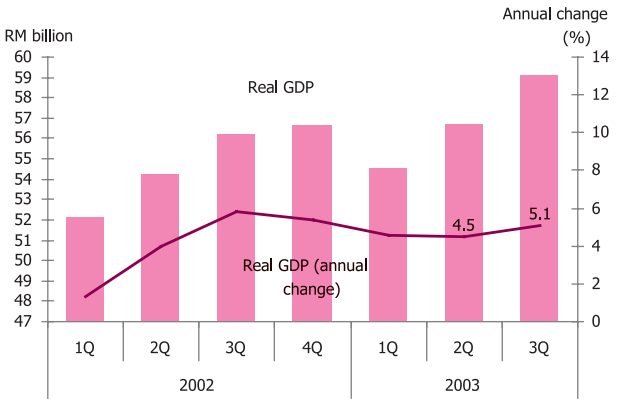
Economic and Financial Developments in the Malaysian Economy in the Third Quarter of 2003

OVERVIEW

Stronger growth momentum in the third quarter

The Malaysian economy expanded at a more rapid pace of 5.1% in the third quarter of 2003 from 4.5% in the second quarter. The growth has been broad based, both in terms of expenditure and production components. Strong economic fundamentals and the comprehensive public sector response to uncertainties in the global economy in the early part of the year has enabled the economy to benefit from the more favourable external environment in the third quarter. The strong private sector response to the pro-active Government measures and a low interest rate environment has contributed to the strengthening of the growth momentum.

Stronger real GDP growth in 3Q 2003



Growth in domestic demand was driven mainly by the private sector. Private sector activity strengthened with both consumption and investment picking-up momentum as a result of the cumulative effects of low interest rates, the Government measures, which resulted in higher disposable incomes and increased access to financing, and the beneficial impact of higher commodity prices on rural incomes. Other important factors supporting private sector activity was the growth in productivity and rising real wages amidst stable labour market conditions. The positive response to policies and the improved external outlook led to increased consumer and business confidence during the quarter. Private consumption grew strongly by 5.4% during the quarter. The more favourable economic environment and higher capacity utilization in the manufacturing sector stimulated the growth in private investment. As a result, growth in gross fixed capital formation accelerated to 3.2%.

Despite public consumption expenditure being sustained at a high level, the fiscal deficit declined in the third quarter as a result of improved revenue performance following the overall strengthening of the economy.

All sectors of the economy expanded markedly, except mining. Recovery in tourism, together with stronger consumer confidence, resulted in the sector recovering completely from SARS and the geopolitical uncertainties in early 2003.

The stronger expansion in manufacturing of 8.5% was stimulated by more buoyant domestic consumption and higher production for export. Capacity utilization remained high across both

domestic- and export-oriented industries. Generally, improved business confidence and a more optimistic outlook for global growth have resulted in further inflows of new foreign direct investment into the manufacturing sector in the third quarter.

Agriculture registered its fifth quarter of strong expansion as further increases in commodity prices stimulated robust production of both palm oil (+15.2%) and rubber (+17%). While crude oil production rose, lower output of natural gas from a temporary shut down of a gas field led to a marginal decline in the mining sector.

Stronger economic growth in the third quarter was achieved with low inflation. Consumer prices remained benign, rising by 1%. A combination of excess capacity, rising productivity and more competitive pricing of goods and services contained pricing power despite strengthening demand. Latest indicators on property prices, available to end-June, show only marginal increases, mainly for landed properties in choice locations. The overall price index is still at about levels in 1997-98.

The contribution from the external sector remained strong during the third quarter. The increase in reserves by US$3.7 billion to US$40.7 billion at the end of the quarter continued to accrue largely from long-term inflows associated with trade and investment activities. Net inflows of portfolio capital also contributed to the increase, though the flows only rose at a slightly higher rate since end-September. International reserves have risen further to US$43.6 billion as at 31 October, sufficient to finance 6.9 months of imports and is 4.7 times short-term external debt.

Preliminary data published indicates that the trade surplus declined to RM15.2 billion during the quarter as both gross exports (-3.1%) and gross imports (-5.7%) declined. The trade data is currently being reviewed by the Department of Statistics (DOS) as the changeover from the manual processing system to the Electronic Data Interchange System (EDIS) has given rise to some exclusions. DOS will release the data when the review is completed.

In the financial account, a notable development is the sustained foreign direct investment. New long-term equity inflows doubled during the third quarter, with foreign direct investment being channeled mainly into the services sector, particularly into financial and business services, wholesale and retail trade and the transport sector. Foreign investments in the manufacturing sector were mainly for semiconductor and petroleum-related activities.

