%-100% on outstanding interest including penalty interests and a 2-year moratorium on the repayment of the remaining balance would be granted. In the event that the borrower defaults on the instalment payments, the financial institutions would reinstate any haircuts provided prior to the default and the Government would withdraw the financial assistance that was given to help the distressed companies.

An added unique feature to the financing scheme under the ERDF is the mandatory requirement for the approved applicant to undergo structured training programmes and the existence of advisory services. This added feature attempts to equip Bumiputera SMEs with current business expertise and skills required to succeed in the present business environment through the various training and awareness programmes that are conducted by Institut Bank-Bank Malaysia (IBBM). The training is organised to cover topics such as financial cash flow management, computerised accounting, financing tools and motivational talks. The programmes also help to ensure optimal and prudent usage of the disbursed funds to maximise business opportunities that are available at any given time.

To ensure that only qualified SMEs are given access to the ERDF, the applicants to the ERDF must meet the following eligibility criteria:

- The Bumiputera SMEs total outstanding NPLs must not exceed RM1 million;
- The SMEs must be at least 60% owned by Bumiputera;
- The NPLs must be for business related loans only;
- The financial duress suffered by the SMEs must be due to the economic crisis and not due to mismanagement or fraud;
- The loans turned non-performing between 1 January 1998 and 30 June 2001; and
- The borrower must have an ongoing business or potential viable business venture.

Eligible SMEs are expected to use the combination of working capital assistance, NPLs restructuring and training programmes to both rehabilitate and develop existing businesses that would otherwise have been forced to cease operations due to the economic downturn.

pre-emptive actions, such as loan rescheduling or restructuring, to ensure that borrowers will be able to continue their business activities and thus mitigate any potential losses. To facilitate the monitoring and review process, banking institutions are required to develop an internal credit risk rating system which would cover all the credit exposures of the banking institution to the borrowers, including off-balance sheet exposures. With a better understanding of the behavioural patterns that are inherent in certain types of loans or industries, banking institutions would then be able to price their loans correctly to match the level of risk inherent in the credit facility.

In addition to the new requirements that were introduced in the guideline, existing practices such as the setting of credit authority limits, limits on particular sectors, single customer credit limit and rules regarding the provision of credit facilities to related entities, would continue to be a significant part to the overall management of credit risk. The guidelines that have been issued are by no means conclusive and exhaustive. The framework would be continually reviewed to be in line with international best practices and to be reflective of the credit practices of the banking industry.

The availability of a comprehensive and up-to-date centralised database that houses credit information of previous and present borrowers can assist banking institutions in their credit assessment and monitoring process, by expediting the credit evaluation process whilst enabling banking institutions to have more comprehensive information on a particular borrower on a real time basis. To enhance the existing centralised credit bureau that was established in the early 1980s, BNM has developed a sophisticated and comprehensive electronic-based system, known as the Central Credit Reference Information System (CCRIS) which became operational in October 2001. The CCRIS would capture information of all borrowers in the banking system, thereby enabling banking institutions to conduct background checks on prospective borrowers and the level of indebtedness of the borrower in the banking system on a real time basis. From a broader perspective, CCRIS would help to develop sound credit culture in the financial system by enabling personnel engaged in credit approval process to make informed decisions based on centrally available and comprehensive information.

In addition to credit risk, another area of risk that needs to be properly managed by banking institutions is market risk. BNM is currently developing minimum standards for the management of market risk for banking institutions. These guidelines would focus on three main components of market risk, namely: interest rate risk, exchange rate risk and equity risk. The issuance of this guidelines envisaged in 2002 would enhance the overall risk management practices of banking institutions in both credit and market risks.

The raising of standards of risk management practices among banking institutions, in particular with respect to market and credit risks would not only help banking institutions to better understand the risk-return relationship in their own business, but also help them to prepare for the new capital regulatory requirements to be introduced by the Bank for International Settlements, known as 'Basel II'. While the new capital adequacy rules will allow greater flexibility in the use of internal systems to determine regulatory capital requirements, this would be subject to banking institutions having the ability and capacity to maintain high standards of risk management practices. To attain the flexibility, banking institutions would not only be required to meet the technical requirements with respect to their risk management systems for instance, covering the structure of the internal loan rating system and the minimum historical data requirement, but they would also be required to conduct comprehensive evaluation on the use of such systems in the decision making process within the institutions. The issuance of minimum standards on risk management would therefore be consistent with the developments in the international arena and would help domestic banking institutions in particular lay the foundation for stronger business culture to cope with changing market structure and regulatory framework.

Since the financial crisis, various efforts have been channelled towards strengthening the supervisory framework over banking institutions. With the completion of the consolidation programme for domestic banking institutions, it is imperative that closer monitoring and supervision over banking groups be conducted to maintain the overall stability of the banking sector. To achieve this, BNM has intensified its supervisory focus on bank holding companies and their subsidiaries in the supervision process. Previously, the examination focus has mainly been on the banking institutions and their subsidiaries. As the financial system evolves and becomes increasingly complex, supervisory oversight needs to be extended to the group as a whole, to provide a better understanding on the linkages and interdependencies between the respective entities within each banking group. The extension of the supervisory net to include bank holding companies would place BNM in a better position to assess the overall condition of the banking group and act upon the areas of vulnerabilities that may threaten the solvency of the banking group, and ultimately the stability of the financial sector. The expansion of the examination process to include the bank holding company of banking institutions and their subsidiaries is also consistent with the overall move towards consolidated supervision. Close monitoring of the activities of the bank holding companies, as well as other entities within a particular banking group would only be possible with the availability of key information such as capital strength and leverage position of the bank holding company and the group as a whole. The framework for regular reporting by the bank holding company would therefore be finalised to enable BNM to assess the risk profile of each banking group on a consolidated basis and to extend the prudential regulatory framework to include bank holding companies. The prudential framework aims to ensure that bank holding companies are well capitalised and able to lend financial support to its subsidiaries should the need arise. At the same time, an assessment of the group structure would also be undertaken. While group structures would naturally take into account the need for business synergy, regulatory principles would ensure that such structures do not hamper the effective conduct of consolidated supervision. The framework for consolidated supervision would need to continuously evolve as the market develops and continuously enhanced to provide a comprehensive framework that will culminate into a specific legislation to regulate the holding companies of banking groups.

As the banking system undergoes the transition towards a more deregulated and a market-oriented financial system, strong corporate governance becomes a key pre-requisite. Good corporate governance practices such as transparency, efficient internal controls and having an effective board of directors would contribute positively towards ensuring that banking institutions are well-run and well-managed, with the ultimate objective of enhancing efficiency, productivity and shareholders' value. As banking institutions grow larger and undertake more complex business activities, it would be increasingly important for members of the board and senior management to comprehend the factors that may affect the financial position of their banking institution so that appropriate measures can be implemented to safeguard the soundness of their banking institution. Directors and senior management are also expected to continuously upgrade their knowledge on emerging issues such as trends emerging in the market, new technology and techniques that can enhance their performance and efficiency, as well as new challenges facing the banking business in order for them to exercise their duties effectively. Given the critical role played by the CEOs in managing the daily operations of the banking institutions, it would be vital for CEOs to accord their full attention to the running of their banking institution. Therefore, BNM has restricted the number of directorships that a CEO may hold at any one time to five directorships. To ensure that the positions that they hold will not be in conflict or adversely affect the objectivity of the CEOs, they are also not permitted to become a director, chairman or hold any executive powers in other entities, other than as a director in a subsidiary or a holding company of their banking institution.

It has been a practice previously for banking institutions to request for approval for the remuneration rewarded to their CEOs and directors. This was necessary at the time to ensure that the compensation packages of senior management commensurate with increases in the level of productivity of the banking institutions. However, moving forward, to enable banking institutions to attract the best talents and for the remuneration to be market driven, BNM has removed the requirement for banking institutions to obtain the prior approval of BNM on the remuneration of their CEOs and directors. The responsibility of determining the appropriate amount of remuneration now lies with the board of directors and shareholders of banking institutions, who are primarily responsible for ensuring that the remuneration packages of their senior management are based on transparent, measurable and objective criteria. In line with the move towards promoting greater market discipline, this liberalisation is accompanied by the requirement for banking institutions to disclose the aggregate amount of remuneration paid to their CEOs, executive directors and non-executive directors in their annual accounts.

Taking into account the increasing demand for greater public disclosure and the enhancement of financial reporting by standard setters, BNM has recently issued a consultative paper to the banking industry on the proposed amendments to the Guidelines on the

Specimen Financial Statements for the Banking Industry (GP8). The revised GP8 has been drawn up with greater focus on the role of the board of directors. Directors are placed in a position of trust by shareholders while the law places the responsibility for managing the affairs of the banking institutions on the board. The board therefore carries the ultimate responsibility for proper stewardship of company resources and the achievement of corporate objectives. In line with this, the primary responsibility for the preparation of the financial statements is placed on the board of directors and the board is expected to develop a sound financial reporting structure to ensure the integrity and credibility of its accounts. A less prescriptive stance has been adopted in the reporting of several items in the revised GP8. This is intended to give banking institutions the flexibility in disclosing their policies and reporting of financial performance and business operations according to the specific circumstances pertaining to the institution.

The shift towards fair value accounting framework with the adoption of International Accounting Standard 39 (IAS 39) is another area of challenge to financial institutions in terms of financial reporting. While the fair value model is yet to be fully implemented in Malaysia, banking institutions must stand ready and make preparations for compliance with the new requirements. Policies on investments in financial assets as well as hedging activities for example, would need to be re-examined to be consistent with the new recognition and measurement rules. The new framework would also require banking institutions to reassess the capability of their management information systems to cope with the new measurement rules. Similarly, the board and management of banking institutions would need to be informed of the overall impact of the fair value accounting framework on the institution’s balance sheet and profitability, in particular with respect to potential increase in income volatility.

Banking is a business which is founded on the basis of integrity and is dependent upon the confidence level that is placed by the public on the banking system. Therefore, it is important that the integrity of the financial system is preserved to maintain confidence of the public on the financial sector. The board of directors therefore, have an equally important role to ensure that the reputation of their banking institution is preserved. The board of directors must ensure that there is an appropriate mechanism to monitor and manage reputational risks, as even though a banking institution may have strong fundamentals, certain issues if not managed, may have destabilising effects on the banking institution. It has been a practice for banking institutions to have adequate controls and procedures in place to verify the authenticity of their customers before establishing a banking relationship with them. These requirements have been put in place since the introduction of the guidelines on “Know Your Customer Policy” in 1993 to ensure that the banking system is not used as a conduit for criminal activities.

However, in light of the higher degree of innovation and greater use of technology in the banking sector, efforts were directed towards strengthening the overall regulatory framework on anti-money laundering. In June 2001, the Government passed a new legislation, Anti-Money Laundering Act 2001 (AMLA), to combat money laundering activities in Malaysia. Prior to the enactment of this legislation, legal provisions on money laundering activities focused mainly on drug and corruption activities and these provisions were incorporated in various specific legislations. Legal statutes on money laundering were therefore fragmented. The AMLA also aims to address the gaps in the various legislations by ensuring that all activities relating to money laundering are curbed in a cohesive manner. The AMLA enhances the overall anti-money laundering framework by making it more comprehensive. Firstly, money laundering itself would now be treated as a separate criminal offence. Secondly, the scope of AMLA would cover laundering of proceeds from 122 offences. Thirdly, existing administrative requirements in relation with customer identification, record keeping and suspicious transaction reporting would now be made legally binding. The AMLA also requires the establishment of a financial intelligence unit to receive suspicious transaction reports and conduct intelligence. The Government has appointed BNM as the competent authority to collect, process and conduct intelligence gathered relating to suspected money laundering activities from reporting entities. The AMLA which came into force on 15 January 2002 has identified at the initial stage, commercial banks, finance companies, merchant banks and Islamic banks as reporting entities. Other entities such as stockbroking companies, discount houses, insurance companies and money changers will be included as reporting entities at a later stage. Fourthly, the AMLA enhances the powers of law enforcement agencies to seize and freeze properties to enable them to detect, monitor and prosecute money laundering offences.

Following the enactment of the AMLA, BNM will revise the guidelines on "Know Your Customer Policy" to be in line with the provisions in the AMLA and to incorporate international best practices prescribed by the Bank for International Settlements and the Financial Action Task Force. At the initial stage, the reporting mechanisms on cases of money laundering would be based on suspicious transactions reporting only. The requirement to report all transactions exceeding a certain prescribed amount would be imposed at a later stage when banking institutions have put in place the necessary systems to record and track information of individual customers in a more comprehensive manner. Procedures and controls to address the integrity of their employees, training programmes including "know-your-customer" programmes, designate compliance officers at management level and develop audit functions to test compliance would also form part of the compliance requirements, to be complied by all branches and subsidiaries of banking institutions.

Meeting Socio-economic Needs

One of the important objectives highlighted in the FSMP is to promote greater consumer awareness and activism. BNM continued to pursue efforts towards achieving this objective whilst building the safeguards to protect the interests of consumers of banking services. Consumer activism has been identified as an important element that would help to drive performance in banking institutions and the desired efficiency and effectiveness in a market driven environment. The need to ensure adequate and effective consumer education and protection is also becoming more crucial. The prevention of any disruptions in the level or reliability of service to bank customers and also their protection from potential unfair practices reflects positively on the ability of the financial system to absorb increasing competition. Active and structured consumer education programmes are needed to increase consumer understanding of banking institutions' products and services, which will in turn give rise to more active consumerism. The objectives of the consumer awareness initiative are threefold: to educate and enhance consumer knowledge on personal financial issues; to improve legal protection for consumers and customer redress avenues; and to increase product transparency and disclosure. To achieve these objectives, BNM has taken several measures in 2001 to lay the necessary foundation towards building a more active consumerism movement in Malaysia.

As part of the ongoing efforts to educate consumers on financial issues, BNM has also undertaken an extensive education and public announcement programme to curb the activities of illegal deposit taking entities. This effort was conducted through media advertisements, distribution of pamphlets and placement of posters to reach a wide spectrum of the population and to enhance consumer knowledge on such illegal activities. Due to the lack of information and understanding by the public, illegal deposit taking businesses were able to develop particularly amongst the less informed segment of the population. With the extensive education campaign, it is hoped that greater awareness would help towards preventing the activities of illegal deposit taking from taking place in the future.

Towards further improving legal protection for consumers, the guidelines on the acceptance of guarantee for credit facility were amended to further safeguard the interests of guarantors in May 2001. The level of protection accorded to guarantors was emphasised by prohibiting banking institutions from obtaining a waiver of guarantor's rights voluntarily or involuntarily. This was to ensure that guarantors were aware of their rights and would not be caught off-guard by the fine prints in the guarantee agreement. Greater emphasis was also placed on ensuring that banking institutions educate the guarantors on their obligations before committing to the loan agreement, and to keep the guarantors updated on the status of the loan at all times. Actions against guarantors should only be taken after banking institutions have exhausted all means available to recover the amount owed to them from the borrower.

In a move towards providing avenues of redress for customers and to enhance the level of service provided by banking institutions, all commercial banks and finance companies are required to set up a dedicated Complaints Unit as a channel for customers to raise their problems with their respective banking institutions and to enable banking institutions to record and monitor the progress of complaints received from consumers in order to improve the services that are provided. The Complaints Unit is the focal point for managing complaints received by banking institutions and is responsible to take the necessary actions so that similar grievances would not reoccur in the future. Previously, BNM had actively mediated to resolve grievances raised by consumers. With the setting up of the Complaints Unit, banking institutions would now be the first point of reference for dissatisfied customers. Banking institutions should endeavour to act upon and respond to the complainant as soon as possible. In the event that the customer remained dissatisfied with the decisions made by the banking institution, the matter could be forwarded to the Banking Mediation Bureau.

BNM also continued to accord priority to the development of Bumiputera entrepreneurs. In particular, to improve the accessibility of banking services for Bumiputera entrepreneurs, banking institutions have been required to set up a designated Bumiputera Development Unit (BDU) within each organisation to address specific issues related to the Bumiputera entrepreneurs. The role to be played by the BDU included acting as a one-stop centre to coordinate all financing and advisory services for Bumiputera entrepreneurs, to be responsible for handling loan applications received from Bumiputera businesses, to undertake functions of marketing and promoting banking related products to the Bumiputera entrepreneurs, and to undertake and coordinate training programmes in areas such as product familiarisation and financial management for Bumiputera entrepreneurs. With the established point of reference within each banking institution, the mechanism for Bumiputera entrepreneurs to gain access to banking credit will be more efficient and effective.

BNM also established a special fund, Entrepreneur Rehabilitation and Development Fund or "Tabung Pemulihan dan Pembangunan Usahawan" to provide financial assistance to small and medium Bumiputera enterprises (Bumiputera SMEs). The objectives of the fund was to provide financing to help affected Bumiputera SMEs to resolve their NPL problems by providing working capital to enable them to continue with their business. Although the funds were provided by the Government, banking institutions were required to assess the viability and repayment capacity of the SMEs. The Fund is aimed at providing assistance to Bumiputera SMEs that faced difficulties in obtaining new financing and thus helped to preserve their businesses that were still viable.

Moving Ahead

The FSMP has outlined the direction for the development of the banking sector in the next 8-10 years. The implementation of the recommendations of the FSMP needs to be carefully sequenced in order to minimise disruption to the overall economy.

The developments during the next few years would be vital towards achieving the end-game envisaged in the FSMP. They would form the building blocks on which further developments of the banking sector would take place. With the global financial industry continuing to evolve and the acceleration in the rate of change, the Malaysian banking sector, particularly the domestic banking institutions would be faced with mounting pressure to become more efficient and competitive, innovative, technology-driven and strategically more focused. Therefore, greater emphasis would continue to be given towards strengthening the resilience and competitive position of banking institutions to enable them to remain relevant in a more globalised and liberalised environment.

SUPERVISORY ACTIVITIES

BNM continues to adopt a two-pronged supervisory approach for banking institutions, focusing on both on-site examination and off-site surveillance. In line with the philosophy of creating a framework for a strong, risk-adjusted prudential regulation and supervision of the banking sector, emphasis continued to be placed on high risk areas that could affect the safety and soundness of banking institutions. The risk profile and business activities of the banking institution and its related companies are taken into account in determining the areas of supervisory focus to enable appropriate assessment of the overall health of the banking group and to ensure that activities undertaken by the group would not result in an adverse impact on the banking institutions and the banking system as a whole. The supervisory process therefore covers not only the banking institutions, but also the bank holding companies and related companies.

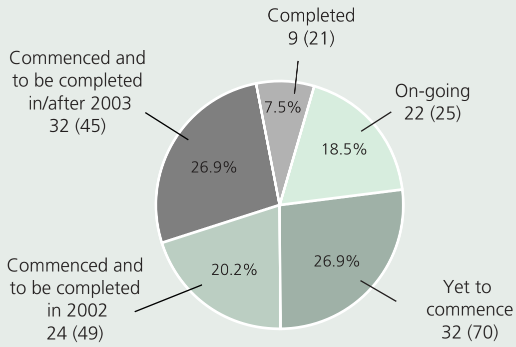
In 2001, BNM conducted 85 examinations on banking institutions, of which, 35 examinations were conducted on the local and overseas branches of the banking institutions and another 7 examinations on bank holding companies and related companies of banking institutions. In addition, there were 5 examinations of non-bank financial institutions. The on-site examination continues to focus primarily on the assessment of the financial and operating conditions of banking institutions, reinforced with emphasis on the assessment of risk profiles and adequacy of risk management systems of banking institutions. The off-site supervisory function complements on-site examination through dynamic ongoing surveillance of the financial health of banking institutions. It includes the review and approval of financial statements of banking

PROGRESS OF IMPLEMENTATION OF FINANCIAL SECTOR MASTERPLAN

The Financial Sector Masterplan (FSMP), launched in March 2001, outlines the medium and long-term strategies for the development of the financial sector. In the context of the plans and strategies that have been put in place, it is important for the development to be monitored and managed. Towards this end, a FSMP Secretariat and a FSMP Steering Committee (FSMP SC) have both been set up in BNM to monitor the implementation of the FSMP recommendations. The FSMP Secretariat has drawn a framework to monitor the progress in the implementation of the recommendations. It will also review the relevance of the recommendations against current and future developments, especially in the international markets and to monitor the progress of the domestic financial institutions and financial system in the context of attaining the specified milestones. The FSMP SC reviews on a monthly basis the progress of the FSMP recommendations, provides strategic directions to the FSMP Secretariat as well as discuss policy issues that have emerged in taking the FSMP recommendations forward for implementation.

To facilitate monitoring the progress in the development of the financial system, the recommendations are divided into five categories based on objectives that are being envisioned for the financial system. This will include building efficiency and capacity, enhancing competition, providing an efficient payment system, strengthening the regulatory framework and enhancing consumer awareness. With regard to the recommendations under the Islamic Banking and Takaful sector, its progress is being monitored in accordance with four objectives, namely, to strengthen regulatory framework development, to promote product and market development, to strengthen the legal and Shariah framework and to enhance knowledge and expertise to promote human capital development. In line with the consultative and iterative approach that has been adopted in the implementation of the FSMP recommendations, a number of working groups with participation and representations from the industry, the private sector and related Government agencies have been and will be established in the development of the financial sector as outlined in the FSMP. This is to ensure that the implementation of the FSMP recommendations are being carried out in a manner where the desired results are achieved without disruptions to the financial sector.

Graph I.1
Progress of Implementation of FSMP Recommendations



Total recommendations : 119
Total projects : 210
( ) No. of projects

As at end-2001, out of the total 119 recommendations, 22 recommendations are being implemented on an on-going basis, where its implementation is on a continuous basis and runs throughout the FSMP's 10-year period, while nine or 9% of the remaining 97 recommendations have been fully implemented. The associated work in the implementation of each recommendation involves several related projects. The recommendation for the "Development of a Comprehensive Framework for Consolidated Supervision" for example encompasses eight projects. The projects under the recommendation include developing a framework for consolidated supervision of financial conglomerates relating to information/statistical reporting by bank holding companies to BNM as well as putting in place the legal framework and regulations relating to group structures, intra-group transactions, corporate governance, liquidity, capital adequacy and other prudential requirements. The recommendation would only be considered complete when all projects under it have been fully completed. To achieve the implementation of the remaining 88 recommendations, a total of 164 projects will need to be completed.

Consistent with the focus under Phase 1 of the FSMP on building domestic capacity, current efforts are focused on implementing measures to enhance the capability and capacity of financial institutions to improve their level of efficiency, competitiveness and effectiveness, measures to promote stability in terms of strengthening the regulatory and institutional framework as well as measures to put in place an efficient and market driven consumer protection framework.

The recommendations to enhance domestic capacity and enhance competition include the benchmarking exercise to enable banking institutions to benchmark their performance against international standards and

Table I.1
Status of Implementation of Recommendations

Completed	On-Going
Banking Sector	
R3.5 Uplift restriction on employment of expatriates to attract best international talents to meet the demand for expertise in specific areas of banking	R3.2 Improve awareness of best practices and conduct focused training to raise the level of awareness of best practices and enhance understanding of chief executive officers and directors of banking institutions on emerging trends and issues facing the banking industry
R3.12 Encourage outsourcing of non-core functions to gain greater strategic focus and efficiency	R3.3 Enhance credit skills and monitor the requirement for accreditation of credit officers and managers to strengthen credit skills of credit officers and managers and ensure effectiveness of the accreditation requirement
R3.14 Encourage the development of new delivery channels to increase the range of product and services at more effective rates	R3.13 Require management of banking institutions to give greater attention to the development of ICT to ensure the formulation of appropriate ICT strategies
	R3.15 Adopt 'what is not prohibited is allowed' regulatory philosophy and phase-out product pre-approval requirements to remove impediment to innovation
	R3.19 Facilitate the development of a conducive tax regime to provide incentives to encourage financial prudence and innovation
	R3.34 Initiate an active and structured consumer education programme to develop active consumerism
	R3.36 Encourage consumers to pursue formal administrative and legal redress to protect customers from possibilities of unfair practices by banking institutions
Insurance Sector	
R4.2 Allow all players in the market to operate via the internet to enhance competitiveness and efficiency of the insurance industry	R4.5 Open up the pension industry to insurers to increase the market share of domestic life insurers
R4.16 Increase the statutory minimum paid-up capital of insurers to accelerate consolidation process that will enable domestic insurers to capture the size and scale needed to compete effectively in a more deregulated and liberalised market	R4.8 Allow insurers to distribute other personal financial service products to enable insurers to make more effective use of the agency force and other distribution channels
Islamic Banking and Takaful	
R5.6 Increase the number of takaful operators to accelerate the expansion of takaful industry	R5.11 Create a favourable tax regime to avoid barriers in adopting Islamic banking concepts and takaful products

Alternate Modes of Financing	
Completed	**On-Going**
R7.2 Establish a RM500 million VC Fund to increase the availability of VC financing and stimulate new ventures	R7.13 Establish a one-stop agriculture research and development centre as well as a comprehensive and integrated information database to facilitate banking institutions in their assessment of specialised risks involved in agriculture financing
R7.3 Introduce further tax incentives for the VC industry to promote the growth of VCs	R7.14 Develop structured and systematic training programme for borrowers to ensure the orderly development of players in the agriculture sector
R7.4 Liberalise the MESDAQ listing requirements to facilitate the exit of VCs from their investments	R7.15 Establish risk-distribution mechanism that will reduce risks to the financial institutions and at the same time, reduce borrowing costs through a guarantee and insurance protection scheme
	R7.16 Provide subsidies to agriculture industry to help reduce insurance costs especially for small scale farmers
	R7.17 Grant tax exemptions to provide greater financial assistance to the sector

Labuan International Offshore Financial Centre	
Completed	**On-Going**
	R8.1 Develop an active International Offshore Financial Centre (IOFC) for Malaysia to support the increasing demands of the domestic economy
	R8.2 Review existing rules and regulations to facilitate expansion in the scope of core business to facilitate new offshore businesses and allow offshore service providers to maximise capabilities and expertise to expand their businesses
	R8.3 Adopt a consultative and market driven approach to create a conducive tax and business environment to enhance the competitiveness and attractiveness of Labuan
	R8.6 Strengthen Islamic banking and finance as well as Islamic insurance (takaful) to develop Labuan with a strategic focus on Islamic products and services
	R8.7 Enhance the Labuan International Financial Exchange (LFX) to be a one stop financial exchange for residents and global companies
	R8.8 Enhance the e-commerce gateway to encourage global e-commerce operators to set up domicile in Labuan
	R8.9 Maximise potentials of Labuan IOFC by developing other complementary economic measures

to use it as a strategic tool to drive performance. BNM has disseminated reports to banking institutions, benchmarking each bank's performance against that of the industry and that of their peers on the basic indicators. In order to enhance awareness and garner the support and commitment of board members and senior management of banking institutions on the importance of benchmarking, BNM had conducted a "Seminar on Benchmarking". The seminar was part of a series of seminars planned for the directors and chief executive officers of banking institutions and insurance companies to enhance awareness on important areas which are vital prerequisite for taking the development of financial services sector forward. In addition to quantitative indicators, market research will be conducted on customers' needs and satisfaction levels to drive customer segment strategies, particularly in the areas of retail and small business banking.

Internal benchmarking will also be established to determine the pace of implementation of the FSMP. To gauge the extent of progress achieved in relation to the specific objectives set out under the various phases of the FSMP, the performance and development will be periodically measured against specific milestones set at the various stages of implementation. The results of the periodic reviews will serve both to determine the sequence and pace of subsequent implementation, as well as prompt remedial actions or adjustments that may be needed to ensure that the measures implemented achieve their intended objectives.

Given the crucial importance of developing expertise and skilled personnel to manage and control credit risk within banking institutions, a recommendation relating to the accreditation of credit personnel programme has also been introduced. The accreditation programme is aimed at ensuring that all credit personnel have a complete understanding of the risks associated with lending activities, which in turn would help to enhance the credit culture and credit standards of banking institutions. The recommendation relating to removal of salary restrictions has also been implemented whereby banking institutions are now given flexibility to determine the salaries, allowances and bonuses of their employees based on their productivity and efficiency levels. This has enhanced the ability of banking institutions to mobilise, attract and retain the best talents into the industry.

To allow greater operational flexibility, banking institutions have also been allowed to outsource their non-core business activities to third party service providers and engage in cross-selling activities. To date, 22 banking institutions have outsourced some of their non-core functions to third party service providers and 6 banking institutions are engaged in cross-selling financial products and services of entities within the same group, including those belonging to their related non-bank financial institutions. The ability of banking institutions to offer a broad range of financial services through different distribution channels also become increasingly important to maintain their competitive edge. To date, eight domestic banking institutions and three foreign-owned banking institutions offer internet banking facilities. Various efforts have also been put in place to enhance the efficiency and competition in the payments system. This includes enhancements to the RENTAS system, introduction of a real time surveillance system to enhance transaction monitoring and liquidity management, and a Repurchase Agreement Enhancement Module to enhance liquidity in the secondary bond market and facilitate the settlement of repurchase agreement transactions. In order to allow market forces to shape developments in the payments system, a National Payments Advisory Council (NPAC) was established in mid-2001 to perform an advisory function and provide market input in the development of payment systems policies. Members of the NPAC comprise of officials from the Ministry of Energy, Communications and Multimedia of Malaysia, BNM, Securities Commission, Hong Kong Monetary Authority, Bank of Japan, Malaysian Administrative Modernisation and Management Planning Unit (MAMPU), Malaysian Electronic Payment System Sdn. Bhd. (MEPS), the Association of Banks in Malaysia, the Association of Finance Companies of Malaysia, the Association of Merchant Banks in Malaysia and the General Insurance Association of Malaysia.

To further strengthen the regulatory framework, three consultative papers on the banking sector have been issued namely, the prompt corrective measures which recommend a set of regulatory actions that would be automatically instituted on banking institutions found to be operating in a manner detrimental to depositors' interest; the consultative paper on single customer credit limit which is intended to refine the existing guidelines; the consultative paper on the revised Guidelines on the Specimen Financial Statements for the Banking Industry (BNM/GP8), which is intended to cater for the rapid pace of development in the financial markets; and the increasing demand for greater public disclosure to foster market discipline and strengthen financial stability.

In the insurance sector, the consolidation of the industry was further advanced with the implementation of the recommendation to increase the statutory minimum paid-up capital for direct insurers to RM100 million with effect from 30 September 2001. To date, a total of eight mergers and acquisitions (M&As) involving 16 insurers have been completed, while M&As involving another 13 insurers are at various stages of implementation.

The FSMP also contained a set of recommendations to enhance the effectiveness of financial institutions that are not licensed under the Banking and Financial Institutions Act 1989. The recommendations were directed at improving the regulatory framework for Development Financial Institutions (DFIs) and building capacity and increase efficiency of DFIs in utilising their financial resources in meeting the Government's objectives. The Development Financial Institutions Act 2002, which came into force effective 15 February 2002 has accorded BNM powers to enforce the Act. Following the enforcement of the Act, six DFIs have been placed under the purview of the Act. In order to further enhance the development of alternative modes of financing, the listing requirements by venture companies on the MESDAQ have been liberalised and the Government has established a RM500 million Venture Capital (VC) Fund to increase the availability of VC financing in the economy and in the process, stimulate more new ventures, particularly in the ICT industry. In addition, tax incentives in the form of tax deductions equivalent to the amount of investments made in approved venture companies at start-up, seed capital and early stage financing have also been given to the industry.

In promoting consumer awareness and initiating a structured consumer education programme, BNM and the banking institutions have initiated a comprehensive plan for an active and structured Consumer Education Programme. The Association of Banks in Malaysia in consultation with The Product Transparency and Disclosure Working Group had published the first series of information pamphlets namely, on areas such as protecting your credit card, protecting your ATM card, investing in unit trusts and prepayment charges on housing loans. An information pamphlet on "Illegal Deposit Taking/Get Rich-Quick Schemes" was also published to highlight and promote public awareness of the dangers of participating in get rich-quick schemes involving illegal deposit-taking. In addition, BNM, together with the banking institutions have established a committee for consumer education to enhance consumer knowledge on personal financial issues including awareness on consumers' rights and liabilities; and to improve legal protection for consumers and customer redress avenues. In moving towards a standard full disclosure model for products, the committee will develop guidelines on the minimum level of product transparency to ensure that consumers are well informed of all risks and liabilities associated with particular banking products and services.

In the same vein, consultative papers were also issued on a proposed framework for the development of independent financial advisers (IFAs) in the insurance industry and 'best advice' practices in the sale of life insurance products. These recommendations under the FSMP, which are currently being finalised for implementation in 2002, will enable consumers to obtain professional independent advice on their financial planning and management from certified IFAs who can provide advice on a broader range of insurance products. The 'best advice' practices regulation would ensure that proper advice, based on the specific financial circumstances and needs of individuals, is rendered by intermediaries in the sale of life insurance products.

With regard to Islamic banking, a standard framework has been formulated for the computation of the rate of return for Islamic banking institutions aimed at providing a level playing field and terms of reference for the Islamic banking players in deriving the rate of return. The framework would allow BNM to assess the efficiency, profitability, prudent management and fairness of Islamic banking institutions more effectively. Two committees had been formed namely, the Consultative Committee on Services (CCS) and Consultative Committee on Product and Market Development (CCPMD). The CCS was formed with the objective of setting the minimum best practice standard for Islamic banking in customer service, establishing image building as well as promoting public awareness and knowledge on Islamic banking and finance. The CCPMD was formed to drive the innovation and development of Islamic banking products. Both CCS and CCPMD have members comprising of BNM officials and representatives of the Islamic banking institutions and takaful companies.

A total of 24 recommendations or 27% of the 88 recommendations are targeted to be fully implemented in 2002. With the implementation of the recommendations under Phase 1, the foundations for developing stronger domestic banking and financial institutions would have been established. The expected outcome, by the end of Phase 1 should be the emergence of domestic players that are stronger, more efficient and innovative, besides being increasingly more competitive and resilient, as well as effective DFIs that play a significant role in addressing the development strategies of the nation by complementing the established banking institutions to meet financing requirements of the changing economy. BNM would continue to closely monitor the progress of the implementation of the recommendations under the FSMP to ensure a smooth transition from one phase to another, based on the achievement of specified milestones and to ensure measures implemented are timely and the desired strategic direction and objectives are achieved.

institutions. Financial statements are reviewed to ascertain if the statements are prepared in compliance with accounting standards and BNM guidelines, as well as to ensure adequate provisioning for bad and doubtful debts. In addition to the review of audited accounts on an annual basis, the review of semi-annual and quarterly (for listed companies) accounts are also performed.

In addition to examination conducted on banking-related activities, emphasis was also placed on the information systems within banking institutions to ensure that they were adequately maintained with high data integrity. With the introduction of internet banking as a new delivery channel and the increased usage of technology in banking activities, additional attention was given to the information systems of banking institutions in order to mitigate the potential risks associated with the widespread adoption of electronic banking delivery channels. The maintenance of data integrity in these delivery channels, especially where it involves payment services, becomes increasingly critical and warrants supervisory focus. BNM has therefore increased its information system examinations throughout the year to ensure that the information systems of banking institutions form a foundation for the safe and sound operation of banking institutions. A rigorous monitoring of the performance of banking institutions, compliance with regulatory requirements and occurrence of fraud, complements the stress tests. These would enable BNM and the banking institutions to undertake pre-emptive and remedial actions in areas of supervisory concern. Special surveillance programs were also conducted to curb the rise in ATM related frauds.

Moving forward, developmental efforts will continue to be taken to further strengthen the supervision of the banking institutions. In line with the increasing complexity of risks undertaken by banking institutions, the CAMEL framework is being expanded to include a separate component on Sensitivity to Market Risk. In addition (following the enactment of the Development Financial Institutions Act 2001), the scope of banking supervision was expanded to include the supervision of Development Financial Institutions.

PROGRESS OF BANKING SECTOR RESTRUCTURING

The institutional arrangements put in place to preserve the stability of the banking sector during the Asian crisis, namely, Pengurusan Danaharta Nasional Berhad (Danaharta) the asset management company; Danamodal Nasional Berhad (Danamodal) a special purpose recapitalisation agency; and the Corporate Debt Restructuring Committee (CDRC) achieved significant progress in their respective operations during the year 2001.

As at 31 December 2001, total loan rights acquired and managed by Danaharta amounted to RM47.7 billion, of which RM39.8 billion were from the banking system. This accounted for approximately 40% of the total non-performing loans of the banking sector. Danaharta completed its loan acquisition phase in 2000 and did not make any direct purchases from the banking institutions in 2001. The increase in loans managed by Danaharta in 2001 was mainly due to the exercise of the put option agreement between Danaharta, Commerce-Asset Holdings Berhad and Bank Bumiputra Malaysia Berhad (BBMB) Group arising from the merger between BBMB and Bank of Commerce (M) Berhad. The put option has since expired on 31 August 2001.

In 2001, Danaharta focused on the management of loans and assets within its administration. With the objective of maximising recovery values, Danaharta adopted various techniques in the management process, including active restructuring and rescheduling for viable loans, foreclosure, appointment of Special Administrators and Schemes of Arrangement for non-viable loans.

As at 31 December 2001, Danaharta has dealt with RM47.7 billion (99.9%) of the total loan rights acquired and managed under its portfolio. Of these loans, Danaharta expects a recovery rate of 56% over the

Table 4.6
Danaharta: Loan Recovery as at 31 December 2001

	Adjusted loan outstanding[1] (RM billion)	Adjusted expected recovery[2] (RM billion)	Expected recovery (%)
Plain loan restructuring	11.6	8.0	69
Settlement	6.9	5.2	76
Scheme of arrangement	9.2	6.9	76
Special Administrators - scheme approved	5.5	2.5	44
Foreclosure	11.6	3.4	29
Others (including partial resolutions)	4.1	2.5	60
Legal action	2.0	-	-
Total	**50.9**	**28.5**	**56**

[1] Comprising loan rights acquired of RM47.7 billion and accrued interest of RM3.2 billion.
[2] Assuming zero recovery on defaulted cases as at 31 December 2001.

outstanding amount of loans acquired (inclusive of accrued interest). The expected recovery rate has been adjusted after applying an assumption of zero recovery for defaulted accounts (average default rate as at 31 December 2001 is approximately 11%).

From the total adjusted loan outstanding already dealt with, Danaharta expects to receive total recovery of RM28.5 billion as at 31 December 2001. Of this, Danaharta has received recovery proceeds totalling RM15.2 billion, of which RM9.7 billion were realised in the form of cash and the remaining in the form of non-cash assets, namely restructured loans, securities and properties. The remaining expected recoveries totalling RM13.3 billion are at various stages of recovery.

Danaharta has distributed net recoveries amounting to RM8 billion in cash and 36,559,542 units of securities at par value. The cash distribution, amounting to RM7.7 billion, was distributed for the recovery on BBMB and Sime Bank Group NPLs and the remaining RM312.6 million and 36,559,542 units of securities at par value were distributed back to 24 financial institutions under the 80 (selling financial institution): 20 (Danaharta) surplus recovery sharing agreement.

