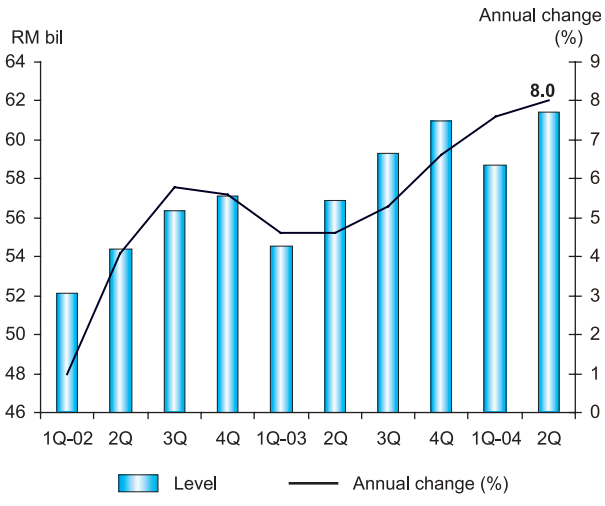
Economic and Financial Developments in the Malaysian Economy in the Second Quarter of 2004

OVERVIEW

Growth momentum strengthens further

The Malaysian economy strengthened further, with growth in real GDP increasing at a faster pace of 8% in the second quarter of 2004, from 7.6% in the first quarter. Private sector aggregate demand was more robust and reinforced by buoyant growth in external demand. Stronger domestic demand emanated largely from stronger household consumption and the strengthening of private investment activities, as the public sector continued to consolidate. The private sector continued to be the main growth driver, contributing significantly to real GDP growth.

Stronger real GDP growth in 2Q 2004



Growth continued to be broad-based, led by the manufacturing and services sectors. The strong growth in the manufacturing sector was sustained at 12.1% (1Q 2004: 12.7%). Both the export- and domestic-oriented industries registered strong expansion of 18.3% and 8% respectively. In the export-oriented industries, higher growth was recorded in the electronics, chemical products and rubber products industries. Strong expansion was seen in the electronics industry, particularly from high demand for consumer electronics and communication devices. This had positive spillover effects on growth in the chemical products industry, particularly resins and plastic products, which supply inputs to the electronics industry. Meanwhile, sustained external demand for gloves continued to support the expansion in the rubber products industry. In the domestic-oriented industries, robust growth in domestic demand underpinned the expansion in the food products, fabricated metal products, and iron and steel as well as transport equipment industries.

Value-added growth in the services sector was faster at 7.4% (1Q 2004: 6.2%), with both final and intermediate services recording strong growth of 7.3% and 7.6% respectively (1Q 2004: 5.4% and 7.4% respectively). Growth in the final services segment, particularly the wholesale and retail trade, hotels and restaurants sub-sector, was stronger due partly to the combined effects from a strong pick-up in tourism and domestic consumption activities, and partly due to the low base effect. In the intermediate services segment, the transport, storage and

communication sub-sector continued to record strong growth due to increased trade- and travel-related activities and strong expansion in the telecommunication industry. Higher bank lending and insurance activities as well as property transactions provided further support to the services sector.

Growth in the agriculture sector was sustained at 3.2%, due mainly to higher expansion in rubber and other agriculture activities such as livestock and fisheries, which more than offset the decline in palm oil production owing to lower yields. Meanwhile, growth in the mining sector moderated to 1.1%, due mainly to the decline in crude oil production following the temporary shutdown of several oil and gas fields and plants for maintenance purposes.

The construction sector contracted by 1.7% due to lower civil engineering activity which was partly mitigated by higher activities in the residential and non-residential segments. Low interest rates, higher incomes amidst favourable commodity prices and a stable job market supported the demand for residential property. Expansion in the non-residential sub-sector was due mainly to improved business sentiment and investment activity, which underpinned demand in the retail shop and office segments. Overall, construction activity is expected to benefit from the additional allocation of RM10 billion for development expenditure under the Eighth Malaysia Plan.