The ringgit exchange rate continues to be well supported by the strong level of foreign exchange reserves, low inflation, continued surpluses in the current account, low external debt as well as a strong and resilient banking system. Notwithstanding recent developments in the foreign exchange markets, it is assessed that the ringgit remains at fair value. The peg provides stability and predictability, facilitating trade and investment activities and thus remains an integral part of macroeconomic management in Malaysia.

Monetary policy supported robust growth

Monetary conditions mirrored the strengthening of growth. Demand for credit rose, non-performing loans declined and the financial system was strongly supportive of private sector

activity. Loans disbursed by the banking system rose at an annual rate of 14.6%. Compared with the second quarter, higher amounts were disbursed to SMEs, the household sector and to large corporations. Loans disbursed to the businesses during the quarter increased by 17%.

As a consequence of the higher disbursements, total loans outstanding increased at an annual rate of 4.7% at end-September. Loans outstanding to the SMEs, which accounted for 15.6% of all outstanding loans and 31.5% of total loans outstanding to businesses, rose more rapidly by 7%. In the first nine months, outstanding loans to the SMEs expanded by RM4.8 billion. Overall, financing provided by the banking system through extension of loans and its holdings of PDS expanded by 5.7% as at end-September. Total gross private sector financing raised through the banking system and from the capital market increased significantly by 13.9% during the quarter.

The increase in all three monetary aggregates was also reflective of the significantly improved consumer and business sentiments. While stronger expansion in M1 (11.9%) reflected increased demand for liquidity from consumers, businesses and higher trading in the stock market, higher growth in M3 (9.2%) reflected the increase in direct lending by the banking system and an expansionary external sector.

Despite the stronger demand for loans, average lending rates continued to decline following the 50-basis point reduction of BNM's policy rate in May 2003 as well as the more competitive banking environment. Notwithstanding larger capital inflows, BNM's liquidity operations ensured that rates remained stable. There remains adequate instruments to facilitate sterilization operations. As a result, growth in money supply has remained consistent with the higher level of economic activities.

The profitability of the banking sector remained strong during the quarter while the better economic conditions saw improving asset quality. The banking system recorded a higher gross operating profit of RM3 billion in the third quarter due mainly to higher income, though interest expenses on deposits and operating costs were also lower.

The net NPL ratio (6-month basis) declined to 6.5% at end-September 2003 (9% on a 3-month basis). The level of NPLs for the business sector, in particular continued to record improvements. The largest decline was observed in NPLs for community, personal and social services sector, and financial services sector following the implementation of a number of restructuring exercises. NPLs for the household sector remained manageable at 8.2%.

Forward-looking indicators point to sustained strong growth

Prospects for the global economy for the remaining part of 2003 and into 2004 are turning significantly more positive. The US economy rebounded strongly in the third quarter, with rising job creation and investments and a consequent decline in the unemployment rate. This development is expected to have a positive impact in sustaining US private consumption. Stronger evidence of increases in investment is indicative of a more sustainable recovery in global growth. Encouraging trends have also emerged in Japan and Europe.

This more positive external environment will reinforce stronger domestic demand. Greater

consumer and business confidence is expected to reinforce the momentum of growth in private consumption and investment while the public sector gradually consolidates.

The major indicators continue to support sustained growth in the near to medium term. The Malaysian Institute of Economic Research Consumer Sentiments Index, which rose by 5.9 points to 112.8 points in the third quarter, reflects rising consumer optimism. Similarly, the outlook for investment, especially private investment, also shows an upward trend. Among the forward-looking indicators, the rising trend in loan applications showed sustained demand for finance to expand business activities. In addition, the economy continues to enjoy the positive effects of the earlier stimulus measures taken by the Government. More importantly, the improvement in sentiment is supported by strong underlying fundamentals that not only provide stable conditions for future growth but also allow risks to remain contained. The outlook for inflation remains low and stable while trade and long-term investment flows have contributed a significant share to the increase in international reserves. In addition, the banking system is well capitalized with NPLs on a declining trend, suggesting a more resilient banking sector. Notwithstanding the positive outlook and relatively low risks, the Government has the flexibility to implement preemptive action in the event of adverse external developments.

While current circumstances support growth exceeding earlier forecasts, it will take some time before the gap between potential and actual output narrows. Under these circumstances, the current accommodative monetary policy will be maintained to support the growth momentum.