Danaharta continued to sell foreclosed property collateral via open tenders during the year. Properties that remained unsold during the tenders were transferred to Danaharta Hartanah, which continues to sell the properties via its "secondary sales" programmes. In 2001, Danaharta conducted a fifth property tender involving 269 properties, of which 49% received successful bids for a total consideration of RM283.4 million, representing a 17% surplus over their total indicative value of RM242.3 million. The fifth tender saw the highest participation of property buyers amongst all the tenders that had been conducted by Danaharta. It also further exemplified the strong trend of successful sales via real estate agents (REAs), during which the REAs were responsible for selling 126 or 96% of the 131 properties that received successful bids. On 22 January 2002, Danaharta launched a specific property tender involving 30 units of six-storey shopoffices in one location only with a total indicative value of RM31.9 million. The closing date for the tender was 28 February 2002. Danaharta expects to launch its sixth property tender in the second quarter of 2002. As at 31 December 2001, Danaharta has sold 498 of the 614 properties offered since the first open tender held in 1999, for a total consideration of RM843.5 million. These included 357 properties sold in primary sales (RM593.3 million) and 141 properties sold in secondary sales (RM250.2 million).

Danaharta also embarked on its first asset-backed securitisation (ABS) exercise through Securita ABS One Berhad (Securita), a special purpose vehicle. The ABS exercise was the first collateralised loan obligation securities in Malaysia, to provide Danaharta with a more efficient method of divestment as it helped to overcome the operational difficulties faced in outright sales or auctioning a large number of accounts and avoided the risk of "cherry picking" by investors. It also enabled a wider investor base to be addressed. Funds raised from this and future issues will help to enhance Danaharta's cash collection in meeting bond redemption and operational requirements.

The first Danaharta ABS exercise, which will mature on 20 December 2005, involved the issuance of RM310 million triple-A rated Senior Notes with a coupon rate of 3.875% per annum that were backed by approximately RM595 million worth of performing loans. The successful exercise garnered a subscription rate of 3.5 times above the nominal amount of the issue.

In the case of Danamodal, no further capital injection was made since December 1999 as the capital position of banking institutions has continued to strengthen. In August 2001, Danamodal concluded the Sales and Purchase agreement on the disposal of its investment in one finance company. With the completion of the sale, Danamodal's outstanding investment in the banking sector has reduced to RM2.1 billion, from RM7.1 billion since its inception. Danamodal expects to recover the entire remaining investment over time.

Noting that debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, borrowers were also required to undertake operational restructuring, over and above the financial restructuring, to ensure the viability of the company over the longer term.

Table 4.7
Status of CDRC cases as at 8 March 2002

	Total debt outstanding* (RM million)	Number of accounts
Total referred to CDRC	67,644	87
Cases withdrawn / rejected / transferred to Danaharta	13,076	36
Cases accepted	54,568	51
Resolved	35,773	39
Outstanding	18,795	12
Being restructured by CDRC	*17,770*	*11*
Revised	*1,025*	*1*

* Including non-banking and offshore institutions.

Changes were made to the CDRC debt restructuring framework during the year. The changes which were made to accelerate the pace of corporate debt restructuring in Malaysia included the setting of specific timeline to ensure effective implementation of the restructuring and enhanced disclosure and reporting requirements. Noting that debt restructuring on its own may not bring about long term solution for the problems faced by the large corporates, borrowers were also required to undertake operational restructuring, over and above the financial restructuring, to ensure the viability of the company over the longer term. The criteria for the acceptance of loans under CDRC was also amended to borrowers with aggregate borrowing of RM100 million with exposure to at least five creditor banks. (The details of the revision in the framework can be found in the section on Banking Measures 2001).

As at 8 March 2002, 12 cases with debts totalling RM18.8 billion remained outstanding. This included one case which was previously resolved but had to be revised. For cases in which the creditors and borrowers are unable to reach a consensus on the terms of the restructuring exercise, the cases would be removed from the purview of CDRC. Any further negotiations between the creditors and borrowers will be conducted outside the auspices of CDRC. To date, CDRC has rejected or discharged 12 cases from its purview. CDRC is on course in its target to ensure that all workout proposals of borrowers under its purview are approved and implemented by end-July 2002.

PERFORMANCE OF THE BANKING SYSTEM

Profitability

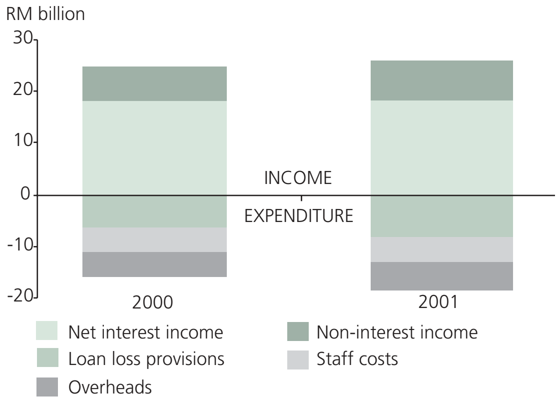
For the third consecutive year since the Asian crisis, the Malaysian banking sector continued to record profits, albeit at a lower level. Profits for the calendar year 2001 amounted to RM7.5 billion. Higher provisioning accounted for the lower profits in 2001. Analysed by institution type, the lower profits were attributed to the commercial and merchant banks. The decline in the profits recorded by the banks was however mitigated by the higher profits recorded by

Table 4.8
Banking System[1]: Income and Expenditure

	For the calendar year			
	2000	2001*p*	Annual change	
	RM million			%
Interest income net of interest -in-suspense	38,217	37,601	-616	–1.6
(Interest-in-suspense)	5,139	5,787	648	12.6
Less: Interest expense	19,575	19,330	–244	–1.2
Net interest income	18,642	18,271	–371	–2.0
Add: Non-interest income	6,700	7,917	1,218	18.2
Less: Staff cost	4,597	4,841	245	5.3
Overheads	4,706	5,321	615	13.1
Profit before provisions	16,039	16,026	–13	–0.1
Less: Loan loss provisions	6,716	8,552	1,836	27.3
Pre-tax profit	9,324	7,474	–1,849	–19.8
Of which:				
Commercial banks	6,848	5,112	–1,737	–25.4
Finance companies	1,889	2,060	171	9.0
Merchant banks	586	302	–283	–48.4
Return on assets (%)	1.5	1.1		
Return on equity (%)	19.5	14.5		
Cost to income (%)	36.7	38.8		

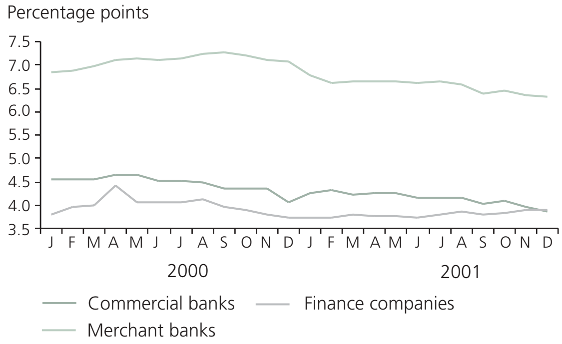
[1] Excludes Islamic banks.
p Preliminary.

Graph 4.5
Banking System [1] : Profitability



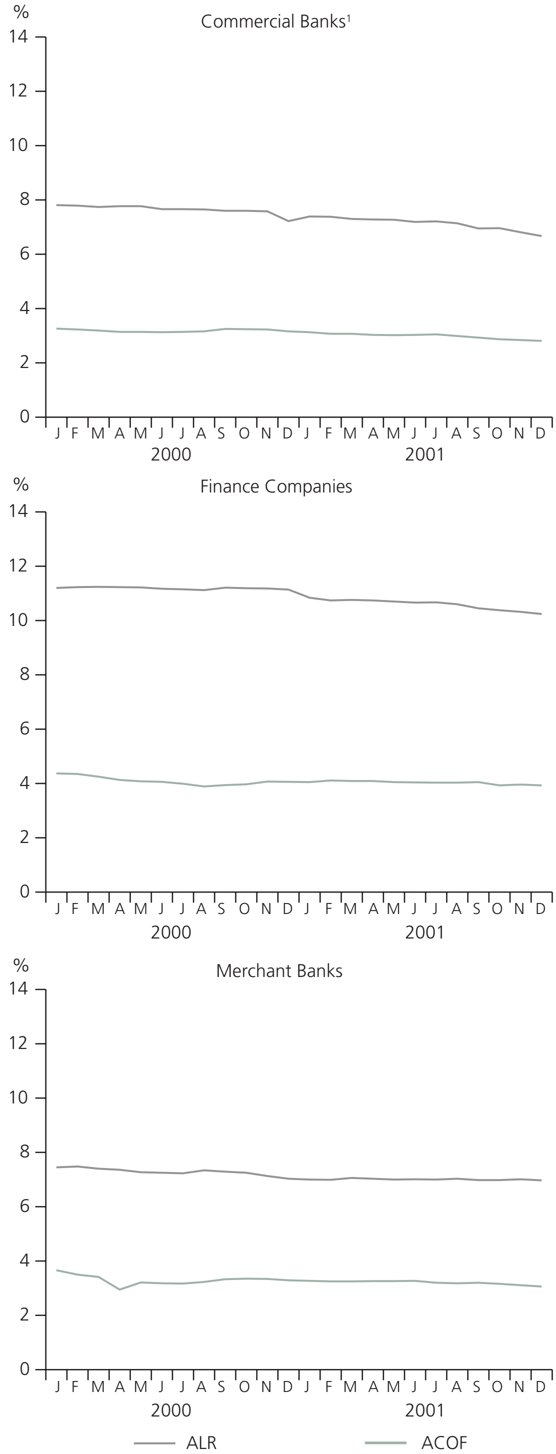
[1] Excludes Islamic banks

Graph 4.6
Net Interest Rate Margins



[1] Exclude Islamic banks
Note: Net interest margin = Average lending rate for all loans - Average cost of funds

Graph 4.7
Average Lending Rates and Average Costs of Funds



[1] Exclude Islamic banks
Note: ALR includes interest which have been suspended and penalty interest on NPLs
ACOF excludes the costs of overheads, statutory reserves and liquid asset requirements

the finance companies. While the banks' profits were eroded by the higher provisions for loan losses, the strong loan growth of the finance companies especially for the purchase of passenger cars, coupled with a decline in loan loss provisions, had contributed to their higher profitability.

The higher loan loss provisions charged by the banking system in 2001 was the result of the increase in the NPL (6-month classification) to RM60 billion as at end-December 2001. The increase in loan loss provisioning expenses was due partly to anchor banks having to realign the policies on loan loss provision of the acquired loan portfolios to be in line with their more stringent standards. These were, however, one-off adjustments which in effect would place the banking system on a stronger footing as the adjustments were from minimum to more prudent standards.

Net interest income remained at about the same level as in the previous year, recording only a marginal decline of 2% during the year. The reduction in net interest income was due to a larger decline in gross interest income compared to the decline in interest expense. Lower interest income from interbank placements and investment securities contributed largely to the decline in gross interest income. As the banking system remained flushed with liquidity in 2001 and interest rates continued to be low, banking institutions switched their asset mix from lower yielding investment securities to loan assets. This change in strategy to maximise yields led to intense competition in the retail and mortgage loans sectors. The competitive interest rate environment and lower lending rates were compensated by a healthy growth in loan base which resulted in total income received from lending activities recording an increase of 3.5%.

The lower lending rates were also compensated by a decline in interest expense due to lower interest paid on deposits (-RM0.3 billion or -1.9%) although total deposits mobilised by the banking system increased.

The non-interest income (excluding recoveries) of the banking system increased by 18.2% in 2001. This was due mainly to extraordinary gains from disposal of investments and dividends received which rose by RM0.9 billion (+73.9%) and trading income of RM0.5 billion (+28.4%). Fee-based income, which accounted for 26.3% of the non-interest income, registered an increase of RM17.9 million to RM3 billion, reflecting the greater attention by banking institutions on the provision of fee-based services to complement traditional fund-based income.

The rationalisation and systems integration efforts undertaken consequent to the merger exercise resulted in an increase in overhead costs of RM0.6 billion or 13.1%. These are, however, one-off costs and banking institutions are expected to be able to reap the benefits of the rationalisation and integration process in the future years.

Loan Activity

The lending activities of the banking system moderated in 2001 following a modest economic growth during the year. The slowdown, which was primarily a consequence of the global economic downturn, had affected the domestic economy through lower exports, unfavourable business sentiment and short-term prospects. Against these developments, demand for loans and financing declined, resulting in a lower number and amount of loan applications received by banking institutions in 2001. In view of the lower number of loan applications received, loan approvals declined by 6.5% during the year. However, loan repayments increased marginally by 3.8% as many borrowers repaid and refinanced their loans to take advantage of the low interest rate environment. Loan disbursements also recorded a marginal increase of 2.3%.

Consumer credit extended by the banking system which rose by 11.9% was supported by the strong consumer spending. Similarly, loans for purchase of transport vehicles (primarily for purchase of passenger cars) recorded a strong growth of 27.4%, while loans for purchase of residential properties expanded by 9.3%. The strong demand for loans by the retail sector reflected mainly the positive response of the public to the current low interest rate environment as well as the Government's pump-priming expenditure to spur the domestic economy. The demand for housing loans was also augmented by the competitive housing loan packages offered by banking institutions and the home ownership promotion campaigns initiated by the private sector to boost sales. In addition, several incentives were accorded during the promotion period such as stamp duty exemption for buyers, waiver of processing fees and a higher margin of financing.

Table 4.9
Banking System[1] : Financing Activities

	For the year		Annual growth (%)
	2000	2001	
	RM billion		
Loan approvals	133.3	124.7	–6.5
Loan disbursements	357.3	365.5	2.3
Loan repayments	345.0	358.2	3.8
	As at end		Annual growth (%)
	2000	2001	
	RM billion		
Outstanding loans[2]	447.4	462.7	3.4
Adjusted outstanding loans[3]	454.5	473.3	4.1
Adjusted total financing for the economy[4]	551.4	586.6	6.4

[1] Excludes Islamic banks.
[2] Includes loans sold to Cagamas and Danaharta.
[3] Outstanding gross loans, adjusted for loans sold to Cagamas and Danaharta as well as loans written-off and conversions and repayment of loans of the two LRT companies.
[4] Outstanding gross loans, adjusted for loans sold to Cagamas and Danaharta, loans written-off and conversions as well as repayment of loans of the two LRT companies and outstanding private debt securities.

Demand for loans from the corporate sector, however, remained weak throughout 2001 due to the decline in exports and the domestic economic slowdown. The low demand for loans from the construction and real estate sector was attributable to the overhang situation and the Government's directive to the local authorities to defer approval for new construction of office and commercial space to combat the property overhang situation. As a result, approximately 50% of the new loans approved during the year were to individuals, with loans for residential properties accounting for a significant share of 22%.

As the time lag between approval and disbursement of loans for credit cards and purchase of passenger cars is short, loan disbursements to the two sectors in 2001 recorded strong growth at 59.2% and 40.1% respectively. This was followed by loans for purchase of residential properties at 10.6% and loans for the manufacturing sector at 9%. Disbursements of loans to finance the purchase of residential properties were slower due to the legal documentation process whilst for properties under construction, drawdowns are progressive according to the stage of completion. Loan disbursements in other sectors declined following the downward trend in loan approvals. As in the previous year, the manufacturing sector accounted for a significant proportion of loan disbursements, totaling RM101.4 billion or 27.7% of total disbursements. Funds disbursed to the wholesale, retail, restaurant and hotel sector amounted to RM65.4 billion, a marginal increase of 4.6% from RM62.5 billion as at end-2000. The manufacturing sector also contributed the largest share in loan repayments, accounting for 28.1% or RM100.7 billion, which was 10.8% higher than the amount of repayments last year (RM90.9 billion). The wholesale, retail, restaurant and hotel sector also recorded a significant amount of repayments, accounting for 17.9% or RM64.1 billion.

Compared with the previous year, total undrawn loans edged up by 8.1% in 2001. With higher undrawn loans and repayments marginally lower than disbursements, total outstanding loans of the banking system, including loans sold to Cagamas and Danaharta, registered an annual growth of 3.4% in 2001, compared with 5.4% the previous year. Taking into account loans written-off and loans converted into equity and bonds in the course of restructuring, as well as the repayment of the loans of the two LRT companies, the total outstanding loans grew at an annual rate of 4.1%, compared with 7.1% in 2000.

As interest rates continued its downtrend to a record low in 2001, new private debt securities (PDS) issued increased sharply by 23.8%, raising a total of RM33.3 billion from the market. Total redemption amounted to RM16.9 billion, which was mainly due to the redemption and maturity of several medium-term PDS that were issued in 1996/97. Subsequently, outstanding PDS rose by 16.9% to RM113.3 billion and total outstanding loans, adjusted for loans written-off and loan conversion, as well as the repayment of the loans of the two LRT companies and taking into account outstanding PDS in 2001, amounted to RM586.6 billion. This translated into an annual growth of 6.4%, relatively lower than 9.6% achieved in 2000.

Moderating demand for financing throughout 2001 had resulted in a slower pace in lending activities of the banking institutions during the year. However, further drawdown of existing approved credit facilities, as well as the various measures introduced in 2001, are expected to translate into improved loan activity in 2002. The upliftment of the restriction on the provision of bridging finance for residential property development exceeding RM250,000 per unit in November 2001 is envisaged to spur further the growth in the property sector. A further impetus for growth in the property sector would be the extension of ringgit credit facilities to non-residents for the purchase of immovable properties in Malaysia. Effective July 2001, resident financial institutions are allowed to provide loans to non-residents to finance the purchase or construction of any property in Malaysia. Various incentives were also introduced to enhance access of small- and medium-sized enterprises (SMEs) to financing under the existing special funds, as well as to promote domestic economic activity and investment growth. These included a reduction in lending rates and liberalisation of eligibility criteria of special funds, as well as additional allocations for certain funds. For example, the Fund for Food (3F) was increased from RM1 billion to RM1.3 billion and the lending rates reduced to 3.75% per annum from 4% per annum. The allocation for the New Entrepreneur Fund (NEF) rose from RM1.25 billion to RM1.5 billion, with a reduction in lending rates to 5% per annum. A new Entrepreneur Rehabilitation and Development Fund (ERDF) was established and incorporates rehabilitation measures such as advisory services, new contracts and financial support. In addition, on 20 September 2001, given the increased risks biased towards further economic weakness following the 11 September incident, the 3-month BNM intervention rate was reduced by 50 basis points to 5% per annum. This resulted in a corresponding fall in the base lending rates (BLR) of commercial banks and finance companies to 6.39% per annum and 7.45% per annum, respectively. This reduction, in part, has provided an impetus for consumer lending, as well as enhance domestic business and consumer confidence to support domestic economic activity. These measures are expected to continue to translate into an improved outlook in loan activities in 2002.

Asset Quality

Amidst the economic slowdown in 2001, the asset quality of the banking system deteriorated marginally during the year. Net NPLs on a 6-month classification increased by RM8 billion to RM32.1 billion as at end-

December 2001. Similarly, net NPLs on a 3-month classification increased by RM8.4 billion to RM45.2 billion as at end-December 2001. The asset quality during the year was largely affected by two factors; the expiry of the NPL indulgence period granted to borrowers participating in the debt restructuring process under the auspices of the CDRC and the economic slowdown that had hampered the ability of corporations and retail borrowers to repay their debts. Towards the first half of 2001, loans amounting to RM4.3 billion or 34.7% of the increase in gross NPLs were classified as NPLs due to the expiry of the indulgence period. The reclassification of these loans however did not adversely affect the profitability of banking institutions on account of the requirement that interest on these loans be recognised on a cash basis and specific provisions be set aside. In

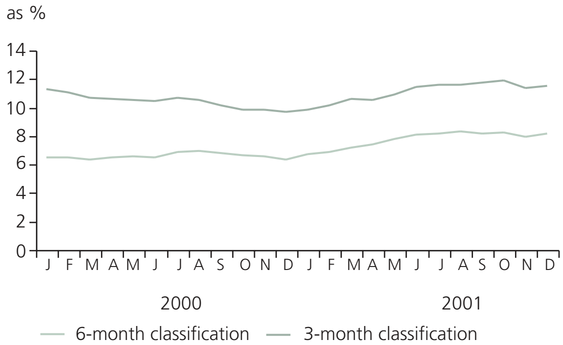
Despite the build-up of NPLs over the year, the institutional and regulatory framework put in place by BNM over the years and the prudent provisioning policies of banking institutions had positioned the banking sector on a sound footing to adjust and respond positively to these pressures. The banking system continued to maintain a strong capital position, with RWCR well above 12% throughout the year.

Table 4.10
Banking System[1]: Non-performing Loans and Loan Loss Provisions

	As at end					
	2000			2001		
	Actual[2]	Classification		Actual[2]	Classification	
		3-month	6-month		3-month	6-month
	RM million					
Commercial banks						
General provisions	6,399.8	6,365.9	5,241.9	6,125.6	6,134.3	5,416.9
Interest-in-suspense	5,576.2	5,672.7	5,263.1	6,632.0	6,661.8	6,435.7
Specific provisions	11,360.8	11,726.5	10,721.5	14,134.0	13,975.7	13,188.7
Non-performing loans	35,660.6	41,107.3	31,607.3	46,934.8	51,578.9	41,682.7
Net NPL ratio (%)[3]	6.4	8.1	5.3	8.8	10.4	7.4
Total provisions/NPL (%)	65.4	57.8	67.2	57.3	51.9	60.1
Finance companies						
General provisions	1,647.1	1,640.4	1,656.7	1,822.5	1,802.6	1,802.5
Interest-in-suspense	2,343.3	2,435.3	2,211.6	2,640.6	2,849.3	2,579.8
Specific provisions	4,809.0	5,055.4	4,514.3	4,971.2	5,095.2	4,840.2
Non-performing loans	14,255.4	17,627.0	13,338.3	15,266.0	18,781.8	14,602.9
Net NPL ratio (%)[3]	9.2	13.2	8.5	9.0	12.8	8.4
Total provisions/NPL (%)	61.7	51.8	62.8	61.8	51.9	63.2
Merchant banks						
General provisions	377.1	336.3	336.9	379.0	340.5	374.6
Interest-in-suspense	513.5	568.5	524.0	523.1	540.0	522.8
Specific provisions	816.3	827.2	806.4	1,056.8	1,073.9	1,017.0
Non-performing loans	3,084.2	4,387.4	3,211.1	4,415.8	5,029.3	4,373.9
Net NPL ratio (%)[3]	10.9	18.7	11.7	21.7	26.2	21.6
Total provisions/NPL (%)	55.3	39.5	51.9	44.4	38.9	43.8
Banking system						
General provisions	8,423.9	8,342.6	7,235.4	8,327.0	8,277.4	7,594.0
Interest-in-suspense	8,433.0	8,676.6	7,998.7	9,795.7	10,051.2	9,538.4
Specific provisions	16,986.0	17,609.0	16,042.3	20,162.0	20,144.9	19,045.9
Non-performing loans	53,000.3	63,121.7	48,156.7	66,616.6	75,390.0	60,659.5
Net NPL ratio (%)[3]	7.2	9.6	6.3	9.3	11.5	8.1
Total provisions/NPL (%)	63.9	54.9	64.9	57.5	51.0	59.6

[1] Excludes Islamic banks.
[2] Loans classified as NPL based on individual banking institution's NPL classification policy i.e. 3-month or 6-month classification.
[3] Net NPL ratio = (NPL less IIS less SP) / (Gross loans less IIS less SP) x 100%.

Graph 4.8
Banking System[1]: Net Non-performing Loans Ratio



[1] Excludes Islamic banks

addition, a number of loan accounts that had previously been restructured were reclassified as NPL as the economic slowdown and weak capital market impeded the ability of corporations to raise funds to improve their leverage position.

Despite the increase in NPLs over the year, the institutional and regulatory framework put in place by BNM over the years and the prudent provisioning policies of the banking institutions had positioned the sector on a sound footing to respond positively to these pressures. The banking system continued to maintain a strong capital position, with RWCR well above 12% throughout the year. The specific provisions set aside by banking institutions increased by RM3 billion or 18.7% during the year. As a result, the net NPL ratio of the banking system was sustained within the range of 7.9% to 8.3% throughout the second half of the year. In terms of loan loss coverage, the level of provisioning outstanding remained high at 59.6% of total NPLs as at 31 December 2001. Including the value of collateral, the total loan loss coverage of the banking sector strengthened to 148.1% of NPLs as at end-December 2001. The stress tests conducted on banking institutions on a quarterly basis have also indicated that the banking sector as a whole would continue to remain strong and well capitalised under adverse economic conditions and depressed asset prices, with the RWCR of the banking sector remaining above 8%, and some banking institutions recording RWCR well above 8%.

Table 4.11
Banking System[1]: Non-performing Loans by Sector

	As at end				
	NPL by sector		Change	As percentage of total loans to sector	
	2000	2001	2000/2001	2000	2001
	RM million		%		
Agriculture, hunting, forestry and fishing	702.5	924.0	31.5	6.4	8.1
Mining and quarrying	210.3	244.5	16.3	14.7	19.4
Manufacturing	8,865.9	12,409.6	40.0	14.4	20.3
Electricity, gas and water supply	252.9	358.8	41.9	3.3	7.3
Wholesale and retail trade, restaurants and hotels	4,729.5	4,983.4	5.4	13.3	13.8
Wholesale trade	*2,058.6*	*2,126.5*	*3.3*	*10.7*	*10.7*
Retail trade	*1,300.5*	*1,364.5*	*4.9*	*11.8*	*12.0*
Restaurants and *hotels*	*1,370.4*	*1,492.4*	*8.9*	*26.0*	*30.1*
Broad property sector	20,874.0	27,346.3	31.0	15.8	17.1
Construction	*8,021.2*	*10,526.0*	*31.2*	*23.2*	*31.6*
Purchase of residential property	*5,055.3*	*6,727.9*	*33.1*	*9.0*	*8.0*
Purchase of non-residential property	*4,159.7*	*4,918.7*	*18.2*	*15.8*	*18.2*
Real estate	*3,637.7*	*5,173.7*	*42.2*	*24.5*	*33.2*
Transport, storage and communication	1,920.5	1,595.0	-17.0	16.3	15.5
Finance, insurance and business services	2,990.4	4,633.8	55.0	9.6	14.5
Consumption credit	6,260.7	5,803.3	-7.3	11.1	8.3
Personal uses	*1,885.2*	*1,873.5*	*-0.6*	*14.6*	*14.2*
Credit cards	*377.8*	*409.4*	*8.4*	*5.1*	*4.6*
Purchase of consumer durable goods	*80.3*	*70.1*	*-12.7*	*10.1*	*14.8*
Purchase of transport vehicles[2]	*3,917.4*	*3,450.3*	*-11.9*	*11.1*	*7.3*
Purchase of securities	4,438.5	5,206.6	17.3	18.2	24.6
Community, social and personal services	783.8	1,237.3	57.9	13.1	21.1
Others	971.3	1,874.0	92.9	8.4	17.9
Total	**53,000.3**	**66,616.6**	**25.7**		

[1] Excludes Islamic banks.
[2] Includes commercial vehicles.

The global economic downturn and the slump in the global electronics industry in 2001 adversely impacted exports during the year and consequently, the volume of production and sales of the manufacturing sector. Against this backdrop, the sector recorded the largest increase in NPL over the year, from RM8.9 billion as at end-2000 to RM12.4 billion as at end-2001. In terms of distribution of gross NPLs by economic sectors, the manufacturing sector continued to account for a large portion of total NPLs in the banking system. As at 31 December 2001, gross NPLs to the manufacturing sector accounted for 18.6% of total NPLs of the banking system and 20.3% of total loans granted to this sector. However, towards the last quarter of 2001, the NPLs of this sector stabilised as both external and domestic demand improved during the quarter.

The construction sector was also adversely affected by the economic slowdown. As at end-December 2001, the NPLs for this sector accounted for 15.8% of total NPLs of the banking sector and 31.6% of total loans to this sector. As the construction sector has been a major beneficiary of the Government's fiscal stimulus measures, the NPLs in this sector is expected to improve in 2002. NPLs for the purchase of residential properties remained manageable at 8% of total loans extended for this purpose. Within the finance, insurance and business services sector, NPLs increased by 55% during the year. The bulk of the NPLs to this sector were attributed to investment holding companies which had difficulties servicing their debts due to lower dividends from subsidiary companies.

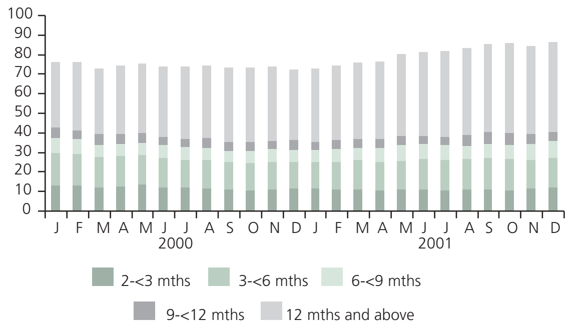
Despite the relatively stronger performance of the stock market in 2001, NPLs for the purchase of securities increased by RM0.8 billion or 17.3%. Although the NPL ratio to this sector accounted for 24.6% of total loans to the sector as at 31 December 2001, the total exposure of the banking sector to the sector remained small at 5% of total loans extended by the banking sector.

In terms of potential risk to the banking sector, total outstanding loans in arrears have stabilised and continued to remain at manageable levels throughout the year. Despite a more difficult economic environment, total outstanding loans in arrears net of NPLs in the 2 to less than 6 months buckets increased only marginally by 1.4% or RM280.8 million in the year 2001. These were mainly due to increases in loans in arrears in the 2 to less than 3 months buckets, whilst total outstanding loans in arrears in the 4 to less than 6 months buckets declined by 4.5% during the year. New loans classified as NPLs have also started to moderate over the second half of the year, recording a decline from RM20.1 billion in the first half of the year to RM11.2 billion in the second half of the year 2001. The banking system has also recorded a 27.8% increase in recoveries in the second half of the year.

The pre-emptive initiatives that have been taken to accelerate the pace of corporate debt restructuring have started to yield positive results in enhancing the asset quality of banking institutions and significantly reduced risks to the banking system. During the year, the successful restructuring of the debts of two large corporate borrowers had reduced the NPLs of the banking system by RM2.9 billion or 0.7% of total NPLs. The satisfactory progress of corporate debt restructuring under the new CDRC framework is expected to further alleviate a significant portion of the NPL problems from the banking sector. With the completion of the debt restructuring process under CDRC envisaged by July 2002, the asset quality of banking institutions can be expected to improve by approximately 3 percentage points. Therefore, the banking institutions are well placed to support the economic recovery in 2002.

It is therefore envisaged that the level of NPLs in the banking system will continue to remain manageable as the banking system has emerged stronger following the restructuring efforts as well as the various measures introduced to improve the risk management practices of banking institutions. As the economy is expected to record stronger performance in the year 2002, the asset quality of banking institutions will also improve in tandem with the positive economic outlook.

Graph 4.9
Banking System[1]: Ageing Profile of Loans in Arrears



[1] Excludes Islamic banks

Liquidity Management

The international reserves declined during the first half of the year to RM98.9 billion as at end-June 2001. To stabilise liquidity conditions, BNM liquidity operations was expansionary, releasing liquidity that was absorbed from the banking system in the previous year. The total intervention by BNM in the form of outstanding net interbank borrowing and issuance of Bank Negara Bills (both conventional and Islamic) declined from RM49.6 billion as at end-2000 to RM34.1 billion as at end-June 2001.

Liquidity in the banking system however increased in the second half of the year as international reserves rose by RM18.4 billion, from RM98.9 billion as at end-June 2001 to RM117.2 billion as at end-December 2001. The significant current account surplus, the steady inflow of foreign direct investment and the interest rate differential in Malaysia's favour during the period following coordinated interest rate cuts in the major economies during the year accounted for the increase in inflows, thereby contributing to the increase in the level of liquidity in the banking system. To absorb the impact of the additional liquidity, BNM increased its intervention and sterilised the inflows during the second half of the year through additional interbank borrowing (including Islamic borrowing) of RM12 billion, increasing the total intervention by BNM to RM46.1 billion as at end-December 2001. This has ensured that interbank rates remained stable, with the three-month weighted average interbank rate ranging from 2.85% to 3.06% per annum during the year.

Graph 4.10
Liquidity in the Banking System in 2001

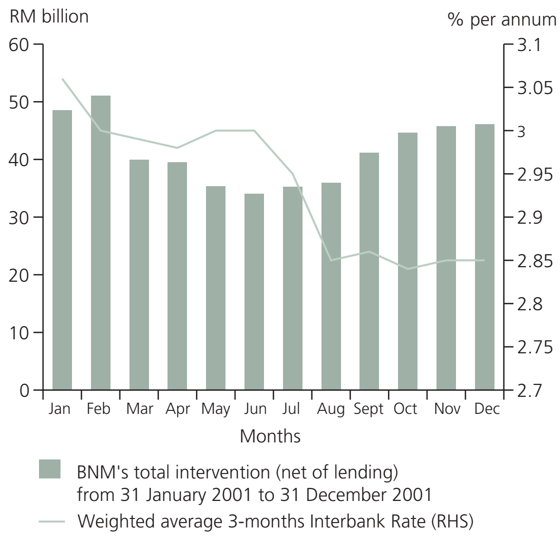


Table 4.12
Banking System[1]: Liquidity Projection as at 31 December 2001

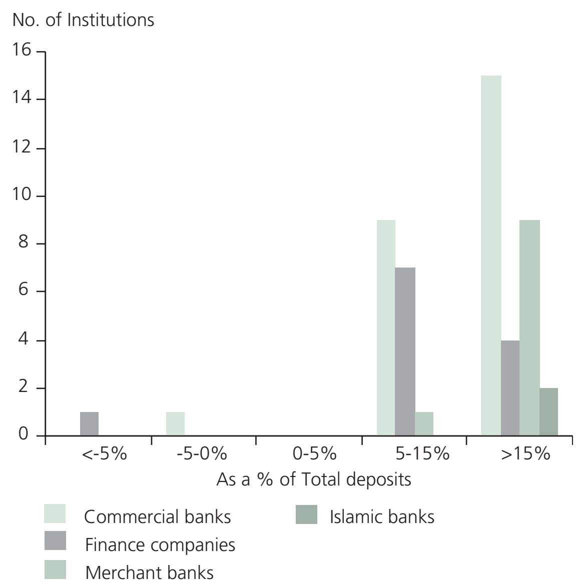
	Cumulative Mismatch (RM billion)		Buffer as % of total deposits	
	1 wk.	**1 mth.**	**1 wk.**	**1 mth.**
Commercial banks[1]	37.1	51.8	11.5	16.1
Finance companies	8.0	11.4	9.9	14.1
Merchant banks	6.6	6.4	46.1	44.1
Banking system[1]	**51.7**	**69.6**	**67.5**	**74.3**

[1] Excludes Islamic banks.

The liquidity management of the banking institutions showed an overall improvement as the adoption of the new liquidity framework become mandatory from January 2001. As at end-December 2001, the cumulative liquidity surplus of the banking system (excluding two Islamic banks) was projected at RM51.7 billion in the very short-term bucket of up to 1-week and RM69.6 billion in the 1-month bucket. As a group, commercial banks, finance companies and merchant banks projected large surpluses in the 1-month bucket amounting to 16%, 14% and 44% of their total deposit base respectively.

On an individual basis, the majority of the banking institutions have projected surpluses, well above the regulatory requirement in the 1-week and 1-month

Graph 4.11
Banking System: Profile of Potential Liquidity Surplus/Shortfall up to One Month Ahead as at 31 December 2001

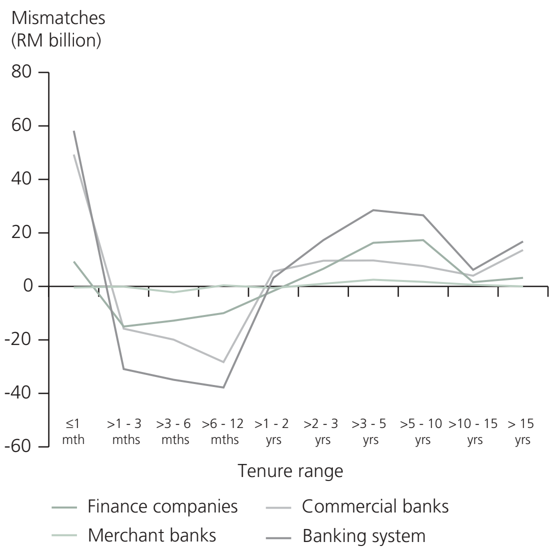


buckets and only one finance company and one commercial bank projected a shortfall of between -5% and 0% for the 1-month bucket as compared to 12 banks as at end-December 2001. With the proportion of assets that were liquid also remaining high at RM59.4 billion (in terms of forced sale value) as at end-December 2001, the ability of the banking system to withstand potential liquidity shocks has significantly improved. The ample liquidity in the banking system would then enable banking institutions to conduct increased intermediation activities to support the economic growth momentum.

Interest Rate Risk

As activities in the debt market increased in tandem with the low interest rate environment, and significant growth in fixed rate loans, particularly loans for the purchase of transport vehicles, the level of interest rate risk in the banking system remained manageable. Nevertheless, the overall interest rate mismatch profile of the banking system as at end-2001 remained structurally similar, with negative interest rate mismatch positions concentrated in the shorter term maturities and positive interest rate mismatches in the longer term maturities. This reflects the nature of domestic banking activities and the lack of long-term hedging instruments, where assets with longer tenure interest rate repricing are not funded by liabilities of similar interest rate repricing tenure.

Graph 4.12
Banking System[1]: Net Interest Rate Position Mismatches as at 31 December 2001



[1] Excludes Islamic banks

Table 4.13
Banking System[1]: Impact of 1% Rise in Interest Rate on Solvency and Balance Sheet

	Duration weighted net position					
	RM million		As a percentage of: Capital base (%)		As a percentage of: Total assets (%)	
	2000	2001	2000	2001	2000	2001
Commercial banks	-1,842	-2,281	-4.3	-5.2	-0.4	-0.4
Finance companies	-1,323	-1,846	-14.2	-19.3	-1.2	-1.5
Merchant banks	-216	-224	-4.7	-4.9	-0.6	-0.6
Banking system	-3,381	-4,351	-6.0	-7.5	-0.5	-0.6

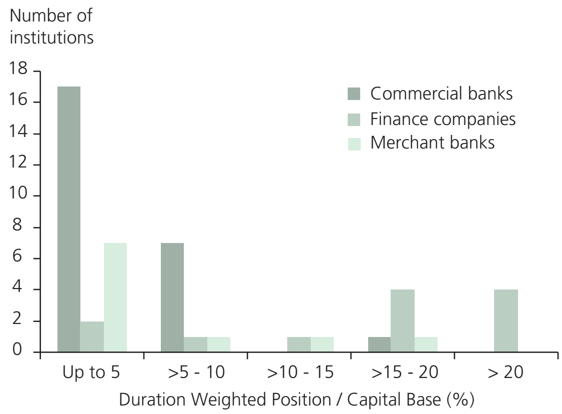
[1] Excludes Islamic banks.

Focusing on the shorter term tenure of the interest rate mismatch profile, the net positive gap position in the less than 1-month repricing bucket is driven by significant concentration in floating rate BLR type loans that mature or are repriced within 1-month, accounting for over 40% of banking institutions' interest sensitive assets. Nevertheless, with short-term deposits being predominantly repriced between the 1 to 12 months buckets, the negative gap position within these repricing buckets have offset the positive gap position in the less than 1-month bucket. As at 31 December 2001, over 83.3% of interest rate sensitive liabilities were concentrated in the less than one year repricing buckets.

On the other hand, across the medium- to long-term spectrum of banking institutions' interest rate maturity profile, the depth in funding is still relatively shallow generally due to the lack of long-term hedging instruments and partly to the preference of depositors towards shorter term deposits in view of the present low interest rate environment. This has resulted in the positive interest rate mismatch. As a percentage of interest rate sensitive assets with repricing maturity above one year, fixed rate loans accounted for 67% whilst fixed rate debt securities accounted for 30%.

