The Malaysian Economy in 2004

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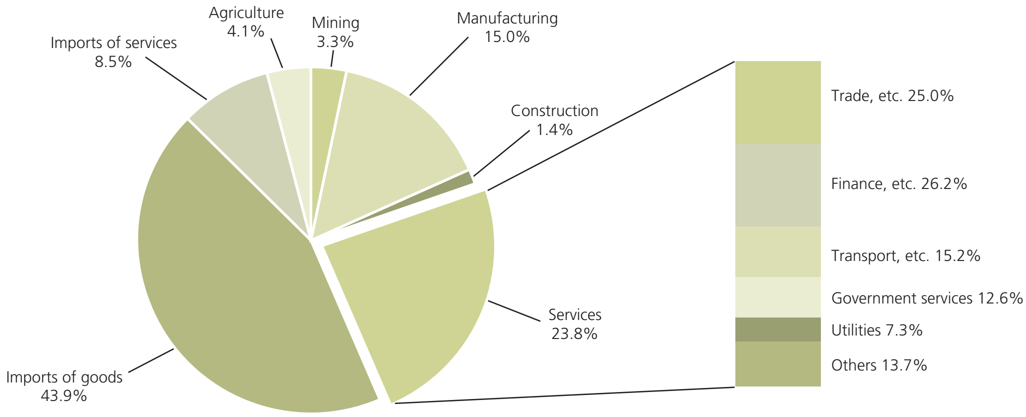
The Malaysian economy experienced its most rapid growth in four years, expanding by 7.1% in 2004 as a result of robust growth in both global trade and domestic demand. Growth was led by the private sector, while the Government made further progress in fiscal consolidation.

OVERVIEW

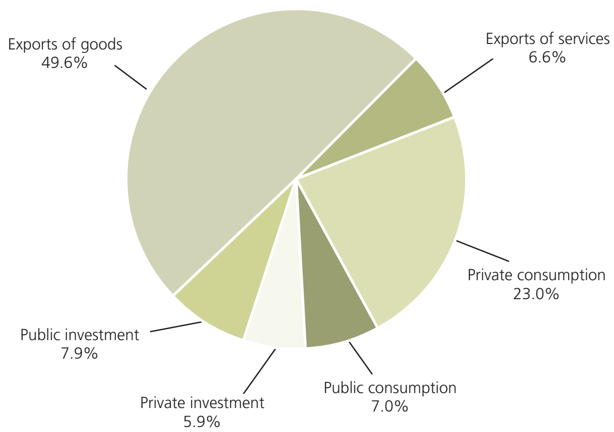
With the more robust growth in global trade and domestic demand, the momentum of economic growth in Malaysia, which began in the second half of 2003, gathered pace in 2004. Real gross domestic product (GDP) increased by 7.1% in 2004 (2003: 5.3%), the fastest growth since 2000. The economy benefited from the rapid growth of global trade in manufactures and higher prices for primary commodities. Although global growth moderated somewhat in the second half of the year, the

Graph 1.1
The Economy in 2004 (at 1987 Prices)

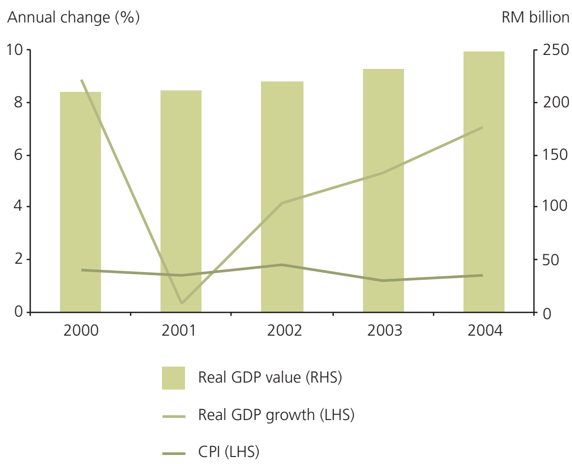
Supply of goods and services (RM520.8 billion)



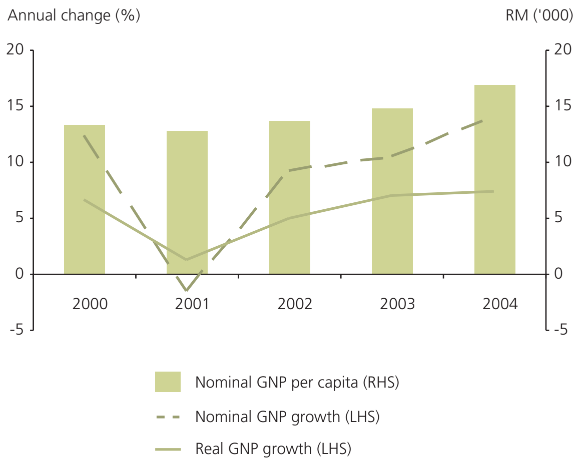
Demand for goods and services (RM520.8 billion)



Graph 1.2
Real GDP and Inflation Rate



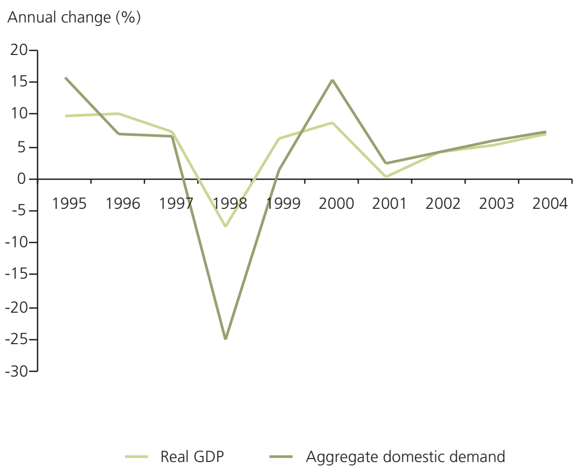
Graph 1.3
GNP Growth and Nominal GNP per Capita



Malaysian economy remained resilient with stronger domestic demand providing the impetus for sustained expansion. The private sector was the main force of economic expansion, while the Government continued with fiscal consolidation.

The improvement in the economy was reflected by positive growth across all sectors except construction. The main drivers of growth were the manufacturing, services and primary commodities sectors. Value added in the manufacturing sector expanded strongly by 9.8%, as output growth in both export- and domestic-oriented industries reflected stronger external and domestic demand for manufactured goods. In the export-oriented industries, the strongest output expansion was seen in the electronics industry, benefiting from the upturn in the global semiconductor cycle. However, the high production during the earlier part of the year led to some inventory accumulation, which led to more moderate expansion in the second half of the year. In addition to strong growth in the electronics industry, growth was reinforced by sustained external demand for resource-based products such as chemical, rubber and wood products. Growth in the domestic-oriented industries was supported by strong demand in the fabricated metal products industry and a turnaround in the transport equipment industry. The favourable performance of the manufacturing sector was also reflected in the stronger expansion in manufactured exports (19.7%) and sustained high capacity utilisation level (79%), in spite of investments in new capacity during the year.

Graph 1.4
Real GDP and Aggregate Domestic Demand



Graph 1.5
Contribution to Real GDP Growth

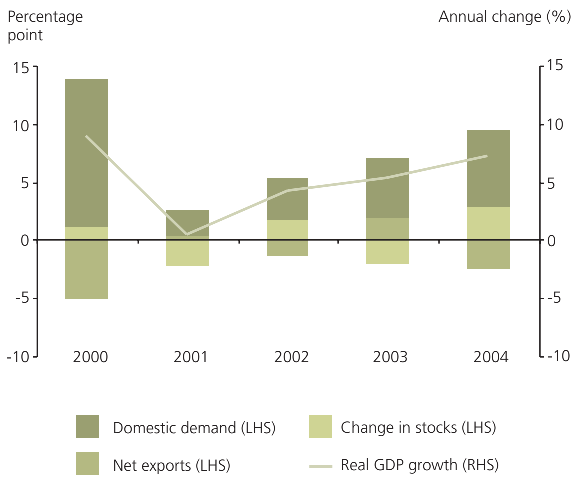


Table 1.1: Malaysia – Key Economic Indicators

	2002	2003	2004*p*	2005*f*
Population (million persons)	24.5	25.0	25.6	26.1
Labour force (million persons)	9.9	10.2	10.6	10.9
Employment (million persons)	9.5	9.9	10.2	10.5
Unemployment (as % of labour force)	3.5	3.6	3.5	3.5
Per Capita Income (RM)	13,722	14,838	16,538	16,987
(US$)	3,611	3,905	4,352	4,470
NATIONAL PRODUCT (% change)				
Real GDP	4.1	5.3	7.1	5.0 ~ 6.0
(RM billion)	220.0	231.7	248.0	260.3
Agriculture, forestry and fishery	2.6	5.7	5.0	3.3
Mining and quarrying	4.0	5.9	4.1	5.0
Manufacturing	4.1	8.3	9.8	4.5
Construction	2.3	1.9	-1.9	-1.0
Services	6.4	4.4	6.7	5.7
Nominal GNP	9.0	10.4	13.8	4.9
(RM billion)	336.6	371.7	423.1	443.9
Real GNP	4.7	6.8	7.2	4.6
(RM billion)	202.7	216.5	232.2	242.8
Real aggregate demand[1]	4.2	5.9	7.3	4.3
Private expenditure[1]	0.3	5.5	11.1	8.7
Consumption	4.4	6.6	10.1	8.5
Investment	-15.1	0.4	15.8	9.6
Public expenditure[1]	11.5	6.6	1.0	-4.0
Consumption	11.9	10.0	6.6	4.5
Investment	11.2	3.9	-3.5	-11.6
Gross national savings (as % of GNP)	34.6	36.3	37.1	34.7
BALANCE OF PAYMENTS (RM billion)				
Goods	72.1	97.7	104.5	114.8
Exports (f.o.b.)	358.5	399.0	481.2	514.9
Imports (f.o.b.)	286.4	301.3	376.8	400.1
Services balance	-6.0	-15.0	-8.8	-8.0
(as % of GNP)	-1.8	-4.0	-2.1	-1.8
Income	-25.1	-22.5	-24.5	-26.4
(as % of GNP)	-7.4	-6.1	-5.8	-5.9
Current transfers, net	-10.6	-9.3	-14.6	-14.1
Current account balance	30.5	50.8	56.6	66.3
(as % of GNP)	9.1	13.7	13.4	14.9
Bank Negara Malaysia international reserves, net[2]	131.4	170.5	253.5	-
(in months of retained imports)	5.4	6.6	8.0	-
PRICES (% change)				
CPI (2000=100)	1.8	1.2	1.4	2.5
PPI (1989=100)	4.4	5.7	8.9	-
Real wage per employee in the manufacturing sector	3.2	2.8	1.8	-

Note: Figures may not necessarily add up due to rounding.

[1] Exclude stocks.

[2] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account.

p Preliminary

f Forecast

Table 1.2: Malaysia – Financial and Monetary Indicators

	2002		2003		2004p	
FEDERAL GOVERNMENT FINANCE (RM billion)						
Revenue	83.5		92.6		99.4	
Operating expenditure	68.7		75.2		91.3	
Net development expenditure	35.1		38.3		27.5	
Overall balance	-20.3		-20.9		-19.4	
Overall balance (% of GDP)	-5.6		-5.3		-4.3	
Public sector net development expenditure	69.1		83.3		67.8	
Public sector overall balance (% of GDP)	-0.7		-1.2		-0.3	
EXTERNAL DEBT						
Total debt (RM billion)	185.7		186.6		197.3	
Medium- and long-term debt	153.2		152.9		154.3	
Short-term debt[1]	32.4		33.7		43.0	
Debt service ratio (% of exports of goods and services)						
Total debt	6.6		6.2		4.3	
Medium- and long-term debt	6.4		6.0		4.2	
	Change in 2002		**Change in 2003**		**Change in 2004**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
MONEY AND BANKING						
Money Supply M1	8.3	10.3	13.0	14.6	12.2	11.9
M2	21.0	5.8	42.5	11.1	108.1	25.4
M3	31.6	6.7	48.5	9.7	68.0	12.4
Banking system deposits	25.3	5.3	49.5	9.8	70.1	12.7
Banking system loans[2]	19.8	4.6	21.6	4.8	40.2	8.5
Manufacturing	-1.2	-2.0	-0.2	-0.3	2.0	3.2
Broad property sector	10.8	6.6	14.6	8.4	19.8	10.5
Finance, insurance and business services	-2.5	-7.7	-0.6	-2.1	1.7	5.7
Loan-deposit ratio (end of year)	84.9%		80.9%		78.6%	
Financing-deposit ratio[3]	95.1%		91.7%		87.7%	
	2002		**2003**		**2004**	
	%		**%**		**%**	
INTEREST RATES (AVERAGE RATES AS AT END-YEAR)						
3-month interbank	3.13		2.87		2.80	
Commercial banks						
Fixed deposit 3-month	3.20		3.00		3.00	
12-month	4.00		3.70		3.70	
Savings deposit	2.12		1.86		1.58	
Base lending rate (BLR)	6.39		6.00		5.98	
Finance companies						
Fixed deposit 3-month	3.20		3.00		3.00	
12-month	4.00		3.68		3.70	
Savings deposit	2.65		2.18		1.98	
Base lending rate (BLR)	7.45		6.90		6.90	
Treasury bill (3-month)	2.82		2.77		1.96	
Government securities (1-year)	2.94		2.93		2.24	
Government securities (5-year)	3.15		4.28		3.64	
	2002		**2003**		**2004**	
	%		**%**		**%**	
EXCHANGE RATES						
Movement of Ringgit (end-period)						
Change against SDR	-7.3		-8.5		-4.3	
Change against US$[4]	0.0		0.0		0.0	

[1] Excludes currency and deposits held by non-residents with resident banking institutions.
[2] Includes loans sold to Cagamas.
[3] Adjusted to include holdings of private debt securities.
[4] Ringgit was pegged at RM3.80=US$1 on 2 September 1998.
p Preliminary

The services sector recorded a stronger expansion of 6.7% in 2004. The growth was driven mainly by higher consumer spending amidst rising disposable incomes, higher tourist arrivals and increased trade-related activities spurred by the buoyant export performance. Growth in final services, particularly the wholesale and retail trade, hotels and restaurants sub-sector, was due to higher consumer spending and was reinforced by robust tourism activities. In the intermediate services, the transport, storage and communication sub-sector recorded stronger growth, mainly on account of increased trade- and travel-related activities as well as the strong expansion in the telecommunications industry. The growth in the finance, insurance, real estate and business services sub-sector was underpinned by higher bank lending, stronger performance in the insurance industry, greater activity in the real estate market and higher turnover in the capital market. Expansion in new growth areas, such as private education and private healthcare services, Islamic financial services as well as the shared services industry, provided further support to the services sector.

The agriculture sector expanded further by 5%, driven mainly by stronger production of crude palm oil and rubber amidst the favourable commodity prices. Other agriculture commodities, particularly food-related crops, also showed strong growth, in line with the Government's concerted efforts in revitalising the agriculture sector as an important engine of growth. The mining sector grew by 4.1%, mainly on account of increased output of crude oil and natural gas, benefiting from higher domestic and external demand.

On the other hand, the construction sector contracted by 1.9% due to lower activity in the civil engineering sub-sector, which was partly mitigated by expansion in both residential and non-residential sub-sectors. Lower civil engineering activity was mainly attributed to the completion of several large infrastructure projects in recent years and the consequent reduction in public spending on infrastructure projects in 2004. In contrast, the residential sub-sector continued to grow due to sustained demand for residential property, which was supported by higher incomes as well as attractive housing mortgage financing packages. Expansion in the non-residential sub-sector was due mainly to improved business and investment activity, which supported the demand in the office and retail space segments.

With policy orientation supportive of private sector activity and with the improved economic conditions, the private sector contributed 6.2 percentage points to economic expansion. Private consumption expanded strongly by 10.1% in 2004 as consumer confidence was restored following the events of early 2003, including the Severe Acute Respiratory Syndrome (SARS) outbreak. Despite some moderation in activity towards the end of 2004, sentiments remained strong. Both the Consumer Sentiment and Retail Trade Indices, compiled by the Malaysian Institute of Economic Research, remained above the 100-point mark throughout the year. In addition, various tax rebates to sustain consumption announced during the 2004 Budget and the prevailing supportive interest rate and credit environment further supported consumption spending.

The stronger growth of private consumption was driven mainly by higher disposable income in both the household and the corporate sectors on account of higher export earnings and favourable employment conditions in the domestic economy. The findings of the Malaysian Employers Federation's Salary and Fringe Benefits Survey for Executive and Non-Executive 2004 showed that a large majority of companies (86%) continued to pay out bonuses to their employees. The percentage of companies granting salary increases was also higher during the year compared to 2003. Higher commodity prices, particularly prices for rubber and palm oil, provided the impetus for rural income earners to increase their consumption. Meanwhile, sustained high profits and cash flows of the corporate sector continued to emanate from rising productivity and higher export earnings. A sample of 350 listed non-financial companies, which represents almost 75% of the total market capitalisation of Bursa Malaysia, showed that most sectors recorded higher profits in 2004. The annualised return on equity for companies in the sample rose to 9.1% in 2004 (2003: 8.2%).

Growth in private investment, which had turned around in the second half of 2003, accelerated to 15.8% in 2004 as business confidence strengthened further. The stronger growth was due mainly to high capacity utilisation arising from improved external demand and higher domestic consumption. This high level of capacity utilisation, together with improving corporate profitability and favourable financing conditions, has encouraged investment activity. Higher capital expenditure was evident in all sectors

Potential Output in the Malaysian Economy

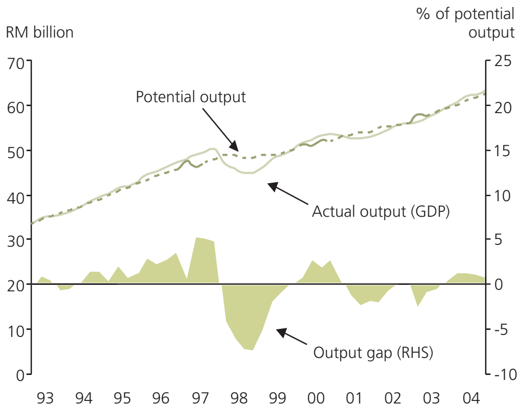
Potential output is defined as the level of output that is consistent with the productive capacity of an economy. Conceptually, the level of potential output is determined by the growth of non-inflationary trend levels of physical capital and the labour force as well as the rate of technological advancement. The output gap – the difference between actual output and the trend level of potential output – is a measure of the cyclical deviation from the non-inflationary trend of output. Knowledge on potential output and the output gap, together with other relevant information would help policymakers in making an assessment on the current position of an economy in the economic cycle, as well as indicating the latent growth path of the economy in the long term.

Potential output and the output gap are however not directly observable concepts. Nonetheless, by using a production function approach and using information regarding the existing physical capital stock and employment levels, estimates of potential output and the output gap for Malaysia can be obtained. It should be emphasised that these estimates alone do not provide an exhaustive perspective of the state of an economy, such as the extent of inflationary pressure. This is especially true for a structurally dynamic economy such as Malaysia.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1994-1998	9.2	8.0	14.1	3.9	2.3
1998	-7.4	3.0	-43.0	-2.1	-6.3
1999	6.1	1.3	-6.5	3.7	-2.0
2000	8.9	4.5	25.7	4.3	2.2
2001	0.3	3.8	-2.8	1.3	-1.2
2002	4.1	3.5	0.3	1.9	-0.7
2003	5.3	5.5	2.7	3.6	-0.9
2004	7.1	5.0	3.1	3.4	1.1

Graph 1
Actual and Potential Output



The latest estimates indicate that the Malaysian economy in 2004 was operating slightly above potential amidst the strong global economic growth, with the output gap estimated at 1.1% of potential output. A similar trend was observed during the previous global upswing in 2000. On the whole however, the deviations of actual from potential output have been modest since 1998, as illustrated in Graph 1, with growth in the Malaysian economy remaining in line with the growth of its potential capacity.

Prior to 1997, potential output of Malaysia grew at a rapid rate, with an average of 8% annually for the period of 1994 to 1997. The pronounced downturn in 1998 and following structural adjustments however altered the productive capacity of the economy. The potential growth path was affected and potential output growth subsequently slowed down during the recovery period as spare capacity within the economy was used up. Since 2000 however, the potential growth path began to improve and by 2004, potential output was growing at a rate of 5% annually, an almost fourfold increase compared to the low of 1999, as shown in Table 1 and Graph 1.

Given that steps have been taken to improve the contribution of productivity to growth, the current momentum in the expansion of productive capacity is expected to persist, resulting in further enhancement in potential output growth. This suggests that the potential growth path of the Malaysia economy is expected to continue to improve in the near future.

of the economy, with the manufacturing, services and mining sectors registering significant levels of spending during the year. The increase in private investment was also supported by foreign direct investment (FDI), particularly in the services, manufacturing and oil and gas sectors.

Public sector expenditure was less expansionary on growth as the Federal Government continued with its policy of fiscal consolidation, lowering the fiscal deficit to 4.3% of GDP in 2004 (2003: -5.3%). Efforts to reduce the fiscal deficit were balanced by the need for the Government to provide for basic support and social services as well as spending to enhance the long-term productivity of the economy. During the year, the Federal Government's expenditure on supplies and services as well as emoluments was higher. As a result, public consumption increased by 6.6% in 2004. On the other hand, public investment declined by 3.5% in 2004 as a result of lower Federal Government development expenditure, which was partially mitigated by the sustained high capital expenditure of the non-financial public enterprises (NFPEs). Notwithstanding the lower development expenditure, spending in 2004 was channelled mainly to smaller scale projects in economic and social sectors that have significant multiplier effects on the economy. The higher capital expenditure of the NFPEs was due mainly to upgrading and capacity expansion programmes.

As a result of the stronger private sector activity, real aggregate domestic demand (excluding change in stocks) expanded further by 7.3%. The stronger growth of domestic demand, however, was achieved within the context of limited price pressures as new capacity was put in place in sectors experiencing strong growth. This expansion in capacity ensured that GDP growth remained broadly in line with the potential capacity of the economy. Stable labour market conditions, high labour productivity and increased competition in the economy also contributed towards containing price pressures. As a result, the consumer price index (CPI) and core inflation were marginally higher at 1.4% and 1% respectively during the year (2003: 1.2% and 0.5% respectively).

In 2004, external demand expanded further and provided an important contribution to the overall growth of the economy. The stronger expansion in exports of manufactured goods, in particular electronics, and sustained growth in commodity earnings contributed to the large trade surplus of RM81.1 billion (2003: RM81.3 billion). The stronger export growth of 20.8% (2003: 11.3%) reflected the buoyant growth in consumer and investment demand in major industrial countries as well as in the region. In tandem with the stronger private sector demand and manufacturing output, imports recorded a higher growth of 26.3% (2003: 4.4%). The sustained large trade surplus, coupled with the significant improvement in the services account deficit due to higher tourism receipts, more than compensated for the larger income account deficit attributed to higher profits accruing to foreign direct investors. As a result, the current account surplus increased further to RM56.6 billion, equivalent to 13.4% of GNP (2003: RM50.8 billion or 13.7% of GNP).

The financial account turned around, recording a net inflow of RM15.4 billion in 2004 (2003: -RM12.1 billion). The higher inflows of FDI and portfolio investment more than offset the higher outflow due to overseas investments by Malaysian companies and other investments by both the public and private sectors. A significant portion of the FDI was channelled to the manufacturing sector, particularly the electronics industry, and the services sector. Meanwhile, inflows into the oil and gas sector were the result of recent discoveries, especially off the coast of East Malaysia. Funds for portfolio investment increased significantly, in tandem with improved investor confidence amidst sovereign ratings upgrades, and speculation that some regional currencies, including the ringgit, had the potential for an upward revaluation during the year.

Arising from the larger current account surplus, higher inflows for investment and foreign exchange revaluation gains, Bank Negara Malaysia's net international reserves increased further to a record level of RM253.5 billion, or equivalent to US$66.7 billion at the end of 2004. By 28 February 2005, the reserves level rose further to RM272.9 billion or US$71.8 billion, adequate to finance 8.6 months of retained imports and is 6.1 times the short-term external debt.

Malaysia's external debt increased moderately to RM197.3 billion in 2004 (2003: RM186.6 billion), reflecting mainly higher short-term debt of the banking sector, which was largely due to hedging activities for trade-related transactions and treasury activities. Nevertheless, the share of short-term debt to total debt remained low, accounting for 21.8% of total external debt. Given the prudent debt management policy in place, Malaysia's external debt position remains sustainable with the share of external debt to GNP and debt-service ratio improving to 46.6% and 4.3% respectively (2003: 50.2% and 6.2% respectively).

Macroeconomic Management

The strong performance of the economy in 2004 reflected the broad-based improvement in the Malaysian economy, amidst the rapid growth of global trade in manufactures and higher prices for oil and most non-oil commodities. The strengthening of domestic demand provided the impetus for sustained growth throughout the year in spite of some moderation in global growth in the second half of the year. There were notable shocks to the global economy in 2004, namely, high oil prices, revival in inflationary pressures, tightening of the global monetary cycle, tightening measures to reduce overheating in the People's Republic of China (PR China), sporadic outbreaks of avian flu and effects of the tsunami in December. Nevertheless, the Malaysian economy remained resilient. With the private sector assuming the lead role in driving growth, Government policies were targeted at maintaining stable economic conditions and ensuring a more efficient, pro-business and investor-friendly public sector delivery system to sustain private investment growth.

Macroeconomic policy in 2004 focused on maintaining stability and improving the risk-bearing capacity of the economy. Looking ahead, improved flexibility, innovativeness and productivity are the key components to sustaining long-term growth.

The monetary policy stance in 2004 remained supportive of domestic economic activities. Domestic inflation was low at 1.4%, with no significant pass-through arising from higher import prices. In addition, external inflows comprised mainly long-term trade and investment flows, with some increase in portfolio flows. Given the ample liquidity in the system arising from sustained trade and investment inflows, money market operations by the Central Bank were focused on stabilizing interest rates at levels that were supportive of economic activity. In addition, sustained competition in the banking sector also contained any upward pressure on interest rates as private sector demand for funds gathered momentum.

The stable macroeconomic conditions allowed the Central Bank to make a significant change in the conduct of monetary policy during the year. On 23 April, the New Interest Rate Framework, designed to strengthen the monetary policy transmission mechanism and promote more efficient pricing by the financial system, was announced. Although the new framework represented a change in the implementation mechanism for monetary policy, it did not reflect any change in the policy stance. The framework was designed to enhance the effectiveness of monetary policy by facilitating the transmission of changes in the policy rate, the Overnight Policy Rate (OPR), to the other market interest rates and ultimately, to key macroeconomic objectives. The OPR serves a dual role – as a signalling device to indicate the monetary policy stance and as a target rate for the Central Bank's day-to-day liquidity operations. The introduction of the OPR complements the changes that began with the issuance of the Monetary Policy Statement in 2003. These changes aimed at improving communications on policy, while also conveying the Bank's assessment of economic and financial conditions to the market. This would also help anchor market expectations, thereby increasing the efficacy of monetary policy.

