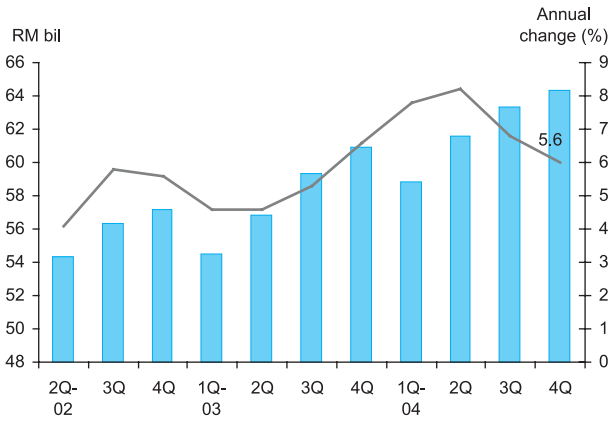
# Economic and Financial Developments in the Malaysian Economy in the Fourth Quarter of 2004

## OVERVIEW

### *Growth was led by the private sector*

The Malaysian economy registered a growth of 5.6% in the fourth quarter of 2004. Growth was led by private sector activity while the Federal Government continued with its fiscal consolidation program. For 2004 as a whole, the Malaysian economy expanded by 7.1%.

**Growth momentum sustained in 4Q 2004**




In the manufacturing sector, the more diversified base has provided support to moderate the impact of the slowdown in the electronic equipment sub-sector. The services sector continued to remain firm, with higher growth in most sub-sectors. The primary commodity sector recorded another quarter of strong performance supported by higher palm oil and natural gas production. However, the construction sector remained weak due mainly to lower civil engineering activity.

Value-added in the manufacturing sector increased by 5.4% in the fourth quarter of 2004 (3Q: 9.9%). The pace of growth moderated mainly in the electronics and electrical products industry (production growth: 4.7%, 3Q: 19.3%) in line with the adjustments in inventories in the global electronics sector. Among the other major export-oriented industries, the chemical products industry recorded a higher growth of 13.4% (3Q: 8.7%), attributed to higher production of industrial gases as well as expansion in the plastics segment. As a result, export-oriented industries as a group registered a growth of 7.5% in the fourth quarter (3Q: 12.8%). Meanwhile, growth in the domestic-oriented industries was sustained at a high level of 6.2% (3Q: 7.2%), supported by strong growth in the transport equipment and fabricated metal industries, and to a lesser extent iron and steel industries.

Value-added in the services sector rose by 6.3% (3Q 2004: 6.1%). The transport, storage and communication sub-sector recorded a significant expansion due to robust performance of the telecommunication industry and continued expansion in trade-related activities. In the telecommunication sub-sector, growth was driven by higher

subscriber base in the cellular segment. The utilities sub-sector was supported by increasing demand for electricity by all categories of users. Growth in the wholesale, retail, and restaurant sub-sector was 6.9%. The finance, insurance, real estate, business services sub-sector recorded a growth of 6.2%.

In the fourth quarter, both the agriculture and mining sectors expanded further by 7.7% and 4.7% respectively (3Q 2004: 5.3% and 4.7% respectively). The agriculture sector was underpinned by exceptionally strong performance of the palm oil sector (16.5%), while the expansion in the mining sector was driven largely by higher production of natural gas.

In the construction sector, the residential and non-residential segments expanded with firm demand, particularly for landed properties, supported by the attractive financing packages and rising disposable income. Construction of the non-residential segment was driven largely by demand for office and retail space amidst the favourable business activities. Nevertheless, the overall construction sector contracted by 3.3% (3Q 2004: -3%), due mainly to lower civil engineering activity.

During the fourth quarter, the private sector led the expansion in domestic demand. The rise in consumer sentiment was attributed to stable employment conditions and sustained high disposable incomes from strong commodity export proceeds. Favourable financing conditions, low interest rates and low inflation led to a strong 9.7% increase in private consumption. Although the Consumer Sentiments Index, a forward looking consumption indicator compiled by the Malaysian Institute of Economic Research, was lower in the fourth quarter, the index remained above the 100-point threshold, indicating that consumer confidence remains positive. Consumer optimism was reflected in higher imports of consumption goods, sales of passenger cars, loans approved and disbursed to households for the purposes of consumption and purchase of durable goods. Growth in public consumption moderated to 3.7% (3Q 2004: 4.6%).

During the fourth quarter, private investment activity was robust, on account of expenditure on the replacement of machinery and equipment in the manufacturing sector as well as investment in seismic and geophysical survey apparatus for oil exploration activities. As a result, gross fixed capital formation increased (2.2%) in spite of the decline in the Federal Government development expenditure. Notwithstanding the lower development expenditure, spending continued to be channelled to important fiscal operations and services such as education, housing, transportation, agriculture and rural development.

Growth in the Malaysian economy in the fourth quarter was achieved amidst low inflation. Inflation edged up slightly to 2.1% in the fourth quarter, reflecting increases in food prices, higher personal transportation charges, as well as higher taxes on cigarettes and tobacco. Nevertheless, the upside risks to inflation were limited by expansion in capacity and continued

productivity growth. Meanwhile, labour market conditions remained stable, supported by strong growth in productivity. In the manufacturing sector, real sales value of products per employee rose by 15.3%.

During the fourth quarter, Malaysia's balance of payments position remained strong, with trade account recording a sustained large surplus of RM21 billion (3Q 2004: RM22.7 billion). Gross exports registered a lower growth of 16.1% due mainly to the slowdown in the exports of electronics and electrical (E&E) products. Gross imports increased, albeit at a more moderate pace of 18.6%. Imports of intermediate goods continued to expand by 12.8%, supported by higher demand for metals and resource-based inputs. Imports of capital goods continued to expand strongly by 37.7%, with the bulk being channelled into the manufacturing and services industries for upgrading technology and capacity expansion. Capital imports excluding lumpy items, grew by 26.6%. Consonant with higher disposable income a nd higher demand related to festivities, imports of consumption goods grew by 16.5% during the fourth quarter, with higher demand for food and beverages and consumer goods.