Adopting the duration weighted position concept in the analysis of banking institutions' interest rate risk which ascertains the potential loss in economic value of banking institutions' on- and off-balance sheet position given a one percentage point shift in interest rates, as at end-2001, the duration weighted net position of the banking system amounted to RM4.4 billion. Reflective of the interest rate mismatch profile, most of the exposure to interest rate risk was concentrated in the maturity buckets exceeding three

Graph 4.13
Banking System[1]: Distribution by Duration Weighted Net Position as a Percentage of Capital Base as at 31 December 2001



[1] Excludes Islamic banks

years. The duration weighted position of the banking system in the 3 to 10 years and the more than 15 years repricing buckets amounted to RM2.4 billion and RM1.5 billion respectively, representing 54% and 35% of the total duration weighted position of the banking system. This was largely due to fixed rate financing granted by the finance companies, particularly hire purchase financing, block discounting and lease financing, and the commercial banks and merchant banks long-term fixed rate loans and holdings of fixed rate securities for liquidity and investment purposes.

On an industry-type basis, the majority of the exposure to interest rate risk has been from commercial banks and finance companies, which have respectively accumulated a duration weighted position of RM2.3 billion and RM1.8 billion or a 52.4% and 42.4% share from the total duration weighted position of the banking system as at end-2001. The rise in interest rate risk of finance companies can be explained by the significant growth in fixed rate loans in the 3 to 5 years and 5 to 10 years bucket by 56.1% and 89% to RM8 billion and RM17.4 billion respectively. On the other hand, the commercial banks' growth in interest rate risk is due to their increased activities in fixed rate debt securities in the medium-term tenures and the long-term fixed rate loan activities of two commercial banks, predominantly in the form of Islamic type financing and staff loans with maturity exceeding 15 years amounting to over RM9 billion. The duration weighted position of merchant banks remain relatively small with a total amount of RM224 million as compared to RM216 million as at end-2000.

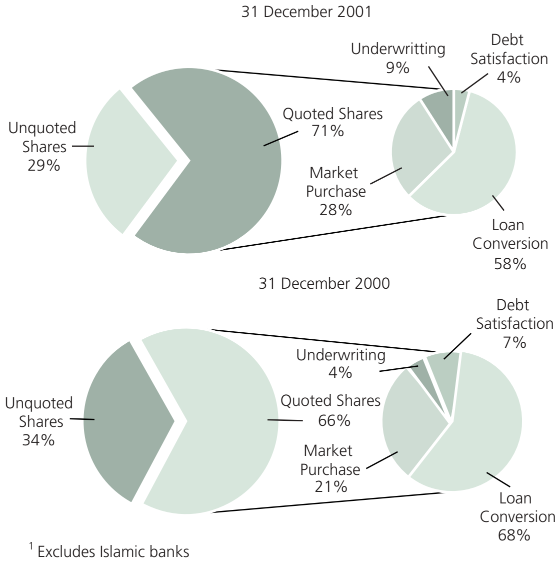
In relating the impact of interest rate risk to the stability of the banking system, the duration weighted position can be used to measure against the potential erosion of the value of banking institutions' capital base and assets. In terms of assets, as at 31 December 2001, the exposure of the banking system towards interest rate risk was rather insignificant with a potential loss of only 0.6% in the value of the banking system's total assets for a one percentage point rise in interest rates. Nevertheless, this would translate to an erosion of 7.5% in the value of the banking system's capital base compared to 6% as at end-2000. This was due to the increased exposure of finance companies to interest rate risk in relation to their fixed rate loan activities. The potential loss to the value of finance companies' capital base amounts to 19.3%, higher than 14.2% recorded in the previous year. On the other hand, merchant banks and commercial banks experienced a marginal increase in the erosion in capital base for a one percentage point rise in interest rates, recording 4.9% and 5.2%, respectively. On an individual institution basis, 12 institutions were exposed to interest rate risk exceeding 10% of their capital base, nine of which were finance companies reflecting the high interest rate risk nature of their activities. The other institutions were one commercial bank and two merchant banks whose activities in the debt market increased significantly. Most of the remaining commercial banks and merchant banks had a potential loss in capital base of less than 5% for a one percentage point shift in interest rates.

Equity Risk

The banking system's exposure to equity investments remained insignificant as at end-2001, with the overall outstanding equity holdings representing only 0.2% of the system's total assets. Investments in quoted shares during the year declined from RM1.8 billion to RM1.5 billion due mainly to the lacklustre performance of the Kuala Lumpur Composite Index (KLCI) as a result of global economic slowdown. The KLCI peaked just above 700 points in the first quarter of 2001, but remained below 700 points for the remaining part of the year, resulting in lower debt-to-equity conversions which declined by 25% during the year.

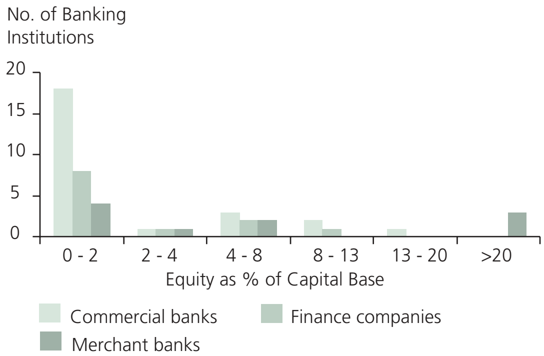
The relative uncertainty and weak sentiment in the stock market throughout the year, led to a larger proportion of equity held by banking institutions due to underwriting, which increased by 5% from RM64.5 million as at end-2000 to RM143.7 million as at end-2001. The holdings of unquoted shares, which represented 0.1% of the system's total assets also registered a decline.

Graph 4.14
Banking System[1]: Composition of Equity Investments



[1] Excludes Islamic banks

Graph 4.15
Banking System[1]: Distribution by Equity as a Percentage of Capital Base as at 31 December 2001



[1] Excludes Islamic banks

Reflective of the weak stock market, both the commercial banks and finance companies reduced their equity holdings by 25% and 15% respectively in 2001. The merchant banks however registered an increase in their equity holdings by 30.2%, mainly from underwriting activities as a result of lacklustre initial public offers in the first half of the year. Consequently, merchant banks had the highest equity exposure as their holdings of quoted shares accounted for more than 8% of their capital base, while equity exposure of commercial banks and finance companies accounted for only 1.8% and 3.7% of their capital base respectively. In terms of individual banking institutions, most banks had less than 2% of the capital base exposed to equity risk. However, three merchant banks had an equity exposure in excess of 20% of capital base.

In the face of a more volatile market, the estimated potential loss in equity value based on a 10-day volatility of the KLCI, was higher at 17% in the year 2001 as compared to only 10% in 2000. Despite the higher volatility, potential loss to the banking system in the event of a decline in the stock market was estimated to be only 0.4% of the total capital base in 2001, as compared to 0.5% in 2000. This marginal loss is due to the overall reduction in the equity holdings of the banking institutions.

While the equity potential loss of commercial banks and finance companies was reduced to 0.3% and 0.6% of their respective capital base, merchant banks, on the other hand, had the highest potential loss from equity risk of 1.5%, which is 40 basis points higher compared to the year 2000, due to higher equity holdings coupled with the merchant banks' relatively smaller capital base. However, this exposure remained insignificant and did not pose any threat to the stability of the banking system.

Table 4.14
Banking System[1]: Equity Exposure

	Equity[2] holdings (RM million)		Equity[2] / Capital base (%)		Potential equity[2] loss / Capital base (%)	
	2000	2001	2000	2001	2000	2001
Commercial banks	1,031.2	768.5	2.4	1.8	0.4	0.3
Finance companies	417.3	354.9	4.6	3.7	0.8	0.6
Merchant banks	305.8	398.1	6.6	8.7	1.1	1.5
Banking system[1]	1,754.3	1,521.6	3.1	2.6	0.5	0.4

[1] Excludes Islamic banks.
[2] Amount of investment in quoted shares.

Foreign Exchange Risk

Although the interest rate differential between the USD and Ringgit narrowed in the first half of 2001 causing the forward discount in the foreign currency forward market to reduce considerably, there was strong demand for foreign currency forward contracts by importers during this period. Foreign currency forwards sold by banking institutions increased by RM10 billion during the period of heightened speculation by the market that the Ringgit would be repegged downwards against the USD. As a hedge against these forward contracts, holdings of foreign currency assets by banking institutions rose to peak at RM21.3 billion as at end-May 2001. Consequently, the net open foreign currency position of the banking system rose to RM3.1 billion as at end-June 2001 before easing off in the second half of the year to RM2.3 billion at the end of 2001.

In the second half of 2001, the continued fall in USD interest rates further narrowed the interest rate differential between the USD and Ringgit, and subsequent rate cuts by the US Federal Reserve resulted in USD interest rates falling below the domestic interest rate from September 2001 onwards. This dampened the demand for foreign currency forwards by importers which resulted in foreign currency forward sales by banking institutions declining from RM25.9 billion as at end-May 2001 to RM13.6 billion as at end-2001. Subsequently, the holdings of foreign currency denominated assets by banking institutions contracted in response to reduced hedging requirements. By year end, net foreign currency assets of the banking system declined to RM8.4 billion as against RM9.8 billion as at end-2000.

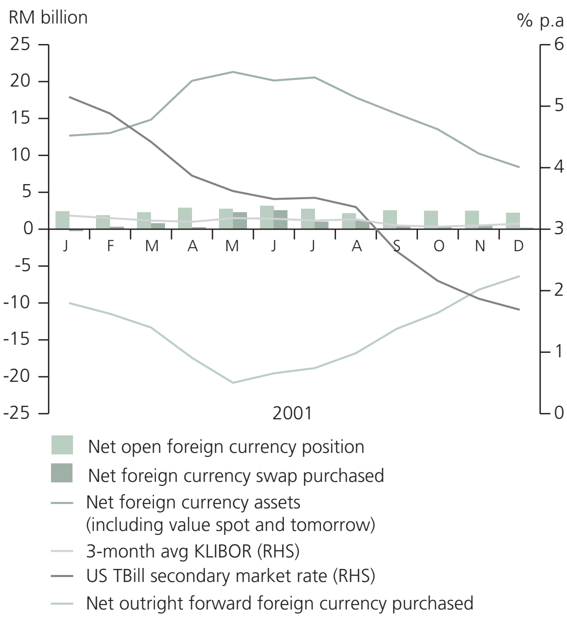
Table 4.15
Banking System[1]: Foreign Currency Exposure

	NOP (RM million)		NOP/Capital Base (%)	
	end-2000	end-2001	end-2000	end-2001
Commercial banks	1,824	2,221	4.2	5.1
Merchant banks	-8	47	0.2	1.0
Banking system	1,816	2,268	3.8	4.7

[1] Excludes Islamic banks.

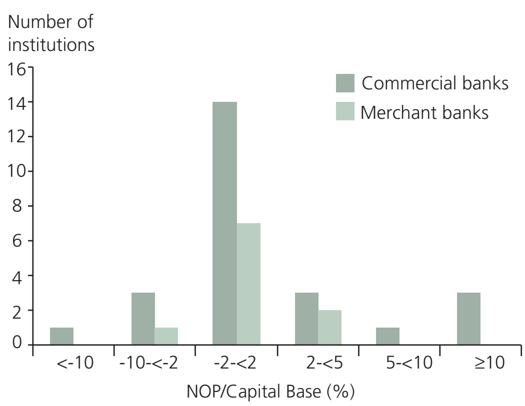
The foreign currency risk undertaken by the banking institutions remained within prudential levels as there was only a marginal increase in foreign currency exposure compared to end-2000. The commercial banks' net open foreign currency position as a percentage of capital base increased by 0.9 percentage points to 5.1% and by 0.8 percentage points to 1% for the merchant banks. On an individual banking institution basis, only six commercial banks and one merchant bank out of the total 35 commercial and merchant banks had net open foreign currency position as a percentage of capital base above 5%. Of the seven, four had a net exposure beyond 10%. The high exposure of these institutions were generally attributable to increased forward purchases as well as off-balance sheet funding of domestic activities through the swap market.

Graph 4.16
Banking System[1]: Foreign Currency Exposure



[1] Excludes Islamic banks

Graph 4.17
Banking System[1]: Distribution of Net Open Foreign Currency Position as at 31 December 2001



[1] Excludes Islamic banks

Capital Strength

The capital position of the banking system strengthened during the year to 12.8% as at end-2001 on the back of continued profitability and capital injections into the banking institutions to support their enlarged operations following the conclusion of the mergers as well as to meet the 31 December 2001 deadline of a higher minimum capital funds requirement. Profits (excluding unaudited profits for the year 2001) accounted for RM2.8 billion of the increase whilst new capital injections contributed another RM3.7 billion. On a net basis, capital base of the banking system has increased by RM1.6 billion on a year-on-year basis. This is largely due to the exclusion of the capital base of 16 banking institutions amounting to RM4.1 billion, which were merged or absorbed as a result of the consolidation process during the first quarter of the year.

Concurrent with the profits earned and increase in capital funds, total Tier-1 capital of the banking system increased by RM2.6 billion or 5.2% to RM53.4 billion as at end-2001. Total Tier-2 capital however recorded a marginal increase of RM0.2 billion. Reflective of the stronger capital position of the banking system in 2001, its risk-weighted capital ratio (RWCR) increased to 12.8% in December 2001 from 12.5% as at end-2000 while core capital ratio (CCR) increased by 10 basis points to 10.8%. Both the RWCR and CCR far exceeded the internationally prescribed ratios of 8% and 4%. Overall, the RWCR of the banking system was consistently above 12% throughout 2001 except for January 2001 when it dipped to 11.8% while the CCR was sustained above 10% throughout 2001.

Although the capital base of the commercial banks and finance companies improved from their end-2000 position, only the commercial banks registered an improvement in their RWCR from 12.2% as at end-2000 to 12.6% as at end-2001. The increase in the capital base of the finance companies was moderated by higher investments in subsidiaries following the takeover of a finance company in conjunction with the merger exercise. This, coupled with strong demand for hire purchase financing in 2001, resulted in the RWCR of the finance companies declining by 10 basis points to 11.4% as at end-2001. The capital base of merchant banks has declined after deducting investments in subsidiaries which has increased by 658% in 2001 following the acquisition/establishment of two new subsidiaries by a merchant bank. However, the RWCR of merchant banks increased to 19.1% from 17.1% as at end-2000 due to the reduction in the risk-weighted assets caused by a decline in the loan base, in line with the trend to shift the focus of activity from lending to advisory services.

Table 4.16
Banking System[1]: Constituents of Capital

	As at end		Annual change	
	2000	2001		
	RM million		RM million	%
Tier-1 capital	50,786.9	53,419.5	2,632.6	5.2
Tier-2 capital	14,753.6	14,960.2	206.6	1.4
Total capital	65,540.5	68,379.7	2,839.2	4.3
Less:				
Investment in subsidiaries and holdings of other banking institutions' capital	7,662.6	8,923.6	1,261.0	16.5
Capital base	57,877.9	59,456.1	1,578.2	2.7
Risk assets:				
0%	121,482.3	124,822.2	3,339.9	2.7
10%	17,864.5	15,985.5	-1,879.0	-10.5
20%	104,355.8	97,728.5	-6,627.3	-6.4
50%	80,985.4	92,666.9	11,681.5	14.4
100%	401,143.3	397,872.7	-3,270.6	-0.8
Total risk-weighted assets	464,293.6	465,350.4	1,056.8	0.2
Risk-weighted capital ratio (%)				
Banking system[1]	**12.4**	**12.8**	**0.4**	**3.2**
Commercial banks	12.2	12.6	0.4	3.3
Finance companies	11.5	11.4	-0.1	-0.9
Merchant banks	17.1	19.0	1.9	11.1

[1] Excludes Islamic banks.

The total risk-weighted assets of the banking system increased marginally by 0.2% or RM1.1 billion to RM465.4 billion as at end-2001 in line with a moderate loan growth. Of the various categories of risk-weighted assets, the risk-weighted assets of 0% and 50% risk-weight categories had increased due to the increase in investments in low risk assets and housing loans secured by first charge. Assets in the 10% risk-weight category continued to shrink as banking institutions reduced their holding of Cagamas papers whilst assets in the 20% risk-weight category shrank due to the reduction in investments in corporate papers that are guaranteed by domestic BIs following the maturity of such papers. Assets in the 100% risk-weight category fell mainly due to the write-off of the amount recoverable from Danaharta.

With the strong capital base of the banking system following the higher revised minimum capital funds, the conclusion of the merger programme and the profits recorded in 2001, the banking system is well positioned to meet the loan demands which would augur well for the growth of the economy in 2002.

ISLAMIC BANKING

The Islamic banking industry sustained its expansion despite slower economic growth during the year. In terms of the market share relative to the banking system, the share of Islamic banking assets and deposits increased to 8.2% and 9.5% respectively, surpassing the 8% targets set for the year 2001 (6.9% and 7.4% respectively in 2000). Total financing registered an increase to 6.5% compared with 5.3% in 2000. The continued expansion of the Islamic banking sector was mainly attributable to

Table 4.17
Islamic Banking: Key Data

	As at end		Change (%)
	2000	2001	2001
Number of financial institutions	**49**	**38**	**–22.4**
Commercial banks	21	14	–33.3
Finance companies	14	10	–28.6
Merchant banks	5	5	0.0
Islamic banks	2	2	0.0
Discount houses	7	7	0.0
Total assets (RM million)	**47,068**	**58,929**	**25.2**
Commercial banks	20,094	26,750	33.1
Finance companies	7,150	9,749	36.3
Merchant banks	1,507	1,353	–10.2
Islamic banks	14,029	17,328	23.5
Discount houses	4,288	3,749	–12.6
Total deposits (RM million)	**35,923**	**47,106**	**31.1**
Commercial banks	16,091	22,031	36.9
Finance companies	5,393	7,664	42.1
Merchant banks	867	673	–22.4
Islamic banks	11,304	14,375	27.2
Discount houses	2,268	2,363	4.2
Total financing (RM million)	**20,891**	**28,201**	**35.0**
Commercial banks	8,606	12,256	42.4
Finance companies	5,090	7,613	49.6
Merchant banks	769	771	0.3
Islamic banks	6,426	7,561	17.7
Discount houses	–	–	0.0
Financing-deposits ratio (%)	**58.2**	**59.9**	**1.7**
Commercial banks	53.5	55.6	2.1
Finance companies	94.4	99.3	5.0
Merchant banks	88.7	114.6	25.9
Islamic banks	56.8	52.6	–4.2
Discount houses	–	–	0.0
Number of branches	**131**	**132**	**0.8**
Commercial banks	7	8	14.3
Finance companies	2	2	0.0
Islamic banks	122	122	0.0
Number of counters	**2,087**	**2,065**	**–1.1**
Commercial banks	1,338	1,335	–0.2
Finance companies	745	730	–2.0
Merchant banks	4	0	–100.0

the various measures undertaken by BNM and continuous efforts by the industry players in introducing new instruments as well as measures to enhance the Islamic banking industry in areas that were outlined in the Financial Sector Masterplan (FSMP) on Islamic banking and takaful.

The FSMP has set a 20% target to be achieved by 2010, in terms of the market share of Islamic banking assets relative to the total banking system. The development of a well-established and comprehensive regulatory framework that preserves the integrity of the Islamic banking operations is an integral component of the work being undertaken to set up an appropriate prudential standard for the Islamic banking industry. To further strengthen the regulatory framework of Islamic banking and to improve the operational efficiency of Islamic banking institutions, BNM introduced the following measures in 2001:

- **Requirement to observe the minimum risk weighted capital adequacy ratio framework for the Islamic banking portfolios of conventional banking institutions participating in the Islamic Banking Scheme (IBS banks)**
  With effect from 2 January 2002, in order to steer the development of Islamic banking, BNM set a series of targets to be achieved by the IBS banks. IBS banks are required to observe a minimum core capital ratio of 4% and risk-weighted capital ratio of 8% for their Islamic banking portfolios. The new requirement is expected to promote a more efficient utilisation of Islamic banking capital funds and enhance the level playing field among IBS banks. This is an initial effort to prepare the regulatory platform that is sensitive and tailored specifically to address the distinct risk characteristics of Islamic banking. To ensure full disclosure and transparency, the IBS banks are required to maintain a separate disclosure on the capital adequacy of their Islamic banking portfolios in the financial statement.

- **Standard framework for the computation of the rate of return for Islamic banking institutions**
  BNM formulated a standard framework for the computation of the rate of return for Islamic banking institutions, aimed at providing a level playing field and terms of reference for the Islamic banking players in deriving the rate of return. The framework would allow BNM to assess the efficiency, profitability, prudent management and

fairness of Islamic banking institutions more effectively. Furthermore, the standardisation of the calculation of the rate of return would serve to address the information asymmetry between the bank and its depositors, by enhancing transparency and ensuring that depositors receive their fair share of the return on investment, in conformity with the Shariah principles.

To provide greater strategic focus to Islamic banking operations and facilitate greater economies of scale, BNM has encouraged the IBS banks to rationalise their Islamic banking operations within their respective banking groups. Consolidation would result in a wider range of Islamic banking facilities, better synergies within the group, enhanced cost effectiveness and efficiency, thereby, placing the IBS banks in a better position to expand their Islamic banking operations. One domestic banking group established the first domestic one-stop Islamic financial centre, providing a wide range of facilities to meet customer requirements.

As part of the activities to promote Kuala Lumpur as a regional Islamic financial centre, the Kuala Lumpur International Summit was held from 19 to 21 February 2001. The Summit provided an avenue for regulators, practitioners and academicians to deliberate on the issues and challenges confronting Islamic banking and finance. In conjunction with the Summit, the Islamic Banking and Finance Institute Malaysia (IBFIM) was launched as an industry-owned research and training institute. IBFIM would be a one-stop centre for providing education, training and research on Islamic financial services, covering Islamic banking, takaful and Islamic capital market at both the domestic and the international levels.

As part of the initiatives to enhance the effectiveness in disseminating information on Islamic banking and takaful, the Islamic Banking and Takaful Week (IBTW) was held from 26 October to 2 November 2001. The primary objective was to promote greater public awareness and knowledge on Islamic banking and takaful, as well as to build a high impact campaign on Islamic banking and takaful at the Islamic financial institutions. Apart from the Islamic banking institutions (comprising the Islamic banks and IBS banks) and takaful companies, the development finance institutions offering Islamic products and services also participated in the campaign.

The Islamic banking logo provides the branding of Islamic financial products and services and reflects the commitment of the Islamic banking institutions in developing Islamic banking and finance as envisioned by the FSMP.

In conjunction with the IBTW, was the launch of the Islamic banking logo. The main objective of the logo is to increase the visibility of Islamic banking, particularly in conventional banking institutions offering both conventional and Islamic banking products and services. The Islamic banking institutions are required to display the logo at their premises to indicate the availability of Islamic banking products and services offered. The logo would also be used by the Islamic banking institutions in their documents and brochures related to Islamic banking transactions. In conjunction with the IBTW, the Association of Islamic Banking Institutions Malaysia (AIBIM) introduced two awards, the ‘Islamic Banker Award’ for individual contribution and ‘Best Performance Institution Award’ for individual institution contribution, to acknowledge meaningful contributions made for the development of the Islamic banking industry in Malaysia.

In line with the recommendations of the FSMP to increase the market penetration level and to deepen the Islamic financial market, BNM formed two consultative committees, the Consultative Committee on Services (CCS) and Consultative Committee on Product and Market Development (CCPMD), comprising BNM and representatives of the Islamic banking institutions and takaful companies. The CCS was formed with the objective of setting the minimum best practice standard for Islamic banking in customer service, establishing image building as well as promoting public awareness and knowledge on Islamic banking and finance. The CCPMD was formed to drive the innovation and development of Islamic banking products.

Consequent to the continuous efforts to enhance the savings avenue for senior citizens and charity organisations, half of the Bon Simpanan Malaysia Siri 03 issuance was based on the Islamic principle of Bai’

Al-Inah (sell and buy back) where the bank identifies the assets and sells them to the customers. The customers will then sell back the assets at a higher price and in return, the bank issues the bond to the customers. The Islamic bonds have a maturity period of two years and a rate of return of 5% per annum. During the year, BNM issued specific operational guidelines to govern the administration of three government funds disbursed under the Islamic concept, namely the New Entrepreneurs Fund 2 (NEF 2), Entrepreneurs Rehabilitation and Development Fund (ERDF) and Fund for Food (3F).

During the year, the Malaysian Accounting Standards Board (MASB) issued MASB Standard *i*-1 (Presentation of Financial Statements of Islamic Financial Institutions). The objective of the standard is to lay down the basis for the presentation and disclosure of financial statements of Islamic financial institutions that conduct Islamic banking activities.

Table 4.18
Islamic Banking: Sources and Uses of Funds

	As at end			
	2000		2001	
	RM million	% share	RM million	% share
Sources:				
Capital and reserves	2,526	5.4	3,434	5.9
Debentures and notes				
Deposits	35,923	76.3	47,106	79.9
of which	–	...	–	...
INI issued	*500*	*1.1*	*1,222*	*2.1*
Repos	*431*	*0.9*	*1,655*	*2.8*
Amount due to financial institutions	4,796	10.2	4,173	7.1
Domestic	*4,796*	*10.2*	*4,173*	*7.1*
Foreign	–	...	–	...
Bankers acceptances	597	1.3	728	1.2
Others	3,227	6.9	3,488	5.9
Total	**47,069**	**100.0**	**58,929**	**100.0**
Uses:				
Cash	348	0.7	201	0.3
Reserve with BNM	724	1.5	878	1.5
Amount due from financial institutions	8,743	18.6	11,502	19.5
Domestic	*8,743*	*18.6*	*11,062*	*18.8*
Foreign	–	...	*440*	*0.7*
Investments	3,135	6.7	10,148	17.2
of which:				
Stock and shares	*82*	*0.2*	*45*	*0.1*
Debentures	*2,808*	*6.0*	*9,909*	*16.8*
Fixed Assets	*245*	*0.5*	*194*	*0.3*
Foreign investments	–	...	–	*0.0*
Placement with discount houses	–	–	–	...
Marketable securities	12,877	27.4	5,309	9.0
of which:				
Treasury bills	-	-	-	-
GII	*357*	*0.8*	*908*	*1.5*
INI held	*212*	*0.5*	*184*	*0.3*
Cagamas bonds	*134*	*0.3*	*84*	*0.1*
Financing	20,891	44.4	28,201	47.9
Others	351	0.7	2,690	4.6
Total	**47,069**	**100.0**	**58,929**	**100.0**

Sources and Uses of Funds

In 2001, the total assets of the Islamic banking sector increased by RM11.9 billion or 25.2%, to RM58.9 billion as at end-2001. A significant portion of the increase in the total assets (RM7.3 billion or 61.3%) was contributed by the financing disbursed during the period. As in the previous years, the largest portion of the Islamic banking assets remained with the IBS commercial banks with a market share of 45.4%, followed by the Islamic banks (29.4%) and the IBS finance companies (16.5%). Both the IBS commercial banks and finance companies recorded moderate growth in their assets of 33.1% and 36.3%, respectively. The increase in assets was attributable to the growth in total financing of IBS commercial banks (42.4%) and finance companies (49.6%), constituting 70.5% of the total financing.

A major portion of funds in the Islamic banking sector continued to be sourced from deposits, which accounted for 79.9% of the total resources. Total deposits recorded a moderate growth of 31.1% or RM11.2 billion to reach RM47.1 billion as at end-2001, capturing a market share of 9.5% (7.4% in 2000) of the total banking industry. While the deposits of the IBS finance companies recorded the highest growth (42.1%), the bulk of Islamic banking deposits (46.8%) remained with the IBS

Table 4.19
Islamic Banking: Deposits by Type and Institutions

	Annual change				As at end
	2000		2001		2001
	RM million	%	RM million	%	RM million
Demand deposits	**1,190**	**22.1**	**–107**	**–1.6**	**6,457**
Commercial banks	580	18.1	55	1.5	3,841
Islamic banks	610	28.1	–162	-5.8	2,616
Savings deposits	**817**	**32.5**	**822**	**24.7**	**4,149**
Commercial banks	567	56.0	553	35.0	2,133
Finance companies	145	50.7	131	30.4	562
Islamic banks	105	8.7	138	10.5	1,454
Investment deposits	**9,405**	**62.5**	**9,041**	**37.0**	**33,505**
Commercial banks	3,917	66.6	3,808	38.8	13,610
Finance companies	2,214	87.3	2,237	47.1	6,986
Merchant banks	129	32.2	-160	-30.2	370
Islamic banks	877	14.1	3,066	43.1	10,181
Discount houses	1,159	104.5	90	4.0	2,358
Other deposits	**814**	**108.1**	**1,428**	**91.1**	**2,995**
Commercial banks	451	95.6	1,524	165.1	2,447
Finance companies	–	–	–96	–45.3	116
Merchant banks	337		–34	–10.1	303
Islamic banks	26	37.7	29	30.5	124
Discount houses	–	–	5	–	5

commercial banks. The growth in deposits reflected public confidence and acceptance of Islamic banking as well as the competitive rate of return on deposits.

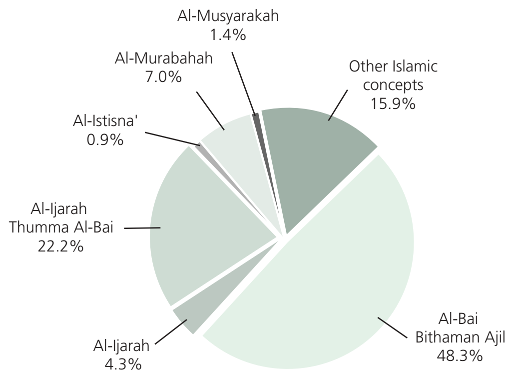
In terms of types of customers, deposits from business enterprises accounted for 30.5% of the total deposits, followed by Government (23.7%) and the domestic non-bank financial institutions (20.2%). Investment deposits continued to capture a major portion of the Islamic banking deposits (71.1%), registering a strong growth of 37% to reach RM33.5 billion as at end-2001. The savings deposits recorded a growth of 24.7%, while the demand deposits recorded a slight decline of 1.6% during the period.

In terms of the maturity profile of the investment deposits, 61.1% of the deposits (65.3% in 2000) continued to be concentrated at the shorter end of the yield curve, mainly one to three months maturity. The one to three months maturity captured 59.4% of the general investment deposits and 72% of the specific investment deposits (63.6% and 80.8% respectively in 2000). The trend is relatively similar to the fixed deposits of the conventional banking system for which the shorter end of the yield curve represented a share of 49.3% of the deposits placement (53.4% in 2000). The average rates of return for the investment deposits with placement of less than three months maturity were in the range of 2.6% to 3.6% and for placement of one year and above, the range was 3.3% to 4.5%. The small incremental return between the shorter and longer placement tenures and the uncertainty of future rates of return led to the continued concentration at the shorter end of the yield curve by depositors.

Table 4.20
Islamic Banking: Direction of Financing

	As at end			
	2000		2001	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	1,577.7	7.6	1,639.6	5.8
Mining and quarrying	78.5	0.4	64.0	0.2
Manufacturing	2,044.3	9.8	3,073.4	10.9
Electricity, gas and water	855.6	4.1	543.6	1.9
Community, social and personal services	292.7	1.4	353.1	1.3
Broad property sector	7,506.3	35.9	10,782.5	38.2
Real estate	*363.1*	*1.7*	*565.8*	*2.0*
Construction	*1,572.0*	*7.5*	*1,698.3*	*6.0*
Purchase of residential property	*3,974.4*	*19.0*	*6,845.9*	*24.3*
Purchase of non-residential property	*1,596.8*	*7.6*	*1,672.4*	*5.9*
Wholesale, retail, restaurants and hotels	854.7	4.1	1,135.2	4.0
Transport, storage and communications	787.9	3.8	763.0	2.7
Finance, insurance and business services	595.7	2.9	1,229.5	4.4
Purchase of securities	705.0	3.4	872.6	3.1
Consumption credit	4,043.1	19.4	6,812.7	24.2
Credit cards	*1.4*	*…*	*3.0*	*…*
Personal uses	*340.2*	*1.6*	*686.9*	*2.4*
Purchase of consumer durables	*43.1*	*0.2*	*55.2*	*0.2*
Purchase of transport vehicles	*3,658.4*	*17.5*	*6,067.7*	*21.5*
Others	1,549.7	7.4	932.1	3.3
Total	**20,891.2**	**100.0**	**28,201.3**	**100.0**

Graph 4.18
Islamic Financing Concepts as at December 2001



As at end-2001, shareholders' fund of the Islamic banks and the Islamic banking capital fund of the IBS banking institutions saw a significant increase of RM908 million to RM3.4 billion. This increase was mainly attributable to higher retained profits during the year. The profitability of the Islamic banking sector recorded a total pre-tax profit of RM905.9 million during the year compared with RM533.3 million in 2000.

Total financing extended by the Islamic banking sector expanded by RM7.3 billion or 35% (RM7.2 billion or 52.2% in 2000). The financing-deposits ratio increased to 59.9% at end-2001 from 58.2% at end-2000. As in the previous years, financing to the broad property sector and consumption credit remained significant, increasing by 38.2% and 24.2% respectively. The higher demand for property sector financing was attributed to the growth in the end-financing for residential properties (72.2%), benefiting from the Property-Ownership Campaign backed by the Government during the year. Meanwhile, financing for the purchase of passenger vehicles also recorded an increase of

65.9% to RM6.1 billion in 2001 from RM3.7 billion in 2000, duly caused by the relatively lower profit-taking ratio charged for financing which averaged 4.5% per annum in 2001 (averaged 6% per annum in 2000).

In tandem with the continued exposure of Islamic financing to the broad property sector, financing based on Bai Bithaman Ajil (BBA) constituted the bulk of total financing (48.3%), amounting to RM13.6 billion as at end-2001. This was followed by Ijarah Thumma Al-Bai (AITAB) financing that recorded a significant increase of 68.3%, reflecting the tremendous demand for the Islamic hire purchase financing during the year.

Profitability

As in the previous year, the Islamic banking sector continued to record a significant increase in profits. Pre-tax profit rose by 69.9% to RM905.9 million for the calendar year 2001 (RM533.3 million in 2000). With the improvement in profitability, the Islamic banking sector was able to provide a positive rate of return on assets of 1.5% (1.1% in 2000) and a return on equity of 26.4% (21.2% in 2000).

The higher profitability recorded in 2001 was largely due to the increase in total finance income of RM2.9 billion, where income from financing constituted 67% of the total finance income. Investment income also increased by 206.8% or RM89.1 million in 2001 (RM29 million in 2000) due to gains from the sale of investment securities, while trading income increased by 60.4% to RM108.1 million in year 2001 (RM67.4 million in year 2000).

Asset Quality

The asset quality of Islamic financing deteriorated moderately during the year 2001, with net non-performing financing (NPF) ratio increasing to 7.2% from 7% in 2000. The financing loss provisions (income-in-suspense, specific provisions and general provisions) increased slightly to RM1.4 billion from RM1 billion in 2000. The increase in financing loss provisions was mainly due to the increase in general provisions by 49.4%, and specific provisions by 49%.

The bulk of the NPF was concentrated in the broad property sector, where NPF expanded by 57.4% or RM609.8 million in 2001 to account for the largest share of 56.7% of total NPF (50.2% in 2000). The high NPF in the broad property sector reflected the significant increase of NPF in the residential and non-residential property sectors of RM371.1 million and RM128.3 million respectively.

Table 4.21
Islamic Banking: Non-performing Financing and Financing Loss Provision

	As at end	
	2000	2001
	RM million	
Islamic Banking		
General provisions	314	469
Income-in-suspense	163	182
Specific provisions	535	797
Non-performing financing (NPF)	**2,119**	**2,949**
Net NPF ratio (%)	7.04	7.24
Total provisions/NPF (%)	47.76	49.10

Islamic Interbank Money Market (IIMM)

The outstanding amount of liquidity absorbed from the IIMM through BNM operations increased by 51.3% to RM5.9 billion, mainly due to the concentration of BNM's liquidity operation on medium-term tenure investment via the Mudharabah Money Market Tender. This was evidenced by the increase of 46.3% in the volume of the one-month maturity profile of Mudharabah Interbank Investments. However, this had led to a decline in the volume of Mudharabah funds in the overnight (-17.8%) and 1-week (-26.4%) tenures, which subsequently resulted in a reduction in the overall trading volume of Mudharabah interbank investments of 14.9% from RM283.6 billion in the year 2000. This reduction was also due to the shift of Mudharabah funds to investment activities in other Islamic instruments.

The total trading volume of Islamic instruments increased by 42.5% to reach RM12.2 billion in the year 2001 (RM8.6 billion in 2000). An important

Table 4.22
Islamic Interbank Money Market (IIMM) *

	2000		2001	
	Volume (RM billion)	Annual change (%)	Volume (RM billion)	Annual change (%)
Mudharabah Interbank Investments	283.6	-32.8	241.2	-14.9
Green Bankers Acceptances	13.6	7.9	19.5	43.4
Islamic Acceptance Bill	4.7	291.7	3.9	-17.0

*Volume transacted through brokers.

Table 4.23
Islamic Interbank Money Market (IIMM) - Maturity Profile *

	2000 Volume (RM billion)	2001 Volume (RM billion)	Change (%)
Overnight and weekends	**223.8**	**184**	**-17.8**
1 week	**66.3**	**48.8**	**-26.4**
1 month	**13.4**	**19.6**	**46.3**

* Volume transacted through brokers and Mudharabah money market tender.

development in the trading of short-term Islamic instruments was the marked growth in the volume of trading of Bank Negara Negotiable Notes (BNNN), which amounted to RM1.2 billion (RM70 million in 2000). The increase in the trading volume of BNNN was associated with the higher issuance of BNNN of RM1 billion (RM250 million in 2000) and high demand for short-term Islamic instruments. The total trading volume of green bankers acceptance also recorded a significant growth of 43.4% (RM19.5 billion). However, the trading volume of the Islamic acceptance bills was lower, totalling RM3.9 billion compared with RM4.7 billion in the year 2000.

The trading of long-term Islamic instruments continued to improve in 2001. During the year, the total trading volume was RM11 billion compared with RM8.5 billion in 2000. This was mainly attributable to the increase in trading of Khazanah bonds amounting to RM5.9 billion (RM5.4 billion in 2000). The total trading volume of Government Investment Issue (GII) amounting to RM2.4 billion, also contributed to the increase in the total trading volume of long-term Islamic instruments. Prior to June 2001, GII was not a tradable instrument as it was issued under the Islamic principle of Qardhul Hasan (benevolent loan), which did not permit secondary trading. As part of BNM's efforts to develop and promote the secondary trading of Islamic instruments, the issuance concept of GII was changed from Qardhul Hasan to Bai' Al Inah (sell and buy back) concept as to allow GII to become one of the tradable instruments in the IIMM. As at the end of 2001, the outstanding amount of GII amounted to RM4 billion.

The average gross rates of return of the Islamic banking institutions for the year 2001 were in the range of 2.9% to 8.7%, with an average of 5.3%. Meanwhile, the average Mudharabah interbank rates concluded in the IIMM were in the range of 2.8% to 3.1% with the tenure ranging from overnight to 6 months. There were no activities concluded above the 6 months tenure, as market participants were uncertain of the return on investment and also due to the lack of hedging instruments available for market participants to hedge their longer-term exposure.

