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Monetary and Fiscal Developments

MONETARY POLICY IN 2004

Following the reduction in interest rates in May 2003, Bank Negara Malaysia maintained the accommodative monetary policy stance to support the growth momentum in 2004. In particular, monetary policy continued to support private sector activity as the Government began to gradually consolidate its budgetary position. At the same time, the Bank remained vigilant of inflationary pressures. The assessment at several junctures over the course of the year was that the inflation rate, as measured by the CPI, would remain below the average of 1.5% for the year as a whole.

The macroeconomic fundamentals, that provided the base for growth in economic activity in 2003, strengthened to support a more rapid pace of expansion in 2004. In particular, the financially sound positions of the corporate, household and banking sectors were instrumental in ensuring the effectiveness of the accommodative monetary policy. On balance, given developments in the domestic economy and on the global economic horizon, the decision was to keep interest rates unchanged during the year with the goal of policy focussed on achieving sustainable long-term growth with price stability.

In early 2004, the outlook for the Malaysian economy improved substantially. The significant recovery in the global economy, which had been underway since the middle of 2003, had a positive impact on the Malaysian economy. In terms of domestic demand, consumption and investment indicators were trending upwards, supported by improving consumer and business sentiment. Businesses had benefited from the measures implemented under the 2003 Economic Package. In addition, the various efforts by the Bank to strengthen the small and medium enterprises' (SMEs) financing infrastructure had created an important conduit for the increase in financing provided to the sector. At the time of the release of the Bank's first Monetary Policy Statement (MPS) for 2004 in February, it was highlighted that maintaining the low interest rate environment was necessary to strengthen the private sector-led expansion, particularly given the early stage of the recovery in the investment cycle and the need for accommodation during the process of fiscal consolidation.

In the subsequent months, developments in the major industrial economies and regional countries confirmed that the global economy had gained firmer traction in the first quarter of 2004. However, possible factors for a moderation in global growth had also emerged. The sustained increase in crude oil prices had the potential to weaken growth in Malaysia's major trading partners. At the same time, there was potential for slower growth in the People's Republic of China (PR China), following measures by the authorities in that country to prevent the economy from overheating. There were also greater expectations, particularly in May, that interest rate increases in the United States (US) were imminent. With the emerging threat of deflation in the US in 2003, the Federal Reserve had reduced interest rates significantly. Meanwhile, domestic interest rates did not move as much, resulting in a substantial positive interest rate differential in favour of Malaysia. This, together with the strong economic fundamentals, provided the flexibility for domestic interest rates to be governed by domestic considerations, while being consistent with the exchange rate policy.

Monetary policy remained accommodative to support the growth momentum amid low underlying inflationary pressures.

With stable conditions more entrenched and the underlying fundamentals strengthening significantly in the early part of the year, favourable conditions provided a window of opportunity for the Bank to introduce a new interest rate framework in late April. Under the new interest rate framework, the Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the policy rate and the corresponding overnight interbank rate became the operating target of monetary policy. To reflect the unchanged stance of monetary policy, the OPR was set at the prevailing overnight interbank rate of 2.70%. The rationale and operational infrastructure of the new framework are discussed in the white box on **New Interest Rate Framework**.

In May, it was evident that the domestic economy had strengthened substantially. The economy had expanded by 7.8% in the first quarter of 2004, with

New Interest Rate Framework

A significant development in 2004 was the implementation of the new interest rate framework on 26 April 2004. The new framework involved the introduction of a new policy rate and improvements to the conduct of monetary operations, as well as the removal of the ceiling on base lending rates (BLRs) and prescribed lending spreads. Banking institutions now set their BLRs based on their respective cost structures and business strategies. The changes were designed to enhance the effectiveness of monetary policy by facilitating the transmission of movements in the policy rate to other market rates and ultimately to key macroeconomic variables. The new framework also serves as a catalyst for the efficient pricing of financial products and services by banking institutions. The deregulation of pricing is a key initiative under the Financial Sector Masterplan (FSMP) to ensure greater efficiency in the allocation and distribution of resources in the financial system.

The transition to the new interest rate framework was timely given the favourable macroeconomic fundamentals and the more developed financial infrastructure, which is supported by a strong banking system as well as sound regulatory and supervisory frameworks. These factors have been reinforced by on-going enhancements to the consumer protection framework.

Changes in Monetary Policy Implementation and Communication

To signal monetary policy more effectively and enhance the efficiency of the monetary transmission mechanism, Bank Negara Malaysia adopted a policy rate that is closely linked to other interest rates and has introduced enhancements to its monetary operating procedures. Under the new interest rate framework, the Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of monetary policy stance. The OPR is effectively the target for the average overnight interbank rate (AOIR). In turn, the AOIR serves as the sole operating target for the Bank's daily liquidity operations. The overnight rate was chosen as the policy rate due to its minimal expectations content and high degree of controllability.

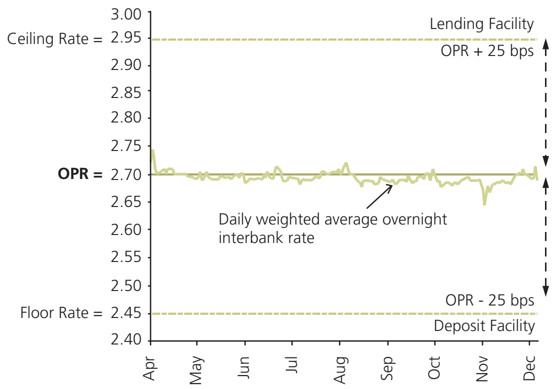
Liquidity operations conducted at maturities other than the overnight tenure are done without targeting any specific interest rate level, thereby allowing interbank rates for these maturities to be market determined. To reflect the unchanged stance of monetary policy at the time of the implementation of the new framework, the OPR was set at the prevailing AOIR of 2.70%. Over the period 26 April – 31 December 2004, the AOIR traded within a narrow range of 2.65 – 2.74% and averaged 2.70%.

In order to prevent excess volatility in the AOIR, the Bank has put in place an interest rate corridor and standing facilities. Essentially, the market rate is allowed to move within a corridor of ± 25 basis points around the OPR. The ceiling and floor rates of the corridor are the rates at which the Bank is willing to lend to or borrow from the market to alleviate residual overnight liquidity shortages or surpluses.

The Bank has begun to complement direct borrowing in the money market with repo-based open market operations in its liquidity management. The use of such open market operations had been previously hindered by the insufficiency of suitable papers. This has been partially addressed with the introduction of the Institutional Securities Custodian Programme (ISCAP) in late 2004. Through ISCAP, the Bank borrows securities, mainly Malaysian Government Securities (MGS), from major institutional investors such as pension funds and insurance companies for its repo operations.

An important aspect of enhancing the monetary transmission mechanism under the new interest rate framework is the communication of monetary policy. The Bank's stance has been made more transparent with explicit policy and operating target rates and the announcement of monetary policy decisions through the Monetary Policy Statement (MPS). The structured and transparent approach to the announcement of monetary policy decisions reduces uncertainty among market participants on the

Graph 1
Daily Weighted Average Overnight Interbank Rate
26 April - 31 December 2004



Bank's stance and policy direction. Any change to the OPR will be announced in the MPS. The MPS is issued at pre-determined quarterly intervals to coincide with the release of Malaysia's quarterly GDP data. Should there be a change in the monetary policy stance, in the period between two scheduled dates, an additional MPS would be issued.

The Impact of the New Interest Rate Framework

The introduction of the new interest rate framework involved changes to the system of implementing monetary policy. The monetary policy stance, however, remained unchanged. The introduction of the new framework did not bring about a change in the cost of funds of banking institutions. As such, no significant variation was expected in the general level of interest rates.

Lending Rates and Financing

Under the new framework, the maximum lending rates charged by banking institutions are no longer subject to the previous BLR formula and the maximum lending spread of 2.5 percentage points above the BLR has also been removed. Instead, the BLR of each banking institution is based on the institution's own cost structure and lending strategy as well as the level of competition in the industry.

At the end of 2004, the average BLR of commercial banks was relatively stable at 5.98% per annum (end-2003: 6.00% per annum), with one banking institution having reduced its BLR. The average BLR of finance companies remained unchanged at 6.90% per annum. Given the unchanged stance of monetary policy, it was expected that most banking institutions would not vary their BLRs in the short- to medium-term.

With the removal of the ceiling on lending rates, loans are increasingly priced according to the risk profile of borrowers or projects. The flexibility accorded to banking institutions in the pricing of spreads allows wider access to financing for borrowers who previously faced difficulty in obtaining funds. Already, several banking institutions have introduced new specialised lending packages for individuals and small businesses.

