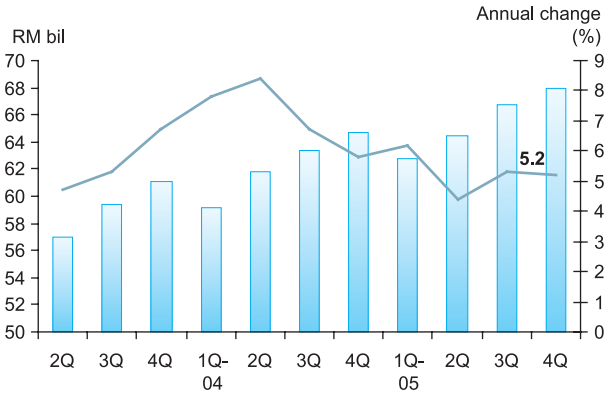
# Economic and Financial Developments in the Malaysian Economy in the Fourth Quarter of 2005

## OVERVIEW

### *Sustained growth driven by domestic and external demand*

The Malaysian economy expanded at a strong annual rate of 5.2% in the fourth quarter of 2005. The manufacturing and services sectors were the main drivers of this growth. A stronger upturn in exports provided added support to domestic private sector activities. Higher consumer sentiment and sustained business confidence underpinned the strong growth. For the whole of 2005, the combination of strong domestic demand and exports resulted in an overall growth in real gross domestic product (GDP) of 5.3%.

**Sustained real GDP growth in 4Q 2005**




Source: Department of Statistics, Malaysia

Domestic demand continued to increase, expanding by 7.3%, due to strong private consumption and investment spending. Private consumption remained robust, registering a growth of 9% in the fourth quarter. The improvement in the employment market, payment of year-end bonuses, firm commodity prices and strong export earnings enhanced consumer optimism and encouraged spending. Almost all major consumption indicators, including disbursements of consumption credit loans and imports of consumption goods, pointed to strong consumer spending. Public consumption also increased due to higher expenditure on emoluments, supplies and services and defence.

Gross fixed capital formation grew by 0.4%. Private sector investments remained strong due to capacity expansion, upgrading and new investments across the economy and in particular in the manufacturing and upstream oil and gas sectors. Public development expenditure was higher in the fourth quarter resulting in an overall fiscal deficit of 3.8% of GDP for the year as a whole.

In terms of sectoral origin, value added in the manufacturing sector strengthened during the fourth quarter to expand by 7.3%, significantly higher than the 3.5% recorded during the previous quarter. The resulting contribution to overall growth was 2.3 percentage points. This strong performance was led by the strong revival in external demand for electronics products, and further

reinforced by stronger expansion in the chemical products, textiles and wearing apparel, transport equipment and petroleum products industries. Output of electronics and electrical (E&E) products improved notably to register a double-digit growth, supported by strong external demand for computers, computer-related products and semiconductors.

Strong consumer spending and favourable trade and business activities, including in the financial services led to a growth of 6% in the services sector. Meanwhile, the construction, agriculture and mining sectors recorded declines during the quarter. The decline in the construction sector, however, was smaller, while in the agriculture and mining sectors, lower production of key commodities was partly caused by poor weather conditions.

Inflation, as measured by the Consumer Price Index (CPI), was unchanged at 3.4% in the fourth quarter of 2005[1]. Almost all CPI categories registered increases, although there was a moderation in the price increases in the beverages and tobacco, and transport and communication categories, following the lapse of the effects of the 2004 price adjustments. Conditions in the labour market continued to improve with the upward trend in job vacancies becoming entrenched. The strength in the labour market was also supported by the strong growth in labour productivity.

On the external front, the trade balance recorded a larger surplus of RM28.6 billion (3Q 2005: RM23.3 billion). Gross exports grew strongly by 12.6% in fourth quarter of 2005, led mainly by the double-digit growth in exports of manufactured goods (13.1%) and growth in both volume and prices of commodity exports. The growth in manufactured exports was led mainly by the strong pick-up in exports of E&E products, in line with the upturn in the global semiconductor cycle. Growth in the E&E exports more than doubled to 14.7% (3Q 2005: 6.8%) due to higher shipment of semiconductors, computers and parts, and industrial electrical machinery. Exports of chemical and rubber products were also higher due to strong external demand. Although receipts from palm oil declined, overall receipts from agriculture exports turned around to record a positive growth as receipts from saw logs, sawn timber and, in particular, rubber were much higher. Rubber exports strengthened notably supported by the strong increase in price (28.7%). Similarly, reflecting the substantially higher prices for crude oil and liquefied natural gas (LNG), receipts from mineral exports remained high.

Gross imports grew by 7.5%. Imports of intermediate goods, which are inputs for manufactured goods, expanded at a stronger rate of 7.7% in line with the upturn in global demand for E&E exports. Overall imports of capital goods recorded a decline of 5.9%. However, capital imports excluding transport equipment, rose by 6%, an indication that capacity expansion and upgrading activities in the economy, have continued. Reflecting the sustained private consumption activities, imports of consumption goods increased by 4.4%.