National Shariah Advisory Council

In 2001, the bank re-appointed all the seven members of the National Shariah Advisory Council for Islamic Banking and Takaful (the Council) for the 2001-2003 term. The Council held four meetings during the year of 2001 and deliberated more than 15 Shariah issues. Among the major issues discussed and decided by the Council were:-

(i) Financing obtained through the New Entrepreneurs Fund (NEF) should be based on *Bai' Al-Inah* (sell and buy back arrangement) concept instead of *Bai' Ad-Dayn* (sale of debt). This is to avoid the possibility of sale and purchase of non-existence debt which may occur in the previous financing mechanism of the NEF based on *Bai' Ad-Dayn*;

(ii) Islamic banking institutions are allowed to sell debt arising from vehicle financing based on *Ijarah Thumma Al-Bai'* concept to Cagamas Berhad, following which, Cagamas will issue *Cagamas Mudharabah bonds* to finance the transaction. This will facilitate the securitisation of Islamic financing and provide additional investment opportunities to the market players; and

(iii)Islamic money market players are allowed to participate in intra-day transactions to manage their short-term liquidity needs. The mechanism for the intra-day transaction is similar to the inter-bank *Mudharabah* investment which is currently being practised. The shortened maturity period in intra-day transaction would ease liquidity constraints and allow market players to manage liquidity positions more efficiently.

International Developments

While the FSMP primarily focused on the development of the Islamic banking industry on the domestic front, BNM also participated actively in the global development of Islamic banking and finance. With the rapid development in the global Islamic financial industry, there was recognition for the need of a standard-setting body to adapt, develop and harmonise standards for Islamic financial products and services that would foster the development of the industry. Against this background, meetings on the Risk Management and Regulatory Standards for Islamic Financial Institutions among the central banks of the Muslim countries, the Islamic Development Bank, Accounting and Auditing of Islamic Financial Institutions, and the IMF agreed that an international standard-setting entity, preliminarily known as the Islamic Financial Services Board (IFSB), be established. The objectives of IFSB, among others, would be to promote the development of Islamic financial services industry as well as effective supervision and regulation of institutions offering Islamic financial products through adaptation of new or existing standards, based on the recognition of the unique risks of Islamic financial products and practices. IFSB would also liaise and cooperate with relevant standard setters and facilitate training and capacity development of personnel in relevant areas to ensure effective oversight of the industry. In addition, it would enhance and coordinate initiatives to develop instruments and procedures for efficient operations and risk management as well as undertake research on the Islamic financial industry. The IFSB is expected to be established in 2002 and Malaysia has been chosen to be the headquarter for the Secretariat of the IFSB.

The year 2001 also witnessed a significant development in the International Islamic Financial Market (IIFM). Bahrain, Indonesia, Islamic Development Bank, Iran, Malaysia and Sudan signed the Article of Agreement on the establishment of an IIFM Board on 13 November 2001. This signified the global commitment and support for the initiative to create and structure an international financial market which accords and embraces Islamic principles. The IIFM Board is entrusted to develop and supervise the orderly development of the IIFM. The Board is supported by two committees, the Market and Product Development Committee (MPDC) and the Shariah Supervisory Committee (SSC). The MPDC would undertake research and development on universally accepted financial products which comply with the Shariah principles, and the SSC would endorse and approve the new products before they are traded in the market. For this purpose, Shariah scholars from several regions would be appointed to become the SSC members to ensure the harmonisation of the Shariah interpretations. Meanwhile, the IIFM Secretariat is located in Bahrain. The Labuan Offshore Financial Services Authority and Labuan offshore players are expected to capitalise on this development in promoting Labuan IOFC as one of the active centres for Islamic money and capital markets, particularly in this region.

On 1 November 2001, Malaysia entered into a Memorandum of Understanding (MoU) with Bahrain to jointly promote the development of Islamic banking and finance on the international front. The MoU outlined the co-operative framework between Malaysia and Bahrain for the development of the IIFM, the development of prudential standards to govern the operations of Islamic financial institutions, the convergence of the accounting, auditing and Shariah standards for international harmonisation as well as training and research in the field of Islamic banking and finance.

DEVELOPMENT FINANCIAL INSTITUTIONS

Background

Development Financial Institutions (DFIs) are institutions that have been established and largely funded by the Government to promote the development of certain identified priority sectors and sub sectors of the economy, such as agriculture sector, infrastructure development, shipping, capital-intensive and high-technology industries as well as to achieve certain social goals, by providing financial services and support to complement the banking institutions. These DFIs are generally specialised in the provision of medium and long-term financing of projects that may carry higher credit or market risks due to the longer investment tenures. DFIs have played a significant role in the socio-economic development of the country. It is envisaged that in the next decade, DFIs will continue to progress and assume a more significant role in pursuing the Government policy goals for strategic, social and economic development. The realisation of this vision is supported by the recommendations for DFIs in the Financial Sector Masterplan (FSMP) that aims to improve supervisory framework for DFIs and to enhance DFIs' effectiveness and efficiency in providing specialised financial services.

Supervisory and Regulatory Framework for the DFIs

DFIs were regulated and supervised by several Ministries and State Agencies. The Development Financial Institutions Act 2002 (DFIA) came into force with effect from 15 February 2002 to provide a comprehensive regulatory framework to ensure safe and sound financial management of the DFIs. DFIA takes into consideration the unique roles, functions and objectives of each DFI, the relevant provisions in the existing statutes, the current supervisory standards that are provided in the Banking and

Financial Institutions Act 1989 (BAFIA) and the Insurance Act 1996. It aims to ensure that the policies and objectives of DFIs are consistent with the Government initiatives. Under the DFIA, BNM would be the single regulatory and supervisory body for the DFIs. In performing its role, BNM's focus will be to promote effective and efficient DFIs which will eventually minimise the Government cost in meeting its policy objectives. This will contribute towards realisation of the vision and objectives for DFIs in the FSMP.

The important aspects of DFIA include: -

(a) Selective application of the Act
Recognising the unique characteristics of each DFI, DFIA is structured to allow flexible application of the Act on selected DFI or on specific role, function and operating structure of each selected DFI.

(b) Centralised supervisory body
Efforts to develop effective and efficient DFIs require effective and dynamic supervision by a centralised regulatory authority which would play a strong coordination role in the overall supervision of DFIs. The appointment of BNM as the centralised supervisory body for the DFIs is aimed at meeting this requirement.

(c) Monitoring role and objectives of DFIs
There is strong emphasis on the assessment of the efficiency and effectiveness of DFIs in performing their roles and objectives to ensure consistency with the Government policies. The performance measurement of DFIs will encompass quantitative and qualitative indicators that evaluate the economic and social contribution as well as financial performance.

(d) Efficient management and effective corporate governance
DFIA emphasises on efficient management and effective corporate governance in the DFIs through the appointment of qualified board of directors and senior management. Additionally, this will be augmented by credible external auditor and transparent disclosure of information. The aim is to harness sufficient check and balance and greater accountability by the management.

(e) Comprehensive supervision mechanism
A formal and comprehensive supervision framework is required to ensure the safety and soundness of the DFIs so as to minimise the need for financial assistance from the Government. The legislation incorporates prudential rules, on-site and off-site supervision, reporting requirement, disclosure standard and powers to the regulator to deal with any mismanagement and malpractices in the DFIs.

(f) Strengthen financial position and improve efficiency of asset and liability management
DFIA provides the mechanism to strengthen the financial position of DFIs. Prudential requirements are imposed with the aim to ensure safe and sound financial operations of DFIs, so as to be in line with the best practices of insurance companies and banking institutions.

OTHER FINANCIAL INSTITUTIONS

Discount Houses

Total resources of discount houses continued to rise in 2001 by RM2.7 billion or 12.8% (RM2.6 billion or 13.8% in 2000). The increase mainly reflected higher interbank borrowings and deposits. With deposits increasing at a slower rate (8%; 38.2% in 2000), discount houses resorted to other sources of funds to finance their investment. As a result, there was greater reliance on interbank borrowings, which increased by 23.8% in 2001 (-25.3% in 2000). Furthermore, recognising the tendency for customers to make withdrawals towards the end of the year, discount houses increased their interbank borrowings to safeguard their year-end trading

Table 4.24
Discount Houses: Sources and Uses of Funds

	Annual Change		At end 2001
	2000	2001	
	RM million		
Sources:			
Approved capital funds	191	277	2,065
Deposits	3,858	1,117	15,070
Interbank borrowings	-1,670	1,173	6,099
Others	181	129	582
Total	**2,561**	**2,696**	**23,816**
Uses:			
Investment in securities:	2,337	1,657	20,382
Government debt securities	*46*	*1,111*	*1,788*
MGS held	*-122*	*993*	*1,462*
Khazanah bonds	*163*	*222*	*655*
BNM bills	*709*	*-590*	*120*
Private debt securities	*342*	*942*	*11,647*
Bankers acceptances	*990*	*-941*	*3,234*
Negotiable instruments of deposit	*-603*	*-124*	*220*
Cagamas debt securities	*858*	*-224*	*1,087*
Others[1]	*-169*	*1,259*	*1,631*
Interbank placements	313	724	2,856
Others	-90	315	578
	1999	2000	2001
Number of discount houses	7	7	7

[1] Includes Danaharta and Danamodal bonds.
Note: Total may not add-up due to rounding.

positions. Deposits accepted grew at a slower rate during the year because of the non-rollover in Sistem Perbankan Islam (SPI) deposits upon maturity and the less competitive interest rates offered by discount houses.

The increase in total resources continued to be invested mainly in securities, which expanded by RM1.7 billion or 8.9% in 2001 (RM2.3 billion or 14.3% in 2000). In particular, there was a shift of investment into longer-dated bonds, particularly MGS, Danaharta and Danamodal bonds, as well as bonds issued by the private sector (PDS). The shift reflected the declining interest rate environment which enhanced the attractiveness of longer-dated papers as compared to shorter-term instruments.

During the year, discount houses also expanded their fee-based activities. The industry arranged, lead-managed and co-managed the issuance of PDS worth RM4.4 billion (RM2.8 billion in 2000). The total amount underwritten by the discount houses was RM1.6 billion (RM2.5 billion in 2000), for 16 PDS issues (58 issuance in 2000). Following the annual review of the Principal Dealer System by BNM in early 2001, only one discount house was appointed as a principal dealer (two in 2000).

Table 4.25
National Savings Bank

	Annual change		At end
	2000	2001*p*	2001*p*
	RM million		
Deposits[1]	3,299	243	10,307
Savings	-69	-84	1,230
Fixed	3,092	-317	5,400
GIRO	384	427	3,300
Islamic banking	-108	216	360
Others	1	1	17
Premium Savings Certificates	40	97	700
Investments (book value)	1,212	1,687	6,053
Malaysian Government Securities	178	18	1,111
Shares	32	913	2,045
Government guaranteed bonds	544	458	1,587
Other investments	458	298	1,310
Deposits with financial institutions	2,793	-986	2,700
Gross loans	310	-69	2,302
Net loans (less provision for doubtful debt, bad debts, and interest in suspense)	312	-74	2,164
Number of NSB branches[2]	-3	-9	414
Number of post offices with NSB facilities[3]	-18	-180	443
Number of account holders ('000)	600	390	9,500
Number of Automated Teller Machines	14	-5	606

[1] Includes interest credited
[2] Includes mini-branches and sub-branches
[3] Includes permanent and mobile offices
p Preliminary

National Savings Bank

Total resources of the National Savings Bank (NSB) continued to expand, increasing by RM451 million or 4% to RM11.8 billion as at end-2001. The increase was due mainly to higher GIRO and Islamic banking deposits, which more than offset the decline in fixed and savings deposits. GIRO deposits grew by RM427 million or 14.9%. The increase in GIRO deposits was due mainly to attractive product enhancements that offered additional advantages to depositors. Islamic banking deposit schemes, which were introduced in 1994 have gained popularity, with Islamic banking deposits rising by RM216 million in 2001. Although fixed deposits decreased marginally, due mainly to redemptions by corporations, it nevertheless remained the major source of deposit funds, accounting for 52.4% of total deposits outstanding as at end-2001, followed by GIRO deposits with a share of 32%.

In terms of the composition of its assets, there was a shift from placements of deposits with financial institutions to investments in shares and Government guaranteed bonds. Investments in shares and Government guaranteed bonds increased by RM913 million (+80.7%) and RM458 million (+40.6%) respectively. Meanwhile, deposits placed with financial institutions declined by RM986 million, reflecting the low interest rates environment. As at end-2001, the bulk of NSB's assets was in the form of investments in securities (51.1%), deposits with financial institutions (22.8%) and loans (18.3%).

Provident and Pension Funds

Total resources of the 14 provident and pension funds (PPF) surveyed by BNM expanded by 6.7% in 2001 to RM231.5 billion. The bulk of the increase were new contributions to the Employees Provident Fund (EPF). Accumulated contributions, however, grew at a slower rate of 6% or RM11.7 billion during the year, reflecting lower net contributions and dividends credited during this year. At the same time, withdrawals were also higher (RM6.6 billion to RM17.3 billion), resulting in the PPF recording lower net contributions of RM3.4 billion during the year (2000: RM9.5 billion).

Higher withdrawals were mainly under the four EPF schemes, for which withdrawal procedures had been made more flexible during the year. Withdrawal of EPF

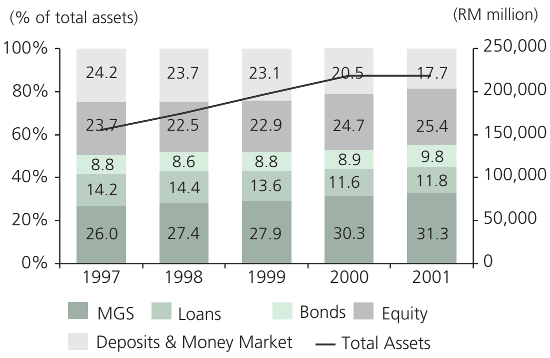
Table 4.26
Provident and Pension Funds: Selected Indicators

	2000	2001*p*
	RM million	
As at end		
Number of contributors ('000)	19,075	19,058
of which: EPF	*9,966*	*10,074*
SOCSO	*8,877*	*8,769*
Accumulated contributions	196,290	208,023
Assets	216,936	231,479
of which:		
Investments in MGS	65,810	72,512
During the year		
Gross contributions	20,178	20,701
Withdrawals	10,689	17,314
Net contributions	9,489	3,387
Dividends credited	10,237	9,366
Investment income	12,150	11,113

p Preliminary

Source: Employees Provident Fund, Pension Trust Fund, Social Security Organisation, Armed Forces Fund, Malaysian Estates Staff Provident Fund, Teachers Provident Fund and eight other private provident and pension funds.

Graph 4.19
Provident and Pension Funds: Major Asset Composition



contributions were made more flexible for pensionable employees as well as retirees who took optional retirement; for all contributors for the purchase of a second house on condition that the first house is sold; the purchase of computer for own use; and for payment of fees for tertiary education. Withdrawals under the annuity scheme were also higher during the year before the scheme was discontinued on 5 October 2001. Improved efficiency which led to shorter processing time for withdrawal applications also contributed to higher withdrawals during the year.

During the year, gross contributions to PPF expanded at a slower rate of 2.6% (2000: 15.1%) reflecting mainly the more moderate increase in gross contributions to the EPF. In April, EPF contributors were given an option to reduce their monthly contributions from 11% to 9% in line with the Government efforts to stimulate domestic demand. About 75% of the active contributors opted for the reduction in their contribution. The number of contributors to the PPF also fell marginally by 0.1% to 19.1 million as a result of the decline in the number of non-active members of the Social Security Organisation. Meanwhile, total dividends credited during the year were lower, at RM9.4 billion, reflecting lower investment income amid a low interest rate environment.

In terms of the composition of assets of the PPF, there was some shift from the holdings of deposits and money market papers to MGS and corporate bonds. The share of MGS and corporate bonds increased to 31.3% and 9.8% respectively, while the share of deposits and money market papers declined to 17.7% at the end of 2001. The shift reflected the preference for assets with higher returns and also the larger issuance of MGS and corporate bonds during the year. Meanwhile, investment in equities recorded a higher share of 25.4% while the share of loans declined to 11.8%, reflecting some shift in the investment strategy of PPF in 2001.

Several recommendations affecting the PPF industry were contained in the Capital Market Masterplan, which was launched in February 2001. These included recommendations for PPF to participate in venture capital funds in order to diversify their holdings and enhance returns on portfolio; deregulation of restrictions on participation in exchange-traded derivatives; and liberalising the restrictions on the management of funds by foreign fund management companies. Specifically for EPF, the recommendations included a review of the investment restrictions imposed on EPF in order to allow for a greater free float of MGS; and diversification of the management of funds by placing out a greater portion of its funds with external fund managers. In January 2002, the EPF's Annuity Scheme was replaced by the Withdrawal Payment Scheme. Under this new scheme, contributors can transfer not more than 50% of their savings from Account 1 to a new account, Account 4. The scheme allows contributors to make monthly withdrawals from Account 4 over a 20-year period on reaching the age of 55.

Industrial Finance Institutions
Industrial finance institutions constitute Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB), Bank Industri dan Teknologi Malaysia

Table 4.27
Industrial Finance Institutions : Changes in the Direction of Lending

Sector	Annual Change					
	1999		2000		2001	
	RM million	% change	RM million	% change	RM million	% change
Transport & storage	995.3	291.6	1,612.7	120.7	862.7	29.3
Agriculture	-13.4	-13.1	38.3	42.9	-3.9	-3.0
Manufacturing	-0.8	…	-96.8	-2.8	128.5	3.9
General commerce	-24.8	-7.9	-212.9	-73.6	8.0	10.4
Real estate & construction	838.2	37.9	-372.7	-12.2	315.0	11.8
Others	-198.8	-15.7	541.7	50.7	-2.7	-0.2
Total	1,595.7	20.8	1,510.4	16.3	1,307.6	12.2

Berhad (BITMB), Sabah Development Bank Berhad (SDB), Export-Import Bank of Malaysia Berhad (EXIM Bank), Malaysian Industrial Development Finance Berhad (MIDF), Malaysian Industrial Estates Berhad (MIEL), Borneo Development Corporation (Sabah) Sendirian Berhad (BDC Sabah), and Borneo Development Corporation (Sarawak) Sendirian Berhad (BDC Sarawak).

Total assets of the industrial finance institutions continued to increase in 2001 by RM3.4 billion or 16.7% compared with RM2.5 billion or 14.1% in 2000. The growth in total assets was mainly attributed to the increase in deposits placed with financial institutions and loans and advances which accounted for 53.9% (+RM1.8 billion) and 38.9% (+RM1.3 billion) of the increase respectively.

Loans extended by the industrial finance institutions registered a lower growth of 12.1% in 2001 compared with 16.3% in 2000. The growth was largely influenced by the loans extended by BPIMB and SDB which registered increases of 28.9% (+RM1.5 billion) and 18.5% (+RM178.7 million) respectively. However, excluding the two institutions, the total loans extended by industrial finance institutions recorded a decline of 6.9% (-RM329.9 million) in 2001.

Total loans extended by BPIMB and SDB accounted for 63.3% (RM7.6 billion) of total loans of industrial finance institutions. The growth was driven by the expansion in development and infrastructure loans of BPIMB as reflected in the growth rate of 29.2% (RM862.7 million) in loans to the transport and storage sector (especially infrastructure sub-sector). In the case of SDB, the increase was triggered by the implementation of loan expansion strategy in 2001. The decrease in total loans extended by other industrial finance institutions was largely attributed to early repayment of loans by borrowers of BITMB and MIDF and conversion of loans to loan stocks by borrowers of MIDF.

Deposits placed with financial institutions by industrial finance institutions increased by 40.4% (+RM1.8 billion) in 2001 compared with 46.4% (+RM1.4 billion) in 2000. The large increase was partly the result of lower demand for loans experienced by many of the industrial finance institutions relative to increase in borrowings.

Industrial finance institutions have traditionally relied heavily on funding from the Government and government-related institutions in the form of equity, grants, loans and placement of deposits to fund their operations as they are not licensed to mobilise deposits from the public. The industrial finance institutions also relied, to a lesser extent, on external funding at preferential terms under special bilateral agreements with international multilateral development finance institutions. More recently, however, some industrial finance institutions have raised funds from the capital market to better match the long investment tenure of the projects financed by them and to be less dependent on government funding.

Total borrowings of industrial finance institutions increased by 16.9% (+RM2.4 billion) in 2001 compared with 23.8% (+RM2.8 billion) in 2000. Borrowings from the Government by the industrial finance institutions registered a substantial increase of 44.5% to RM10.7 billion in 2001 and accounted for 63.8% of total borrowings. The increase was mainly contributed by a significant increase in borrowings (131.3% or +RM3.4 billion) by BPIMB from the Government to support its development and infrastructure projects. Borrowings from the non-Government entities however, declined by 12.4% to RM6.1 billion in 2001.

Table 4.28
Venture Capital Funds/Companies

	At End	
	2000	2001*p*
No. of venture capital funds/companies	31	36
No. of investee companies	159	180
	RM million	
Sources		
Shareholders' funds	972.6	983.2
Liabilities	543.4	993.8
Total	**1,516.0**	**1,976.9**
Uses		
Investments in investee companies	718.2	652.9
Other assets	797.8	1,324.0
Total	**1,516.0**	**1,976.9**

p Preliminary

Table 4.29
Venture Capital Funds/Companies: Investments During the Year

	2000	2001p
No. of investee companies	35	42
	RM million	
Investments during the year	**131.3**	**109.3**
By sector		
Manufacturing	*25.4*	*16.8*
of which:		
- IT based products	*0.3*	*1.9*
- Electrical and electronic products	*7.5*	*–*
- Advance electronics technology	*8.9*	*11.3*
Information communication technology	*53.1*	*76.0*
Life sciences	*3.5*	*3.2*
Others	*49.4*	*13.4*

p Preliminary

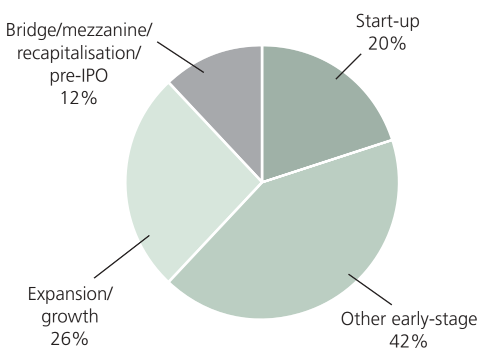
Venture Capital

The venture capital (VC) industry continued to expand in 2001 as an alternative source of financing. Total resources increased by 30.4% to RM2 billion as at end-2001, due mainly to the establishment of two Government-owned venture capital companies (VCCs). The number of VC funds/companies also rose to 36 as at end-2001. Similarly, the total number of investee companies backed by VC investments increased to 180, from 159 in the previous year.

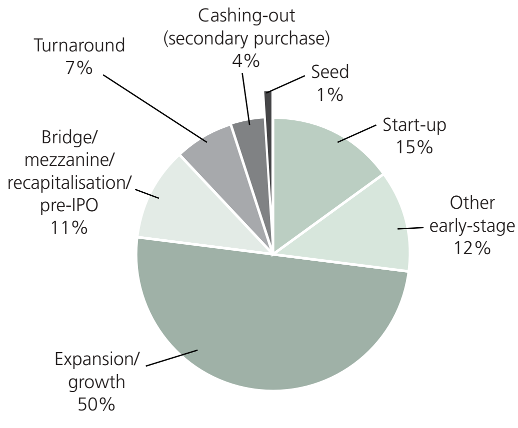
During the year, VCC investments were placed with 42 companies (35 companies in 2000) for a total value of RM109.3 million. The bulk of investments (70%) continued to be placed in the information communication technology (ICT) sector, in line with Government policy to develop the ICT industry. Investments in the life sciences sector, albeit small, were sustained at 2.9% of total investments. Another encouraging development in 2001 was the higher share of investments in companies at the start-up and early stages, which accounted for 62% of total investments (27% in 2000). The higher investments in these stages indicated an increased risk tolerance of the VC industry in supporting companies during the more risky period of their lifespan.

The Government continued its efforts in supporting the VC industry by providing adequate liquidity to meet the industry needs. Following the announcement of the establishment of the RM500 million VC fund, a Government-owned company, Malaysia Venture Capital Management Berhad (MAVCAP) was set up to manage this VC fund. To date, MAVCAP has committed to invest RM20 million into one investee company and appointed three VCCs to manage a total of RM75 million of its total fund. In addition, another Government-owned

Graph 4.20
Investments by stages in 2001



Investments by stages in 2000



company, Kumpulan Modal Perdana Sdn. Bhd. was established to manage the Venture Capital Fund for Technology Acquisition amounting to RM190 million. The objective of this VC fund is to assist entrepreneurs in technology acquisition by investing into foreign technology-based companies which would lead to technology transfer to Malaysia. The fund would also be used for the implementation of the Advanced Microchip Design and Training Centre. In a move to improve the quality of Malaysian technopreneurs, the Government launched the Technopreneur Development Flagship spearheaded by the Multimedia Development Corporation. The Flagship is aimed at developing a sizable number of SMEs in the ICT sector and nurturing them into world-class companies. Several measures were introduced to increase the usage and deployment of ICT, including sales tax exemption on smart cards and related equipment, tax reduction on income derived from trading via websites in Malaysia and income tax deduction on costs incurred in developing business websites.

During the year, there were also new private sector initiatives which contributed to the development of the VC industry. The first business plan competition, Venture 2001, which was launched in November 2000 with the objectives of converting potential ideas into actual businesses and fostering an entrepreneurial environment in Malaysia successfully received 447 business plans, significantly higher than its initial target of 250. Venture 2002 was subsequently launched in January 2002 to build on earlier efforts to develop an entrepreneurial culture in Malaysia.

FINANCIAL MARKETS

Overview

In 2001, trading volume in the money market and capital markets, comprising bond and equity markets, and futures market were higher, while the foreign exchange market recorded a lower trading volume. The financial markets remained effective in their role as financial intermediaries for mobilisation and allocation of funds in 2001. During the course of 2001, relevant authorities continued to undertake new initiatives in order to improve market infrastructure to better meet the financing needs of the economy.

Total volume of funds traded in the money market increased moderately, reflecting mainly the higher trading of money market papers, amidst lower trading of interbank deposits. The higher trading in the money market papers reflected the significant increase in trading of Malaysian Government Securities (MGS) as well as the shift in investments from lower-yielding papers to the high-yielding papers in view of ample liquidity and the low interest rates environment. Meanwhile, the lower trading in interbank deposits was an outcome of the ample liquidity situation, which led to the reduced reliance on the interbank market for funding needs.

New initiatives to further improve infrastructure of the financial markets resulted in improved efficiency of market as financial intermediaries, as reflected in generally higher trading volumes.

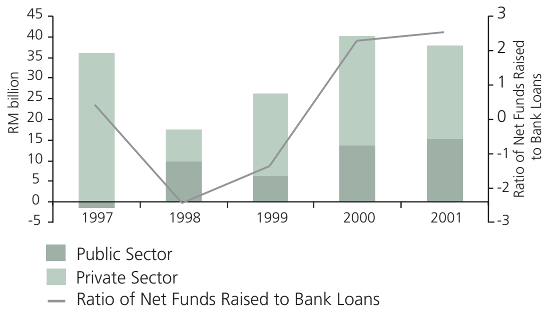
In the interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions was lower during the year. Trading activity in the ringgit was concentrated mainly in trade-related transactions following the non-internationalisation of ringgit. Activities continued to

Table 4.30
Funds Raised in the Capital Market

	2000	2001*p*
	RM million	
By Public Sector		
Government Securities, gross	16,413	23,087
Less Redemptions	5,286	7,100
Less Government holdings	-	-
Equals Net Federal receipts	11,127	15,987
Khazanah Bonds (net)	551	-220
Govt. Investment Issues (net)	2,000	-195
Malaysia Savings Bond (net)	-19	-359
Net funds raised by public sector	13,659	15,213
By Private Sector		
Shares	6,013	6,123
Debt securities[1]	30,953	37,220
Less Redemptions	10,459	20,890
Equals Net Issues	20,494	16,330
Net funds raised by private sector	**26,507**	**22,453**
Total Net Funds Raised	**40,166**	**37,666**
Short-term papers and notes (net)[2]	-1,482	-2,288
Total	**38,684**	**35,378**

[1]Exclude debt securities issued by banking institutions.
[2] Refers to Commercial Papers and Cagamas Notes only.
p Preliminary

Graph 4.21
Net Funds Raised in the Capital Market by the Public and the Private Sectors



be dominated by transactions in the US dollar against the ringgit, reflecting the importance of the dollar as a vehicle currency and the high dollar concentration in trade settlements and other capital account transactions.

The capital market, comprising the equity and bond markets, remained important as a source of financing, although net funds raised in the capital market was slightly lower at RM37.7 billion. The bulk of funds was raised in the bond market by both the private and public sectors (RM31.6 billion), while the balance (RM6.1 billion) was raised in the equity market by the private sector. The public sector raised a total amount of RM15.2 billion mainly through new issuances and reopening of MGS to meet the higher financing needs of the Government.

In the private sector, total funds raised in both the PDS and equity markets amounted to RM22.5 billion, of which the PDS market accounted for 72.7%. Although funds raised in the equity market remained relatively unchanged at RM6.1 billion, they remained an important source of financing. Funds were raised largely through rights issues, initial public offerings (IPOs) and private placements. Improved sentiment on the Kuala Lumpur Stock Exchange (KLSE) as a source of financing was evidenced by oversubscription in many of the IPOs. These IPOs were also traded at a premium over their offer prices at the end of their first day of trading. In a challenging environment in 2001, the KLSE performed relatively well, with its composite index rising marginally by 2.4% to 696.09 points at the end of 2001. Market capitalisation also increased by 4.6% to RM465 billion. Besides the low interest rates and ample liquidity situation coupled with the expansionary fiscal policy, factors such as positive corporate restructuring and strengthened macroeconomic fundamentals contributed positively to the performance of the KLSE.

In the PDS market, total gross funds raised during the year was higher at RM37.2 billion (2000: RM31 billion) as companies resorted to issuing PDS to take advantage of low interest rates, ample liquidity and investor preference for more stable investment options. Nevertheless, high redemptions, in particular by a major corporation under the debt-restructuring scheme resulted in lower total net funds raised during the year. In contrast to the year 2000, the bulk of the funds raised during the year were utilized to finance new activities and for refinancing purposes. During the year, there was a steady decline in the yields of bonds due to market expectations of lower interest rates and continued ample liquidity in the market. Meanwhile, trading activity in the secondary market increased sharply during the year following the higher supply of MGS.

In the derivatives market, trading in the KLIBOR Futures and Crude Palm Oil (CPO) Futures was higher during the year while trading activities in the KLSE CI Futures remained thin. The decline in turnover volume of KLSE CI Futures was due mainly to the lack of volatility of the KLSE CI. Trading in KLIBOR Futures, on the other hand, was active due to the ample liquidity situation in the interbank cash market and improved interests in the local bond and interest-rate swap markets. Meanwhile, higher production of crude palm oil and favourable developments on the price fronts contributed to the higher trading in the CPO Futures Contract.

During the year, several measures and initiatives were implemented to strengthen market practices and build a stronger financial infrastructure. A notable development in the capital market during the year was the launching of the Capital Market Masterplan in February with the objective of setting out the strategic position and future direction for the Malaysian capital market. At the same time, in the equity market, measures introduced during the year emphasized efforts to improve corporate governance and efficiency in market activity. The introduction of the guidelines on offering of asset-back securities was the major development in the bond market. Meanwhile, the Malaysia Derivatives Exchange (MDEX) was established in June 2001 as an integrated derivatives exchange following the merger of two exchanges, the Kuala Lumpur Options and Financial Futures Exchange and the Commodity and Monetary Exchange of Malaysia, aimed at facilitating economies of scale and depth of market through improved operating efficiencies and the trading of more derivative products.

Money Market

Volume of transactions in the money market rose moderately in 2001. A notable development was the significant expansion in trading of Malaysian Government Securities (MGS) and the shift of trading into the longer-dated papers. These developments were influenced by interest rates developments, the underlying liquidity in the system and supply factors. During the year, trading in the money market instruments was concentrated in the MGS. The higher trading volume (148.2%) reflected mainly market expectations that the domestic interest rates would remain low, following the aggressive interest rate cuts by the US. The September 11 incident compounded these expectations, precipitating a significant rise in trading of MGS in the months of September and October to account for one-fifth of total volume of transactions during the year. These developments, together with the sustained inflows of funds amid the ample liquidity situation, as well as the larger issuance of MGS to finance the Government's fiscal deficit, prompted market participants to lock in their funds in higher-yielding MGS. In addition, longer-dated papers such as MGS tended to exhibit wider range of price movements, thereby providing the market with arbitrage opportunities particularly in a declining interest rate environment. In 2001, the average yield to maturity (YTM) of the 5-year MGS fluctuated within a wide range of 136 basis points, compared with 72 basis points in 2000. Furthermore, there was also greater participation of non-bank players, notably insurance companies and large corporations. The heightened interest in the MGS resulted in lower yields, particularly for the longer-dated MGS.

Graph 4.22
Money Market Instruments

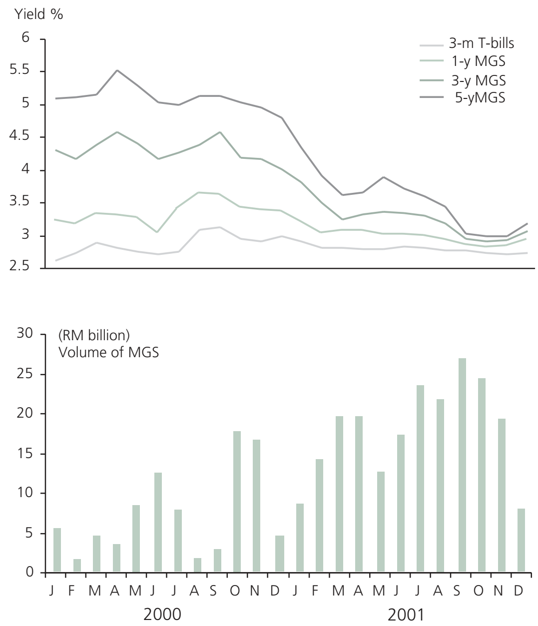
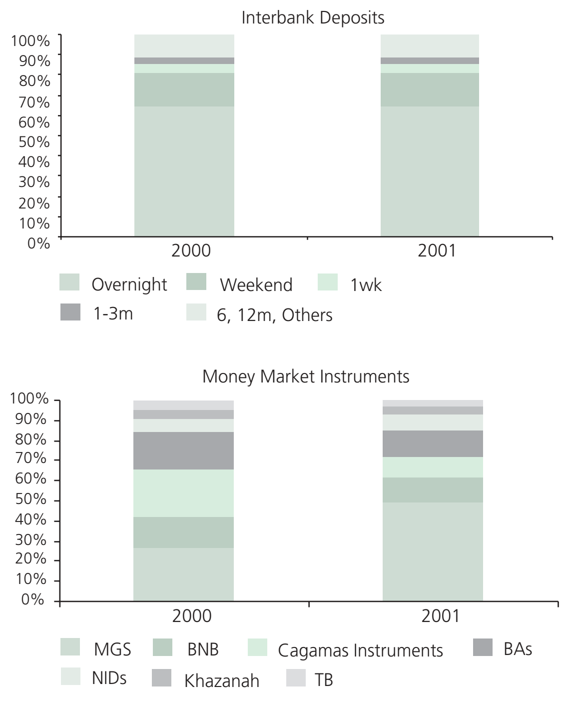


Table 4.31
Money Market[1]

	2000		2001	
	Volume (RM bilion)	Annual Change (%)	Volume (RM bilion)	Annual Change (%)
Total money market transactions	**1425.4**	**0.7**	**1500.8**	**5.3**
Interbank deposits	**1091.7**	**-8.2**	**1055.3**	**-3.3**
Money market papers	**333.7**	**47.7**	**445.5**	**33.5**
Bankers Acceptances (BAs)	63.6	-6.3	60.5	-4.9
Negotiable instrument of deposits (NIDs)	21.0	-22.8	34.3	63.3
Malaysian Government Securities (MGS)	88.6	38.9	219.9	148.2
Khazanah bonds	15.5	-3.7	17.9	15.5
Treasury bills	15	30.4	13.4	-10.7
Bank Negara Bills	50.9		55.2	8.4
Cagamas bonds	29.3	127.1	25.9	-11.6
Cagamas notes	49.8	87.9	18.4	-63.1

[1]All data are sourced from the Bond Information and Dissemination System, except BAs and NIDs which are sourced from money market brokers.

Graph 4.23
Share of Total Volume Traded



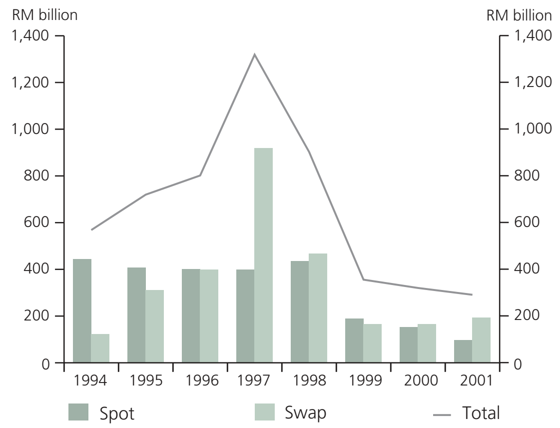
Consequently, the yield curve shifted downwards from the position at end-2000, before edging upwards since November when sentiments on the prospects for global economic recovery improved towards the end of the year. To some extent, the higher MGS yield in December also reflected the liquidation of papers by some market players following the large accumulation of MGS in their portfolio in September and October.

In contrast, trading in the shorter-dated papers, notably the Cagamas notes, Treasury bills and Bankers Acceptances was lower during the year (-28.1%). Similarly, the interbank deposits also recorded a lower transactions volume (-3.3%), due to the preference among banks to invest in the higher-yielding papers, while the ample liquidity in the system has reduced recourse to interbank funding. Overnight deposits remained the most actively traded tenure in the interbank market, accounting for 70% of interbank deposit trades.

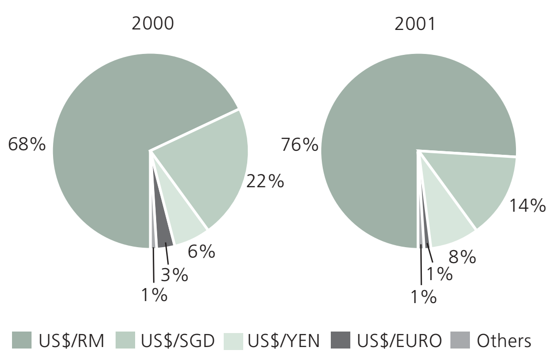
Foreign Exchange Market

In the KL interbank foreign exchange market, the average daily volume of interbank foreign exchange transactions (spot and swap transactions) done through the eight foreign exchange brokers declined by 9.5% compared to the volume traded in 2000. Trading activity reflect mainly trade-related transactions. Position-taking activity on the ringgit has been contained through the elimination of the offshore ringgit market as well as through guidelines governing the operating framework of banking institutions. As a result of these measures, the volume of transactions conducted has stabilised following the significant decline at end-1998.