While the prevailing low interest rates were appropriate and consistent with the overall needs of the economy, it was recognised that there were segments of society who depend on income from deposits, such as senior citizens and charitable groups, could be affected. In view of this, a special instrument, the Merdeka Savings Bond (MSB), was launched to alleviate the effects of lower interest income to these groups. The MSB provides holders with a return of 5%, which is higher than the fixed deposit rates, would be issued at regular intervals in 2004 and 2005.

On the exchange rate front, the pegged exchange rate arrangement continues to provide significant benefits to the Malaysian economy by maintaining predictability and relative stability for trade and investment activities. The weakness of the US dollar and speculation that PR China was considering a more flexible regime during the year underpinned some market expectations that Malaysia's exchange rate policy would be reviewed. The Central Bank has consistently maintained that the exchange rate regime would only be reviewed in the event that the ringgit was headed for a sustained misalignment arising from major structural changes within the international and regional financial system, or if economic fundamentals warranted a change in the system. Any change to the exchange rate regime would thus be on the basis of such longer-term structural considerations and not short-term movements in capital flows and transient shifts in exchange rate expectations.

Given the stronger economic fundamentals, the Central Bank has taken steps during the year to further liberalise the foreign exchange administration rules. Effective 1 April, several changes are being made, including the simplification of reporting requirements for exporters to reduce administrative costs and business processes; increasing the overnight limit of Foreign Currency Accounts of residents to enhance cash flow management and support value chain expansion in Malaysia; extension of loans in ringgit to non-residents to enhance access to ringgit funds for operations in Malaysia; allowing selected residents to invest abroad to enhance flexibility in fund management; and allowing residents to enter into forward foreign exchange contracts to facilitate efficient risk management of foreign currency exposure. These changes are part of the Bank's continuous efforts to enhance the business environment and increase efficiency of the regulatory delivery system. The relaxation of the rules allows greater flexibility to residents in managing their investments by promoting a wider risk management options.

As part of this package of measures, Bank Negara Malaysia allowed Multilateral Development Banks (MDBs) or Multilateral Financial Institutions (MFIs) and Multinational Corporations to raise ringgit-denominated bonds in the Malaysian capital market. In addition, the Securities Commission allowed interest income derived by non-resident companies from approved Ringgit-denominated Islamic securities and debentures, excluding convertible loan stocks and securities issued by the Government of Malaysia to be tax exempt. The impact of these changes was immediate. In particular, the move to allow multilateral development banks to issue ringgit bonds was followed by two important issues in the domestic bond markets. The Asian Development Bank became the first foreign entity to issue ringgit-denominated bonds in November. This issuance was closely followed by the International Finance Corporation, which also became the first multilateral body to issue ringgit-denominated bonds that conform to Islamic principles.

The monetary developments were complementary to the Government's continued pursuit of a policy of gradual fiscal consolidation. The overall Federal Government deficit declined from 5.3% of GDP in 2003 to 4.3% in 2004. The Government strengthened its financial position by improving spending efficiency and effectiveness and enhancing revenue whilst optimising the utilisation of existing resources and capacity.

In addition to the focus on strengthening the management of public finances, public policy in 2004 aimed at improving the delivery system to enhance competitiveness. Development expenditure was targeted towards expenditure that ensured higher productivity and competitiveness in the economy. The focus of development expenditure was towards rural development and smaller projects in agriculture sector, improving the supply of utilities to rural areas, enhancing roads and other transport links, healthcare and low-cost housing programmes for the general populace. These programmes, while small in value terms, have significant multiplier effects, thus ensuring that the Government's socio-economic goals are met.

The Government will continue to proceed with its measured pace of implementing the fiscal consolidation programme. Prudent financial management remains a key feature of fiscal policy towards improving the overall financial position of the Government. A lower deficit will provide greater policy options for the Government and would permit macroeconomic policy to more effectively mitigate potential adverse shocks in the economy.

The 2004 and 2005 Budgets were formulated with the objective of generating stronger private investment activity and reinstating the private sector as the main engine of economic growth. In particular, public policy continued to emphasise on the need for Malaysian companies to identify and take advantage of the opportunities available in new growth areas. The diversification of the economy would further enhance the resilience of the economy while providing opportunities for companies to move up the value chain. Among the sectors targeted included agriculture, services and high value-added manufacturing activities. In order to further boost some of these activities, the Budgets provided additional funds to further develop the venture capital industry. Other incentives announced included the extension of the MSC status to Kulim High-Technology Park and Bayan Lepas, improving ICT infrastructures including broadband facilities and introducing a centralised Government portal as a single gateway to public services, as well as various tax incentives to specific sectors.

Special attention was given to improve competitiveness and promote investment by small and medium enterprises (SMEs), not only because of their significant contribution to the economy but also due to their strong growth potential. In 2004, Bank Negara Malaysia initiated the establishment of the National SME Development Council, chaired by the Prime Minister. The Council represents the highest policy-making body and will chart the future direction and strategies for SME development. The Council is not only responsible for formulating broad policies and strategies to facilitate SME development but also for ensuing the effective implementation of the policies and action plans. Bank Negara Malaysia has been appointed the Secretariat for the Council. During the year, the Council standardised the definitions for SMEs across all sectors of the economy and took initiatives to improve information on SMEs as first steps towards more effective policy formulation and implementation. The Council also initiated a number of schemes to improve access to financing, training and advisory services for SMEs.

The activities of Government-linked companies (GLCs) were revisited during the year in order to transform them into more efficient and globally competitive corporations. The GLCs have started to undergo a series of reforms to promote a culture of high performance, which includes, among others, shareholders value creation and performance-linked compensation and competitive contracts for senior management of all GLCs. Given the influence and impact of the GLCs on the economy, their reform would also have a beneficial impact on private sector companies that are suppliers and customers of these large corporations. The restructuring of the GLCs, with the greater emphasis accorded to commercially-driven strategies, would thus enhance overall competitiveness.

Short- and longer-term macroeconomic policies in Malaysia have been designed to reinforce one another to achieve sustainable economic development. Short-term policies that destabilise long-term fundamentals are not only less likely to succeed in their own right but would also adversely affect the ability to implement appropriate policies in the future. Therefore, policy design and implementation in Malaysia has been balanced to ensure the interaction between short- and longer-term policies are mutually reinforcing and supportive. Given the encouraging growth performance, strong fundamentals and the supportive macroeconomic and development policy stance, Malaysia is well placed to sustain economic growth. The private sector response to public policy has been encouraging and it is expected that actions and strategies taken would contribute to sustainable long-term growth with balanced socio-economic development.

SECTORAL REVIEW

Manufacturing Sector

The **manufacturing sector** recorded another strong double-digit expansion in 2004, with output growth strengthening to 12.7% (2003: 10.5%). The robust performance was supported by the positive external environment following stronger growth in both the industrial and regional countries, and further reinforced by improved domestic demand. Growth was more pronounced in the first half-year (16.1%; second half-year: 9.6%), fuelled by strong demand for electronics, in line with the upward momentum in the global semiconductor cycle. Growth during the year was also underpinned by strong export demand for resource-based products including

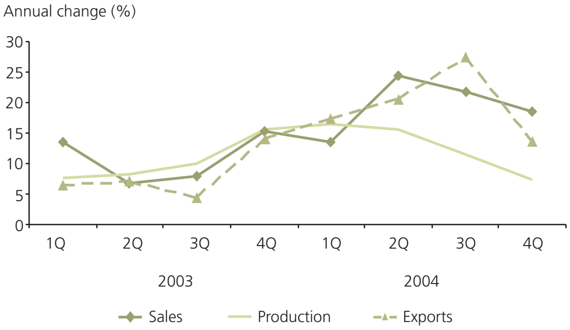
Robust performance in the manufacturing sector supported by positive external environment and improved domestic demand.

Table 1.3
Manufacturing Sector: Value Added and Production

	2003	2004
	Annual change (%)	
Value added (Constant at 1987 prices)	**8.3**	**9.8**
Overall Production	**10.5**	**12.7**
Export-oriented industries	**11.9**	**14.2**
of which:		
Electronics	15.1	25.0
Electrical products	-7.0	-9.4
Chemicals and chemical products	20.8	14.1
Wood and wood products	0.9	12.7
Off-estate processing	11.8	4.0
Textiles and wearing apparel	-2.2	-11.7
Rubber products	18.7	14.8
Domestic-oriented industries	**6.1**	**7.1**
of which:		
Construction-related products	10.2	-0.6
Fabricated metal products	7.4	29.2
Food products	8.8	3.0
Transport equipment	-5.5	8.6
Petroleum products	2.3	1.3

Source: Department of Statistics, Malaysia

Graph 1.6
Manufacturing Sector: Sales, Production and Exports



Source: Department of Statistics, Malaysia

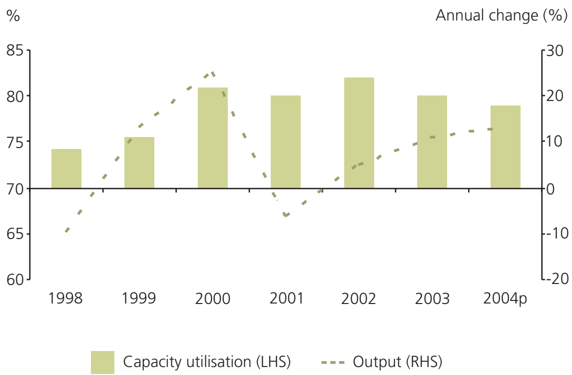
rubber, chemicals and wood. In the domestic-oriented industries, growth was led by a turnaround in the transport equipment industry and robust expansion in the fabricated metal industry, which more than offset the moderation in the construction-related materials industry. Consequently, growth in both the export-oriented and domestic-oriented industries strengthened to 14.2% and 7.1% respectively in 2004 (2003: 11.9% and 6.1% respectively).

In tandem with the significant expansion in production, overall value added growth of the manufacturing sector in 2004 strengthened further to 9.8% (2003: 8.3%). The manufacturing sector remained as the leading driver of economic growth, with its contribution to GDP increasing from 30.8% in 2003 to 31.6% in 2004. Amidst the strong output growth, the overall capacity utilisation rate in the manufacturing sector was marginally lower at 79% in 2004 (2003: 80%), due to additions in capacities in selected industries. The capacity utilisation rate for export-oriented and domestic-oriented industries stood at 81% and 75% respectively (2003: 82% and 76% respectively).

Growth in the electronics and electrical products (E&E) industry doubled to 17.7% in 2004 (2003: 9.6%), spurred by the robust expansion in the electronics segment. The performance of the **electronics industry** was in line with trends in the global semiconductor cycle. In the early part of the year, the electronics sector was buoyed by the strong growth momentum in the global semiconductor industry which started in the second half of 2003. The cycle peaked in mid-year and consolidated thereafter as companies undertook inventory adjustments due to overproduction in the early part of the year.

The semiconductor up-cycle in 2003 – 04 was broad based, characterised by expansion in all categories of chips, from personal computers (PCs) spurred by the replacement cycle, to telecommunications and wireless products to consumer electronics. The strong consumer demand and pick-up in business investment in the industrial countries during the year further contributed to the strength in global semiconductor sales. This positive development was further augmented by the continued trend in wider application of chips and the higher chip content, particularly in the consumer electronics segment. Newly emerging electronic devices such as digital cameras, personal digital assistants, flat panel

Graph 1.7
Capacity Utilisation in the Manufacturing Sector



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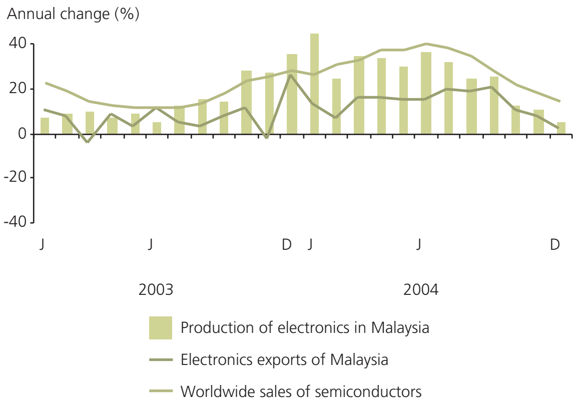
Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Graph 1.8
Production and Exports of the Electronics Industry



Source: Department of Statistics, Malaysia
Semiconductor Industry Association (SIA)

televisions and multi-function handsets became the drivers of growth in the consumer electronics segment. Global sales of PCs also continued to expand rapidly in 2004, led mainly by strong demand from the Asia-Pacific region.

Unlike the previous semiconductor cycle (1999 – 2000), which was mainly driven by Y2K-related corporate spending, the latest cycle is differentiated by no significant over-investments in the technology sector. Secondly, the current downturn is caused by an oversupply situation, while the previous cycle was caused by both supply and demand factors. World growth almost halved within a year to 2.4% in 2001 (2000: 4.7%). However, latest indicators show that demand for electronics should continue to hold up as the outlook for world growth remains positive in 2005 (4%). In the US, new orders for electronics continued to register growth throughout 2004 and the US book-to-bill ratio for semiconductor equipment has hovered close to one. Thirdly, inventory accumulation has not been excessive in the current cycle. The inventory-to-shipment ratio of electronic products in the US has remained low at 1.22 at end-December 2004 (September 2004: 1.26; August 2001: 1.93). Lastly, the adjustment to inventories have been relatively quick, as large multinational companies have begun to cut back on production and reduced their inventories since the fourth quarter of 2004. Given these factors, the view is that the current downcycle can be expected to be modest compared with the sharp downturn in 2001.

Since many multinational companies are located in Malaysia, domestic manufacturers are also undertaking the inventory adjustment as reflected in the slowdown in manufacturing production index in the closing months of 2004. During the year, semiconductor manufacturers in Malaysia have also continued to move up the value chain to produce higher value added products and ventured into manufacturing-related activities, including locating their regional hubs in Malaysia.

The **electrical products** industry continued to consolidate further in 2004, with the industry still undergoing structural adjustments in shifting to higher value added products. With the migration to high-value products, the number of units produced was lower while the total export value of electrical products expanded during the year on higher selling prices.

The **chemicals and chemical products** industry expanded at a double-digit rate of 14.1% for the second consecutive year (2003: 20.8%). The strong expansion was led mainly by higher growth in industrial gases, which accounted for about 40% of the overall chemicals and chemical products industry. The robust growth in industrial gases (19.5%; 2003: 15.8%) was in line with the strong increase in natural gas production following the addition in the capacity and the rise in the capacity utilisation of the MLNG plants, especially the new MLNG Tiga Plant. Meanwhile, production of plastic products expanded further, supported by stronger domestic and external demand. Intensification in the usage of fertilisers and pesticides in the agriculture sector due to Good Agriculture Practices amidst the favourable commodity prices spurred the strong growth in the fertilizer and pesticides sub-sector in 2004. Only output of the synthetic resins industry moderated during the year due partly to shortages in chemical inputs as well as the slowdown in the production of PVC pipes due to subdued construction activity. Overall, external demand for chemical products continued to remain strong, with both PR China and Japan remaining as Malaysia's largest export market for chemical products.

Growth in production of **wood products** accelerated to 12.7% (2003: 0.9%), amidst the strong external demand and high prices. The production of plywood and particleboard was stronger in response to rising demand from the US, United Kingdom (UK) and Japan. The move by Indonesia to ban exports of sawn timber has also benefited the timber-producing sector in Malaysia. Meanwhile, the furniture industry was supported by higher demand from the US, UK, Thailand, Chinese Taipei and the Netherlands.

Similarly, output of **rubber products** remained strong, expanding by 14.8% in 2004 (2003: 18.7%). The double-digit expansion was supported mainly by rising external demand for rubber gloves, as more than 90% of the domestic production is for the export market. Stable prices and sufficient supply of latex enabled domestic glove manufacturers to compete successfully in the global market. Manufacturers remained competitive by utilising a higher share of inputs with natural rubber given the higher cost of oil-based synthetic rubber. The US remained as the major export destination of Malaysia's rubber products, followed by Europe, Japan, Korea and Australia.

Production of the **off-estate processing industry** expanded, albeit at a more moderate pace in line with the output of crude palm oil during the year. Palm oil production expanded at a moderate rate during the year after two consecutive years of high growth.

Production of **transport equipment** turned around in 2004 to record a positive growth, following higher volume of cars assembled and sharp increase in production of motorcycle and scooters for the export market. Assembly of motor vehicles rebounded strongly following a contraction in 2003 to record a double-digit growth of 10.6%, spurred by pent-up demand for passenger cars following the revision to the tariff structure in the early part of the year. Rising income levels amidst the availability of attractive financing packages as well as the introduction of many affordable new models during the year further lent support for the motor vehicles industry. In the motorcycle and scooters segment, the year 2004 witnessed the increase in production from new capacity mainly targeted for exports to the regional countries such as Indonesia and Singapore as well as European countries such as Greece and Turkey.

The **textiles and wearing apparel** industry continued to undergo a structural change. Output declined further due to competition from lower cost producing countries, namely PR China, India and Vietnam. As part of their business strategy, some local textile manufacturers established a presence in other countries in the region to benefit from the lower operating cost and to reap the opportunities arising from the expiry of the Agreement on Textile and Clothing (ATC) in early 2005. Amidst the strong competition, local textile manufacturers also continued to move up the value chain by producing higher value added products for external markets as reflected in the increase in exports of textile and clothing in 2004.

Output of **construction-related products** declined for the first time after five consecutive years of expansion. The sector was affected by the subdued performance of the construction sector during the year. In particular, output of non-metallic minerals products, namely cement and structural clay products, were adversely affected. Nevertheless, the iron and steel industry continued to register expansion as steel manufacturers gradually shifted away from long products, mainly for the construction sector to flat products that have a wider usage, ranging from electronic appliances to furniture. Flat products were also not subject to domestic price controls and had benefited from strong export demand during the year.

Production of **fabricated metal** surged during the year (29.2%; 2003: 7.4%), mainly supported by demand from the export market. Of significance, manufacturers, particularly those producing bolts, nuts, gas and water pipes as well as steel structures for buildings and containers, increased their production during the year, responding to the strong external demand and higher prices.

Growth in the **paper products industry** softened to 2.3% in 2004 (2003: 8%), arising from the strong competition from the regional countries in the pulp and paper segment. While the pulp and paper segment contracted, the containers and paperboards segment continued to register expansion during the year following the increased economic activities that supported the packaging industry. Production of **petroleum products** continued to increase, albeit at a more moderate pace given that the oil refineries were operating close to full capacity.

The **food products** industry continued to expand, albeit at a more moderate pace due partly to import substitution, while output in the **beverages and tobacco industries** were negatively affected by the increase in excise duties as well as stricter regulations on cigarette advertisement and packaging requirement.

The services sector remained as one of the main drivers of economic growth and was supported by domestic consumption, tourism and trade-related activities.

Services Sector

In 2004, growth in the services sector strengthened to 6.7% supported by strong domestic consumption, tourism, and trade-related activities. In particular, the **final services segment**, comprising the wholesale and retail trade; hotels and restaurants; utilities; Government services; and other services strengthened significantly, with growth picking up from 3.7% in 2003 to 6.3% in 2004, reflecting

Table 1.4
Growth in the Services Sector at Constant 1987 Prices

	2003	2004*p*	2003	2004*p*
	Annual change (%)		% share of GDP	
Services	**4.4**	**6.7**	**57.6**	**57.4**
Intermediate services	5.5	7.2	23.8	23.8
Transport, storage and communication	5.7	8.4	8.6	8.7
Finance, insurance, real estate and business services	5.4	6.5	15.1	15.0
Final services	3.7	6.3	33.9	33.6
Electricity, gas and water	5.7	8.1	4.1	4.2
Wholesale and retail trade, hotels and restaurants	1.5	7.1	14.3	14.3
Government services [1]	7.6	5.1	7.4	7.2
Other services [2]	3.3	5.0	8.0	7.9

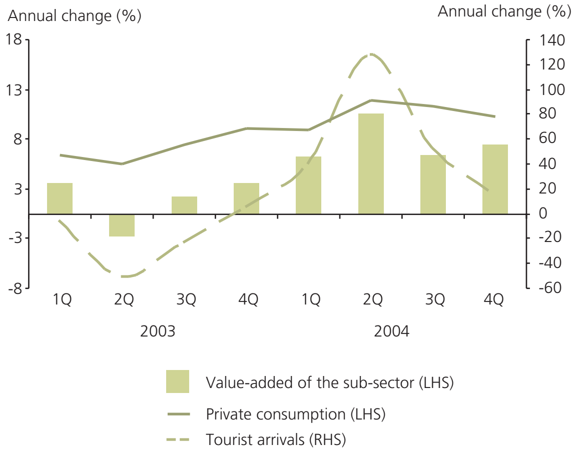
[1] Include general public services (general public administration, external affairs and public order and safety), defence, health, education and others.
[2] Include imputed rent from owner-occupied dwellings; community, social and personal services; products of private non-profit services to households and domestic services of households.
p Preliminary

Source: Department of Statistics, Malaysia

mainly stronger consumption and the recovery in tourism activities during the year. In line with the higher trade, business and travel activities, growth in **intermediate services segment** was also higher during the year at 7.2% (2003: 5.5%).

Of significance, the **wholesale and retail trade, hotels and restaurants sub-sector** rebounded strongly from the effects of SARS in the previous year to expand by 7.1% (2003: 1.5%). Growth was supported by increased consumer activity arising from higher disposable incomes and increased consumer confidence, and was further reinforced by robust tourism activities. Expenditure on durables, including passenger cars, rose during the year. In particular, sales of passenger cars and imports of consumption goods recorded strong growth rates of 15.3% and 24.1% respectively in 2004.

Graph 1.9
Trends in the Wholesale and Retail Trade, Hotels and Restaurants Sub-sector vis-à-vis Private Consumption and Tourist Arrivals



In the post-SARS period, there was a strong revival in tourist arrivals with the total number of tourists reaching a record level of 15.7 million in 2004 (2003: 10.6 million). The increase in tourists from high-spending markets such as the West Asian and North Asian countries supported activities in the hotels, restaurants and specialty retail stores. The hosting of the Formula One Grand Prix Championship in March and the twice-a-year Mega Sales Carnival (in the first and third quarters of the year) attracted tourist spending. The average occupancy rate of hotels rose to over 60% for the first time since 1996 (2003: 53.3%) with many premier hotels recording close to full occupancy during the peak seasons.

The **transport, storage and communication sub-sector** registered a strong growth of 8.4% in 2004 (2003: 5.7%) in line with the rapid expansion in trade and travel activities. Growth was further augmented by the robust expansion in the telecommunications industry, driven mainly by the cellular segment. Wider subscriber base, increases in international calls and increased popularity in the usage of mobile data supported the growth in this segment. By end-2004, the number of cellular phone subscribers rose to 14.5 million (end-2003: 11.1 million), representing a penetration rate of 55.9%. The intense price competition between operators has helped to increase the usage of short messaging service (SMS) and other mobile data during the year. Subsequently, revenue from data accounted for an increased share of 16% of total mobile revenue in 2004, up from 12% a year ago, while SMS traffic reached 9.5 billion (2003: 6.2 billion).

Robust trade activities contributed favourably towards the growth in sea and air cargo. Total TEUs handled at major ports expanded by 10.7%, reflecting increases in both indigenous cargo as well as transhipment activity. In terms of operational efficiency, Port of Tanjung Pelepas (PTP) recorded the highest level of productivity among local ports at 32 gross moves per crane per hour. The port received the Container Terminal of the Year Award at the Asia Logistics Award 2004 held in Kuala Lumpur. Air cargo handled in the country also recorded a higher growth of 10.5% in 2004, due mainly to the aggressive promotion by the national airline, including the promotion of the I-port concept, which facilitates seamless movement of cargo between airports and the three major seaports in Malaysia, namely Northport, PTP and the Kuantan Port.

Meanwhile, the passenger segment of the air transportation industry recorded a strong performance of close to 20%. The segment benefited not only from the strong growth of inbound tourists but also from more Malaysians travelling locally and abroad due to greater affordability with the advent of low-cost air travel.

The **finance, insurance, real estate and business services sub-sector** recorded a stronger growth in 2004, driven mainly by banking and insurance activities, which account for the bulk of the sub-sector. In the banking industry, growth emanated from both interest and non-interest income, namely fee-based income. Nevertheless, narrowing interest spreads amidst ample liquidity and intense competition continued to limit the growth in interest income. The increasing Islamic banking activity further contributed to growth during the year. In terms of lending, Islamic financing rose by 19% to account for 11.3% of total bank lending during the year. Total assets in Islamic banking doubled in the last four years to RM94.6 billion as at end-2004. Meanwhile, in the insurance industry, net insurance premiums collected rose significantly underpinned by strong consumer demand for investment-linked life insurance and endowment products.

Activities in the real estate and business services segments also expanded during the year. Real estate activity was supported by a marked increase in the volume of property transactions (20.5%), while the increased turnover at Bursa Malaysia benefited the stock broking industry in the business services segment. Other new growth areas, namely ICT services and shared services, gained momentum to add to the growth in the business services segment. As at end-2004, 910 companies were in operation at the Multimedia Super Corridor (MSC), of which 67 are world-class companies. Activities of these companies include software and content development and providing Internet-based service applications and e-commerce solutions. In the shared services and outsourcing industry, by end-2004 the Malaysian Industrial Development Authority (MIDA) had approved incentives to 87 Operational Headquarters, 162 International Procurement Centres and seven Regional Distribution Centres as companies found Malaysia a suitable country to locate their regional hub for insourcing and outsourcing activities. A.T. Kearney's 2004 Offshore Location Attractiveness Index ranked Malaysia as the third most attractive offshore location for companies to locate their shared services operations abroad.