In the financial account, foreign direct investment (FDI), overseas and portfolio investments increased during the fourth quarter. Gross inflows of FDI rose to RM4.6 billion and were channelled evenly to the manufacturing, services and the oil and gas sectors. Gross outflows for overseas investment increased significantly to RM16.5 billion, attributed mainly to higher short-term loan extension by non-resident controlled companies in Malaysia to their related companies abroad arising from the centralisation of their treasury operations. Excluding the outflows for treasury operations, overseas investment from the services, oil and gas and manufacturing sectors were higher in the quarter. Portfolio investment recorded a higher net inflow of RM11.1 billion during the fourth quarter, reflecting renewed active foreign participation in both Malaysian equities and debt securities.

The international reserves of Bank Negara Malaysia strengthened further by RM37.4 billion (US$9.8 billion) in the fourth quarter of 2004 to a record level of RM253.5 billion (US$66.7 billion) as at 31 December 2004. The increase reflected the higher repatriation of export earnings, as well as higher inflows of FDI and portfolio funds. The reserves increased further to RM269.6 billion (US$71 billion) as at 15 February 2005, supported mainly by sustained repatriation of export earnings. The reserves level is sufficient to finance 8.5 months of retained imports and is 6 times the short-term external debt.

### *Monetary policy continued to support growth*

In an environment of low inflation, the Overnight Policy Rate (OPR) was maintained at 2.70% in November. Monetary policy continued to support the expansion in private investment and private consumption. Gross private sector financing through the banking system and capital market was higher,

amounting to RM142.6 billion, equivalent to an annual increase of 6.7%.

Loan disbursements to the business sector grew by 7.8% on an annual basis. The disbursements were channelled mainly to the manufacturing sector (35.7% of total loan disbursements to businesses); the wholesale, retail, restaurants and hotels sector (26.4%); and the finance, insurance and business services sector (9.4%). Loan disbursements to large businesses and small and medium enterprises (SMEs) rose at annual rates of 7.2% and 9.1% respectively. A total of RM8.7 billion new loans were approved to 25,918 SME accounts during the quarter. Meanwhile, financing to the household sector was sustained with loan disbursements increasing by 12%.

In the private debt securities (PDS) market, gross new issuances by the private sector remained high, amounting to RM10.1 billion and were primarily in the construction and utilities sectors. In particular, the issuances by the corporate sector to finance new activities amounted to RM3.8 billion or 40.3% of new issuances. In the equity market, higher funds of RM2.3 billion were raised, with RM2 billion raised through 24 initial public offerings (IPOs).

The larger trade and capital inflows during the quarter remained manageable. Bank Negara Malaysia's liquidity operations were aimed at ensuring a level of interest rates that was consistent with domestic considerations. As a result, the growth in the broad money aggregate, M3 remained broadly in line with the expansion in economic activity.

***Increased resilience of the banking system***

The banking system continued to exhibit increased resilience in the fourth quarter, with a high level of capitalisation, improvement in profitability and the lowest level of non-performing loans since the Asian financial crisis. The risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of the banking system remained high at 13.8% and 10.8%, despite recording marginal declines. The expansion of capital base was attributed mainly to lower capital deductions for investments in subsidiaries (-RM1.6 billion) post-Bafin mergers, while the higher risk-weighted assets was due mainly to increased lending. The banking system recorded a 6.1% increase to RM3 billion in pre-tax profits during the quarter, compared to RM2.8 billion in the previous quarter.

The net NPLs based on the 6-month classification continued trending downwards to account for 5.9% of total net loans, the lowest level since the Asian crisis (3Q2004: 6.1%). Similarly, the net NPLs based on 3-month classification showed significant improvements to RM37.5 billion or 7.6% of total net loans (3Q2004: 8.1%). The improvement was largely attributed to higher recoveries, reclassifications and write-offs.

***The Malaysian economy is expected to sustain growth in the near term …***

Going forward, the global economic expansion is expected to be sustained at a steady pace in 2005. The pace of slowdown in the United States and People's Republic

of China is expected to be moderate, based on the premise that adjustment in imbalances in these economies would be gradual. Monetary policy is expected to remain accommodative as inflation is forecast to remain manageable, amidst high but stable oil prices. Labour market conditions have improved in several regions. These developments would be supportive of growth in the Asian region. The impact from the electronics down-cycle will vary across countries. While the global electronics industry is consolidating after reaching a peak in mid-2004, the downcycle is forecast to be modest in view of the continued global demand, more rapid inventory adjustments and relatively low inventory levels. Overall, domestic demand in the region is expected to be supportive of growth, backed by favourable fundamentals and contribution from new growth areas. The impact of the tsunami is estimated to be minimal and short term, confined to the tourism and fishery industries in selected areas in the affected countries.

The growth prospect for Malaysia therefore remains favourable in 2005. The sustained increase in the Leading Index in November suggests that economic growth momentum will be maintained into 2005. Growth would be driven by the private sector as the public sector consolidates its fiscal position. The Consumer Sentiment Index remained well above the critical 100-point mark in December indicating the strong consumer optimism. Growth in the Malaysian economy would continue to be achieved amid low inflation. The upside risks to inflation are limited by capacity expansion and continued productivity growth.

Monetary policy stance would continue to ensure that the interest rates remain consistent with domestic economic activity and be supportive of growth.