Graph 4.24
Volume of Interbank Transactions in the Kuala Lumpur Foreign Exchange Market



Graph 4.25
Interbank Transactions in the Kuala Lumpur Foreign Exchange Market by Currency



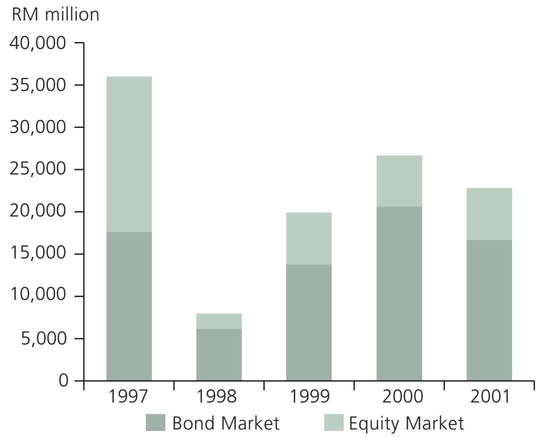
The majority of trades transacted in 2001 occurred in the first half, before subsiding towards the end of the year. The increased activity in the first half of the year reflected mainly forward purchases of foreign exchange for imports of goods and services, and loan repayments in view of the discount on the ringgit swap rate. By composition, transactions in the Kuala Lumpur foreign exchange market continued to be dominated by transactions in the US dollar against the ringgit, with the share of such transactions increasing to 76% in 2001 from 68% of total transactions in 2000. This development reflects the increasing significance of the US dollar in the KL interbank foreign exchange market as well as the high usage of the US dollar in the settlement of trade, services and capital account transactions.

Equity Market

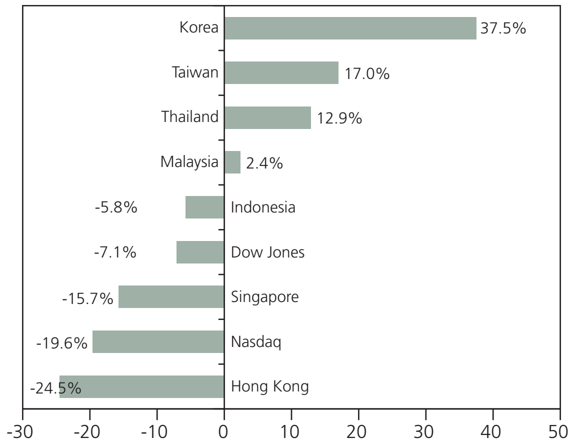
Notwithstanding a more challenging global environment in 2001, the Kuala Lumpur Stock Exchange Composite Index (KLSE CI) ended the year slightly higher (2.4%). Market capitalization also rose by 4.6% to RM465 billion (RM444.4 billion in 2000). Compared to the regional bourses, which include Hong Kong, Singapore, Indonesia and the Philippines, the KLSE also performed quite favourably. During the year, strong economic fundamentals, the completion of restructuring of large corporations and positive changes in corporate governance issues became factors that have increasingly influenced the performance of the KLSE CI. Meanwhile, the KLSE as well as the Securities Commission continued to further enhance regulations and their enforcement to address issues of concern to investors, particularly minority shareholders.

The equity market remained an important source of financing for the private sector in 2001. Funds raised through the equity market amounted to RM6.1 billion

Graph 4.26
Funds Raised by the Private Sector in the Capital Market



Graph 4.27
Performance of Selected Regional & Emerging Stock Market Indices (% change from 2000 to 2001)



Source: International Federation of Stock Exchanges (FIBV)

or 27.3% of the total funds raised by the private sector in the capital market (RM6 billion or 22.7% in 2000). The new funds were mainly raised through rights issues (31%), initial public offerings (IPOs) (27.4%) and private placements (27.4%). In 2001, there was a total of 20 IPOs, of which six were listed on the Main Board and the other 14 on the Second Board. The amount raised through IPOs was higher, at RM1.7 billion during the year. Compared with 2000, using IPOs to raise funds were exercised by companies in a broader range of industries and sectors, including telecommunications, trading and services, industrial and consumer products, and information technology. Improved confidence in the equity market was evident in the oversubscription for about 70% of the total number of IPOs raised during the year. Furthermore, the bulk of the IPOs was traded at a premium over the offer prices at the end of the first day of trading, influenced mainly by the issuers' prospects and investor interest in specific sectors.

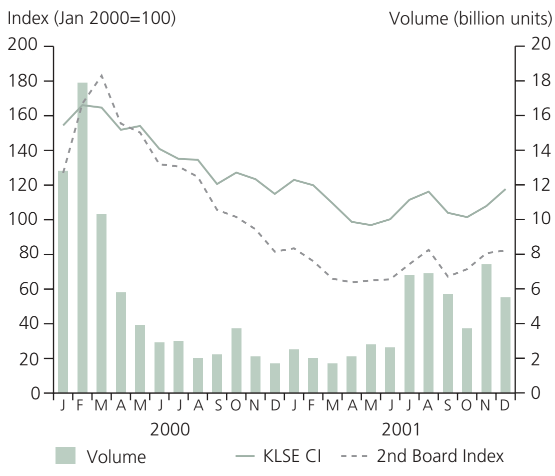
Table 4.32
Kuala Lumpur Stock Exchange: Selected Indicators

	2000	2001*p*
Price indices		
Composite	679.64	696.09
EMAS	159.77	165.23
Second Board	132.98	134.13
Total turnover		
Volume (billion units)	75.4	54.9
Value (RM billion)	244.1	96.0
Average daily turnover		
Volume (million units)	208.1	204.4
Value (RM million)	911.1	349.8
Market Capitalisation (RM billion)	444.4	465.0
Market Capitalisation / GDP (%)	130.4	134.6
Total number of companies listed	795	812
Main Board	499	520
Second Board	296	292
Market liquidity:		
Turnover value / Average market capitalisation (%)	42.3	22.2
Turnover Volume / Number of listed securities (%)	39.5	27.4
Market concentration:		
*10 Most Highly Capitalised Stocks/ Market Capitalisation (%)	38.9	36.7
Average paid-up capital of stockbroking firms (RM million)	129.6	138.2

p Preliminary
* based on market transaction only

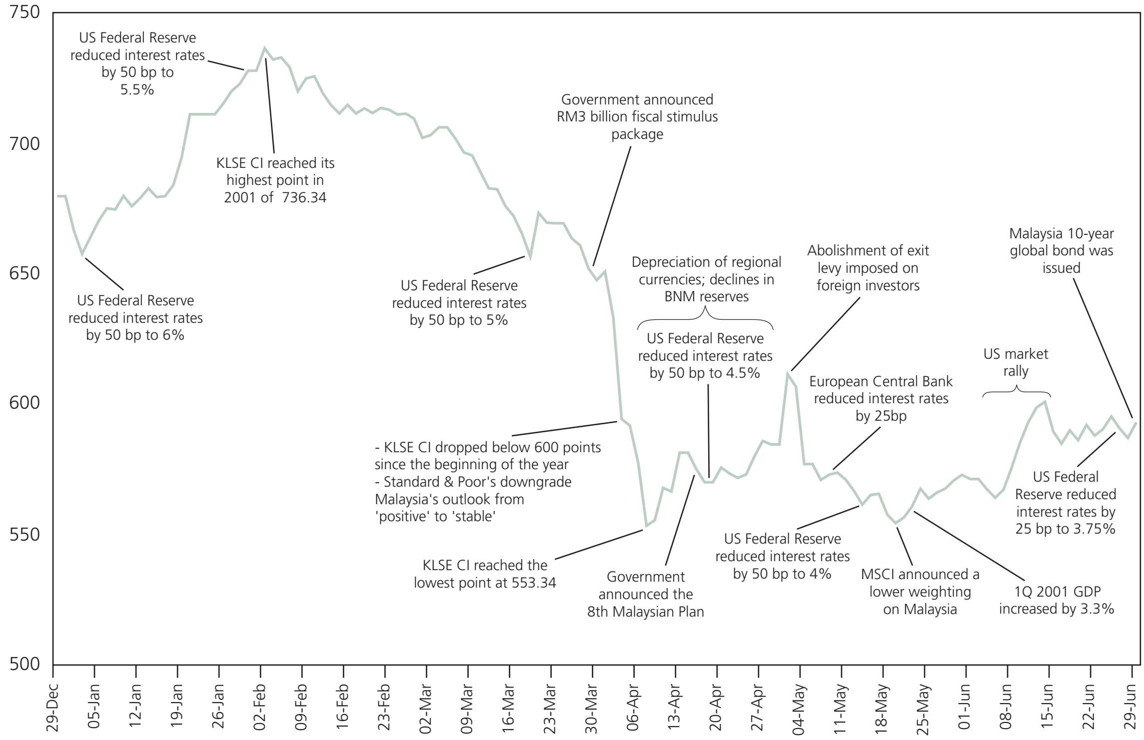
Source: Kuala Lumpur Stock Exchange

Graph 4.28
Kuala Lumpur Stock Exchange Composite Index, (KLSE CI) Second Board Index and KLSE Trading Volume

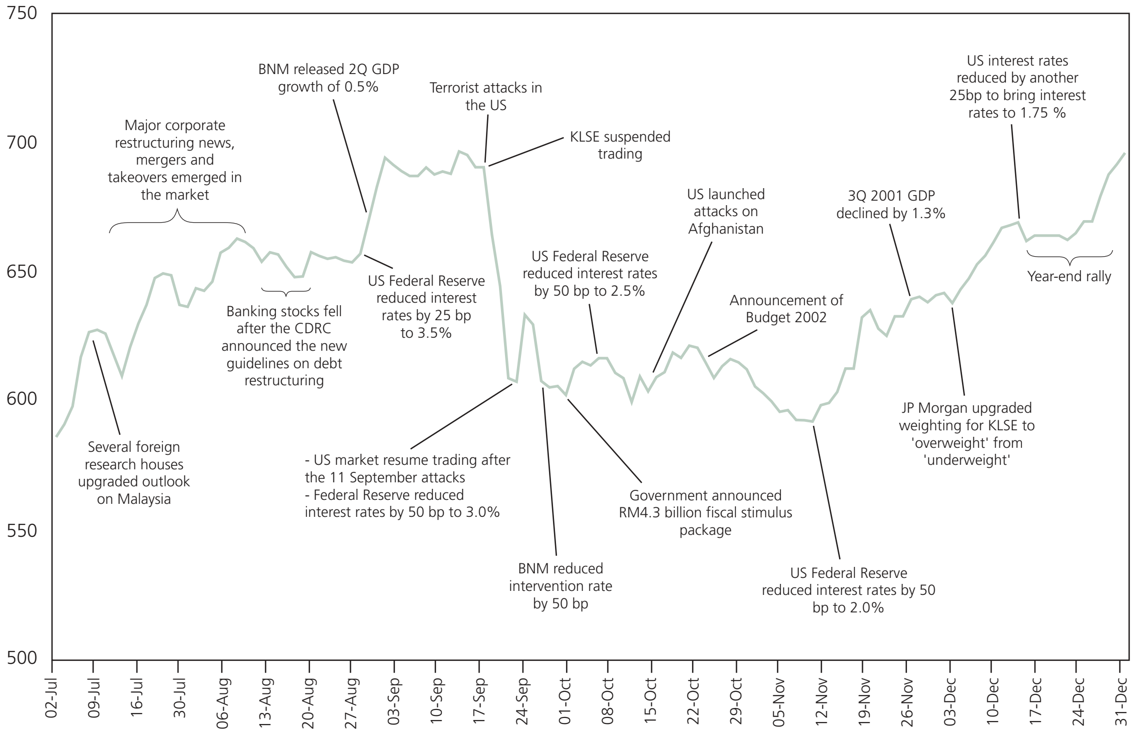


Source: Kuala Lumpur Stock Exchange

Graph 4.29
Performance of the KLSE CI (31 December 2000 - 30 June 2001)

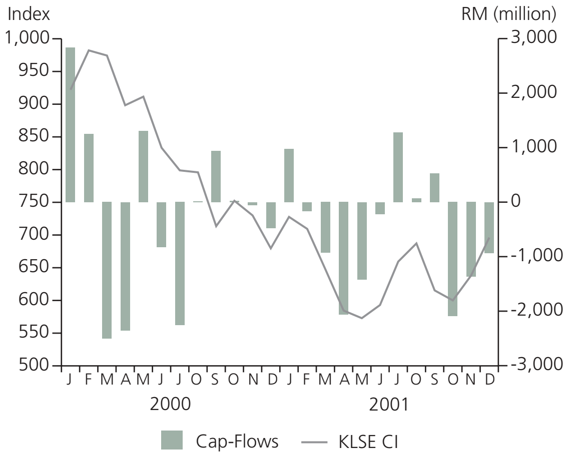


Graph 4.30
Performance of the KLSE CI (1 July - 31 December 2001)



In the first half of 2001, the decline of 11% in the KLSE CI was influenced mainly by poorer-than-expected corporate earnings as well as concerns over the slowdown in the global economy. Other factors included concerns over the impact of the depreciation of yen on regional currencies, and the revision of the Malaysian economic outlook from positive to stable by an international rating agency. Some other factors, however, mitigated the decline in the KLSE CI. These included the fact that other major international

Graph 4.31
KLSE CI vs Flows through External Accounts (Jan 2000 - Dec 2001)



rating agencies maintained their favourable ratings on the outlook for the Malaysian economy, as well as the abolishment of the exit levy on profits from portfolio investment repatriated within one year, effective May 2001.

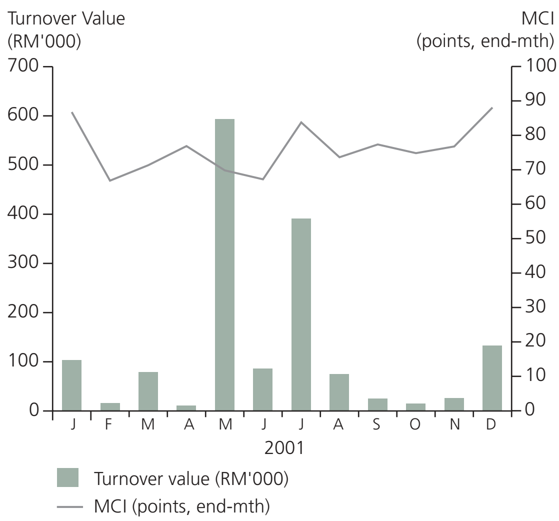
The KLSE CI rebounded strongly by 17.4% in the second half of 2001 against the backdrop of improving prospects for the domestic economy and positive reception of the institutional changes made to accelerate corporate debt restructuring. Prior to the September 11 incident, the better market performance was due partly to more favourable views on the Malaysian economy following positive GDP growth in the second quarter. Recovery in the US market and other markets also aided sentiment. The September 11 incident had temporarily disrupted the market. The KLSE was suspended on 12 September in order to maintain the orderly functioning of the market and to provide investors with sufficient time to fully assess the situation. After a brief bearish performance, market sentiment improved in October following better prospects for the Malaysian economy and positive developments in corporate restructuring. Market sentiment improved further towards year-end, supported by announcements of corporate restructuring of big enterprises, further fiscal spending to support growth as well as the Government's success in raising the US$1 billion 10-year global bond.

During the year, the performance of the KLSE was to a large extent, influenced by movements in foreign portfolio investment funds. It was evident that the KLSE CI performance tracked the trend in the flow of funds through the external accounts. These are the ringgit accounts maintained by non-residents, indicating that activities in the KLSE were to some extent, influenced by foreign participation.

In the Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ), the MESDAQ Composite Index (MCI) declined by 5.4% to close the year at 88.08 points. The total trading volume was lower, valued at RM1.6 billion (2000: RM4.7 billion). Trading activities also remained thin with trades concentrated in May and July. Market capitalisation, nevertheless, increased to RM177.6 million at the end of the year (2000: RM141.4 million). This was due to one new listing on MESDAQ in 2001. By end-2001, four companies were listed on MESDAQ. The increasing underwriting risks amidst a weak market made it difficult for companies to secure underwriting commitments. As at end-2001, MESDAQ's total membership rose to 20 (2000: 19), of which 16 were stockbroking companies while the remaining were merchant banks.

In line with the recommendations of the Capital Market Masterplan to establish a single Malaysian exchange, MESDAQ signed a Merger Agreement with the KLSE on 31 December 2001. The consolidation of the exchanges would streamline the regulatory and market development functions of KLSE and MESDAQ, enabling the offering of a wider range of products and

Graph 4.32
Malaysia Exchange of Securities Dealing and Automated Quotation: Trading and MESDAQ Composite Index (MCI)



Source: Malaysian Exchange of Securities services to market participants. As a result of the proposed merger, certain projects were aborted or put on hold. These included the enhancement of the MESDAQ Order Routing and Execution Surveillance System, the on-line registration of registered representatives and the on-line Capital Adequacy reporting by members.

In 2001, further measures were introduced to bring practices in the equity market in line with international standards. At the same time, the KLSE strengthened their monitoring and enforcement of compliance to existing and new regulations. In ensuring that investors would continue to have confidence in investing on the KLSE and in the Malaysian economy, emphasis continued to be given to improving the level of corporate governance. The new Listing Requirements introduced in January achieved the objectives of enhancing corporate governance and transparency, and efficiency in capital market activities, thereby strengthening investor protection and promoting investor confidence. At the same time, there was some relaxation of rules affecting the issue, offer and listing of securities in an effort to make the Malaysian capital market the preferred fund-raising venue for Malaysian companies.
Other measures included steps to enhance investor protection, especially minority shareholders.
The details of the measures introduced during the year are contained in the box "Key Capital Market Measures in 2001."

The ringgit bond market expanded further in 2001 and has increased in importance as a source of financing. A larger number of companies issued PDS in order to "lock-in" financing at low interest rates.

Bond Market

The ringgit bond market expanded further in 2001 and has increased in importance as a source of financing. The growth of the bond market was due to the low interest rate environment and ample liquidity situation, increased recourse to the bond market for longer-term financing and intensified debt restructuring exercise. In addition, the expansionary fiscal stance of the Federal Government resulted in significantly higher issuance of Malaysian Government Securities (MGS) to finance the fiscal deficit. Such a development continued to provide a benchmark yield curve for the ringgit bond market.

Total net funds raised in the bond market remained high at RM31.5 billion, accounting for 83.7% of the total funds raised in the capital market. As at end-2001, outstanding ringgit bonds rose by 13.3% to RM275.8 billion from RM243.6 billion as at end-2000.

In the primary market, the public sector raised net funds of RM15.2 billion. During the year, the Government issued and reopened a total of four MGS issues. New issues were raised to finance the Government's fiscal stimulus programmes. These new issues were also the rollover of maturing issues and as a means to enhance secondary

Table 4.33
Funds Raised in the Bond Market

	2000	2001*p*
	RM million	
By Public Sector		
Government Securities, gross	16,413	23,087
Less Redemptions	5,286	7,100
Equals Net Federal Receipts	11,128	15,987
Khazanah Bonds (net)	551	-220
Govt. Investment Issues (net)	2,000	-195
Malaysia Savings Bond (net)	-19	-359
Net Funds Raised by the Public Sector	**13,659**	**15,213**
By Private Sector		
Private Debt Securities, gross	**30,953**	**37,220**
Straight bonds	12,940	13,813
Bonds with Warrants	0	913
Convertible Bonds	1,944	1,328
Islamic Bonds	7,666	13,501
Asset Backed Securities	0	1,235
Cagamas Bonds	8,403	6,430
Less Redemptions	**10,459**	**20,890**
Private Debt Securities	6,205	15,575
Cagamas Bonds	4,254	5,315
Net Funds Raised by the Private Sector	**20,494**	**16,330**
Net Funds Raised in the Bond Market	**34,153**	**31,544**
Net Issues of Short-term Securities [1]	–1,482	–2,093
Total	**32,671**	**29,451**

[p] Preliminary.
[1] Refers to Cagamas Notes and Commercial Papers only.

market liquidity. As announced in the MGS auction calendar, the MGS were issued regularly on a quarterly basis, with a relatively large size of RM5 billion each in the first three quarters and RM6.5 billion in the fourth quarter of the year. Of the four MGS issues, three were reopening of existing MGS.

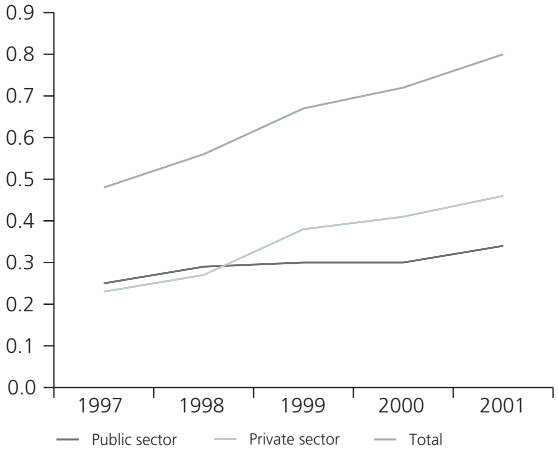
During the year, Government Investment Issues (GII) and Khazanah bonds were issued in order to rollover existing issues. In November, the Malaysia Savings Bonds Series 02 (BSM02) issued in November 1999 matured. The Government announced in the 2002 Budget that BNM would issue the third series of the savings bond, BSM03, for subscription by senior citizens and charitable organizations. The purpose was to mitigate the impact of the low interest rate environment on incomes of senior citizens and charitable organizations that were primarily dependent on income from deposits placed with banking institutions. BSM03 was offered for sale in January 2002.

The private sector also turned to the bond market to raise funds for its medium and long-term financing needs. A larger number of companies issued PDS in order to "lock-in" financing at low interest rates. In an environment of ample liquidity and uncertainties in the equity markets, there was also investor preference for more stable investment options. In 2001, the value of new PDS issues increased to RM37.2 billion. After netting off redemptions of RM20.9 billion, however, total net funds raised were lower at RM16.3 billion (2000: RM20.5 billion). The high redemptions were due partly to the early redemptions by a major corporation under a debt-restructuring scheme. In aggregate, total PDS outstanding increased by 13.1% to RM158.4 billion, or equivalent to 47.6% of GDP (41.1% at end-2000). Compared to the equity market which raised RM6.1 billion, the PDS market remained the main source of financing in the capital market for the private sector.

In terms of types of instruments, straight bonds and Islamic PDS were the most popular forms of funding during the year. Of the total proposed PDS issues rated by Rating Agency Malaysia (RAM), 35% were medium-term (5-7 years) while 60% were long-term (more than 7 years) bonds. Meanwhile, the higher issuance of Islamic PDS was due to the higher demand for Islamic instruments, partly due to the increased number of Islamic unit trust funds that were launched during the year. In addition, privatised projects such as water and power projects have been successfully funded by Islamic PDS. On the other hand, the issuance of bonds with warrants and convertible bonds remained small.

A notable development in the PDS market during the year was the introduction of the Guidelines on the Issuance of Asset-backed Debt Securities (ABS) by the Securities Commission. Total issuance of ABS amounted to RM1.2 billion in 2001. The interest in issuance of ABS reflected the benefits accruing to both originators and investors. From the originators' perspective, securitisation provides a vehicle for transforming relatively illiquid financial assets into liquid assets. In addition, it enables the originator to achieve a more efficient and cheaper cost of financing as ABS generally carry a higher rating compared with the long-term credit rating of the originator. This is because payments

Graph 4.33
Ratio of Bonds Outstanding to GDP



Graph 4.34
PDS Issues in 2001 by Type of Instrument

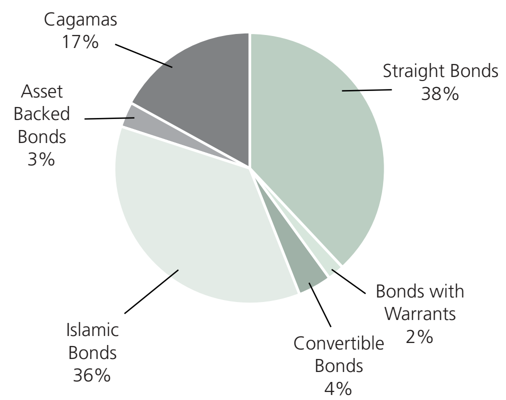


Table 4.34
New Issues of Private Debt Securities by Sector[1]

Sector	2000		2001*p*	
	RM million	% share	RM million	% share
Agriculture, hunting, forestry and fishing	42.5	0.2	26.6	0.1
Mining and quarrying	0.0	0.0	0.0	0.0
Manufacturing	1,354.6	6.0	2,512.0	7.5
Electricity, gas & water supply	4,564.1	20.2	10,006.9	30.0
Wholesale & retail trade, restaurants and hotels	1,853.9	8.2	420.0	1.3
Construction	2,006.3	8.9	3,299.9	9.9
Transport, storage and communication	7,320.3	32.5	5,374.5	16.1
Financing, insurance, real estate and business services	5,108.3	22.7	5,103.2	15.3
Government and others	300.0	1.3	6,598.2	19.8
Total	**22,550.0**	**100.0**	**33,341.3**	**100.0**

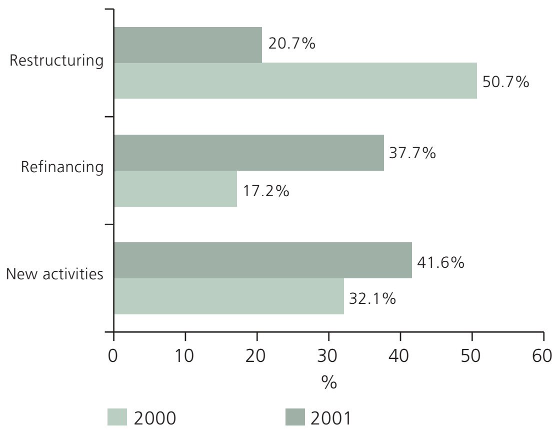
[1/] Excluding Cagamas Bonds
p Priliminary

to investors in respect of such debt securities are principally derived, directly or indirectly, from the cash flows on these assets. Thus, the credit rating of such debt securities is derived from the quality of the underlying assets and not the credit standing of the originator of the assets, as is the case in debt securities issued by the corporation itself. From the investors' perspective, ABS widens the selection of fixed income products in the Malaysian bond market.

During the year, Cagamas has maintained its position as an active issuer in the PDS market, accounting for 17.3% of total issues. Cagamas re-opened seven of its existing fixed rate bonds in order to enlarge the size of existing issues, thereby enhancing the liquidity of Cagamas bonds in the secondary market. For the first time, Cagamas issued 10-year fixed rate bonds in December 2001 to fund its purchases of housing loans for a 10-year tenure. The issuance of these bonds enabled Cagamas to develop a longer-term yield curve for its debt securities. This, in turn, would enable Cagamas to price its purchases of loans, particularly for the longer tenures, at market rates.

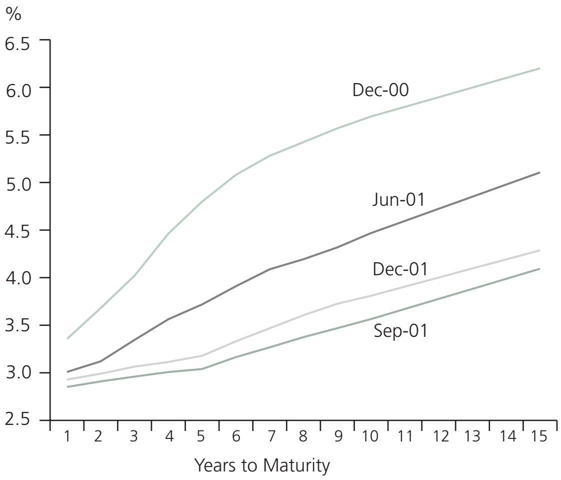
Companies from the utilities and infrastructure sectors were among the largest issuers of PDS, accounting for 30% and 16.1% of the total new issues respectively. Major issuers within this sector were independent power producers and toll road concessionaires which required long-term financing of more than 10 years for their projects. There was also increased recourse to the PDS market by companies in the manufacturing sector which accounted for about 7.5% of the total PDS issues in 2001. The debt restructuring of a few large and strategic corporations was reflected in higher new issues of PDS in the Government and other services sector. Issues were made by the special purpose vehicles, which were set up during the year, as part of the Government's commitment to accelerate the corporate restructuring process to strengthen investor confidence. The maturity of bonds issued by these special purpose vehicles have been appropriately sequenced. The issuance of bonds was accompanied by other debt and operational restructuring in order to improve the financial and operational capacities of the corporation to generate the cash flows to redeem the bonds.

Graph 4.35
Utilisation of Proceeds

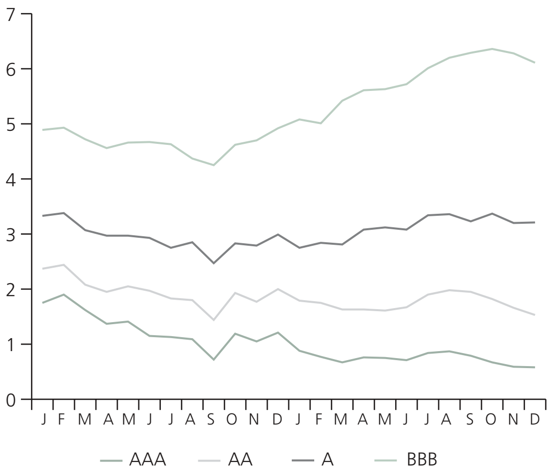


Graph 4.36
Indicative Yields of Selected Three-Year Bonds

Graph 4.37
MGS Yield Curves



Graph 4.38
Yield Differentials for 3-Year Bonds vis-a-vis the 3-Year MGS



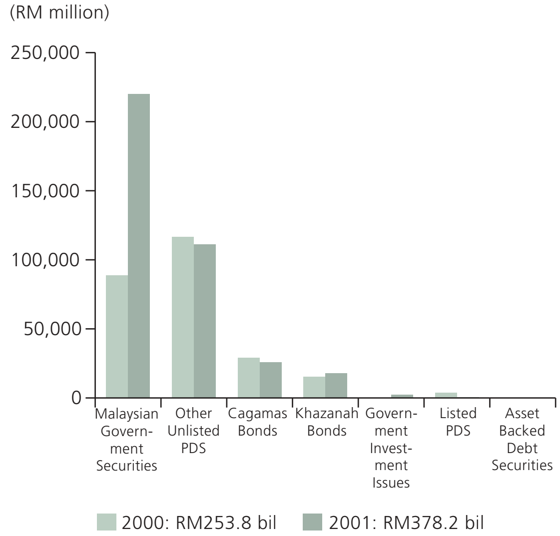
Of the total PDS issued, 41.6% were for new activities, 37.7% for refinancing and 20.7% were for restructuring purposes. This marked a positive development in the economy as a significant share of the funds would be used to generate new economic activities. In 2000, the bulk of the PDS issued had been for restructuring purposes.

There was a steady decline in the yields of bonds in all tenures, with the yield curves continuing to shift downwards throughout the year. The three-year MGS fell from 4.02% at end-1999 to 3.07% at end-2000. The same trend was observed for the 10-year MGS which had fallen by 188 basis points during the same period. Yields for other papers such as three-year Khazanah and Cagamas bonds also trended lower with narrowing yields differentials vis-à-vis the MGS papers. The yield differentials between three-year Cagamas bonds and three-year MGS in the secondary market were about six to 18 basis points. The narrow spreads enabled Cagamas to continue to play its role in providing low cost funds to financial institutions. The declining yield trend was due to market expectations of further reduction in interest rates, continued ample liquidity in the market and the shift of investments from equities to bonds in an environment of greater volatility in the global stock markets. The yields fell further in September following further interest rates cut in the United States and the reduction in the 3-month BNM Intervention Rate. In December, however, some upward shifting of yields occurred due to the expectations of interest rates bottoming out, in line with the shifting of yield curves in the regional markets, following indications of US economic recovery.

The MGS yields curves flattened throughout the year as the spread between the 10-year and the three-year papers narrowed from 167 basis points to 75 basis points, reflecting market expectations that interest rates would remain low for the medium term. The yields of PDS trended lower since early 1999 and the spreads against MGS narrowed notably. The narrowing of spreads of the AAA-rated PDS against the MGS was significant, indicating a trend towards lower risk premiums required by investors. In 2001, the spreads for A- and BBB-rated bonds, however, widened from 275 - 508 basis points in January to 321 - 611 basis points in December due to concerns over deteriorating global and local economic performance. This resulted in investors shifting their investments to the more secured Government and quasi-Government papers as well as highly rated and good quality corporate bonds.

Trading activities in the secondary market for ringgit bonds was sharply higher in 2001, which augured well for the deepening of the bond market. Trading volume increased by 49% and was valued at RM378.2 billion in 2001 (2000: RM253.8 billion). Similarly, liquidity in the bond market, as measured by the ratio of trading volume to total outstanding, also rose to 137.1% (2000: 104.2%). The higher trading activity was mainly due to the higher supply of MGS during the year. MGS were the most actively traded papers, rising by 148.2% and accounting for 58.2% of total trading activities (2000: 34.9%). The volume traded was highest in the third quarter. Expectations of a possible

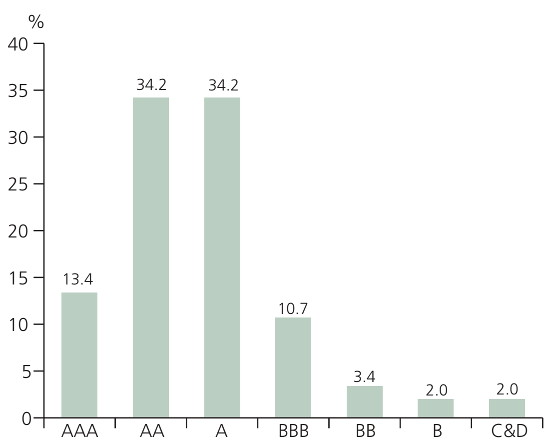
Graph 4.39
Trading of Ringgit Bonds



reduction in interest rates prompted investors to take longer positions in the bond market, especially in risk-free papers. During this period, bond investors were also switching to Government and quasi-Government papers due to the more stable returns from Government issues.

In contrast, secondary trading for Cagamas bonds declined sharply by 11.4% during the year, accounting for 6.9% of total trading activities (2000: 11.5%). In the low interest rate environment, trading interest was skewed towards longer-maturity papers such as MGS. Most Cagamas bonds were issued for tenures of two to three years. In addition, the size of Cagamas bonds was relatively small (RM200 million

Graph 4.40
Rating Distributions of Outstanding PDS*
(As at end December 2001)



* In terms of number of issues
Source: RAM and MARC

to RM400 million per issue), hence affecting liquidity for Cagamas papers. Despite investor interest being centered on MGS, demand for PDS with high ratings and good quality remained high. Nevertheless, the share of PDS turnover moderated to 29.4% of total trades compared with 45.9% in the previous year.

During the year, requests for ratings remained high as corporations, especially those with strong credit ratings, shifted to bonds as a cheaper funding option. In 2001, RAM completed 88 new ratings with the proposed gross issue valued at RM27.1 billion. Long-term issues represented 76% and 87% of the total number and gross issue value respectively. Meanwhile, the Malaysian Rating Corporation Berhad (MARC) completed 29 new corporate debt ratings with a total rated value of RM9.5 billion. The rated issues generally concentrated on the AA and A categories, as companies with good credit quality took advantage of their relatively easy access to the bond market.

During the year, of the total 192 rating reviews of the existing long-term debt securities conducted by RAM and MARC, 153 were affirmations/reaffirmations, 14 issues were upgrades while 25 issues were downgrades. As at the end of 2001, the bulk of the long-term bonds was in the AA and A categories.

During the year, several measures were introduced to further develop the bond market. The key measures are contained in the box "Key Capital Market Measures in 2001". These measures included the introduction of guidelines on offering of asset-backed securities, relaxation of the restrictions on the use of proceeds from the issuance of PDS and guidelines on the securities borrowing and lending programme under the Real Time Electronic Transfer of Funds and Securities System.

Unit Trust Industry

The unit trust industry expanded further in 2001, as evidenced by the growth in the number of unit trust management companies and unit trust funds as well as the increased units in circulation and number of accounts. Gross sales of the unit trust funds also exceeded repurchases during the year, resulting in net sales of RM6.1 billion. While net sales in 2001 were marginally lower than in 2000, it nevertheless remained high, relative to the average net sales of RM0.5 billion during the period 1995-99.

Growth of the industry was stimulated by increased investor demand for unit trust funds to suit their risk-return profiles and the continued availability of the EPF Member's Investment Scheme. Following

Key Capital Market Measures in 2001

Capital market measures introduced in 2001 were aimed at promoting a more efficient, transparent, innovative and competitive capital market which would attract increased participation among market players. Overall, the measures were aimed at enhancing investor confidence by addressing areas of concern, including issues of corporate governance. The key capital market measures introduced in 2001 were as follows:

Setting A Clear Direction for Capital Market Development

- A notable development in the year 2001 was the launching of the Capital Market Masterplan (CMP) in February with the objectives of setting the strategic position and future direction for the Malaysian capital market. There were six key objectives:
  i) To be the preferred fund-raising centre for Malaysian companies;
  ii) To promote an effective investment management industry and a more conducive environment for investors;
  iii) To enhance the competitive position and efficiency of market institutions;
  iv) To develop a strong and competitive environment for intermediation services;
  v) To ensure a stronger and more facilitative regulatory regime; and
  vi) To establish Malaysia as an international Islamic capital market centre.
  Of the 152 recommendations, 14 recommendations have been fully implemented, 24 partially completed while another 48 were ongoing. Progress has been made in the areas of exchange consolidation, stockbroking consolidation, disclosure-based regulation and the corporate bond market.

Strengthening the Stockbroking Industry by Enhancing Transparency and Governance

- On 22 January, the Kuala Lumpur Stock Exchange (KLSE) issued its **New Listing Requirements** to further strengthen the capital market and securities industry. The New Listing Requirements strengthened provisions in areas relating to disclosure, corporate governance, continuing listing obligations, financial reporting and enforcement. It codified unwritten rules and procedures relating to listed companies, simplified procedural requirements and processes, clarified requirements by removing ambiguities, and adopted international best practices and standards in listing rules.

- On 10 May, the Securities Commission (SC) **introduced several flexibilities to facilitate the issue, offer and listing of securities** by Malaysian companies. These flexibilities were in line with the CMP objective of making the Malaysian capital market the preferred fund-raising centre for Malaysian companies by enhancing the efficiency of the overall fund-raising process. The flexibilities introduced were:
  i) Revision of the historical profit-performance requirement for initial public offerings and reverse take-overs/backdoor listing on the KLSE;
  ii) Allowing the issuance and listing of irredeemable convertible unsecured loan stock (ICULS) as part of the floatation scheme on the KLSE;
  iii) Abolishing the preferential allocation limit of 10 lots per person for directors, employees and other persons in relation to a floatation scheme on the KLSE. However, the 5% overall limit of the preferential allocation scheme was retained;
  iv) Removal of the merit-based criteria for bonus issues arising from capitalisation of share premium and other reserves. Listed companies are now allowed to undertake bonus issues of securities through the capitalisation of share premium as long as the availability of the share premium is verified by the external auditors to the company; and
  v) Revision of the guidelines on employee share option schemes.

- On 3 September, further flexibilities were introduced by the SC to complement the previous flexibilities given on **Initial Public Offering** (IPOs) issuance and **fund-raising and restructuring.** For the issuance of IPOs, the SC amended the requirements for public offers, placements, underwriting, shareholding spread, retention of reserves and limitations on capital structure. Amendments to the Issues Guidelines relating to the use of proforma accounts were also introduced. With respect to flexibilities for fund-raising and restructuring exercise, flexibilities previously granted to rescue cases were extended. The post-restructuring net-tangibleasset position requirement for distressed listed companies, on the other hand, was reduced to 35% from 50% of the par value of their ordinary shares. In addition, all distressed listed companies were allowed to issue convertible securities with nominal values below RM1.00.

