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# Monetary and Fiscal Developments

# Monetary and Fiscal Developments

## MONETARY POLICY IN 2005

The conduct of monetary policy in 2005 had the task of balancing the risks to economic growth and price stability. While the Malaysian economy benefited from the sustained expansion in global growth and world trade, the country also faced greater uncertainties arising from developments in the external environment, including higher and more volatile energy prices, volatile short-term capital flows, large payment imbalances, and the gradual removal of monetary accommodation globally. The upward trend in global oil prices led to increases in headline inflation around the world. Globally, monetary authorities increased interest rates in successive steps as high oil prices fed into higher inflation and the build-up of inflationary expectations. Oil importing countries faced deterioration of their current account balances, while the growing burden of oil subsidies in some countries was reflected in their deteriorating fiscal positions. Despite the more challenging global environment, the Malaysian economy showed great resilience amid supportive monetary conditions and the stable financial positions of the corporate, household and banking sectors. Inflation was higher, largely on account of the gradual adjustments to administered prices and the cost-induced adjustments of other prices.

The response of monetary policy to oil price shocks depends largely on the second round inflationary effects in terms of increases in other prices and wages. An exclusive focus on output stabilisation may lead to an inability to anchor inflationary expectations, with wages and prices self-reinforcing. On the other hand, emphasising only on neutralising the impact of oil price shocks on inflation, risks a significant contraction in growth and welfare. Monetary policy, therefore, needs to undertake a careful assessment of both the risks to inflation and economic growth over the medium term. It is the relative balance of these risks that formed the major consideration in the stance of monetary policy for 2005.

At the outset of 2005, a moderate slowdown in external demand was expected in the first half of the year, arising from the continued downcycle of the global semiconductor industry, as well as the global monetary tightening cycle in response to rising inflationary concerns. Domestic GDP growth had moderated to 5.8% in the fourth quarter of 2004. In May, it was evident that the economy had remained resilient in the first quarter of 2005, with GDP expanding by 6.2%. Meanwhile, inflation, as measured by the annual rate of change in the CPI, increased to an average of 2.5% for the first four months of the year, mainly on account of the increases in administered prices and prices of controlled items in late 2004 and early 2005. The inflation rate was expected to edge upwards over the subsequent months, mainly reflecting adjustments in costs, before moderating later in the year.

Following the increases in transportation charges and retail prices of petrol and diesel in May, the inflation rate breached the 3% level and stood at 3.2% at the end of the second quarter. Core inflation, which is indicative of demand-driven inflation, in contrast, registered a more gradual increase in the first half of the year. Real sector and monetary indicators did not suggest that demand pressures were a source of inflationary concern. Consumption and investment activities were holding steady. Bank lending and money supply continued to increase at relatively stable rates. The lack of strong demand pressures allowed monetary policy to continue to remain accommodative to support economic growth.

On the external front, there was an increase in net portfolio flows in the first half of the year, following speculation of a revaluation of the Chinese yuan and ringgit. These inflows, however, were manageable. The Bank sterilised this additional liquidity. There were no signs of excessive credit growth or sharp increases in asset prices.

On 21 July, the Bank adopted a managed float exchange rate regime for the ringgit, with the value of the ringgit being determined by economic fundamentals (See **Exchange Rate Developments**). While the system by which the value of the ringgit is determined was changed, there was no change to the existing monetary policy framework, where the average overnight interbank rate continues to function as the operating target.

At the time of release of the third Monetary Policy Statement in August, the international environment had become more challenging, with increased uncertainty over the likely economic impact of oil prices that had reached new record highs. In the domestic economy, indicators suggested that overt demand pressures had been relatively contained in the second quarter. A more moderate pace of economic expansion of 4.4% was registered during the period. In terms of production capacity, the weighted average of capacity utilisation in

**Table 2.1**
**Monetary Policy Decisions**

The Monetary Policy Comittee (MPC) met eight times in 2005. Monetary Policy Statements (MPS) to convey the policy decision were issued following four of those meetings to coincide with the release of the quarterly GDP data. Since its introduction in April 2004, the OPR remained unchanged at 2.70% until the end of November 2005. On 30 November, the OPR was increased by 30 basis points to 3%.

| MPS Date | Overnight Policy Rate (OPR) |
|---|---|
| 28 February | 2.70% |
| 25 May | 2.70% |
| 24 August | 2.70% |
| 30 November | 3.00% |

the manufacturing sector remained stable at 76%. Furthermore, labour productivity, as measured by real sales value of products per employee in the manufacturing sector, rose by 9.6% while real wage per employee declined by 0.4%. The risks of slower growth and higher inflation respectively appeared to be in balance. Inflation rose to 3.7% in August, following the second increase in administered prices of retail petrol products. The Bank viewed that the cumulative impact of the price adjustments would cause inflation to peak in the third quarter and to moderate thereafter, barring further price adjustments during the year, as the effect of the previous year's price adjustments lapsed. Therefore, although real returns on savings and short-term fixed deposits had turned negative, this situation was not expected to persist for long.

## As growth strengthened and with inflationary pressures remaining strong, the OPR was increased to 3%.

Following the floating of the ringgit, speculative portfolio positions that had been built-up in the first half of the year, started to be unwound in September and continued into October and November. These outflows, however, subsided in December. The unwinding of these flows was orderly. In the debt securities market, local institutional demand was a stabilising force. Price adjustments were orderly in the market for short-term bills and Government securities. The high international reserves level provided sufficient cushion for outflows while the domestic financial system continued to be characterised by a situation of ample liquidity.

Towards the latter part of the year, it became more evident that the growth momentum of the global economy remained intact. The electronics sector showed signs of a pick-up, while domestic demand indicators strengthened. The economy expanded at a higher rate of 5.3% in the third quarter, with the growth momentum expected to continue into the fourth quarter of 2005 and into 2006. Inflation, meanwhile, moderated slightly to 3.3% in October. Core inflation had increased by small increments and was expected to continue to increase at a steady pace going forward. A high level of uncertainty remained with regard to the upside risk to oil prices. With the risk of slower growth diminishing, and inflation risks biased towards the upside, the OPR was raised by 30 basis points to 3% on 30 November 2005. At 3%, the OPR continued to remain below its neutral level, and therefore, remained supportive of economic activity.

### MONETARY DEVELOPMENTS IN 2005

In 2005, monetary conditions remained supportive of domestic economic activity. The OPR was maintained at 2.70% in the first 11 months of the year. Towards the end of the year, with the risk of slower economic growth diminishing and inflation risks biased towards the upside, the OPR was increased by 30 basis points to 3.00% on 30 November 2005.

## Monetary conditions remained supportive of economic activity.

The daily weighted average overnight interbank rate moved in the range of 2.60% – 2.73% and averaged 2.70% over the period January – November 2005.

