Outlook and Policy

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THE INTERNATIONAL ECONOMIC ENVIRONMENT

Developments in 2004

In 2004, the global economy expanded at its strongest pace of 4.8% since 1984, led by the United States (US), reinforced by strong growth in the Asian region and revival of growth in Japan and Europe. Above-trend growth in the first half-year reflected the strong rebound from the lower base of 2003 due to economic uncertainties related to the war in Iraq and the outbreak of Severe Acute Respiratory Syndrome (SARS) in Asia. In the second half-year, despite the dampening effects of sharply higher oil prices and the reversal of interest rate trends, the growth momentum was maintained, reflecting sustained strong consumer spending and the revival in investments. Overall, the global economy exhibited greater resilience to energy shocks.

Robust global growth was reflected in significant improvements in international trade and financial flows. World trade grew by 8.8% in 2004, supported by the global electronics up-cycle, higher commodity prices and rising import demand, notably in the US and People's Republic of China (PR China). In the Asian region, these developments in tandem with stronger domestic demand contributed to further expansion in intra-regional trade. In the financial markets, major equity market indices rose strongly, buoyed by improved investor optimism amidst higher corporate earnings. In the foreign exchange markets, growing concerns on the large and widening US current account imbalances, and the sustainability of capital inflows to finance the deficit led to the depreciation of the US dollar against the other key currencies.

Among the major industrial countries, the **US** registered above-trend growth in 2004. Growth was broad based, with sustained expansion in consumption and strength in investment expenditure supplemented by inventory rebuilding. Household spending remained strong throughout the year. Despite the tapering off in tax cuts, increases in household wealth supported by rising house prices and historically low mortgage rates

Table 3.1
World Economy: Key Economic Indicators

	Real GDP Growth (%)			Inflation (%)		
	2003	2004*e*	2005*f*	2003	2004*e*	2005*f*
World Growth	**3.9**	**4.8**	**4.0**	–	–	–
World Trade	**5.1**	**8.8**	**5.8**	–	–	–
Major Industrial Countries	**2.0**	**3.4**	**2.6**	**1.8**	**2.0**	**2.1**
United States	3.0	4.4	3.5	2.3	2.7	3.0
Japan	1.4	2.6	1.3	-0.3	0.0	-0.1
Euro area	0.5	2.0	1.5	2.1	2.2	1.9
United Kingdom[1]	2.2	3.1	2.1	1.4	1.3	1.9
East Asia	**6.4**	**7.5**	**6.3 ~ 6.5**	**1.8**	**3.4**	**2.9 ~ 3.2**
Asian NIEs	**3.0**	**5.8**	**4.1 ~ 4.2**	**1.2**	**2.3**	**2.3 ~ 2.4**
Korea	3.1	4.7	4.0	3.6	3.6	3.0
Chinese Taipei	3.3	5.7	4.2	-0.3	1.6	1.9
Singapore	1.4	8.4	3.0 ~ 5.0	0.5	1.7	1.0 ~ 2.0
Hong Kong China[2]	3.2	7.5	4.5	-2.6	-0.4	1.5
The People's Republic of China	**9.3**	**9.5**	**8.5**	**1.2**	**3.9**	**3.0**
ASEAN[3]	**4.8**	**6.3**	**5.0 ~ 5.9**	**3.8**	**4.5**	**3.9 ~ 5.1**
Malaysia	5.3	7.1	5.0 ~ 6.0	1.2	1.4	2.5
Thailand	6.9	6.1	5.3 ~ 6.3	1.8	2.8	2.5 ~ 3.5
Indonesia	4.9	5.1	5.0 ~ 6.0	6.6	6.1	5.0 ~ 7.0
Philippines	4.7	6.1	5.3 ~ 6.3	3.1	5.9	5.0 ~ 6.0

[1] Inflation refers to the Retail Price Index excluding mortgage interest.
[2] Refers to composite prices.
[3] Includes Singapore.
e Estimate
f Forecast

Source: International Monetary Fund, Datastream, OECD Economic Outlook, National Sources continued to provide significant stimulus to consumption expenditure. The pick-up in labour markets, particularly evident in the second half-year, led to improved household incomes and consumer confidence. Meanwhile, strong investment expenditure was supported by healthy corporate balance sheets and rising demand, and further reinforced by an investment tax incentive. The stronger-than-expected surge in demand in 2004 after a period of lean inventories in the preceding year led to a significant rebuilding of inventories, contributing to growth. The strong demand amidst higher oil prices, however, led to further deterioration in the current account deficit.