Table 1.5
Selected Indicators for the Services Sector

	2003	2004*p*
	Annual change (%)	
Electricity production index	5.7	8.3
Loans outstanding in the banking system	4.8	8.5
Insurance premiums	14.0	16.3
Bursa Malaysia (turnover, value)	57.2	18.3
LRT ridership[1]	8.8	5.7
Tourist arrivals	-20.4	48.5
Airport passenger traffic	2.0	18.9
Air cargo handled	7.0	10.5
Bulk cargo throughput at major ports[2]	7.9	9.1
Container throughput at major ports[3]	14.9	10.7
	%	
Hotel occupancy rate	53.3	60.8
Penetration rate of telecommunications services (end-period)		
- Internet dial-up	11.4	12.7
- Broadband	0.45	0.98
- Cellular phone	43.9	55.9
- Fixed line	18.1	17.2

[1] STARline and PUTRAline.
[2] Comprise Port Klang, Johor Port, Penang Port, Sabah ports and Bintulu Port.
[3] Comprise Port Klang, Johor Port, Port of Tanjung Pelepas, Penang Port, Sabah ports and Bintulu Port.
p Preliminary

Source:
Bursa Malaysia Berhad; Department of Statistics, Malaysia; Malaysia Airports Holdings Berhad; Senai Airport Terminal Services Sdn. Bhd.; Malaysian Communications and Multimedia Commission; Ministry of Finance; relevant port authorities; Syarikat Prasarana Negara Berhad; Malaysia Tourism Promotion Board; and Bank Negara Malaysia

The **other services sub-sector** expanded at a faster pace of 5% (2003: 3.3%) with strong growth in the entertainment segment and supported by the new growth areas such as private education and private healthcare services industries. In the private higher education segment, there were 27 private universities, including six foreign university branch campuses, and 532 private colleges in operation as at end-2004. Total student enrolment in these institutions was around 232,200, of which 8.3% comprised foreign students (2003: 7.9%). In the private healthcare industry, the existing 35 private hospitals treated about 174,300 foreign patients during the year. The majority of patients came to Malaysia for treatment for cardiology, radiology and general surgery. Some tourists also came for diagnostic services and wellness programme, including basic and total health-screening services.

The **Government services sub-sector** continued to expand by 5.1%, due to higher expenditure on emoluments for the civil service, including the higher bonus payment made during the year. Meanwhile, the **utilities sub-sector** expanded strongly in line with the stronger economic performance resulting in increased demand for electricity and water by all categories of consumers, including the industrial, commercial and household sub-sectors.

Agriculture Sector

The **agriculture, forestry and fishing (agriculture)** sector registered another year of strong and broad-based growth, reflecting its revival as an important engine of growth for the economy. The sector contributed to 0.4 percentage points to overall GDP growth in 2004 (2003: 0.5 percentage points; 1993-2002: average of 0.03 percentage

The agriculture sector recorded a strong and broad-based expansion amidst favourable commodity prices.

Table 1.6
Agriculture Sector: Value Added, Production and Exports

	2003		2004*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value Added (RM million at 1987 prices)	**20,123**	**5.7**	**21,135**	**5.0**
Production[1]				
of which:				
Crude palm oil	13,355	12.1	13,976	4.7
Rubber	986	10.8	1,186	20.4
Saw logs	21,532	4.3	21,576	0.2
Cocoa beans	36	-24.0	33	-7.8
Fish landings	1,480	1.1	1,576	6.5
Exports (RM million)	**33,693**	**28.0**	**36,176**	**7.4**
of which:				
Palm oil				
('000 tonnes)	12,487	15.0	11,788	-5.6
(RM/tonne)	1,617	18.3	1,706	5.5
(RM million)	20,192	36.1	20,107	-0.4
Rubber				
('000 tonnes)	946	2.0	1,105	16.7
(sen/kilogramme)	379	41.0	470	24.3
(RM million)	3,583	43.8	5,198	45.1
Saw logs				
('000 cubic metres)	5,532	8.4	5,207	-5.9
(RM/cubic metre)	366	1.8	398	8.9
(RM million)	2,021	10.3	2,070	2.5
Sawn timber				
('000 cubic metres)	2,789	1.3	3,166	13.5
(RM/cubic metre)	1,134	2.9	1,015	-10.4
(RM million)	3,162	4.2	3,214	1.7

[1] All in '000 tonnes, except for saw logs in '000 cubic metres.
p Preliminary

Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board
Fisheries Department, Malaysia

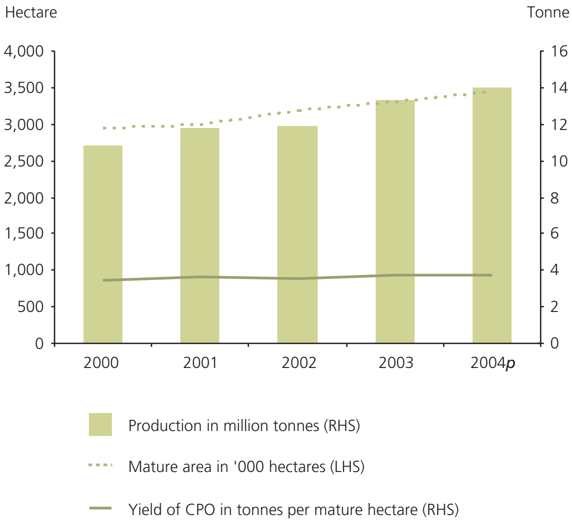
points). Value added growth in the sector expanded by 5% in 2004 reflecting an expansion across a wide range of commodities, namely crude palm oil, rubber, saw logs and food-related activities. On the external front, foreign exchange earnings from agriculture commodities increased by 7.4%, due wholly to the marked increases in export prices of between 5 – 47%. Agriculture exports accounted for 7.5% of gross exports in 2004.

The strong performance of the agriculture sector was due to a confluence of positive developments during the year. Conducive weather conditions, increases in mature areas and strong productivity gains as a result of Good Agriculture Practices (GAP) by farmers encouraged by the high global prices of agriculture commodities were key factors driving growth. In particular, production of crude palm oil and rubber reached record levels during the year. While palm oil production was supported by large expansions in new matured areas and more widespread application of agricultural inputs, especially fertilisers, rubber output was induced by intensive tapping activity, especially among smallholders and higher yields from application of new labour-saving technologies.

The broad-based growth in the agriculture sector was also contributed by higher output of the food crops sub-sector, a major component of Malaysia's agriculture sector (about 40% of the value added in the agriculture sector). The Government's efforts to transform and modernise the agriculture sector in recent years, by encouraging higher productivity and establishing deeper linkages with downstream agro-based industries, has helped to diversify the agriculture base. These contributed to higher and more stable income and increased consumption activity among farmers, fishermen and other smallholders in the rural communities of Malaysia.

Production of **crude palm oil (CPO)** reached a record high of 13.98 million tonnes in 2004, representing an increase of 4.7% over the previous year (2003: 13.35 million tonnes; 12.1%). Growth was driven by two key factors. Firstly, matured oil palm areas rose by 4.5% to 3.45 million hectares in 2004 (2003: 3.6%), reflecting mainly increases in East Malaysia. Sabah and Sarawak registered growth rates of 4.4% and 17.7% respectively, while in Peninsular Malaysia the expansion was more moderate at 2.2%. Nevertheless, Peninsular Malaysia continued to constitute a majority share of about 58% to total CPO production.

Graph 1.10
Oil Palm: Area, Production and Yield

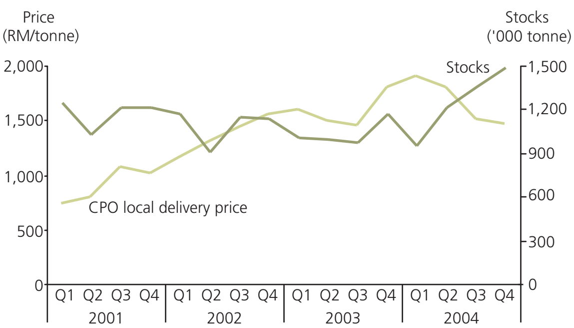


p Preliminary
Source: Malaysian Palm Oil Board (MPOB)

The second factor was the marked improvement in the oil extraction rates (OER), which is one of the critical barometers of palm oil yield productivity. The Malaysian OER breached the critical 20% threshold for the first time in history, to 20.03% (2003: 19.75%). This is an important milestone in the industry, as every 1% increment in OER translates to an estimated increase of about 500,000 tonnes in CPO output. Given these positive developments, Malaysia retained its position as the world's largest palm oil producer and exporter, accounting for 47% of global output, and 54% of world exports.

The Malaysian palm oil commanded a strong price in the global market, with the CPO local delivery prices averaging RM1,664 per tonne in 2004 or 5.5% higher than in 2003 (RM1,577 per tonne). Prices strengthened considerably in the first half of the year (RM1,848 per tonne) amidst the shortage of world supply of oils and fats, which began since the latter half of 2003. The three largest producers of soybean oil (palm oil's closest competitor), namely the US, Brazil and Argentina recorded disappointing harvests in early 2004 due to drought and the onset of the Asian rust disease. Nevertheless, CPO prices consolidated thereafter (second half of 2004: RM1,481 per tonne) following a bumper soybean harvest in the US. Market sentiment was also influenced by the slowdown in external demand for palm oil as well as the gradual build-up in domestic crude palm oil

Graph 1.11
Palm Oil Price and Stocks



Source: Malaysian Palm Oil Board (MPOB)

stocks (end-2004: 1.49 million tonnes; end-2003: 1.16 million tonnes). This caused the already large price discount of CPO against the three other major competing edible oils (soybean, rapeseed and sunflower oils) to widen further during the year.

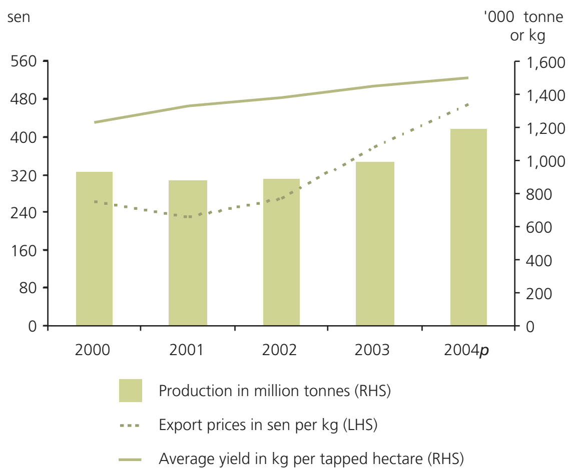
PR China continued to dominate as the major buyer of Malaysian palm oil, accounting for about 24% of the total exports. Exports to PR China rose during the year as its import quota for palm oil increased to 2.7 million tonnes (2002: 2.3 million tonnes) following the republic's accession into the World Trade Organisation (WTO). There was also a discernable increase in offtake by the US (29.2%) to 298,760 tonnes following the announcement by the Food and Drug Administration (FDA) on the changes to the regulations on the labelling of food products that contain *trans* fatty acid. Beginning 2006, US food manufacturers are mandated to label all products that contain *trans* fatty acids, which clinical studies have linked to serious diseases. Palm oil, which is *trans* fatty acid-free has benefited from the regulation as it has been increasingly used by US manufacturers as a substitute for other edible oils. Meanwhile, purchases from other Asian countries, notably India and Pakistan, declined sharply (-44% and -24.2% respectively) following an improvement in the production of their domestic rapeseed oil.

On the development front, the Malaysian palm oil industry continued to make significant progress. Malaysia ventured into four new markets during the year, namely Sao Tome and Principe, Tuvalu, Costa Rica and Guam. In terms of research and development, the Malaysian Palm Oil Board (MPOB) introduced 43 new technologies and products for commercialisation in the industry and undertook 312 research projects during the year. The new breakthroughs were mainly in developing cost-effective milling and refining techniques, improving yields, minimising wastage and creating higher value-added palm-based products (edible and non-edible products) and palm-based biomass. In line with the Government's policy on utilising renewable energy sources, efforts were also intensified in research and development related to biofuel energy prompted by the sharp increase in crude oil prices in 2004.

Natural rubber production continued to expand strongly for the second consecutive year, to breach the 1 million tonne mark for the first time in eight years. Output increased by 20.4% to reach 1.19 million tonnes. The sharp increase emanated entirely from smallholders, who accounted for almost 95% of total Malaysian rubber output. Output by smallholders rose by 22.7% as high prices motivated increased tapping activity and utilisation of improved techniques that raised productivity. While total tapped areas by smallholders expanded by 2.3% to 768,440 hectares, areas tapped by estates declined further by 1.5%, as more rubber land holdings were either replanted with other crops or converted into other economic activities during the year. Malaysia maintained its position as the third largest producer of rubber (16% share of world output) after Thailand and Indonesia.

Malaysian rubber prices, as benchmarked by SMR 20 (RSS 1 was discontinued effective 1 January

Graph 1.12
Natural Rubber: Production, Prices and Yield



p Preliminary for average yield
Source: Malaysian Rubber Board (MRB)

2004), strengthened significantly by 21% to an average of 461 sen per kilogramme in 2004 (2003: 381 sen/kg). Prices rose significantly in the early part of the year to reach the highest daily traded price of 502 sen on 2 March and to record a monthly high of 489 sen in March. The surge in prices was caused by lower world supply as a result of heavy rains and some localised disruptions, while global demand continued to remain strong especially from PR China. As output picked up in the major producing regions in the latter part of the year, prices trended lower to around 425 sen before closing the year slightly higher at 450 sen due to rising price of synthetic rubber following the higher crude oil prices.

Export proceeds from rubber rose significantly by 45.1% to RM5.2 billion in 2004, to account for 1.1% share of total exports. PR China expanded its purchases from Malaysia, registering a strong double-digit growth for the third consecutive year (39.2%; 2003: 60.3%). The strong purchases were fuelled by demand from tyre manufacturers catering to the surge in demand for automobiles. This was further augmented by the Chinese government's decision earlier in the year to abolish the import quota for natural rubber, in accordance with the WTO's trade liberalization measures. As a result, PR China continued to remain as Malaysia's largest importer of rubber with a 26.1% share of total exports (2003: 21.9%). Apart from PR China, the other major export market was the European Union (EU), which accounted for 32% of the total rubber exports, particularly Germany and France.

Rubber remains an important crop for Malaysia, given its strong linkages to the rural community and downstream industries. In recent years, the strong prices have helped to revive the industry, particularly among smallholders. Besides increasing tapping activities, smallholders have also adopted exploitation technologies such as the low frequency tapping system (LITS) and Good Agricultural Practices by using stimulants to improve rubber yield.

The Government has also provided replanting grants since 2002 amounting to RM330 million to encourage smallholders to replant rubber as well as to diversify their activities to supplement their income. They were encouraged to replant latex timber clones (LTC) that yield higher latex. These clones would also ensure adequate supply of rubber wood in future for the local furniture industry. At the same time, the Government has implemented a number of programmes including the G++ Planting System (integrated farming in rubber plantation) and Rubber Technology Village Projects (incorporating technology in rubber cultivation). These initiatives have resulted in higher incomes for smallholders. Rubber smallholders under the Federal Land Development Authority (FELDA) schemes (accounting for 10% of the nation's rubber output) doubled their monthly income from RM980 in 2002 to RM1,800 in 2004.

Other agriculture commodities, comprising fisheries, livestock, as well as miscellaneous agriculture (which includes fruits and vegetables), performed favourably in 2004. The **fisheries** sub-sector grew by 6.5% in 2004 to 1.58 million tonnes (2003: 1.48 million tonnes), driven mainly by more active deep-sea fishing and increased output of high value-added aquaculture and ornamental fish. Similarly, **livestock** production expanded by 4.5%, led by growth in output of cattle and poultry, mainly through better farming techniques such as the integrated cattle farming in oil palm and rubber plantations and poultry rearing via the closed house system. The increase in output was to meet the rising external demand and demand from the domestic food processing industries. Strong growth in **fruits** (7.1%) and **vegetables** (25%) production was due mainly to increases in cultivation areas amidst the strong domestic consumption.

During the year, the Ministry of Agriculture and Agro-based Industry (MoA) and related agencies undertook a Food Trade Balance Action Plan. The aim is to reverse the net deficit in the balance of payments for the food bill to a surplus position by 2010, as stated in the Third National Agriculture Policy (NAP3). In realising this goal, three key objectives have been emphasised. Firstly, to raise the production levels of food crops by increasing planting and catchment areas through schemes such as Permanent Food Production Parks (TKPM), Aquaculture Industrial Zones (AIZ) and private sector-led large scale commercial farming endeavours. Secondly, to strengthen the industry's competitiveness by establishing a deeper linkage with higher value-creating downstream processing activities, such as the agro-based food industries. Thirdly, to establish a sound marketing plan and ensuring the quality and safety of the food products for overseas markets by embarking on a series of accreditation and labelling schemes that is benchmarked to internationally recognised food standards. Some of these schemes that were launched recently include the Farm Accreditation Scheme of Malaysia (SALM), Malaysian Aquaculture Farm Certification Scheme (SPLAM), Livestock Farm Accreditation Scheme (SALT) and labelling of 'Malaysia's Best' on exported fruits.

In the **forestry** sector, logging activities were moderate during the year in line with the conservation efforts to implement sustainable forest management practises. Production of saw logs increased marginally by 0.2% to 21,576 million cubic metres (2003: 21,532 million cubic metres). However, global demand for logs remained firm during the year, particularly from Japan, PR China, US and the EU countries, which led to higher prices. The average Malaysian log price reached a record high of RM398 per cubic metre following a ban on log exports and sawn timber by Indonesia. Amidst the increase in export prices (8.9%) and the decline in volume of 5.9%, export proceeds from saw logs rose by 2.5% to RM2.1 billion.

Tropical timber continued to come under pressure by environmentalists, particularly from Europe, on concerns regarding illegal logging and trade in endangered tropical species. Malaysia has developed its own timber certification scheme to provide confidence and assurance to importers and consumers that Malaysian timber products are from legal and sustainable sources. By end-2004, the Malaysian Timber Certification Council (MTCC) awarded the Certificate for Forest Management to eight Peninsular Malaysia states, as well as the Upper Ulu Baram region in Sarawak, covering a total of 4.73 million hectares of permanent reserve forests. The credibility of these certification efforts have been recognised by major buyers of Malaysian timber products, most recently by the UK and the Netherlands. In addition, to counter persistent allegations that Malaysia was importing illegal tropical logs from Indonesia, including the endangered Ramin species, the Government has imposed a blanket ban on importing such logs. Malaysia has also been vigilant in enforcing regulations on trade in Ramin in accordance with the regulations under the Convention for International Trade of Endangered Species of Wild Flora and Fauna (CITES).

As a long-term strategy to reduce reliance on natural forest, the Government has embarked on forest plantation as well as considered alternative resources such as oil palm biomass and *Kenaf* to supplement the inadequate supply of raw materials. While biomass has been identified as being suitable for manufacturing of panel products, *Kenaf*, from the hibiscus family, is for production of fibreboard. On forest plantation, as of end-2004, there has been a total of 316,196 hectares in Malaysia, with almost 68% of the planted areas in Sabah. Almost one-third of the total forest plantation is expected to emanate from the rubber species from which rubberwood is produced. In recent years, rubberwood has been increasingly used by the domestic furniture and building component industries due to its suitability. In addition, rubberwood products have also been exported, contributing to about RM5 billion export receipts in 2004. The replanting of rubber trees with LTCs would augment the production of rubberwood in the years to come.

Cocoa production fell further by 7.8% to 33,423 tonnes (2003: 36,236 tonnes) amidst the continued reduction in cultivated area to 44,000 hectares (2003: 44,897 hectares; 1990: 393,000 hectares). The reduction reflected mainly the active conversion into other crops. In addition, average productivity has also declined especially amongst smallholders, who account for two-thirds of total Malaysian cocoa acreage, due to decreased application of inputs. Nevertheless, demand for cocoa from the domestic downstream industries has been increasing, resulting in a significant increase in the import bill. As part of the efforts to encourage cocoa planting among smallholders, the Malaysian Cocoa Board has implemented the Cocoa Smallholders' Development Programme. Currently, there are 4,673 farmers who are actively involved in the programme, with a total area of 4,609 hectares. In addition, the Government has also announced that a 100% replanting grant would be given to cocoa smallholders.

Mining Sector

The **mining and quarrying (mining)** sector expanded further by 4.1% in 2004, on account of higher production of crude oil and natural gas due to strong external and domestic demand. Meanwhile, production of tin-in-concentrates continued to decline amidst the lower number of active tin mines in the country. As a net oil exporting nation, Malaysia largely benefited from the prevailing high crude oil prices during the year. Export receipts from minerals rose significantly for the second consecutive year by 38.2% to RM41.2 billion resulting in its share to total exports increasing to 8.6% (2003: 7.5%).

Malaysian **crude oil** production (including condensates) rose to the highest level of 762,318 barrels per day (bpd) in 2004, an increase of 3.6% (2003: 737,858 barrels per day). Output excluding condensates was within the target range set for the year under the National Depletion Policy. The higher production was supported by increase in demand from Australia, Thailand and Korea, as well as increased domestic demand from downstream industries producing petroleum products. High prices and increased volume resulted in proceeds from crude oil rising by 36.1% to RM21.3 billion, constituting an increased share of 4.4% to total export receipts (2003: 3.9%).

The year saw the Malaysian Tapis Blend, which is of the 'light and sweet' variety due to its low sulphur content, priced at a premium relative to the North Sea Brent. In 2004, the price of Tapis Blend strengthened by 38% to US$41.12 per barrel (2003: US$29.79 per barrel). The price rose steadily during the course of the year to reach a high of US$55.10 per barrel on 21 October. The surge in crude oil prices during the year was driven by both fundamental factors as well as market sentiment. The fine balance between global supply and demand as well as higher risk premiums for crude oil prices due to geopolitical risks, was further exacerbated by active speculative activities in the energy markets.

Crude oil and natural gas production rose to the highest levels. Higher external demand and strong prices contributed to a significant increase in export earnings from minerals.

Based on the estimates by the International Energy Agency (IEA), global oil demand in 2004 experienced the strongest yearly increment in 21 years, rising by 2.7 million bpd to 82.4 million bpd, while global

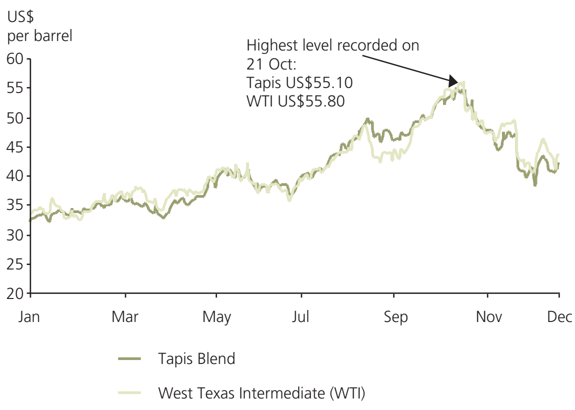
Table 1.7
Mining Sector: Value Added, Production and Exports

	2003		2004*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value added (RM million at 1987 prices)	**16,699**	**5.9**	**17,384**	**4.1**
Production				
Crude oil and condensates (barrels per day)	737,858	5.6	762,318	3.6
of which: *Crude oil (barrels per day)*	*621,902*	*4.3*	*623,957*	*0.6*
Natural gas - net (million standard cubic feet per day)	5,013	7.2	5,196	4.0
Tin-in-concentrates (tonnes)	3,358	-20.3	2,800	-16.6
Exports (RM million) *of which:*	**29,801**	**33.3**	**41,177**	**38.2**
Crude oil				
('000 tonnes)	17,913	10.6	18,090	1.0
(US$/barrel)	30.27	22.0	40.81	34.8
(RM million)	15,659	35.0	21,318	36.1
Liquefied natural gas				
('000 tonnes)	17,311	15.4	20,729	19.7
(RM/tonne)	772	17.1	824	6.8
(RM million)	13,358	35.1	17,079	27.9
Tin				
(tonnes)	15,244	-43.7	29,966	96.6
(RM/tonne)	18,730	19.2	31,585	68.6
(RM million)	286	-32.9	947	231.5

p Preliminary

Source: PETRONAS
Department of Statistics, Malaysia
Department of Minerals and Geoscience, Malaysia

Graph 1.13
Crude Oil Prices (1-Month Futures) in 2004



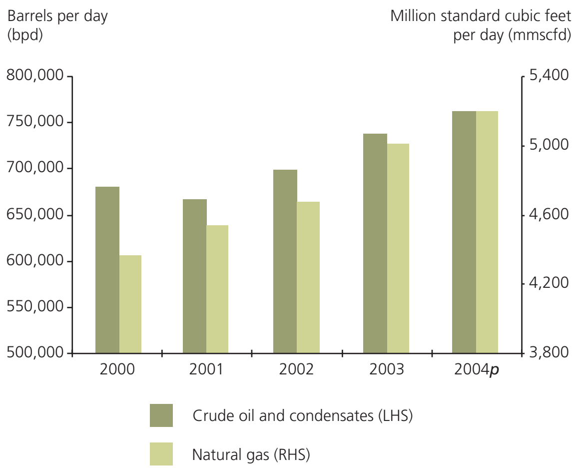
supply picked up slightly to 83 million bpd. The strong global demand emanated mainly from the PR China and the US. PR China contributed to about one-third of the increase in global demand driven by robust economic activities, while strong demand from the US reflected its need to build up its inventory level. Sentiment was further heightened by geopolitical risks in the Middle East and supply disruptions in some producing nations, such as Russia, Venezuela and Nigeria. As such, the risk premium inherent to crude oil prices widened significantly, leading to higher speculative activities. Thus, the global benchmark oil prices, namely West Texas Intermediate and North Sea Brent, averaged higher at US$41.40 and US$38.34 per barrel respectively (2003: US$30.92 and US$28.70 per barrel respectively).

Crude oil prices were also influenced by decisions of the Organisation of Petroleum Exporting Countries (OPEC). For the first time in 23 years, OPEC, which accounts for almost 40% of global oil supply, experienced a sharp reduction in spare production capacity to around 1 million bpd, lower than the average of 4 – 5 million bpd seen previously. This was crucial as non-OPEC producing nations have essentially very little spare capacity. After initially cutting its output quota by 1 million bpd to 23.5 million bpd in March, OPEC subsequently reversed its action due to strong global demand. OPEC raised its quota on three occasions, by 2 million bpd, 0.5 million bpd and 1 million bpd respectively, ending the year with a quota of 27 million bpd. Production increases by OPEC helped to stabilise and moderate oil prices. The Tapis Blend closed the year at US$40.50 per barrel.

Natural gas production also reached historic levels in 2004, with a rise in output by 4% to 5,196 million standard cubic feet per day (mmscfd) (2003: 5,013 mmscfd). The increased capacity utilisation at the MLNG plants and Gas Processing Plants (GPPs) enabled the industry to meet the higher demand from traditional buyers. In addition, domestic demand for natural gas rose during the year due to higher utilisation by the power generation sub-sector and also increased growth from domestic industrial users.

The year 2004 also saw Malaysia remaining as the third largest liquefied natural gas (LNG) exporter in the world after Indonesia and Algeria. Malaysia exported a record high of 20.7 million tonnes or about 16% of the world's total LNG exports. This represented a strong increase in volume of 19.7%. The higher offtake were mainly from traditional buyers, namely Korea and Chinese Taipei whose imports rose sharply by 74.7% and 24.4% respectively. While the majority of Malaysian LNG trade is conducted on a medium- to long-term contractual basis, the country has also benefited from the growing trend in LNG trading on spot and short-term contractual basis (defined as less than five years). In 2004, the US bought about 300,000 tonnes of Malaysian LNG on a spot basis to offset declining imports from Canada, their traditional supplier of natural gas. In line with trends in the energy markets, LNG export price rose by about 6.8% to RM824 per tonne. Accordingly, export receipts from LNG rose by 27.9% to RM17.1 billion.

