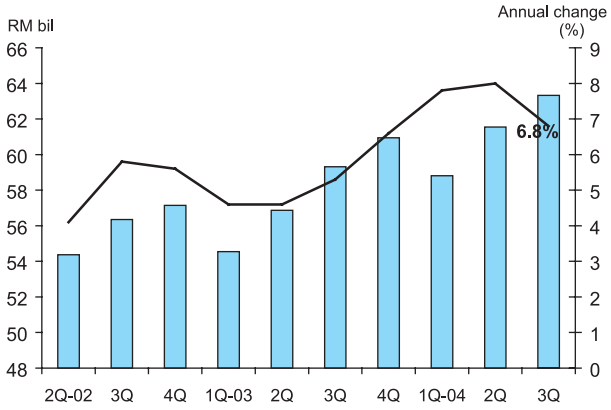
Economic and Financial Developments in the Malaysian Economy in the Third Quarter of 2004

OVERVIEW

Growth remained favourable

Following two consecutive quarters of strong growth averaging 8%, real GDP growth for Malaysia continued to remain favourable at 6.8% in the third quarter of 2004. Growth was driven mainly by the private sector as the public sector remained committed to fiscal consolidation. The expansion in domestic demand was due largely to stronger household consumption and sustained private investment activities. Nonetheless, the modest expansion in public consumption during the quarter contributed marginally to overall growth.

Real GDP remained favourable in 3Q 2004



Source: Department of Statistics Malaysia

The key economic sectors, namely, manufacturing, services and the primary commodity sectors, continued to drive growth. The manufacturing sector continued to record a strong growth supported by both domestic and external demand. Meanwhile, growth in the services sector was sustained by strong consumption and tourism- and trade-related activities, while the primary commodity sector posted stronger growth on account of higher production, especially for major commodities. The weaker performance in the construction sector was mainly on account of slower activity in the civil-engineering sub-sector.

Production in the manufacturing sector expanded further by 11.5% in the third quarter. Growth in the export-oriented industries, of which electronics and electrical products (E & E) account for 33% share, still remained high at 12.3% (2Q 2004: 18.2%), with growth in electronic products increasing by 26.3% (2Q 2004: 33%). The chemical products cluster, especially plastic and resins, continued to perform in tandem with the electronics industry. Meanwhile, growth in the domestic-oriented industries strengthened to 8.8% (2Q 2004: 7.5%), supported mainly by increased output of industries producing fabricated metal products, beverages and transport equipment.

Reflecting strong consumption and increased tourism- and trade-related activities, the services sector expanded by 6.1% during the quarter (2Q 2004: 7.8%). The final services sub-sector increased by 6%, while growth in the intermediate services was at 6.2%. Growth in final services emanated

mainly from the wholesale and retail trade, restaurants and hotels sub-sector on improved consumer sentiments and high tourist arrivals. The Malaysian Institute of Economic Research (MIER) survey for the third quarter showed that the Consumer Sentiments Index gained 1.5 points quarter on quarter to 113.9 points, while other indicators such as imports of consumption goods, sales of passenger cars, consumption credit and loans approved and disbursed to households and the wholesale, retail, restaurants and hotels segment remained strong and continued to record significant growth. Expansion of the intermediate services segment was attributable mainly to growth in trade related activities and sectoral development, as reflected in the sustained expansion of the transport, storage and communication (transport) and the finance, insurance, real estate and business services (finance) sub-sectors. While the transport sub-sector benefited from increased trading activities and a large number of tourist arrivals during the quarter, growth in the finance sub-sector was underpinned by high bank lending and strong insurance activities in tandem with the expansion in domestic economic activities.

Growth in the agriculture and mining sectors strengthened to 6.1% and 4.2% respectively during the third quarter (2Q 2004: 3.6% and 1.2%). Growth in the agriculture sector was broad based, driven mainly by higher production of palm oil, rubber and forestry as well as other miscellaneous agriculture, including fisheries, vegetables and fruits. The expansion in the mining sector was driven wholly by increased crude oil production, as natural gas production declined. Meanwhile, the construction sector declined by 3% (2Q 2004: -1.7%), due mainly to slower activity in the civil engineering sub-sector. It was, however, partially mitigated by sustained growth in the residential and non-residential segments.

During the third quarter, the private sector continued to take the lead in stimulating domestic demand amidst ongoing consolidation by the public sector. The expansion in domestic demand was underpinned mainly by stronger household consumption and sustained private investment activities. Private consumption increased strongly by 10.8% supported by a sustained increase in disposable incomes following higher export earnings and favourable commodity prices, stable employment conditions, low inflation and the low interest rate environment.