[1] This is based on the previous base reference period for the CPI (2000 = 100).

In the financial account, net foreign direct investment (FDI), recorded a higher inflow of RM2.3 billion. These FDI inflows were broad-based, channelled mainly into the manufacturing, services and oil and gas sectors. As this FDI data is on a cash basis, it does not capture retained earnings and investment in the form of imported machinery and equipment. There was also a higher net outflow in portfolio investment. Meanwhile, overseas investment recorded a net inflow of RM1.9 billion due mainly to repayment of inter-company loans from abroad.

The net international reserves of Bank Negara Malaysia amounted to RM266.4 billion (USD70.5 billion) as at 31 December 2005. As at 15 February 2006, the reserves amounted to RM270.4 billion (USD71.6 billion), sufficient to finance 7.7 months of retained imports and is 6.7 times the short-term external debt.

### *Monetary policy remained supportive of economic activities*

In the fourth quarter, indicators pointed to strong economic growth and economic activity was expected to gain momentum going into 2006. At the same time, the inflation rate was expected to remain close to the prevailing level for some time. Consequently, the OPR was increased by 30 basis points to 3% on 30 November 2005. Notwithstanding the increase, the OPR continued to be below its neutral level and therefore, monetary policy continued to remain supportive of economic activity.

Following the increase in the OPR, the daily weighted average overnight interbank rate moved within a range of 2.97% - 3.01% and averaged 3.00%. Interbank rates for other tenures also rose in December.

Gross financing to the private sector through banking system loans and the capital market remained firm, expanding at a combined annual rate of 7.8% in the fourth quarter of 2005. On a net basis, banking system loans and private debt securities (PDS) outstanding increased at a combined annual rate of 9.3%.

Bank lending activity remained firm in the fourth quarter of 2005, with total loans outstanding expanding at an annual rate of 8.6% at the end of the quarter. Loans outstanding to businesses increased by 3% on an annual basis, driven by the growth in SME loans outstanding, which expanded by 8.7% on an annual basis. Loan disbursements to both large corporations and SMEs were also higher on an annual basis, but business loan applications and approvals moderated somewhat from the high levels recorded in the third quarter of 2005. Bank lending to households remained strong, with household loans outstanding growing by 15.1% on an annual basis at the end of the quarter.

Net funds raised by the public and private sectors through the capital market increased to RM12.6 billion in the fourth quarter of 2005, due to a strong increase in the amount of funds raised from the PDS market. A substantial share (52.6% of total, excluding Cagamas) of the funds raised through the PDS market during the quarter was for the financing of new economic activities. More than half or 51.6% of the PDS were also in Islamic instruments.

Narrow money, M1, expanded at an annual rate of 8.5% at the end of the fourth quarter (3Q 2005: 9.9%), while broad money, M3, increased at an annual rate of 8% at the end of the fourth quarter (3Q 2005: 10.9%).

The ringgit appreciated against the yen, pound sterling and euro, but depreciated against the US dollar over the fourth quarter of 2005. The US dollar strengthened amidst general expectations for further increases in the Fed Funds rate. Against regional currencies, the ringgit depreciated in the range of 0.1 - 5.6%. While the ringgit continued to depreciate against the regional currencies in early 2006, in early February this trend reversed. In February, the ringgit appreciated against most regional currencies in the range of 0.5 - 2.0%.

### *The banking system remained strong*

The banking system remained strong in the fourth quarter of 2005. The risk-weighted capital ratio (RWCR) was 13.1% as at end-2005. Pre-tax profits for the quarter amounted to RM3.5 billion. This stronger performance was largely on account of higher net investment income and higher recoveries.

Asset quality of the banking system continued to improve with the decline in non-performing loans (NPLs) following the reclassification of some NPLs to performing accounts, write-offs and the lower incidence of new NPLs. With the decline, the net NPL ratio improved further to 4.6% based on the 6-month classification and 5.8% based on the 3-month classification.

### *Underlying trends support stronger near term growth*

Prospects are for stronger growth in the Malaysian economy in 2006. Of significance, the outlook for global economic growth remains sound and would be driven by the upturn in the global investment and electronics cycle. Additional support is expected to come from Japan and the euro area, as domestic demand strengthens in these economies. Regional demand is also expected to remain robust supported by the recovery in the global electronics cycle, in particular in semiconductors, and sustained economic expansion in P.R. China, India and South Korea. Commodity prices have also shown signs of remaining firm. These trends would continue to have positive impact on both exports and private consumption. With high capacity utilization rates in both the domestic-oriented and export-oriented E&E industries in the manufacturing sector, private investment activities would be sustained. Thus private sector activities would continue to underpin growth. The latest DOSM leading index indicates that the Malaysian economy would continue to expand during 2006.