Economic recovery in **Japan** was better-than-expected in the first half-year, underpinned by export growth and mild improvement in private consumption. Growth in the **euro area** improved mainly due to stronger demand for exports but remained below-trend. In the **United Kingdom** (UK), strength in both consumption and investment spending continued to sustain growth.

technology goods, progress in corporate restructuring, improved corporate profitability and ample liquidity in the financial systems.

Stronger external payments positions were supported by sustained current account surpluses and strong private capital inflows, which have resulted in a continued build-up of foreign reserves. The improved macroeconomic fundamentals and stronger banking sectors led to sovereign ratings upgrade in several countries in the region.

Prospects for 2005

Going forward, the outlook for 2005 remains favourable. World output and world trade are projected to expand at a steady pace of 4% and 5.8% respectively in 2005. The pace of slowdown in the US and PR China is expected to be modest, on the basis that adjustments of the imbalances in these economies would be gradual. The scenario assumes that the US dollar weakness would be orderly and that the US fiscal deficit narrows, albeit moderately. In addition, as oil prices recede from its peak in October 2004, inflationary pressures are expected to remain manageable, providing flexibility for gradual increases in interest rates in the US to a neutral level. Monetary conditions are, therefore, expected to remain supportive of growth. Meanwhile, PR China is expected to manage some softening of the economy.

Global growth would be sustained at a steady pace in 2005. The pace of slowdown in the United States and PR China is expected to be modest with gradual adjustment in the current account imbalances. Monetary conditions are expected to remain supportive of growth.

In the **Asian region (excluding Japan)**, growth accelerated to 7.5% in 2004, the strongest since 2001. PR China led the expansion with strong growth in fixed investment, robust consumption and exports. Overall, the strong growth in the region was driven mainly by a combination of rapid increase in exports as well as continued strength in domestic demand. The pick-up in domestic demand emanated from higher private investment activities and rising consumer spending in most parts of the region. Export growth accelerated to 26.2% (2003: 19.7%), despite some easing towards the second half-year. Intra-regional trade, measured by exports to regional countries as a share of total exports of the region, rose further to exceed 40% (2000: 36%).

Growth in consumption was supported by low interest rates, continued growth in consumer finance and higher incomes from stronger employment conditions. In Korea, however, consumer spending continued to contract since the second quarter of 2003, with households consolidating from the unwinding of the credit card boom in 2002. Fixed investment grew at low double-digit rates for most of the regional economies, driven by the revival in demand for

Industrial Countries

In 2005, growth in the **US** economy is expected to be near-potential, with real GDP expanding by 3.5%. While the stimulus arising from wealth effects of higher house prices and mortgage refinancing would taper off, higher incomes through continued job creation and lower unemployment would lend support to consumption spending. On the corporate front, prospects are for continued growth in investment expenditure, albeit at a more moderate pace, stemming from diminishing excess capacity, favourable corporate financial positions and incentives under recent legislation to encourage profit repatriation for domestic investment. Meanwhile, the US fiscal deficit is expected to narrow modestly. Moderate domestic demand is expected to reduce the current account deficit, amidst a weaker US dollar.

In **Japan**, the expected lower growth in 2005 reflects to a large extent the slowdown in external demand. Capital expenditure would be affected by the lower export demand for capital goods, particularly as measures to moderate China's investment boom take effect.

In the **euro area**, the recovery is uneven, with final domestic demand likely to grow more strongly in France and Spain, but weaker in Germany and Italy. In Germany, growth is expected to be dampened by sluggish growth in household income amidst ongoing labour market adjustments and some increase in savings by households in response to social security reforms. The strong appreciation of the euro would also impact the larger exporting countries, such as Germany and France where non-European Union (EU) exports account for about 40% of total exports. However, some improvement in investment spending is expected due to the effects of ongoing corporate balance sheet restructuring, which has lagged behind the US and Japan.

In the **UK**, real GDP growth in 2005 is expected to moderate to 2.1%, as household consumption growth trends to a more sustainable pace in response to previous interest rate increases and less favourable wealth effects from the housing market. The labour market is still close to full employment, sustained by private sector hiring. Investment expenditure would continue at a more modest pace, supported by the declining excess capacity. Although the housing market has been slowing steadily thus far, a sharp correction in house prices would remain a concern.