- On 25 April, the SC issued the **Guidelines on Offer Documents** for take-overs with the objective of enhancing disclosure in offer documentation, in line with the move towards a full disclosure-based regulation. The Guidelines would facilitate a take-over exercise by ensuring the clarity of the process, protecting the interests of minority shareholders of companies and providing timely and adequate information to shareholders.

Promotion of the Bond Market

- The SC released the **Guidelines on the Offering of Asset-Backed Securities** (ABS) on 10 April, marking an important milestone in the development of the corporate bond market. The Guidelines served to set out clear and transparent criteria to facilitate market participants in the offering of asset-backed debt securities. In accordance with the 2001 Budget announcement, asset securitisation transactions that are in full compliance with the SC's ABS Guidelines would be eligible for real property gains tax and stamp duty exemption, where applicable.

- On 3 December, **the restrictions on the use of proceeds from the issuance of PDS were further relaxed**. Proceeds from PDS issues can now be used to finance the development of residential properties and shop houses priced above RM250,000 per unit on condition that the proceeds of the bond issues should only be drawn upon achieving break-even sales (in value terms). In addition, such development of shop houses should be located within residential areas. This relaxation was in line with the relaxation of lending restrictions by BNM.

- BNM issued the Guidelines on Securities Borrowing and Lending (SBL) Programme under the Real Time Electronic Transfer of Funds and Securities System. The Guidelines, which took effect on 10 December, were part of the measures implemented during the year to promote the development of the bond market. A SBL transaction involves an exchange of securities between two parties for a period of time to meet the temporary needs of either or both parties. The objective of implementing of the SBL programme was to enhance the liquidity in the secondary bond market by providing a new mechanism to support trading strategies for dealers as well as to enhance the returns on bond portfolio investment for investors.

Enhancing Market Mechanism and Competitiveness

- On 1 July, the SC reduced the SCANS clearing fee, the SCORE fee, and SC levy as part of continuous efforts to enhance industry competitiveness. The SCANS clearing fee was reduced to 0.04% from 0.05%, subject to a maximum of RM200 per contract. The SCORE fee was reduced to 0.0025% from 0.005%. The SC levy, which was derived from the brokerage commission and the SCANS clearing fee, was reduced to 0.015% from 0.02%.

- Effective 18 July, the KLSE through its clearing house, SCANS, commenced the **Institutional Settlement Service (ISS) for direct business transaction**. The implementation of the ISS for direct business transaction would reduce the settlement risk exposure of international investors and enhance the delivery versus payment environment in line with international settlement best practices and requirements.

- On 29 August, the SC released the **Guidelines on the Establishment of Electronic Access Facilities by Universal Brokers** in line with the effort to create a framework for the orderly and effective implementation of electronic commerce in the capital market. "Electronic access facility" refers to a range of physical sites, locations or premises which contain facilities that enable clients to initiate orders or obtain investment advisory information electronically. Universal Brokers are free to determine the type, size, number and location of these facilities. However, they must ensure that the facility is reasonably secure against unauthorised tampering and intrusion. In addition, as a further step towards developing a more facilitative electronic commerce framework, particularly with regard to online trading, Universal Brokers were given the flexibility to provide discounts of up to 25% of the current commission rates applicable to trades with contract values of RM100,000 and below, for all electronically-routed trades executed by them.

- In the Budget 2002 presentation in October 2001, the Government announced the implementation of the **circuit breaker** mechanism in the stock market exchange. The mechanism has the capacity to halt trading activities temporarily when large declines are experienced during a trading day. The mechanism is expected to be in operation in the first quarter of 2002. It aims to provide investors some "breathing space" and opportunity for greater information dissemination during excessive market volatility by allowing closure or cessation of trading for a specific period, before resuming stock market trading activities. In this event, maintaining investor and market confidence can be ensured, especially when the trading environment becomes extremely uncertain.

Enhancing Investor Protection

- On 17 September, the SC released the **Guidelines on Trustees for Debenture Holders**, which would provide the check and balance to ensure that the interest of debenture holders are protected. Under these guidelines, the SC would grant a blanket approval to any trustee seeking to be appointed or to act as trustee under subsection 69(2) of the Securities Commission Act, provided that the requirements of these guidelines were met. A condition of approval by the SC was that the trustee must continue to meet these requirements while acting as a trustee in respect of a particular debenture issue.

- On 26 November, the **SC announced that companies listed on both the main and second boards of the KLSE which have yet to increase their paid-up capital to at least RM60 million and RM40 million respectively, were required to inform investors of their non-compliance and their plans to achieve compliance through updates in their quarterly financial reports**. The deadline for compliance with the requirement was extended from 30 April 2002 to 31 December 2002. Companies that failed to meet the minimum paid-up capital requirement by the extended deadline would be subjected to trading restrictions.

Improving Corporate Governance and Minority Shareholder Protection

- Effective 15 February, directors of public listed companies were required to attend **Mandatory Accreditation Programme (MAP) and Continuing Education Programme (CEP)** pursuant to the revamped Listing Requirement, which was issued on 22 January. The objectives of these training programmes were to better equip directors to discharge their duties and to enhance the overall calibre of directors of listed companies.

- Effective 1 June, public listed companies were required to comply with the **revamped Listing Requirements** (except for a few provisions), which came into effect on 15 February. Among others, the revamped Listing Requirements has brought into effect recommendations of the Finance Committee, in relation to the Malaysian Code on Corporate Governance. These recommendations were to create an environment that demands higher standards of conduct and higher quality disclosures from companies, board of directors and management. The new Listing Requirements has encouraged compliance with the Malaysian Code on Corporate Governance. The amendments made to the previous Listing Requirements include:
  i) Requirements on reporting the extent of compliance with the Malaysian Code of Corporate Governance by public listed companies;
  ii) Rules on disclosure requirements by directors when reporting on the state of internal controls;
  iii) Rules on non-executive directors and the requirement for one third of the board to be independent; and
  iv) Rules requiring the mandatory accreditation of directors of public listed companies.

- Effective 1 June, public listed companies were required to comply with the **'Statement on Internal Control: Guidance for Directors of Public Listed Companies'** issued by the Taskforce on Internal Control of the KLSE. The objective is to provide guidance to directors of listed companies in making disclosures on the state of internal control of their companies in their annual reports. In particular, explanation was provided on the key areas that directors must focus on before making any statements about the state of the company's internal control. These key areas were the system of internal control, responsibilities of various parties in the maintenance of the system of internal control, the process of review of the adequacy and integrity of the system of internal control and the minimum disclosures on the state of internal control to be made by the Board of Directors.

- The **Minority Shareholder Watchdog Group (MSWG)**, which was established in August 2000, commenced operations in July 2001. Its founding members are the Employees Provident Fund, Permodalan Nasional Berhad, Armed Forces Fund, Pilgrims Fund Board and Social Security Organisation (SOCSO). The role of the MSWG is to promote awareness among minority shareholders, particularly institutional investors, of their rights and responsibilities, to protect minority shareholders from exploitation by public listed companies and to deter and if necessary, to combat abuses by public listed companies on minority shareholders.

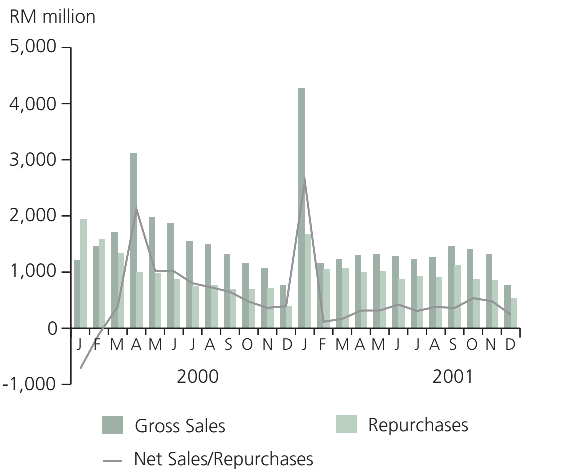
Table 4.35
Unit Trust Industry (Includes Islamic Unit Trust Funds) - Selected Indicators

	2000	2001	2000	2001
			Growth (%)	
Number of Unit Trust Management Companies	34	37	3.0	8.8
Number of Unit Trust Funds*	119	149	17.8	25.2
Units in Circulation (billion)	63.8	71.4	21.3	11.9
Number of accounts (million)	9.6	10	7.9	4.2
Net Asset Value (RM billion)	43.3	47.3	0.5	9.2
Net Sales (RM billion)	7.0	6.1		
Ratio of NAV to KLSE market capitalisation (%)	9.8	10.2		

* Refers to funds already launched

Source: Securities Commission

Graph 4.41
Unit Trust Industry - Gross Sales, Repurchases and Net Sales



marketing efforts by the industry, there was also greater awareness of the benefits of unit trust schemes for the smaller retail investors. The number of institutional unit trust agents also increased to 27 from 17 in the previous year. Together, these factors contributed to the 9.2% growth (2000: +0.5%) in the net asset value (NAV) of the unit trust industry. Consequently, the ratio of the industry's NAV to KLSE market capitalisation increased to 10.2% as at end-2001, from 9.8% at the end of the previous year.

Exchange Traded Derivatives Market

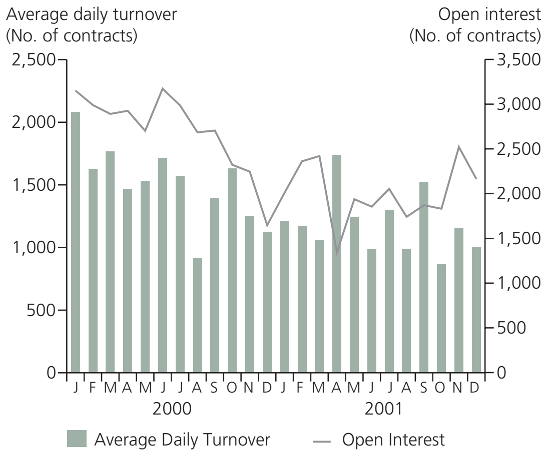
In line with the recommendation of the Capital Market Masterplan, the Malaysia Derivatives Exchange (MDEX) was established on 11 June 2001 as an integrated derivatives exchange, following the merger of two exchanges, the Kuala Lumpur Options and Financial Futures Exchange and the Commodity and Monetary Exchange of Malaysia. The establishment of the MDEX was aimed at facilitating economies of scale and depth of market through improved operating efficiencies and the trading of more derivative products. In 2001, the MDEX offered four products, namely the KLSE CI Futures, KLSE CI Options, 3-Month KLIBOR Futures and Crude Palm Oil (CPO) Futures Contracts.

Table 4.36
MDEX
Turnover: Number of Contracts

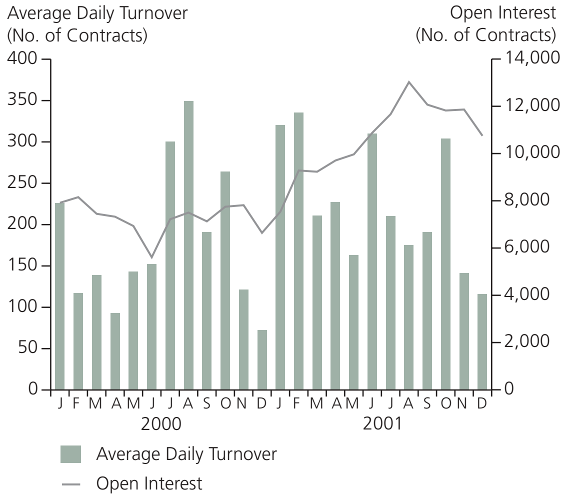
	2000	2001	% change
KLSE CI Futures	366,942	287,528	-21.6
KLSE CI Options	349	565	61.9
KLIBOR Futures	44,812	54,914	22.5
CPO Futures	308,622	479,799	55.5

Source: Malaysia Derivatives Exchange

Graph 4.42
KLSE Composite Index Futures and Option

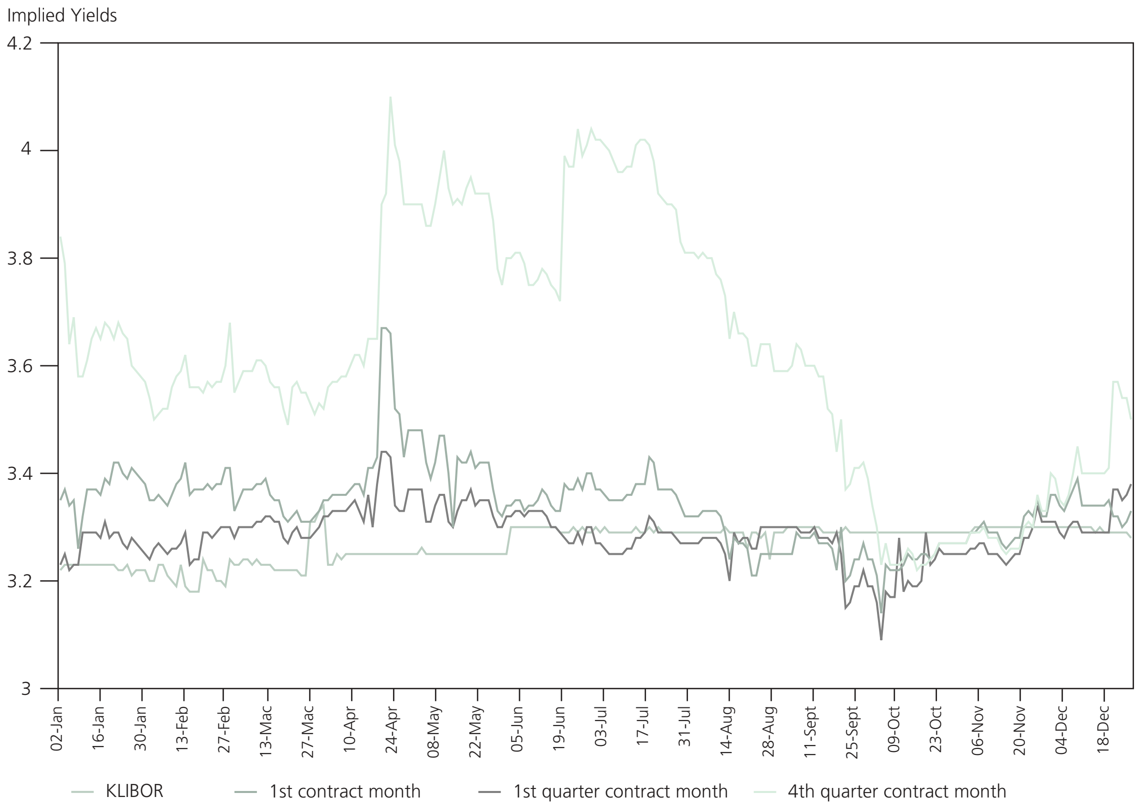


Graph 4.43
KLIBOR Futures

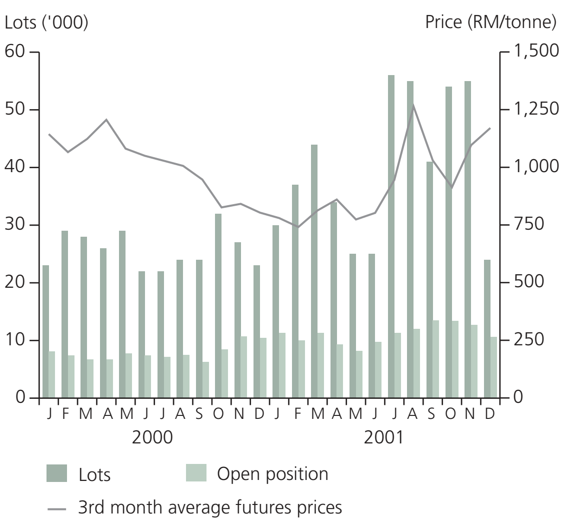


The performance of products traded over the MDEX was mixed in 2001. Trading activities in the **KLSE CI Futures** were weak with trading volume declining by 21.6%. The month-end open position, which is the number of unsettled positions was also low. The lower trading volume was due mainly to the lack of volatility of the KLSE CI that resulted in less participation by local and foreign investors. This was reflected in the low Derivatives Liquidity Ratio (DLR), which represented the ratio between the turnover value of futures against the turnover value of the component stocks. The DLR remained below the 100 mark throughout the year, implying that investors' exposure in the underlying market was not fully covered by their futures contracts. On the

Graph 4.44
KLIBOR Futures Implied Yields and Spot Yields



Graph 4.45
Crude Palm Oil Futures



price front, the KLSE CI Futures prices, which tracked the movement of the underlying KLSE CI closely, increased marginally by 1.4% in 2001. Similarly, total trading volume of the **KLSE CI Option**, which was introduced in 2000, remained low at 565 contracts and there was no open position. The weak trading activities were due to the lack of understanding of the product and high margin requirements.

Meanwhile, the annual turnover for **3-Month KLIBOR** Futures increased by 22.5%. In addition, the month-end open position was generally on a rising trend during the year, with the highest level recorded in August at 13,023 contracts, before closing at 10,751 contracts at year-end (end-2000: 6,642 contracts). The higher turnover was due to the ample liquidity situation in the interbank cash market and improved interest in the local bond and interest rate swap (IRS) markets. Banking institutions were the major players and accounted for the bulk of the trading activities. KLIBOR Futures prices were mixed during the year. The implied yields (4th quarter month contracts) increased from 3.84% in January to a peak of 4.10% in April before declining to the lowest level at 3.22% in October. The implied yields rose subsequently to close at 3.50% at the end of the year.

In 2001, the total trading volume for **CPO Futures Contracts** on the MDEX was higher, reflecting mainly higher crude palm oil production, which grew by 8.9% as well as developments on the physical palm oil markets, which began to show stronger prices since July. Reflective of the favourable development on the price front, total lots traded on the MDEX were significantly higher in the second half year, compared to the first half-year. During the year, the price range for the benchmark 3rd month futures contract widened to RM622 (2000: RM492), with the highest daily price trading at RM1,315 per tonne on 8 August 2001. Analysis on a bi-annual basis showed that average monthly CPO futures prices were lower in the first half-year, ranging between RM741-RM860 per tonne before surging to a higher price range of RM913-RM1,264 per tonne in the second half-year. The price rally during the second half of 2001 was mainly on account of increasingly tight global supplies of vegetable oils, as production of several major vegetable oils, including palm oil, rapeseed and sunflower oils declined, while demand continued to increase.

DEVELOPMENTS IN PAYMENT AND SETTLEMENT SYSTEMS

In 2001, BNM undertook several measures and enhancements to improve the efficiency of the payment systems operated by BNM as well as other domestic payment systems in co-operation with participating banks and the payment consortium. These efforts were important to ensure that the country's payment systems remain efficient, stable and reliable, while keeping abreast with technological developments.

RENTAS

During the year, several measures were introduced to further enhance the efficiency and flexibility of RENTAS. This included the introduction of a real time surveillance system to enhance transaction monitoring and liquidity management, as well as a Repurchase Agreement (REPO) Enhancement

Table 4.37
Payment and Settlement Systems

	2001			
	Value		Volume	
	(RM billion)	Annual change (%)	('000)	Annual change (%)
RENTAS				
IFTS transactions	10,436	-4.8	1,511	4.9
SSTS transactions	559.8	33	68	30.8
SPICK				
Cheques cleared	996	7.4	165,473	0.4
GIRO (IBG)				
IBG instructions	1.08	1,250[1]	125	1,150[1]

[1] The Interbank Giro system was introduced in October 2000

Malaysian Payment Systems

RENTAS

- RENTAS is the Real Time Gross Settlement System (RTGS) that was developed to reduce the financial risks associated with high value payments. The RENTAS system was launched in July 1999 and consisted of an inter-bank funds transfer system (IFTS) and a scripless securities trading, processing and settlement system (SSTS). The introduction of RENTAS has facilitated the attainment of the real time Delivery versus Payment (DVP) Model 1 for the sale and purchase of designated scripless securities.

SPICK

- SPICK (or Sistem Penjelasan Imej Cek Kebangsaan) is an image-based cheque clearing system, which provides for imaging of inward cheques for the purpose of examination and verification of signatures by the paying banks. With SPICK, banks are able to process and verify the cheques based on the data and compact disc received from the SPICK centres without having to sight the physical cheques. This enables a larger area of the country to enjoy same day clearing facilities and reduces the day-hold of outstation cheques as well as minimises the handling and movement of physical cheques. The system, which has centres located in Pulau Pinang, Kuala Lumpur and Johor Bahru, processes about 90 percent of the nation's cheques. SPICK retained its ISO 9002 certification in November 2001.

Automated Teller Machines (ATMs)

- Following the integration of the three ATM networks in 1996, the domestic banks now have a fully integrated ATM network of more than 3,800 ATMs. The payment consortium, Malaysian Electronic Payment System (1997) Sdn. Bhd. (MEPS) provides the switching, clearing and settlement services for the shared ATM network. This collaboration amongst the domestic banks has enabled customers to use all ATMs within the MEPS network and reduced the need for further expansion of each individual bank's ATM network.

Interbank GIRO

- The Interbank GIRO (IBG) service operated by MEPS since October 2000 involves an exchange of digitised transactions to transmit payment orders. The IBG system, which is capable of processing large volumes of individual payments electronically, has shortened the clearing cycle for payment transfers, especially for outstation payment transactions. The IBG payments include standing instructions for loan repayment, as well as payments of insurance premiums, salaries, income tax and contributions to the Employees Provident Fund. The IBG facility is currently provided by 11 banking institutions (including an Islamic bank). Plans are underway to enhance the IBG system to a browser-based system to facilitate e-commerce payment transactions. Graph 4.49 shows the performance of IBG system.

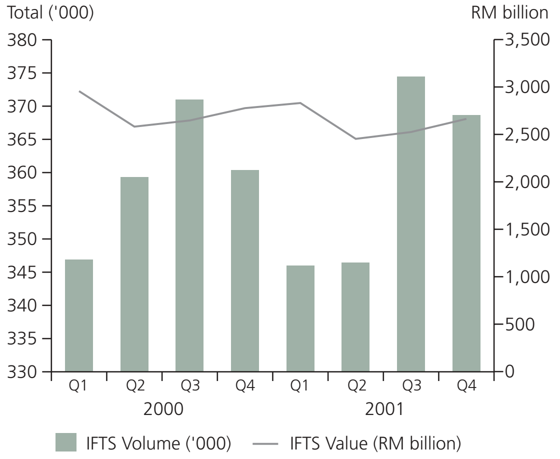
SET Payment Gateway

- In supporting the development of e-commerce, MEPS launched an internet payment gateway in March 1999 to process card-based payments for its member banks. The payment gateway accepts both Secure Sockets Layer (SSL) and Secured Electronic Transaction (SET) transactions. Currently, a total of eight banking institutions are participating in this system. Graph 4.50 shows the performance of the SET Payment Gateway.

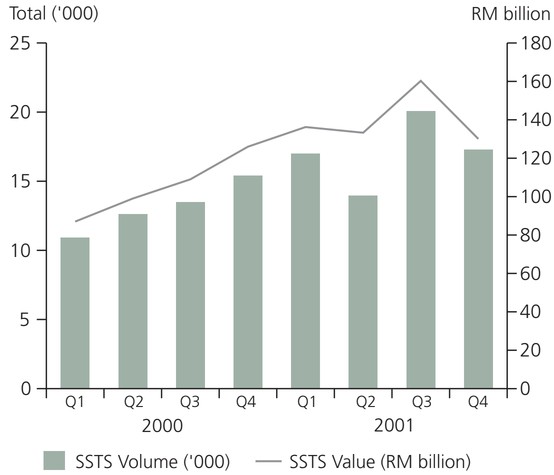
Debit Card System

- MEPS launched an interbank debit ePOS (electronic point of sale) service with three domestic banks in early February 2002. In this system, MEPS would operate the switching network for domestic debit cards, such that ATM cardholders of participating banks would be able to pay for purchases using their ATM cards at participating merchants, regardless of the acquiring bank. A debit card system allows cardholders to have their purchase transactions charged directly to funds in accounts with the issuing banks.

Graph 4.46
RENTAS IFTS Turnover



Graph 4.47
RENTAS SSTS Turnover



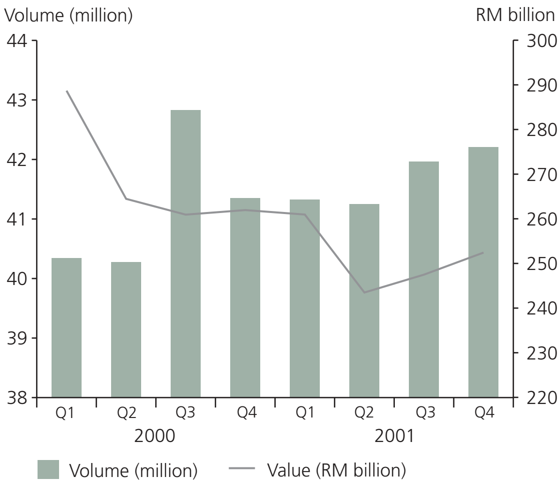
Module (REM) and securities borrowing and lending (SBL). The objectives of REM and SBL are to enhance the liquidity in the secondary bond market by providing a new framework or mechanism to support the trading strategy of dealers and to enhance returns on investment in bond portfolio for investors. The implementation of REM and SBL is also to facilitate greater flexibility in the settlement of REPO and SBL transactions among RENTAS members. At the same time, discussions are on-going to establish linkages with other domestic clearing systems such as the equities clearing and settlement system to enhance the current equities Delivery versus Payment model.

SPICK

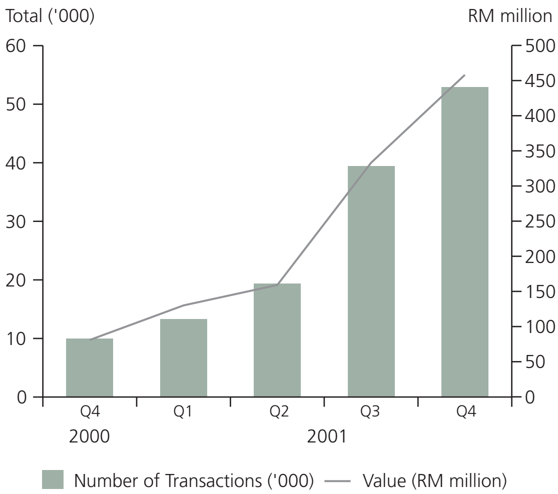
BNM introduced new day-hold periods for the clearing of outstation cheques deposited at and drawn on the respective SPICK and non-SPICK areas, which are cleared at SPICK-KL. With effect from 1 December 2001, the day-hold for cheques deposited at SPICK-KL, which are drawn on all towns, would be three days, whilst cheques deposited at Pulau Pinang, Johor Bahru, Kelantan, Terengganu, Sabah and Sarawak would be between three to eight days. The cut-off time of 2.00 p.m. for same day clearing, which was introduced as a temporary measure by BNM, was also removed. Hence, all local cheques deposited during the day would be cleared on the same day.

Cheque clearing for the non-SPICK areas in the states of Kelantan and Terengganu in the East Coast of Peninsular Malaysia and in Sabah and Sarawak in East Malaysia is currently done manually.

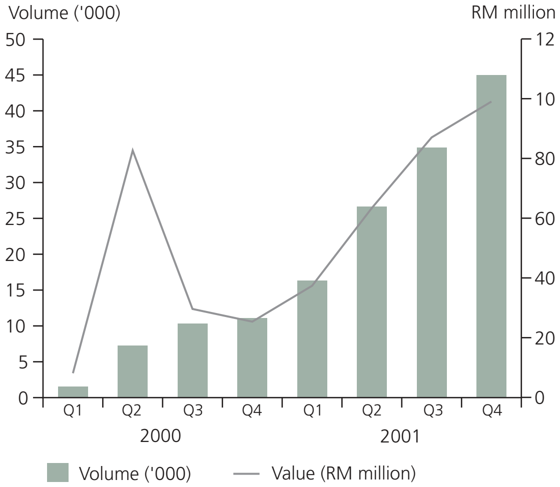
Graph 4.48
Value and Volume of Cheques Cleared by SPICK Centres



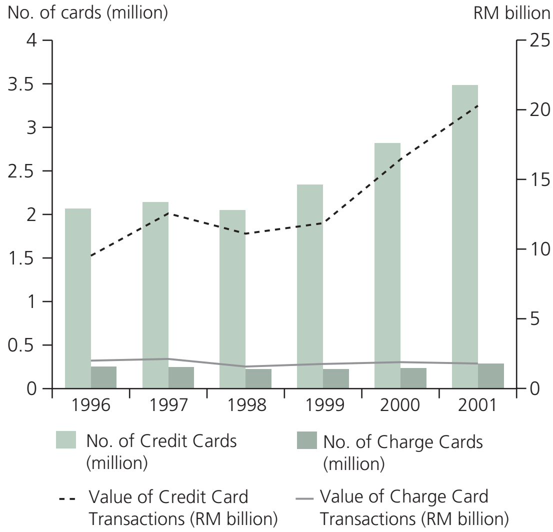
Graph 4.49
Inter-Bank GIRO Transactions



Graph 4.50
SET Payment Gateway Transactions



Graph 4.51
Credit and Charge Card Operations in Malaysia



BNM is exploring ways to improve the cheque clearing services in these areas, particularly in reducing further the number of day-holds.

Automated Teller Machines (ATMs)
During the year, the banking institutions continued to enhance their ATM services to provide additional facilities for customers to perform various banking transactions, including requests for new cheque books, fixed deposit placements, unit trust purchases, bill payments, electronic ticketing, share issue applications, loan repayments and the reloading of prepaid cards. Plans are also underway to migrate the current set of magnetic stripe ATM cards to chip-based ATM cards by January 2003 as part of the nation's efforts to encourage the ulitisation of multipurpose smart cards (MPC) and the banking industry's drive to counter fraud. As such, the ATM machines would be upgraded to read chip-based cards.

The Internet and Other Payment Services
At the end of 2001, eight domestic banks have introduced transactional internet banking services. The services offered allow customers to, among others, remit payments and transfer funds between accounts and banks, conduct account balance inquiries and statement requests, request for stop cheque payments and new cheque books, and access up-to-date account information. In some cases, it is also possible to submit loan applications and perform online share trading. Several banks have also provided online bill payment services using credit cards.

Table 4.38
Payment Media : Credit and Charge Cards

	2000		2001	
	No. of cards ('000)	Value of transactions (RM billion)	No. of cards ('000)	Value of transactions (RM billion)
Credit Cards	2,818	16.4	3,485	20.3
Charge Cards	235.7	1.9	286.9	1.8
Debit Cards	n/a	0.04	n/a	0.04

In 2001, a private sector operator had also introduced an electronic bill payment service via kiosks. The services provided at these kiosks include payment of utility bills as well as prepaid uploading and payments via credit cards, MEPS Cash and ATM cards of participating banks.

Developments in Payment Media
While cash is still the most common retail payment instrument used in Malaysia, the usage of credit cards, charge cards, debit cards and electronic money has been on an increasing trend. To some extent, this reflected the growing sophistication of Malaysian consumers as well as aggressive promotions by the card issuers.

BNM together with banks and credit card associations have implemented various measures to address the problem of credit card fraud. These measures included close monitoring of credit card activities through the issuance of guidelines and supervision, formation of a Risk Management Coordination Unit by the industry to coordinate fraud data collection, increasing the awareness of credit card fraud activities among merchants and cardholders, promoting cooperation and enhancing the investigative capabilities of banks in combating credit card fraud, and upgrading the banks' card surveillance system.

Progress has also been made in the implementation of the electronic money scheme, MEPS Cash, which was first introduced in 1998 during the Commonwealth Games. To increase its usage, the MEPS Cash card was piloted in September 1999 at selected areas in Kuala Lumpur, with six banking institutions participating and a total of 187 merchants accepting the MEPS Cash card. The banking institutions are now in the final stages of implementing a nationwide roll out of the MEPS Cash application. Besides being introduced as a stand-alone card, MEPS Cash will also be issued as an application in MyKad and the Payment Multi-Purpose Card (PMPC), which will contain ATM and debit applications.

Co-operation Initiatives

In 2001, BNM had established the National Payments Advisory Council (NPAC), which was set up in 1993. The roles of the NPAC are:-

- To provide input to address the short and long-term payment systems infrastructural needs;
- To monitor and keep abreast of developments in payment systems locally and abroad;
- To help co-ordinate various initiatives on payment systems to maximise utilisation of resources and avoid duplication of efforts;
- To provide inputs on the formulation of standards where necessary, for application of new technology in payment systems; and
- To provide their respective agency perspective on payment systems matters.

Currently, members of the Council include representatives from the Bank of Japan and the Hong Kong Monetary Authority, as well as the Ministry of Energy, Communications and Multimedia, the Malaysian Administrative Modernisation and Management Planning Unit (MAMPU) of the Prime Minister's Department, the Securities Commission, MEPS, the Association of Banks in Malaysia, the Association of Finance Companies of Malaysia, the Association of Merchant Banks in Malaysia, and the General Insurance Association of Malaysia.

External Relations

External Relations

OVERVIEW

The conduct of Bank Negara Malaysia's (BNM's) external relations in 2001 was focused on regional initiatives to further strengthen regional surveillance and support mechanisms for crisis prevention. BNM also participated in international meetings in the global efforts to reform the international financial architecture (IFA). This also included initiatives to strengthen the domestic financial systems and to enhance the voluntary adoption of appropriate standards and codes of good practices in the banking sector and in capital market regulation and supervision.

As the year unfolded, the attention of international and regional fora turned progressively to surveillance issues when the weakening of global economic conditions became increasingly pronounced. Malaysia's participation in regional and international meetings provided opportunities to benefit from the sharing of experiences and exchange of views in assessing the efficacy of alternative policy responses to manage the adverse impact of developments in the major industrial countries on the global and regional economies.

During the year, significant progress was achieved at the regional level in terms of the implementation of concrete measures to assist regional economies in crisis prevention. This included the successful implementation of the Chiang Mai Initiative (CMI), a regional financial arrangement for crisis prevention among the ASEAN+3 countries (namely, members of the Association of South-East Asian Nations, and the People's Republic of China, Japan and Korea). Malaysia concluded a bilateral swap arrangement with Japan under the CMI. The aim of the arrangements are to enhance the capacity of regional economies to respond expeditiously to avert emerging crises. Progress was also made in further strengthening the economic review process among the ASEAN+3 countries to complement the implementation of the CMI. In addition, further work was undertaken at another regional forum to enhance regional co-operation in information sharing on capital flows. The South-East Asian Central Banks (SEACEN) Expert Group on Capital Flows developed a common framework to address gaps in data on capital flows. This co-operative effort aims to facilitate an exchange of country experiences on the risk management of capital flows, an issue of high priority to Malaysia and regional economies.

At the international level, progress in terms of the IFA reforms was limited. Although some improvements were made in enhancing transparency and streamlining the operations of the International Monetary Fund (IMF), fundamental reform remained elusive, particularly in the area of reform of the IFIs and managing the risks of excessive volatility in capital flows. As part of on-going efforts on IFA reforms, BNM hosted a meeting of the Group of 15 (G-15) Expert Group on the Reform of the International Financial Architecture in Kuala Lumpur on 26 February 2002 to maintain the momentum for the reforms as well as to ensure that the views and concerns of developing countries, including the G-15 members, were addressed.

Although the issue of global co-operation to counter money laundering and terrorist financing activities became a major theme in the international and regional fora only after September 2001, Malaysia's involvement in promoting co-operation in this area had been evident since early 2001. As the co-chair of the Asia/Pacific Group on Money Laundering, BNM's involvement in the Group's work focused on promoting regional and international co-operation to counter money laundering activities. Malaysia also implemented a series of measures to prevent the abuse of the Malaysian financial system to finance any criminal or terrorist activities. A further development in Malaysia's external relations in 2001 was the enhanced participation of BNM in promoting international co-operation in the development of Islamic banking and finance.

During the year, BNM's external relations continued to accord importance to enhanced bilateral co-operation. Additional contacts were made to promote bilateral payment arrangements, in line with the Government's objective to strengthen South-South trade. This would also facilitate efforts to diversify Malaysia's export markets and reduce vulnerability to adverse developments in the traditional export markets. In 2001, BNM continued to provide technical assistance to a number of central banks, primarily in the form of attachments and training programmes.

REFORM OF THE INTERNATIONAL FINANCIAL ARCHITECTURE

In 2001, efforts toward reforming the IFA continued to emphasise crisis prevention and management. Progress had been made in the areas of transparency and standards and codes, which were considered essential for crisis prevention. Some headway was also made in the reform of the international financial institutions (IFIs). However, progress was limited in addressing the issue of the governance of the IFIs and risk management of international capital flows. In this connection, BNM participated in a number of regional and international meetings, focusing on the concern that there was an urgent need for the international community to persevere with concrete measures to reform the IFA to ensure greater efficiency in international financial markets. Malaysia supported the international community's efforts to counter money laundering and terrorist financing activities following the events on 11 September 2001. Such efforts should, however, not weaken the resolve to pursue on-going IFA reform initiatives to promote international financial stability and address the risks and challenges of globalisation.

Reforms in the international financial architecture in 2001 made further progress in the areas of transparency, and standards and codes. Progress in fundamental reforms, particularly in addressing governance issues in the international financial institutions and risk management of international capital flows, has been more limited.

Besides the continuing emphasis on transparency and standards and codes, an equally important element of IFA reforms was the **reform of the IFIs**. Progress was mixed, with some improvements in streamlining conditionality in IMF programmes while governance issues at the IMF (notably the issue of IMF quotas) remained unresolved. The IMF's Independent Evaluation Office (IEO) began operations during the year, with the appointment of the Director of the IEO in August 2001. In December, the IEO outlined its work programme, which included plans to conduct an independent assessment of various aspects of IMF operations, as mandated by the IMF Board of Governors. Among others, the work programme included a study on fiscal adjustments and structural conditionality in IMF-supported programmes, an evaluation of the IMF's role in capital account crises, the role of IMF surveillance in crisis prevention and the IMF's approach to capital account liberalisation.

The establishment of the IEO was in response to calls by the IMF membership, including Malaysia, for an independent evaluation of the IMF's role and operations and an objective assessment of issues related to the IMF. Following the Asian financial crisis, it was considered important that the IMF drew lessons from the crisis and improved its operations and capacity to respond more effectively to the changing needs of its diverse membership. In doing so, it would be essential for the IEO to operate independently of the IMF management, as stated in its terms of reference.

During the year, the IMF introduced several reforms to streamline its financing facilities and the conditions associated with their use (IMF conditionality). Work in this area is ongoing. In addition to safeguarding IMF resources, the conditionality associated with IMF financing was seen as important in ensuring the success of its financial assistance to member countries. There was general consensus that conditionality should be streamlined to focus on areas that were critical to achieving the macroeconomic objectives of the programme and enhanced country ownership of reforms. It was also agreed that conditionality should aim to achieve a clearer division of labour and a more systematic and co-ordinated working relationship between the IMF and the World Bank. During the year, the IMF organised several outreach seminars to seek the views of its members on IMF conditionality. BNM forwarded a note to the seminar that was held in Tokyo on 10 July 2001 to discuss these issues. The note highlighted the importance for IMF conditionality to be more focused and tailored to the requirements of its member countries, and that the application of IMF conditionality needed to take into account country-specific circumstances, and a country's ability or capacity to adopt and implement the required policy reforms. Malaysia also reaffirmed the importance of enhancing the IMF's capabilities in

IMF Meetings in 2001

International Monetary and Financial Committee (IMFC) Meetings in 2001

- 29 April 2001, Washington D.C., United States of America
- 17 November 2001, Ottawa, Canada
  (The 2001 IMF-World Bank Annual Meetings were cancelled following the September 11 incident.)