**Graph 2.1**
**Lending Rates: Commercial Banks and Finance Companies**

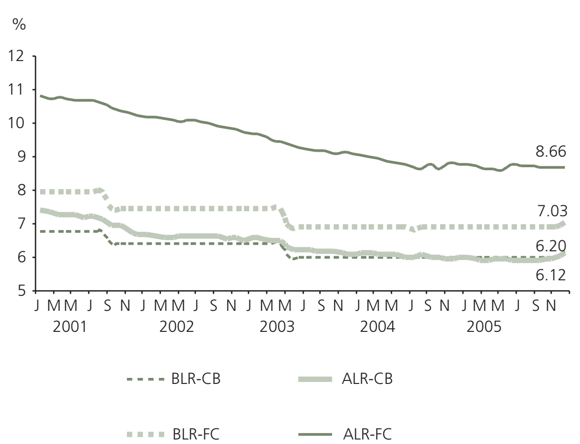


**Table 2.2**
**Interest Rates and Liquidity**

| | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|
| | As at end-period (%) | | | |
| 3-month Intervention Rate | 5.0 | 4.5 | - | - |
| Overnight policy rate (OPR)[1] | - | - | 2.70 | 3.00 |
| Interbank rates | | | | |
| Overnight | 2.71 | 2.72 | 2.69 | 3.00 |
| 1-month | 2.99 | 2.99 | 2.77 | 3.12 |
| Base lending rate (BLR) | | | | |
| Commercial banks | 6.39 | 6.00 | 5.98 | 6.20 |
| Finance companies | 7.45 | 6.90 | 6.90 | 7.03 |
| Average lending rate (ALR) | | | | |
| Commercial banks | 6.51 | 6.11 | 5.98 | 6.12 |
| Finance companies | 9.75 | 9.11 | 8.78 | 8.66 |
| ALR of new loans approved by commercial banks | | | | |
| Business loans | 6.25 | 5.72 | 5.64 | 5.70 |
| *of which: SMEs* | *6.84* | *6.30* | *6.20* | *6.36* |
| Household loans[2] | 4.66 | 4.32 | 4.34 | 4.09 |
| Fixed deposit rates | | | | |
| Commercial banks | | | | |
| 3-month | 3.20 | 3.00 | 3.00 | 3.02 |
| 12-month | 4.00 | 3.70 | 3.70 | 3.70 |
| Finance companies | | | | |
| 3-month | 3.20 | 3.00 | 3.00 | 3.00 |
| 12-month | 4.00 | 3.68 | 3.70 | 3.70 |
| Savings deposits rates | | | | |
| Commercial banks | 2.12 | 1.86 | 1.58 | 1.41 |
| Finance companies | 2.65 | 2.18 | 1.98 | 1.53 |
| | Average during the period (%) | | | |
| Nominal interest rate differential | | | | |
| Malaysia ñ United States | 1.31 | 1.66 | 1.16 | -0.77 |
| Malaysia ñ Singapore | 2.15 | 2.14 | 1.79 | 0.57 |
| | As at end-period (RM billion) | | | |
| Resource surplus (+) / gap (-) | 76.2 | 106.0 | 134.8 | 155.6 |
| Adjusted resource surplus (+) / gap (-)[3] | 24.6 | 45.9 | 77.0 | 98.6 |
| | As at end-period (%) | | | |
| Loan-deposit ratio | 84.9 | 80.9 | 78.4 | 77.5 |
| Financing-deposit ratio[3] | 95.1 | 91.7 | 87.7 | 85.8 |

[1] OPR replaced 3-month intervention rate as Bank Negara Malaysia's policy rate from 26 April 2004.
[2] Excludes credit cards.
[3] Adjusted to include holdings of Private Debt Securities.

Following the increase in the OPR, the daily weighted average overnight interbank rate rose in December, to move within a tight band of 2.97% – 3.01%, averaging 3.00%. Interbank rates of other tenures, namely the 1-week, 1-month and 3-month maturities, which had shown mild upward trends since April on market expectations of an increase in the OPR, rose by 23 – 32 basis points in December.

With domestic interest rates unchanged for most of the year, interest rate differentials between domestic and US rates turned negative in February and continued to widen as the US Federal Funds rate steadily increased. Notwithstanding this development, domestic liquidity continued to increase amid sustained inflows from the external sector. These inflows mainly reflected the repatriation of export earnings and foreign direct investment, and were also reinforced by significant inflows of portfolio investment in the first half of the year. The large inflows of short-term funds were in part, driven by expectations of a change in the ringgit exchange rate regime. These speculative flows were largely unwound in September through November, and subsided by December. In view of the magnitude and volatility of these flows, Bank Negara Malaysia's money market operation was to ensure that conditions in the domestic financial markets remained orderly.

In terms of retail interest rates, the average base lending rates (BLRs) of commercial banks and finance companies remained unchanged at 5.98% and 6.90% respectively over the period January to November. Following the increase in the OPR, most banking institutions adjusted their BLRs upwards in the range of 25 – 30 basis points. Consequently, the average BLRs of commercial banks rose to 6.20% at end-December. Meanwhile, the average lending rates (ALRs) of commercial banks and finance companies, weighted by outstanding loans, were relatively stable with a modest upward tendency over the period January to November. The merger of two large finance companies with their respective commercial banks resulted in some technical adjustment to the ALRs of the latter, which in turn had a marginal upward impact on the overall ALR for commercial banks. Following the adjustment to BLRs after the policy rate increase, the ALR of commercial banks rose to 6.12%.

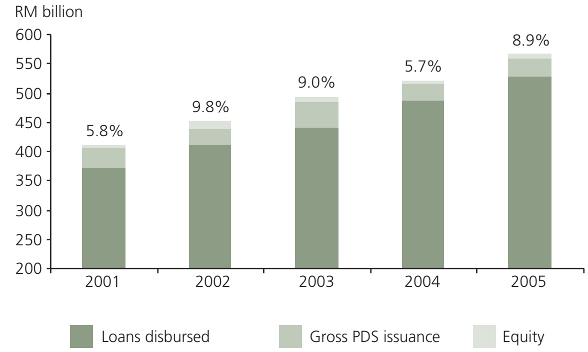
Meanwhile, the ALRs on new loans approved indicated that financing costs in general, were marginally lower for businesses (including SMEs) and households for most of the year compared with 2004. This was notwithstanding the slight upward trend in interest rates on loans approved to the household sector in the second half of the year.

In terms of retail fixed deposit (FD) rates, adjustment to the rates were made by a number of banking institutions. These adjustments were concentrated in the middle tenures, such as the 6-month and 9-month maturities while the rates for the 1-month and 12-month maturities were mostly unchanged at 3.00% and 3.70%. The slower response of deposit rates to the change in the OPR, relative to lending rates, reflected the continued prevalence of ample liquidity in the financial system. This was also reflected by the lower loan-deposit and financing-deposit ratios at 77.5% and 85.8% respectively as at end-2005 (2004: 78.4% and 87.7% respectively).

With accommodative monetary conditions, there was continued growth in financing of the private sector during the year. Gross financing extended through the banking system and capital markets expanded by 8.9% in 2005 (2004: 5.7%), with higher loan disbursements and higher funds raised in the private debt securities (PDS) market. On a net basis, banking system loans and PDS outstanding rose at a combined annual rate of 9.3% at end-2005 (8.6% at end-2004).

Bank lending activity expanded further in 2005. Demand for new credit continued to increase, albeit more moderately, as reflected in new loan applications, which rose by 11.7% (2004: 20.1%). The ratio of new approvals to applications, meanwhile, remained relatively stable with new loan approvals amounting to RM193.4 billion or an annual increase of 11.4% (2004: 13.6%). Loan disbursements increased by 8.4% (2004: 10.6%), significantly exceeding loan repayments, and providing momentum to the steady increase of 8.6% in loans outstanding at end-2005 (2004: 8.5%).

**Graph 2.2**
**Private Sector Gross Financing through the Banking System and the Capital Market**




Trends in the loan indicators were reflective of developments in the real sector; with resilient growth in private consumption and investment, and the services sub-sector being the main growth driver. Growth in demand for new bank loans was observed across most business sub-sectors, with total new loan applications increasing at a more moderate rate of 5.7% in 2005 (2004: 20%). By economic sub-sectors, the slower pace of growth in new business loan applications was mainly attributable to a decline in applications from the construction sector, as well as slower increases in applications from the manufacturing sector; the wholesale and retail trade, restaurants and hotels sector; and for the purchase of non-residential property. Notwithstanding the more moderate increase in applications, growth in new loan approvals was stable at 9.8% while loan disbursements increased by 7.4% (2004:10.5%), with higher or sustained disbursements recorded to most of the business sectors. In particular, the growth in total business loan disbursements was mainly from loans to the wholesale and retail trade, restaurants and hotels sector, which increased by 16.5% on an annual basis.

During the year, corporate financial conditions remained healthy as reflected by indicators such as profitability, leverage and corporate savings. Capital expenditure