Graph 1.14
Production of Crude Oil and Natural Gas



p Preliminary
Source: PETRONAS

Table 1.8
Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at end	
	2003	2004*p*
Crude oil (including condensates)		
Reserves (billion barrels)	4.84	4.81
Reserve/Production (year)	17.5	17.7
Natural gas		
Reserves (trillion standard cubic feet)	87.02	87.33
Reserve/Production (year)	36.7	35.1

[1] The National Depletion Policy was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).
p Preliminary

Source: PETRONAS

Reflecting the vast potential of the Malaysian oil and gas industry, further **discoveries of oil and gas resources** were recorded in 2004. Six new oil fields were discovered offshore Sabah, including deepwater discoveries in Gumusut, Malikai and Senangin. This brings the total number of discoveries since 2002 to 12. In addition, 11 new gas fields were discovered. Of the 507,263 square kilometres of onshore and offshore areas in Malaysia made available for oil and gas exploration, 227,520 square kilometres have been awarded under 52 production sharing contracts (PSCs), four of which were signed during the year. In addition, 125 development wells and 36 exploration wells were drilled. During the year, the national oil corporation, Petroliam Nasional Berhad (PETRONAS) undertook major geological and geophysics studies. 3D seismic data mapping amounting to 546,311 line kilometres were acquired for exploration and development purposes, more than double the acquisition made just two years ago (2002: 246,475 line kilometres). Steps were also taken to enhance oil recovery via utilisation of non-conventional drilling methods.

Production of **tin-in-concentrates** continued to decline by 16.6% in 2004 due mainly to a decrease in the number of active tin mines in the country, as well as a depletion of tin reserves in the existing mines. This development took place despite the strong tin prices during the year. The average tin prices at the Kuala Lumpur Tin Market rose substantially by 73.8% to US$8,494 per tonne. The surge in prices was due to decreasing global tin stocks (particularly in the US), coupled with strong demand from the electronics industry arising from the environmental guidelines set by the EU, to replace lead with tin as the main material in soldering activities.

Construction Sector

In 2004, the **construction sector** contracted by 1.9% due mainly to lower civil engineering activity. The weaker civil engineering performance was a result of fewer infrastructure projects following the completion of many privatised projects in recent years as well as lower Government spending on new large infrastructure. On the other hand, overall activity in the residential and non-residential segments expanded during the year. Demand for residential properties was supported by rising disposable incomes and attractive financing packages, while the non-residential segment recovered in line with the stronger economic and business activities during the year.

In the construction sector, activity in the residential and non-residential segments expanded but overall activity was subdued due mainly to lower civil engineering activity.

The sharp decline in **civil engineering activity** was on account of completion of major privatised projects as well as lower public spending on large infrastructure projects. The slowdown was, however, partially mitigated by higher construction activity in the oil and gas sector following the discovery of several oil fields offshore Sabah. Construction activity centred on building terminals and production facilities, such as installation of oil rigs and pipelines. Ongoing construction in the civil engineering sub-sector was largely for power generation plants, roads, ports, and water and sewerage projects. Malaysian construction companies also secured a number of overseas contracts particularly in India, Middle East and Indochina to help to diversify their earnings base.

Activity in the **residential segment** remained strong, underpinned by firm demand for residential property, especially affordable housing in choice locations with good accessibility. Demand for residential property was encouraged by the low interest rates, attractive housing loan packages as well as incentives provided under the 2003 Economic Package which ended at end-May 2004. Supported by the favourable demand conditions,

Table 1.9
Residential Property Indicators

	2003	2004
	Units	
Residential property transactions		
Units	164,723	195,241
Value (RM billion)	23.0	29.3
Approvals[1]	203,372	174,671
Developers' licences		
New	1,062	1,071
Renewals	436	353
Sales and advertising permits		
New	1,103	1,038
Renewals	1,707	1,510
Loans by banking system - Value (RM billion)		
Outstanding	116.6	132.9
Approvals	30.0	35.7

[1] Units approved for construction by private developers.

Source: NAPIC, Valuation and Property Services Department, Ministry of Housing and Local Government and Bank Negara Malaysia

construction of new houses as indicated by incoming supply and housing starts, continued to expand by 5.5% and 1% respectively in the first nine months of 2004. In recent years, the development of high-end properties has gained growing buyer interest. Reflecting this, the construction of high-end houses, as reflected by the incoming supply of semi-detached and detached houses, rose by 4.7% in the first nine months of 2004. With improving demand, house prices trended upwards in 2004. Latest data for the first half of 2004 showed that the Malaysian House Price Index rose by 5.7%, with increases recorded in all types of houses.

In line with the Government's effort to provide affordable houses to the low-income group, an additional RM1 billion was allocated to implement the *Projek Perumahan Rakyat* (PPR) in 2004. In the 2005 Budget, the Government has allocated RM778 million for the construction of 21,000 low-cost houses under the PPR.

During the year, guidelines on the purchase of properties by foreigners were further liberalised. Bank Negara Malaysia liberalised its lending guidelines to allow all residents (bank and non-bank) to extend ringgit credit facilities up to a maximum of three property loans to a non-resident to finance or re-finance the purchase or construction of properties in Malaysia with no limitation on the credit facilities. As of 1 August 2004, the Foreign Investment Committee (FIC) also relaxed its guideline to allow foreigners to purchase properties valued more than RM150,000 (previously: more than RM250,000). For the year as a whole, FIC approvals for purchase of properties by foreigners rose significantly by 74.6% to 2,824 units or RM1.5 billion (2003: RM770.6 million). Average price of properties purchased by foreigners increased by 10.2% (2003: 0.4%). However, the purchase of commercial properties by foreigners declined during the year.

In 2004, the definition of **property overhang** was reclassified to cover only completed property with certificate of fitness for occupation (CFO) issued, but remaining unsold for more than nine months after it was launched for sale. Previously, all properties that were launched and remained unsold for more than nine months, irrespective of whether the CFO was issued, were defined as overhang. Based on the new classification, data compiled by National Property Information Centre (NAPIC) showed that the overhang of residential properties increased to 15,162 units as at end-September

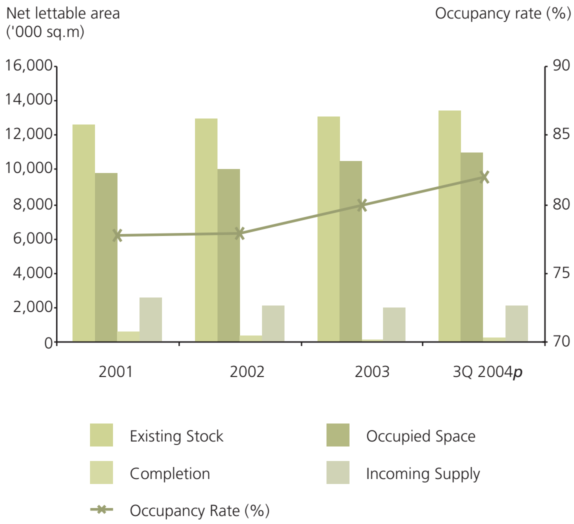
Table 1.10
Incoming Supply and Planned Supply of Property

	Incoming Supply[1]	Planned Supply[2]	Incoming Supply[1]	Planned Supply[2]
	As at end-2003		As at end-Sept 2004*p*	
	Units/'000 sq.m.			
Residential (units)	595,248	539,655	608,140	575,325
Purpose-built office ('000 sq.m.)	2,155	1,903	2,074	1,920
Shopping complexes ('000 sq.m.)	1,707	1,701	1,570	1,723
Retail shops (units)	33,455	35,260	36,123	34,839
Industrial properties (units)	8,443	22,077	8,333	21,658

[1] Consists of properties that are under construction, including those where certificates of fitness/temporary certificates of fitness have not been issued.
[2] Approved but not started.
p Preliminary

Source: NAPIC, Valuation and Property Services Department

Graph 1.15
Supply and Occupancy Rate of Office Space in Malaysia : 2001 - 2004



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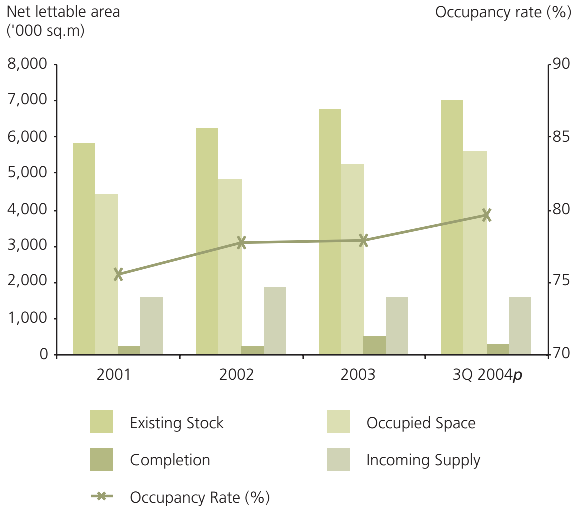
Graph 1.16
Supply and Occupancy Rate of Retail Space in Malaysia : 2001 - 2004



p Preliminary

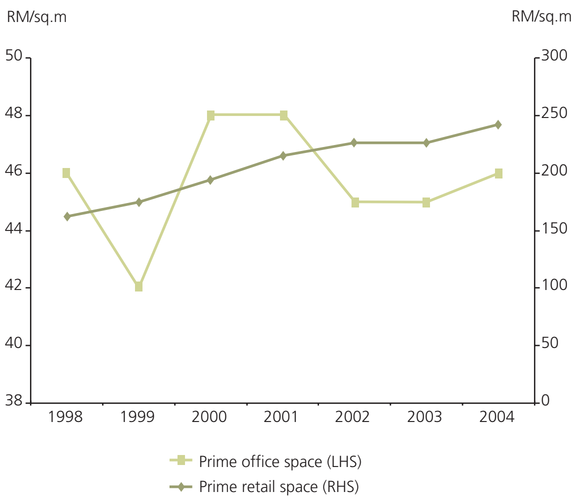
2004 (end-2003: 9,300 units) due to increased supply. Total value of overhang was RM1.8 billion. The overhang units were mainly located in the states of Johor, Selangor and Melaka. Majority of the overhang involved properties priced below RM150,000.

Construction activity in the **non-residential segment** recovered in 2004, driven largely by higher demand for office and retail space following more robust business activities. New office and retail space completed increased by 222,000 sq. metres and 265,000 sq. metres respectively in the first nine months of 2004 (first nine months of 2003: 159,000 sq. metres and 183,000 sq. metres respectively). In the purpose-built office segment, demand was supported by growth of service-related businesses such as finance, insurance, education and health. In the shopping complex segment, demand for retail space was boosted by strong consumer spending. The new shopping complexes were located mainly in the popular residential areas and suburbs to target the growing affluent population in the surrounding neighbourhoods. Notwithstanding the increase in new supply, the overall occupancy rate for office and retail space improved to 81.9% and 79.6% respectively in the first nine months of 2004 (2003: 80.5% and 78% respectively).

Reflecting stronger demand, rentals for prime office and retail space in the Klang Valley firmed during the year. The average monthly rental rates of prime retail space in the shopping complexes rose to RM242 per square metres (2003: RM226 per square metres), while rentals for prime office space rose slightly to RM46 per square metre per month (2003: RM45 per square metre).

In the **hotel segment**, there were 235 new hotels completed during the year, providing an additional

Graph 1.17
Average Monthly Rentals for Prime Office and Retail Space in the Klang Valley[1]



[1] Refers to Kuala Lumpur and Selangor.
Source: CH Williams Talhar & Wong Sdn. Bhd.

Table 1.11
Office and Retail Space - Unoccupied Space, Incoming Supply and Planned Supply by State (as at end-September 2004)

	Office Space			Retail Space		
	Unoccupied Space	Incoming Supply[1]	Planned Supply[2]	Unoccupied Space	Incoming Supply[1]	Planned Supply[2]
	('000 sq.m.)					
WP Kuala Lumpur	1,158	1,078	1,061	322	566	653
Selangor	335	58	0	171	304	63
WP Putrajaya	0	419	177	44	0	0
Johor	273	118	495	299	232	809
Pulau Pinang	281	63	41	268	212	47
Negeri Sembilan	18	45	111	36	72	88
Perak	60	52	0	42	0	0
Melaka	34	0	0	66	0	0
Kedah	26	29	1	53	53	14
Pahang	16	23	15	51	4	6
Terengganu	9	0	0	6	7	0
Kelantan	7	4	20	0	63	0
Perlis	0	26	0	0	0	0
Sabah	118	134	0	30	56	44
WP Labuan	40	0	0	15	0	0
Sarawak	49	25	0	28	0	0
Total[3]	**2,423**	**2,074**	**1,920**	**1,431**	**1,570**	**1,723**

[1] Consists of properties that are under construction, including those where certificates of fitness/temporary certificates of fitness have not been issued.
[2] Approved but not started.
[3] Total may not not necessarily add up due to rounding.

Source: NAPIC, Valuation and Property Services Department

6,755 rooms. After being adversely affected by SARS in 2003, the hotels segment recovered strongly with the average occupancy rate rising to above 60% in 2004 (2003: 53%). The improved performance was supported largely by the significant increase in tourist arrivals, which rose by almost 50% to 15.7 million (2003: 10.6 million) as well as robust domestic tourism.

The availability of affordable **financing** contributed significantly to the increase in construction activities. During the year, Bank Negara Malaysia liberalised restrictions on the provision of bridging finance for property development. While the banking sector remained the main provider of financing, the construction sector increased its reliance on the private debt securities (PDS) market as well as Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB) to meet part of its financing requirements. During the year, funds raised via PDS issuance for the construction sector rose to RM8.8 billion, representing a significant increase of 46.2% to account for a higher share of 31.5% of total PDS issued (2003: 14.1%). Loans extended by BPIMB also increased strongly by 15.3% to RM9.9 billion (2003: RM8.6 billion). Reflecting the strong demand for houses, end-financing for properties approved by the banking system rose by 18.8% to RM35.7 billion (2003: 2.9% to RM30 billion). Loans approved by other housing credit institutions as a group also increased during the year. Of significance, loans approved by Bank Kerjasama Rakyat Malaysia Berhad, Malaysia Building Society Berhad and Bank Simpanan Nasional as a group rose significantly by 195% to RM3.1 billion (2003: RM1.1 billion).

In early 2004, activity in the construction sector was partly affected by the temporary shortage of steel bars, which led to delays in some projects, particularly in the civil engineering segment. To address the situation, the Government implemented several measures, including a relaxation on imports of steel bars and billets as well as stricter control on exports of steel. The Government also revised upwards the ceiling price of steel bars and billets to reflect the increase in the global prices of these materials. These measures, coupled with the increased stability in global steel prices helped to ease the shortage. Beside steel products, cost of other building materials such as sand and timber products also increased during the year. This was reflected by the Building Materials Cost Index (BMCI), which showed that prices of building materials generally increased during the year.

Report on Small and Medium Enterprise Development Framework

The development of diverse and competitive small and medium enterprises (SMEs) remains central in the national agenda towards creating economic resilience in the face of an increasingly challenging economic and financial landscape. Bank Negara Malaysia has been actively driving inter-Ministry initiatives to strengthen the infrastructure for SME development and promotion through the formation of the SME Steering Committee, which is chaired by the Governor.

Culminating from the recommendations of the SME Steering Committee, the National SME Development Council was established and is chaired by the Prime Minister. The formation of the Council represents the Government's commitment at the highest level to promote the development of SMEs. It is recognised that efforts to promote and strengthen SMEs require a comprehensive approach comprising establishing enabling infrastructure for SME development, strengthening the capacity and capability of SMEs, and enhancing access to financing. A formal structure dedicated to the development of SMEs would allow for greater synergies and the synchronisation of efforts among the various stakeholders involved in SME development. It also ensures that SME development issues across all sectors are adequately addressed.

Bank Negara Malaysia continues its SME developmental role through its SME Unit, which focuses on the promotion of greater access to financing by SMEs. The SME Unit is also the Secretariat to the National SME Development Council.

Towards Focused and Coordinated SME Development

The establishment of the National SME Development Council provides the necessary strategic framework for more focused and coordinated inter-Ministry and Agency efforts on SME development to oversee efficient coordination and ensure effectiveness of policy implementation and outreach. The terms of reference of the Council are as follows:

- Formulate broad policies and strategies to facilitate the overall development of SMEs across all sectors;
- To increase the focus of the roles and responsibilities of Government Ministries and Agencies responsible for SME development;
- Enhance inter-Ministry and Agency cooperation and coordination to ensure effective implementation of SME development policies and action plans;
- Encourage and strengthen the role of the private sector in supporting the overall development of SMEs; and
- To give emphasis to the development of Bumiputera SMEs across all economic sectors

The Ministries and Agencies represented in this Council, based on their role and contribution in SME and entrepreneurial development, are as follows:

1. Y.A.B. Prime Minister (Chairman)
2. Minister of International Trade and Industry
3. Minister of Domestic Trade and Consumer Affairs
4. Minister of Entrepreneurial and Cooperative Development
5. Minister of Agriculture and Agro-Based Industries
6. Minister of Human Resources
7. Minister of Finance II
8. Minister of Energy, Water and Communications
9. Minister of Plantation Industries and Commodities
10. Minister of Science, Technology and Innovations
11. Minister of Tourism

12. Minister of Rural and Regional Development
13. Minister of Education
14. Minister of Higher Education
15. Minister of Housing and Local Government
16. Minister in the Prime Minister's Department, Y.B. Dato' Mustapa Mohamed
17. Governor of Bank Negara Malaysia
18. Director General of the Economic Planning Unit
19. Chief Executive Officer of the Multimedia Development Corporation

The Council convened two meetings in 2004 and have implemented a number of strategic initiatives. The Council approved the following initiatives to strengthen the existing infrastructure for SME development.

Strengthening Infrastructure for SME Development

Definitions for SMEs in Various Sectors for Targeted Development

To assist in the identification of SMEs across sectors and for more effective targeting of SMEs with respect to the design of future development policies, support programmes and the provision of technical and financial assistance, the Council had approved the definitions for SMEs according to the manufacturing, manufacturing-related services, primary agriculture and services sectors. The adoption of a common identifier for SMEs in these sectors will facilitate the identification of issues and prospects of the sectors concerned to enable appropriate policy actions to be taken. It will also allow closer monitoring of SME performance and contribution to the economy.

An enterprise is considered an SME in each of the respective sectors based on the Annual Sales Turnover or Number of Full-Time Employees as shown in the tables below.

Approved SME Definitions in terms of Annual Sales Turnover

Size	Manufacturing (including Agro-Based) & Manufacturing-Related Services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than RM250,000	Less than RM200,000	Less than RM200,000
Small	Between RM250,000 and less than RM10 million	Between RM200,000 and less than RM1 million	Between RM200,000 and less than RM1 million
Medium	Between RM10 million and RM25 million	Between RM1 million and RM5 million	Between RM1 million and RM5 million

Approved SME Definitions in terms of Number of Full-Time Employees

Size	Manufacturing (including Agro-Based) & Manufacturing-Related Services	Primary Agriculture	Services Sector (including ICT)
Micro	Less than 5 employees	Less than 5 employees	Less than 5 employees
Small	Between 5 and 50 employees	Between 5 and 19 employees	Between 5 and 19 employees
Medium	Between 51 and 150 employees	Between 20 and 50 employees	Between 20 and 50 employees

Establishment of a Comprehensive National SME Database

The availability of relevant and timely information on SMEs, including their operational conditions, financial status and development requirements, is important to facilitate better policy formulation in promoting SME development. Towards this end, the Department of Statistics has been appointed to establish and maintain a comprehensive National SME Database. To facilitate the collection of relevant and comparable SME data across the various sectors, the Department of Statistics has launched a nationwide 2005 Baseline Census of all enterprises and businesses, with a focus on establishments in the manufacturing, agriculture and services sectors. This would assist the Council in assessing the current status of SMEs and their requirements, as well as identifying important issues relating to SMEs' performance and development. Information compiled from the census would facilitate the formulation of policies to promote SMEs as an important driver of growth and in the formulation of strategies for the forthcoming 9th Malaysia Plan.

Enhanced Management and Publication of SME Statistics

The role of the Secretariat under Bank Negara Malaysia has been enhanced to include the function of overseeing and coordinating the monitoring, evaluation and publication of SME statistics and reports. Apart from meeting the information requirements of SME policymakers, the Secretariat will also be responsible for developing key performance indicators to monitor and evaluate the progress of SME development, and will oversee the management of the National SME Database. The Secretariat will also publish annual reports on SME development for the benefit of policymakers and the SMEs, thereby improving the availability of SME information in the market.

Building Capacity through Coordinated Training and Human Resource Development for SMEs

Pembangunan Sumber Manusia Berhad (PSMB), an agency under the Ministry of Human Resources, has been appointed as the coordinating authority to oversee and coordinate overall training and human resource development for SMEs. The role of PSMB will therefore be expanded to include: identification of training needs of SMEs across all sectors of the economy, coordination, monitoring and evaluation of SME training and development programmes conducted by Ministries and Agencies, and development of a formal training accreditation system for SMEs.

Enhancing Access to Financing by SMEs

In 2004, the banking system approved RM31.6 billion of new loans to more than 92,000 SME accounts, a significant increase of 21.9% from 2003. Loan disbursements grew strongly by 15.3% to RM100.4 billion, while outstanding loans to SMEs expanded by 7.7% to RM88.3 billion. Loans to SMEs accounted for 40.3% of outstanding business loans as at end-2004, compared with 38% as at end-2003. On a sectoral basis, lending to SMEs was diversified, with almost two-thirds being channelled to distributive trade, manufacturing and construction sectors, reflective of the business focus of majority of the SMEs. Gross non-performing loans of SMEs contracted by 11.4% to RM10.6 billion (NPL rate of 12.0%), reflective of the improving financial position of the SMEs.

Policy initiatives by BNM on enhancing access to financing by SMEs during the year focused on:
- The provision of advisory support and awareness programmes;
- Strengthening the existing infrastructure to ensure a more effective intermediation of funds to SMEs; and
- Assisting in debt restructuring of financially distressed SMEs with viable businesses.

New Initiatives to Improve Access to Financing by SMEs

To further improve access to financing by the SMEs, the National SME Development Council approved the following initiatives in 2004:

- *Establishment of an SME Bank*

  The Council approved the concept of establishing a specialised financial institution to nurture and meet the unique needs of SMEs. The banking system, with large financial resources and extensive outreach, will continue to be the main provider of funds to SMEs. The set-up of a dedicated SME Bank will complement the banking institutions through provision of financial and non-financial services to SMEs, including ancillary services and credit information. Besides financing, the SME Bank will focus on nurturing the SMEs and creating an entrepreneurial society.

Direct lending activities include start-up and working capital financing, while the SME Bank may also guarantee loans granted by banking institutions to SMEs and facilitate securitisation of SME loans. The SME Bank will also provide ancillary services aimed at nurturing SMEs through the provision of advisory services on financial and business management, marketing and other business aspects. In addition, similar to countries like Japan and Korea, the SME Bank will provide credit information on SMEs to facilitate credit rating and business report on individual SMEs.

- *Interest Subsidy*
  Viable SMEs are currently being assisted through special funds established by the Government to obtain financing at relatively lower costs. As a strategic initiative to further extend accessibility to financing at reasonable costs to more SMEs, while reducing the Government's financial outlay, the Council has approved the introduction of a mechanism to provide interest subsidy on SME loans to selected priority sectors extended by the banking institutions.

- *Securitisation of SME Loans*
  To provide greater flexibility to banking institutions in managing their SME loan portfolio and further enhance their financial capacity to provide lending to SMEs, the Council approved a framework to facilitate the banking institutions to securitise their SME loans. The securitisation framework would also enable SMEs to indirectly tap the capital market for financing, thus broadening the sources of funding for them.

- *New Trade Financing Arrangement for SMEs*
  In an effort to encourage SMEs to participate in the export markets, especially in the non-traditional markets and with members of the Organisation of Islamic Countries, new trade-financing arrangements for SMEs that are more accessible and with lower financing costs will be introduced. Under the arrangements, the SMEs would be able to obtain financing for pre- and post-shipment from banking institutions, with credit risks to be shared between banking institutions and the Malaysian Export Credit Insurance Berhad.

Expanded Role of SME Unit in Bank Negara Malaysia

Bank Negara Malaysia established a dedicated SME Unit in May 2003 to provide information on various sources of financing, facilitate loan application process, assist viable SMEs in accessing financing, and to provide advisory services on financial requirements. For greater effectiveness in planning, implementation and outreach of SME programmes and institutional arrangements for access to financing, the Council approved the enhancement of the SME Unit's role to include:

i Coordination, monitoring and evaluation of overall SME financing across all economic sectors;
ii Coordination of the implementation of all SME financing policies and strategies for greater effectiveness;
iii Review of policies and strategies to enhance SMEs access to financing; and
iv Formulate alternative modes of financing for SMEs.

With this enhancement, the Unit is now responsible for interfacing with the banking institutions, relevant Ministries and Agencies to ensure that a comprehensive financial infrastructure is in place to continuously support the growth and development of SMEs across all sectors.

During the year, the Unit undertook various initiatives to increase awareness among SMEs on financial requirements and procedures, as well as financing sources. These were done through road shows, exhibitions and briefings to SMEs, as well as publication of brochures on special funds. In addition, the Unit also conducted quarterly dialogues with SME-related trade organisations and banking institutions. Also, in 2004, the Unit received 1,401 enquiries, requests for assistance and complaints from the SMEs, of which 90% were enquiries on information and sources of financing and details relating to the special funds. Complaints relating to access to financing constituted only 10% of the enquiries received.

Higher Allocations for Special Funds

To ensure continued access to financing at reasonable costs, Bank Negara Malaysia has established several special funds for SMEs. The funds are channelled through participating institutions comprising banking institutions, development financial institutions and ERF Sdn Bhd with lending rates ranging from 3.75% to 5.00%. Five special funds are currently available to the SMEs, namely:

- Fund for Small and Medium Industries 2 (fund size: RM4.5 billion);
- New Entrepreneurs Fund 2 (fund size: RM2 billion);
- Fund for Food (fund size: RM1.3 billion);
- Rehabilitation Fund for Small Businesses (fund size: RM800 million); and
- Bumiputera Entrepreneurs Project Fund (fund size: RM 300 million);

Due to strong demand, allocations for the Fund for Small and Medium Industries 2 and the New Entrepreneurs Fund 2 had been increased in 2004, by RM2.5 billion and RM850 million respectively. As a result, the total allocation of the five special funds amounted to RM8.9 billion at the end of 2004. Of this amount, RM8.1 billion or 91% has been approved to more than 19,000 borrowers. In 2004, RM2.9 billion in financing was approved to 4,570 new borrowers, compared with RM1.9 billion to 3,741 borrowers in 2003.