SMEs have continued to enjoy access to financing under the new interest rate framework, with increased demand for funds as reflected in higher loan applications in the second half-year. Loan approvals and disbursements also rose in the second half-year. At the same time, the lending rates on loans to the SME sector have, on average, remained competitive. In the second half-year, the average lending rate on new loans approved to SMEs by commercial banks was 6.37% per annum compared with 6.42% per annum for the first half-year. In the business sector as a whole, the average lending rate on new loans approved in the second half-year was 5.79% per annum compared with 5.89% per annum in the first half-year.

For the consumer-related sectors, the average lending rates on new loans approved for the purchase of residential property and passenger cars, the latter by finance companies, were 3.27% per annum and 6.74% per annum respectively in the second half-year compared with 3.58% per annum and 6.82% per annum respectively for the first half-year.

The Bank will continue to monitor lending rates charged by banking institutions. To ensure fair and just pricing, the Bank has undertaken several new initiatives to safeguard the interests of consumers. These measures are aimed at ensuring greater product transparency and disclosure, strengthening the infrastructure for consumer redress as well as increasing the financial literacy of the public (See **Management of the Banking System** in Chapter 5 for further details).

The prescribed lending rates have been maintained for financing allocated through the Bank-administered special funds for SMEs and the ceiling still applies on lending rates on housing loans extended to the low- and middle-income groups under the Lending Guidelines to Priority Sectors. In addition, lending rates on hire purchase loans remain subject to the Hire-Purchase Act 1967, while lending rates on credit card loans are subject to the maximum interest rate of 18% per annum as prescribed in the Credit Card Guidelines issued by the Bank.

Deposit Rates

In the sequencing of interest rate liberalisation, a distinction was made between wholesale and retail transactions as well as loan and deposit transactions. The gradual approach adopted aimed at facilitating a smooth transition while at the same time recognising the different levels of financial sophistication among different market participants, namely financial institutions, business enterprises and the general public.

The gradual approach ensures a smooth transition under the new interest rate framework, such that the intermediation process is not disrupted. Another important consideration is the fact that a large section of the population, particularly the middle to lower income groups and retirees, relies on savings in the form of bank deposits. Minimum rates are thus prescribed for deposits of RM1 million and below with tenures between 1 to 12 months. Notwithstanding the current prescribed deposit rates, the Bank has provided an enabling environment for banking institutions to broaden their product range to serve the growing sophistication of the range of savers with different risk-return profiles. In addition, the Bank has channelled efforts towards increasing the financial literacy of the general public.

further expansion in private investment and consumption, as well as buoyant export growth. The external sector had benefited from the global electronics up-cycle, high commodity prices and increased tourist arrivals. However, this faster growth was taking place in an environment of low inflation, with the CPI rising by an average of 1% in the first four months. The increase in crude oil prices was assessed to have minimal impact on inflation given the control of retail prices of petroleum products through the automatic pricing mechanism. In terms of production capacity, the weighted average of capacity utilisation in the manufacturing sector remained relatively stable at 82% in the first quarter and there was evidence of capacity expansion in sectors experiencing strong growth. Further, labour productivity, as measured by real sales value of products per employee in the manufacturing sector, rose by 9%, exceeding the 2.7% increase in real wage per employee. With these considerations, interest rates could continue to remain low to support the growth momentum in an environment of positive output gap still prevailing in the economy. Thus, the OPR remained unchanged at 2.70%.

By the time of the release of the second quarter GDP along with the third MPS in August, global growth for the first half-year had exceeded expectations. During this period, the global monetary cycle entered a tightening phase, engendered by the stronger-than-expected recovery cycle and higher commodity prices. Indicators, however, pointed to some moderation in global growth in the second half-year, but the consensus was that the impact of high crude oil prices and rising interest rates would be modest. In the domestic economy, GDP expanded by 8.2% in the second quarter, with stronger household consumption and private investment activity as the public sector continued to consolidate. Growth for 2004 was now expected to surpass previous forecasts, with the

Table 2.1
Monetary Policy Statements in 2004

The Monetary Policy Statement (MPS) which was introduced in August 2003, was issued four times in 2004 to coincide with the release of the quarterly GDP data in February, May, August and November. The respective MPS issued during the year stated the decision to leave the policy rate unchanged.

Date	Policy Rate: 3-month Intervention Rate	Policy Rate: Overnight Policy Rate (OPR)[1]
25 February	4.50%	
26 May		2.70%
25 August		2.70%
30 November		2.70%

[1] The new interest rate framework was implemented on 26 April 2004. The OPR replaced the 3-month intervention rate as the indicator of monetary policy stance. To reflect the unchanged stance of monetary policy, the OPR was set at the prevailing average interbank overnight rate of 2.70%. See the white box on **New Interest Rate Framework**, for details.

strong first-half performance. CPI inflation remained low at 1.2% in the second quarter of 2004. Importantly, core inflation, reflecting price increases due to demand pressures, averaged less than 1% in the same period. Over the period January to June, approvals for capital investment totalled RM7.2 billion, paving the way for capacity expansion in the electronics and electrical products sector, and in sectors such as chemical and chemical products, and transport equipment, where spare capacity had declined to low levels. Importantly, labour productivity in the manufacturing sector continued to outpace real wage growth. As the outlook for both growth and inflation remained favourable, the monetary policy stance remained unchanged.

Towards the end of the year, indicators showed that global economic activity had remained firm in the third quarter. However, expectations were for a slight tapering off in US economic expansion in the fourth quarter. In addition, the positive outlook for the US economy was dampened slightly by renewed concerns over the US current account deficit and the declining strength of capital inflows into the country. These concerns also led to a sharp depreciation in the US dollar. Among regional countries, a more moderate pace of economic expansion was apparent, as export growth eased, due largely to the gradual slowdown in the global electronics cycle. Inflation trended upwards in most regional countries due mainly to the high crude oil prices, with some countries raising interest rates to contain inflationary pressures.

On the domestic front, a slightly slower but sustained pace of growth was evident in the third quarter. In line with the softening trend in the global electronics cycle, growth in the manufacturing sector moderated somewhat. Despite signs of moderating global growth, the near-term outlook for Malaysia remained favourable. The direct impact of higher crude oil prices was positive for the economy in the short-term, contributing to the trade surplus and to Government revenue.

In the last few months of the year, there were heightened expectations that currencies in the Asian region would be subject to realignments, following speculation of a revaluation of the Chinese yuan and the continuing depreciation in the US dollar. An increase in net portfolio inflows into the domestic economy was registered from September, though these inflows were manageable and had not caused disequilibrating mispricing of asset prices nor distortions in resource allocation in both the financial and real sectors. There continued to be no fundamental pressures that warranted a review of the exchange rate policy (See **Exchange Rate Developments** for a detailed discussion of the ringgit exchange rate). For the year as a whole, the Bank's international reserves increased mainly due to trade proceeds, and to a lesser extent, net capital inflows. The Bank's monetary operations, including the sterilisation of these inflows, were intended to ensure a level of interest rates consistent with domestic conditions. The cost of monetary policy operations continued to remain manageable during the year.

After averaging 1.5% in the third quarter, inflation edged up to 2.1% in October, reflecting mainly higher food prices, higher taxes for cigarette and tobacco as well as higher personal transportation charges after the second increase of retail petrol prices in October, following the first increase in May. Nevertheless, on a historical basis, this inflation rate was still relatively low. Core inflation remained at less than 1.5% in October and averaged less than 1% for the first 10 months of 2004. Additionally, there was no discernible evidence of a pass through from higher crude oil prices.

The fourth MPS for the year was released in late November. The assessment was that there was little evidence of demand-driven inflationary pressures building up in the medium-term, particularly given the moderation in the pace of growth expected in 2005. Inflationary pressures would also be contained given the existence of adequate capacity, which was likely to increase in the year ahead with sustained private investment activity. The risk of strong inflationary pressures in the property market was also limited as the supply of residential units remained ample, with average prices and rentals having risen slowly. Meanwhile, growth in the broad money measure, M3, had remained relatively stable, at around 10% for most of 2004 and consistent with the growth of nominal income. Preliminary forecasts suggested that the CPI was unlikely to breach 3% in 2005. Monetary policy has the flexibility to respond to continue to support growth in 2005.

MONETARY DEVELOPMENTS IN 2004

Monetary developments in 2004 reflected the policy to support domestic economic activities. While some moderation in economic growth occurred in the second half-year, monetary conditions remained favourable to support private sector activities.

Since the transition to the New Interest Rate Framework, the OPR has been maintained at 2.70%. In the interbank money market, the overnight rate averaged 2.70%, consistent with the OPR, and moved within a tight band of 2.65 – 2.74%.

With domestic interest rates unchanged, the interest rate differentials between domestic and US rates narrowed following the steady increase in US Federal Funds rates during the year. Notwithstanding the narrowing interest rate differentials, the external sector continued to inject liquidity into the system. These inflows reflected mainly long-term flows, including the repatriation of export earnings arising from the strong trade performance. Inflows of portfolio funds were also higher as international fund managers increased their exposure to Malaysia, following the continuous upward adjustments in ratings and improved economic and earnings outlook. Nonetheless, the larger capital inflows did not create any significant destabilising conditions in the domestic financial system. Bank Negara Malaysia continued to manage the excess liquidity to maintain interest rates at the desired level.