**Table 2.3**
**Banking System[1] : Loan Indicators**

| | During the year (RM billion) | | | | | Annual growth (%) | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 2001 | 2002 | 2003 | 2004 | 2005 | 2001 | 2002 | 2003 | 2004 | 2005 |
| **Total** | | | | | | | | | | |
| Loan applications | 190.6 | 217.2 | 227.6 | 273.3 | 305.4 | -8.7 | 14.0 | 4.8 | 20.1 | 11.7 |
| Loan approvals | 125.6 | 137.6 | 152.8 | 173.6 | 193.4 | -6.8 | 9.5 | 11.1 | 13.6 | 11.4 |
| Loan disbursements | 373.5 | 411.6 | 441.5 | 488.2 | 529.3 | 3.5 | 10.2 | 7.3 | 10.6 | 8.4 |
| Loan repayments | 365.4 | 402.7 | 430.4 | 461.6 | 489.2 | 5.3 | 10.2 | 6.9 | 7.3 | 6.0 |
| Change in loans outstanding[2] | 16.1 | 19.8 | 21.6 | 40.1 | 44.2 | 3.9 | 4.6 | 4.8 | 8.5 | 8.6 |
| **Businesses** | | | | | | | | | | |
| Loan applications | n.a. | 135.3 | 124.9 | 149.9 | 158.5 | n.a. | n.a. | -7.7 | 20.0 | 5.7 |
| Loan approvals | 63.5 | 68.5 | 77.3 | 84.9 | 93.2 | -19.7 | 7.9 | 12.8 | 9.8 | 9.8 |
| Loan disbursements | 270.4 | 282.0 | 303.3 | 335.3 | 360.1 | 0.1 | 4.3 | 7.6 | 10.5 | 7.4 |
| Loan repayments | 276.8 | 275.8 | 299.5 | 319.8 | 343.7 | 2.8 | -0.4 | 8.6 | 6.8 | 7.5 |
| Change in loans outstanding[2] | -5.6 | -3.1 | -5.2 | 5.5 | 6.5 | -2.5 | -1.4 | -2.4 | 2.6 | 3.0 |
| **SMEs** | | | | | | | | | | |
| Loan applications | n.a. | 48.7 | 44.5 | 54.2 | 59.7 | n.a. | n.a. | -8.6 | 21.7 | 10.3 |
| Loan approvals | n.a. | 30.7 | 25.9 | 31.6 | 35.8 | n.a. | n.a. | -15.5 | 22.0 | 13.1 |
| Loan disbursements | n.a. | 49.5 | 87.1 | 100.4 | 110.7 | n.a. | n.a. | 76.0 | 15.3 | 10.2 |
| Change in loans outstanding[2] | 4.0 | ... | 7.4 | 6.3 | 7.7 | 5.7 | ... | 10.0 | 7.7 | 8.7 |
| **Large corporations** | | | | | | | | | | |
| Loan applications | n.a. | 86.6 | 80.4 | 95.7 | 98.8 | n.a. | n.a. | -7.2 | 19.1 | 3.2 |
| Loan approvals | n.a. | 37.8 | 51.4 | 53.3 | 57.4 | n.a. | n.a. | 35.8 | 3.7 | 7.8 |
| Loan disbursements | n.a. | 232.5 | 216.2 | 234.9 | 249.5 | n.a. | n.a. | -7.0 | 8.6 | 6.2 |
| Change in loans outstanding[2] | -9.6 | -3.1 | -12.7 | -0.8 | -1.2 | -6.1 | -2.1 | -8.8 | -0.6 | -0.9 |
| **Households** | | | | | | | | | | |
| Loan applications | n.a. | 81.9 | 98.4 | 120.2 | 141.9 | n.a. | n.a. | 20.2 | 22.1 | 18.0 |
| Loan approvals | 59.2 | 66.9 | 72.0 | 86.8 | 97.2 | 11.5 | 13.0 | 7.6 | 20.5 | 12.0 |
| Loan disbursements | 87.0 | 105.1 | 114.4 | 130.3 | 145.2 | 14.5 | 20.8 | 8.9 | 13.9 | 11.4 |
| Loan repayments | 71.5 | 83.7 | 94.1 | 107.0 | 115.1 | 9.9 | 17.0 | 12.4 | 13.7 | 7.6 |
| Change in loans outstanding[2] | 23.1 | 26.2 | 26.2 | 33.3 | 40.0 | 14.8 | 14.7 | 12.8 | 14.4 | 15.1 |

[1] Includes Islamic banks.
[2] The annual growth is for loans outstanding at end-period.
n.a. Not available
... Negligible

continued to increase, and was supported by internally generated funds as well as financing via bank loans and the PDS market. New loan applications by large corporations increased at a more moderate rate of 3.2% (2004: 19.1%) while loan disbursements rose by 6.2% (2004: 8.6%). Meanwhile, in the PDS market, where borrowing costs remained competitive, funds raised by businesses for new activities increased, and were mainly channeled to the utilities and construction sectors.

Following continued efforts to enhance access to financing by SMEs, loans to this sector continued to expand in 2005, notwithstanding the more challenging environment. SMEs' demand for loans continued to increase as reflected in the increase of 10.3% in new loan applications (2004: 21.7%). Importantly, this growth was closely matched by an increase in loan approvals of 13.1% (2004: 22%). A total of RM110.7 billion loans were disbursed to the sector, representing an expansion of 10.2% on an annual basis, and accounting for a slightly higher proportion of 30.7% of total loan disbursements to businesses.

Notwithstanding some weakening in consumer sentiment during the second and third quarters, household consumption and investment activities generally remained resilient, supported by rising income, stable labour market conditions, and attractive financing options. The year saw a significant rise in passenger car sales, and continued growth in retail sales and imports of consumption goods. The launch of new car models, particularly of national cars, led to a strong increase of 34.4% in loan disbursements for the purchase of passenger cars on an annual basis (2004: 18.8%). Loans disbursed for credit card transactions, meanwhile, increased by 17.6% (2004: 19.1%). At end-2005,

**Graph 2.3**
**Loan Disbursements by Sector: Value and Share**

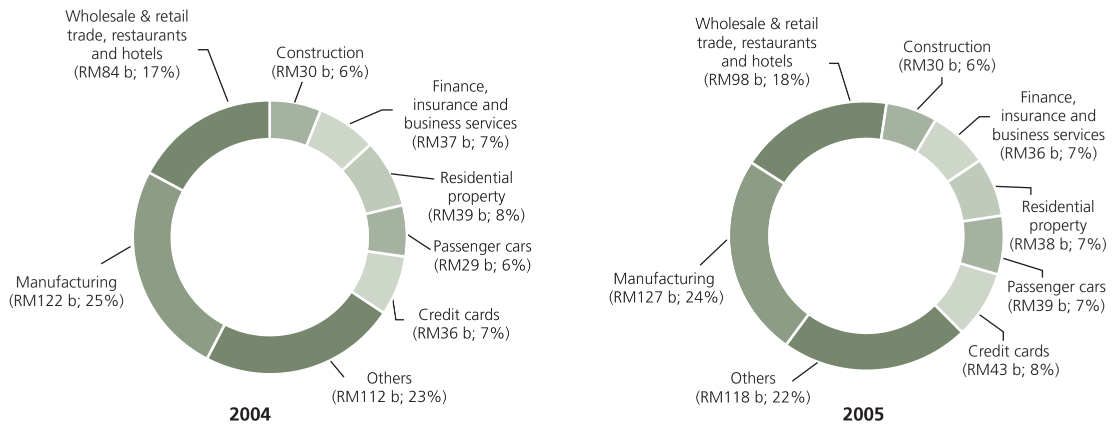



**Table 2.4**
**Banking System[1]: Loans Outstanding**

| | Annual change 2004 | Annual change 2005 | % share of total loans at end 2005 |
|---|---|---|---|
| | RM billion | | |
| **Banking system loans, of which extended to:** | | | |
| Business enterprises | 5.5 | 6.5 | 40.4 |
| Individuals | 33.3 | 40.0 | 54.5 |
| **By sector:** | | | |
| Agriculture, hunting, forestry and fishing | 0.4 | 0.1 | 2.0 |
| Mining and quarrying | -0.1 | -0.2 | 0.1 |
| Manufacturing | 1.9 | -2.4 | 10.9 |
| Electricity, gas and water supply | 0.1 | -0.5 | 0.8 |
| Wholesale and retail trade, restaurants and hotels | 4.3 | 3.6 | 8.4 |
| Broad property sector | 19.7 | 20.5 | 41.0 |
| *Construction* | *1.2* | *-0.7* | *5.4* |
| *Purchase of residential property* | *16.4* | *16.3* | *26.7* |
| *Purchase of non–residential property* | *2.3* | *4.0* | *6.3* |
| *Real estate* | *-0.2* | *1.0* | *2.6* |
| Transport, storage and communication | -0.8 | 1.4 | 2.0 |
| Finance, insurance and business services | 1.7 | -0.8 | 5.4 |
| Consumption credit | 14.6 | 19.4 | 22.1 |
| *of which:* | | | |
| *Credit cards* | *2.0* | *2.5* | *3.0* |
| *Purchase of passenger cars* | *10.6* | *14.4* | *15.5* |
| Purchase of securities | -0.4 | 1.5 | 3.7 |
| Purchase of transport vehicles | -0.8 | 0.4 | 0.5 |
| Community, social and personal services | 0.1 | 0.6 | 1.0 |
| Others | -0.7 | 0.4 | 1.9 |
| **Total loans outstanding[2]** | **40.1** | **44.2** | **100.0** |

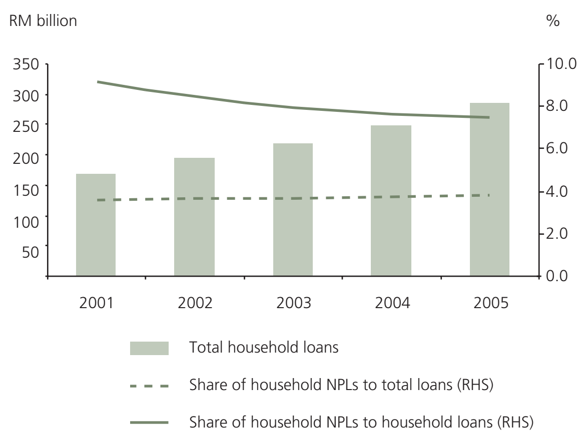
[1] Includes Islamic banks.
[2] Includes loans sold to Cagamas.
Note: Numbers may not add–up due to rounding.

outstanding balances on credit cards amounted to RM16.7 billion, expanding by 17.3% on an annual basis, and accounting for 3% of total banking system loans outstanding.