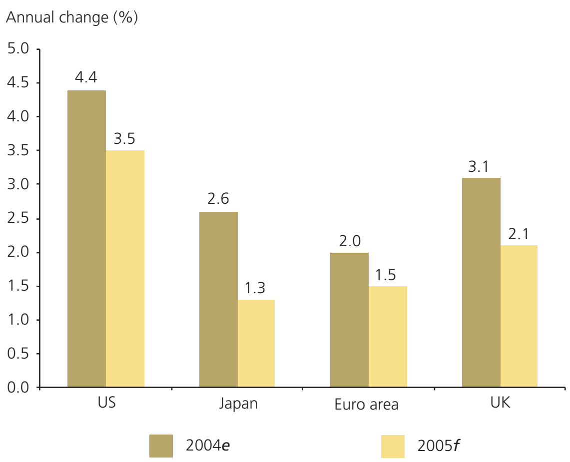
While global growth could be sustained at a steady pace in 2005, several risks could adversely affect the outlook. Inflation could rise more than expected, resulting in higher interest rates globally. In the financial markets, a disorderly realignment of the major currencies could dampen trade and investments. As a supportive engine of global growth, a significantly slower growth in China would lower growth prospects in the rest of Asia.

In 2005, growth in the US economy is expected to be near-potential. Economic expansion would be sustained by improving labour market conditions and the strong financial position of the corporate sector.

East Asian Economies

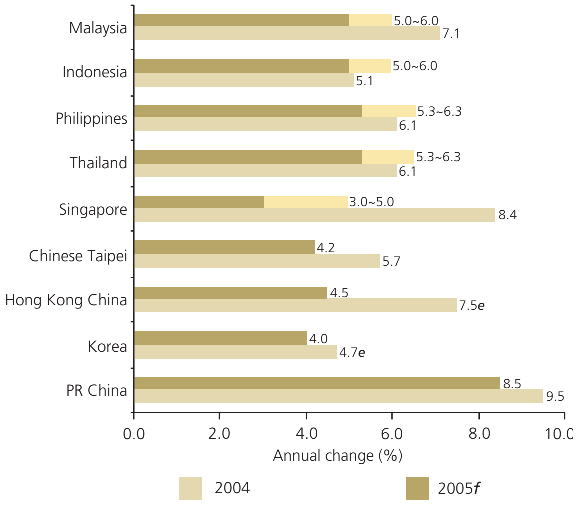
With the external environment and domestic demand projected to remain favourable, growth in the East Asian region is expected to expand at a reasonably high rate of 6.3 – 6.5%. The economic impact of the tsunami disaster is estimated to be minimal, with short-term impact on the tourism and fishery industries in the affected countries. Among the regional countries, China will remain the driver of growth. In the other Asian economies, growth will vary across countries, depending on their exposure to the downturn in the global electronics cycle.

Graph 3.1
Major Industrial Countries: Real GDP Growth (2004-2005)



e Estimate
f Forecast

Graph 3.2
Regional Countries: Real GDP Growth



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f Forecast

In the external sector, the global electronics industry is consolidating from its cyclical peak in mid-2004. Unlike the previous cycles, where both demand and supply contracted simultaneously (in 2001), the current down-cycle is characterised by some inventory accumulation due to overproduction in the first half of 2004. Thus, the current down-cycle is expected to be modest, given that world demand continues to hold up and the inventory levels are still relatively low.

On the domestic front in the East Asian region, favourable fundamentals amid continued strong overall growth and progress in economic restructuring would continue to support growth in domestic spending. Consumption will be sustained by rising disposable income and increases in employment. Another key contributing factor is the rising young age groups in the labour force in an increasingly urbanised environment with higher propensity to consume. Private demand would also benefit from the accommodative monetary stance. While interest rates have been rising in some countries, the rise has been gradual and from historical lows. Domestic demand is also likely to remain resilient, given increasing contribution of intra-regional trade, the bulk of which is for final consumption within the Asian region. Meanwhile, progress in corporate restructuring, improved corporate profitability and ample liquidity are expected to underpin the rise in investment. The fiscal stance of consolidation remains on track, with new measures to increase tax revenues, reform public enterprises and reduce fuel subsidies.

Promotion of new growth areas in various countries has also been effective in diversifying sources of growth and enhancing resilience. The broadening of the economic base to cover the promotion of SMEs, agro-business and services industries has contributed to enhancing growth.

The **Asian Newly Industrialised Economies (NIEs)** as a group is expected to register a growth of 4.1 – 4.2%, sustained by intra-regional trade and domestic demand.

PR China is still expected to lead the region's growth by registering real GDP growth of 8.5% in 2005, above the earlier target of 7%. Continued high growth rates in investment and credit in 2004 raised the concern of overheating and longer-term sustainability of growth. However, policy measures taken to address the concern in 2004 have led to some realignments of growth in fixed investment and credit expansion.

