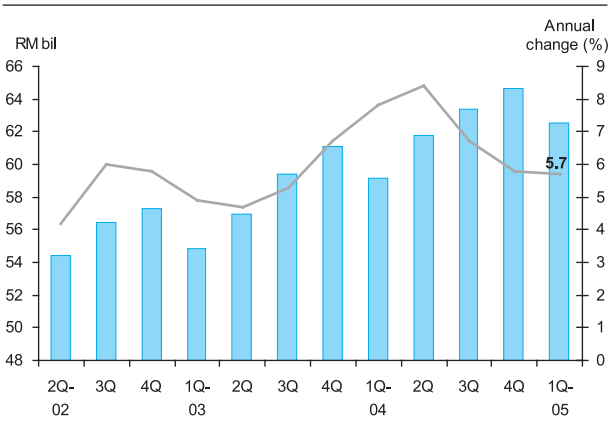
Economic and Financial Developments in the Malaysian Economy in the First Quarter of 2005

OVERVIEW

First quarter growth within expectations….

The Malaysian economy remained resilient despite a moderation in global economic activity amidst high oil prices and the continued downcycle of the global semiconductor industry. Real GDP growth of the Malaysian economy remained favourable and was within expectations, expanding by 5.7% in the first quarter of 2005. During the period under review, Malaysia continued to be one of the strong economic performers in the region.

1Q 2005 growth within expectations...



Source: Department of Statistics, Malaysia

Growth in the first quarter was broad based, with all major sectors of the economy, except construction, registering positive growth rates. The services sector continued to be the main contributor to growth, followed by the manufacturing and the primary commodity sectors. The overall services sector grew by 6%, supported by expansion in both the final and intermediate services groups. The final services benefited from robust consumer spending, high tourists arrivals and high usage of utilities amidst the favourable business environment. Meanwhile, increased banking, insurance and trade activities as well as robust growth in the telecommunication sector amidst the higher usage of voice and data services supported the intermediate services group.

Value added in the manufacturing sector expanded by 5.6%. Despite the slowdown in the electronics industry, the export-oriented industries continued to be resilient on the back of strong performance of resource-based industries such as chemicals, rubber products and off-estate processing industries. Growth in the domestic-oriented industries remained high, with higher output expansion in almost all the sub-sectors. The agriculture sector grew by 6% during the quarter, underpinned by strong performance in the palm oil sector following a substantial rise in productivity and an expansion in matured oil palm areas in East Malaysia. In the mining sector, although production of natural gas increased significantly, value added growth of the sector moderated to 3.3% due mainly to lower output of crude oil (including condensates). The construction sector

remained subdued in the quarter (-2.4%), due to lower civil engineering activity as well as delays in some projects due to the slow return of legal foreign workers following the Amnesty programme.

Domestic demand remained firm during the quarter under review, registering a growth of 5.9% . Private sector continued to be the key driver of economic growth in the first quarter, underpinned by robust consumer spending activities (10.1%), as a result of the cumulative effects of rising disposable income, high export earnings, favourable commodity prices and a stable employment market. Gross fixed capital formation rose by 2%, supported mainly by private investment activities which were spurred by improved business confidence and favourable financing conditions. Although the Federal Government's development expenditure declined, public investment for essential projects such as provisions for education, rural development, housing programme and health services continued during the quarter. The fiscal position saw an improvement to register a surplus of 2.3% of GDP in the first quarter of 2005, attributable to strong revenue collection and lower development expenditure.

Inflation increased moderately to 2.4% in the first quarter. This increase was driven mainly by higher prices of food and transport. The increase in prices of food was due to the higher demand for food given the festivals during the quarter coupled with tight supplies amid adverse weather conditions. The increase in prices of transport was caused mainly by the 10% increase in toll charges in January. Meanwhile, labour market conditions improved significantly underpinned by strong growth in productivity.

On the external front, the trade surplus increased to RM25.2 billion in the first quarter (4Q 2004: RM20.6 billion), due to a higher export growth relative to import growth. Gross exports increased by 13.5%, supported by strong growth in mineral exports that benefited from high prices for crude oil. Manufactured exports continued to post double-digit growth rate, underpinned by strong growth in exports of electronics and electrical (E&E), chemicals and petroleum products. Import growth increased at a more moderate pace of 9.8%. The growth in imports reflected the expansion in production and exports of manufactured goods as well as domestic consumption and private investment activity. Imports of capital goods (excluding lumpy items) remained strong, with a growth of 10.1% reflecting investment for capacity expansion and upgrading of technology. Meanwhile, imports of consumption goods grew by 10.4%, underscoring the sustained strength in private consumption. In line with the strong manufactured exports, imports of intermediate goods continued to post a double-digit growth rate. The market share of exports to the Asian (ex-Japan) region grew further to 45.8%, supported by increased outsourcing activities as well as the extensive production networks and linkages in the region following the relocation of companies to PR China and ASEAN countries. The market share of exports to India rose to 3%, while share of exports to US and EU remained significant at 17.6% and 11.9% respectively.