Performance of Small Debt Resolution Scheme

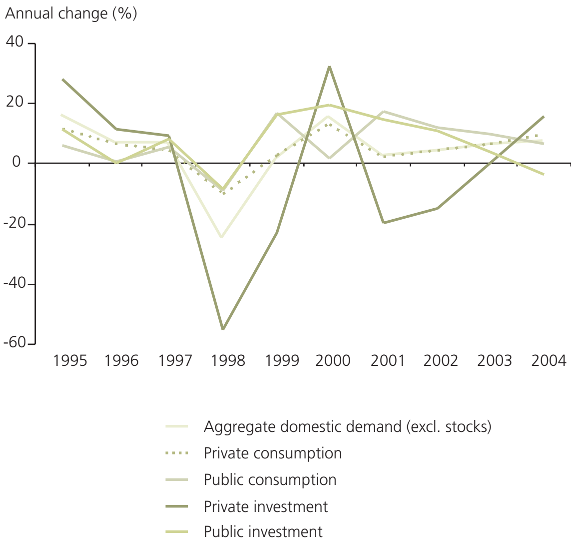
The Small Debt Resolution Scheme was established on 1 November 2003 to facilitate the restructuring of non-performing loans (NPLs) of SMEs with on-going businesses. Under this mechanism, a Small Debt Resolution Committee was established to undertake independent assessments on the viability of the businesses, and loan restructuring and financing requirements of the SMEs, with the SME Unit serving as its Secretariat.

As at end-December 2004, 228 applications with NPLs of RM180.2 million were received under the scheme. Of these, 116 applications (51%) involving NPLs amounting to RM81.8 million have been approved for restructuring, whilst RM10.5 million in new financing was approved to eligible borrowers under the Rehabilitation Fund for Small Businesses. A total of 25 cases, with total NPLs of RM26.5 million, were rejected due to non-viability, while 87 cases involving NPLs of RM72 million were being evaluated. For most of the cases under evaluation, the evaluation by the implementing institutions and the Secretariat have been delayed due to the inability of applicants to provide the necessary information that form an important part of the evaluation process. The performance of the scheme has demonstrated that the restructuring of NPLs is more important than the provision of new financing to ensure the viability and sustainability of financially distressed SMEs.

DOMESTIC DEMAND CONDITIONS

Domestic demand conditions strengthened further, registering a growth of 7.3% in 2004 (2003: 5.9%). Growth in **aggregate domestic demand** was supported mainly by the robust expansion in private sector. Stronger consumer confidence was supported by higher disposable incomes, low inflation and favourable financing conditions. Business spending also accelerated as companies added capacity in response to strong demand and replaced obsolete machinery and equipment. The public sector, while consolidating, remained supportive of growth by providing better infrastructure facilities and improving the delivery of essential services.

Graph 1.18
Real Domestic Demand Aggregates



Public consumption increased steadily by 6.6% in 2004, largely on account of higher expenditure on supplies and services as well as emoluments. The increased expenditure for supplies and services was to improve the administrative machinery and delivery system of the public sector. Reflecting the Government's emphasis on human resource development to enhance the nation's productivity and competitiveness, expenditure on emoluments increased further.

Domestic demand conditions continued to strengthen in 2005, supported mainly by robust expansion in private sector activities. Public sector expenditure, while lower, remained supportive of private demand.

Public investment declined by 3.5% in 2004 (2003: 3.9%) on the back of the notable decline in Federal Government's development expenditure. However, capital expenditure for the Government remained supportive of growth, with a bias towards economic and social sectors, and spread over larger numbers of smaller-scale projects. In the economic sector, expenditures were mainly for modernising the non-plantation agriculture, improving the living standard in rural areas and the transportation system in the country. Meanwhile, capital spending for social projects mainly focused on essential services provided by the Government, such as education, health and housing. Capital expenditure of the NFPEs remained high during the year, due mainly to upgrading and capacity expansion programmes by the three largest NFPEs, namely PETRONAS, Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TMB). The bulk of PETRONAS' expenditure continued to focus on oil and gas projects in Malaysia and abroad, as well as the shipping business. TNB's capital spending was largely for further improving the power generation and transmission system, while TMB's expenditure was mainly to expand its network infrastructure to meet increasing demand for mobile and data services as well as broadband Internet access.

Private consumption increased at a faster pace of 10.1% in 2004 (2003: 6.6%), following rising consumer confidence. The MIER Consumer Sentiments Index (CSI), which measures consumers' perception of the economy and personal finances, improved since the second quarter of 2003 and peaked in the first quarter of 2004. Although the CSI softened somewhat towards the second half of the year, consumers' willingness to spend remained unaffected. While the prolonged increase in oil prices had some effect on consumers' optimism, these were largely mitigated by the continued rise in disposable income and continuing favourable employment market. The higher oil prices were not fully translated into higher retail fuel cost as Malaysia, being a net oil exporter, was able to cushion the impact on consumers through graduated subsidies on fuel. In addition, various

Table 1.12
Private Consumption Indicators

	2003	2004				
		1Q	2Q	3Q	4Q	Year
Sales of passenger cars (incl. 4WD)						
'000 units	334.4	82.3	98.8	107.2	97.3	385.7
Annual change (%)	-10.9	-3.3	18.8	19.6	27.3	15.3
Imports of consumption goods						
(RM billion)	18.7	5.1	5.8	6.1	6.3	23.2
Annual charge %	-1.2	14.8	28.0	38.8	16.5	24.1
Tax collection						
Sales tax (RM billion)	8.0	1.2	1.8	1.6	2.2	6.8
Service tax (RM billion)	2.0	0.3	0.7	0.5	0.8	2.3
Narrow money (M1)						
Annual change (%)	14.6	19.6	15.9	14.9	11.9	11.9
Loans disbursed by banking system						
Consumption credit (excl. passenger cars) Annual change (%)	10.2	21.4	17.5	16.7	12.5	16.8
Retail trade, restaurants and hotels Annual change (%)	8.4	13.2	14.0	25.5	24.3	19.5
MRA retail sales						
Annual change (%)	8.4	5.9	15.1	8.8	n.a.	n.a.
Credit card operation						
Turnover spending (RM billion)	30.9	8.5	8.7	9.6	10.0	36.8
Annual change (%)	15.5	17.6	22.3	20.0	16.7	19.1
MIER Consumer Sentiments Index	-	117.5	112.4	113.9	109.3	-
KL Composite Index	793.9	901.9	819.9	850.0	907.4	907.4
Commodity prices						
CPO (RM/tonne)	1,577	1,895	1,800	1,505	1,458	1,664
Crude oil (USD/barrel)	30	35	38	46	47	41
Rubber (sen/kg)	381	476	475	435	459	461

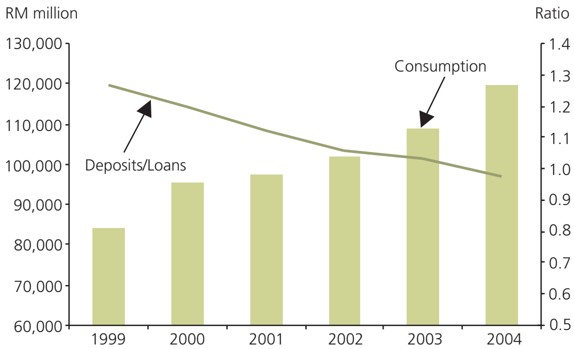
tax rebates to sustain consumption announced during the 2004 Budget and the bonus payments to civil servants reinforced the resilience of household consumption.

The low interest rates provided additional impetus for households to spend on durable goods and houses. Sales of passenger cars rose by 15.3% in 2004, as the car buyers were enticed by the introduction of new car models and attractive financing packages. The willingness to accumulate debt by individuals was reflected in the ratio of deposits to loans dipping below 1.

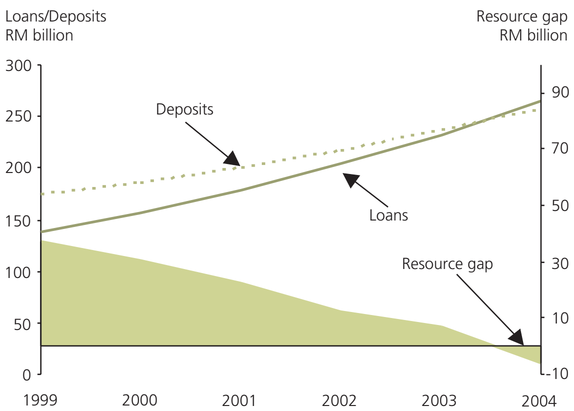
However, the increased willingness to access credit for consumption expenditure did not see an increase in the vulnerability of households. Rather, this new development was primarily driven by income growth and financial innovation, as new lending packages were made available to households by an increasingly competitive banking sector. The implementation of the Central Credit Reference Information System has brought down the cost of assessing the credit-worthiness of potential customers, thereby allowing banks to provide more attractive financing terms to viable borrowers. The non-performing loan (NPL) ratio for consumption credit declined from 9.5% to 8% in 2004 while the NPL ratio for credit card debt remained stable at 4.7%. Importantly, the availability and popularity of other modes of savings, such as unit trusts, insurance funds and pension funds, ensured that while deposit growth slowed, household savings remained high.

Apart from the purchases of passenger cars, purchases of household furnishings and equipment increased in tandem with the relatively strong property sales in recent years. In addition, households that continue to see some modest appreciation in the values of their homes were

Graph 1.19
Individual Deposits/Loans and Consumption



Graph 1.20
Individual Loans and Deposits



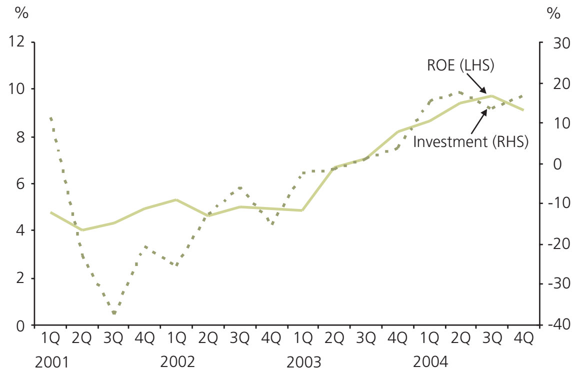
encouraged to spend further. The favourable equity market performance also stimulated household consumption.

Private investment in 2004 was robust (15.8%; 2003: 0.4%) as businesses gained confidence in the strength of economic expansion and in the prospective payoffs of capital investment. Additional production capacities were put in place in response to strong demand, while replacement of obsolete machinery was at a brisk pace as companies were keener to invest in an expanding economy. At the same time, favourable financing

Table 1.13
Private Investment Indicators

	2003	2004				
		1Q	2Q	3Q	4Q	Year
Sales of commercial vehicles (incl. 4WD)						
'000 units	70.6	19.4	23.7	24.3	28.0	95.5
Annual change (%)	18.5	30.2	46.4	25.3	39.5	35.2
Import of capital goods						
(RM billion)	40.8	12.3	13.3	14.0	16.0	55.5
Annual change (%)	-5.6	30.9	37.0	38.4	37.7	36.1
Applications to MITI						
No. of projects	925	286	285	260	248	1,079
Capital investment (RM billion)	25.6	3.9	5.3	7.0	13.1	29.3
Foreign	11.6	1.6	2.3	1.7	7.4	13.0
Local	14.0	2.3	3.0	5.3	5.7	16.3
Approvals by MITI						
No. of projects	965	299	249	246	307	1,101
Capital investment (RM billion)	29.1	3.7	3.5	5.5	16.1	28.7
Foreign	15.6	1.4	1.7	2.6	7.5	13.1
Local	13.5	2.3	1.8	2.9	8.6	15.6
Loans disbursed by banking system						
Manufacturing sector Annual change (%)	4.8	-0.4	15.1	11.7	14.2	10.2
Construction sector Annual change (%)	-8.6	11.3	10.4	3.0	17.2	10.4
Business services Annual change (%)	6.7	53.6	9.3	13.0	5.8	19.0
Private Debt Securities (excluding Cagamas)						
Total funds raised (RM billion)	42.8	2.8	6.5	9.3	9.5	28.1
New activities	2.8	1.1	3.6	4.5	3.8	13.0
Initial Public Offerings (KLSE)						
Total funds raised (RM billion)	4.0	0.4	0.4	1.3	2.0	4.0
MIER Business Conditions Survey						
Business Conditions Index	-	112.0	124.1	110.2	97.3	-
Capacity Utilisation Rate (%)	-	80.2	81.1	82.5	82.2	-
MSC-Status Companies						
No. of companies	161	38	46	56	50	190
Approved investment (RM billion)	1.6	0.2	0.5	0.8	0.5	2.0

Graph 1.21
Investments and Profitability

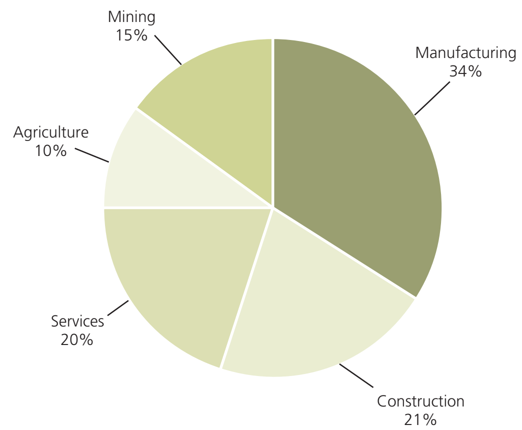


conditions were supportive of business investment activities. Loans disbursed to businesses increased further by 10.5% (2003: 7.6%) during the year. The strengthened financial position of companies in terms of profitability and debt-servicing capacity also encouraged companies to expand their productive capacities.

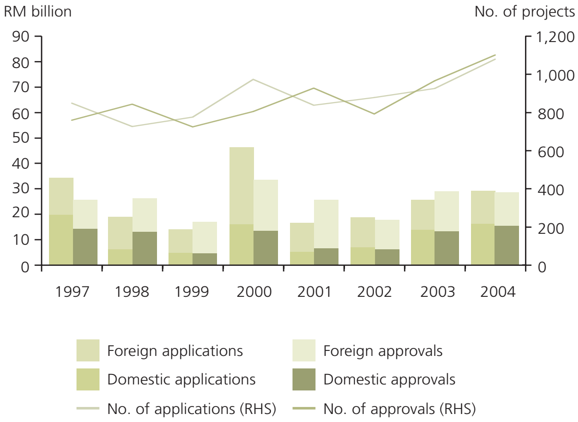
The strong global growth environment, together with steps taken by the Government to improve the business environment, led to indicators of Malaysia's investment climate improving in 2004. For instance, the A.T. Kearney FDI Confidence Index for 2004, which measures the likelihood of investment in specific markets, showed that Malaysia scored well among foreign investors. Malaysia demonstrated among the strongest improvements in investor confidence among all the countries surveyed, rising to 15th place during the year from 23rd in 2003. This significant

Graph 1.22
Private Investment by Sector (% share)

2004

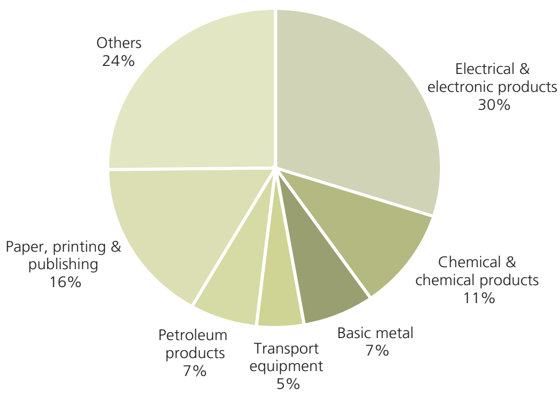


Graph 1.23
Private Investment in the Manufacturing Sector



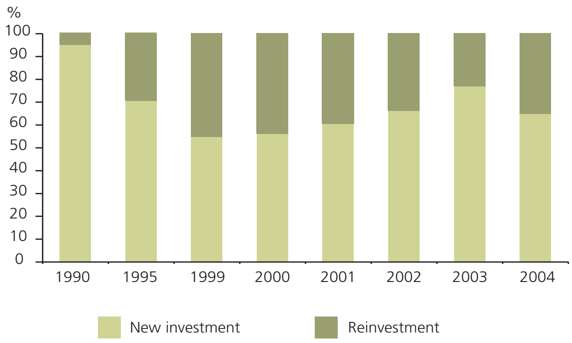
Source: Malaysian Industrial Development Authority

Graph 1.24
Approved Manufacturing Investment by Industry, 2004 (% share)



Source: Malaysian Industrial Development Authority

Graph 1.25
Share of Approved New Investments and Reinvestments in the Manufacturing Sector



Source: Malaysian Industrial Development Authority

improvement underscores the better domestic investment climate and augurs well for the promotion of domestic investment activities.

Higher capital expenditure was evident in all sectors of the economy, with the manufacturing, services and mining sectors registering exceptionally strong outlays during the year. Investment in the **manufacturing sector**, which registered a 32.7% (2003: 4%) growth, was mainly supported by capacity expansion and replacement of old machinery and equipment. Although investment approvals by MITI declined by 1.4% (2003: +63%), the staggered implementation of previously approved projects had contributed to the outlays in 2004. Approvals for new investments continued to exceed reinvestments, suggesting that manufacturers remained keen on venturing into high value-added manufacturing activities. These investments were largely concentrated in the electrical and electronic products, chemicals and chemical products and paper, printing and publishing industries. The positive sentiment that was observed among domestic investors was echoed by foreign investors in the manufacturing sector. In the A.T. Kearney's FDI Confidence Index, both heavy and light manufacturers indicated that Malaysia's attractiveness as an investment destination had improved. Heavy manufacturers now rate Malaysia as the 16th most attractive destination in their industries, up from 18th place in 2003 while light manufacturers placed Malaysia in 9th place, a significant improvement from the 21st position a year ago.

Investment in the **construction sector** increased moderately during the year. Construction activities in the residential sub-sector were the main contributor to the investment in this sector, arising from the strong demand for residential property, which was supported by the prevailing low interest rates and attractive housing mortgage packages offered by the banking institutions. Meanwhile, activity in several ongoing privatised projects, namely, the Guthrie Corridor Expressway, Kajang-Seremban Expressway, Jelutong Highway and Butterworth Outer Ring Road, also provided support to the investment in the construction sector.

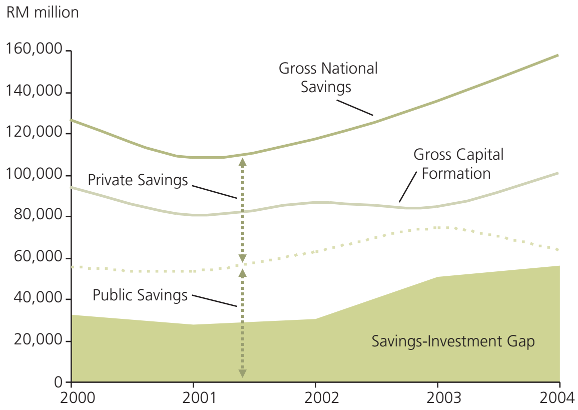
Investment was higher in the **services sector** as evidenced by stronger capital spending activities in the utilities and the retail, wholesale and business sub-sectors. Capital expenditure in the utilities sub-sector included the development of the Tanjung Bin power plant and water projects, namely, the Sungai Selangor Project Scheme Phase 3 (SSP3) and Stormwater Management and Road Tunnel (SMART). Following the consolidation process in the telecommunication industry in 2003, the industry players began to increase their investment to further improve their services and develop new systems to enhance their competitiveness. Capital spending activities in the transport sub-sector were supported by capacity expansion and development of PTP and West Port. During the year, banking institutions continued to invest in IT projects, mainly to upgrade and optimise their retail banking systems, enhance processing capacity and improve the management of product offerings in order to further improve their customer support services. In the retail sector, capital-spending activities were visible from the establishment of new outlets by major hypermarket operators and retailers in major towns.

Capital outlays in the **mining sector** remained largely driven by the oil and gas segment. The spending was spurred by the increased upstream activities in exploration and production, following the new discoveries of oil fields, stronger demand and higher prices for crude oil. Investment in the **agriculture sector** was mainly for the development of crop plantation. Capital spending for crop plantation activities remained high, particularly for palm oil plantations arising from the increase of crude palm oil production coupled with the favourable CPO prices during the year. The bulk of the capital expenditure was mainly to expand capacity and new planting. In addition, higher imports of agricultural equipment for the year also reflected increased capital spending in the agriculture sector.

The significant expansion in nominal gross national income in 2004 was not only reflected in a robust consumption spending, but also in a further increase in **Gross National Savings (GNS).** Recording a growth of 16.3%, this increase largely reflected the continuing expansion of private sector savings amidst stronger corporate profitability and higher households' disposable incomes due to the concurrent improvement in domestic and external activities. As such, both households and the corporate sector enjoyed stronger cash flows, supported mainly by favourable commodity prices, high export earnings, low levels of inflation and interest rates as well as a stable employment condition. In all, private sector savings increased by 53% in 2004.

In the public sector, however, lower savings were recorded, due mainly to the lower operating surplus of the Federal Government. The decrease in the Federal Government's operating surplus was due mainly to higher subsidies as a result of higher oil prices, higher

Graph 1.26
Gross National Savings and the Savings-Investment Gap



payments for emoluments, increased expenditure on supplies and services to upgrade the quality and efficiency of public services as well as larger refunds and write-offs. However, due to the lower public gross fixed capital formation, the public sector savings-investment balance remained in surplus.

Overall, GNS continued to increase in 2004 to total 37.1% of Gross National Product (GNP) as compared to 36.3% in 2003. This high rate of savings has enabled Malaysia to finance its growth primarily from domestic sources. Excess liquidity and a lower cost of debt contributed to the marked improvement of private gross investment, which despite the decline in public investment expenditure, resulted in a total improvement of 19.3% for overall gross domestic capital formation (including stocks). Given the simultaneous increase in savings, the savings-investment balance, as reflected in the current account of the balance of payments, remained large at 13.4% of GNP in 2004.

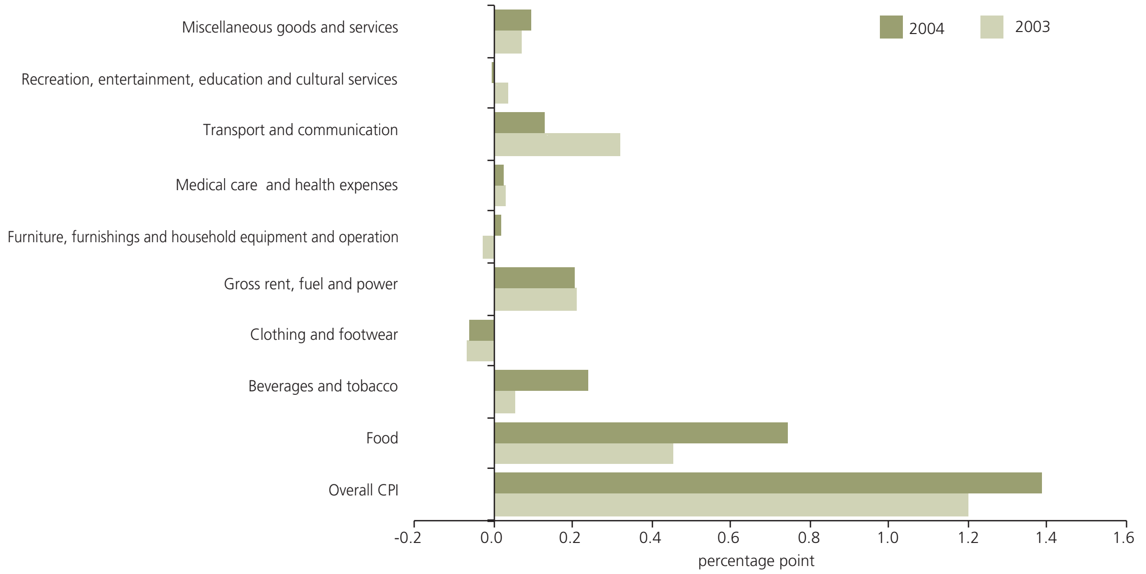
PRICES AND EMPLOYMENT

Consumer Prices

Inflation edged up slightly in 2004. The overall inflation rate, as measured by the annual change in the Consumer Price Index (CPI), was marginally higher at 1.4% (2003: 1.2%). Core inflation, which is inflation excluding price-controlled and price-volatile items as well as items that are subject to one-off price adjustments, also increased to 1% in 2004 (2003: 0.5%).

Despite the stronger expansion in domestic demand during the year, several factors combined to ensure that price pressures were contained. The continued

Graph 1.27
Contribution to Annual Change in the Consumer Price Index



improvements in productivity growth, the absence of wage cost pressures, adequate expansion in capacity and a more competitive environment were factors that contributed to price stability.

The marginal rise in overall prices in 2004 was due mainly to faster increases in the prices of food and beverages and tobacco, moderated by the slower increase in prices in the communications sector. The increase in food prices contributed the most to the increase in prices in 2004, due mainly to the higher prices of food taken away from home, followed by the increase in the prices of beverages and tobacco consequent to the increase in excise duties announced in Budget 2005. The impact however, was offset by the slower increase in telephone and telegraph charges. The increases in the retail prices of petrol in May and October had minimal impact on the rise in personal transportation charges and on the overall inflation rate.