Despite the ongoing fiscal consolidation, domestic demand growth strengthened further in the second quarter of 2004, with further expansion of private sector activities. Growth in private consumption expanded strongly by 11.4% (1Q 2004: 8.4%), supported by higher disposable income, improved consumer confidence, low inflation and interest rates, as well as stable employment conditions. In line with the Government's commitment to fiscal consolidation, public consumption increased moderately, while public investment continued to be pared down. Gross fixed capital formation continued to register a strong growth of 3.5% (1Q 2004: 3.5%), underpinned entirely by stronger private investment activities as Federal Government's development expenditure continued to decline. The fiscal deficit was 4.5% of GDP in the second quarter.

Inflation remained low at 1.2% in the second quarter. New capacity expansion in sectors experiencing strong growth, stable labour market conditions and increasing competitive pressures, contributed towards reining in price pressures in a strong growth environment.

Balance of payments developments also reflected more buoyant economic conditions. The large trade surplus narrowed slightly (2Q 2004: RM18.1 billion; 1Q 2004: RM19.3 billion), as imports of intermediate and capital goods rose in response to strengthening investment and capacity expansion. The growth in gross exports by 22% was due to stronger expansion in exports of manufactured goods and commodities. The trend of stronger growth in manufactured exports reflected strong external demand for electronics and electrical products, chemicals and rubber products. With the exception of

palm oil and saw log exports, which were driven entirely by strong prices, higher exports of other major agriculture commodities and minerals were due to both higher prices and volume, especially for rubber, crude oil and LNG.

The stronger expansion in gross imports by 32.1% reflected mainly stronger consumption demand and private investment, rising manufacturing production as well as increased outsourcing for lower cost inputs from regional countries for the electrical and electronics industry. In tandem with strong external demand for electronic products, imports of intermediate goods recorded a strong growth of 31.6%. Consonant with the upward trend in private investment growth, imports of capital goods expanded further by 27.6%. Increase in capital imports is reflective of capacity expansion in the manufacturing and oil and gas sectors. Imports of consumption goods increased rapidly by 26.5%, reflecting stronger growth in domestic consumption. Another significant development during the quarter was the strong growth in imports for re-exports which involved packing and assembling activities at distribution parks located in the free commercial zones at the major ports. Excluding re-exports, imports rose by 30%.

In the financial account, FDI inflows remained high and were channeled mainly to the services sector, specifically the business and support services and wholesale and retail trade sub-sectors. The manufacturing sector, especially the electrical and electronics, petroleum-related and chemical-related manufacturing activities, as well as the oil and gas sector continued to attract FDI inflows.

With the continued high repatriation of export earnings, sustained inflows of FDI and portfolio funds and drawdown of external loans, net international reserves increased by US$2.5 billion to US$53.9 billion at end-June 2004. The level of international reserves rose further to US$54.4 billion as at 14 August 2004, sufficient to finance 7.2 months of retained imports and is 5 times the short-term external debt.

Strong expansion of financing to the private sector

Ample liquidity and prevailing low interest rates effectively supported the financing needs of the private sector. Gross private sector financing through the banking system and the capital market increased significantly by 8.7% in the second quarter of 2004. Loan disbursement by the banking system increased further by 14.8% during the quarter (1Q 2004: 14.4%), with higher lending to both the business and household sectors. Higher loan disbursements to businesses remained broad based, with financing channeled mainly to the manufacturing sector, the wholesale and retail trade, restaurants and hotels sector, and the finance, insurance and business services sector. Lending to small and medium enterprises (SMEs) continued to increase in the second quarter. A total of RM8.3 billion was approved to 22,161 SME accounts (1Q 2004: RM5.7 billion to 18,703 accounts). While lending to households was sustained during the quarter, the gross NPL ratio of the sector remained manageable at 7.6% at end-June 2004 (7.9% at end-March).

A significant development in the second quarter was the introduction of the new interest rate framework on 26 April 2004. The Overnight Policy Rate (OPR) replaced the 3-month intervention rate as the indicator of monetary policy stance. The OPR was set at the prevailing overnight interbank rate of 2.70%, reflecting that the new interest rate framework did not represent a change in monetary policy stance. Transition to the new framework was smooth as market participants responded within expectations. The daily weighted average of the overnight interbank rate moved within a narrow range in the period 26 April -19 August, averaging 2.70%.