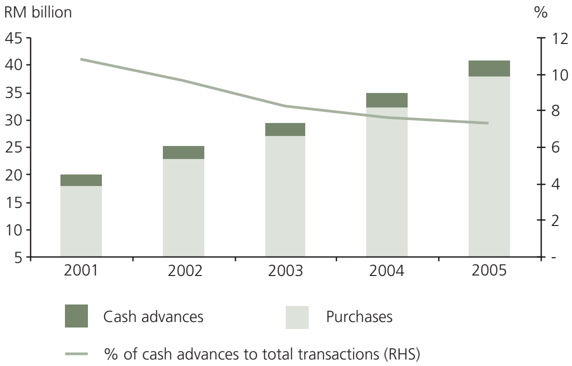
In terms of household investment in residential property, loan disbursements for the purchase of residential property declined marginally by 0.9% (2004: 9.1%), after the strong increase in the previous year, which was driven to some extent, by the home-ownership incentives that was implemented in June 2003 and lapsed in June 2004.

Although lending to households has continued to increase, the debt service burden on an aggregate basis remains manageable for households. Defaults on payments

**Graph 2.4**
**Banking System: Loans to Households (at end-period)**

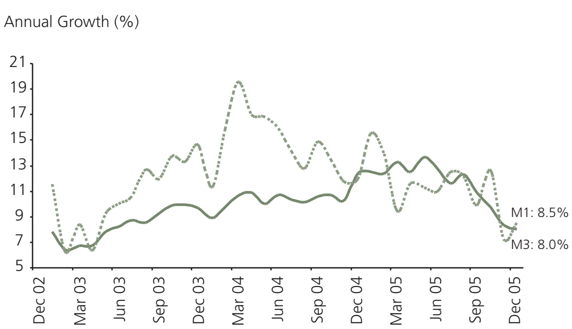


### Graph 2.5
### Aggregate Value of Credit Card Transactions by Malaysian Cardholders




remained relatively stable. Household NPLs as a percentage of total outstanding loans to the household sector displayed a stable trend and stood at 7.5% at end-December 2005 (end-December 2004: 7.6%). Meanwhile, the number of individual bankruptcies declined by 2.4% on an annual basis. Households' net wealth position also remained strong, with indicators such as deposits and other financial investments suggesting that household financial assets continue to exceed household debt. These factors, along with benign trends in house prices, support the sustainability of household consumption and investment activity. The number of overstretched households whose capacity to service and repay loans could be affected by unexpected developments remains small. Prudent lending practices as well as ready access to comprehensive credit information among banks via the Central Credit Reference Information System (CCRIS) has led to improved risk management in the financial sector, which has been important in balancing credit risk exposures.

### Graph 2.6
### Monetary Aggregates




### Table 2.5
### Broad Money, M3

| | Change (RM billion) | |
|---|---|---|
| | 2004 | 2005 |
| **M3** | 68.0 | 49.7 |
| Currency | 2.6 | 1.6 |
| Demand deposits | 10.1 | 8.7 |
| Broad quasi money | 55.3 | 39.4 |
| *Fixed deposits* | *24.7* | *4.9* |
| *Savings deposits* | *6.1* | *1.9* |
| *NIDs* | *8.2* | *12.8* |
| *Repos* | *13.3* | *17.3* |
| *FX deposits* | *3.0* | *2.5* |
| **Determinants of M3** | | |
| Net claims on Government | -15.9 | -5.5 |
| Claims on private sector | 30.6 | 45.4 |
| *Loans* | *39.8* | *45.0* |
| *Securities* | *-9.2* | *0.4* |
| Net external operations | 82.0 | 16.5 |
| *Bank Negara Malaysia* | *75.1* | *28.3* |
| *Banking system* | *6.9* | *-11.8* |
| Other influences | -28.7 | -6.7 |

Nevertheless, as a pre-emptive measure, Bank Negara Malaysia has established the Credit Counseling and Debt Management Agency, which will commence operations in the first quarter of 2006, to address potential credit issues that may be faced by households.

Money supply continued to increase during the year, in tandem with economic and financial developments. Broad money, M3, displayed a relatively stable growth trend in the first half of the year, which subsequently moderated slightly towards end-year. At end-2005, M3 had increased at an annual rate of 8% (end-2004: 12.4%). Higher private sector financing during the year was the main driver of the expansion in M3. In addition, the external sector also contributed to M3 growth, albeit to a lesser extent compared with 2004. In particular, in the last few months of the year, net foreign assets exerted a contractionary impact on M3, reflecting to a large extent, the unwinding of speculative long positions in the ringgit.

Meanwhile, M1, which is a measure of transaction balances, expanded at an annual rate of 8.5% in 2005 (2004: 11.9%), roughly in tandem with the sustained growth of spending activity.

## EXCHANGE RATE DEVELOPMENTS

On 21 July 2005, Malaysia shifted from a fixed exchange rate regime of USD1 = RM3.80 to a managed float against a basket of currencies. The policy shift was taken to better position Malaysia to respond to and benefit from the structural changes occurring in the region. With regional countries becoming increasingly important trading partners to Malaysia, their importance is expected to increase further over time in line with regional efforts to promote closer economic and financial inter-linkages.

The overriding objective of the exchange rate policy continues to be the promotion of exchange rate stability against the currencies of Malaysia's major trading partners. Being a small and highly open economy, a stable exchange rate environment against major trading partners is important to achieve sustainable growth and price stability. Under the managed float system, the ringgit exchange rate is largely determined by ringgit demand and supply in the foreign exchange market. The Central Bank does not actively manage or maintain the exchange rate at any particular level – economic fundamentals and market conditions are the primary determinants of the level of the ringgit exchange rate. In this regard, the Central Bank only intervenes to minimise volatility, and to ensure that the exchange rate does not become fundamentally misaligned.

The ringgit exchange rate regime, and therefore movement in the ringgit exchange rate can be distinguished by two periods in the year 2005. The fixed exchange rate regime of USD1 to RM3.80 was maintained from 1 January – 21 July 2005, as it had been maintained since 2 September 1998. During this period, developments in the ringgit were driven entirely by movements in the US dollar and the consequent realignments of major and regional currencies against the US currency. During 2005, the dollar appreciated against the major currencies amidst expectations of continued increases in the US Federal Funds Rate, which widened yield differentials in favour of the US dollar, as well as on continued expectations that economic growth in the US would outpace that of the euro area and Japan. The US dollar was also supported by sustained demand for US assets by international investors. Regional currencies were, in general, also affected by concerns that higher oil prices would increase import costs and dampen demand for regional exports. Due to the US dollar strength, the ringgit appreciated against the euro (11.9%), pound sterling (10.4%) and Japanese yen (9.7%). Similarly, the ringgit appreciated within the range of 0% - 7.7% against regional currencies, with the exception of the depreciation against the Philippine peso (0.6%).

**Graph 2.7**
**Exchange Rate of the Malaysian Ringgit against Major Currencies**

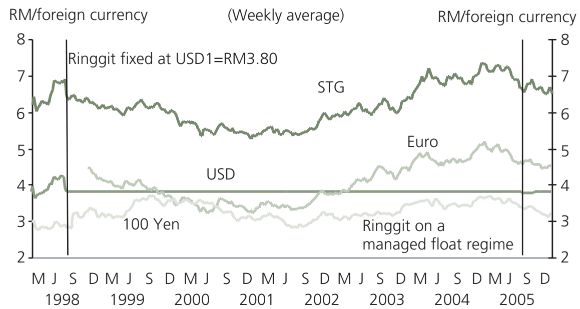
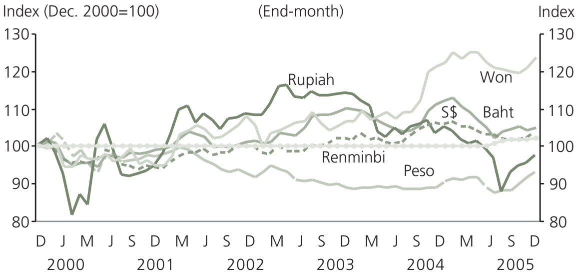