Gross fixed capital formation increased further by 3.2% (2Q 2004: 3.5%), supported mainly by sustained private investment activities as the Federal Government further reduced its development expenditure, lowering the fiscal deficit to 1.3% of GDP during the third quarter. Growth in private investment, which had turned around since the third quarter of 2003, was stronger due primarily to higher capacity utilisation, with some industries operating at near full capacity. This high level of capacity utilisation, together with improving corporate profitability and favourable financing conditions, have encouraged investment in new projects as well as increased investment in machinery and equipment for capacity expansion. Key private investment indicators, namely, loan approvals

and disbursements to businesses and the construction sector, imports of capital goods and sales of commercial vehicles, suggest continued sustainability of private investment activities. This is corroborated by MIER Business Confidence survey for the third quarter, which showed the Business Confidence Index at 110.2 points, above the 100-point threshold level. This essentially reflects ongoing expansion in the manufacturing sector. Domestic investment was also supported by higher inflows of FDI, particularly to the manufacturing, services and oil and gas sectors, during the quarter.

Growth in the Malaysian economy was achieved amid low inflation, with consumer prices edging up slightly to 1.5% during the quarter (2Q 2004: 1.2%). On the other hand, the Producer Price Index trended upwards during the quarter, largely reflecting firmer commodity prices. Meanwhile, labour market conditions remained stable, supported by sustained productivity, as reflected in the manufacturing sector's real sales per employee growth of 18.3%, far exceeding the 2% increase in real wage per employee.

During the quarter, Malaysia's balance of payments position remained strong, with the trade surplus increasing to RM22.7 billion (2Q: RM18.1 billion), with strong gross exports and gross imports growth of 26.9% and 29.9% respectively (2Q: 22% and 32.1% respectively). Growth in exports was attributable to stronger growth from manufactured goods and minerals, while the increase in agriculture revenue moderated. Overall, export volume increased by 21.1% and prices by 6.5%. However, export prices of a number of major primary commodities, including crude oil, LNG and rubber, were significantly higher during the quarter. The market share of exports to the region remained strong at 43.6%, while the share to the US was 19.5% and to the EU, 11.7%.

The strong increase in gross imports was broad based. Imports of intermediate goods, which accounted for the bulk of total imports, rose by 25.9% in tandem with continued domestic economic activities, particularly in the manufacturing sector. Among imported inputs that registered marked increases were industrial supplies, parts for electrical apparatus and construction materials. Imports of capital goods were also stronger, rising by 30.4%, while capital imports excluding lumpy items rose by 26.1%. Consonant with higher private consumption and demand owing to festivities, imports of consumption goods surged by 37.8% during the quarter.

In the financial account, FDI and both overseas and portfolio investments rose during the quarter. Gross inflows of FDI were higher at RM4.1 billion and were channelled mainly into the services, manufacturing and oil and gas sectors. Gross outflows of overseas investment doubled during the third quarter and were mainly by companies in the services, oil and gas and manufacturing sectors. Portfolio investment also recorded a net inflow during the quarter in line with improvement in stock market sentiment and sustained foreign interest in Malaysian debt securities. Given the inflows of FDI and portfolio funds as well as continued repatriation of export proceeds, the

international reserves position increased to RM231.4 billion (US$60.9 billion) as at 12 November 2004. The reserves level is sufficient to finance 7.5 months of retained imports and is 5.6 times the short-term external debt. Owing to concerns on the rising trend in oil prices and its impact on the global economy, especially the US economy, sentiment on the US dollar weakened. Thus, the ringgit depreciated against the euro but recorded a mixed performance against the regional currencies.

Monetary policy continued to support growth

During the third quarter, the financial sector continued to support growth. In response to strong demand from both the business and household segments, gross private sector financing through the banking system and the capital market increased at an annual rate of 7.5% to RM133.6 billion. This amount was higher than levels recorded in the first two quarters of this year, and reflected the higher bank loan disbursements and the larger issuance of PDS. On a net basis, banking system loans and PDS outstanding grew at an annual rate of 8% at end-September (8.2% at end-June). Compared with the second quarter, the growth rates of most loan indicators moderated in the third quarter partly due to the high base effect.

Total loan disbursements to businesses rose at an annual rate of 5% and by 11.3% to households during the quarter. Loans disbursed to businesses were channelled mainly to the manufacturing sector (37.4% to total disbursements of businesses), and the wholesale, retail, restaurants and hotels sector (25.8%). Within the business sector, loan disbursements to SMEs grew at an annual rate of 12.8%. A total of RM8.7 billion was approved to 25,379 SME accounts during the quarter, up from RM8.4 billion to 22,161 SME accounts in the second quarter. An important development during the quarter was the establishment of the National SME Development Council in August to coordinate policy initiatives and to ensure the effective implementation of policy measures to develop this sector.

As part of the ongoing financial structural reform efforts, three mergers between commercial banks and their finance companies were effected, resulting in some technical adjustments to their base lending rates (BLRs) and average lending rates (ALRs). Notwithstanding these adjustments, the average BLR of all the commercial banks and finance companies remained stable at 5.98% and 6.90% respectively as at end-September 2004.

