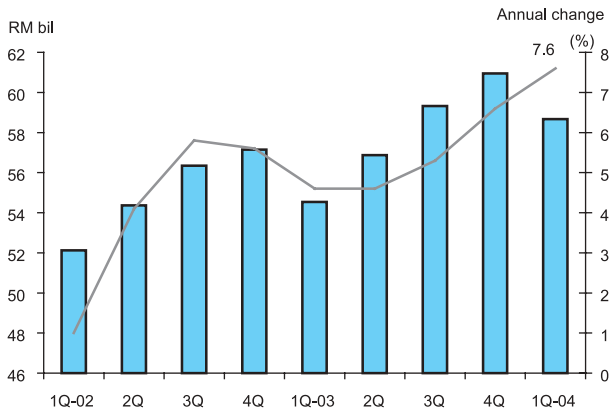
Economic and Financial Developments in the Malaysian Economy in the First Quarter of 2004

OVERVIEW

Robust economic activity in the first quarter

Economic expansion strengthened further, with growth in real GDP rising at the pace of 7.6% in the first quarter of 2004 from 6.6% in the fourth quarter of 2003. The robust economic activity, driven mainly by the private sector, reflected sustained strong growth in household consumption and an increase in momentum in private investment activity.

Higher real GDP growth in 1Q 2004



Growth was broad based across all sectors. The key contributor to the strong GDP performance was the strengthening in growth of the manufacturing and services sectors. Growth in the manufacturing sector strengthened to 12.5%, contributing 3.8 percentage points to GDP. The expansion was supported by stronger growth in export-oriented industries and sustained growth in domestic-oriented industries. The growth reflected stronger external demand, in particular for electronics, and the improving domestic demand and continued recovery in the investment cycle.

In the export-oriented industries, higher output growth was recorded in the electronics, rubber and chemical products industries. Strong growth in the semiconductor industry stemmed from higher corporate spending on information technology products and rising global consumer expenditure in the wireless product segment. Strong domestic and external demand in the electronics sub-sector had significant spill-over effects on the chemical industry, which was already expanding, following higher demand for industrial gases. The expansion in the rubber products industry was mainly due to higher external demand for gloves. In the domestic-oriented industries, growth was supported mainly by the fabricated metal, food and iron and steel products industries.

More robust economic activity for final and intermediate services products led to value added growth in the services sector strengthening to 6.2% (4Q 2003: 4.7%). In the final services segment, growth was driven by high consumer expenditure amidst rising domestic incomes and a record level of tourist arrivals during the quarter. Expanding external and domestic trade activity and tourist arrivals induced stronger growth in the intermediate

services segment particularly in the transport, storage and communication sub-sector. Higher loan growth, stronger performance of the insurance sub-sector and real estate and stock market activities also led to strong demand for finance, insurance, real estate and business services.

Despite the seasonally low period for the major agriculture commodities, the sector continued to expand further with higher production of rubber and palm oil amidst firm prices. Growth was also supported by higher production of other agriculture activities such as fisheries and livestock. Meanwhile, growth in the mining sector picked up, driven mainly by higher crude oil production and sustained output of natural gas.

Growth in the construction sector continued to be supported by activity in the residential sub-sector. The low interest rates, attractive financing packages and incentives under the Economic Package supported demand for residential property. The performance of the civil engineering sub-sector was subdued, reflecting mainly the completion of several large infrastructure projects. Construction activity, particularly in the civil engineering sub-sector, was also affected by the temporary shortage of steel bars. Measures taken by the Government, including permitting steel imports, stricter controls on exports and revisions to the ceiling price of steel, are expected to alleviate the shortage.

On the demand side, private consumption remained robust, underpinned by the rise in disposable income, improvement in business conditions, low interest rates and stable labour market conditions. Amidst growing consumer confidence, the increase in propensity to consume was broad based, stemming from high commodity prices, positive wealth effect from the pick-up in stock market performance during the quarter as well as the strong growth in manufactured exports.

Importantly, the growth momentum has been sustained by a stronger expansion in private sector capital spending since the turnaround in investment activity in the third quarter of 2003. Investment in machinery and equipment and capacity expansion strengthened as business sentiment improved further while capacity utilisation remained high. Sustained inflows of FDI, higher reinvestment amidst improving business conditions and the rapid growth in capital goods imports indicate that the underlying trend in private investment recovery is becoming entrenched.