**Table 2.6**
**Movements of the Ringgit**

| | RM to one unit of foreign currency[1] | | | | | Annual change (%) | | Change (%) | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1997 | 1998 | 2004 | 2005 | 2006 | 2004 | 2005 | End-June '97- Dec. 2005 | 2 Sept.'98 - Dec. 2005 | End-Dec '05- 28 Feb. '06 |
| | End-June[2] | Sept. 2[3] | End-Dec. | | Feb. 28 | | | | | |
| SDR | 3.5030 | 5.1177 | 5.8818 | 5.4020 | 5.3234 | -4.3 | 8.9 | -35.2 | -5.3 | 1.5 |
| US dollar | 2.5235 | 3.8000 | 3.8000 | 3.7800 | 3.7135 | 0.0 | 0.5 | -33.2 | 0.5 | 1.8 |
| Singapore dollar | 1.7647 | 2.1998 | 2.3258 | 2.2714 | 2.2857 | -3.9 | 2.4 | -22.3 | -3.2 | -0.6 |
| 100 Japanese yen | 2.2088 | 2.7742 | 3.7026 | 3.2229 | 3.1907 | -4.0 | 14.9 | -31.5 | -13.9 | 1.0 |
| Pound sterling | 4.1989 | 6.3708 | 7.3169 | 6.5226 | 6.4643 | -7.5 | 12.2 | -35.6 | -2.3 | 0.9 |
| Swiss franc | 1.7368 | 2.6450 | 3.3517 | 2.8825 | 2.8106 | -8.6 | 16.3 | -39.7 | -8.2 | 2.6 |
| Euro[4] | – | – | 5.1729 | 4.4867 | 4.4055 | -7.6 | 15.3 | – | – | 1.8 |
| 100 Thai baht | 9.7470 | 9.3713 | 9.7636 | 9.2049 | 9.4407 | -1.7 | 6.1 | 5.9 | 1.8 | -2.5 |
| 100 Indonesian rupiah | 0.1038 | 0.0354 | 0.0408 | 0.0385 | 0.0402 | 9.8 | 6.2 | 169.9 | -7.9 | -4.4 |
| 100 Korean won | 0.2842 | 0.2827 | 0.3671 | 0.3739 | 0.3827 | -13.4 | -1.8 | -24.0 | -24.4 | -2.3 |
| 100 Philippine peso | 9.5878 | 8.8302 | 6.7706 | 7.1254 | 7.1793 | 1.1 | -5.0 | 34.6 | 23.9 | -0.8 |
| Chinese renminbi | 0.3045 | 0.4594 | 0.4591 | 0.4686 | 0.4619 | 0.0 | -2.0 | -35.0 | -2.0 | 1.5 |

[1] US dollar 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 dollar are cross rates derived from rates of these currencies against the US dollar and the RM/US dollar rate.
[2] End-June 1997 represents pre-Asian Financial Crisis levels.
[3] Ringgit was fixed at USD1 = RM3.8000 on 2 September 1998.
[4] The euro began to be traded on 4 January 1999 (EUR 1= RM4.5050).

**Graph 2.8**
**Exchange Rate of the Malaysian Ringgit against Selected Regional Currencies**




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

With the ringgit strengthening significantly since the beginning of 2005, any undervaluation that existed as a result of the US dollar depreciation in 2003 and 2004 had effectively been reversed. The exchange rate was therefore not expected to change substantially at the time of the change to the new regime. The price discovery process following the unpegging of the ringgit was orderly, resulting in relative stability of the exchange rate. During the period after the move to a managed float regime, between 22 July – 30 December 2005, the ringgit moved not only against the US dollar, but also other major and regional currencies, and reflected the overall strength of the domestic economy. There was, however, a substantial unwinding of the large speculative long positions in the ringgit. During the remaining part of the year, since the introduction of the new regime, the ringgit appreciated against the US dollar (0.5%), Japanese yen (4.7%), euro (3%) and pound sterling (1.6%). Against regional currencies, the ringgit depreciated within the range of 0.6% - 4.4%, the exception being an appreciation of 0.5% against the Indonesian rupiah.

For the year as a whole, the ringgit appreciated against the US dollar (0.5%), euro (15.3%), Japanese yen (14.9%) and pound sterling (12.2%). Against the regional currencies, the ringgit recorded a mixed performance, appreciating against the Indonesian rupiah (6.2%), Thai baht (6.1%) and Singapore dollar (2.4%), but depreciating against the Philippine peso (5%), Chinese renminbi (2%) and Korean won (1.8%).

## FISCAL POLICY AND OPERATIONS

Fiscal policy in 2005 remained focused on improving the Federal Government's financial position while supporting capacity building to enhance economic growth. The Government continued to play a supportive role in facilitating the further entrenchment of the private sector as the main engine of growth. The Federal Government's overall macroeconomic strategy continued to concentrate on reinforcing economic growth by stimulating domestic sources of growth, enhancing human capital development, improving capacity of delivery system of the Government and promoting higher productivity. These efforts, together with supportive monetary policy, enabled total private sector consumption and investment to sustain a strong expansion of 9.5% to contribute 5.7 percentage points of economic growth.

### While fiscal policy in 2005 continued to focus on capacity building to support economic growth, the Federal Government's fiscal consolidation strategy remained on course with a lower fiscal deficit of 3.8% of GDP.

Notwithstanding higher petroleum-related expenditure, the continued fiscal discipline and prudence in spending, combined with a favourable revenue performance, led to an improvement in the **Federal Government's financial position.** The Federal Government registered a smaller overall deficit of RM18.7 billion or 3.8% of GDP. The reduction of fiscal deficit for the third successive year underscored the Government's strong commitment to a policy of fiscal consolidation. With this manageable deficit, the Government will now have the added

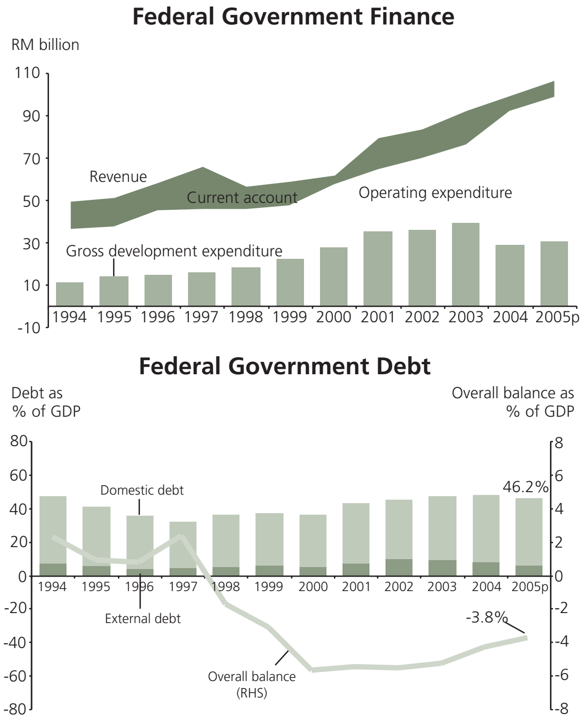
**Table 2.7**
**Federal Government Finance**

| | 2004 | 2005*p* |
|---|---|---|
| | RM million | |
| Revenue | 99,397 | 106,304 |
| Operating expenditure | 91,298 | 97,744 |
| **Current account** | **8,099** | **8,560** |
| **% of GDP** | **1.8** | **1.7** |
| Net development expenditure | 27,518 | 27,284 |
| *Gross development expenditure* | *28,864* | *30,534* |
| *Loan recoveries* | *1,346* | *3,250* |
| **Overall balance** | **-19,419** | **-18,724** |
| **% of GDP** | **-4.3** | **-3.8** |

*p* Preliminary
Note: Numbers may not add up due to rounding.

Source: Ministry of Finance

**Graph 2.9**




*p* Preliminary

flexibility to provide more resources for activities that will contribute to further strengthening the economic resilience of the economy.