The base lending rates (BLR) of banking institutions remained steady given their relatively stable cost of funds structure. The BLR of commercial banks moderated slightly to 5.98% per annum while the BLR of finance companies remained unchanged at 6.90% per annum. Five mergers between commercial banks and their finance companies were effected during the year, resulting in technical adjustments to their average lending rates (ALR). With lower interest rates offered on new loans, the ALR of commercial banks and finance companies moderated to 5.98% per annum and 8.78% per annum respectively at end-2004 from 6.11% per annum and 9.11% per annum at end-2003.

While deposit rates were broadly unchanged from the levels recorded at end-2003, depositors continued to enjoy positive real rates of return from their deposits amidst a low inflation environment. During the year, Bank Negara Malaysia created a new instrument, the Merdeka Savings Bond, to provide retirees with an additional higher-yielding avenue for their savings. The Merdeka Savings Bond, which was based on the Islamic principle of *Bai' Al-Inah*, offered a profit margin of 5% per annum, which was higher than interest rates paid by the commercial banks for 12-month fixed deposits. The bonds would be carried over in 2005 with a total issuance of RM1.31 billion planned for 2005 compared with RM1.94 billion issued in 2004.

Monetary conditions remained favourable to support private sector activities.

The accommodative monetary conditions during the year facilitated financing of private sector activity. Gross financing extended by the banking system and the capital markets increased by 6.2% in 2004 (2003: 9%). On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9% at end-2004 (end-2003: 10.3%).

Bank lending activity was robust in 2004 as reflected by a faster pace of growth in total loans outstanding of 8.5% at end-2004 (end-2003: 4.8%). Stronger demand

Graph 2.1
Lending Rates:
Commercial Banks and Finance Companies

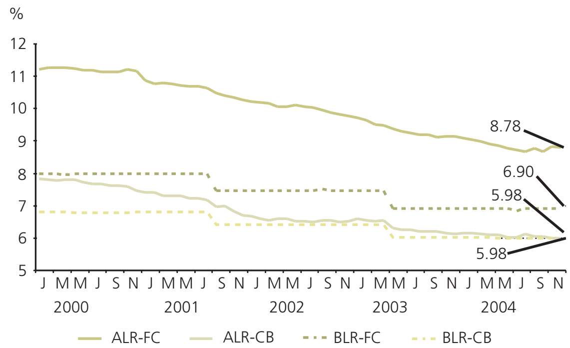


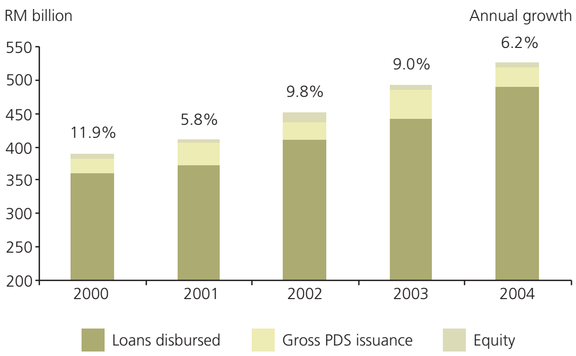
Table 2.2
Interest Rates and Liquidity

	2001	2002	2003	2004
	As at end-period (%)			
3-month Intervention Rate	5.0	5.0	4.5	-
Overnight policy rate (OPR) [1]	-	-	-	2.70
Interbank rates				
Overnight	2.76	2.71	2.72	2.69
1-month	2.97	2.99	2.99	2.77
Base lending rate (BLR)				
Commercial banks	6.39	6.39	6.00	5.98
Finance companies	7.45	7.45	6.90	6.90
Average lending rate (ALR)				
Commercial banks	6.67	6.51	6.11	5.98
Finance companies	10.24	9.75	9.11	8.78
Fixed deposit rates				
Commercial banks				
3-month	3.21	3.20	3.00	3.00
12-month	4.00	4.00	3.70	3.70
Finance companies				
3-month	3.22	3.20	3.00	3.00
12-month	4.01	4.00	3.68	3.70
Savings deposits rates				
Commercial banks	2.28	2.12	1.86	1.58
Finance companies	2.94	2.65	2.18	1.98
	Average during the period (%)			
Nominal interest rate differential				
Malaysia – United States	-0.49	1.31	1.66	1.16
Malaysia – Singapore	1.31	2.23	2.27	1.93
	As at end-period (RM billion)			
Resource surplus (+) / gap (-)	67.4	76.2	106.0	133.4
Adjusted resource surplus (+) / gap (-) [2]	28.6	33.3	57.7	86.9
	As at end-period (%)			
Loan-deposit ratio	85.9	84.9	80.9	78.6
Financing-deposit ratio [2]	95.7	95.1	91.7	87.7

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

for funds was also evident, with loan applications growing significantly by 20.1% compared to 4.8% in 2003. Similarly, loan approvals were higher, amounting to RM173.6 billion, or an increase of 13.6%.

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



In line with the recovery in private investment, bank borrowings by the business sector strengthened after three years of decline in loans outstanding. In 2004, loans outstanding to businesses grew by an annual rate of 2.6% (end-2003: -2.4%). The growth in the demand for bank loans was observed across most business sub-sectors, with total loan applications by businesses increasing at an annual rate of 20% in the year (2003: -7.7%).

The annual growth rate of loan disbursements to businesses also expanded by 10.5%. Sectoral lending data showed that lending to the wholesale, retail, restaurants and hotel sector, predominantly SMEs, accounted for 25% of total business loan disbursements during the year, increasing from 23.1% in 2003.

The confluence of stronger balance sheets, improved profitability and positive business sentiments placed

Table 2.3
Banking System[1]: Loan Indicators

	During the year (RM billion)				Annual growth (%)			
	2001	2002	2003	2004	2001	2002	2003	2004
Total								
Loan applications	190.6	217.2	227.6	273.3	-8.7	14.0	4.8	20.1
Loan approvals	125.6	137.6	152.8	173.6	-6.8	9.5	11.1	13.6
Loan disbursements	373.5	411.6	441.6	488.2	3.5	10.2	7.3	10.6
Loan repayments	365.4	402.7	430.4	461.6	5.3	10.2	6.9	7.2
Change in loans outstanding[2]	16.1	19.8	21.6	40.2	3.9	4.6	4.8	8.5
Businesses								
Loan applications	n.a.	135.3	124.9	149.9	n.a.	n.a.	-7.7	20.0
Loan approvals	63.5	68.5	77.3	84.9	-19.7	7.9	12.8	9.8
Loan disbursements	270.4	282.0	303.4	335.3	0.1	4.3	7.6	10.5
Loan repayments	276.8	275.8	299.5	319.8	2.8	-0.4	8.6	6.8
Change in loans outstanding[2]	-5.6	-3.1	-5.2	5.6	-2.5	-1.4	-2.4	2.6
SMEs								
Loan applications	n.a.	48.7	44.5	54.1	n.a.	n.a.	-8.6	21.6
Loan approvals	n.a.	30.7	25.9	31.6	n.a.	n.a.	-15.5	21.9
Loan disbursements	n.a.	49.5	87.1	100.4	n.a.	n.a.	76.0	15.3
Change in loans outstanding[2]	4.0	...	7.4	6.3	5.7	...	10.0	7.7
Large corporations								
Loan applications	n.a.	86.6	80.4	95.7	n.a.	n.a.	-7.2	19.1
Loan approvals	n.a.	37.8	51.4	53.3	n.a.	n.a.	35.8	3.8
Loan disbursements	n.a.	232.5	216.3	234.9	n.a.	n.a.	-7.0	8.6
Change in loans outstanding[2]	-9.6	-3.1	-12.7	-0.7	-6.1	-2.1	-8.8	-0.5
Households								
Loan applications	n.a.	81.9	98.4	120.2	n.a.	n.a.	20.2	22.1
Loan approvals	59.2	66.9	72.0	86.8	11.5	13.0	7.6	20.5
Loan disbursements	87.0	105.1	114.4	130.3	14.5	20.8	8.9	13.8
Loan repayments	71.5	83.7	94.1	107.0	9.9	17.0	12.4	13.7
Change in loans outstanding[2]	23.1	26.2	26.2	33.3	14.8	14.7	12.8	14.4

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

large corporations in better positions for new investment activity. In this environment, the demand for bank loans by large corporations rose during the year with loan applications growing by 19.1%. The amount of loans disbursed to large corporations also grew at an annual rate of 8.6% during the year.

