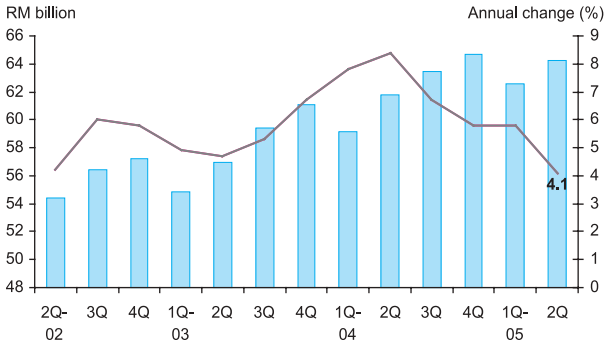
Economic and Financial Developments in the Malaysian Economy in the Second Quarter of 2005

OVERVIEW

Growth supported by private sector activity…

The Malaysian economy expanded by 4.1% in the second quarter of 2005. Private sector activity continued to be the main driver of growth.

Growth driven by private sector activities...



Source: Department of Statistics, Malaysia

Domestic demand increased by 5.6%, underpinned by strong private consumption spending and continued increase in private investment activity. Stable income and employment, amidst high export earnings and savings, as well as competitive credit market conditions, contributed to positive consumer confidence and consumer spending. Indicators of consumption spending such as credit disbursed for consumption purposes and consumer-oriented businesses as well as imports of consumption goods point to robust underlying demand.

Gross fixed capital formation rose by 6.7%, supported mainly by private investment. The resilience in private capital spending was evident in the strong growth in imports of capital goods for capital expansion and upgrading of technology and expansion of lending to the business sector. Business confidence improved as indicated by the findings of MIER's Business Conditions survey.

Despite the higher petroleum-related expenditure, improved revenue collection by the Federal Government has contained the fiscal deficit at RM2.7 billion or 2.3% of GDP in the second quarter of 2005.

On the supply side, the services sector continued to provide the main impetus to growth. Strong consumer spending, increased tourist arrivals and improved business activity led to growth of 5.4% in the services sector. In particular, the wholesale and retail trade, hotels and restaurants; transport, storage and communication; and electricity, gas and water sub-sectors, continued to experience robust growth in line with expansion in private sector activities. Value added in the manufacturing sector increased by 3.2% during the quarter. Output of electronics and electrical products improved, supported mainly by external demand for computer and computer-related products. Performance of selected resource-

based industries, namely chemical products and off-estate processing industries, continued to sustain double-digit growth to support the expansion in the export-oriented industries, which more than offset the decline in the output of selected domestic-oriented industries.

Value added in the agriculture sector grew by 3.2%, due mainly to strong expansion in palm oil production, while the mining sector contracted by 1.6% due to decline in crude oil production following the shutdown of oil fields and plants for maintenance purposes. Growth in the construction sector continued to decline, albeit at a moderate rate of 2%.

During the quarter, inflation edged up to 3% reflecting mainly cost adjustments arising from higher input prices. Demand-driven price pressures remained moderate. Meanwhile, conditions in the labour market continued to improve as the number of vacancies increased significantly in the second quarter. The strength in the labour market was also supported by strong growth in productivity.

Malaysia's external position remained strong with the trade balance recording a large surplus of RM22.9 billion. Gross exports registered a growth of 10.8%, supported by robust growth in exports of minerals (31.5%) and reinforced by expansion in exports of manufactured goods (9.2%) and agriculture commodities (5.3%). Higher receipts from crude oil was entirely due to higher prices while the increase in earnings from liquefied natural gas (LNG) was attributable to positive price and volume effects supported by stronger demand from Chinese Taipei and Japan. In the manufacturing sector, exports of electronics and electrical products (E&E) increased by 8.7% (1Q 2005: 9.9%). Stronger demand for computer-related products, particularly from the US, supported the expansion in the E&E sector. Exports of resource-based products continued to be robust, led mainly by exports of petroleum products, furniture and rubber products. Meanwhile, growth in agricultural exports was supported by increases in export receipts of sawn timber, saw logs and palm kernel oil. Export proceeds of palm oil increased, underpinned by demand from the European Union, for biodiesel production; and higher purchases by the People's Republic of China and India.

In the financial account, foreign direct investment (FDI) and portfolio investment increased during the quarter. Gross inflows of FDI increased to RM8.7 billion, channelled mainly into the oil and gas and services sectors. Malaysian corporations, particularly from the services, oil and gas and manufacturing sectors, continued to invest abroad. Meanwhile, portfolio investment recorded a higher net inflow of RM4.5 billion reflecting mainly sustained foreign interest, particularly in debt securities.