Federal Government **revenue** continued to rise, increasing by 6.9% to RM106.3 billion in 2005, reflecting sustained growth in the Malaysian economy and higher petroleum-related revenue. Higher tax revenue collection also reflected the concerted efforts made by the Government to broaden the tax base. The proportion of total revenue to GDP remained at a high level of 21.5% (2004: 22.1%). Both categories of tax revenue, direct and indirect taxes, increased in 2005, and resulted in larger shares of 50.4% and 25.4% of total revenue, respectively (2004: 49% and 23.5%, respectively). Receipts from the petroleum income tax registered a significant growth of 26.9% following higher oil prices. Favourable business performance and further improvements in the tax collection machinery contributed to the increased revenue from corporate income tax. Higher revenue was achieved despite the re-computation of current year corporate tax after taking into account treatment for tax refund. In addition, several tax concessions and incentives were introduced in 2005 to promote private investment activity and to reduce the corporate tax burden. During the year, measures

**Table 2.8**
**Federal Government Revenue**

| | 2004 | 2005*p* | 2004 | 2005*p* |
|---|---|---|---|---|
| | RM million | | Annual change (%) | |
| **Tax revenue** | **72,050** | **80,594** | **11.0** | **11.9** |
| **% of GDP** | **16.0** | **16.3** | | |
| Direct taxes | 48,703 | 55,543 | 13.2 | 9.9 |
| *Companies* | *24,388* | *26,381* | *1.7* | *8.2* |
| *Petroleum* | *11,479* | *14,566* | *35.6* | *26.9* |
| *Individuals* | *8,977* | *8,649* | *12.4* | *-3.7* |
| *Stamp duties* | *2,381* | *2,460* | *18.6* | *3.3* |
| *Others* | *1,479* | *1,487* | *160.1* | *0.6* |
| Indirect taxes | 23,347 | 27,051 | 6.7 | 15.9 |
| *Export duties* | *1,600* | *2,085* | *38.4* | *30.3* |
| *Import duties* | *3,874* | *3,385* | *-1.1* | *-12.6* |
| *Excise duties* | *6,427* | *8,641* | *27.7* | *34.5* |
| *Sales tax* | *6,816* | *7,709* | *-14.4* | *13.1* |
| *Service tax* | *2,350* | *2,582* | *15.3* | *9.9* |
| *Others* | *2,280* | *2,648* | *29.1* | *16.2* |
| **Non-tax revenue** | **27,347** | **25,710** | **-1.3** | **-6.0** |
| **Total revenue** | **99,397** | **106,304** | **7.3** | **6.9** |
| **% of GDP** | **22.1** | **21.5** | | |

*p* Preliminary
Note: Numbers may not add up due to rounding.

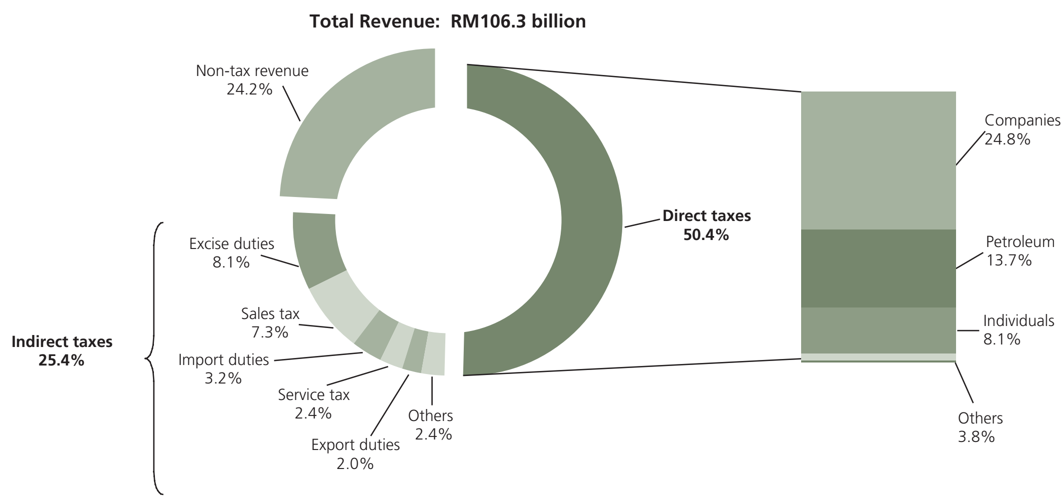
Source: Ministry of Finance

taken by the Inland Revenue Board included enhancing its services and intensifying collection efforts through stricter enforcement. However, individual income tax collections were lower. During the year, higher tax relief was provided to assist disabled taxpayers, for expanding the use of information and communications technology by households, and to inculcate the habit of reading. Commencing in 2005, the Self Assessment System was introduced for individual taxpayers as part of the Government's effort to modernise and streamline the tax administrative system.

The Government continued to emphasise efficiency and effectiveness in its financial management by streamlining tax measures, improving tax administration and intensifying collection efforts. In 2005, the Government established a Taxation System Review Panel comprising representatives from the public and private sectors to review the tax system. Tax administration was enhanced with the setting up of the Fund for Tax Refund to expedite income tax refunds.

Most major sources of indirect taxes recorded double-digit growth, reflecting stronger domestic aggregate demand during the year. Excise duties receipts were significantly higher due to continued high demand for motor vehicles. It also reflected the upward revision of excise duties on locally manufactured cigarettes and

**Graph 2.10**
**Composition of Federal Government Revenue, 2005 (% share)**




## Summary of Major Tax Measures Implemented in 2005

### Individuals Income Tax

- Tax relief on contributions for EPF and insurance premiums increased to RM6,000.
- Additional tax relief for disabled citizens and spouses increased to RM6,000 and RM3,500, respectively.
- Tax rebate for purchases of computers increased to RM500.
- Tax relief for purchases of books increased to RM700.
- Tax exemption on retirement benefits of up to RM6,000 for each year of service.

### Companies Income Tax

- Tax deduction for zakat on business income paid by companies.
- Tax exemption on interest income from bonds received by non-resident companies.
- Tax incentives given to encourage the modernisation and commercialisation of the agriculture sector.
- Tax incentives extended for existing companies for relocating manufacturing activities to promoted areas.
- Scope of tax incentives extended for usage of renewable energy to companies which generate such energy for own consumption.
- Double deduction provided for expenses incurred on promoting the export of professional services.

### Indirect Tax

- Import duty for selected goods (surgical gloves, carpet, glassware and semi-finished components for the wood-based industry) was abolished.
- Import duty on selected raw materials for apparel industry and herbicides was reduced between 5-30%.
- 5% exemption given for import duty on natural gas vehicles (NGV) conversion kits for vehicles.
- Excise duty on cigarettes increased to RM81 per 1,000 sticks.
- Excise duty on liquor increased between 10 sen to RM28 per litre.

### Non-tax revenue

- Road tax for motorcycles with engine capacity between 151-250 cc reduced by 50%.
- Road tax for passenger cars with engine capacity between 1,001-1,600 cc reduced by 50%, while those below 1,000 cc the road tax was charged at RM30 per year.
- Road tax for mono gas and dual-fuel vehicles reduced by 50% and 25%, respectively.
- 10% exemption given for road tax for vehicles with NGV conversion kits.
- Road tax abolished for school and stage buses.

liquor announced in the 2005 Budget to promote a healthy lifestyle and to curb social ills. Meanwhile, the escalating oil prices contributed to the higher export duties receipts. In line with Malaysia's commitment to the Asean Free Trade Agreement (AFTA), the gradual reduction in import tariffs on Complete Built-up (CBU) motor vehicles from ASEAN countries as well as the reduction and abolishment of duties on selected goods introduced in the 2005 Budget, resulted in lower import duties collection during the year.

Collection from non-tax revenue declined by 6% in 2005 due to lower investment income. Nevertheless, its share to total revenue remained favourable at 24% (2004: 27%).

The Federal Government's **gross expenditure** increased by 6.8% to RM128.3 billion in 2005. The overall thrust of the Federal Government's expenditure was to strengthen the fundamentals of the economy and to increase the private sector's resilience. In managing expenditure, emphasis was placed on enhancing efficiency and cost effectiveness. **Operating expenditure** was higher by 7.1% or RM6.4 billion in 2005. The substantially higher subsidies for petroleum products (RM11 billion), which was more than three times the amount recorded in 2004, was the major reason for the increase in operating expenditure. To contain the growth of operating expenditure within a reasonable range, the Government reviewed policies on petroleum subsidies. The prices of retail petroleum products were raised three times during the year in view of escalating oil prices. On 1 March, the Government raised the diesel price by 5 sen. The retail price of petrol was raised by 10 sen and diesel by 20 sen on 2 May and 31 July respectively.

**Table 2.9**
**Federal Government Operating Expenditure by Object**

| | 2004 | 2005*p* | 2004 | 2005*p* |
|---|---|---|---|---|
| | RM million | | % share | |
| Emolument | 23,779 | 25,587 | 26.0 | 26.2 |
| Supplies and services | 16,633 | 17,984 | 18.2 | 18.4 |
| Asset acquisition | 1,764 | 1,603 | 1.9 | 1.6 |
| Debt service charges | 10,920 | 11,604 | 12.0 | 11.9 |
| Pensions and gratuities | 6,060 | 6,809 | 6.6 | 7.0 |
| Subsidies | 5,796 | 12,831 | 6.3 | 13.1 |
| Other grants and transfers[1] | 21,264 | 20,982 | 23.3 | 21.5 |
| Other expenditure[2] | 5,082 | 344 | 5.7 | 0.3 |
| **Total** | **91,298** | **97,744** | **100.0** | **100.0** |
| **% of GDP** | **20.3** | **19.8** | | |

[1] Includes grants and transfers to state governments as well as public agencies and enterprises.
[2] Includes refunds, grants to international organisations, insurance claims and gratuities and others.
*p* Preliminary
Note: Numbers may not add up due to rounding.