In the financial account, gross FDI inflows (excluding retained earnings) remained high at RM4.4 billion, mainly to the services, manufacturing and the oil and gas sectors. Malaysian companies' investments abroad increased further while portfolio investment moderated as fund managers reallocated their equity portfolio in the Asian region. Bank Negara Malaysia's net international reserves rose to RM275.2 billion or USD72.4 billion as at end-March 2005, supported by sustained repatriation of export proceeds and inflows of FDI and portfolio investment. International reserves strengthened further to RM284.4 billion or USD74.8 billion as at 14 May 2005, sufficient to finance 8.7 months of retained imports and is 7.2 times the short-term external debt.

Monetary policy continued to support growth

In the first quarter, monetary policy continued to support the expansion in private investment and consumption, with the Overnight Policy Rate (OPR) remaining unchanged at 2.70%. Low interest rates and ample liquidity in the banking system continued to support the financing of economic activities.

During the quarter, gross and net private sector financing through the banking system and the capital market grew at annual rates of 12.3% and 9.6% respectively. Total loans disbursed by the banking sector grew at a faster pace of 10.2% during the first quarter compared with 8.3% in the previous quarter. Similarly, total loans outstanding recorded a higher annual increase of 9.1% at end-March 2005 (end-2004: 8.5%). Of significance, the improvement in the demand for business loans since end-2004 continued into the first quarter of 2005. Loans outstanding of businesses grew at a positive rate for the second consecutive quarter, registering an annual growth of 2.8% at end-March 2005. Bank lending to small and medium enterprises (SMEs) rose further, with loans outstanding of SMEs increasing by 10.5%. Meanwhile, financing to the household sector was sustained at a high level, as reflected by the higher annual growth in the loans outstanding of households of 15.2% at end-March 2005.

In addition to bank financing, the capital market continued to be an important source of financing, especially for long-term business financing. In the first quarter of 2005, net funds amounting to RM10.5 billion were raised from the capital market. Gross funds raised from the private debt securities (PDS) market totalled RM5.5 billion, or 1.8 times the amount raised during the corresponding period of last year. Funds raised via the PDS market were mainly for restructuring and refinancing purposes as well as for new activities. During the quarter, funds amounting to RM2 billion were raised through the equity market.

In line with the expansion in domestic economic activity, narrow money or M1, expanded by 9.4% on an annual basis at end-March 2005. Meanwhile, broad money, M3, grew at an annual rate of 13.3%, driven mainly by higher claims on the private sector arising from increased lending by the banking

system as well as the continued inflow of external funds.

The banking system remained sound

The banking sector remained sound with a strong capitalisation level and improved profitability in the first quarter. The risk-weighted capital ratio of the banking system remained strong at 13.7%, while the pre-tax profits of the banking system improved by 12.2% to RM3 billion due mainly to lower loan loss provisions and operating expenses during the quarter. Banks' balance sheets were also healthier with the continued decline in non-performing loans (NPLs). The net NPL ratio based on 6-month classification continued to trend downwards to account for 5.4% of total net loans at end-March 2005. The 4.7% decline in net NPLs was due primarily to lower new loans classified as non-performing as well as higher restructuring and rescheduling of credit facilities during the quarter.

Sustained growth prospects

Going forward, the near-term outlook for Malaysia remains favourable despite some signs of moderating growth in the global economy and rising prices. Global growth is nevertheless still expected to be strong, supported by continued growth in consumer and investment demand. In the US, although the first quarter growth moderated, growth was supported by strong inventory-rebuilding and sustained consumption. In addition, current indicators point to continued strong growth in the Asian region. In particular, PR China continues to benefit from strong consumer spending, investment and high FDI inflows. Given the increased regional integration in trade and production with PR China, this trend will increasingly promote mutually reinforcing growth among regional economies including Malaysia. Meanwhile, the cyclical downturn in the global semiconductor industry is forecast to be modest and transitory in view of continued global demand, more rapid inventory adjustment and relatively low inventory levels.

On the domestic front, the prospects are for sustained growth in 2005. Although economic expansion may moderate due to the weaker external environment, economic activities would be sustained, driven by the private sector as suggested by the forward leading indicators. The Department of Statistics's Leading Index suggests continued economic expansion for the second and third quarters of 2005. This optimism is further corroborated by the MIER Consumer Sentiments Index which rose by more than 10 points to 120.9 points, reflecting rising consumer confidence. Given that households are not burdened by excessive debt, robust consumer spending is likely to be sustained. In addition, the MIER Business Conditions Index breached the 100-point threshold level to 104.1 points, indicating an upward trend in private investment activities.

More recently, there are emerging concerns over inflationary pressures. For Malaysia, price pressures have been contained to some extent by improvements in labour productivity and capacity expansion, while continued gains in external trade enable monetary policy to remain supportive of

growth. In addition, the recent liberalisation of the foreign exchange administration rules would further reduce the cost of doing business and encourage better risk management practices in the private sector. The banking system has also emerged stronger from the crisis, with NPLs trending downwards and profitability improving. The sound financial position of the banking institutions amidst favourable household and business sentiment would provide further support to the economy. Finally, the well-diversified economy increases resilience to weather developments in the external environment.