In **Korea**, real GDP is projected to increase by 4% in 2005. Private consumption is expected to turn around after two consecutive years of negative growth with the Government's introduction of a 10 trillion won (US$10 billion) fiscal stimulus package, aimed at supporting growth in 2005 and creating 400,000 jobs. Investment in the construction sector is projected to slow down. Export performance would, however, be affected by the downturn in the global electronics industry.

The East Asian region is expected to expand at a reasonably high rate. The current electronics down-cycle is expected to be modest given that world demand continues to hold up and the inventory levels are still relatively low compared with the 2001 period. In the domestic sector, favourable economic fundamentals and progress in restructuring efforts are expected to support domestic demand.

Supported by the strong economic link with mainland China, **Hong Kong China** is expected to grow by 4.5% in 2005. The close economic relationship between Hong Kong and the mainland as well as the expectation of a Renminbi revaluation has encouraged a continued inflow of funds. The strong inflow and ample liquidity have allowed the commercial lending rates to remain low, notwithstanding the increase in Hong Kong Monetary Authorities (HKMA)'s overnight discount rates which follows US interest rate trends very closely. In **Chinese Taipei**, growth is expected to moderate to 4.2%, following slower exports after a strong expansion in 2004.

Growth is expected to range between 3 – 5% in **Singapore**, depending on the performance of the electronics sector. However, its increasing diversification into biomedical as well as financial and education services would cushion the impact of the electronics cycle. Furthermore, the improvement in the unemployment situation and higher asset prices would provide some support for domestic consumption.

The **ASEAN** economies as a group is expected to grow at 5 – 5.9% in 2005. In **Thailand**, real GDP growth is expected at around 5.3 – 6.3%. Elections and infrastructure spending during the year would provide added support to domestic demand. Real GDP growth in the **Philippines** is projected to range between 5.3 – 6.3%.

The fiscal gap is projected to narrow further in 2005 following the introduction of tax reform measures. Growth in **Indonesia** is expected to be 5 – 6%, the fastest pace in nine years, with private consumption as the primary source of growth. The outlook for investment is also improving, with recovery already apparent in the second half of 2004 and likely to gather strength.

On the **global inflation** front, price increases are forecast to rise gradually, stemming mainly from the pass-through effects of high commodity prices and the narrowing output gap in some countries. The inflation pass-through effects in some economies may accelerate as producer price indices have risen faster than consumer price indices for some time, while declining corporate profit margins have eroded the capacity to absorb higher costs of production. Nonetheless, the rise in inflation is expected to be gradual as labour productivity continues to exceed real wage growth.

In 2005, inflationary pressures are expected to trend upwards in the regional countries except in Korea. In Hong Kong China, deflationary pressures have begun to ease, while in Indonesia, price pressures are expected to increase in view of the Government's plan to remove fuel subsidies. In Korea, however, inflation is projected to moderate, reflecting a stabilisation in oil prices and domestic wage growth as well as continued lacklustre domestic demand and the continued strengthening of the won.

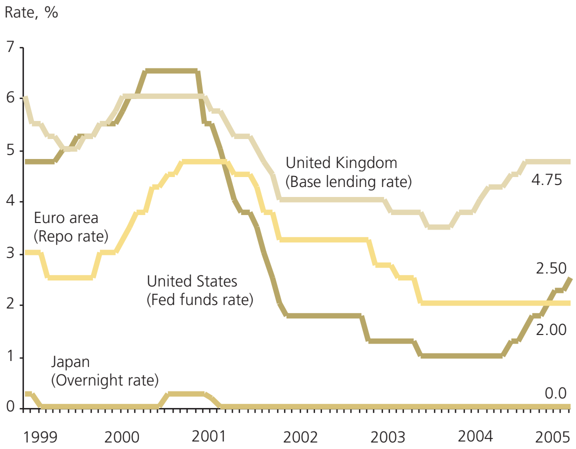
Interest Rates and Exchange Rates

In 2004, **monetary policy** in the major industrial countries remained accommodative. In view of robust economic growth and a mild upturn in inflation, several central banks began raising interest rates from low levels towards a more neutral stance.