Conclusion by IMFC Members

- **World Economic Outlook**
  - Noted that the September 11 incident would result in a more prolonged slowdown of the world economy, despite policy actions to support a recovery in 2002.
  - Emphasised the important responsibility of advanced economies to promote early recovery in global growth.
  - Noted the importance of pursuing sound and proactive policies in emerging markets and developing countries in the context of weakening global demand and higher risk aversion in financial markets.
  - Noted the importance of increased trade opportunities in promoting recovery.

- **The Role of the IMF**
  - Welcomed the move by the IMF to refocus its work on crisis prevention and supporting policies aimed at sustainable growth and poverty reduction.
  - Considered the Contingent Credit Line to be an important signal of the strength of countries' policies and a safeguard against contagion in financial markets.
  - Urged the IMF to work on outstanding issues in the area of private sector involvement in crisis prevention and management.

- **IMF Surveillance on Financial Markets and Crisis Prevention**
  - Welcomed the decision to establish the International Capital Markets Department to enhance the IMF's understanding of and assessment on capital market issues; to enhance its early warning capabilities; and to strengthen crisis prevention.
  - Emphasised the need to make progress on early warning indicators of potential crises.
  - Noted the progress in the implementation of the IMF's initiatives on crisis prevention and financial sector surveillance, pertaining to the following:
    - Agreement on a list of international standards and codes;
    - The IMF's work with countries to strengthen data underpinning external vulnerability analyses;
    - Implementation of initiatives on the IMF's transparency policy; and
    - Progress in strengthening national and international financial sector surveillance, particularly on the joint IMF-World Bank Financial Sector Assessment Programme.
  - Welcomed the expansion of the IMF's financial sector work to include voluntary assessments of offshore financial centres.

- **Conditionality in IMF-supported Programmes**
  - Welcomed the on-going review of conditionality and emphasised that it remained indispensable; and reaffirmed that the objective of the streamlining was to make it more efficient, effective and focused.
  - Endorsed that conditionality should focus on measures critical to achieving macroeconomic objectives of a programme.
  - Noted the importance of taking into account the country's decision-making processes and capacity to implement reforms, and the need for strong country ownership of a programme.
  - Noted the importance of enhanced collaboration and clearer division of labour between the IMF and other international financial institutions in streamlining conditionality.

- **Combating Financial Abuse/Money Laundering/Financing of Terrorism**
  - Called on member countries to ratify and fully implement the United Nations instruments to combat terrorism.
  - Agreed that the 40 Recommendations by the Financial Action Task Force (FATF) be accepted as the international standard for combating money laundering, and that the Recommendations should be made operational in the work of the IMF.
  - Supported the Special Recommendations of the FATF to combat terrorist financing.
  - Urged international action to combat terrorist financing, and called for countries to take the following measures, preferably by 1 February 2002:
    - Establish financial intelligence units to receive and process reports of suspicious transactions from the country's financial sector, and to monitor suspected terrorist funds; and
    - Institute mechanisms for sharing of information and co-operation among national financial intelligence units.

- **Efforts in Poverty and Debt Reduction in Poor Countries**
  - Expressed concern at the adverse impact of the global slowdown on low-income and heavily indebted poor countries, and called on the IMF and World Bank to respond flexibly and proactively to address the needs of these countries.
  - Emphasised the different roles to be played by heavily indebted poor countries, developing countries and advanced economies in fighting poverty.
  - Recognised the importance of close collaboration and effective partnership among the international institutions in poverty and debt reduction efforts.

- **Other Issues**
  - Welcomed on-going measures to improve transparency, governance and accountability in the IMF, with the expectation that the Independent Evaluation Office would improve IMF operations and enhance its accountability.
  - Agreed that the IMF should address governance issues that had a significant macroeconomic impact.
  - Underscored the importance of open markets, and urged both the developed and developing countries to find a common ground for the launch of a new round of multilateral trade negotiations in 2001.
  - Looked forward to further progress on the work on IMF quotas, which reflected the changing conditions in the international economy.

analysing issues of political economy, to ensure that programme design would address social and political concerns as well as to ensure the successful implementation of a programme. Consideration of these factors would contribute towards enhanced country ownership of a programme. In this regard, closer consultation and collaboration with local or regional "experts" would enhance the IMF's understanding of situations in a particular country. BNM's views were recorded in the proceedings of the IMF seminar in Tokyo.

Malaysia also highlighted that the application of conditionality must remain consistent with the IMF's Guidelines on Conditionality, and not violate the principle of equal treatment across its membership. There was also a need for shared accountability by the IMF in a programme. To the extent that an IMF programme adopted by any member country was designed by IMF staff and based on the advice of the IMF, the IMF should also assume some responsibility to ensure success of the programme.

The issue of IMF governance, notably the under-representation of developing countries in the decision-making process at the IMF, remained unresolved in 2001 as discussions on this issue were focused on the technical aspects only. The IMF held an Executive Board seminar in October 2001 to further examine issues pertaining to the choice and specification of the IMF quota formula (which determined a member's quota or capital subscription in the IMF). The aim was to develop a more representative quota formula. The Executive Board agreed that further work is needed to further develop quota formulas that appropriately reflect members' position in the global economy. It noted that this task is made difficult as quotas are overburdened by having to perform a variety of roles (quotas determine a member's voting power in the IMF, its ability to contribute resources to the IMF as well as access to IMF financing facilities). The seminar was held following an independent review of the quota formula carried out by the Quota Formula Review Group (QFRG). The QFRG believed that quotas should be adjusted to recognise the constantly changing world economy, and the continual relative change of the circumstances of individual members.

Malaysia remained concerned over the lack of significant progress on the review of IMF quotas. To ensure a more equitable representation in the decision-making process in the IMF, radical changes are needed to reform the quota structure. A new approach or formula to governance may be necessary to ensure that representation at the IMF Executive Board reflects the relative position of individual countries in the current global economy.

A major activity of the IMF in 2001 was the implementation of standards and codes to enhance **transparency.** On the issue of adherence to the standards and codes, adherence should be voluntary and the IMF's Report on Observance of Standards and Codes and the Financial Sector Assessment Programme (FSAP) should not become mandatory elements in the IMF Article IV Consultation process. Malaysia supported the transparency initiative. However, also of importance was the need to ensure that this greater transparency resulted in more informed decision-making by investors. In this connection, the conclusions of an IMF economic forum entitled "Transparency at the IMF: The Road Ahead" on 13 December 2001 provided useful insights. The consensus was that good transparency practices did not necessarily guarantee economic and financial stability. It was also important that there was a clear legal framework governing the IMF's operating rules and procedures to enable the public and the market to understand how the IMF conducted its business and made its policy decisions.

Malaysia has remained committed towards transparency of its data and economic policies. Malaysia continues to meet all the requirements of the Special Data Dissemination Standard, including the forward-looking templates on Malaysia's external reserves as well as the continued publication of the Public Information Notice of the IMF on the Annual Article IV Consultation on Malaysia.

Efforts toward enhancing greater transparency by the private sector made further progress at the 9th Manila Framework Group (MFG) Meeting in Auckland in December 2001. Malaysia had emphasised the need for a more balanced approach to the issues of transparency, in particular on disclosure by the private sector. There was a general consensus that there should be greater disclosure by market participants. This should include those institutions that were of systemic importance, such as the highly leveraged institutions and international credit rating agencies whose activities had implications on market stability.

An issue of particular interest to Malaysia, namely, the risk management of **capital flows**, continued to feature prominently on the agenda of several international fora in 2001. Some progress was made on work on capital flows, notably at the IMF and the BIS. The ongoing work programme of the IMF in the area of crisis prevention and financial sector surveillance included wider use of the IMF's Special Data Dissemination Standard and the General Data Dissemination System; expanded coverage of the IMF's Coordinated Portfolio Investment Survey to include additional instruments and jurisdictions, including offshore financial centres (OFCs); and progress made with respect to the FSAP.

During the year, the BIS continued with its efforts to replace the existing capital adequacy framework (the 1988 Capital Accord) with a more risk-sensitive framework. In supporting this initiative, BNM provided feedback and participated in discussions on issues related to the draft new Accord. The Basel Committee on Banking Supervision planned to undertake a review of the impact of the new Accord on banks and issue a consultative paper in 2002. The Accord will be finalised during 2002 for implementation in 2005.

BNM had the opportunity to relate its experience on the issue of capital flows and policy in emerging economies, which was the subject of a BIS Monthly Board meeting in September 2001. During the year, BNM also accepted the invitation by the BIS to participate in the BIS survey on international banking statistics. Data were submitted on a quarterly basis, based on currently available international banking data on a locational basis by instrument.

Transparency at the IMF

IMF's Publication Policy

On 4 January 2001, the IMF Executive Board agreed on a set of principles for the IMF's publication policy as follows:

- The publication of **country papers** should aim at:
  i. Ensuring that frank policy discussions and reporting to the Board would be maintained;
  ii. Striking the appropriate balance between transparency and confidentiality in dealing with sensitive issues; and
  iii. Continued improvement in the quality of IMF staff reports.

- Publication of country papers should be subjected to a **uniform deletions policy**, which would be minimal and limited to the highly market-sensitive information.

- The presumption that the **Letters of Intent/Memoranda of Economic and Financial Policies** would be released. Such Letters would state a government's policy intentions. These Letters would include Technical Memoranda of Understanding with policy content and Poverty Reduction Strategy Papers.

  These documents would be published in full, subject to the agreed deletions policy. A member that did not intend to publish these documents would explain its reason prior to the IMF's approval of its request for an arrangement.

- The publication of **Heavily Indebted Poor Countries (HIPC) Initiative papers** and relevant Poverty Reduction Strategy Papers and **Chairman's Statements**, conveying key points to the public would be continued.

- The Board would continue with the policy of **voluntary publication** of Public Information Notices (PINs) following Article IV Consultation and Board discussions on regional surveillance papers, concluding statements of Article IV Consultation, Recent Economic Developments, Selected Issues, Statistical Appendices and Reports on Observance of Standards and Codes (ROSCs).

Assessment of Implementation of Standards and Codes

On 29 January 2001, the IMF Executive Board reviewed the experiences in the implementation of standards and codes, and discussed the next steps of action. The Executive Board agreed that:

- The development and implementation of standards in areas relevant to the effective functioning of members' economic and financial systems were central to strengthening the architecture of the international financial system;

- Increased attention to standards and the introduction of standards assessments would help sharpen the focus of IMF policy discussions with country authorities and strengthen the functioning of markets; and

- ROSCs, as the principal tool for assessing implementation, would provide rigour, content and focus to the work on standards. The ROSCs were initiated in January 1999 as a pilot programme for the preparation and use of summary assessments of members' implementation and observance of standards and codes.

Code of Good Practices on Fiscal Transparency

On 23 March 2001, the IMF Executive Board approved a revision of the Code of Good Practices on Fiscal Transparency as well as the Manual on Fiscal Transparency, with the objective of placing greater emphasis on the importance of fiscal data quality.

Review of the IMF's Data Standards Initiatives

On 23 July 2001, the IMF Executive Board conducted its Fourth Review of the IMF's Data Standards Initiatives, and agreed on the following:

- Observance of the Special Data Dissemination Standard:
  - Observance issues would be addressed by placing notices on the observance of the Standard, indicating the nature of non-observance, and stating the time-bound plans for coming into observance by subscribers; and
  - Outreach efforts would be strengthened through seminars on international standards and codes and surveys on users of the Dissemination Standards Bulletin Board.

- A common voluntary database for reserves template data would be established and disseminated over the IMF's website.

- Work should continue on finalising the Debt Guide and raising awareness of the data dissemination standard for external debt.

- Establishment of a General Data Dissemination System (GDDS) unit at the IMF. Meanwhile, the IMF and the World Bank would collaborate closely on the socio-demographic component of the GDDS and the development of metadata for countries wishing to participate.

- An assessment methodology to assess data quality called the Data Quality Assessment Framework would be integrated into the structure of the data module of the ROSC as a central element of a Data Quality Assessment Programme.

During the 11th Summit of the Heads of State and Government of the Group of 15 (G-15) in May 2001, concern was expressed that increased reliance on private capital flows in financing development accentuated the inequality in resource distribution among countries while simultaneously inducing more volatility in financial flows. Given the shortage of capital inflows in many developing countries despite restructuring and reform efforts, participants called for effective public and private partnerships in efforts to increase such flows. Investors were called upon to give due cognisance to the development objectives of their host countries.

At the regional level, Malaysia continued to play an active role in the SEACEN Expert Group on Capital Flows (SEG). Progress made included the development of a common set of data templates for SEG members to exchange information on capital flows. Moving forward, the SEG would work towards developing concrete and practical proposals that members could implement individually or collectively to enhance the risk management of volatile capital flows.

In the light of the challenges posed by increased globalisation and financial liberalisation, Malaysia emphasised the need for additional initiatives at the 9th Meeting of the MFG in December 2001. At the international level, Malaysia proposed that an IFI assume an increased role in promoting and safeguarding international financial stability. Initiatives at the regional level could encompass the strengthening of regional surveillance and the improvement of regional financing arrangements. At the national level, an integrated risk management framework could be developed to monitor debt- and non-debt creating flows, identify acceptable levels of risk and develop the methodology and technology to measure and monitor increased risks.

During the year, there was some progress in ongoing initiatives with regard to the **Highly Leveraged Institutions (HLIs)**. The Joint Working Group on HLIs (of the Basel Committee on Banking Supervision and International Organisation of Securities Commissions) reviewed issues related to the dealings of banks and securities firms with HLIs in March 2001. Encouraging progress in the firms' implementation of the HLI Sound Practice recommendations made by both the Basel Committee and International Organisation of Securities Commissions was evident from the strengthening of the oversight of senior managements through improved policies and a clearer definition of risk appetites. Additional progress was needed in the assessment of firms' exposure to HLIs. While disclosure by HLIs to their counterparties had improved, progress was inconsistent.

In its review in March 2001, the Financial Stability Forum (FSF) Working Group on HLIs reported similar findings in the areas of counterparty risk management and disclosure. In the area of market conduct, the Principles for Foreign Exchange Trading released in February 2001 would be incorporated into existing codes of market conduct. Progress in the development of legal documentation practices was good, although progress in resolving issues in the area of improving consistency between different industry standards of documentation had been difficult.

Despite the progress, the issue of HLIs remained a matter of concern in various fora, including the 11th Summit of the Heads of State and Government of the G-15 in May 2001 and the 9th Meeting of the Manila Framework Group in December 2001. In view of the need to maintain international financial stability, the G-15 Leaders called for the monitoring and regulation of HLIs to safeguard countries from the destabilising effects of their activities.

At the 9th Manila Framework Group Meeting, concern was expressed that not much attention had been given to the impact of hedge fund activities on the integrity and stability of small emerging markets, as current initiatives were focused on enhancing disclosure by the HLIs and ensuring that counterparties strengthened risk management practices when dealing with the HLIs. Malaysia reiterated its stance that "self regulation" among HLIs was not a viable option. Additional measures were proposed in the area of improving risk management by both hedge funds and banks, dealing practices of hedge funds, identifying incentives for observance of practices by hedge funds and identifying mechanisms to solve disputes between economies on hedge fund activities.

The issue of **private sector involvement** (PSI) in forestalling and resolving financial crises gained further ground in 2001. Based on the basic principle that a market economy required debtors and private creditors to bear the consequences of their decisions, principles for transparency and good communication were drawn up by the Working Group on Creditor-Debtor Relations set up by the IMF's Capital Markets Consultative Group. The latter comprised a group of senior representatives of private financial institutions, which had an informal dialogue with the IMF on a regular basis.

Going forward, in November 2001, the IMF proposed a framework which would encourage both debtors and creditors to restructure unsustainable sovereign debts in a timely and efficient manner. The IMF mechanism offered the debtor country legal protection from creditors who stood in the way of a necessary restructuring, while the debtor country was obligated to negotiate with its creditors in good faith and implement policies to prevent a similar problem in the future. The proposed mechanism attempted to deal with the complex issue of sovereign debt restructuring in an orderly, predictable and prompt manner. However, many issues, ranging from legal to political concerns, needed to be resolved before the mechanism could be implemented. Further work would need to be done to make the principles and rules of the mechanism clear, credible and operational.

Discussions on **exchange rate regimes** continued to feature prominently among members of the international community, with widespread acknowledgement that no one exchange rate regime was suitable for all countries in all circumstances. Furthermore, there was consensus in the international community, including the Executive Meeting of East Asia and Pacific (EMEAP) Central Banks and the Asia-Europe Meeting (ASEM) as well as international financial institutions such as the IMF, that countries should adopt exchange rate regimes that supported and complemented their macroeconomic and structural policies.

Amid the debate on the costs and benefits of the two "corner regimes", namely an independent floating exchange rate or a hard peg, the IMF underscored the importance for countries to adopt exchange rate regimes consistent with their specific macroeconomic fundamentals. With respect to Malaysia's pegged exchange rate system, the IMF observed during its Annual Article IV Consultation with Malaysia in August 2001 that the pegged system was sustainable as long as the level of the ringgit exchange rate was not misaligned from its long-term equilibrium and that economic fundamentals remained strong. The issue, therefore, was not the type of exchange rate regime itself that was adopted but whether the exchange rate regime was supported by sound policies which served the

FSF Meetings in 2001

Meetings of the FSF

- 22 - 23 March, Washington, D.C., United States of America
- 6 - 7 September, London, United Kingdom

Issues Discussed

- **International Financial System Outlook**
  - Assessed the implications of the current global economic outlook on financial stability, and agreed on the need for continued vigilance.
  - Reviewed the responses of key financial systems and markets to the world economic slowdown.

- **Highly Leveraged Institutions (HLIs)**
  - Reviewed the actions taken so far to address concerns raised in the report of its Working Group on HLIs.
  - Welcomed the completion of the work of the Multidisciplinary Working Group on Enhanced Disclosure and urged taking this initiative forward.
  - Welcomed and encouraged further progress by the Global Documentation Steering Committee in efforts to improve the consistency of the documentation standards.

- **OFCs**
  - Welcomed the efforts of standard-setting bodies and international financial institutions to improve supervisory, regulatory, and cooperation and information practices in OFCs.
  - Encouraged OFCs to further enhance their implementation of relevant international standards, seek assistance from the IMF and World Bank, and participate in assessment programmes.
  - Noted that disclosure of action plans and assessment findings were a useful means for OFCs to demonstrate their progress towards meeting such standards.
  - Reviewed the actions taken so far to address concerns raised in the March 2000 Report of the FSF Working Group on OFCs.
  - Welcomed the proposal of the Basel Committee on Banking Supervision to set up a contact group with offshore supervisors.

- **Implementation of Standards**
  - Reviewed work to foster the implementation of international standards for sound financial systems.
  - Discussed progress in providing incentives to foster the implementation of standards.

- **International Guidance on Deposit Insurance Systems**
  - Welcomed the development of guidance for the benefit of countries establishing or reforming a deposit insurance system.

- **Risk Management and Capital Regulation**
  - Welcomed the work of the Joint Forum (Basel Committee on Banking Supervision, International Association of Insurance Supervisors and International Organisation of Securities Commissions) in comparing approaches to risk management and capital regulation across the banking, insurance and securities sectors.

- **Financial Sector Robustness**
  - Welcomed the work of the Joint Forum in comparing the three sets of Core Principles for effective banking supervision, insurance supervision and securities regulation.

- **Developments in E-finance**
  - Discussed developments in e-finance for supervision, regulation and market functioning.

needs of the economy and did not create macro-economic imbalances. In this regard, it was concluded that Malaysia's pegged exchange rate was well sustained by strong fundamentals of the Malaysian economy.

Participation in IMF Meetings

As part of its outreach programme, the IMF organised periodic study visits to member countries, in order to familiarise IMF Executive Directors with the current situation in member countries. Malaysia hosted a visit from a group of IMF Executive Directors on 25-27 October 2001, who were on a study tour of four South-east Asian countries (the others being Cambodia, Thailand and Vietnam). The IMF Directors had wide-ranging discussions with the Deputy Prime Minister, the Governor of BNM, the Secretary-General of the Ministry of Finance, the Executive Director of the National Economic Action Council, the Chairman of Securities Commission, other senior government officials, and representatives from the private sector. Malaysia updated the IMF on the current economic situation and policies in Malaysia. In response to questions posed by the Executive Directors, Malaysia shared its concern that there should be greater flexibility in IMF policy prescriptions, with due consideration being accorded to the institutional framework and the specific economic, social and political situation in individual countries. Malaysia also conveyed its view that while it supported the IMF's efforts to improve the transparency of IMF operations, there was a need to achieve a balance in terms of preserving the confidentiality of its policy advice to member countries.

On exchange rate policy, BNM highlighted that in small, highly open trade-oriented economies such as Malaysia, stability in the exchange rate was important. In Malaysia, the pegged exchange rate system was well supported by the macroeconomic fundamentals of low inflation, a strong external balance, low external indebtedness, a high level of reserves, and a well-capitalised banking system. The stable foreign exchange and financial market environment allowed significant progress to occur in the reform in the financial and corporate sectors.

In the area of Islamic banking and finance at the international level, BNM participated in the IMF meetings, both at the preparatory committee and Governors' consultative meetings, on Risk Management and Regulatory Standards for Islamic Financial Institutions. These meetings discussed and deliberated on the feasibility of establishing a standard-setting body for Islamic financial institutions that was expected, among others, to develop and disseminate uniform prudential, disclosure and regulatory standards to govern risks inherent to Islamic financial products. Among the participants who attended the meetings were Governors and senior officers of the central banks from Bahrain, Bangladesh, Egypt, Iran, Indonesia, Jordan, Kuwait, Malaysia, Pakistan, Saudi Arabia and Sudan, and representatives from the IMF, the Islamic Development Bank and Accounting and Auditing of Islamic Financial Institutions (AAOIFI).

The preparatory committee met in March 2001 (Washington D.C.), June 2001 (Kuala Lumpur), July 2001 (Bahrain) and January 2002 (Paris) to prepare the framework and Articles of Agreement of the standard-setting body for deliberation at the Governors' consultative meeting. The consultative meetings of Governors were held in April 2001 (Washington D.C.) and November 2001 (Paris). At their meeting in November, Governors agreed on the establishment of a standard-setting body for Islamic financial institutions, with Malaysia as the host country of the standard-setting body. During the year, Bahrain and Malaysia also concluded a Memorandum of Understanding in October 2001 with the objective of entering into greater co-operation in the area of finance. This involved the collaborative efforts with other countries to develop the International Islamic Financial Market.

FINANCIAL SECTOR LIBERALISATION

World Trade Organisation

The most significant event for the World Trade Organisation (WTO) in 2001 was the Fourth WTO Ministerial Conference (4th MC), which was held in Doha, Qatar, on 9 - 14 November 2001. The 4th MC agreed to launch a new round of multilateral trade negotiations, to be called the Development Agenda. The new round of trade negotiations would include the continuation of current negotiations in the agriculture and services sectors, as well as negotiations or possible negotiations on a range of issues, including market access for non-agricultural products, implementation issues, environment, investment, competition policy and transparency in government procurement. Negotiations under the Development Agenda were scheduled to be concluded by 1 January 2005.

Malaysia was supportive of a new round of multilateral trade negotiations but highlighted the importance of having a balanced and manageable agenda, which gave due consideration to the interests and concerns of all members, particularly the developing countries. In this regard, Malaysia supported the inclusion of negotiations in the agriculture and services sectors, as well as market access for non-agricultural products. In addition, the new round also recognised the special needs of the developing countries, particularly in implementing the existing WTO agreements, and committed WTO members to addressing the particular vulnerability of these countries through technical assistance and capacity building. On the contentious issues of investment, competition policy, transparency in government procurement and trade facilitation, the educative process with a more focused work programme would continue. In deference to the views of a number of developing countries, negotiations on these areas would only start after the 5th MC, provided that explicit consensus on the modalities of negotiations was achieved.

A new round of multilateral trade negotiations, covering negotiations in the agriculture and services sectors as well as several new areas, was launched in 2001. Negotiations are to be completed by 1 January 2005.

Negotiations to further liberalise the services sector, including the financial services sector, were formally launched on 25 February 2000. The 4th MC further agreed that member countries should submit initial requests for specific commitments by 30 June 2002 and initial offers by 31 March 2003. It was also agreed that negotiations on the services sector were to be completed by no later than 1 January 2005.

BNM was involved in the services negotiations in 2001, especially in discussions relating to the further liberalisation of the financial services sector. With negotiations entering into the "request and offer" phase on 28 March 2001, a number of countries had submitted negotiating proposals in the financial services sector, identifying areas and issues that they intended to pursue in the current round of negotiations. These included requests for the removal of existing restrictions on market access and any preferential treatment currently accorded to domestic players, as well as calls for national authorities to improve transparency in the regulation of the financial sector.

At the last round of negotiations on the financial services sector, which were concluded in December 1997, Malaysia made a number of improvements in the insurance and offshore financial sectors. Malaysia had committed under the General Agreement on Trade in Services (GATS) to allow an aggregate maximum foreign equity limit in the domestic banking institutions of 30%. In line with the policy to consolidate the banking sector, no commitment was made to issue new banking licences to either locals or foreigners. In the insurance sector, a commitment was made to allow existing original foreign shareholders to own up to 51% of the insurance companies. In addition, new entry of foreign insurance companies was also welcomed through participation (up to 30% of total equity) in locally-incorporated insurance companies.

The negotiations for the further liberalisation of the financial sector would be in accordance with the financial sector development path charted in the Financial Sector Masterplan (FSMP). To date, the foreign presence in the domestic financial sector is significant. Of the 27 commercial banks (including two Islamic banks), 14 are wholly foreign-owned and foreigners further owned an average of 18% of the total equity of five domestically-owned banks. Together, foreigners accounted for about 32% of total commercial bank assets. Similarly, foreign presence is also significant in the domestic insurance industry, with 25 out of 63 insurance companies being foreign-owned. The market share of foreign-owned insurance companies operating in Malaysia amounts to 64% of life insurance premiums and 39% of general insurance premiums.

In line with the commitment towards further liberalisation of the financial sector, the focus of policy in 2001 was to strengthen the capacity and capability of the domestically-owned financial institutions. This was aimed at enhancing their ability to compete on a more level playing field with the foreign financial institutions. The negotiations to liberalise the financial services sector under the new round have further increased the urgency to strengthen the capacity of the domestically-owned financial institutions. A number of capacity-building initiatives had been

Schedule of WTO Negotiations on Trade in Services (2000-2005)	
25 February 2000 The new round of services negotiations was formally launched	Negotiations began with the "rules-making" phase where Members negotiated the new rules and disciplines relating to specific provisions of the General Agreement on Trade in Services (GATS), including on subsidies, emergency safeguards and government procurement. The discussions also focused on the procedures and guidelines for the "request and offer" phase of negotiations, scheduling guidelines and disciplines on domestic regulation. BNM was actively involved in negotiations to formulate an agreement on emergency safeguard measures for the services sector (see BNM Annual Report 2000).
28 March 2001 Services negotiations entered into the "request and offer" phase	The adoption of negotiating guidelines by Members marked the start of the "request and offer" phase of negotiations. Negotiations for further liberalisation would be conducted on the basis of negotiating proposals submitted by Members. "Request and offer" is essentially a bilateral negotiating approach, whereby negotiations are conducted based on requests submitted by a country to a trading partner and offers submitted by the trading partner.
30 June 2002	Members to submit initial requests for specific commitments from other Members by 30 June 2002.
31 March 2003	Members to submit initial offers of specific commitments by 31 March 2003.
1 January 2005	Services negotiations to be completed.

identified under the FSMP, including appropriate strategies to raise performance standards. Indeed, as part of the measures to further develop the financial sector, the FSMP had identified a number of liberalisation measures that would be undertaken over the next 10-year period.

ASEAN Framework Agreement on Services

The ASEAN Framework Agreement on Services (AFAS) was signed on 15 December 1995 by the ASEAN Economic Ministers at the Fifth ASEAN Summit in Bangkok. The aim of AFAS was to develop and enhance the competitiveness of the services industry in ASEAN through, among others, liberalising trade in services beyond the commitments undertaken in the GATS (that is, "GATS-plus"). The first round of negotiations under AFAS to liberalise the services sector, including the financial services sector, was concluded in 1998. Subsequently, a second round of negotiations was launched in January 1999, and scheduled to be concluded in 2001. In this connection, in August 2000, the "Working Committee on ASEAN Financial Liberalisation under AFAS" was formed to provide a forum for negotiations to liberalise the financial sector among the ASEAN countries. BNM participated in a number of meetings held by the Working Committee throughout 2001, during which ASEAN member countries tabled and negotiated their GATS-plus offers. The offers of commitments by member countries had been finalised and the "Protocol to Implement the Package of

Commitments on Financial Services under the AFAS" was expected to be signed in April 2002.

REGIONAL CO-OPERATION INITIATIVES

ASEAN Financial Co-operation

In 2001, significant progress was achieved in a number of initiatives to further enhance regional co-operation. At the ASEAN level, BNM assumed the chairmanship of the ASEAN Central Bank Forum (ACBF), a forum for the Deputy Governors of the 10 central banks and monetary authority in ASEAN to exchange views on economic and financial developments in the region. In this connection, BNM hosted the 8th and 9th ACBF Meetings, which were held in Kuala Lumpur on 3 April and 13 September 2001 respectively. At the 9th ACBF Meeting, member central banks agreed to strengthen the format of the ACBF in order to further enhance the peer review process and encourage frank exchange of views among the members.

Efforts to strengthen regional co-operation intensified in 2001. Significant progress was made in the implementation of the Chiang Mai Initiative and work had started on enhancing the effectiveness of regional economic reviews and policy dialogue.

ASEAN Central Bank Forum (ACBF) Meetings in 2001

I. 8th ACBF, 3 April 2001, Kuala Lumpur, Malaysia
II. 9th ACBF, 13 September 2001, Kuala Lumpur, Malaysia

Issues Discussed:

- **Peer Review:** Members discussed extensively the implications of the global economic slowdown for the ASEAN countries and exchanged views on the policy responses adopted by member countries to mitigate the consequent adverse effects. It was agreed that strengthening domestic demand was critical in mitigating the effects of the slowdown in external demand on the region's economic growth. Members also agreed that it was important to maintain exchange rate and financial stability in the region, and to strengthen financial and corporate sector restructuring.

- **Bilateral Swap Arrangements (BSA) under the Chiang Mai Initiative**: Members discussed the progress of the implementation of the BSA.

- **Proposed Modalities to Enhance Regional Economic Reviews and Policy Dialogues:** Members exchanged views on proposed ways to enhance existing economic reviews and policy dialogues among the ASEAN+3 countries.

- **ASEAN Common Currency and Exchange Rate Mechanism:** Members discussed the report presented by the Chairman of the ASEAN Currency and Exchange Rate Mechanism Task Force, and agreed that the Task Force should analyse the costs and benefits of having a common currency in ASEAN, and identify measures that would need to be undertaken for the common currency arrangement to be feasible.

- **ASEAN Central Bank Governors' Conference:** Members discussed the proposal to hold an annual ASEAN Central Bank Governors' Conference to complement the ACBF. The Conference would provide a forum for the Governors to exchange views on recent economic and financial developments in the region as well as to identify possible areas for co-operation among the ASEAN central banks. A consensus was reached to hold the first Governors' Conference tentatively in June 2002.

BNM, as the chair of the ASEAN Currency and Exchange Rate Mechanism Task Force, organised a seminar on "Common Currency Arrangements and Exchange Rate Mechanisms in ASEAN" in Kuala Lumpur on 6-7 August 2001, as well as hosted the inaugural meeting of the Task Force on 8 August 2001. The seminar provided an opportunity for participants to hear the views of experts on the preconditions, costs and benefits of common currency arrangements. The inaugural meeting of the Task Force agreed that the work of the Task Force would focus on identifying the costs, benefits and feasibility of having a common currency arrangement in ASEAN.

Another important development in ASEAN financial co-operation in 2001 was the finalisation of the memorandum of understanding to establish the ASEAN Insurance Training and Research Institute (AITRI) in Malaysia as the ASEAN network centre for insurance education and research. Initially, the operations of the AITRI would be co-ordinated by the Malaysian Insurance Institute. On 8 April 2001, the ASEAN Finance Ministers signed the "Protocol to Establish an ASEAN Scheme of Compulsory Motor Vehicle Insurance". The implementation of the Protocol represents the first step towards the establishment of an insurance scheme within ASEAN which would facilitate the movement of goods among the ASEAN countries by reducing delays in cross-border crossings.

ASEAN+3 Financial Co-operation

During 2001, significant progress was made in the implementation of the Chiang Mai Initiative (CMI), which was launched by the ASEAN Finance Ministers and their counterparts from the People's Republic of China, Japan and Korea (that is, the ASEAN+3 Finance Ministers) on 6 May 2000.

BNM entered into two Bilateral Swap Arrangements (BSA) with the Bank of Japan, acting on behalf of the

ASEAN and ASEAN+3 Finance Ministers' Meetings in 2001

I. 5th AFMM, 7-8 April 2001, Kuala Lumpur, Malaysia
II. AFMM+3, 9 May 2001, Honolulu, United States of America

Issues Discussed:

- **Peer Review:** Ministers noted the deterioration in the global economic outlook and pre-emptive measures taken by some of the member countries to alleviate the effects of lower external demand. Ministers agreed on the need to continue with financial and corporate sector restructuring, as well as to promote robust and strong financial systems to better withstand external shocks. Ministers also agreed to have closer policy dialogues and strengthen regional co-operation in the areas of monitoring capital flows, support mechanisms, and international financial reforms.

- **ASEAN Finance Co-operation:** Ministers welcomed progress made in implementing the ASEAN Finance Work Programme, including in the areas of strengthening the financial system, capital market development and liberalisation of the financial sector under AFAS.

- **East Asia Finance Co-operation:** Ministers noted the progress of the implementation of the BSA under the CMI and agreed to review the main principles of the BSA in three years, taking into account the actual operation of the BSA and other relevant factors.

- **Study Group to Enhance the Effectiveness of Economic Reviews and Policy Dialogues:** Ministers agreed to establish an ASEAN+3 Study Group to enhance the effectiveness of economic reviews and policy dialogues among the ASEAN+3 countries.

- **Monitoring of Capital Flows:** Ministers agreed to engage in regular exchange of information on short-term capital flows. In this connection, member countries agreed to exchange information on capital flows using an agreed format on a voluntary basis.

- **International Financial Architecture:** Ministers noted the latest developments in the G-7, G-20 and the FSF in 2001.

Ministry of Finance, Japan, on 5 October 2001. The agreements comprised a new US$1 billion BSA under the CMI and the renewal of the existing swap arrangement of US$2.5 billion under the New Miyazawa Initiative (NMI). These agreements are for a period of three years.

Regionally, Japan has also entered into a swap arrangement of US$2 billion with Korea on 4 July 2001. This was in addition to their existing US$5 billion swap arrangement with Korea under the NMI. Japan has also signed swap agreements with Thailand amounting to US$3 billion on 30 July 2001, and with the Philippines also for US$3 billion on 27 August 2001. Thailand and the People's Republic of China concluded an agreement for a swap arrangement of US$2 billion on 6 December 2001.

Another important milestone in the area of regional financial co-operation was the establishment of an "ASEAN+3 Study Group to Examine Ways of Enhancing the Effectiveness of Economic Reviews and Policy Dialogues" by the ASEAN+3 Finance Ministers at their meeting in Honolulu on 9 May 2001. The task of the Study Group was to examine ways to further enhance the effectiveness of economic reviews and policy dialogues among the ASEAN+3 countries. Enhanced reviews and policy dialogues, encompassing peer review, would aid in identifying emerging issues and potential problems, and thus enable authorities to take prompt corrective and pre-emptive policy actions and minimise the risk of contagion. In addition, an enhanced regional policy dialogue process would also promote sound macroeconomic policies and address any moral hazard problem that might arise in implementing the CMI. The Study Group was co-chaired by Japan and Malaysia, and comprised senior officials from finance ministries and central banks of the ASEAN+3 countries. The First Meeting of the Study Group was held in Kuala Lumpur on 22 November 2001. The Meeting discussed the possible modalities to enhance regional economic reviews and policy dialogues as proposed by Japan and BNM.

SEACEN

During the Thirty-sixth Conference of Governors of South-East Asian Central Banks (SEACEN), which was held in Singapore on 1-2 June 2001, Governors shared their countries' experiences in maintaining financial stability. Discussions ranged from the issue of exchange rate management to upgrading supervisory capabilities and framework; and the implementation of the New Basel Capital Accord.

A significant activity undertaken by the SEACEN Research and Training Centre (SEACEN Centre) was the completion and submission of the SEACEN Strategic Review to the SEACEN Board of Governors in June 2001. The Board of Governors deliberated on the Review's recommendations on the structure, resources and mode of operation of the SEACEN Centre. The proposed changes were aimed at ensuring the Centre's relevance in enhancing the skills capacity of its members to meet the challenges of globalisation and strengthening its role as a unique and reputable training and research institute in the region. In this regard, the Governors agreed in principle to the proposals to realign and give greater focus to the Centre's activities and organisational structure. An immediate enhancement of the governing structure of the SEACEN Centre was the establishment of an Executive Committee comprising the Deputy Governors of member central banks. The new governance structure would enable the Board of Governors to delegate the responsibility for the management and oversight of the SEACEN Centre's operations, such as its annual work programme and budget to the Executive Committee. This would allow the Board of Governors, which remained the highest policy-making body of the SEACEN Centre, to focus on deliberations on key issues in monetary and financial policies.

To upgrade the quality of its training programmes, SEACEN continued to strengthen its strategic alliances with international financial institutions such as the IMF, BIS and the Toronto Centre. The Centre's financial resources were augmented by the Bank of Japan's pledge to provide financing for five SEACEN training events a year as agreed by the Bank of Japan. During the SEACEN Centre's operating year 2001/2002, BNM hosted two training activities, namely the Workshop on Communication Strategy for Monetary Policy (19-21 February 2002) and the SEACEN-Toronto Centre Leadership Seminar for Senior Management of Central Banks on Financial System Oversight (18-22 March 2002).

The SEACEN Expert Group on Capital Flows (SEG) made further progress in developing a regional framework to promote information sharing on capital flows among its members. At its third meeting which was held in Kuala Lumpur on 3-4 May 2001, members agreed to provide information, based on a common set of data templates, which sought to address current gaps in data on capital flows. The data would be shared via a secure electronic data exchange facility at the SEACEN Centre. During the meeting, members exchanged country experiences on the risk management of capital flows. In addition, a half-day workshop on managing risks associated with capital flows was held, with presentations by the World Bank and the private sector. Going forward, the SEG would commence work on the second objective of drawing up concrete and practical proposals that members could implement individually or collectively to enhance the risk management of volatile capital flows.

Under the SEACEN Trust Fund (STF) Grant and Scholarship Scheme, four scholarships were awarded to eligible member countries, while one was awarded to a SEACEN observer central bank. The Scheme, which began in 1993, provided financial assistance to eligible member and observer central bank officers to attend training programmes conducted by the SEACEN Centre.