In line with the pick up in private sector investment, almost half of the total funds raised in the PDS market were to finance new projects. The share of PDS funds raised for new projects rose significantly to 46.5% compared with 6.6% in 2003, mainly for power generation and water supply services in the utilities sector and provision of highway infrastructure in the construction sector. This also reflected the greater recourse of large corporations to the PDS market for long-term financing needs.

For the SMEs, the favourable macroeconomic conditions during the year increased their demand for financing. Banking institutions adopted a more focused approach to SME lending with the establishment of specific SME lending divisions to concentrate on the promotion of loan packages to this sector. The increased demand for funds by the SMEs, as reflected by the annual growth rate of loan applications of 21.6%, was matched by loan approvals, which rose by 21.9%. Outstanding loans of the SMEs grew at an annual rate of 7.7% (2003: 10%), to account for 40.3% of total outstanding loans of the business sector (2003: 38.4%). The demand for funds by SMEs is expected to continue to trend upwards, with the sector emerging as an important driver of growth in the economy.

Households' willingness to spend improved during the year, amidst rising consumer confidence, rising disposable income and the positive monetary environment. Given the positive sentiments and outlook, household sector loans outstanding continued to grow strongly by 14.4% in the year (end-2003: 12.8%). At end-2004, the share of loans

Table 2.4
Banking System[1]: Loans Outstanding

	Annual change 2003	Annual change 2004	% share of total loans at end-2004
	RM billion		
Banking system loans, of which extended to:			
Business enterprises	-5.2	5.6	42.6
Individuals	26.2	33.3	51.4
By sector:			
Agriculture, hunting, forestry and fishing	-1.1	0.4	2.1
Mining and quarrying	0.1	-0.1	0.2
Manufacturing	-0.2	2.0	12.3
Electricity, gas and water supply	-1.7	0.1	1.0
Wholesale and retail trade, restaurants and hotels	2.1	4.3	8.5
Broad property sector	14.6	19.8	40.6
Construction	*-2.7*	*1.3*	*6.0*
Purchase of residential property	*16.2*	*16.4*	*25.9*
Purchase of non–residential property	*1.1*	*2.3*	*6.1*
Real estate	...	*-0.2*	*2.7*
Transport, storage and communication	1.0	-0.8	1.9
Finance, insurance and business services	-0.6	1.7	6.0
Consumption credit	8.9	14.6	20.2
of which:			
Credit cards	*1.6*	*2.0*	*2.8*
Purchase of passenger cars	*6.5*	*10.6*	*14.0*
Purchase of securities	-1.8	-0.4	3.8
Purchase of transport vehicles	0.3	-0.8	0.5
Community, social and personal services	-0.7	0.1	1.0
Others	0.9	-0.7	2.0
Total loans outstanding[2]	**21.6**	**40.2**	**100.0**

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

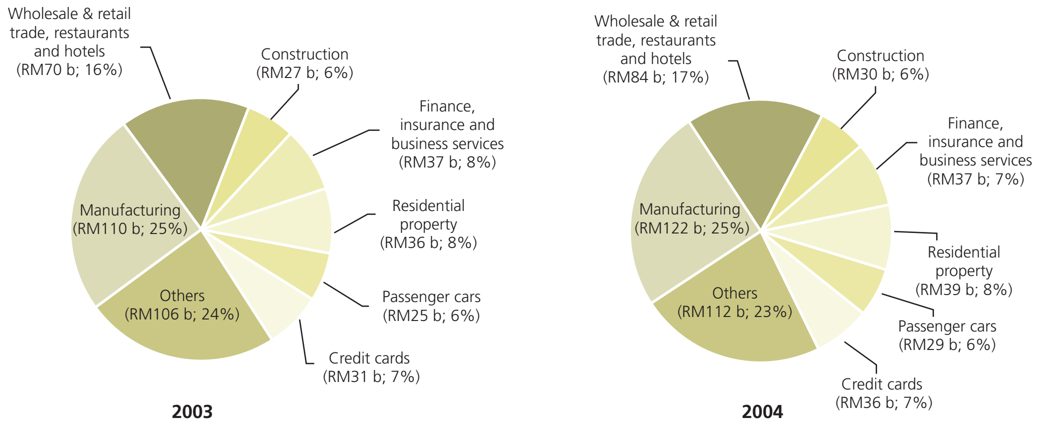
outstanding to the household sector relative to total loans outstanding edged up further to 51.4%, from 48.8% in the previous year. The increase in lending was also driven by supply-side factors, particularly active competition between banking institutions to enlarge their market share in retail lending. Household loan applications and loan approvals also grew during the year.

In terms of household sectoral loan growth, lending for the purchase of residential properties continued to be the main driver of household loans, with loans outstanding accounting for 49.3% of total household loans at end-2004. The high loan growth for the purchase of residential properties was especially evident in the first-half year, buoyed by the sustained buying interest for landed residential properties observed since the second half of 2003, and by the imminent expiry of property-related incentives announced in the Economic Package of May 2003.

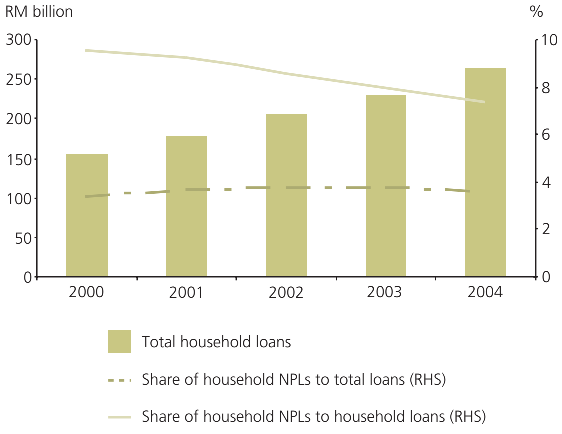
The growth in the demand for loans for the purchase of passenger cars was significant during the year. The announcement by the Ministry of Finance on the framework for the levy of import and excise duties, in line with Malaysia's commitment to the ASEAN Free Trade Agreement (AFTA), removed the uncertainty regarding prices and spurred consumers who had held back on purchases in 2003 and the first quarter of 2004. In addition, the release of new models by both domestic and foreign carmakers also heightened consumer interest. As a result, the demand for loans for passenger cars exhibited a strong uptrend since the second quarter. The annual growth of loan disbursements for the purchase of passenger cars rose by 18.8% in 2004 (2003: -4.9%).

In tandem with the improved economic performance and growth in private consumption, credit card usage

Graph 2.3
Loan Disbursements by Sector: Value and Share



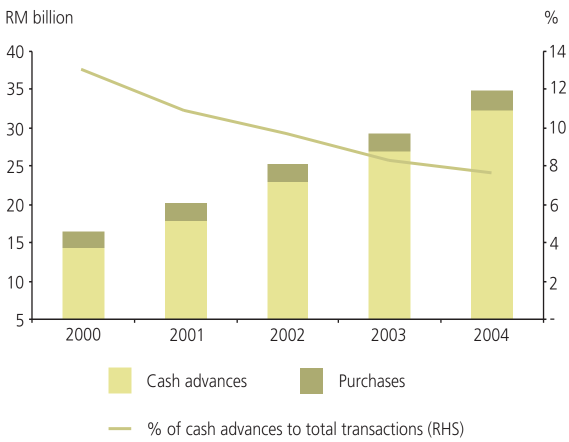
Graph 2.4
Banking System: Loans to Households (at end-period)



increased in 2004. The number and value of credit card transactions by Malaysian cardholders grew by 12.3% and 18.8% respectively in 2004 (2003: 15.5% and 16% respectively). With the bulk of the transactions mainly for the purchases of goods and services, the share of cash advances to total credit card transactions continued to decline to 7.5% (2003: 8.2%). At end-2004, the NPL ratio for credit card loans remained low at 4.7%, while credit card loans outstanding accounted for 2.8% of total banking system loans outstanding.

The financial position of the household sector remained sound. During the year, indicators of household financial conditions showed that households were in a position to manage their debts. The gross NPL ratio for the household sector was lower at 7.2% in 2004 (2003: 7.9%). Similarly, the gross NPL ratio for residential properties was also lower at 8.5% at end-2004 (end-2003: 8.7%). In addition, the number of bad cheque offenders declined by 6.5% from a year ago.

Graph 2.5
Aggregate Value of Credit Card Transactions



Following robust economic activity, money supply expanded during the year. Broad money, M3, grew by an annual rate of 12.4%, driven mainly by higher net inflows of RM82.2 billion, mostly in the form of foreign direct investment, repatriation of export earnings and portfolio inflows. In addition, higher private sector financing activity also contributed RM30.3 billion to the increase in money supply during the year. In contrast, fiscal consolidation by the Government had a restraining effect on money supply (-RM11.8 billion).

