OVERVIEW

Economic and Financial Developments in the Malaysian Economy in the First Quarter of 2003

First quarter growth within expectations...

The Malaysian economy has remained resilient despite an external environment marked by heightened uncertainty and the impact of SARS on regional economies in the final part of the quarter. Real GDP growth of the Malaysian economy in the first quarter of 2003 was within expectations. Economic activity expanded at an annual rate of 4% compared with 1.3% in the corresponding period last year. Expansion was positive in all sectors.

Growth in the first quarter was largely supported by domestic demand, underpinned by stronger public sector spending. Export performance remained strong in several sectors, reinforcing domestic demand. Expansion of monetary aggregates, especially M1, reflected the strong domestic demand. Further growth in bank lending and stronger expansion was seen in loans to small businesses.

A combination of accommodative monetary and fiscal policies, low inflation, a stable job market as well as higher commodity prices were factors supporting domestic demand during the quarter. Domestic demand was underpinned by higher public sector spending on emoluments, and supplies and services. Private consumption spending also showed a resilient trend, supported by extensive retailers' promotions sustained by growth of disposable income and positive consumer confidence. An important factor was the continued positive growth in gross fixed capital formation. Higher public sector investment was expended on education, health and infrastructure development. Forward-looking indicators such as MIER Business Conditions Index, consisting of orders and anticipated production, as well as high bank loan approval rates signalled that investment activities could improve as uncertainties abate.

Sustained growth in all economic sectors

Growth in the first quarter was marked by continued expansion across all sectors of the economy with the main impetus emanating from the manufacturing and services sectors. The manufacturing sector expanded by 5.2%, supported by stronger growth in the domestic-oriented industries and expansion in the export-oriented industries. This was reflected in the higher capacity utilisation rate in the sector of 82%. Export and domestic-oriented industries operated at 83% and 80% respectively.

The overall services sector continued to register a relatively strong growth of 4%, supported by domestic demand and trade-related activities in tandem with the sustained expansion in exports. In particular, growth in the transport, storage and communication sector strengthened, underpinned by strong expansion in the telecommunication sector, as well as robust growth in port and trade-related activities. Similarly, the wholesale, retail trade, restaurants and hotel sector performed better, supported by domestic demand.

Construction sector activity expanded by 1.2%, supported by public sector projects and continued demand for housing, amidst an improving labour situation. The return of foreign workers enhanced expansion in construction activity. Output from the mining sector continued to increase, underpinned mainly by expansion in natural gas production with the coming onstream of the MNLG 3 plant in March, as well as continued growth in crude oil production. The agriculture sector continued to register a positive growth despite the weaker crude palm oil production. The sector was supported by higher production of other major commodities such as rubber, saw logs and cocoa amidst the favourable prices and strong external demand.

Inflation remained low while labour market remained stable

The annual increase in CPI averaged 1.6% in the first two months of 2003 but moderated to 0.7% in March. This was due to the lapse of the impact of the higher tariff on telephone services implemented in March 2002.

Overall, labour market conditions remained stable during the quarter. As employers expect the slowdown to be transitory and cyclical in nature, the pace of retrenchment and other cost-cutting measures have slowed down. Productivity in the first quarter increased with annual growth in real sales per worker outpacing the growth in real wages.

External position remained resilient

The trade surplus was larger at RM17.6 billion in the first quarter. Export performance remained moderately strong, supported by the upturn in global semiconductor demand. Gross exports expanded by 7.8%, reflecting growth in exports of manufactured goods, agriculture and minerals. In line with strong global demand, exports of semiconductors and palm oil were exceptionally robust. While the volume of Malaysia's crude oil exports was stable, higher export proceeds reflected the war premium on oil prices. Import growth moderated to 2.3%, mainly due to slower growth in imports of intermediate goods. Reflecting the sustained strength in private consumption, imports of consumption goods grew by 4.7%. Excluding lumpy items, imports of capital goods increased by 0.3%.