The international reserves of Bank Negara Malaysia amounted to RM285.8 billion (USD75.2 billion) as at 30 June 2005. The reserves increased to RM298.7 billion or equivalent to USD78.7 billion as at 29 July 2005. About two-thirds of the inflows in July had occurred on the day following the announcement of the change in the exchange rate regime to a managed float. The flows

normalised in the subsequent days with both inflows and outflows reflecting normal transactions. Overall, the price discovery process has been orderly. The transactions during this period were mainly for international trade, foreign direct investment and portfolio investment. International reserves amounted to RM305.2 billion or USD80.4 billion as at 15 August. During this period, there was a major drawdown of an external loan. The reserves position is sufficient to finance 9 months of retained imports and is 6 times the short-term external debt.

Monetary policy remained accommodative to support economic growth

Monetary policy during the quarter has continued to focus on supporting economic growth. The Overnight Policy Rate (OPR) remained unchanged at 2.70%. Meanwhile, the daily weighted average overnight interbank rate moved within a range of 2.67 - 2.73%, averaging at 2.70% during the quarter.

Financing of the private sector remained robust in the second quarter. Gross private sector financing grew at an annual rate of 8.7% in the second quarter, reflecting the higher loans disbursed by the banking system and the larger amount of PDS issuance. On a net basis, banking system loans and PDS outstanding increased at an annual rate of 9.3% as at end of the second quarter of 2005.

Bank lending activity remained resilient, with total loans outstanding expanding at an annual rate of 8.4% as at end of the second quarter of 2005. On a sectoral basis, the growth in loans to the household sector continued to underpin the growth in loans outstanding of the banking system. Loan disbursements for credit card spending and purchase of passenger cars supported the expansion in loan disbursements to households.

Lending to businesses remained resilient. Loans outstanding to businesses registered the third consecutive quarter of growth, increasing at an annual rate of 1.5% as at end of the second quarter of 2005. Within the business sector, lending to small and medium enterprises (SMEs) continued to drive the growth of loans to businesses, with loans outstanding to the SMEs expanding by 9% on an annual basis as at end of the second quarter of 2005. Furthermore, a higher number of SMEs accounts (21,421) had their loans approved during the quarter.

Total gross financing sourced in the PDS market was higher, amounting to RM7.8 billion in the second quarter, supported by the prevailing low yields in the bond market. The bulk of the funds raised in the second quarter were for new activity (52.8% of new issuances) and for the refinancing of existing debt (35.4%).

Monetary aggregates exhibited relatively stable growth during the quarter, with narrow money, M1, and broad money, M3, growing at annual rates of 11% and 12.8% respectively, as at end of the second quarter of 2005, reflecting the continued expansion in financing for private sector activities, as well as the expansion in net foreign assets.

On 21 July 2005, the ringgit peg to the US dollar was removed, and a managed float was introduced, whereby the value of the ringgit would be determined by economic fundamentals. Bank Negara Malaysia now monitors the exchange rate against a basket of currencies. Given that the ringgit has strengthened since the beginning of 2005, much of the undervaluation derived from the US dollar depreciation in 2004 had been reversed. At the time of the unpegging, the ringgit therefore was close to its fair value. Consequently, the exchange rate of the ringgit has not shifted significantly following the adoption of the new regime. Promoting stability of the exchange rate would continue to be a primary objective of policy.

The banking system strengthened further

The banking system showed greater resilience with key financial indicators remaining strong. The risk-weighted capital ratio (RWCR) of the banking system remained strong at 13.3% as at end of the second quarter of 2005 (1Q 2005: 13.8%). With effect from 1 April 2005, a more stringent calculation of risk-weighted assets has been adopted with the inclusion of market risk in the capital adequacy framework. Asset quality continued to improve with the lowest level of non-performing loans since the Asian crisis. The net non-performing loans (NPLs), based on the 6-month classification, declined further to 5.1% of total loans as at end-June 2005 (3-month classification: 6.9%) from 5.4% as at end-March. The improvement was due primarily to lower incidences of new loans classified as non-performing as well as continued write-offs and higher reclassification of NPLs to performing accounts. The pre-tax profits of the banking system rose by 10.9% to RM3.1 billion, attributable to higher investment income and net interest income.

The near term outlook remains favourable

Prospects for the Malaysian economy in the second half-year remain favourable. Global demand is expected to be sustained in the second half of the year based on the favourable indicators emerging recently from the US, Japan and the euro area, and further reinforced by the expected improvement in the global electronics sector in the latter part of the year. In the US, consumption spending is expected to remain strong, underpinned by the buoyant housing market. For semiconductor products, industry experts have revised upwards their growth forecast for 2005 as a whole. The favourable external environment is therefore expected to support the expansion in domestic demand. The six-month smoothed growth of Leading Index also suggests continued economic expansion. This is further supported by the MIER's Business Conditions and Consumer Sentiment Indices, which point to expansion in private sector activities in the near term.

In an environment where inflation has increased, the level of monetary accommodation will be balanced to ensure that the maximum sustainable growth is achieved in an environment of price stability. Given the uncertainties associated with both the inflation and economic outlook, particularly in relation to the impact of high oil prices, the balance of these risks will be closely monitored in setting the future course of monetary policy.