The new interest rate framework also included removal of the base lending rate (BLR) formula. Each banking institution now announces their own BLR based on their cost structure and business strategies. With only one bank lowering its BLR, the average BLR of the commercial banks was slightly lower at 5.98%, while the average BLR of finance companies remained unchanged at 6.90% as at 15 August 2004. The average lending rates (ALRs) of the commercial banks and finance companies continued to decline during the quarter and as at end-July 2004, stood at 6.00% and 8.69% respectively (6.10% and 8.95% respectively as at end-March). This reflected the larger proportion of new loans priced at lower rates.

Sound Banking System

The banking system remained sound with the risk-weighted capital ratio (RWCR) at 13.8% as at end-June 2004. The profitability of the banking system improved further with a pre-tax profit of RM3.3 billion, as higher incomes and lower provisions offset the increase in operating costs during the quarter. The annualized return on average assets and equity of the banking system was higher at 1.6% and 18.7% respectively. The net NPL ratio based on 6-month classification declined further to 6.2% at end-June 2004 due to higher loan recoveries and reclassifications as well as lower incidences of new NPLs.

Expectations of sustained growth in the second half-year

Overall, the global economic performance in the first half of 2004 has surpassed expectations. GDP growth was higher than expected in the first half-year and more balanced across regions. While indicators point towards some moderation in global growth in the second half-year, global growth is still expected to remain strong, supported by continued growth in consumer and investment demand. In the United States, positive labour market conditions suggest more self-sustaining growth in the second-half year. In Asia, recovery in Japan is ongoing while growth in P.R. China remains high. Continued expansion in intra-regional trade and domestic demand as well as favourable outlook for the global economy would continue to support growth in the regional economies.

Global economic conditions have become more challenging with higher energy prices, rising interest rates and some slowdown in the major economies. Our

assessment is that the impact of these risks on global growth in 2004 would be modest. While oil prices are expected to remain high due to concerns on supply disruption, the global economy has a greater capacity to manage high energy costs in view of better economic conditions, higher incomes, improvements in job prospects and more efficient use of energy. Gradual interest rate increases towards a more neutral stance would ensure growth is sustained in the United States. Current indications of a soft landing to be achieved in P.R. China and sustained domestic demand in regional economies will be positive for Malaysia. Overall, the balance of risks indicates sustainable growth prospects going forward.

This favourable external environment is expected to further reinforce domestic demand growth in Malaysia. Forward-looking indicators continue to support strong and sustainable growth in the domestic economy. The Index of Leading Indicators also suggests that the economy will further expand in the second half-year. In the manufacturing sector, demand for semiconductors is expected to remain strong given the increasing application of chips in a broad range of applications, particularly those which are consumer driven. Malaysia is positioned to benefit from growth in consumer electronics and communications, due to the large share of Malaysia's electronics output used in these applications. In the services sector, expansion in the wholesale and retail trade, hotels and restaurants, and transportation and communication sub-sectors is likely to continue with strong tourist arrivals and expanding trade and manufacturing-related services.

Improved consumer and business confidence, favourable commodity prices, stable employment conditions and rising incomes are expected to support further growth in private consumption and investment. Given the high savings, rising incomes and liquidity in the banking system, there is potential for higher consumption to support growth without undermining financing of private investment from domestic sources. Favourable financing conditions and improving corporate profitability as well as sustained growth in external demand will support private investment in the second half-year. In the business sector, the forward-looking indicators, loan applications and approvals by the banking system were significantly higher in the second quarter. Overall, growth would continue to be private sector driven with ongoing consolidation by the public sector.

The underlying fundamentals of the Malaysian economy continue to remain strong with low inflation, stable labour market conditions, sound and strong banking system and rising external reserves. Expanding capacity and increasing competitiveness of the domestic economy will contain price pressures in the strong growth environment. Monetary policy will, therefore, remain accommodative. The supportive external environment and conducive domestic conditions ensure that growth is likely to remain strong in the second half of the year. Following the strong growth performance of 7.8% for the first half-year, growth for the year as a whole is expected to surpass earlier estimates.