During the quarter, the expansion in broad money, M3, of 10.6%, was broadly in line with the growth rates registered at the end of the last quarter (10.7%). In absolute terms, M3 recorded a larger quarterly expansion attributable to higher external inflows from repatriation of export proceeds as well as inflows of FDI and portfolio funds. The increase was also driven by the sustained increase in the claims on the private sector. Meanwhile, M1 achieved a double-digit annual growth rate largely in line with the expansion in private consumption activity.

The banking system remains sound

The performance of the banking system remained strong in the third quarter with asset quality improving further amidst an expansion in lending activities. In addition, the level of capitalisation remained strong despite a marginal decline, following the completion of the Bafin merger exercise between three commercial banks and three finance companies. The risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of the banking system stood at 13.8% and 11.3% respectively during the quarter. The level of capitalisation of the banking system is expected to improve upon the inclusion of the audited profits. The profitability of the banking system remained favourable with RM2.8 billion pre-tax profits recorded during the third quarter, compared to RM2.4 billion in the corresponding quarter of last year.

The net NPLs based on the 6-month classification continued to trend downwards to account for 6.1% of total net loans, the lowest level since the Asian crisis (2Q 2004: 6.2%). The improvement was mainly on account of lower incidences of new NPLs and higher write-offs.

The near term outlook for Malaysia to remain favourable despite signs of moderating global growth trends…

Prospects are for global growth to trend to more sustainable levels in an environment of high oil prices and rising interest rates. In the US, although the third quarter growth picked up further on account of increased investment and stronger-than-expected consumption, the economy is expected to moderate to a more sustainable pace of expansion as the monetary stimulus is gradually removed. While the growth momentum in Europe and Japan has been supported by strong external demand, nevertheless, signs of slower export-led growth are emerging. In the Japanese economy however, this would likely be offset by stronger domestic demand amidst stable labour market conditions. Meanwhile, export demand in the Asian region still remains strong despite some modest easing, notably for electronics, towards the end of the quarter. The growth prospect for the Asian region is assessed to remain strong, supported mainly by strong underlying domestic demand in most regional economies amidst stable labour market conditions.

Despite some moderation in global growth trend, the Malaysian economy is expected to sustain growth, driven largely by the private sector as the public sector consolidates its fiscal position. Several leading indicators point to continued favourable growth. The improvement in the growth rate of the Leading Index for August suggests continuing favourable growth into early 2005, while the Consumer Sentiment Index is higher in the third quarter, reflecting continued consumer optimism.

Sustained high global oil prices can be expected to have implications on the Malaysian economy. As an open economy and as a small net exporter of oil, Malaysia however, has stronger resilience to such developments. The direct impact of high oil prices had and would in fact benefit Malaysia

in terms of a higher trade surplus and higher gross government revenue. Inflationary pressures are expected to be minimal as oil accounts for only a minor share of the consumption basket for the average consumer while the pass-through effect would also be minimal with improved efficiency in the use of oil. The indirect risk, emanates from its implications on external demand from Malaysia's trading partners should the high oil prices persist into 2005. The trade data for the first nine months has nonetheless remained in Malaysia's favour, with mineral exports, including oil, generating significantly higher export receipts. It is thus expected that on balance, Malaysia would likely continue to be affected positively as a result of the high oil prices in the near term.

Amidst the Government's ongoing fiscal consolidation process, the economy would continue to be private sector-driven, largely through expansion in domestic demand from higher consumption and investment. Despite expectations of some easing in global demand, positive business and consumer sentiments suggest that private consumption would remain favourable, supported by rising incomes amid stable labour market conditions, while inflationary pressures are expected to remain subdued and monetary policy continues to be supportive of economic growth. Similarly, private investment, which has increased since 2003, would continue to be supported by inflows of new FDI and reinvestments. Forward-looking investment indicators signal a continued upward trend in investment activities, as reflected in the higher loan approvals and disbursements including that to the SME sector; imports of capital goods; sales of commercial vehicles; as well as increased investment for capacity expansion. At the same time, measures currently implemented to improve the government delivery system and corporate governance would further enhance the investment environment. In addition, increased investments are also expected in new growth areas such as the ICT and shared services sub-sectors, agriculture and higher value-added technology activities. These new potential sources of growth would also benefit from the various incentives introduced in the 2005 Budget. Overall, the banking sector is in a strong position to support and finance economic growth given its sound position as reflected in the capital adequacy of the banking system while the ratio of NPLs has been trending downwards. Going forward, these supportive investment factors augur well for stronger private investment activity.

Against a potentially less buoyant global environment, Malaysia will continue to have in place policies that are supportive of the growth process while addressing the nation's vulnerability to external developments.