Tourist arrivals remained steady at 2.9 million for the quarter despite the heightened geopolitical risk. Tourist arrivals were sustained at a monthly average of one million arrivals but declined to 0.8 million in March due mainly to the onset of SARS. The SARS impact, with the issue of the WHO travel advisory beginning mid-March, was more concentrated among tourist arrivals from Singapore and Hong Kong. It is largely anticipated that the SARS impact on tourism is likely to be reduced in the second half of the year.

Based on the Cash BOP Reporting System, gross inflows of FDI in the form of direct equity and inter-company loans (excluding retained earnings) increased by RM3.1 billion in 1Q 2003. In terms of composition, gross inflows of FDI during the first quarter were mainly through inter-company loans. About 60% of the loans were received from a related company by an MNC, through its centralised treasury operations in Malaysia. Direct equity inflows continued to be channelled into the manufacturing sector and the oil and gas sector. Outflows of FDI during the first quarter reflected largely the higher repayment of short-term inter-company loans, and payment for an acquisition of foreign interests in the gas sector. After taking into account the gross

outflows, FDI recorded a net outflow of RM3.3 billion. As outflows were mainly to fund the change in ownership of business interests from non-resident to residents, the FDI flows did not adversely affect economic activity in Malaysia. Meanwhile, net overseas investment recorded a lower outflow of RM1.1 billion (4Q 2002: -RM2.1 billion), led by investments into the oil and gas sector and the manufacturing of composite component parts for the aerospace industry. Outflows of portfolio investment was much lower at RM1.6 billion in the first quarter.

Reserves increased further

The net international reserves of Bank Negara Malaysia increased to RM132.6 billion or US$34.9 billion as at end-March 2003. The reserves level had also taken into account the quarterly adjustment of the unrealised foreign exchange revaluation gain amounting to US$211 million. Reflecting the sustained strong fundamentals of the economy, the net international reserves increased further to RM139.7 billion or US$36.8 billion at 13 June 2003. The reserves position is adequate to finance 5.7 months of retained imports and is 4.6 times the short-term external debt.

External debt remained manageable

Malaysia's total external debt position stabilised at RM186.8 billion (US$49.1 billion) as at end-March 2003, equivalent to 52.9% of GNP. Although medium and long-term external debt increased marginally, total short-term external debt declined to RM30.9 billion or US$8.1 billion. The lower short-term debt reflected the decline in the revolving credits of the non-bank private sector, arising mainly from the repayment of these loan facilities by several major companies. As at end-March, short-term debt accounted for only 16.5% of total external debt, among the lowest in the region.

Fiscal stance remained expansionary

Budgetary operations by the Federal Government remained expansionary in the quarter, led mainly by substantially higher development expenditure for social and economic programmes. Consequently, the Federal Government registered a higher overall deficit of RM4.7 billion in the first quarter. Nonetheless, the outstanding debt of the Federal Government was contained at 45.9% of GDP (45.7% of GDP as at end-2002). This level of debt remained manageable, with domestic debt accounting for 78% of the total debt.

Accommodative monetary policy continued to support domestic demand

Monetary policy remained accommodative in the first quarter to support domestic economic activity. Interbank and retail rates continued to remain low and stable while liquidity remained ample. In tandem with the continued expansion in economic activities, all three monetary aggregates continued to expand, with M1, M2 and M3 increasing by 8.4%, 5.6% and 6.7% respectively as at end-March. Strong increase in M1 reflected sustained demand for transaction balances. This corresponds to the sustained increase in private consumption.

Growth in monetary aggregates was mainly due to sustained financing activity of the private sector during the quarter. Total gross financing through the banking system and capital market expanded at an annual rate of 12.2%. During the quarter, bank lending activity was sustained with loan disbursements amounting to RM100.4 billion. Loan applications and approvals, the two leading

indicators, increased by 14.4% and 14.1% respectively. A significant development during the quarter was that outstanding loans extended to the small and medium industries (SMIs) expanded further by RM2.1 billion. Meanwhile, total deposits mobilised by the banking system rose by RM1.1 billion during the quarter or 3.2% at end-March 2003. In April, loans and deposits increased further. Consequently, the loans-deposit ratio, including holdings of private debt securities by the banking system, stood at 93.7% at end-April.