M1, an indicator of transaction activity, grew by 11.9% in the year (2003: 14.6%) as the demand for transaction balances by households and businesses,

Graph 2.6
Monetary Aggregates

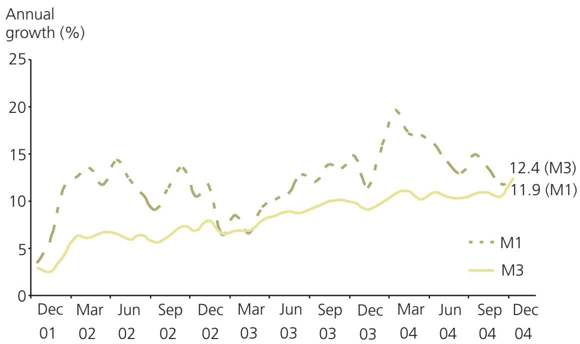


Table 2.5
Broad Money, M3

	Change (RM billion)	
	2003	2004
M3	48.5	68.0
Currency	2.2	2.6
Demand deposits	11.2	10.1
Broad quasi money	35.1	55.3
Fixed deposits	*17.1*	*24.7*
Savings deposits	*5.6*	*6.1*
NIDs	*2.0*	*8.2*
Repos	*8.0*	*13.3*
FX deposits	*2.4*	*3.0*
Determinants of M3		
Net claims on Government	12.9	-11.8
Claims on private sector	31.3	30.3
Loans	*21.5*	*39.8*
Securities	*9.8*	*-9.5*
Net external operations	20.7	82.2
Bank Negara Malaysia	*27.1*	*75.0*
Banking system	*-6.4*	*7.2*
Other influences	-16.5	-32.7

including cash and demand deposits, increased further in line with higher household spending and retail activity. The growth of M1 was notably higher in the first half-year, while exhibiting some moderation in the second half-year, reflecting the trend registered in the real economy.

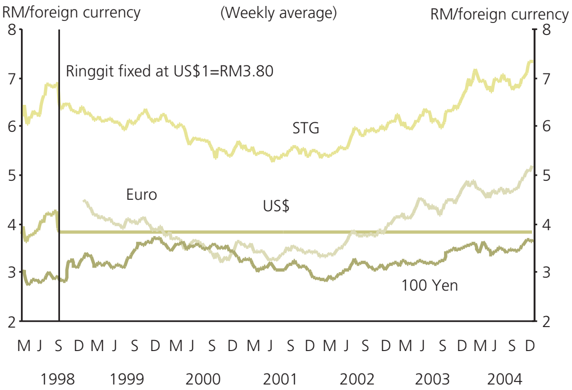
EXCHANGE RATE DEVELOPMENTS

The fixed exchange rate regime of US$1 to RM3.80 has been maintained since 2 September 1998. The fixed parity of the ringgit continues to provide significant benefits to the Malaysian economy by providing predictability and relative stability for trade and investment activities.

In 2004, developments in the ringgit were driven mainly by the depreciation of the US dollar and the consequent realignments of major and regional currencies against the US currency. Due to the dollar weakness, the euro, pound sterling and yen appreciated by 8.3%, 8.1% and 4.2% respectively. The dollar reached an unprecedented low of $1.3619 against the euro on 30 December 2004, a 14-year low of $1.9455 against the pound sterling on 21 December 2004 and a 5-year low of 102.105 against the yen on 6 December 2004.

For the year as a whole, the dollar depreciated mainly on concerns over the widening current account and budget deficits in the US. Among the major currencies, the primary adjustment was in the euro, as investors acquired more euro assets. Against the British pound, sustained United Kingdom (UK) rate increases over the year widened the yield differentials in favour of the UK and provided strong support for the British currency. Concurrently, the yen strengthened on signs of Japanese economic recovery.

Graph 2.7
Exchange Rate of the Malaysian Ringgit against Major Currencies



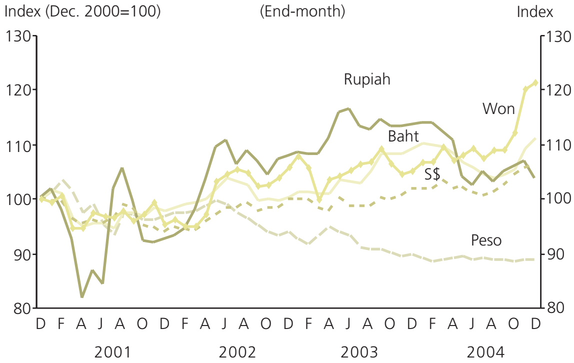
The dollar weakness, however, was interspersed by rallies, noticeably in the second and third quarter of the year. The dollar was aided to some extent by the five Federal Funds Rate increases in the second half of the year, which shifted the yield gaps more favourably to the US, while the weaker performances of Germany and France put some dampener on the euro. Meanwhile, the strength of the yen was tempered by fears of official intervention. From September, the dollar, however, began to depreciate markedly as the foreign exchange market noted that the US was following a policy of a weak US dollar to manage the country's external imbalances.

Table 2.6
Movements of the Ringgit

	RM to one unit of foreign currency[1]				Annual change (%)		Change (%)	
	1997	1998	2003	2004	2003	2004	End-June '97- End-Dec. 2004	2 Sep.'98 - End-Dec. 2004
	End-June[2]	Sept. 2[3]	End-Dec.					
SDR	3.5030	5.1177	5.6264	5.8818	-8.5	-4.3	-40.4	-13.0
US dollar	2.5235	3.8000	3.8000	3.8000	0.0	0.0	-33.6	0.0
S$	1.7647	2.1998	2.2342	2.3258	-2.0	-3.9	-24.1	-5.4
100 yen	2.2088	2.7742	3.5546	3.7026	-9.9	-4.0	-40.3	-25.1
Pound sterling	4.1989	6.3708	6.7678	7.3169	-10.0	-7.5	-42.6	-12.9
Swiss franc	1.7368	2.6450	3.0632	3.3517	-10.6	-8.6	-48.2	-21.1
Euro[4]	–	–	4.7783	5.1729	-16.7	-7.6	–	–
100 Thai baht	9.7470	9.3713	9.5947	9.7636	-8.2	-1.7	-0.2	-4.0
100 Indonesian rupiah	0.1038	0.0354	0.0449	0.0408	-5.3	9.8	154.1	-13.3
100 Korean won	0.2842	0.2827	0.3180	0.3671	0.6	-13.4	-22.6	-23.0
100 Philippine peso	9.5878	8.8302	6.8431	6.7706	4.4	1.1	41.6	30.4

[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.
[2] End-June 1997 represents pre-Asian Financial Crisis levels.
[3] Ringgit was fixed at US$1 = 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.

Under the pegged exchange rate regime, the ringgit depreciated in lockstep with the US dollar against the euro by 7.6%, against the pound sterling by 7.5% and against the yen by 4%. The ringgit depreciated in the range of 1.7 – 13.4% against most regional currencies, with the notable exceptions being an appreciation against the Philippine peso and Indonesian rupiah, by 1.1% and 9.8% respectively. Regional exchange rate appreciations were mainly influenced by the dollar weakness, strong export growth and foreign equity inflows, which outweighed concerns over higher oil prices and the possibility of PR China's policy tightening impacting the economy more strongly than expected.

The weakness of the US dollar underpinned some market expectations that the ringgit peg policy would be reviewed and in particular in the light of considerable speculation that PR China is considering a more flexible regime. Speculation on the possible timing and nature of adjustments to the ringgit peg had ebbed and flowed along with the intensity of the debate pertaining to the Chinese yuan, and movement of the US dollar against other major currencies notably the yen and the euro. Despite these bouts of speculation, the pegged exchange rate continued to function effectively. Bank Negara Malaysia has consistently maintained that unless the ringgit is expected to become significantly misaligned for a prolonged period, or the current regime is no longer consistent with macroeconomic fundamentals due to major structural changes in the international or regional financial system, there would be no revisions to the peg.

FISCAL POLICY AND OPERATIONS

Fiscal policy in 2004 was aimed at improving the financial position of the Government, as well as facilitating the private sector in enhancing its role as the main engine of growth. This objective was in line with the overall macroeconomic strategy to stimulate and accelerate domestic sources of growth. Recognising the necessity for policy flexibility in times of uncertainty, the strong commitment of the Government to fiscal consolidation policy was evidenced by the narrowing of the fiscal deficit to 4.3% of GDP in 2004, from 5.3% in 2003 and a high of 5.7% of GDP in 2000. The steady and gradual reduction in the fiscal deficit was necessary to minimise any negative impact on economic growth.

Fiscal consolidation remains on track. Budgetary operations continued to focus on providing an enabling environment for private sector activity and enhancing the economy's long-term growth potential.

Fiscal consolidation was achieved through both enhancing revenue and improving spending efficiency and effectiveness. Revenue enhancing measures included intensifying efforts through stricter enforcement, tax audits and anti-smuggling measures to minimise tax leakages and evasions.