Reflective of commitment for fiscal consolidation, public sector contribution to growth moderated while the private sector resumed a stronger role as the main driver of growth. The increase in public consumption moderated, while Federal Government development expenditure was lower. Development funds were mainly disbursed for education and training, health, transportation infrastructure and agriculture development. The fiscal deficit narrowed to 3.1% of GDP in the first quarter.

Despite the strengthening of domestic demand, inflation continued to remain low at 1%. Adequate supply and the competitive business environment contributed to containing inflationary pressures.

In the external sector, the trade surplus narrowed from RM 19.9 billion in the fourth quarter of 2003 to RM 18.6 billion, with the stronger increase in imports. While gross exports expanded by 16.6%, gross imports increased at a stronger pace of 23.4%. The growth in exports was due to stronger growth in exports of manufactured goods and sustained expansion in exports of agriculture commodities while receipts from minerals grew at a more moderate pace. Higher manufactured exports were spurred largely by the upturn in the electronics cycle. High prices as well as increased export volume of palm oil, rubber, sawn timber, LNG and crude oil contributed to the strong growth of commodity earnings.

Strong domestic demand, rising production, accumulation of stocks of intermediate goods on expectations of sustained export growth and stronger investment activities induced significantly higher imports. In line with the pick up in electronics exports, imports of intermediate goods, which are inputs for manufactured exports, recorded strong growth. After several quarters of low imports, capital goods imports were substantially higher in the first quarter of 2004, reflecting investment in machinery and equipment and capacity expansion in the manufacturing, services and oil and gas industries. With strong private consumer spending, imports of consumption goods also increased significantly.

In the financial account, the bulk of FDI inflows were channeled into business and support services and wholesale and retail trade. In the manufacturing sector, the electrical and electronics and petroleum-related manufacturing activities continued to attract inflows of new FDI as well as reinvestments by existing non-resident-controlled corporations.

With higher repatriation of export earnings, sustained inflows of FDI and larger inflows of portfolio funds, net international reserves increased by US$6.5 billion to US$51.3 billion at end-March 2004. International reserves rose further to US$53.9 billion as at 14 May 2004, sufficient to finance 7.6 months of imports and 5.5 times the short-term external debt.

The ringgit exchange rate continues to facilitate increasing trade and investment flows and is supported by rising international reserves, low external debt, low inflation and a sound banking sector. The ringgit continues to remain at fair value.

Monetary policy remained supportive of private sector-led activities

Monetary conditions in the first quarter of 2004 continued to support the stronger expansion in private sector activities. Interest rates during the quarter remained low and stable. Reflecting the low borrowing costs and sustained demand for loan financing, the growth in loans disbursed by the banking system was sustained at a high annual rate of 14.4%. Bank lending to the SMEs also remained strong in the first quarter of 2004. Higher approvals from previous quarters resulted in a high annual growth rate of 12.3% in loan disbursements to the SMEs, amounting to RM23.7 billion during the quarter. During the

quarter, a total of RM5.7 billion was approved to 18,703 SMEs. Overall, outstanding banking system loans and PDS continued to increase at a strong annual rate of 8.2%.

In line with the higher growth in private sector-led economic activities and the improved external sector, all three monetary aggregates expanded during the quarter. The annual growth rates of M1, M2 and M3 were higher at 19.8%, 12.6% and 10.7% respectively at end-March 2004 (14.6%, 11.1% and 9.7% respectively at end-December 2003). The higher growth in M1 reflected stronger demand for transactional balances due to higher consumption spending as well as higher turnover in the equity market. Meanwhile, broad money, M3, expanded by RM19.1 billion, reflecting the expansionary external operations and the higher financing by the banking system to the private sector.

A significant development in the conduct of monetary policy was the introduction of the new interest rate framework in April. The changes introduced are to enhance the effectiveness of the monetary policy transmission mechanism and promote more efficient pricing by banking institutions. With effect from 26 April 2004, the overnight policy rate (OPR) replaced the 3-month intervention rate as the indicator of the monetary policy stance. The new framework represented a change in the system of implementing monetary policy. It did not represent a change in monetary policy. To reflect this, the OPR was set at the prevailing interbank overnight rate of 2.70%. The new framework has been well received by the market and the transition to the new framework has been smooth and within expectations. As at 21 May 2004, the BLRs of the commercial banks, with the exception of one institution, remained unchanged at 6.00% while the BLRs of finance companies remained unchanged at 6.90% .