Source: Ministry of Finance

The total wage bill, which was the largest component of operating expenditure (26.2%), rose by 7.6%. During the year, the Government announced salary increases for Members of Parliament and Cabinet Ministers and higher allowances for various groups of civil servants, including specialists, medical officers and housemen working in Government hospitals. Higher disbursement for supplies and services were largely to improve public sector delivery and promote a culture of maintenance. The bulk of the spending was for procurement of office supplies, 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. Payments for grants and transfers to government agencies, statutory bodies and state governments were extended for development and maintenance purposes. Notwithstanding the higher debt level, the debt service charges were contained as new borrowings were raised at lower costs during the year.

**Gross development expenditure** increased by 5.8% to RM30.5 billion in 2005. The focus of development expenditure was to enhance longer-term productivity and competitiveness, while supporting further economic activity. Spending was reprioritised to focus on smaller-sized projects that have multiplier effects in creating more economic activities in the near term. In particular, such spending was directed to agriculture, construction, housing and infrastructure activities in rural areas. During the year, expenditure efficiency was enhanced by ensuring maximum social and economic benefits. In addition, further emphasis on the usage of the open tender system was undertaken to ensure competitive pricing.

In terms of sectoral distribution, economic services continued to be the largest component of total development expenditure for the second consecutive year with its share of total development expenditure increasing to 49% in 2005 from 35% in 2003. A large part of the increase in spending for this sector was directed to the trade and industry sub-sector to facilitate growth. Spending was focussed on strengthening the small and medium-sized enterprises, industrial research and technological development, and tourism development projects. Expenditure on the transport sub-sector was also higher, reflecting the Government's concerted effort to improve the efficiency of public transportation services and establishing an integrated national transportation network. Funding for agriculture and rural development, as well as public utilities (such as rural roads, water and electricity programmes), were made to further modernise and commercialise the agricultural sector and improve the quality of life in rural areas.

In the social services sector, priority continued to be given to the education sub-sector as focus was placed on human resource development to support the strategy of productivity-driven growth. However, total education expenditure was lower, as most of the education projects in the Eighth Malaysia Plan had been completed by 2003. Expenditure for health services remained high to provide better quality healthcare and medical services. The Government also continued to undertake housing projects for public sector personnel and the lower income groups. Meanwhile, general administration spending was higher to improve further the service delivery system, as well as to enhance the working and service environment. Expenditure was channelled for the purchase of information and communications technology equipment for the implementation of various initiatives under the Electronic Government Application projects.

In an effort to cushion the impact of high oil prices on the domestic economy, the Government, throughout 2005, introduced several measures aimed at encouraging the use of alternative energy sources to reduce the heavy dependence on fossil fuels, lower the cost burden on the general public and to encourage energy conservation, especially by the Government sector. A summary of these measures are listed in the white box.

**Table 2.10**
**Federal Government Development Expenditure by Sector**

| | 2004 | 2005*p* | 2004 | 2005*p* |
|---|---|---|---|---|
| | RM million | | % share | |
| Defence and security | 4,133 | 4,803 | 14.3 | 15.7 |
| Economic services | 11,851 | 14,957 | 41.1 | 49.0 |
| Agriculture and rural development | 2,881 | 2,495 | 10.0 | 8.2 |
| Trade and industry | 1,201 | 3,221 | 4.2 | 10.6 |
| Transport | 6,630 | 7,660 | 23.0 | 25.1 |
| Public utilities | 945 | 1,481 | 3.3 | 4.9 |
| Others | 193 | 99 | 0.6 | 0.2 |
| Social services | 10,260 | 7,450 | 35.5 | 24.4 |
| Education | 4,316 | 3,736 | 15.0 | 12.2 |
| Health | 2,352 | 1,220 | 8.1 | 4.0 |
| Housing | 1,593 | 1,082 | 5.5 | 3.5 |
| Others | 1,999 | 1,412 | 6.9 | 4.7 |
| General administration | 2,620 | 3,325 | 9.1 | 10.9 |
| **Total** | **28,864** | **30,534** | **100.0** | **100.0** |
| **% of GDP** | **6.4** | **6.2** | | |

*p* Preliminary
Note: Numbers may not add up due to rounding.

Source: Ministry of Finance

**Measures Taken to Cushion the Impact of Rising Oil Prices**

- **Encourage the use of alternative energy sources**
  - Provide more NGV pumps at petrol stations.
  - Promote the use of NGV, especially by long-haul transport vehicles.
  - The use of renewable energy under the small renewable energy programme.
  - Develop Bakun hydroelectric power Project.
  - Introduce the use of "green" fuels, such as biodiesel, using palm oil.
- **Reduce public burden**
  - The price of fuel for NGV was fixed at half of the price of petrol.
  - 50% and 25% road tax reduction for mono gas and dual-fuel vehicles, respectively.
  - 5% exemption on import duty and 10% on road tax on NGV conversion kits for vehicles.
  - Road tax abolished for school and stage buses.
  - Road tax for passenger cars with engine capacity between 1001-1600 cc reduced by 50%, while below 1000 cc the road tax is RM30 per year.
  - Road tax for motorcycles with engine capacity between 151-250 cc reduced by 50%.
  - Diesel subsidy provided to fishermen.
- **Conserve the use of fuel**
  - Energy conservation moves introduced in Government offices, such as switching off lights during lunch time and increasing room temperature slightly.
  - Encourage the use of public transportation and car pooling.
  - Enhance efforts to improve the public transportation system, especially in the Klang Valley.

**Table 2.11**
**Federal Government Sources of Financing**

| | 2004 | 2005*p* |
|---|---|---|
| | RM million | |
| Net domestic borrowing | 25,650 | 12,700 |
| *Gross borrowing* | *45,850* | *31,500* |
| *Less: Repayment* | *20,200* | *18,800* |
| Net foreign borrowing | 121 | -3,503 |
| *Gross borrowing* | *1,136* | *651* |
| *Less: Repayment* | *1,015* | *4,153* |
| Special receipts | 516 | 454 |
| Realisable assets[1] and adjustments | -6,868 | 9,073 |
| **Total** | **19,419** | **18,724** |

[1] Includes changes in Government's Trust Fund balances.
A positive (+) sign indicates a drawdown in the accumulated realisable assets.
*p* Preliminary
Note: Numbers may not add up due to rounding.

Source: Ministry of Finance

As a prudent measure, the Federal Government had always ensured that revenue exceeded operating expenditure. Given the reinforced fiscal prudence to contain spending amidst higher revenue collection, the Government registered a larger current account surplus of RM8.6 billion in 2005. The larger savings enabled the Government to reduce its need to source additional **financing** for development activity. In addition, a large part of the development expenditure was financed from the drawdown of accumulated assets. During the year, the Government drew down RM9.1 billion from its accumulated assets. Financing through issuances of government securities were reduced in 2005.

Total **gross borrowings** of the Federal Government in 2005 amounted to RM32.2 billion (2004: RM47 billion). The bulk of the funding (98% of total) was raised from domestic sources without "crowding out" the private sector, given the ample liquidity situation in the economy. The Government raised a total of RM27.5 billion by issuing Malaysian Government Securities (MGS) and another RM4 billion through Government Investment Issues. In 2005, new issues of government securities were raised at lower costs reflecting lower yields. New issues of government securities with maturities of 3 and 5 years were issued at average yield rates ranging between 3.155–3.756% (2004: 3.135–4.546%). For those with maturities of 10 and 20 years, the average yield rates ranged between 4.391–4.837% (2004: 5.094–5.734% for maturities of 10 and 15 years). In terms of the ownership structure of MGS, the provident and pension funds and insurance companies continued to be the major holders.