Table 1.14
Price Indicators

	Weight	2003	2004
Consumer Price Index (2000=100)	Annual change (%)		
	100.0	**1.2**	**1.4**
of which:			
Food	33.8	1.3	2.2
Beverages and tobacco	3.1	1.6	7.8
Clothing and footwear	3.4	-2.0	-1.8
Gross rent, fuel and power	22.4	0.9	1.0
Furniture, furnishings and household equipment and operation	5.3	-0.6	0.4
Medical care and health expenses	1.8	1.7	1.4
Transport and communication	18.8	1.6	0.8
Recreation, entertaiment, education and cultural services	5.9	0.6	-0.1
Miscellaneous goods and services	5.5	1.3	1.8
Consumer Price Index			
Durable goods	9.4	-1.1	0.2
Semi–durable goods	5.4	-1.4	-0.9
Non-durable goods	40.2	1.6	2.4
Services	45.0	1.3	1.0
Producer Price Index (1989=100)	**100.0**	**5.7**	**8.9**
of which:			
Local Production	79.3	6.8	10.3
Imports	20.7	0.8	2.0

Source: Department of Statistics, Malaysia

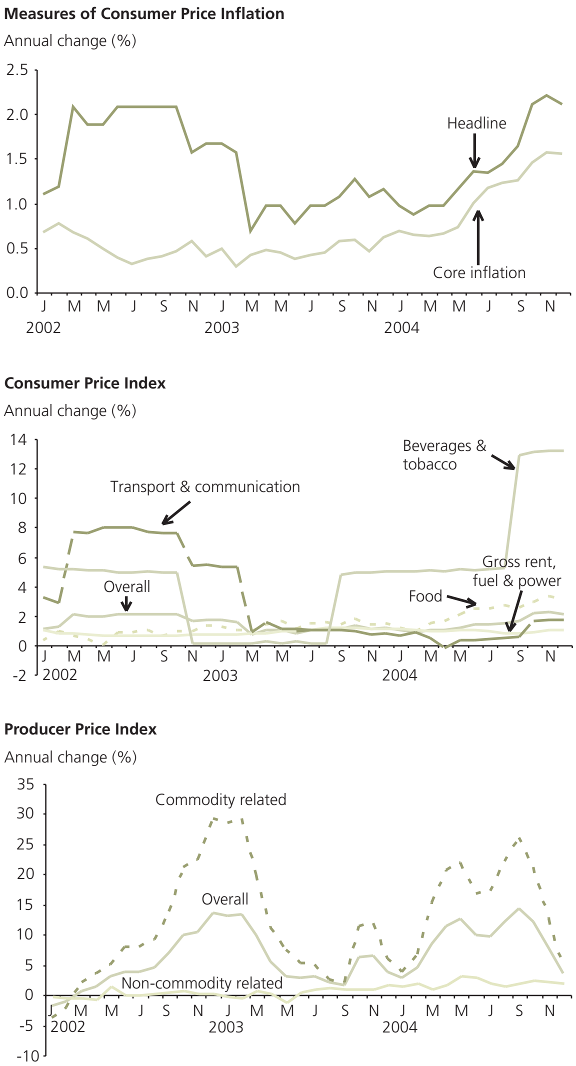
Producer Prices

Producer prices, as measured by the Producer Price Index (PPI), rose at an annual growth rate of 8.9% in 2004 (2003: 5.7%), largely reflecting higher prices for commodity-related products, following higher prices of crude petroleum and crude palm oil. Excluding commodity-related products, the non-commodity related PPI increased at an annual rate of 2% (2003: 0.5%) due mainly to higher prices of food and live animals. Prices paid for imported goods increased by 2% (2003: 0.8%), reflecting mainly higher petroleum prices and the depreciation of the US dollar against the major currencies.

Labour Market Developments

The domestic **labour market conditions** continued to improve in 2004. The underlying growth in labour productivity provided support for competitiveness and the ensuing strong growth environment led to positive job creation. According to latest estimates for 2004,

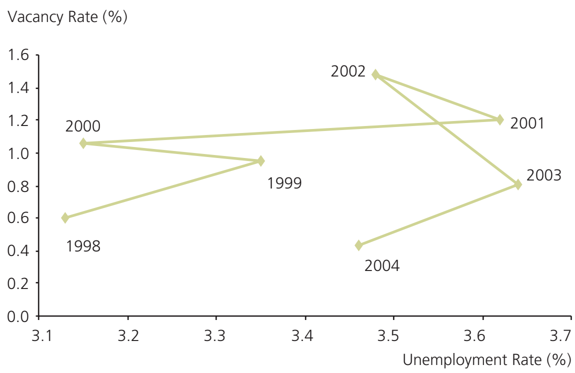
Graph 1.28
Inflation: Annual Rate of Change



employment grew at a faster rate of 3.6% to 10.2 million workers compared with the labour force growth of 3.4% to 10.6 million persons. Consequently, the unemployment rate declined to 3.5% (2003: 3.6%). The labour force participation rate also increased to 66%. Training for workers continued to be promoted to enhance the quality of labour, increase agility and to alleviate skills mismatches to suit the on-going transformation of the economy.

The Beveridge Curve, which tracks the pattern of unemployment and vacancies in the labour market, shifted further downwards and inwards in 2004, indicating lower turnover in the labour market and higher efficiency in the worker-job matching process. Findings from the Salary and Fringe Benefits Survey, conducted by the Malaysian Employers Federation (MEF), confirmed that the overall average monthly turnover rate was lower at 1.51% in 2004 (2003: 1.76%). Similarly, the Salary, Benefits and Employment Conditions Survey in the Manufacturing Sector conducted by the Federation of Malaysian Manufacturers (FMM) showed that the overall average monthly turnover rate remained low at 1.79% (2003: 1.76%).

Graph 1.29
Beveridge Curve for Malaysia (1998-2004)



Source: Economic Planning Unit
Ministry of Human Resources
Bank Negara Malaysia

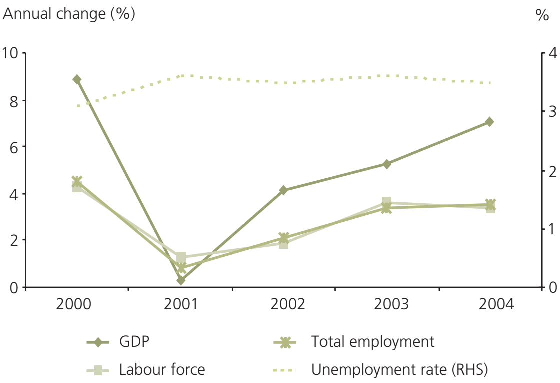
Table 1.15
Labour Market Indicators

	2000	2001	2002	2003	2004e
Labour force ('000)	9,572.5	9,699.4	9,886.2	10,239.6	10,587.7
(annual change in %)	4.3	1.3	1.9	3.6	3.4
Employment ('000)	9,271.2	9,348.1	9,542.1	9,866.7	10,221.0
(annual change in %)	4.5	0.8	2.1	3.4	3.6
Unemployment rate (%)	3.1	3.6	3.5	3.6	3.5
Labour productivity (GDP/Employment)					
(annual change in %)	3.9	-0.5	2.3	1.9	3.4
Real wage per employee in manufacturing sector					
(annual change in %)	5.0	1.7	3.2	2.8	1.8

e Estimate

Source: Economic Planning Unit
Department of Statistics, Malaysia
Bank Negara Malaysia

Graph 1.30
Output and Employment

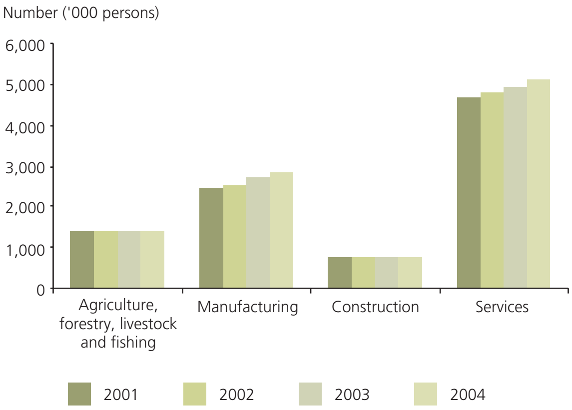


Source: Economic Planning Unit
Department of Statistics, Malaysia

The low turnover in the labour market is also reflected in data on vacancies and retrenchment, while placements and the lower number of unplaced job seekers mirrored the efficiency in the job matching process. Vacancies reported, which were mainly in the services, manufacturing, construction and agriculture sectors, declined to 49,975 positions (2003: 96,918 positions). This could be partly attributed to the more open policy on foreign labour. However, vacancies reported for clerical, managerial and professional positions indicated a significant increase (25,495 positions; 2003: 12,611 positions). Retrenchments, which were mainly in the manufacturing and transport-related sectors, dropped by 6% (19,956 persons; 2003: 21,206 persons). The main reasons for retrenchment included reduction in demand for products, company reorganization, high costs of production, completion of projects and outsourcing. Placements in relation to vacancies remained strong (12%; 2003: 17%) while the number of registered unplaced jobseekers stood at 27,227 persons as at end-2004, the lowest in four years, indicating improving matching of workers to jobs available.

Labour market conditions improved, supported by significantly higher growth in labour productivity.

Graph 1.31
Total Employment by Sector



Source: Economic Planing Unit

The strong economic growth environment did not exert undue pressure on **wages** in 2004. Available indicators showed that the rate of increase in wages was slightly lower in 2004:

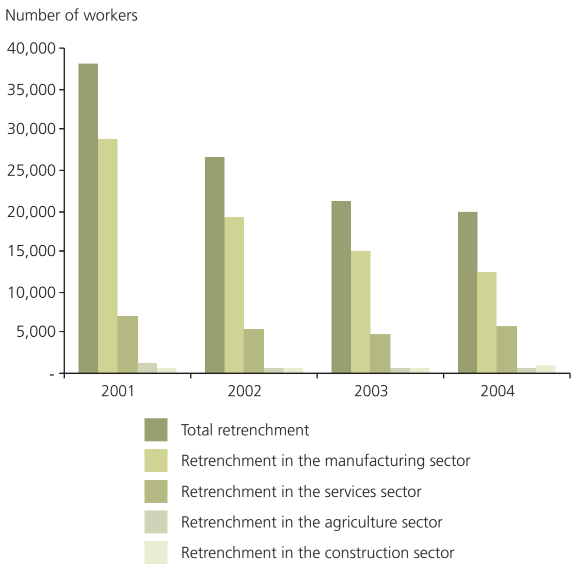
- Data from the Monthly Manufacturing Survey conducted by the Department of Statistics, Malaysia indicated that for 2004, real wage per employee increased by 1.8% (2003: 2.8%).

- The Salary and Fringe Benefits Survey undertaken by the MEF showed that the increase in the average private sector salary was slightly lower at 5.6% in 2004 (2003: 5.8%). On a sectoral basis, the average salary increase in the non-manufacturing sector was higher (6.1%; 2003: 6.1%) than in the manufacturing sector (5%; 2003: 5.5%). The average minimum monthly salary offered to those with a basic degree was unchanged at RM1,666 (2003: RM1,669).

- The Salary, Benefits and Employment Conditions Survey in the Manufacturing Sector conducted by the FMM showed that the increase in overall average salary paid to employees was also moderate at 5.6% in 2004 (2003: 5.5%). The average basic salary offered to a fresh graduate was lower at RM1,799 (2003: RM1,861).

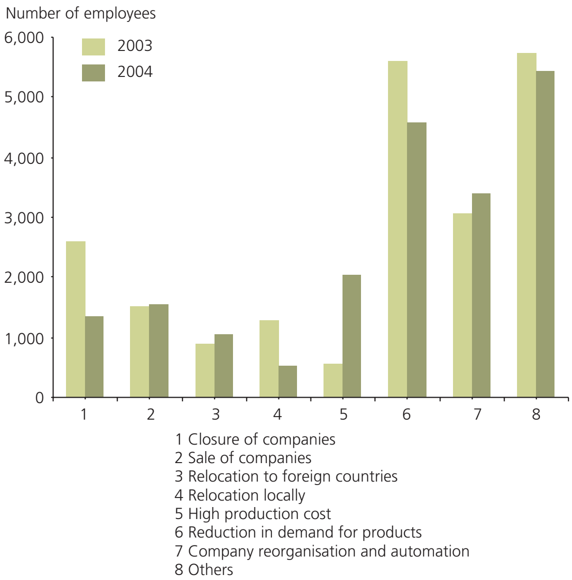
Labour productivity, as measured by the ratio of GDP to total employment, improved significantly, with growth increasing to 3.4% in 2004 (2003: 1.9%). Productivity growth was reflected across most major sectors of the economy. Productivity growth in the manufacturing sector improved significantly to 3.2% (2003: 1.1%) due to increased use of capital and improvements in business processes. Productivity growth in the agriculture and services sectors remained high at 5% and 2.7% respectively. High productivity in the agriculture sector reflected largely higher yields due to good weather

Graph 1.32
Retrenchment in Selected Sectors



Source: Ministry of Human Resources

Graph 1.33
Reasons for Retrenchment



Source: Ministry of Human Resources

conditions, Good Agriculture Practices, mechanisation and automation. The wholesale and retail trade, restaurants and hotels sub-sector also recorded an impressive gain, with productivity growth of 2.3% (2003: 0%) due to higher capital investment.

The Government continues to allow the recruitment of **foreign workers** to alleviate labour and skills shortages and tap synergies that enhance productivity and competitiveness. Currently, there are 34,358 foreign professionals and highly skilled workers employed in the country, mostly in the manufacturing and services sectors. For the semi-skilled and unskilled foreign labour, the number recruited in 2004 declined, despite the strong growth in the economy. This was partly attributed to the subdued performance of the construction sector, where there is a large presence of foreign workers. In addition, employers have increased capital intensity in their businesses, thereby reducing the dependence on foreign labour. The 507,732 foreign nationals recruited during the year (2003: 516,257 foreign nationals) were mostly from Indonesia, Nepal, India, Myanmar and Vietnam and for employment mainly in the manufacturing, agriculture and domestic services sectors.

As at end-2004, the number of foreign workers in the country increased by 18.6% to 1,470,090 (2003: 17.2% to 1,239,406), constituting 14.4% of total employment. They are mostly engaged in the manufacturing sector, followed by the agriculture, services (including domestic services), and construction sectors. About 69.7% are Indonesian nationals, while those from Nepal and India constitute the second and third largest group or 10.2% and 5.4% respectively.

During the year, certain regulations regarding the recruitment of foreign semi-skilled and unskilled workers were amended, mainly to reduce further the dependence on such workers, particularly in the services sector. In addition, with effect from August 2004, foreign workers are only allowed to work in the country for a maximum period of eight years, from ten years previously.

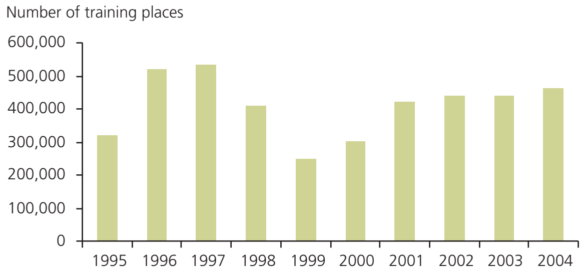
Meanwhile, developmental efforts to enhance the capabilities of the labour force have continued. As at end-2004, a total of 9,213 participants have benefited from the Graduate Training Scheme II. Launched in August 2003, the Scheme helps graduates who are unable to gain employment to acquire additional skills and increase their employability. As funds under the earlier special scheme implemented in 2001 for **unemployed graduates** and retrenched workers were still available, the schemes were continued into 2004. As at end-2004, a total of 40,460 persons have participated in the various attachments and training schemes for unemployed graduates, also known as Graduate Training Scheme I, while another 12,783 participants have benefited from the scheme for retrenched workers and unemployed. To augment the Government's efforts, the various financial institutions associations introduced the Banking Industry Training

Scheme and equivalent insurance training and development programmes for unemployed graduates in early 2004. A total of 148 unemployed graduates, were sponsored by 55 financial institutions to undergo structured training programmes, which were designed and implemented in collaboration with the Institute of Bankers Malaysia (IBBM) and the Malaysian Insurance Institute. The schemes were aimed at improving participants' communication skills, with a focus on English, as well as providing relevant exposure to the graduates in the fields of banking, finance and insurance. Ten other employers have also offered training attachments to unemployed graduates under the double taxation incentive in the 2004 Budget in support of Government efforts to improve the employability of graduates.

The **Human Resource Development Fund (HRDF)** continued to be important in encouraging employers to enroll their staff in initiatives aimed at expanding employees' expertise, knowledge, resourcefulness and ability to adapt to the more liberalised and competitive business landscape. Established in 1993, the HRDF is managed by the corporatised entity known as Pembangunan Sumber Manusia Berhad (PSMB). In 2004, PSMB approved a total of 460,651 training places with financial assistance of more than RM200 million, bringing the total for the period 1993-2004, to 4.4 million training places costing a total of RM1.6 billion. To keep abreast with changes in the business environment, new programmes and training were included under the HRDF during the year. These included strategic management, product branding, English proficiency, adult literacy, particularly for workers in SMEs and an industrial technician apprentice scheme.

The **Skills Development Fund (SDF)** is another initiative for developing and upgrading skills of the workforce. Its aim is to enhance the participation of the private sector as training providers and increase accessibility to technical education and vocational training (TEVT) by providing financial assistance to candidates. School leavers, retrenched workers as well as employees undertaking training in approved public and private training institutes are eligible. After four years in operation, the SDF is being restructured. Legislation for the establishment of a corporatised entity to manage the SDF has been passed and plans are underway to vary the amount of financial assistance such that greater priority in training is accorded to the more crucial skills. In 2004, the SDF provided financial assistance to about 34,000 applicants (2003: 46,421 applicants).

Graph 1.34
HRDF: Number of Training Places Approved



Source: Pembangunan Sumber Manusia Berhad

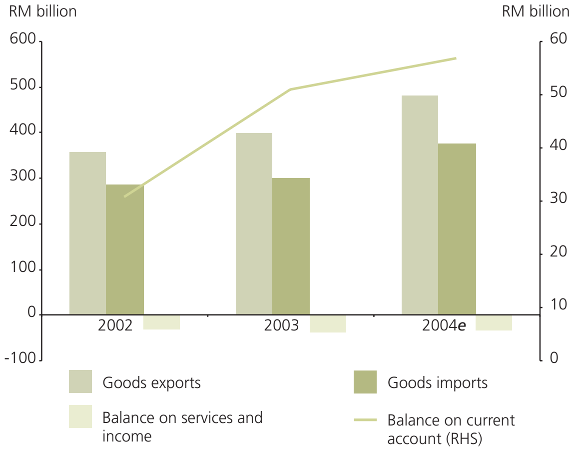
EXTERNAL SECTOR

Balance of Payments

The **overall balance of payments** strengthened in 2004, reflecting the more buoyant external demand underpinned by the stronger global growth and improved foreign investor sentiment on Malaysia. The sustained large current account surplus supplemented by higher foreign direct investment (FDI) and inflows of portfolio capital resulted in a substantial increase in

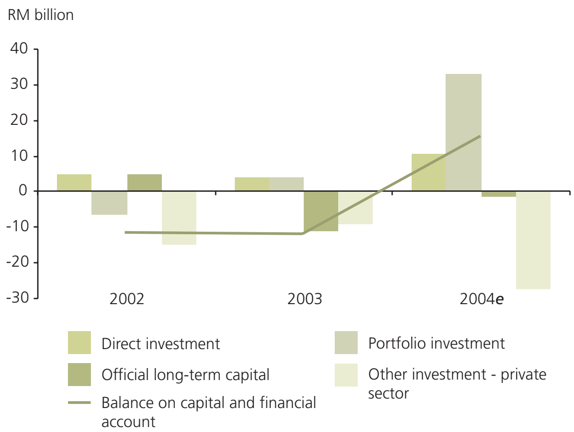
The external position strengthened significantly in 2004, supported by a sustained large current account surplus and higher inflows of foreign direct investment and portfolio investment. External debt remained within prudential limits.

Graph 1.35a
Current Account



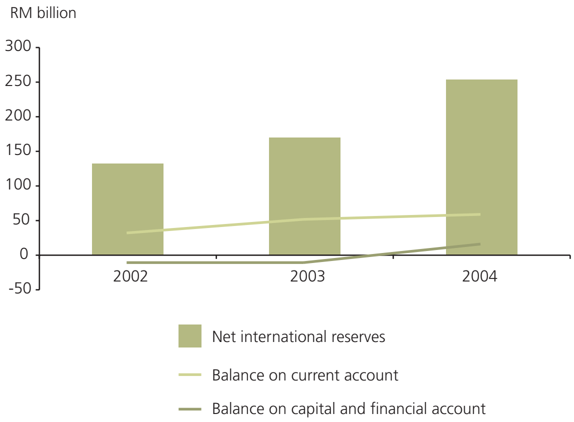
e Estimate

Graph 1.35b
Capital and Financial Account



e Estimate

Graph 1.35c
Net International Reserves



international reserves of Bank Negara Malaysia. Errors and omissions, including exchange gains from the revaluation of international reserves due to the appreciation of major currencies against the US dollar, was RM11.1 billion. After adjusting for the errors and omissions, the overall balance of payments recorded a larger surplus of RM83.1 billion or US$21.9 billion. Consequently, the net international reserves of Bank Negara Malaysia increased to a record level of RM253.5 billion or US$66.7 billion as at end-2004. The reserves increased further to RM272.9 billion (US$71.8 billion) as at 28 February 2005. This level of reserves represented 8.6 months of retained imports and 6.1 times coverage of short-term external debt. Malaysia's reserves remained usable and unencumbered.

Table 1.16
Balance of Payments

Item	2003			2004*e*		
	+	-	Net	+	-	Net
	RM million					
Goods	398,998	301,297	97,701	481,240	376,766	104,474
Trade account	*397,884*	*316,538*	*81,347*	*480,722*	*399,648*	*81,073*
Services	51,595	66,621	-15,026	63,716	72,497	-8,780
Balance on goods and services	**450,594**	**367,918**	**82,675**	**544,957**	**449,263**	**95,694**
Income	13,103	35,630	-22,527	15,307	39,787	-24,480
Current transfers	1,929	11,229	-9,300	1,700	16,333	-14,633
Balance on current account	**465,626**	**414,777**	**50,848**	**561,964**	**505,384**	**56,580**
% of GNP			**13.7**			**13.4**
Capital account			–			–
Financial account			-12,146			15,386
Direct investment			4,194			10,823
Portfolio investment			4,168			33,112
Other investment			-20,508			-28,550
Balance on capital and financial account			**-12,146**			**15,386**
Errors and omissions			358			11,095
of which:						
Exchange revaluation gain (+) or loss (-)			*11,927*			*7,997*
Overall balance			**39,059**			**83,061**
Bank Negara Malaysia international reserves, net			**170,452**			**253,513**
(US$ million)			**44,856**			**66,714**

Note: Numbers may not necessarily add up due to rounding.
e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Current Account

The **current account** recorded a larger surplus of RM56.6 billion or 13.4% of GNP, reflecting sustained large trade surplus and a significant improvement in the services account deficit. The strong export growth was underpinned by the upswing in global demand for electronics and expansion in most commodity exports. The substantial decline in the services account deficit reflected the significant improvement in the travel receipts following higher tourist arrivals. The income account deficit increased due to higher profits and dividends accruing to foreign direct investors. The current transfers account recorded a higher outflow attributable to the one-off remittance by illegal foreign workers under the Amnesty Programme.

Amidst stronger global growth, **gross exports** expanded significantly by 20.8% in 2004 (2003: 11.3%). Growth was supported by marked expansion in exports of manufactured goods and minerals. Growth in agriculture exports moderated during the year. Higher export receipts during the year reflected both increases in volume (16.1%) and unit value (3.6%). The increase in unit value was due to higher prices for most commodities and resource-based industries.

The large trade surplus was attributed to stronger growth in manufactured exports and sustained high growth in commodity earnings. The strong expansion in imports was reflective of growth in production and exports of manufactured goods as well as strong domestic consumer and investment spending.

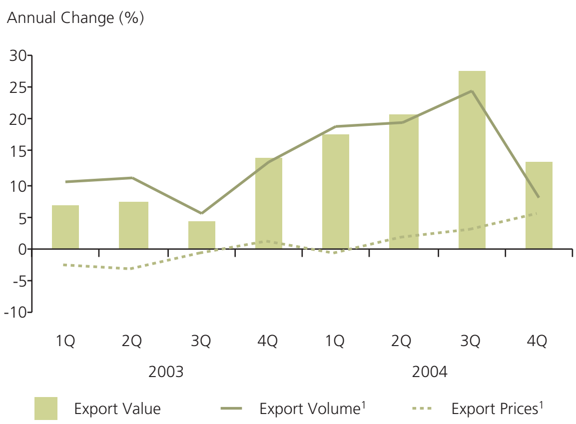
Table 1.17
Gross Exports

	2004*p*		
	RM million	Annual change (%)	% share
Manufactured goods	**390,449**	**19.7**	**81.2**
of which:			
Electronics, electrical machinery and appliances	257,051	15.3	53.5
Electronics	188,605	12.7	39.2
Semiconductor	*89,298*	*4.9*	*18.6*
Electronic equipment & parts	*99,307*	*20.8*	*20.7*
Electrical machinery & appliances	68,446	23.4	14.2
Consumer electrical products	*22,170*	*12.5*	*4.6*
Industrial & commercial electrical products	*25,769*	*27.0*	*5.4*
Electrical industrial machinery and equipment	*17,783*	*30.8*	*3.7*
Household electrical appliances	*2,724*	*45.3*	*0.6*
Chemicals & chemical products	27,767	31.0	5.8
Manufactures of metal	16,140	43.6	3.4
Optical and scientific equipment	11,568	26.3	2.4
Textiles, clothing and footwear	10,328	17.9	2.1
Wood products	8,677	29.5	1.8
Food	7,776	22.7	2.0
Rubber products	6,036	19.3	1.3
Transport equipment	5,324	65.0	1.1
Agricultural commodities	**36,176**	**7.4**	**7.5**
of which:			
Palm oil	20,107	-0.4	4.2
Rubber	5,198	45.1	1.1
Sawn timber	3,214	1.7	0.7
Saw logs	2,070	2.5	0.4
Minerals	**41,177**	**38.2**	**8.6**
of which:			
Crude oil	21,318	36.1	4.4
LNG	17,079	27.9	3.6
Tin	947	231.5	0.2
Other exports	**12,920**	**60.1**	**2.7**
Total	**480,722**	**20.8**	**100.0**

p Preliminary

Source: Department of Statistics, Malaysia

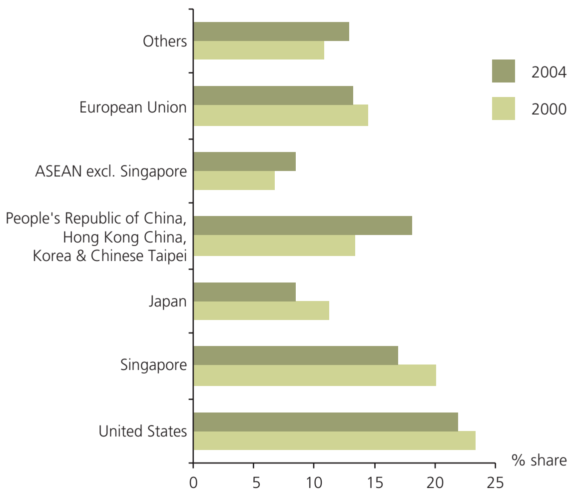
Graph 1.36
Export Performance of the Manufacturing Sector



¹ Volume and prices are estimates based on Bank Negara Malaysia's survey of selected companies.