EMEAP

The Executive Meeting of East Asia and Pacific (EMEAP) Central Banks continued to be an important forum for monetary and financial co-operation among central banks and monetary authorities in the East Asia and Pacific region. During the year, the EMEAP Deputies held their bi-annual meetings in Beijing on 26 March, and in Auckland on 3 December. The 6th Annual Governors' Meeting was held in Sydney on 7 July 2001. EMEAP, through the activities of its three working groups, contributed to capacity building among member central banks. The Working Group on Payment and Settlement Systems focused on ways to reduce foreign exchange settlement risk in the EMEAP region. The Working Group on Banking Supervision focused mainly on the proposed new Basle Accord. Meanwhile, the Working Group on Financial Markets continued to discuss the development of the continuous-linked settlement system for foreign exchange and its implications for central bank market operations and reserves management in the region. The major themes in EMEAP's discussions in 2001 included promoting financial stability; focusing on progress and challenges; and asset prices and central bank policy.

A related development was the establishment of the Asian Consultative Council (ACC) of the BIS in March 2001, comprising all Governors of the EMEAP central banks in the BIS, including Malaysia. The ACC provides a vehicle for communication between the Asian and Pacific members of the BIS and the Board and Management of the BIS on matters of interest and concern to the Asian central banking community. Its inaugural meeting was held in Basel in June 2001.

Manila Framework Group

The Manila Framework Group (MFG) of Finance and Central Bank Deputies met twice in 2001, in Beijing on 27-28 March, and in Auckland on 4-5 December, to review economic developments in the Asia-Pacific region and discuss relevant policy issues. On regional surveillance, the Group recognised that the prevailing weak global economy had heightened the need for members to maintain supportive macroeconomic policies and strong structural policies to facilitate a return to growth, stability and poverty reduction. In view of the events of 11 September, the Group agreed to support the Group of 20 Action Plan on Terrorist Financing and committed to implement steps in the Plan by February 2002.

The Group also discussed the report of the Task Force of the MFG Financing Arrangement, with emphasis on the possible principles to govern the operation of a co-operative financing arrangement, as proposed in the Manila Framework in 1997. The Group agreed that any MFG financing arrangement would involve bilateral financing in support of IMF programmes on a case-by-case basis and that participation would be voluntary. These issues would be revisited by the Group to ensure its continued suitability to members of the Group in terms of principles and modalities governing the financing arrangement.

Discussions at the regional level (EMEAP, APEC, MFG and the ACC of the BIS) focused on macroeconomic policy options to manage the global economic slowdown. Collaborative work by working groups contributed to domestic capacity building among members.

Asia-Pacific Economic Co-operation

Under the theme "Growth with Restructuring, Stability and Equity", the Finance Ministers of APEC met in Suzhou, People's Republic of China on 8-9 September 2001 and focused their attention on the policy challenges faced by APEC economies in promoting sustainable economic growth and financial stability in the region. Finance Ministers

APEC Meetings in 2001

I. APEC Finance and Central Bank Deputies' Meeting, 1 May, Washington D.C., United States of America 6-7 September, Suzhou, People's Republic of China

II. 8th APEC Finance Ministers' Meeting, 8-9 September, Suzhou, People's Republic of China

Issues Discussed

- **Macroeconomic Challenges and Policy Responses**
  In view of the less favourable global economic environment, APEC stressed the importance for the international community to take the appropriate policy actions to facilitate an early recovery in global economic activities. APEC affirmed its commitment to enhance macroeconomic policy dialogue and co-operation in managing the economic difficulties faced by member economies and to build a strong foundation for sustained and broad-based growth in the region. In addition, APEC emphasised the importance of continuing domestic structural reforms to enhance the ability to respond to economic and financial shocks.

  On the trends in globalisation, APEC stressed the need for appropriate policies and framework to be in place to enable all member economies to benefit from the process of increased economic and financial integration.

- **Strengthening the International Financial System**
  APEC welcomed current steps taken to reform the IFA and urged continued implementation of the reforms. Although APEC endorsed the implementation of international standards and codes, it was emphasised that the implementation and assessment of compliance with these standards and codes need to take into account individual country circumstances and institutional capacity.

agreed that wide-ranging structural reforms were essential to strengthen the foundation for macroeconomic stability and sustainable improvement in living standards. APEC members also maintained their collaborative efforts under various APEC initiatives during the year. In addition, to ensure that APEC kept abreast with emerging economic and financial challenges, Ministers also endorsed the Strategic Review of the APEC Finance Ministers' Process. The Strategic Review provided a new framework that would anchor the work undertaken in the finance process so as to complement APEC's overall vision. The new framework took into consideration APEC's unique characteristics, comparative advantages and limitations, such as the diversity of APEC's membership, voluntary nature of economies' involvement and limitations on resources to develop policy initiatives.

As part of the collaborative effort, BNM continued to participate in APEC work programmes conducted under the various initiatives. These work programmes included core group activities; policy dialogues; and training programmes. In this regard, BNM participated in policy dialogues on banking supervision; and bank failure management; as well as in training programmes organised under the Financial Regulators' Training Initiative. BNM also participated in the APEC Working Group on Electronic Financial Transactions Systems and the Working Group on Fighting Financial Crimes.

Group of 15

The 11th Summit of the Heads of State and Government of the Group of 15 (G-15) was held in Jakarta, Indonesia on 30-31 May 2001. At the Summit, members expressed concern over the lack of progress in IFA reforms, which was vital in effectively addressing the risks and challenges posed by globalisation. In order to sustain and accelerate the reform effort, G-15 members agreed with Malaysia's proposal to establish an Expert Group on the Reform of the IFA. The Expert Group had been tasked to assess the progress of the current work on IFA reform, and make recommendations to address the concerns and interests of developing countries, particularly that of the G-15. The establishment of the Expert Group would serve as a means by which the views of the G-15 members would be presented at the various international fora. The Expert Group held its meeting in Kuala Lumpur on 26 February 2002.

Asia-Europe Meeting

Subsequent to the 3rd Asia-Europe Meeting (ASEM) Finance Ministers' Meeting which was held in Japan in January 2001, an ASEM Core Group Meeting was held in Washington D.C., United States on 13-14 April 2001. During the meeting, ASEM members reviewed the progress of on-going ASEM activities such as the Kobe Research Project, ASEM Trust Fund II and ASEM Anti-Money Laundering Initiative. In addition, ASEM members were updated on recent initiatives in regional co-operation in Asia and Europe. On the progress of regional co-operation in Asia, Malaysia updated ASEM members on the status of the CMI, that consisted of the expanded ASEAN Swap Arrangement and the Bilateral Swap Arrangement. Malaysia also informed the Meeting on developments in the ASEAN surveillance process. The next ASEM Finance Ministers' Meeting is scheduled to be held in Copenhagen, Denmark on 5-6 July 2002. The ASEM Leaders' Summit, which is held on a biennial basis, will also take place in Copenhagen, Denmark on 22-24 September 2002.

Asia/Pacific Group on Money Laundering

International initiatives against money laundering, which were started more than a decade ago by international bodies and task forces, have intensified in recent months. In 2001, efforts to combat money laundering were stepped up after the 11 September 2001 events. Malaysia has actively supported regional and international efforts in fighting money laundering. Malaysia enacted the Anti-Money Laundering Act 2001, which came into force on 15 January 2002. The initiative to put this Act in place commenced with the formulation of the concept paper in October 2000, and the Act was gazetted as law on 5 July 2001. The Act criminalises money laundering and provides for related enforcement powers; imposes customer identification, record-keeping and reporting requirements; and mandates the competent authority to receive, analyse and disseminate financial intelligence relating to money laundering activities. For the purpose of carrying out its functions under the Act, BNM has established a new department in 2001 called the Financial Intelligence Unit to implement measures for the prevention and detection of money laundering.

Malaysia became a member of the Asia/Pacific Group on Money Laundering (APG) on 31 May 2000. The APG was formally established in February 1997 at the 4th Asia/Pacific Money Laundering Symposium in Bangkok. The APG Secretariat is based in Sydney. Its mission is "to provide a co-operative regional solution to the global problem of money laundering". The APG's principal strategy is to facilitate the adoption, implementation and enforcement of internationally accepted anti-money laundering standards in the legal, financial and law enforcement sectors and to use mutual evaluations to encourage member compliance.

Malaysia together with Australia are the current co-chairs of the APG. The co-chair arrangement is for a 2-year period, ending in mid-2002. BNM was the lead agency representing Malaysia at the APG, and as co-chair, assisted the APG Secretariat in preparing for its meetings. During the year, BNM was involved in organising the 4th APG Annual General Meeting in Kuala Lumpur (22-24 May 2001). The meeting was the largest APG meeting held to-date, attracting more than 200 attendees, representing 38 jurisdictions, and 13 international and regional bodies. Three new jurisdictions, namely, the Cook Islands, Macau and Niue, were admitted as APG members at the meeting, bringing the APG's total membership to 22. The APG also included eight observer jurisdictions. The 4th APG meeting discussed:

- Four mutual evaluation reports on member jurisdictions;
- Current and future typologies workshops on money laundering methods and counter measures;
- International and regional co-operation; and
- Global anti-money laundering initiatives.

In accordance with the APG membership, member jurisdictions commit themselves to participate in mutual evaluations. The mutual evaluation process gives recognition when standard benchmarks are met, and identifies the areas for improvement. Malaysia was evaluated by the APG during the year. The APG and the Offshore Group of Banking Supervisors jointly evaluated the Labuan IOFC separately as an offshore regime (2-6 April 2001). The APG also evaluated Malaysia's anti-money laundering programme on 9-12 July 2001. The evaluators met the various government agencies and financial institutions in Malaysia during their mission. The mutual evaluation report on Malaysia will be presented for discussion and acceptance at the 5th APG Annual Meeting in June 2002.

During the year, Malaysia participated in the APG's Mutual Evaluation Training Workshop in Bangkok and the Money Laundering Methods Typologies

Workshop in Singapore. Malaysia also became a member of the APG Working Group on Information Sharing. The primary objective of this Working Group was to make recommendations for improving the efficiency and effectiveness of information sharing between jurisdictions, in terms of accuracy, timeliness and reciprocity.

BILATERAL CO-OPERATION

Bilateral Payments Arrangement

During the year, BNM continued to promote the Bilateral Payments Arrangement (BPA) as part of Malaysia's effort to diversify its export markets and to enhance bilateral trade with other developing countries.

BNM also participated in a review on the Palm Oil Credit and Payments Arrangement (POCPA), which was under the purview of the Ministry of Primary Industries. The review was conducted in the wake of an over-supply situation in the palm oil industry, which resulted in historically low prices for palm oil. To promote the POCPA scheme, the counter trade arrangement was introduced as an alternative to cash settlement. In addition, the new POCPA credit would be offered on a revolving basis for three years, during which the recipient country could roll over the credit upon repayment within a stipulated period of time.

BNM Technical Assistance and Information Exchange

In 2001, BNM continued to actively promote closer co-operation with other central banks and monetary authorities, as well as with foreign public and private sector institutions in line with the Bank's policy to share its experience and interact with interested parties.

During the year, BNM received 58 foreign delegations for **discussions, study visits and attachment programmes.** The delegations were from the central banks, government agencies and other public and private sector organisations of Africa, Asia, Europe, North America and Oceania. Interest was focused on various aspects of central banking, including investment and treasury operations, payment system, monetary and financial policy, bank regulation, bank supervision, information technology, exchange control, currency management and operations, human resource management and training and Islamic banking.

In May 2001, BNM launched a two-year Technical and Training Arrangement Programme, at the request of the State Bank of Pakistan. Funding for the programme was provided by the Asian Development Bank. The programme included an attachment arrangement for officials of the State Bank of Pakistan in Kuala Lumpur.

Sixteen participants from the central banks of the African, Asian, European and North American continents joined mid-level BNM officers for the **20th Central Banking Course** conducted by BNM in Kuala Lumpur on 10-29 September 2001. Financing for the participants was provided under the Malaysian Technical Co-operation Programme. To date, a total of 166 participants from 64 foreign central banks had attended this programme. The course, covering topics such as monetary and financial policy formulation and the role of the central bank in regulating the financial system, was structured to prepare officers for their career as central bankers. At the end of the programme, participants are expected to have gained a broader perspective beyond their own areas of work.

In 2001, BNM hosted three **annual bilateral meetings** in Kuala Lumpur, with the Bank of Thailand, the Hong Kong Monetary Authority and the Monetary Authority of Singapore. These bilateral meetings were considered important as they provided an opportunity for an exchange of views and sharing of experiences at a closer level. The meetings contributed to the strengthening of co-operation and ties between BNM and the other central banks. Among the issues discussed at these meetings were the implications of the recent global economic developments; policy strategies and common risks in macro-economic management; exchange rate developments; performance of the banking system; and risk management.

Organisation and Personnel

Organisation and Personnel

ORGANISATIONAL DEVELOPMENT & HUMAN RESOURCE MANAGEMENT

The year 2001 witnessed significant advancement in the efforts to develop the capacity and capabilities of the Bank as an organisation to be in a position to respond effectively to a changing environment. A key development is the process of institutionalising knowledge management (KM) concepts and practices that will ensure the Bank's decision-making capabilities are more than able to meet new challenges. As part of this development, the Bank's human resource management policies and practices were revamped to reflect the changing needs of a forward-looking knowledge based organisation (KBO). Significant investments were also made in upgrading the information and communication technology (ICT) infrastructure and processes to promote operational efficiency as well as to support the Bank's growing need for information and knowledge. Finally, changes were also made to the reporting structure to promote greater operational effectiveness and efficiency in executing the Bank's role and functions.

In line with these initiatives, three new departments were created to discharge the Bank's new responsibilities. These departments were the Development Financial Institution Regulation Department, the Financial Intelligence Unit (FIU) and the Corporate Communications Department (CCD). The Development Financial Institution Regulation Department will serve as a one-stop centre to formulate policies, process applications and handle strategic operational issues for development financial institutions (DFI) and ensure the orderly development of the DFI sector in Malaysia particularly in promoting the efficiency and soundness of the sector. The FIU will be responsible for facilitating the implementation and enforcement of the Anti-Money Laundering Act (AMLA) 2001 nationwide and co-operation with other countries in the global fight against money laundering and serious financial crimes. The CCD on the other hand, will be responsible for managing the communications and dissemination of information on important areas of the Central Bank and financial developments and policies.

As part of the Bank's continuous efforts to maintain a cadre of talented officers and managers, the human resource practices are periodically benchmarked against other leading world class organisations. The year 2001 saw the introduction of several bold and highly innovative policies. These policies reflected the changes in both staff composition as well as expectations within the Bank. The Bank now has a rapidly growing pool of young, highly skilled and dynamic officers. It is reflected in the BNM Flex Plan, which forms the new compensation scheme effective 1 March 2002. The BNM Flex Plan is a benefits plan that provides staff the choice and flexibility to customise selected benefits that takes into account the changing and diverse individual needs throughout the different stages of their career path in the Bank.

To develop the next generation of managers and leaders, a comprehensive Mentoring Programme was also introduced during the year. The programme was launched on 10 January 2002. Mentoring aims to nurture future leaders in the Bank and enhance staff personal development. The relationships that are built through mentoring will also help in preserving many of the time honoured values and beliefs that have been the foundations of this organisation.

Organisational development efforts have also been geared towards further improving performance. In line with the changes taking place in the Bank, the **Performance Management System** (a.k.a. PRIME - Performance Review in Managing Excellence) was refined to further improve its implementation and effectiveness.

Changes were made to the PRIME system, the performance appraisal system, designed to reflect the importance of individual competencies for upward movements along a career path. Equally, the system recognises that performance is measured through the achievement of corporate goals. While short-term rewards are linked directly to achievement of goals, long term rewards are linked to development of necessary competencies. The Bank has introduced the **Staff Assistance Programme (ASSIST)** to complement the performance management system to ensure minimum expected performance targets are being achieved.

The Bank also recognises talent through a formal **Recognition Award**. During the annual dinner held on 8 September 2001, **6 winners** received the bank wide **Recognition Award** for Excellent Performance, Teamwork, Quality Service, Leadership, Sports/Social and Academic Achievement. The recognition programme has also been extended down the organisation to further nurture the culture of excellence at the departmental level in line with the spirit of empowerment.

The Bank has also enhanced its succession-planning programme to ensure continuity and availability of experienced and competent staff for key positions. The pool of possible successors has been enlarged, and a more comprehensive development programme created to equip the Bank's future leaders with the necessary skills and knowledge. The Bank is also improving its **Recruitment, Assessment and Selection process** to meet its staffing requirements for the future.

The Board of Directors extends its deepest appreciation to all Bank staff for their continuous hard work, dedication and commitment in the year 2001.

Awards

The Board congratulates the Governor, Tan Sri Dato' Dr. Zeti Akhtar Aziz on being conferred the **Pingat Panglima Setia Mahkota** (P.S.M) on the occasion of the birthday of His Majesty, the Yang di-Pertuan Agong on 2 June 2001.

The Board extends its congratulations to Datuk Latifah Merican Cheong on being conferred the **Darjah Mulia Seri Melaka** (D.M.S.M.) on the occasion of the birthday of His Excellency, the Yang di-Pertua Negeri Melaka on 13 October 2001.

The Board also congratulates Encik Hamzah bin Abu Bakar on being conferred the **Pingat Pekerti Terpilih** (P.P.T.), Encik Nasaruddin bin Sulaiman, Puan V. Vijayaledchumy, Puan Azmah binti Abd Karim and Puan Alizah binti Ali on being conferred the **Pingat Jasa Kebaktian** (P.J.K.) on the occasion of the birthday of His Royal Highness, the Sultan of Selangor Darul Ehsan on 10 March 2001, Encik Che Sab bin Ahmad on being conferred the **Kesatria Mangku Negara** (K.M.N.) on the occasion of the birthday of His Majesty, the Yang di-Pertuan Agong on 2 June 2001 and **Pingat Kelakuan Terpuji** (P.K.T.) on the occasion of the birthday of His Excellency, the Yang di-Pertua Negeri Pulau Pinang on 14 July 2001, Puan Khalijah binti Hashim on being conferred the **Ahli Mangku Negara** (A.M.N.) on the occasion of the birthday of His Majesty, the Yang di-Pertuan Agong on 2 June 2001, Puan Goh Hooi Choo on being conferred the **Pingat Bakti Setia** (P.B.S.) on the occasion of the birthday of His Excellency, the Yang di-Pertua Negeri Pulau Pinang on 14 July 2001, Encik John Teo and Encik Mukhtar bin Yusof on being conferred the **Pingat Jasa Kebaktian** (P.J.K.) on the occasion of the birthday of His Royal Highness, the Sultan of Terengganu Darul Iman on 20 July 2001 and Encik Aziz @ Abdul Aziz bin Abdul Manaf on being conferred the **Darjah Seri Melaka** (D.S.M.) on the occasion of the birthday of His Excellency, the Yang di-Pertua Negeri Melaka on 13 October 2001.

Retirement

The Board wishes to place on record its appreciation and gratitude to the **28 retirees** who have rendered loyal and dedicated service to the Bank. The staff who retired from the services of the Bank in 2001 are listed in Table 6.1.

Manpower

The Bank's staff strength as at 31 December 2001 was **2049**. This staff strength represents staff in the Head Office, six branches in Pulau Pinang, Johor Bahru, Kota Kinabalu, Kuching, Kuala Terengganu and Shah Alam, the representative offices in London and New York and the Human Resource Development Centre (HRDC) in Petaling Jaya.

Staff Training

The main objective of the staff training programs in 2001 was to close the performance gaps of staff. Training and learning interventions therefore focused on building upon existing skills to enhance capacity for sound diagnostic and implementation skills in order to fulfill the functions of the Bank with greater effectiveness. In this regard, the HRDC implemented several new initiatives aimed at ensuring that the training programs lead to higher levels of performance. These initiatives include:

- The development of a comprehensive Structured Modular Program for the Bank's core competencies. The Bank identified these competencies as the minimum management skills required for all staff in order for them to function effectively in a K-driven economy. These competencies are part of the Bank's performance assessment criteria, Performance Review in Managing Excellence (PRIME).

Table 6.1
List of Retirees

No	Name	Department/Branch
1	Datuk Dr. Awang Adek bin Hussin	Governor's Office
2	Puan Zaini binti Osman	Governor's Office
3	Puan Azizah binti Haji Talib	Corporate Services Department
4	Encik Juraimi bin Slamat	Currency Management and Operation Department
5	Encik Maraiah a/l Maradiah	Currency Management and Operation Department
6	Encik Shaari bin Mohd Shah	Currency Management and Operation Department
7	Encik Wan Ibrahim bin Embong	Currency Management and Operation Department
8	Encik Thangathurai a/l Kumaravelu	Finance Department
9	Cik Vijiah Ranjini Rethna Boi d/o E V Joseph	Human Resource Development Centre
10	Encik Chang Kum Weng	IT Services Department
11	Encik Sheikh Ismail bin S.M.Omar	IT Services Department
12	Puan Yim Siew Yean	IT Services Department
13	Encik Md Ghazali bin Kalam	Payment Systems Department
14	Encik Jamaludin bin Usoh	PPPM Shah Alam
15	Encik Maksom bin Kasan Widi	Property and Services Department
16	Encik Abdullah bin Ahmad	Pulau Pinang Branch
17	Encik Mohd. Zafarula Khan bin Mohd. Shariff	Pulau Pinang Branch
18	Encik Sabaruddin bin Said	Pulau Pinang Branch
19	Encik Abdul Halik bin Sarbini	Security Department
20	Encik Aladin bin Mohd Tahir	Security Department
21	Encik Baharom bin Yusof	Security Department
22	Encik Kasim bin Ahmad	Security Department
23	Encik Shahrudin bin Ahmad	Security Department
24	Encik Mohd. Kambar bin Mohd. Salleh	Kota Kinabalu Branch
25	Encik Abu Samah bin Abu Bakar	Kuala Terengganu Branch
26	Encik Ismail bin Abdullah	Kuala Terengganu Branch
27	Encik Mamat @ Ariffin bin Hj Mahmmud	Kuala Terengganu Branch
28	Encik Abas Anak Rebi	Kuching Branch

The skills included in this program address the various levels of competency requirements that are suitable for staff of various job ranks.

- The creation of a centralised Training and Development Committee. This Committee provides the guidance and focus for the overall goals and direction of training and learning taking place within the Bank.

- The carrying out of a comprehensive and systematic exercise in Training Needs Analysis (TNA) to more accurately gauge current and future staff training needs for technical skills. This, together with support from the Training and Development Committee, provided the basis to adjust training programmes to encompass specific requirements of line departments.

In closing the performance gaps of staff, efforts were made to ensure that training and learning interventions contributed towards expanding the technical and non-technical skills of staff to reinforce the mission, objectives and shared values of the Bank.

In this environment, the bankwide training programmess organised by the HRDC in 2001 catered to the development of core functional and management skills. A total of 77 programs was conducted by HRDC at a total training cost of RM1.4 million. The focus of the training programs was centred on upgrading functional skills and learning of new skills necessary to support the Bank's policy formulation and supervisory role as well as strategic projects of the Bank. Several of the projects were undertaken to formulate strategies for the Bank to implement its new mandates, including the supervision and regulation of development financial institutions and the implementation of the Anti-Money Laundering Act. The HRDC also assisted in implementing decentralised training, managed by line departments. Such training focused on building specific technical skills to support each department's functions and business goals. Total investments in training managed by HRDC and the line departments amounted to RM5.2 million in 2001.

RISK MANAGEMENT IN BANK NEGARA MALAYSIA

In 2001, the Bank continued its efforts to enhance its risk management structure and practices, in line with its risk management policy issued in the previous year. The objective of the policy is to have in place sound policies and operations through the maintenance of safe, relevant and efficient work processes and procedures; protection of its assets, including people; and the efficient use of resources. Information and its effective communication are also key to the attainment of the policy objective.

Risk Management Structure

During the year, the Bank set up the Risk Management Committee (RMC) as the apex of the risk management governance structure. The RMC, comprising the executive management, addresses strategic risk issues, oversees the management of risk that has been delegated to the line departments and drives the risk management work in the Bank. The RMC assists the Board in discharging its governance responsibilities with respect to risk management.

The RMC, which meets at least once every quarter, provides a high level platform for a focused consideration and deliberation of all relevant issues on risk management practices in the Bank. The RMC ensures that there is regular upward reporting of risk issues and risk and control positions of the departments, as well as the downward communication to departments to address existing or potential risks.

Risk Management Practices

As a measure to maintain the relevance and safety of work processes, departments are required to report annually to Management a review of their processes and assessment of the state of their risks and controls. In the report, they are required to also propose action plans for the improvement of existing controls or the implementation of new ones. In addition, the requirement for reporting formalises the process for escalating potential risk issues to Management.

From the line departments' reports the RMU reports its assessment on the state of risk and controls. The objective of the assessment is to ensure that the risk management practices at the department level are not only in place but are functioning. In 2001, to improve the efficiency in monitoring of operational risk position of the Bank, the RMU also identified key risk indicators (KRIs) for monitoring. The purpose of the KRIs is to alert departments and Management on directional changes to operational safety and efficiency.

Financial Risks

Undertaking its responsibilities in reserve management operation, the Bank is exposed to a number of financial risks, which are credit, market and operational risks. These risks are managed daily by the Bank's Middle Office, a unit that is separate from the dealing function, to ensure that the risk exposures remain within acceptable levels. In ensuring that the Bank's risk management effort in its reserve management operations remain relevant and effective, the Middle Office carries out periodic review of the existing operational procedures, investment guidelines and policies in relation to market developments to account for changes in risk factors.

a. Credit Risks

The Bank's exposure to credit risk is kept to a minimum by stringent policies on high credit standards required for the admission of counterparties, as well as, permissible investments, which are mainly limited to highly-rated government securities. Credit exposures are continuously monitored against limits approved in accordance with the Bank's credit policies. The Middle Office periodically reviews the adequacy of the counterparties' credit limits and its usage pattern to proactively manage counterparty exposures. Continuous effort is put in to achieve optimum diversification and avoid concentration of risk in the Bank's exposure to counterparty credit risk through the rationalisation of limits and admission of new qualified counterparties, whilst taking into account the needs of the reserve management operations.

b. Market Risks

In managing its reserves, the Bank is guided by its Benchmark policies, which incorporates the Bank's objectives of holding reserves and its risk tolerance. The benchmark allocations in terms of asset classes, currency mix and duration are periodically reviewed to ensure that they continue to represent the optimal risk/return trade-off whilst meeting the Bank's reserve management objectives. A relative Value-At-Risk measure is used to quantify the excess market risk for deviations from the Benchmark allocations to take advantage of expected changes in market conditions. Such deviations are made within the limits set by the Bank's Board. To enhance the Middle Office's risk management and performance measurement capabilities, the Bank had in 2001 commenced the implementation process of its new treasury system. With the enhanced system, the Bank's benchmark would be maintained on-line in the treasury system to allow the dealers to conduct their analysis, stress testing and track their current market risk exposure.

c. Operational Risks

The Middle Office works with the Back Office (which handles the settlement of trades and performs the accounting function) to address the operational risks arising from the Bank's dealing activities in a more comprehensive manner. Outstanding trades are tracked and irregularities in the settlement of trades are studied in detail to uncover weaknesses that may be attributed to the operational procedures within the dealing operations. As operational risks may arise directly or indirectly through inadequate controls, human errors and system malfunctions, it is vital that the source of the operational risk is uncovered so that appropriate action is taken to effectively eliminate minimise the recurrence of operational lapses. Operational lapses are formally tracked by the Middle Office with detailed explanation on the causes and recommendations for improvements in the operational controls and procedures. In addition, statistics are maintained to track the different type of operational errors to gauge whether the new improved controls introduced are effective. Statistics on errant counterparties that have contributed to trade settlement problems are also maintained to provide an input into the yearly counterparty review exercise. With the implementation of the Bank's enhanced treasury system, existing controls and operational procedures would be automated to further strengthen the management of operational risks in the Bank's reserve management operations. To ensure that adequate internal controls are in place, periodic review of the existing workflow is undertaken.

Policy Risks

In improving the management of policy risks, the Bank rationalised the composition of the various policy working groups and their terms of reference. To address more effectively the management of policy risks, active formal and informal cross-functional consultations have been incorporated in the process of policy formulation. This process extends from policy design to post-implementation stage to enhance the prospect for policy objectives to be achieved.

Disaster Recovery Measures

The backup facilities of the systems for trading, settlement and cheque clearing at the remote recovery centre undergo regular and frequent testing. For the most critical systems, live runs are conducted to ensure people and system preparedness and data availability. The RMU continued to assess and report to Management on the performance of the test and live runs conducted at the remote Recovery Centre.

Inculcating a risk management culture

The Bank continued to enhance the staff's knowledge on risk and risk management concepts and practices, to be well-informed on the developments in the area. Seminars and courses, and sessions on risk management is a regular feature in the Induction Programme for new recruits to inform them of the risk management approach and requirements in the Bank and their role and responsibilities in managing risks at work. The current risk management structure and practices in the Bank have evolved to the present formalised and systematic approach of managing risks.

BANK NEGARA MALAYSIA
Organisation Structure

- **BOARD OF DIRECTORS**
  - **GOVERNOR** – Dr. Zeti Akhtar Aziz
    - Public Relations Adviser to Governor – Zailah Tun Dr. Ismail
      - Corporate Communications – Vacant
    - Secretary to the Board – Mohd Nor bin Mashor
    - **DEPUTY GOVERNOR** – Dato' Huang Sin Cheng
      - Special Investigation – Che Sab bin Ahmad
      - Financial Intelligence – Koid Swee Lian
      - **ASSISTANT GOVERNOR** – ECONOMICS – Datuk Latifah Merican Cheong
        - Monetary and Financial Policy – Ismail bin Alowi
        - Economics – V. Vijayaledchumy
        - International – Tan Sook Peng
        - Foreign Exchange Administration – Mahdi bin Mohd. Ariffin
        - Statistical Services – Chan Yan Kit
      - **ASSISTANT GOVERNOR** – INVESTMENT AND OPERATIONS – Vacant
        - Investment Operations and Financial Market – Muhammad bin Ibrahim
          - New York Rep. Office
          - London Rep. Office
        - Finance – Abdul Aziz bin Abdul Manaf
        - Legal – Gopala Krishnan Sundaram
      - **ASSISTANT GOVERNOR** – ORGANISATIONAL DEVELOPMENT – Dato' Mohamad Daud bin Hj. Dol Moin
        - IT Services – Hong Yang Sing
        - Human Resource Management – Mainor bin Awang
        - Human Resource Development Centre – Lim Lai Hong
        - Strategic Planning – Mior Mohd Zain bin Mior Mohd Tahir
        - Corporate Services – Mohd Nor bin Mashor
        - Security – Che Norudin bin Che Alli
        - Currency Management and Operations – Hor Weng Keng
          - Branches (6)
    - **DEPUTY GOVERNOR** – Dato' Mohd Salleh bin Haji Harun
      - Internal Audit – Yahaya bin Haji Besah
      - **ASSISTANT GOVERNOR** – SUPERVISION – Datuk Zamani bin Abdul Ghani
        - Bank Supervision I – Azizan bin Haji Abd Rahman
        - Bank Supervision II – Donald Joshua Jaganathan
        - Insurance Supervision – Wong Yew Sen
        - Information Systems Supervision – Ramli bin Saad
        - Payment Systems – Ahmad Hizzad bin Baharuddin
        - Property and Services – Zulkifli bin Abd Rahman
      - **ASSISTANT GOVERNOR** – REGULATION – Mohd Razif bin Abd Kadir
        - Bank Regulation – Nor Shamsiah binti Mohd Yunus
        - Insurance Regulation – Zakaria bin Ismail
        - Islamic Banking and Takaful – Bakarudin bin Ishak
        - Risk Management – Teo Kee Tian
        - DFI Regulation – Che Zakiah binti Che Din

Annual Accounts

Balance Sheet as at 31 December 2001

CERTIFICATE OF THE AUDITOR GENERAL ON THE FINANCIAL STATEMENTS OF BANK NEGARA MALAYSIA FOR THE YEAR ENDED 31 DECEMBER 2001

I have audited the Balance Sheet of Bank Negara Malaysia as at 31 December 2001 and the Profit and Loss Appropriation Account for the year then ended. These financial statements are the responsibility of the management of Bank Negara Malaysia. My responsibility is to express an opinion on these financial statements based on my audit.

2. I conducted my audit in accordance with the Audit Act 1957 and in accordance with International Standards on Auditing. These standards require an audit be planned and undertaken to obtain reasonable assurance that the financial statements are free of material misstatement. The audit includes examining on a test basis, evidence supporting the amounts and disclosures in the financial statements. It also includes assessment of the accounting principles used as well as evaluating the overall presentation of the financial statements.

3. In my opinion, the financial statements give a true and fair view of the state of financial affairs of Bank Negara Malaysia as at 31 December 2001 and of the results of its operations for the year then ended.

(DATUK DR. HADENAN BIN ABDUL JALIL)
AUDITOR GENERAL

PUTRAJAYA
14 MARCH 2002

STATEMENT BY DIRECTORS

We, Zeti Akhtar Aziz and Datuk Oh Siew Nam, being the Chairman and one of the Directors of Bank Negara Malaysia, do hereby state that in the opinion of the Board, the accompanying Balance Sheet and Profit and Loss Appropriation Account together with the Notes thereto, are drawn up so as to give a true and fair view of the state of affairs of Bank Negara Malaysia as at 31 December 2001 and of the results of operations for the year ended on that date.

On behalf of the Board,

ZETI AKHTAR AZIZ

CHAIRMAN

8 MARCH 2002
KUALA LUMPUR

On behalf of the Board,

DATUK OH SIEW NAM

DIRECTOR

8 MARCH 2002
KUALA LUMPUR

DECLARATION BY THE OFFICER PRIMARILY RESPONSIBLE FOR THE FINANCIAL STATEMENTS OF BANK NEGARA MALAYSIA

I, Abdul Aziz Abdul Manaf, being the officer primarily responsible for the financial statements of Bank Negara Malaysia, do solemnly and sincerely declare that the accompanying Balance Sheet and Profit and Loss Appropriation Account together with the Notes thereto, are to the best of my knowledge and belief, correct and I make this solemn declaration conscientiously believing the same to be true, and by virtue of the provisions of the Statutory Declarations Act, 1960.

Subscribed and solemnly declared)
by the abovenamed at Kuala Lumpur)
this 8th day of March 2002.)

Before me,

Bank Negara Malaysia

Balance Sheet as at 31 December 2001

LIABILITIES		Note	2001 RM	2000 RM
Authorised Capital	RM200,000,000			
Paid-up Capital		2	100,000,000	100,000,000
General Reserve Fund		3	5,067,022,733	4,860,967,368
Other Reserves		4	18,353,074,749	22,502,935,935
Currency in Circulation			25,385,434,696	26,708,936,975
Deposits:				
Commercial Banks, Finance Companies and Merchant Banks			54,655,303,228	58,153,159,586
Federal Government			25,236,916,020	17,845,321,152
Others		5	10,642,678,946	9,187,717,327
Bank Negara Papers			7,477,409,483	7,084,962,648
Allocation of Special Drawing Rights		6	664,034,013	688,434,713
Other Liabilities			2,096,375,475	1,775,697,797
			149,678,249,343	148,908,133,501

Profit and Loss Appropriation Account for the Year Ended 31 December 2001

	2001 RM	2000 RM
Transfer to General Reserve Fund	206,055,365	368,368,818
Amount Payable to Federal Government	500,000,000	1,000,000,000
	706,055,365	1,368,368,818

Notes on the following pages form part of these accounts.

ASSETS	Note	2001 RM	2000 RM
Gold and Foreign Exchange	7	113,542,290,653	109,835,487,903
International Monetary Fund Reserve Position		3,193,521,377	3,310,871,020
Holdings of Special Drawing Rights		487,814,793	418,681,635
Malaysian Government Papers	8	280,689,715	125,513,697
Deposits with Financial Institutions		1,193,115,000	1,615,727,000
Loans and Advances		8,934,922,674	8,712,001,856
Deferred Expenditure	9	1,141,441,833	1,712,162,748
Other Assets	10	20,904,453,298	23,177,687,642
		149,678,249,343	148,908,133,501

	2001 RM	2000 RM
Net Profit	706,055,365	1,368,368,818
	706,055,365	1,368,368,818

Notes To The Accounts - 31 December 2001

1. **Accounting Policies**

   (a) **Gold, Securities and Investments**
   Gold, securities and investments are stated at cost and provisions have been made for diminution in value as at 31 December 2001.

   (b) **Foreign Currency Translation**
   Assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date. Transactions in foreign currencies during the year have been translated into ringgit at rates of exchange ruling on value dates.

   The US dollar equivalent of the International Reserves comprising Gold and Foreign Exchange, International Monetary Fund Reserve Position and Holdings of Special Drawing Rights at 31 December 2001 was US$30,848.3 million.

2. **Paid-up Capital**
   The entire issued and paid-up capital of RM100 million is owned by the Government of Malaysia.

3. **General Reserve Fund**

	2001	**2000**
	RM	**RM**
As at 1 January	4,860,967,368	4,492,598,550
Net Profit	206,055,365	368,368,818
As at 31 December	5,067,022,733	4,860,967,368

4. **Other Reserves**
   Other reserves comprise the Exchange Rate Fluctuation Reserve and the Contingency Reserve.

5. **Deposits - Others**
   A substantial part of these deposits comprises deposits from Federal Statutory Authorities.

6. **Allocation of Special Drawing Rights**
   International Monetary Fund (IMF) member countries are allocated Special Drawing Rights (SDR) in proportion to their subscriptions to the IMF. The allocation represents a dormant liability of the Bank to the IMF, against which assets are received in SDR from the IMF. The net cumulative of the allocation in SDR amounted to SDR139,048,000.

7. **Gold and Foreign Exchange**

	2001 RM	2000 RM
Foreign Securities	73,906,519,326	49,430,594,309
Foreign Deposits	22,979,839,902	32,481,791,188
Balances with Other Central Banks, Bank for International Settlements (BIS) and IMF	7,584,696,571	18,244,301,173
Others	9,071,234,854	9,678,801,233
	113,542,290,653	109,835,487,903

8. **Malaysian Government Papers**

	2001 RM	2000 RM
Malaysian Government Securities	32,419,715	84,353,697
Government Investment Certificates	248,270,000	41,160,000
	280,689,715	125,513,697

9. **Deferred Expenditure**

This represents the net deficiency arising from foreign exchange transactions in 1993. The Government has undertaken to make good this deficiency as and when required to do so by the Bank. The amount outstanding is being amortised over a period of 10 years, beginning from 1994.

10. **Other Assets**

Other assets include investments in shares and bonds of RM20,788,824,243 acquired under section 30(1)(j) and section 30(1)(oo)(i) of the Central Bank of Malaysia Act 1958 (Revised - 1994).

11. **Contingent Liabilities**

Total contingent liabilities as at 31 December 2001 amounted to RM4,280,564,633. These comprise:-

(a) an amount of RM4,225,348,536 which represents the obligation of the Bank to pay in full, in SDR or other convertible currencies, the amount of Malaysia's quota in the IMF under the Articles of Agreement; and

(b) an amount of RM55,216,097 which represents the uncalled portion of the 3,000 units of shares held by the Bank in BIS. The amount is based on the nominal value (in gold francs) of the uncalled portion and gold price as at the balance sheet date.