Sound Banking sector

The banking system remained sound with the risk-weighted capital ratio at 13.5% as at end-March 2004. The profitability of the banking sector improved with pre-tax profit of RM3 billion during the quarter due partly to lower loan loss provision. The annualised return on average assets and equity was 1.4% and 16.6% respectively (4Q2003: 1.3% and 15%). Write-offs by banking institutions at the end of their financial year and lower new NPLs during the quarter resulted in the net NPL ratio based on 6-month classification declining to 6.7% at end-March 2004 (end-December 2003: 6.8%).

The prospects are for sustained growth

The prospects for higher growth in 2004 have strengthened considerably, with favourable developments in the global economy, reinforced by a strong domestic economy. Expansion in the US economy has been stronger than expected and prospects remain favourable, in particular the pick up in investment and employment creation. The sustainability of the recovery in the US appears to be more entrenched. Current indicators point to robust growth and sustainability in economic expansion in Japan, while continued expansion in consumption and investment are expected to support growth in

the Euro area. Growth for the regional economies has been revised upwards, amidst robust intra-regional trade following the strong upturn in global electronics and stronger expansion in aggregate domestic demand. Growth in the People's Republic of China (P.R. China) will remain strong with rising sales and higher FDI inflows. The region as a whole will continue to benefit from greater integration and rising intra-regional trade which have mutually reinforced the stronger momentum and growth process in Asia.

More recently, some emerging concerns centre on overheating and the impending slowdown in P.R. China, rising energy prices and market expectations of rapid increase in interest rates. While these concerns warrant close monitoring, the balance of risks on the sustainability of growth continues to favour economic expansion. As P.R. China has introduced several measures to mitigate overheating in selected regions and industries, growth is expected to remain strong. In addition, the impact of higher energy prices is expected to be mitigated by continuing efficiency gains in energy utilisation, while the restructuring that has been undertaken in the banking and corporate sectors, globally and within the region in the recent decade, has raised the capacity of Asian economies to absorb shocks and accorded greater flexibility in managing financial risks.

On the inflation front, while expectations of higher short-term price pressure have emerged, the long-term inflationary outlook remains benign given the further enhancement of productivity increases, the continuous competitive pressures to seek low cost advantages arising from globalisation and the addition of new productive capacities. Given the existence of excess capacity in both product and labour markets, the rise in global interest rates is expected to be gradual and modest. Together with improved risk management capacities of the financial system, the strengthened cash flows of corporates, rising productivity of businesses and labour, the balance of risks continues to favour prospects for favourable and sustainable global growth.

The favourable but more challenging external environment is expected to continue to reinforce strong domestic demand growth in Malaysia. Greater consumer and business confidence and favourable commodity prices are expected to reinforce the strong momentum of growth in private consumption while the recovery in private investment will become more deeply entrenched. The public sector will, however, continue to consolidate. Major indicators point to sustained favourable growth. The Malaysian Institute of Economic Research (MIER) Consumer Sentiments Index rose by 2 points to 117.5 points in the first quarter, reflecting rising consumer optimism. The propensity to consume will be enhanced by firm commodity prices, higher export earnings and stable job markets.

The outlook for private investment shows a firming uptrend. Improved corporate profitability and cash flow positions and high capacity utilisation rates would drive and sustain growth in private investment. The improved business sentiment as reflected in the MIER Business Conditions Index, which

rose 2.1 points due to rising sales, higher exports and local orders as well as higher loans disbursed to businesses and imports of capital goods, indicate an expansion of business activities going forward. The strong six-month smoothed growth of the Leading Index also indicates that prospects for the Malaysian economy will remain favourable into the third quarter.

On the supply side, global electronics indicators such as the global SIA semiconductor sales, US book-to-bill ratio and US shipment of electronic products point to sustained global demand, which would also have positive spillover effects on the chemical industry. The robust growth momentum reflected in selected indicators such as higher retail activity, record level of tourist arrivals, sustained port activities and increase in air travel as well as higher bank lending, indicate that the services sector is on track to achieve the earlier growth expectations. Growth in the agriculture sector is expected to be sustained by increased production of crude palm oil and rubber and more intensive use of productivity driven inputs as a result of favourable commodity prices.

Domestic prices are expected to remain subdued. While capacity utilisation has increased considerably in some sub-sectors, new private investment is raising capacity. This, together with productivity enhancing practices, have mitigating influences on increasing price pressures from higher energy cost and rising commodity prices. Competitive pressure on margins continues to contain price pressure in other components of the consumer price index while asset prices have remained relatively stable. Of significance, productivity increases have outpaced the rise in labour costs across the Malaysian economy. Given the robust domestic economic conditions amidst benign inflationary pressures, interest rates in Malaysia will remain low for some time to come.