In the capital market, total funds raised were significantly higher in the first quarter. The public sector raised funds amounting to RM20.3 billion mainly through issuance of Malaysian Government Securities (MGS). Net funds raised by the private sector amounted to RM15.8 billion, mainly from the private debt securities (PDS) for both refinancing and debt restructuring purposes.

Banking sector exhibited increased resilience

Banking capitalization strengthened further as a result of improved quality of assets and profitability. The net NPL ratio (6-month classification) moderated further to 7% at end-March 2003 while net NPL ratio (3-month classification) fell below 10%, the first time since the Asian crisis. The risk-weighted capital ratio (RWCR) and core capital ratio improved further to 13.1% and 10.9% respectively as at end-March 2003.

Danaharta continued with its recovery efforts to maximize the recovery values from the NPLs with an expected recovery rate of 56% (48% for acquired loans and 63% for managed loans). Danaharta's total recovery collection amounted to RM20.3 billion at end-2002, representing 69% of the total amount that it expected to recover from its portfolio. Danaharta has, up to end-2002, distributed surplus recoveries of RM371.1 million in cash and 55,899,542 units of securities to 30 financial institutions.

Upgrading of the Bankcard successfully completed

An important development during the quarter was the successful completion of the upgrading process for Bankcard by MEPS and local financial institutions. The official launching of Bankcard on 28 February 2003 brings to fruition one of the two types of smart card solutions under the Multipurpose Card (MPC) Flagship Application, which is one of the seven MSC Flagship Applications. As at end-March 2003, more than 1.74 million Bankcards have been issued. Banking institutions are also in the midst of upgrading their ATMs to perform MEPS Cash loading which is targeted to be completed by the end of the second quarter. The ATM and MEPS Cash applications are part of the features of the MyKad, issued by the National Registration Department.

Bank Negara Malaysia is also taking steps to increase consumer understanding and to promote the prudent use of credit cards. In this regard, the Bank has issued a guideline on credit card operations on 18 March giving the issuers of credit cards six months to undertake the necessary system adjustments and ensure compliance. The new guidelines set out the minimum requirements on credit card operations revoking previously issued guidelines and covering new areas such as prudent lending requirements, usage of credit card for unlawful activities, supplementary cardholder's liability, liability for lost or stolen credit cards and placing added emphasis on consumer awareness and education programmes.

Near-term outlook remains favourable

Going forward, the outlook for the second half of the year is for further strengthening of the Malaysian economy. On the external front, the outlook for the major industrial economies in general and the US in particular has improved, although growth is likely to be more modest than earlier expectations. Proactive measures by the authorities in the area of monetary and fiscal policies have been taken to support growth.

On the regional front, the SARS impact has been adverse on specific sectors including the retail, travel and tourism-related sectors. The recent downward revisions on regional outlook reflect the varying impact of SARS among countries in the region. In response, the Governments in the region have announced economic relief packages to mitigate the impact of SARS. It is largely expected that the regional growth would pick up in the second half of the year. In Malaysia, a stimulus package amounting to RM7.3 billion was introduced, incorporating 90 measures under 4 main strategies, aimed at alleviating the impact of SARS and strengthening economic activity.

As part of the package, the 3-month intervention rate was reduced by 50 basis points to 4.5%. Together with the other measures in the economic package to increase disposable income, it is expected to enhance the potential for supporting the growth prospects. The interest rate adjustment represents a pre-emptive measure intended to lend support to strengthen further the domestic growth potential in an environment of a more modest growth in the global economy. With economic fundamentals remaining strong and macroeconomic policy in place to support growth, Malaysia is well positioned to realise its underlying growth prospects.