In terms of expenditure management, concerted efforts were made to reduce wastage, optimise the use of available resources and enhance the economic value of physical assets through productive use and maintenance. While development expenditure was lower, emphasis was given to expenditure which ensured longer-term productivity and competitiveness of the economy. Special attention was placed on smaller projects involved in agriculture and rural development to spread the benefits of growth and balanced economic development.

In order to ensure that social projects and rural development remain a priority, the Government increased the development expenditure ceiling under the Eighth Malaysia Plan (2001-05) by RM10 billion to RM170 billion. This was necessary as a significant portion of the original development allocation was utilised during 2001-03, following pro-growth strategies and stabilisation measures taken to mitigate recessionary pressures. During this period, the implementation of social and economic projects, especially in the education and health sectors, were brought forward and accelerated. Consequently, the higher ceiling reduced the impact of a sharp fall in development spending on the economy and thereby ensured that the growth momentum was not disrupted.

At the same time, policies were targeted at ensuring a more efficient public sector. Among the improvements made to the public sector delivery system were the simplification of existing rules and regulations as well as work processes. In addition, a management review and revamp exercise among government-linked companies were undertaken to drive a performance driven culture and creation of shareholders' value. These measures helped promote investor confidence and resulted in a more favourable business environment for the economy.

The Government also offered additional tax breaks, incentives and financing facilities for the private sector to augment its role in spearheading growth. These measures included raising the threshold of 20% corporate tax rate for SMEs to RM500,000 (from RM100,000), establishment of a one-stop agency to promote the services sector, tax incentives for companies providing cold chain facilities and services for perishable agricultural produce, additional incentives for hotels and tourism projects, enhancement of the size of the Micro-Credit Scheme by RM1 billion, allowing deductions on entertainment expenses incurred in sales promotions, reducing or abolishing import duties of selected goods such as computer batteries, wooden and plastic goods, as well as reducing and abolishing export duties on several agricultural produce and commodities. These strategies contributed to creating an environment where private sector activity gained momentum to contribute towards higher economic growth. The private sector's contribution to economic growth rose to 6.2 percentage points in 2004 (2003: 3.1%; 2002: 0.2%).

Given the ample liquidity situation in the economy, the bulk of the financing requirements of the Government were raised from domestic sources without crowding out the private sector. New issues of government securities with maturities of 3, 5 and 7 years were raised at average yield rates ranging between 3.14 – 4.55% and for those with maturities of 10 and 15 years the average yield rates ranging between 5.09 – 5.73%. The Government continued to ensure prudence in its recourse to external borrowing to minimise exposure to external risks. During the year, recourse to external borrowings was limited to the drawdown of project loans committed earlier.

Table 2.7
Consolidated Public Sector Finance

	2003	2004*e*	2005*f*
		RM million	
Revenue[1]	107,055	116,663	115,760
Operating expenditure	84,163	102,727	100,091
Current surplus of NFPEs[2]	55,651	52,295	52,892
Current balance	**78,543**	**66,231**	**68,560**
% of GDP	**19.9**	**14.8**	**14.6**
Net development expenditure[3]	83,315	67,772	63,523
General government[4]	*43,155*	*33,638*	*33,175*
NFPEs	*40,160*	*34,135*	*30,348*
Overall balance	**-4,772**	**-1,541**	**5,037**
% of GDP	**-1.2**	**-0.3**	**1.1**

[1] Excludes transfers within general government.
[2] Refers to 34 NFPEs in 2003 and 2004; 36 NFPEs in 2002.
[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, state governments and non-financial public enterprises (NFPEs)

Reflecting the strong commitment to fiscal consolidation policy, the Government was able to contain its debt at a manageable level. As at end-2004, the debt level was 48.4% of GDP, of which external debt accounted for 16% of total debt.

Consolidated Public Sector

The consolidated public sector's financial position improved in 2004. Although revenue remained favourable, higher operating expenditure resulted in a lower public sector current surplus position of 14.8% of GDP. However, lower development expenditure by both the general government and the non-financial public enterprises (NFPEs) led to a smaller overall public sector deficit of RM1.5 billion or 0.3% of GDP.

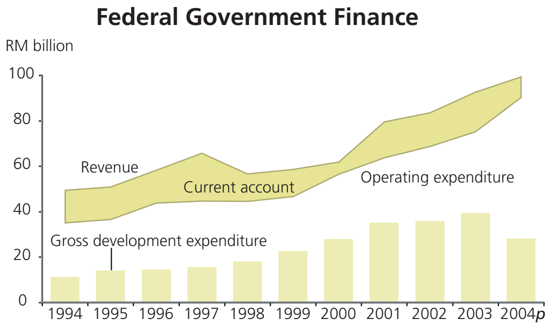
Federal Government Finance

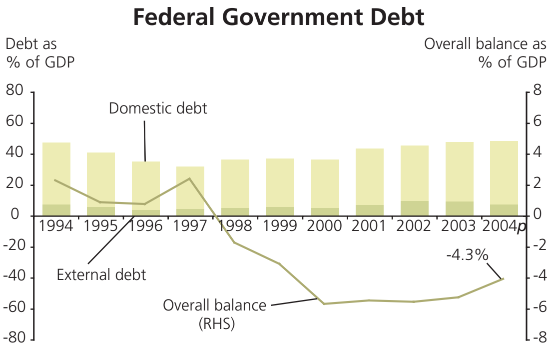
Reflecting its fiscal consolidation stance, the Federal Government registered a lower fiscal deficit of RM19.4 billion or 4.3% of GDP in 2004 (2003: -5.3% of GDP). The improved fiscal position was due to better revenue collection and lower disbursements of development expenditure.

Federal Government **revenue** increased by 7.3% to RM99.4 billion or 22.2% of GDP in 2004. The better revenue performance was due to higher collections from both direct and indirect taxes. Non-tax revenue receipts remained favourable.

The higher tax revenue collection reflected the improved economic performance as well as the high oil prices in the previous year. The higher collections were also the result of several measures implemented to enhance tax collection and minimise tax leakages and evasions. These measures included rationalising the tax structure, intensifying collection efforts through stricter enforcement, tax audits and anti-smuggling measures. Income tax receipts increased sharply, accounting for a larger share of total revenue (46%). Of significance, receipts from the petroleum income tax registered a significant growth of 35.6% following higher oil prices that averaged at US$30.30 per barrel in 2003 (the tax base for 2004) and an increased production of crude oil. Higher personal income and business earnings contributed to increases in personal and corporate income taxes, despite tax concessions implemented in the 2004 Budget to reduce the tax burden of individuals and SMEs. These tax concessions included an increase in child relief from RM800 to RM1,000 for children below 18 years and RM3,200 to RM4,000 for children above 18 years that are studying at local institutions of higher learning and an increase in the chargeable income threshold from RM100,000 to RM500,000 to be eligible for a lower corporate tax rate of 20% for SMEs.

Graph 2.9





p Preliminary

Table 2.8
Federal Government Finance

	2003	2004*p*	2005 Budget
	RM million		
Revenue	92,608	99,397	99,102[1]
Operating expenditure	75,224	91,298	89,141
Current account	**17,384**	**8,099**	**9,961**
% of GDP	**4.4**	**1.8**	**2.1**
Net development expenditure	38,312	27,518	27,589
Gross development expenditure	*39,353*	*28,864*	*28,304*
Less: Loan recoveries	*1,041*	*1,346*	*715*
Overall balance	**-20,928**	**-19,419**	**-17,628**
% of GDP	**-5.3**	**-4.3**	**-3.8**
Sources of financing:			
Net domestic borrowing	23,250	25,650	–
Gross borrowing	*41,850*	*45,850*	–
Less: Repayment	*18,600*	*20,200*	–
Net foreign borrowing	-3,709	120	–
Gross borrowing	*3,144*	*1,136*	–
Less: Repayment	*6,853*	*1,015*	–
Special receipts	0	516	–
Realisable assets[2] and adjustments	+1,387	-6,867	–
Total	**20,928**	**19,419**	**–**

[1] Includes net revenue gains.
[2] Includes changes in Government's Trust Fund balances. A positive (+) sign indicates a drawdown in the accumulated realisable assets.
p Preliminary