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

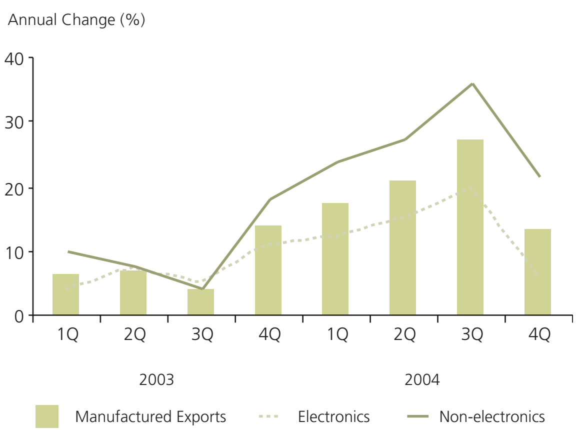
Graph 1.38
Exports of Manufactured Goods by Destination



Source: Department of Statistics, Malaysia

Exports of **manufactured goods** recorded a strong growth of 19.7% in 2004 (2003: 8%), contributed by both higher volume (18.3%) and unit value (1.2%). Of significance, exports of electronics and electrical products expanded strongly, particularly in the first half-year benefiting largely from the global semiconductor up-cycle. Resource-based products such as petroleum, chemical, wood and rubber products also benefited from higher prices and volume. The rapid expansion in construction activity in PR China supported the strong demand for metal products from Malaysia. Exports of rubber products, especially for gloves remained strong during the year due to the demand stimulated by the outbreak of the Avian flu in the regional countries. In the transport equipment sub-segment, increased investments in global oil and gas exploration led to the strong demand for floating and submersible drilling platforms for exploration activity. Meanwhile, growth in exports of wood products was supported by sustained demand from Japan and US.

Graph 1.37
Export Performance of Electronics and Non-electronics Industries



Source: Department of Statistics, Malaysia

Primary commodities continued to contribute significantly to gross exports during the year, with its share rising to 16.1% (2002: 13.6%). Commodity exports grew by 21.8%, reflecting mainly stronger growth in petroleum exports, while growth in agriculture exports was moderate.

Table 1.18
External Trade

	2003	2004*p*	2003	2004*p*
	RM billion		US$ billion	
Gross exports (f.o.b)	**397.9**	**480.7**	**104.7**	**126.5**
Annual change (%)	11.3	20.8	11.3	20.8
	Annual change (%)			
Volume¹	5.9	16.1	5.9	16.1
Prices¹	1.1	3.6	1.1	3.6
Gross imports (c.i.f)	**316.5**	**399.6**	**83.3**	**105.2**
Annual change (%)	4.4	26.3	4.4	26.3
	Annual change (%)			
Volume¹	-1.0	23.0	-1.0	23.0
Prices¹	2.2	3.1	2.2	3.1
Trade balance	**81.3**	**81.1**	**21.4**	**21.3**

¹ Volume and prices for 2004 are estimates.

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Mineral exports recorded another year of strong expansion, increasing by 38.2% to RM41.2 billion. Export revenue from crude oil rose by 36.1% to RM21.3 billion, on the back of significantly higher price which rose by 34.8% to average US$40.81 per barrel for 2004. Exports of LNG also rose strongly by 27.9% to RM17.1 billion, on account of higher volume (19.7%) following the increased offtake by traditional LNG buyers, as well as higher price (6.8%).

Export receipts from **agriculture** totalled RM36.2 billion in 2004, of which palm oil accounted for the largest share of 56% or RM20.1 billion. Despite the higher export price of palm oil, earnings from palm oil fell marginally by 0.4% during the year due to lower export volume (-5.6%). Demand was affected by significant reductions in imports by India (-44%) and Pakistan (-24.2%) as a result of higher production of their domestic oilseeds. Nevertheless, purchases by the other major buyers of Malaysian palm oil, namely PR China and the EU, with a combined share of almost 40% of total palm oil exports, increased by 13% and 12.6% respectively. Rubber exports performed strongly for the second consecutive year, registering a growth of 45.1% (2003: 43.8%) due to both higher prices (24.3%) and volume (16.7%), as imports by PR China and the EU recorded significant increases (39.2% and 15.6% respectively).

Growth in **gross imports** of 26.3% reflected higher production and exports of manufactured goods, as well as stronger domestic consumer and investment spending. Both imports of intermediate and capital goods were higher. Intermediate imports were mainly to support higher manufacturing production, while the surge in imports of capital goods reflected higher investment activity in the services and

Table 1.19
Gross Imports by End Use

	2004*p*		
	RM million	Annual change (%)	% share
Capital goods	**55,545**	**36.1**	**13.9**
Capital goods (except transport equipment)	49,094	28.4	12.3
Industrial machinery and equipment	*13,219*	*36.2*	*3.3*
Office equipment	*9,139*	*78.0*	*2.3*
Telecommunication equipment	*6,957*	*37.8*	*1.7*
Transport equipment	6,451	151.0	1.6
Intermediate goods	**287,223**	**22.0**	**71.9**
Food and beverages, mainly for industry	8,842	52.9	2.2
Industrial supplies, n.e.s.	91,138	38.9	22.8
Metals & metal products	*27,568*	*50.1*	*6.9*
Chemicals	*10,648*	*44.1*	*2.7*
Fuels and lubricants	19,322	41.8	4.8
Parts and accessories of capital goods (except transport equipment)	158,848	10.5	39.7
Electronics	*102,949*	*8.0*	*25.8*
Parts and accessories of telecommunication equipment	*7,434*	*8.2*	*1.9*
Parts and accessories of transport equipment	9,073	35.0	2.3
Consumption goods	**23,234**	**24.1**	**5.8**
Food and beverages, mainly for household consumption	8,926	31.3	2.2
Transport equipment, non-industrial	334	-6.7	0.1
Consumer goods, n.e.s.	13,974	20.8	3.5
Consumer durables	*3,119*	*20.8*	*0.8*
Consumer semi-durables	*4,671*	*18.2*	*1.2*
Consumer non-durables	*6,184*	*22.9*	*1.5*
Dual use goods	**9,310**	**39.8**	**2.3**
Motor spirit	4,743	59.1	1.2
Passenger motor cars	4,567	24.1	1.1
Others	**7,110**	**10.8**	**1.8**
Re-exports	**17,226**	**102.9**	**4.3**
Gross Imports	**399,648**	**26.3**	**100.0**

Note: Numbers may not necessarily add up due to rounding.
n.e.s. Not elsewhere specified.
p Preliminary

Source: Department of Statistics, Malaysia

manufacturing sectors. Higher disposable income and improved consumer confidence led to the growth in imports of consumption goods.

Imports of **intermediate goods** expanded strongly by 22%. Components, such as parts and accessories for the electronics industry, expanded strongly with a rising trend towards substitution from lower cost suppliers, in particular increased sourcing from Thailand, Indonesia and PR China. In line with higher demand in regional countries for metal and resource-based products, significant increases were recorded in industrial supplies, namely, construction materials, metals, and chemicals. Intermediate imports related to the manufacture of goods for the domestic market also registered growth. Growth of the motor assembly industry, stemming from the robust demand for passenger cars, lifted imports of parts and accessories. In line with sustained consumer spending on food and beverages, imports of primary and processed materials used by the food and beverages industry recorded strong growth.

Imports of **capital goods** increased significantly by 36.1% following the strong pick up in investment. The impetus came from capacity expansion and upgrading of technology in the manufacturing, services, shipping and airline sectors. Investment in machinery and equipment in the manufacturing sector, particularly in new growth areas such as chemicals, metal fabrication and higher-end electrical and electronics, strengthened. The extension of network infrastructure and the introduction of new products and technologies by telecommunication companies also caused imports of telecommunication equipment to record strong growth. Imports of office equipment remained strong as corporations in the services industry improved their service delivery by upgrading infrastructure in information technology. Capacity expansion in the power generation sector led to strong growth of imports of generators, turbines and electric motors. Strong external demand for commodity exports and fleet expansion to service new markets also induced the deliveries of ships and aircraft.

Consonant with higher private consumption, imports of **consumption goods** increased by 24.1%. Import growth was strong for food and beverages, electrical goods, furniture, clothing and footwear, household furnishings, and medicine. Nevertheless, the share of consumption goods imports to total imports remained low, accounting for only 5.8% of total imports.

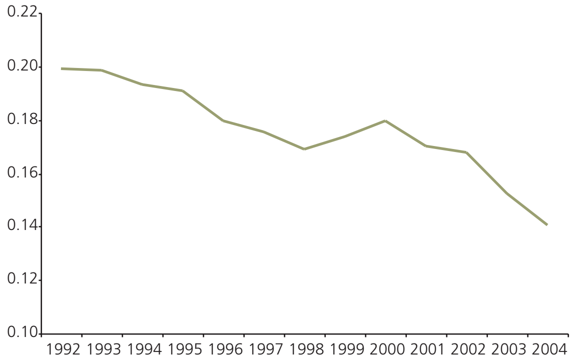
A notable development was the significant growth of 102.9% in imports for **re-exports**, arising from packing and assembling activities in the free commercial zones. These imports, mainly electrical and electronic products, telecommunication equipment and iron and steel products, were largely re-exported to Singapore, Thailand and Hong Kong China.

Malaysia's trade with other countries in East Asia (excluding Japan) has grown over the years and the region now accounts for 45.4% of Malaysia's total trade (1995: 35.9%). Efforts taken to diversify trade with non-traditional markets, such as West Asia, Eastern Europe and South Asia, have made progress. The diversification index, as measured by the normalized Herfindahl-Hirschmann index, improved in 2004. The index for both exports and imports declined from 0.15 in 2003 to 0.14 in 2004, implying increasing diversification.

The **US** remained as Malaysia's largest trading partner with a share of 16.8% (2003: 17.7%) and contributed to a larger trade surplus of RM32.4 billion. The surplus was attributed to higher exports of electrical and electronic products, in particular, integrated circuits, parts for data processing machines and computer components, rubber, optical and scientific instruments, furniture and petroleum products. The US was the second largest source of imports for Malaysia, with imports comprising mainly intermediate inputs, such as semiconductors and office machine parts used in the electrical and electronic industry, optic and medical instruments and aircraft.

Despite the decline in the share of trade to 13.2% (2003: 13.9%), **Singapore** maintained its position as

Graph 1.39
Exports Diversification Index



The exports diversification index is a modified version of Herfindahl-Hirschmann index. It is normalised to obtain a numeric range from 0 to 1. A lower index value signifies a higher degree of diversification.

Table 1.20
Direction of External Trade

	2004*p*				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	RM million
ASEAN countries	**120,601**	**25.1**	**95,729**	**24.0**	**24,872**
Singapore	72,176	15.0	44,437	11.1	27,740
Thailand	22,954	4.8	21,992	5.5	962
Indonesia	11,677	2.4	15,936	4.0	-4,259
Philippines	7,362	1.5	10,667	2.7	-3,305
Other ASEAN countries	6,431	1.3	2,697	0.7	3,735
Selected North East Asia countries	**93,430**	**19.4**	**91,603**	**22.9**	**1,828**
The People's Republic of China	32,143	6.7	39,279	9.8	-7,135
Hong Kong China	28,686	6.0	10,850	2.7	17,835
Chinese Taipei	15,763	3.3	21,630	5.4	-5,867
Korea	16,839	3.5	19,843	5.0	-3,005
European Union (EU) [1]	**60,374**	**12.6**	**47,930**	**12.0**	**12,444**
United Kingdom	10,556	2.2	6,640	1.7	3,916
Germany	10,485	2.2	17,798	4.5	-7,313
Netherlands	15,752	3.3	3,434	0.9	12,318
Other EU countries	23,581	4.9	20,058	5.0	3,523
United States	90,181	18.8	57,752	14.5	32,429
Japan	48,552	10.1	63,693	15.9	-15,141
India	11,410	2.4	4,897	1.2	6,513
Australia	15,783	3.3	6,793	1.7	8,990
Rest of the world	40,389	8.4	31,252	7.8	9,137
Total	**480,722**	**100.0**	**399,648**	**100.0**	**81,073**

Note: Numbers may not necessarily add up due to rounding.
[1] Includes the 10 new member states.
p Preliminary

Source: Department of Statistics, Malaysia

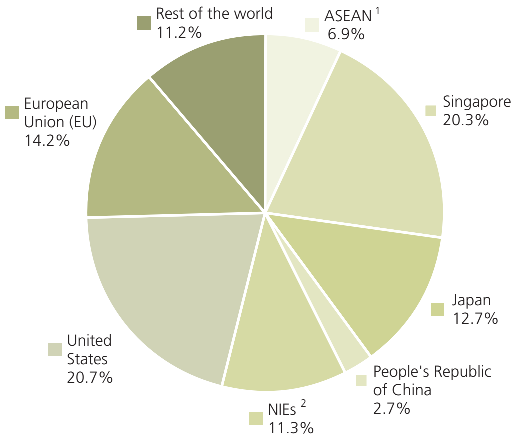
the second largest trading partner of Malaysia. Exports of electrical and electronic products remained the largest export earner with receipts of RM40.9 billion or 56.6% of total exports to Singapore. Other exports that recorded strong growth included refined petroleum products, manufactures of metal, chemicals and transport equipment, particularly floating and submersible drilling platforms for oil and gas exploration activity. On the imports side, Singapore was the third largest source of imports for Malaysia. Imports from Singapore were mainly office machine parts, computers and components, chemicals and optical and scientific equipment.

Japan remained as the third most important trading partner of Malaysia although its share to total trade declined to 12.7%. Export growth of 14.2% was underpinned by exports of electrical machinery, wood products, chemicals, optical and scientific, metal and plastic products. Despite the appreciation of the yen, imports grew by 17.9%, reflecting inelastic demand for machinery, electrical machinery and transport equipment. Consequently, the trade deficit widened to RM15.1 billion (2003: -RM11.5 billion).

Reflecting the improvement in economic performance, total trade with the enlarged **EU** grew by 23.6% to account for a share of 12.3% of Malaysia's total trade. The impetus to the growth came from strong growth in trade with the Netherlands, Spain, Italy, Hungary and Sweden. The trade surplus of RM12.4 billion (2003: RM12.2 billion) recorded with the group arose mainly from trade surplus with Netherlands (RM12.3 billion) and the UK (RM3.9 billion), while trade with Germany and Sweden recorded deficits of RM7.3 billion and RM2.2 billion respectively.

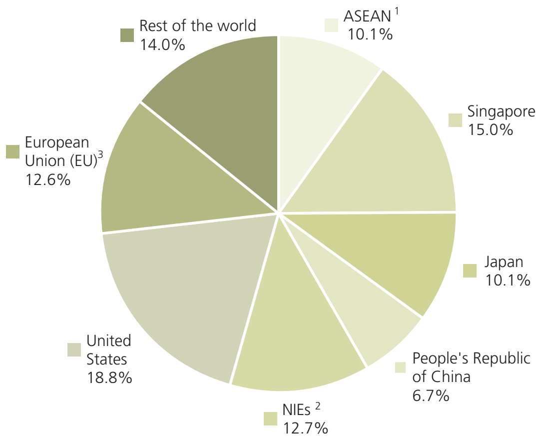
Strong economic growth supported the expansion of intra-regional trade with the East Asia and ASEAN countries. Supporting this growth is the growing extensive production network and the linkages in the region arising from relocation of companies into PR China and ASEAN countries as well as increased outsourcing activity. Trade with the **North East Asia** region (excluding Japan) expanded by 26.3% as increased sourcing of cheaper inputs caused import growth from these countries to outpace export growth. Trade with

Graph 1.40
Direction of Exports (% share): 1995



[1] ASEAN excluding Singapore
[2] Hong Kong China, Korea and Chinese Taipei

Direction of Exports (% share): 2004



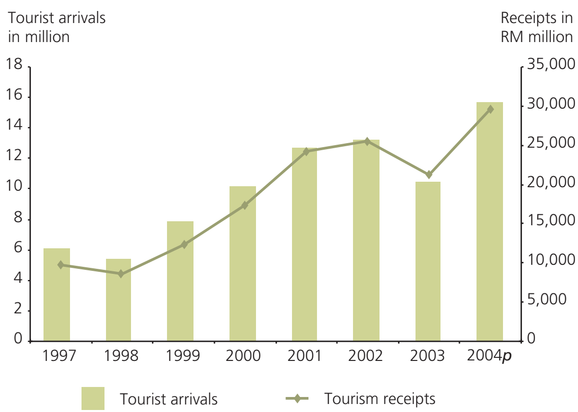
[1] ASEAN excluding Singapore
[2] Hong Kong China, Korea and Chinese Taipei
[3] Includes the 10 new member states

PR China grew by 33.7% and exports consisted mainly of integrated circuits, office machine parts, chemicals and palm oil. Nevertheless, the higher import growth from PR China caused the trade deficit to widen to RM7.1 billion (2003: -RM1.8 billion). Malaysia is PR China's eighth largest trading partner and its largest trading partner in ASEAN. Exports to Korea increased by 45.7% underpinned by demand for resource-based products namely chemicals, petroleum products, rubber products and LNG. The trade pattern was similar for the **ASEAN** (excluding Singapore) countries, with trade expanding by 31.9%. As importers continued to source inputs from low cost suppliers, Malaysia continued to experience trade deficits with Indonesia and Philippines, while the trade surplus with Thailand narrowed. Exports to the ASEAN countries were supported mainly by exports of electrical and electronics and resource-based products. The strong import growth from Thailand and Indonesia were driven by electronic products, chemicals, manufactures of metal and iron and steel products.

In 2004, the **services account** deficit narrowed to RM8.8 billion or -2.1% of GNP (2003: -RM15 billion or -4% of GNP). Policies to promote the export of services and investment in infrastructure in the services industry have enabled new sources of foreign exchange earnings, particularly from tourism and other services, mainly computer and information services, and thereby contributing to significant improvement in the services account deficit.

Travel continued to be the largest contributor to services receipts, accounting for 48.9% of gross services receipts in 2004. Receipts in the **travel account** increased by 38.9% to RM31.2 billion. The strong performance of the travel account reflected the marked increase in the number of tourist arrivals to 15.7 million visitors (2003: 10.6 million). Strong economic performance of regional countries and greater connectivity in air services through an increase in the number of flights, including charter flights and promotional fares provided by low cost carriers, led to a higher number of visitors. Singapore, Thailand, Indonesia and PR China were the main sources of visitors, accounting for 78.8% of total arrivals. Aggressive marketing campaigns targeted, in particular, at summer vacation travel by West Asians induced a

Graph 1.41
Tourist Arrivals and Tourism Receipts



p Preliminary
Source: Malaysia Tourism Promotion Board

Table 1.21
Services and Income Accounts

	2003	2004e		
	RM billion			
	Net	+	–	Net
Services Account				
Transportation	-13.3	12.0	29.8	-17.8
Travel	11.6	31.2	11.8	19.4
Other services	-13.0	20.1	29.8	-9.7
Government services n.i.e.	-0.3	0.4	1.1	-0.7
RM billion	**-15.0**	**63.7**	**72.5**	**-8.8**
US$ billion	**-4.0**	**16.8**	**19.1**	**-2.3**
% of GNP	-4.0			-2.1
Income Account				
Compensation of employees	-1.0	2.6	3.8	-1.1
Investment income	-21.6	12.7	36.0	-23.3
RM billion	**-22.5**	**15.3**	**39.8**	**-24.5**
US$ billion	**-5.9**	**4.0**	**10.5**	**-6.4**
% of GNP	-6.1			-5.8

Note: Numbers may not necessarily add up due to rounding.
e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

travel receipts. Education receipts from foreign students at all levels of education (comprising tertiary, secondary and primary education) increased by 40.5%. Students from PR China accounted for about 40% of the students at private tertiary institutions while the rest were mainly from neighbouring countries, particularly Indonesia and India. Meanwhile, earnings from healthcare services improved further due mainly to the increase in number of foreign patients to 174,289 patients in 2004 (2003: 102,946 patients). The bulk of foreign patients were from the ASEAN countries, accounting for 81.8% of total foreign patients.

On the payments front, higher incomes, increased business activities overseas and improved economic prospects led to higher expenditure on foreign travel which rose by 8.7% to RM11.8 billion. Payments for travel to border towns rose sharply by 108.6% to RM2.4 billion. Education outflows increased by 16.7% due mainly to higher expenditure on tuition

Higher tourism receipts and improvement in earnings from computer and information services contributed to a lower services deficit. Profits and dividends accrued to Malaysian companies abroad also continued to increase.

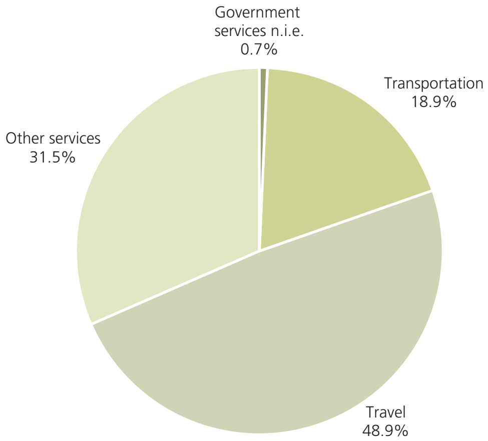
57.1% increase in number of West Asian tourists. Tourists from emerging markets of Asia such as Korea and Chinese Taipei increased sharply by 97.4% and 38.3% respectively.

Higher foreign exchange earnings from education and healthcare services also contributed to higher

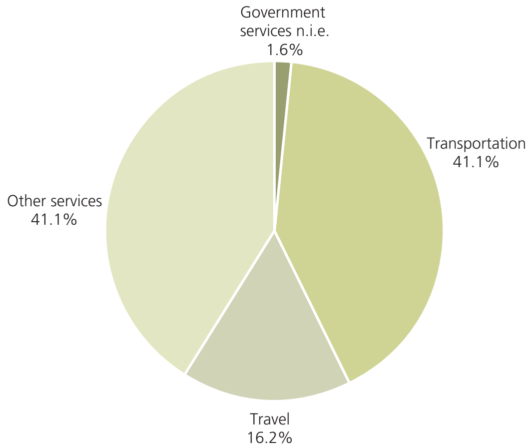
fees and living expenses arising mainly from the appreciation of Australian dollar, pound sterling and Singapore dollar against ringgit.

Another contributory factor to the lower services account deficit was the lower net outflow of RM9.7 billion in the **other services account** stemming mainly

Graph 1.42
2004: Components of Gross Receipts in the Services Account (% share)



Graph 1.43
2004: Components of Gross Payments in the Services Account (% share)



from higher receipts for computer and information services. The setting up of regional hubs for development of ICT products, provision of regional group network support services as well as business process outsourcing and shared services underpinned the growth in exports of computer and information services. On the other hand, payments of royalties and licence fees were larger reflecting usage of intellectual property in areas related to multimedia, communication and retail business. The bulk of these royalties and licence fees payments were made to the US and Japan. Higher payments were also incurred for the import of construction services for power and oil and gas exploration projects. Payments to foreign service providers in areas related to communication and multimedia services also increased in response to strong demand.

The strong expansion in external trade together with higher freight charges by international shipping lines due to tight capacity resulted in the **transportation account** recording a significantly larger net outflow of RM17.8 billion (2003: -RM13.3 billion). The higher gross payments were offset partly by improved earnings from cargo and passenger services provided by major domestic shipping companies and airlines. Capacity expansion by shipping companies and airlines as well as an increase in transhipment cargo contributed to higher earnings.

services sector. For the second consecutive year, income from other investment recorded a net inflow of RM2.6 billion reflecting returns from larger external reserves while the interest payments on external debt continued to decline.

The net outflow in the **current transfers account** increased significantly to RM14.6 billion (2003: -RM9.3 billion). The increase in current transfers payments to RM16.3 billion reflected mainly the one-time lump sum repatriation made by 309,248 illegal workers returning to their home countries under the Amnesty Programme from October 2004 to end of December 2004. Regular remittances by a larger number of registered foreign workers employed, mainly in the manufacturing and agriculture sectors, also contributed towards the larger net outflow.

Financial Account

The **financial account** turned around in 2004, recording a net inflow of RM15.4 billion (2003: -RM12.1 billion). The significant shift was attributed mainly to higher inflows of foreign direct investment and portfolio funds following stronger economic growth and improved corporate earnings. Other investment recorded a larger outflow due to both net repayment of external loans by the official sector for the second consecutive year and higher outflows of other private sector investment.

The financial account turned around to record a net inflow in 2004, attributed mainly to higher inflows of FDI and portfolio funds following stronger economic growth and improved corporate earnings.

The **income account** deficit increased to RM24.5 billion or -5.8% of GNP in 2004, attributable mainly to higher profits and dividends accruing to foreign direct investors. The higher income accruing to foreign direct investors was due mainly to the improved export performance of the electrical and electronics industries as well as the oil and gas sector on the back of the surge in oil prices. Nevertheless, the actual outflows were considerably lower as a large portion of the profits was retained in the country for reinvestment. Meanwhile, income accruing to portfolio investors recorded a larger outflow in line with higher dividend payouts by the Malaysian companies.

Profits and dividends accruing to Malaysian companies from their investment abroad increased further to RM3.6 billion (2003: RM2 billion). These receipts were mainly from the oil and gas sector as well as the

On a gross basis, **foreign direct investment** (FDI) in Malaysia increased to RM24.8 billion (2003: RM19.9 billion) or 5.9% of GNP reflecting broad-based flows to all the major sectors, namely services, manufacturing and oil and gas sectors. The bulk of the FDI continued to be in the form of retained earnings. Nevertheless, inflows of new equity were higher. After taking into account liquidation and loan repayments to parent companies abroad, net FDI increased to RM17.9 billion (2003: RM9.4 billion).