**Table 2.12**
**Holdings of Federal Government Domestic Debt**

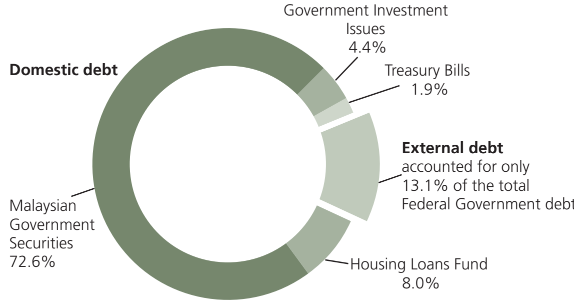
| | 2004 | 2005*p* | 2004 | 2005*p* |
|---|---|---|---|---|
| | Nominal value in RM million | | % share | |
| **Treasury Bills** | **4,320** | **4,320** | **100.0** | **100.0** |
| Social security and insurance institutions | 17 | 82 | 0.4 | 1.9 |
| Banking institutions | 481 | 1,916 | 11.1 | 44.3 |
| Others | 3,822 | 2,323 | 88.5 | 53.8 |
| **Government Investment Issues** | **9,100** | **10,100** | **100.0** | **100.0** |
| Social security and insurance institutions | 973 | 3,374 | 10.7 | 33.4 |
| Banking institutions | 6,755 | 4,146 | 74.2 | 41.0 |
| Others | 1,372 | 2,581 | 15.1 | 25.6 |
| **Malaysian Government Securities** | **154,350** | **166,050** | **100.0** | **100.0** |
| Social security and insurance institutions | 109,402 | 115,109 | 70.9 | 69.3 |
| *of which:* | | | | |
| *Employees Provident Fund* | *91,426* | *96,571* | *59.2* | *58.2* |
| *Insurance companies* | *14,715* | *14,750* | *9.5* | *8.9* |
| Banking institutions | 23,427 | 25,123 | 15.2 | 15.1 |
| Others | 21,520 | 25,817 | 13.9 | 15.5 |

*p* Preliminary
Note: Numbers may not add up due to rounding.

External borrowing was limited to the drawdown of existing project loans committed earlier. A total of RM651 million was disbursed from both bilateral and multilateral sources. During the year, there were large redemptions of RM4.2 billion, reflecting mainly the maturity of the 650 million Euro Bond in November.

Overall, the Federal Government recorded a smaller total net borrowing of RM9.2 billion in 2005. As a

**Graph 2.11**
**Federal Government Debt as at end-2005*p* (% share)**




**Total debt : RM228.7 billion**
**Domestic : RM198.7 billion**
**External : RM30.0 billion**

*p* Preliminary

**Table 2.13**
**Federal Government Debt Indicators**

| | Domestic[1] | External[1] | Total Debt[1] | Debt servicing | | | External debt service ratio |
|---|---|---|---|---|---|---|---|
| | (% of GDP) | | | (% of revenue) | (% of operating expenditure) | (% of GDP) | (% of exports of goods and services) |
| 1985 | 52.6 | 29.7 | 82.4 | 23.9 | 26.9 | 6.5 | 6.7 |
| 1990 | 58.8 | 20.8 | 79.5 | 23.1 | 27.3 | 5.7 | 3.6 |
| 2000 | 31.1 | 5.5 | 36.6 | 14.6 | 16.0 | 2.6 | 1.2 |
| 2001 | 36.3 | 7.3 | 43.6 | 12.1 | 15.1 | 2.9 | 0.5 |
| 2002 | 35.5 | 10.0 | 45.6 | 11.6 | 14.1 | 2.7 | 1.0 |
| 2003 | 38.3 | 9.4 | 47.8 | 11.4 | 14.0 | 2.7 | 1.2 |
| 2004 | 40.5 | 7.7 | 48.2 | 11.0 | 12.0 | 2.4 | 0.5 |
| 2005*p* | 40.2 | 6.1 | 46.2 | 10.9 | 11.9 | 2.3 | 1.0 |

[1] Refers to end-period.
*p* Preliminary

Source: Ministry of Finance

result, the Federal Government **outstanding debt** expanded by a modest rate of 5.6% to RM228.7 billion. Nevertheless, the ratio of outstanding debt to GDP improved to 46.2% of GDP as at end-2005. This level of debt remained manageable with the debt servicing expenditure sustained within prudent levels. Active debt management also reduced bunching of repayments, with about 60% of the debt having remaining maturity of more than three years. The bulk of the loans of about 95% were raised at fixed rates, which reduced exposure to increases in interest rates.

Based on preliminary estimates, the overall financial position of the 30 **non-financial public enterprises** (NFPEs) remained healthy in 2005. The consolidated revenue of the NFPEs rose by 9.6% to RM236.5 billion, as a result of higher earnings of NFPEs involved in oil and gas-related services and utilities sectors. These sectors benefited from the pick-up in economic activities and higher crude oil prices as well as better performance of overseas operations.

**Table 2.14**
**Consolidated NFPEs Finance[1]**

| | 2003 | 2004 | 2005*e* |
|---|---|---|---|
| | RM million | | |
| Revenue | 155,867 | 215,858 | 236,539 |
| Current expenditure[2] | 113,900 | 155,137 | 171,732 |
| **Retained income** | **41,967** | **60,720** | **64,807** |
| **% of GDP** | **10.6** | **13.5** | **13.1** |
| Development expenditure | 40,160 | 24,633 | 39,981 |
| **Overall balance** | **1,807** | **36,088** | **24,826** |
| **% of GDP** | **0.5** | **8.0** | **5.0** |

[1] Refers to 30 NFPEs in 2004 and 2005; 34 in 2003.
[2] Since year 2000, adjusted to include taxes and dividends paid to the Government.
*e* Estimate
Note: Number may not add up due to rounding.

Source: Ministry of Finance and non-financial public enterprises (NFPEs)

Reflective of measures undertaken by enterprises to enhance operational efficiency and to contain the rising operating costs, the NFPEs, as a group registered a higher retained income of RM64.8 billion. Current expenditure rose by 10.7% reflecting largely higher prices of raw materials and inputs, especially for crude oil, natural gas and coal prices. Cost-cutting initiatives undertaken by NFPEs included reviewing processes, improving efficiency and performance, outsourcing, centralising procurement, tightening credit control as well as refinancing and prepayment of loans.

The higher capital outlay of NFPEs was channelled towards the expansion in capacity, enhancement of productivity to improve efficiency and quality of services rendered to the public as well as higher investments abroad to enhance their revenue-generating capacity. The bulk of the development projects were undertaken by the larger NFPEs, such as Petroliam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TM). During the year, PETRONAS continued to invest in the international arena while reinforcing its established domestic operations of both downstream and upstream activities. Among the major domestic projects undertaken by PETRONAS and its subsidiaries were the construction of new service stations, debottlenecking project of MLNG2 as well as acquisition, upgrading and reconditioning of various vessels by MISC Berhad. Meanwhile, overseas investments included exploration and production projects in Egypt as well as developing a gas processing plant in Ghotki, Pakistan.

TNB's capital expenditure was largely concentrated on the interconnection and upgrading of power generation, transmission and distribution networks. Major expenditure incurred during the year included the construction of Tuanku Jaafar Power Station

Phase 2 in Port Dickson, Paka Power Station rehabilitation, Sabah East – West Coast grid expansion and Supervisory Control and Data Acquisition (SCADA) Phase 2 project. During the year, TM focused on expanding and modernising telecommunications infrastructure and networks domestically. It also expanded its global operations through acquisitions of companies in countries such as Indonesia, Ghana and Pakistan. Major projects undertaken included the Asia Pacific Cable Network 2 and Internet Protocol Digital Subscriber Line Access Multiplexcer (IP DSLAM).

The **consolidated public sector** financial position remained strong in 2005. It recorded an overall surplus of RM7 billion or 1.4% of GDP (2004: 4.1% of GDP). The overall surplus was largely attributable to the larger contribution from NFPEs, particularly PETRONAS as a result of higher crude oil prices.

**Table 2.15**
**Consolidated Public Sector Finance**

| | 2004 | 2005*e* | 2006*f* |
|---|---|---|---|
| | RM billion | | |
| Revenue[1] | 116.3 | 122.6 | 134.3 |
| Operating expenditure | 101.6 | 108.4 | 112.5 |
| Current surplus of NFPEs[2] | 60.6 | 63.8 | 63.8 |
| **Current balance** | **75.3** | **78.0** | **85.6** |
| **% of GDP** | **16.7** | **15.8** | **15.8** |
| Net development expenditure[3] | 56.7 | 71.0 | 71.0 |
| *General government[4]* | *32.1* | *31.0* | *39.4* |
| *NFPEs* | *24.6* | *40.0* | *31.5* |
| **Overall balance** | **18.5** | **7.0** | **14.7** |
| **% of GDP** | **4.1** | **1.4** | **2.7** |

[1] Excludes transfers within general government.
[2] Refers to 30 NFPEs in 2004 and 2005; 34 in 2003.
[3] Adjusted for transfers and net lending within public sector.
[4] Comprises Federal Government, state governments, statutory bodies and local governments.
*e* Estimate
*f* Forecast
Note: Numbers may not add up due to rounding.

Source: Ministry of Finance and non-financial public enterprises (NFPEs)