Source: Ministry of Finance

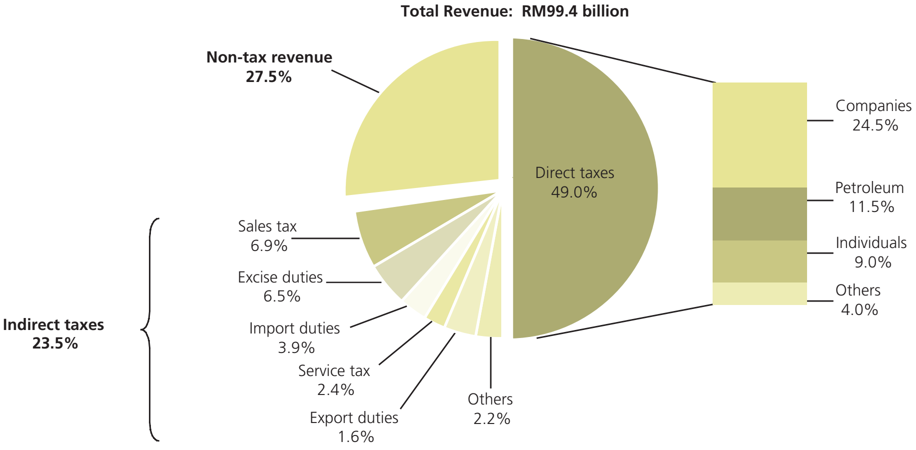
Table 2.9
Federal Government Revenue

	2003	2004*p*	2003	2004*p*
	RM million		Annual change (%)	
Tax revenue	**64,891**	**72,050**	**-2.9**	**11.0**
% of GDP	**16.5**	**16.1**		
Direct taxes	43,016	48,703	-3.0	13.2
Companies	*23,990*	*24,388*	*-2.6*	*1.7*
Petroleum	*8,466*	*11,479*	*10.9*	*35.6*
Individuals	*7,984*	*8,977*	*-19.3*	*12.4*
Stamp duties	*2,008*	*2,381*	*15.9*	*18.6*
Others	*568*	*1,478*	*26.0*	*160.0*
Indirect taxes	21,875	23,348	-2.8	6.7
Export duties	*1,156*	*1,600*	*43.9*	*38.3*
Import duties	*3,919*	*3,874*	*6.9*	*-1.1*
Excise duties	*5,031*	*6,427*	*6.0*	*27.7*
Sales tax	*7,965*	*6,816*	*-13.8*	*-14.4*
Service tax	*2,038*	*2,349*	*-7.9*	*15.3*
Others	*1,766*	*2,281*	*-3.8*	*29.2*
Non-tax revenue	**27,717**	**27,347**	**66.4**	**-1.3**
Total revenue	**92,608**	**99,397**	**10.9**	**7.3**
% of GDP	**23.5**	**22.2**		

p Preliminary

Source: Ministry of Finance

Graph 2.10
Composition of Federal Government Revenue, 2004 (% share)



Stronger domestic demand conditions during the year resulted in higher collections of most major sources of indirect taxes. In particular, the continued high demand for motor vehicles combined with measures announced in the 2004 Budget contributed to higher collections of excise duties. Among the new measures were higher excise duties on cigarettes and tobacco products and measures to curb smuggling activities through the use of special stickers or banderole and security ink. During the year, there was a rationalisation of the tariff structure on motor vehicles in line with Malaysia's commitment to the ASEAN Free Trade Area (AFTA) agreement. With effect from 1 January 2004, under the new tariff structure, import duties for the completely knocked down (CKD) ASEAN passenger cars were reduced to 25% (from 42-80%), while higher excise duties of 60-100% were imposed (from 25-65%). Nevertheless, import duties collection was only slightly affected. Sales tax collections were also lower due to the higher tax exemption given for petroleum products. Under the Automatic Price Mechanism, a higher tax exemption would be provided to oil companies to minimise the impact of higher oil prices on the retail prices of petroleum products.

In line with the Federal Government's fiscal consolidation stance, the growth in total gross expenditure of the Federal Government was lower at 4.9% in 2004 (2003: 9.5%). The overall thrust of Government expenditure was to continue to provide a supportive environment for the private sector and to enhance the productive capacity as well as the quality of life for all Malaysians. The substantially higher subsidy for petroleum products was the major reason for **operating expenditure** increasing by 21.4% in 2004. The sharp increase in oil prices resulted in significantly higher subsidies, largely for petroleum product. Under the Automatic Pricing Mechanism, the Government is required to pay subsidies to oil companies in the event that the duty exemption provided is not adequate to compensate for the loss of revenue arising from increases in oil prices but maintaining stable retail prices of petroleum products. To mitigate some of the impact of further increases in oil prices on the payment of subsidy, the Government raised the retail prices of petroleum products by two sen with effect from 1 May and by five sen with effect from 1 October 2004. Higher expenditure for supplies and services was mainly for maintenance and repairs, rent and payments for professional services to upgrade the quality and efficiency of Government services.

Table 2.10
Federal Government Operating Expenditure by Object

	2003	2004*p*	2003	2004*p*
	RM million		% share	
Emolument	21,721	23,779	28.9	26.0
Supplies and services	13,968	16,633	18.6	18.2
Asset acquisition	1,409	1,764	1.9	1.9
Debt service charges	10,546	10,920	14.0	12.0
Pensions and gratuities	5,870	6,060	7.8	6.6
Subsidies	2,679	5,796	3.6	6.3
Other grants and transfers[1]	16,323	21,264	21.7	23.3
Other expenditure[2]	2,706	5,083	3.6	5.6
Total	**75,224**	**91,298**	**100.0**	**100.0**
% of GDP	**19.1**	**20.4**		

[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

Higher payments were made in the form of grants and transfers to government agencies, statutory bodies and state governments for development and maintenance purposes. There was a sharp increase in the payment of refunds on excess taxes collected prior to 2004. The total wage bill, which was the largest component of operating expenditure (26%), rose by 9.5%. During the year, the Government enhanced incentives for the teaching profession with a 20% pay rise for teachers with excellent performance and also increased salaries for the armed forces. Debt service charges were slightly higher, reflecting the higher level of financing taken to finance the Federal Government deficit. Nevertheless, the share of debt servicing expenditure to operating expenditure declined to 12% (2003: 14%).

Gross **development expenditure** declined substantially by 26.7% to RM28.9 billion during the year (2003: RM39.4 billion). As greater emphasis was placed on agriculture and rural development and public utilities projects, higher outlays were recorded for these sectors.

In terms of sectoral distribution, the economic services sector became the largest component of total development expenditure with its share increasing to 41%. Higher outlays on agriculture and rural development and public utilities, such as rural roads, water and electricity programmes, reflected the Government's efforts to further modernise the agriculture sector and to enhance the standards of living in rural areas. Outlays for the transportation sub-sector remained favourable, in line with the Government's objective of promoting a more efficient and effective integrated transportation network. Funding was channelled mainly towards constructing and upgrading roads and bridges, as well as improving and increasing the capacity of the railroad system, ports and airports. Spending under the trade and industry sub-sector was focussed on industrial research and technological development, promotion of SMEs and tourism development projects.

Table 2.11
Federal Government Development Expenditure by Sector

	2003	2004*p*	2003	2004*p*
	RM million		% share	
Defence and security	6,029	4,133	15.3	14.3
Economic services	13,793	11,851	35.0	41.1
Agriculture and rural development	1,620	2,881	4.1	10.0
Trade and industry	3,456	1,201	8.8	4.2
Transport	7,354	6,630	18.7	23.0
Public utilities	920	945	2.3	3.3
Others	443	193	1.1	0.6
Social services	17,707	10,260	45.0	35.5
Education	10,193	4,316	25.9	15.0
Health	2,681	2,352	6.8	8.1
Housing	1,928	1,593	4.9	5.5
Others	2,905	1,999	7.4	6.9
General administration	1,824	2,620	4.7	9.1
Total	**39,353**	**28,864**	**100.0**	**100.0**
% of GDP	**10.0**	**6.4**		

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

Source: Ministry of Finance

In the social services sector, priority continued to be given to the education sub-sector. However, expenditure on the education sub-sector was significantly lower, as most projects in this sector under the Eighth Malaysia Plan had already been completed. As part of earlier fiscal stimulus programmes, implementation of single session schools and the construction of computer laboratories, polytechnics and universities were accelerated during 2001-03. Expenditure for health purposes also remained high to provide better quality healthcare and medical services. The bulk of this expenditure was for the construction and upgrading of hospitals and the provision of rural health services. The Government also continued to undertake housing projects for public sector personnel and the lower income groups. Spending for defence and internal security purposes was mainly for the modernisation programme of the armed forces and police. Higher expenditure for general administration was largely for Information and Communications Technology (ICT) development as well as for the acquisition of fixtures and fittings for new Government buildings.

Total **gross borrowings** of the Federal Government in 2004 amounted to RM47 billion (RM45 billion in 2003). Almost the entire financing requirement (98% of total) was sourced domestically as there was excess liquidity in the banking system. The regular issuance of government securities helped to further develop the ringgit bond market by ensuring a more reflective benchmark yield curve.