The services sector continued to be a major recipient of new FDI flows particularly in the new growth areas such as the business support and shared services, in line with the Government policies geared towards liberalisation and deregulation. Significant inflows were recorded in the financing, insurance, real estate and business services sub-sector as well as wholesale

Table 1.22
Balance of Payments: Financial Account

	2003	2004*e*	2003	2004*e*
	RM billion		US$ billion	
Financial Account	**-12.1**	**15.4**	**-3.2**	**4.0**
Direct Investment	**4.2**	**10.8**	**1.1**	**2.8**
In Malaysia	9.4	17.9	2.5	4.7
Abroad	-5.2	-7.1	-1.4	-1.9
Portfolio Investment	**4.2**	**33.1**	**1.1**	**8.7**
Other Investment	**-20.5**	**-28.6**	**-5.4**	**-7.5**
Official sector	-11.2	-1.1	-2.9	-0.3
of which:				
Federal Government (net)	-3.7	0.1	-1.0	…
Gross borrowing	3.1	1.1	0.8	0.3
Repayment	-6.9	-1.0	-1.8	-0.3
NFPEs (net)	-7.3	-1.3	-1.9	-0.3
Gross borrowing	5.1	11.4	1.4	3.0
Repayment	-12.4	-12.7	-3.3	-3.3
Private sector	-9.3	-27.4	-2.4	-7.2

Note: Numbers may not necessarily add up due to rounding.
… Negligible
e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

and retail trade, hotels and restaurants sub-sector. In the financing, insurance, real estate and business services sub-sector, there were new investments in the banking sector upon the approval of Islamic banking licences to three foreign banks. In view of favourable fiscal incentives and good infrastructure, the sub-sector also witnessed the emergence of the shared services and outsourcing activities that accelerated the development of value-add chain to support the MNCs' operations in Malaysia and the Asian region. During the year, several MNCs established or expanded their regional or global operation centres for shared services and outsourcing activities in Malaysia. Meanwhile, the information technology-related back room and call centre operations of some foreign banks continued to expand, establishing linkages across different segments of the services sector. The competitive advantage of Malaysia in shared services activities is reflected in the A.T. Kearney 2004 Offshore Location Attractiveness Index which ranked Malaysia as the third most attractive investment destination for Shared Services & Outsourcing (SSO). Confirming this is the increase in the number of international and regional facilities in Malaysia during the year. In 2004, there was an increase of 6% in the international and regional facilities approved in Malaysia, totalling 233, of which 16 were operational headquarters (OHQs), 193 regional and representative offices, 21 international procurement centres (IPCs) and three regional distribution centres (RDCs). In the wholesale and retail trade, hotels and restaurants sub-sector, foreign investments were largely for the set-up and expansion of hypermarkets and new hotels in response to the growing affluence of Malaysians and the rapid growth of the tourism industry.

In view of the large and long-standing presence of MNCs in the manufacturing sector, investment in this sector continued to be funded mainly by retained earnings, especially in the electrical and electronics, petroleum-related and chemicals and machinery equipment industries. Foreign investments in the manufacturing sector were mainly for upgrading of equipment and technology as well as establishing new product lines and capacity. Meanwhile, in the oil and gas sector, investment in the upstream activities continued to be significant following recent discovery of new oil fields offshore East Malaysia. The national oil company and its foreign partners were also actively engaged in deep-water oil exploration. The investment in this sector was also spurred by higher global demand and prices for oil during the year. In view of the expansion in the services, manufacturing and oil and gas sectors, the broadening and deepening of FDI flows has further enhanced the capacity, technology and skill-base to allow the country to continue to move up the value chain.

Direct investment abroad by Malaysian companies increased to RM7.1 billion in 2004 (2003: -RM5.2 billion). The sizable increase in overseas investment reflected companies' strategy in expanding their operations worldwide to enhance synergistic capabilities to their core operations in Malaysia as well as to tap business opportunities available abroad. Most of these investments were undertaken through acquisitions and joint ventures with some new greenfield investments. The investment was led by several large and established Malaysian corporations in the oil and gas and services sectors, followed by companies in the manufacturing, agriculture and construction sectors. In terms of location, overseas investments by Malaysian companies were well-diversified, with investments directed to diverse parts of the world, including Africa, ASEAN, South Asia, Europe and US.

Overseas investment in the oil and gas sector remained large, especially in the upstream oil exploration and extraction activities following the discovery of new oil fields and the success of the national oil company in forging joint venture partnerships with several foreign national oil companies for oil and gas exploration. The investments were concentrated mainly in large undeveloped oil fields in Africa and ASEAN countries. The investment abroad in the services sector was broad-based, with the bulk of the investments channelled into the utilities and the financing, insurance, real estate and business services sub-sectors. In the manufacturing sector, local companies continued to venture abroad, emulating global MNCs in establishing subsidiaries or joint ventures with their counterparties in emerging economies so as to relocate their labour-intensive operations abroad, or to be in close proximity to their suppliers and consumers. These investments were largely for the manufacturing of fabricated metal products, machinery and equipments (including electronic and electrical products), palm oil, and wood and wood products including furniture.

Agro-based overseas investments were mainly for oil palm estates in Indonesia and South Africa. Investments abroad by construction companies also continued to increase during the year. Several large and established construction and engineering companies have leveraged on their expertise and experience in civil engineering and property development to secure numerous development contracts in India, PR China, Sri Lanka, Africa and West Asia. Reflecting Malaysian companies' success in overseas ventures, the net profits and dividends accruing to companies investing abroad increased further to RM3.6 billion in 2004 (2003: RM2 billion).

Portfolio investment recorded a significant increase in net inflow of RM33.1 billion in 2004 (2003: RM4.2 billion) reflecting higher inflows into both the equity and debt markets. The flows of portfolio funds have risen steadily, as international institutional fund managers increased their medium- and long-term strategic exposure in Malaysia in line with upward adjustments in sovereign ratings, positive economic outlook, improving earnings prospects of Malaysian corporations and expectations of realignments of exchange rates in the Asian region.

The **other investment** recorded a higher net outflow of RM28.6 billion (2003: -RM20.5 billion), reflecting the net repayment of external loans by the official sector and larger short-term outflows by the private sector. The **official sector** recorded a net repayment of external loans for the second consecutive year, amounting to RM1.1 billion (2003: -RM11.2 billion), reflecting mainly the Federal Government's fiscal consolidation and sustained net repayments by the Non-Financial Public Enterprises (NFPEs).

The other investment by the **private sector**, comprising mainly borrowing and lending as well as placements and withdrawals of deposits by the banking sector as well as non-bank private sector transactions with unrelated counterparties, recorded a higher net outflow of RM27.4 billion (2003: -RM9.3 billion). This is attributed mainly to the reversal in the banking sector position to register a net outflow during the year arising from higher placement of assets abroad. The net outflows by the non-bank private sector were marginally higher, reflecting the sustained large trade credits extended by Malaysian exporters in line with the significantly stronger trade performance.

External Debt

Malaysia continued to maintain a prudent external debt management strategy. The framework for external debt management has been guided by prudential policies and an efficient debt monitoring system. Permission to allow recourse to external loans by corporations is based on a transparent set of criteria, which requires that external funds be utilised to finance productive investments and for investments that will generate sufficient foreign earnings to service the debt. The prudential safeguards include efforts to minimise risk exposure against global interest rate shocks, adverse exchange rate movements and shifts in investor sentiment. Meanwhile, the debt monitoring system enables the authorities to monitor the overall debt level, the structure of the debt as well as the servicing obligations of both the public and private sectors. These guidelines have been effective in ensuring that the nation's external debt is contained within prudent levels and its debt profile biased towards a longer maturity structure. Overall, the prudential debt management approach has served the nation well in strengthening the underlying economic fundamentals and reducing its vulnerability to external shocks.

In 2004, total external debt outstanding increased by 5.7% to RM197.3 billion (US$51.9 billion). Notwithstanding a higher total external debt, the ratios of

External debt remained within prudent level, with the debt profile biased towards a longer maturity structure. The public sector continued to record net repayments. Lower drawdowns amidst higher repayments resulted in a small net borrowing by the private sector.

Table 1.23
Outstanding External Debt

	2003	2004*p*	*2003*	*2004p*
	RM million	RM million	US$ million	US$ million
Total debt	**186,640**	**197,321**	**49,116**	**51,927**
Medium- and long-term	152,950	154,298	40,250	40,605
Short-term[1]	33,690	43,023	8,866	11,322
As % of total debt	*18.1*	*21.8*	*18.1*	*21.8*
As % of net international reserves	*19.8*	*17.0*	*19.8*	*17.0*
As % of GNP				
Total debt	50.2	46.6	50.2	46.6
Medium- and long-term debt	41.2	36.5	41.2	36.5
As % of exports of goods and services				
Total debt	40.3	35.2	40.3	35.2
Medium- and long-term debt	33.0	27.5	33.0	27.5
Debt service ratio (%)	**6.2**	**4.3**	**6.2**	**4.3**

[1] Excludes currency and deposits held by non-residents with resident banking institutions.
p Preliminary

Source: Ministry of Finance and Bank Negara Malaysia

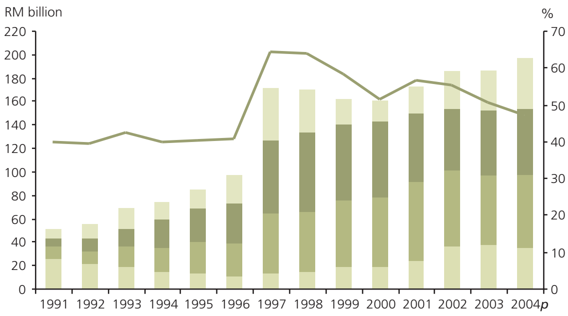
external debt to GNP and exports of goods and services improved further to 46.6% and 35.2% respectively (2003: 50.2% and 40.3% respectively). The increase in external debt reflected mainly an accumulation of short-term debt by the banking sector, resulting from hedging activities for trade-related transactions as well as money market operations involving treasury activities. Nevertheless, the share of short-term debt to total debt remained low, accounting for 21.8% of total external debt. In addition, the ratio of short-term debt to international reserves improved further to account for only 17% of international reserves (2003: 19.8%). The overall debt service ratio (excluding prepayment) declined to 4.3% in 2004 (2003: 6.2%).

The **medium- and long-term external debt** increased by 0.9% to RM154.3 billion (US$40.6 billion) as at the end-2004. The increase was due largely to an exchange revaluation loss of RM1.3 billion following the appreciation of major currencies against the US dollar. During the year, the public sector, comprising the Federal Government and NFPEs, registered a lower net repayment of RM1.2 billion (2003: -RM11 billion). In contrast, gross borrowing by the private sector was lower in 2004, while repayments of external loans increased, resulting in a smaller net borrowing of RM1.6 billion (2003: RM3.9 billion).

The bulk of the medium- and long-term debt continued to be denominated in US dollars, accounting for 77% of the nation's total medium- and long-term external debt as at end-2004. Meanwhile, the share of yen-denominated debt declined marginally to 12.5% (2003:13%) due partly to settlement of a yen-denominated bond by a NFPE. The share of the euro-denominated debt stabilised at 5.2%, while the remaining 5.3% of total external debt was accounted for by other international currencies, including the pound sterling, Swiss franc and Singapore dollar.

The outstanding external debt of the **public sector** declined marginally to RM96.7 billion (US$25.4 billion) as at end-2004 (2003: RM96.8 billion), as the net repayment of external loans more than offset an exchange revaluation loss due to the appreciation of major currencies against the US dollar. Accordingly, the share of public external debt to total external debt declined to 49% (2003: 51.9%). During the year, while the NFPEs increased their borrowings, the Federal Government continued to exercise prudence in its

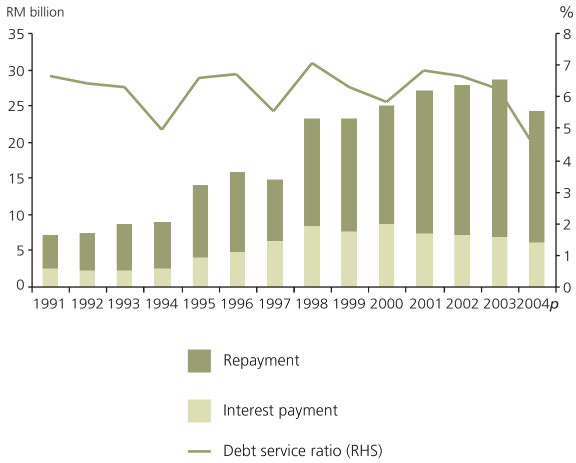
Graph 1.44a
Outstanding External Debt



[1] Excludes currency and deposits held by non-residents with resident banking institutions.

p Preliminary

Graph 1.44b
Debt Servicing



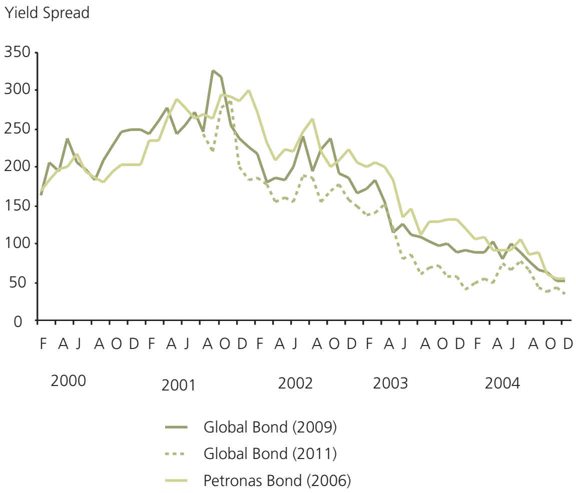
p Preliminary

recourse to external borrowing and relied mainly on non-inflationary domestic sources to fund its development programmes.

The **Federal Government** external debt declined to RM34.7 billion (US$9.1 billion) as at end-2004, attributed mainly to the novation of two external loans, previously acquired from public and privatised enterprises, to the NFPEs. Reflective of the Government's prudent external debt management policy, no new market loan was raised. The drawdown of the external loans by the Government was lower at RM1.1 billion (2003: RM3.1 billion), and were mainly from the loans committed earlier under the Miyazawa Initiative as well as project loans from multilateral sources, such as the World Bank, Islamic Development Bank and Asian Development Bank. Meanwhile, repayments of Government external debt were also significantly lower, amounting to RM1 billion (2003: -RM6.9 billion), reflecting mainly scheduled principal repayments of several project loans.

Malaysia's strong and improving economic fundamentals led to several sovereign rating upgrades in 2004 and the interest spread on Malaysia's benchmark securities narrowed further during the year. The spread on Malaysia's Global Bond due 2011 over US Treasuries narrowed steadily to 29 basis points at the end of 2004 (end-2003: 84 basis points). Similarly, the spread on the Global Bond due 2009 narrowed to 48 basis points at end-2004 (end-2003: 76 basis points). During the year, Malaysia's sovereign ratings were further upgraded by several credit rating agencies. On 30 January 2004, Rating and Investment Information Inc. upgraded Malaysia's long-term foreign currency rating to A-, from BBB+, with a stable outlook. On 11 May 2004, Standard & Poor's reaffirmed Malaysia's long-term foreign currency sovereign credit rating at A-. Fitch International assigned a positive outlook to Malaysia's rating on 6 April 2004 and raised its long-term foreign currency rating to A-, from BBB+, with a stable outlook on 8 November 2004. After assigning the outlook for Malaysia's sovereign foreign currency rating to positive from a stable outlook on 6 February 2004, Moody's Investor Services upgraded the rating further to A3, from Baa1 on 16 December 2004.

Graph 1.45
Spread of Sovereign Bonds and Selected NFPE Bond Over US T-bills



In 2004, the **NFPEs** registered a smaller net repayment of RM1.3 billion (2003: -RM7.3 billion), as gross borrowings were significantly higher (RM11.4 billion; 2003: RM5.1 billion). The repayments, including the maturing of several bonds, were mainly by NFPEs in the oil and gas, telecommunication and utilities sectors. The larger recourse to external borrowing was mainly to finance capital investment and repayments and prepayments of offshore loans. Nevertheless, after taking into account the novation of two external loans from the Federal Government and some exchange revaluation losses, the outstanding external debt of NFPEs increased by RM2.5 billion to RM62.1 billion (US$16.3 billion) in 2004 (2003: RM59.5 billion or US$15.7 billion).

The **private sector** external debt (including short-term debt) stood at RM100.6 billion (US$26.5 billion) as at end-2004 (end-2003: RM89.8 billion) and continued to account for about one-half of Malaysia's total external debt. The medium- and long-term external loans recorded a smaller net borrowing of RM1.6 billion (2003: RM3.9 billion), reflecting a lower drawdown (-9.5%) amidst a higher repayment (+9.9%) during the year. The drawdown of external loans was mainly to finance capital expenditure and repayments of offshore loans, particularly by manufacturing companies. Meanwhile, the bulk of the repayments were effected by companies in the manufacturing and plantation sectors. The overall risk profile of the private sector medium- and long-term external debt remained low as the bulk of these loans carried a natural hedge. Most of these loans were used to finance export-oriented activities and overseas investments with foreign exchange revenue and income. In addition, a significant share of these loans was sourced from the offshore shareholders and parent or associate companies with more flexible terms and at concessionary interest rates. After taking into account some exchange revaluation losses, the private sector medium- and long-term external debt outstanding increased slightly by 2.6% to RM57.6 billion (US$15.2 billion) as at end-2004 (end-2003: RM56.1 billion).

The outstanding **short-term external debt** (maturity of one year or less) rose by RM9.3 billion (US$2.5 billion) to RM43 billion (US$11.3 billion) in 2004, reflecting an increase in the short-term external borrowing by the banking sector, largely for hedging activities on trade-related transactions and treasury activities. Meanwhile, short-term borrowings by the non-bank private sector, comprising mainly revolving credits, overdraft facilities and term loans declined further to RM8.1 billion in 2004 (2003: RM10.4 billion). The decline reflected mainly repayment of these facilities by several large companies, particularly from the manufacturing sector.

Table 1.24
Net International Reserves

	As at end-			Change
	2002	2003	2004	2004
	RM million			
SDR holdings	585.0	685.0	765.3	80.3
IMF reserve position	3,315.5	3,652.0	3,068.4	-583.6
Gold and foreign exchange	127,515.1	166,139.3	249,704.1	83,564.8
Gross International Reserves	**131,415.6**	**170,476.3**	**253,537.8**	**83,061.5**
Less Bank Negara Malaysia external liabilities	21.9	23.8	24.5	0.7
Net International Reserves	**131,393.7**	**170,452.5**	**253,513.3**	**83,060.8**
US$ million equivalent	**34,577.3**	**44,855.9**	**66,714.0**	**21,858.1**
Months of retained imports	5.4	6.6	8.0	
Reserves/Short-term external debt (times)	4.1	5.1	5.9	

International Reserves

The **international reserves** held by Bank Negara Malaysia comprises holdings of foreign exchange and gold, the IMF reserve position and holdings of Special Drawing Rights (SDR). During the course of 2004, net international reserves strengthened by RM83.1 billion or US$21.9 billion to a record level of RM253.5 billion or US$66.7 billion as at 31 December 2004. The reserves level increased further to RM272.9 billion (US$71.8 billion) as at 28 February 2005. The reserves position is adequate to finance 8.6 months of retained imports and cover 6.1 times the short-term external debt. The high level of reserves has increased the country's external resilience against future shocks to the economy.

The net increase in the reserves reflected the overall strong fundamentals of the economy. The increase in **foreign exchange holdings** was due to both the stronger export performance as well as higher inflows of foreign direct investment and portfolio funds. Notably, the increase in reserves occurred amidst higher outflows during the year. The higher payments for imports of goods and services as well as larger repatriation of profits and dividends reflected the strong expansion of domestic economic activity. Overseas investments by Malaysian companies were also higher, reflecting rising interests of Malaysian companies to diversify their activities abroad. Meanwhile, repayments of external loans by the public sector continued to exceed the drawdown of external loans.

Net international reserves strengthened to a record level of US$66.7 billion as at 31 December 2004, reflecting the overall strong fundamentals of the economy, in particular the stronger export performance and higher inflows of foreign direct investment and portfolio funds.

The diversified currency composition of the reserves yielded a net foreign exchange revaluation gain of US$2.1 billion (2003: US$3.1 billion), following the quarterly adjustments of the reserves. The revaluation gains during the third and fourth quarters, arising mainly from the appreciation of the major currencies against the US dollar more than offset the revaluation losses during the first and second quarters when the major currencies depreciated against the US dollar.

In managing the reserves, Bank Negara Malaysia adopts a prudent approach to achieve the objectives of ensuring capital preservation and liquidity whilst optimising returns. The reserves are held in the form of foreign currency deposits or in sovereign and quasi-sovereign papers of high investment grade.

Reflecting Malaysia's strong balance of payments position, Malaysia was included in the Operational

Graph 1.46
Net International Reserves (end-month)

Table 1.25
International Reserves for Selected Regional Economies

Country	Reserves as at end-2004 (US$ billion)	Reserves in months of imports	Reserves as cover of short-term external debt[1]	Reserves as cover of total external debt[1]
Chinese Taipei	241.7	17.3	3.7	2.9
Hong Kong China	123.6	5.5	0.4	0.3
Indonesia	36.3	9.4	5.4	0.3
Korea	199.1	10.6	3.8	1.2
Malaysia	**66.7**	**8.0**	**5.9**	**1.3**
Philippines	16.0	4.6	2.8	0.3
PR China	609.9	13.0	5.8	2.7
Singapore	112.8	8.3	0.8	0.6
Thailand	49.8	6.3	5.2	1.0

[1] External debt data refers to amount outstanding as at end-September 2004, except for Chinese Taipei (end-June 2004), PR China and Malaysia (end-2004).

Source: National authorities; Asian Development Bank; SDDS, International Monetary Fund

Budget of the IMF by making resources available to member countries that are facing short-term balance of payments difficulties. Nevertheless, the **reserve position with the IMF** decreased by RM583.6 million in 2004, due mainly to the net repurchase of SDR86.4 million (RM485.5 million) following repayments to the ringgit account by various IMF member countries under the Operational Budget arrangements and the maturity of investment with the Enhanced Structural Adjustment Facility Trust (ESAF) amounting to SDR40 million (RM224.1 million). Meanwhile, Malaysia's holdings of reserves in the form of **SDR** increased by RM80.3 million, reflecting the net receipt of remuneration from the IMF arising from Malaysia's net creditor position with the Fund and some exchange revaluation gains on holdings of SDR.

The international reserves held by the Bank remains fully usable and unencumbered. There are no foreign currency loans with embedded options, and no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks and other financial institutions. Bank Negara Malaysia also does not engage in options in foreign currencies with regard to the ringgit.

Bank Negara Malaysia releases information on the international reserves position and the statement of the Bank's assets and liabilities on a fortnightly basis with a one-week lag. The Bank also meets the IMF's Special Data Dissemination Standard (SDDS) requirements on detailed disclosure of international reserves and foreign currency liquidity information at the end of each month with a one-month lag. The reserves data template also provides forward-looking information on the size, composition and usability of official reserves and other foreign currency assets, and the future and potential (contingent) inflows and outflows of foreign exchange of the Federal Government and the Bank over the next 12-month period.

FLOW OF FUNDS

The economy registered a higher resource surplus of RM56.6 billion, representing 13.4% of GNP in 2004 (2003: RM50.8 billion or 13.7% of GNP). In terms of the balance of payments, the higher resource surplus reflected higher exports of RM545 billion over imports of RM449.3 billion. From the perspective of the country's savings-investment gap, the higher resource surplus reflected the higher net savings position of the private sector. The flow of funds between various sectors of the economy in 2003 and 2004 are shown in Tables 1.26 and 1.27.

The resource surplus of the public sector was lower at RM8 billion in 2004 (2003: RM17.3 billion). The resource surplus reflected entirely the surpluses from the NFPEs of RM25.3 billion, which helped to offset the resource gap of the general government of RM17.3 billion. The lower resource surplus of the public sector was due to the lower disposable income of the public sector as well as higher operating expenditure. The disposable income of the public sector declined by 4.4% to RM123.8 billion in 2004 largely on account of the higher subsidy payments incurred by the Federal Government to keep retail prices of petroleum products relatively stable following the increase in global crude oil prices. While public investment was lower as the Government began to gradually consolidate its fiscal position, public consumption increased, reflecting primarily higher

Table 1.26
Flow of Funds: 2003

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-362.4	129.5	232.9			0
Consumption	227.3	-54.9	-172.4			0
Investment	87.1	-57.2	-29.9			0
Change in Stocks	-2.8		2.8			0
Exports of Goods and Non-Factor Services	450.6				-450.6	0
Imports of Goods and Non-Factor Services	-367.9				367.9	0
Net Factor Payments Abroad	-22.5				22.5	0
Net Transfers	-9.3				9.3	0
Non-Financial Balance	0.0	17.3	33.5	0.0	-50.8	0
Foreign Financing						
Direct Investment			4.2		-4.2	0
Net Foreign Borrowings		-11.2	-11.5		22.7	0
Change in Net Foreign Assets						
Bank Negara Malaysia				-27.1	27.1	0
Banking System				6.4	-6.4	0
Domestic Financing						
Change in Credit		9.6	25.6	-35.2		0
Change in Deposit[1]		9.4	-48.9	39.5		0
Net Borrowings from Non-Bank Sector		-25.2	25.2			0
Other Items (Net)			-28.0	16.5	11.6	0
Sum		0	0	0	0	

[1] Including currency in circulation

Table 1.27
Flow of Funds: 2004

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-408.4	123.8	284.6			0
Consumption	251.4	-59.4	-192.0			0
Investment	91.8	-56.5	-35.4			0
Change in Stocks	8.7		-8.7			0
Exports of Goods and Non-Factor Services	545.0				-545.0	0
Imports of Goods and Non-Factor Services	-449.3				449.3	0
Net Factor Payments Abroad	-24.5				24.5	0
Net Transfers	-14.6				14.6	0
Non-Financial Balance	0.0	8.0	48.6	0.0	-56.6	0
Foreign Financing						
Direct Investment			10.8		-10.8	0
Net Foreign Borrowings		-1.1	12.9		-11.7	0
Change in Net Foreign Assets						
Bank Negara Malaysia				-75.1	75.1	0
Banking System				-7.2	7.2	0
Domestic Financing						
Change in Credit		9.8	29.1	-38.9		0
Change in Deposit[1]		-25.0	-63.4	88.5		0
Net Borrowings from Non-Bank Sector		8.4	-8.4			0
Other Items (Net)			-29.6	32.7	-3.1	0
Sum		0	0	0	0	

[1] Including currency in circulation

expenditures on supplies and services as well as emoluments. The resource surplus of the public sector together with borrowings from the banking system (RM9.8 billion) and private sector (RM8.4 billion), were placed as deposits (RM25 billion) and utilised for net repayment of foreign borrowings (RM1.1 billion).

The resource surplus of the private sector increased to RM48.6 billion or 11.5% of GNP in 2004 from RM33.5 billion or 9% of GNP in 2003. With continued strengthening in domestic activity and improvements on the external front, disposable income of the private sector increased significantly, to RM284.6 billion (2003: RM232.9 billion). This enabled the private sector to increase consumption expenditure by 11.4%. Private investment was also higher, growing by 18.4% over the previous year. The resource surplus of the private sector, together with net inflows of FDI (RM10.8 billion), net foreign borrowings (RM12.9 billion) and borrowings from the banking system (RM29.1 billion), led to a larger increase of resources available to the private sector amounting to RM101.4 billion in 2004 (2003: RM88.5 billion). The bulk of the resources were placed as deposits with the banking system (RM63.4 billion).

In the external sector, the large current account surplus and capital inflows contributed to the increase of RM75.1 billion (excluding revaluation gain/loss) in Bank Negara Malaysia's net international reserves.