During the year, fourteen issues of Malaysian Government Securities (MGS) totalling RM41.8 billion were issued through open tenders and private placements. Out of this total, the Government reopened nine MGS issues to increase their respective issue sizes, which served to enhance liquidity in the bond market. The Government also made three new issuances of the Government Investment Issues (GIIs)

Table 2.12
Federal Government Debt

	Annual change 2003	Annual change 2004*p*	As at end-2004*p*
	Nominal value in RM million		
Domestic debt	**22,803**	**30,487**	**181,970**
Treasury Bills	0	0	4,320
Government Investment Issues	2,000	2,100	9,100
Malaysian Government Securities	21,250	23,550	154,350
Treasury Housing Loans Fund	2,628	4,837	14,200
Market loans	-3,075	0	0
External debt	**1,001**	**-2,631**	**34,654**
Market loans	-485	-3,259	24,930
Project loans	1,486	629	9,724
Total	**23,804**	**27,856**	**216,624**
% of GDP			**48.4**

p Preliminary

Source: Ministry of Finance

amounting to RM4.1 billion. By holders, the provident and pension funds and insurance companies continued to be the major holders. The banking institutions raised their holdings of MGS to 15% of total outstanding MGS as at end-2004. The holders of GIIs were mainly banking institutions (74% of total amount outstanding).

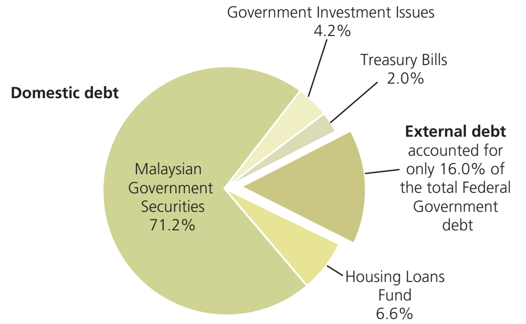
In line with the Government's prudent debt management policy, the Government limited its access to external borrowing to the drawdown on existing

Table 2.13
Holdings of Federal Government Domestic Debt

	2003	2004*p*	2003	2004*p*
	Nominal value in RM million		% share	
Treasury Bills	**4,320**	**4,320**	**100.0**	**100.0**
Insurance companies	67	17	1.6	0.4
Banking institutions	3,266	481	75.6	11.1
Others	986	3,822	22.8	88.5
Government Investment Issues	**7,000**	**9,100**	**100.0**	**100.0**
Insurance companies	390	597	5.6	6.6
Banking institutions	6,611	6,755	94.4	74.2
Others	0	1,748	0.0	19.2
Malaysian Government Securities	**130,800**	**154,350**	**100.0**	**100.0**
Social security and insurance institutions	99,162	109,362	75.8	70.9
of which:				
Employees Provident Fund	*84,678*	*91,402*	*64.7*	*59.2*
Insurance companies	*11,598*	*14,700*	*8.9*	*9.5*
Banking institutions	19,008	23,427	14.5	15.2
Others	12,630	21,560	9.7	14.0

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

Graph 2.11
Federal Government Debt as at end-2004*p* (% share)



Total debt : RM216.6 billion
Domestic : RM182.0 billion
External : RM34.6 billion

p Preliminary

project loans. A total of RM1.1 billion were disbursed from both bilateral and multilateral sources. During the year, the Government novated two loans to government agencies. Hence, the external debt level of the Federal Government was lower at 7.7% of GDP at end-2004, compared to 9.5% at end-2003.

Total **outstanding debt** of the Federal Government increased to RM216.6 billion due mainly to higher domestic debt. In terms of the ratio of Federal Government outstanding debt to GDP, it was slightly higher at 48.4% as at end-2004 (end-2003: 47.9%). Despite the higher debt levels, the Government's debt servicing capacity continued to remain within prudent and manageable levels. Debt servicing as a proportion of operating expenditure and revenue remained low at 12% and 11% respectively in 2004. The external debt service ratio of the Federal Government was also low at 0.5% in 2004, given the low external debt exposure of 16% of total outstanding debt in 2004 (2003: 19.8%). Active debt management also minimised bunching of repayments, with about 60% of the external debt at end-2004 having remaining maturity of more than three years. The bulk of the loans (about 95%) were raised at fixed interest rates, which reduced exposure to any interest rates fluctuations.

State Governments

Based on preliminary estimates, the consolidated financial position of the state governments recorded an overall deficit of 0.3% of GDP. The slight deterioration was due to higher operating and development expenditures despite the stronger revenue performance. The overall deficit was financed by the drawdown of accumulated financial assets of the state governments and loans from the Federal Government.

Table 2.14
Consolidated State Government Finance

	2003	2004e	2005 Budget
	RM million		
Revenue	8,541	10,085	10,183
State sources	*7,217*	*8,277*	*7,448*
Federal grants and transfers	*1,324*	*1,808*	*2,735*
Operating expenditure	5,307	6,796	6,787
Current surplus	**3,234**	**3,289**	**3,396**
% of GDP	**0.8**	**0.7**	**0.7**
Net development expenditure	3,817	4,739	4,852
Gross development expenditure	*4,362*	*4,856*	*4,969*
Less: Loan recoveries	*545*	*117*	*117*
Overall balance	**-583**	**-1,451**	**-1,456**
% of GDP	**-0.1**	**-0.3**	**-0.3**
Sources of financing:			
Net Federal loans	1,033	440	385
Realisable assets[1]	-450	+1,011	+1,071
Total	**583**	**1,451**	**1,456**

[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets.
e Estimate
Note: Numbers may not add up due to rounding.

Source: State governments

During the year, higher revenue was derived from both state and Federal sources. The states' own sources of revenue were enhanced mainly by higher receipts of royalties on petroleum and gas, as well as better returns from investments. As in previous years, receipts from Federal sources were channelled to assist the states in providing infrastructure and essential amenities to improve the quality of life of the people.

The increase in operating and development expenditures of state governments reflected efforts undertaken in improving public amenities and services. The higher operating expenditure was mainly due to higher emoluments and payments for supplies and services. A major portion of the rise in development expenditure was directed towards agricultural and rural development, expansion and upgrading of public utilities and housing development.

Non-Financial Public Enterprises (NFPEs)

Based on preliminary estimates, the consolidated financial position of the 34 NFPEs continued to record an overall surplus. The consolidated revenue of the NFPEs rose by 4.2% to RM162.3 billion, as a result of higher earnings from the oil and gas-related sector, telecommunications and utilities, manufacturing and services sectors. The better revenue performance was attributable to higher economic activity and higher prices of crude oil and gas. To a lesser extent, extraordinary gains from sales of assets also contributed to an increase in revenue. Nevertheless, a smaller current account surplus of 11.7% of GDP was recorded due to the higher current expenditure. The increase in current expenditure resulted from the higher costs arising from business expansion and higher prices of raw materials and inputs, especially for crude oil.

Development expenditure was sustained at a high level. Capital expenditure was channelled towards the expansion of capacity, both at home and abroad. 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 (TMB). During the year, PETRONAS continued its domestic and international investments in both upstream and downstream activities. Acquisition of equity shares in the Egyptian Liquefied Natural Gas (LNG) Project and the Dragon LNG terminal in Milford Haven, UK were significant inroads made by PETRONAS to enter into the Atlantic Basin LNG market. The year also saw a formalisation of Pars LNG, a joint venture with the National Iranian Oil Company and TOTAL S.A, in which PETRONAS holds a 20% equity that established PETRONAS' supply position in the Middle East. Other projects undertaken included the on-going enhancement of LNG and petroleum tanker fleet, and construction of the remaining government buildings, quarters, commercial buildings and infrastructure works. Meanwhile, international projects undertaken by PETRONAS included exploration and production projects in Egypt, Vietnam, Sudan, Iran and Indonesia.

Table 2.15
Consolidated NFPEs Finance[1]

	2002	2003	2004e
	RM million		
Revenue	126,562	155,867	162,337
Current expenditure	80,951	99,429	109,980
Current balance	**45,611**	**56,438**	**52,358**
% of GDP	**12.6**	**14.3**	**11.7**
Development expenditure[2]	32,297	40,160	34,135
Overall balance	**13,314**	**16,278**	**18,223**
% of GDP	**3.7**	**4.1**	**4.1**

[1] Refers to 34 NFPEs in 2003 and 2004; 36 NFPEs in 2002.
[2] Includes grants from the Federal Government.
e Estimate
Note: Number may not add up due to rounding.

Source: Ministry of Finance and non-financial public enterprises

A large portion of capital expenditure by TNB was concentrated on the expansion and upgrading of power generation, transmission and distribution networks which were needed to ensure adequate and reliable supply of electricity in meeting the increasing demand from commercial, industrial and residential users. Projects undertaken included the Rehabilitation of Tuanku Jaafar Power Station Phase I and II in Port Dickson, Yan Power Station, Gelugor Combined Cycles Power Plant and Power Quality Monitoring System. TMB continued with its upgrading and expanding of telecommunication infrastructure and services, which included the submarine cable network connecting the Asia Pacific region, lease line of Internet protocol and the virtual private network for Government.