In the US, after keeping official interest rates stable in the first half-year, strong domestic demand and some supply side factors (higher energy prices) prompted the **US Federal Reserve Board (Fed)** to start raising interest rates in June 2004, marking the first increase in four years. This move signalled the Fed's intent to return monetary policy to a more neutral stance at a measured pace. Interest rates were increased in six consecutive Fed meetings, by 25 basis points each, bringing the Federal funds rate to 2.50% by early-2005. Meanwhile, in the UK, in view of the continued strength in the housing market and rapid consumer borrowing, the **Bank of England (BOE)** raised its base lending rate twice in 2004, by 25 basis points each in February and August, to 4.75%.

In the euro zone, despite some increase in inflation due mainly to higher oil prices in 2004, the **European**

Graph 3.3
Major Industrial Countries: Official Interest Rates



Central Bank (ECB) maintained its benchmark repo rate at 2% throughout the course of the year to support domestic demand and fragile growth outlook in the euro area. Throughout 2004, with official short-term interest rates (uncollateralised overnight call rate) in Japan at around zero percent, the **Bank of Japan (BOJ)** continued to use quantitative easing measures, introduced four years ago, to inject liquidity into the banking system in order to counter deflationary pressures. As at end-2004, the quantitative easing target for current account balances of the commercial banks and financial institutions held at the BOJ stood between 30 – 35 trillion yen.

During the second half-year, to contain rising inflationary pressures emanating from higher global oil prices and rising food prices, several regional economies such as Thailand, Chinese Taipei and PR China raised their interest rates. Korea, on the other hand, reduced interest rates twice to support domestic demand.

In 2005, the timing and magnitude of monetary policy actions would depend on country-specific factors, including the strength of economic growth, inflationary expectations, movements in exchange rates and the performance of the financial markets.

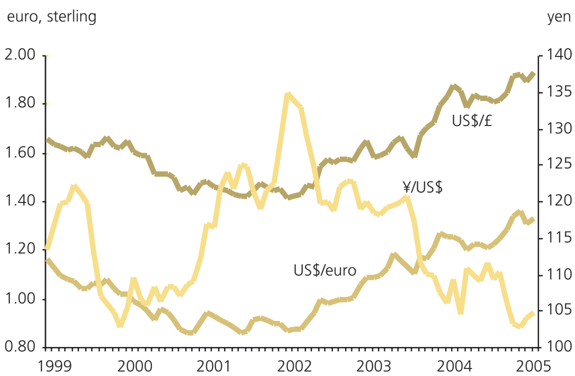
In the **foreign exchange** markets, the US dollar continued to depreciate against all major currencies in **2004**, extending its decline which began in early 2002. Measured on a trade-weighted basis[1], the dollar has declined by about 17% from its peak in March 2002 to end-December 2004. While the

[1] US Federal Reserve Board's broad nominal index.

cumulative depreciation has been most prominent against major currencies, such as the euro (36%), sterling (24%) and the yen (23%), of significance is that the dollar has recently begun to depreciate against several Asian currencies in the last quarter of 2004. On a cumulative basis since March 2002,the dollar has depreciated by about 21% against the Korean won and about 10% against both the Singapore dollar and Taiwan dollar. Against the backdrop of a weaker dollar, the euro appreciated in 2004 and ended the year at a record high of E1=US$1.3538, while several Asian currencies also appreciated against the US dollar at end-2004.

A combination of factors contributed to the dollar's decline. Underlying the depreciating trend has been the pressure from structural problems in the US, namely a widening and large current account deficit and to a lesser extent, the fiscal deficit. The relatively orderly pattern of dollar depreciation has been related to trends in the financing of the current account deficit. Since 2002, large official flows namely from the Asian region, have become an important source of financing for the current account deficit, in contrast to 2000 when foreign direct investment flows were more significant due to the technology related boom in the US. On balance, conditions exist for a further weakening dollar. The dollar is still, however, expected to receive some longer-term support given its status as a vehicle currency for trade and international financial transactions.

Graph 3.4
Movement of the US Dollar against Major Currencies



In 2005, the movement of the dollar against other major currencies is expected to be influenced by a number of factors. These include global asset reallocation among the major currencies, the path of adjustment in global imbalances, investors' perception on growth and interest rate differentials and the performance of equity and bond markets. In addition, country-specific issues that relate to inflationary trends and geo-political risk premiums could also affect sentiments on the major currencies.

MALAYSIAN ECONOMY IN 2005

The prospects for the Malaysian economy in 2005 remain sound. Real GDP is expected to expand by 5 – 6%. The sustained global growth, the modest downturn in the global semiconductor industry as well as relatively favourable prices for primary commodities are expected to provide support to export growth. While the global electronics industry is consolidating after reaching a peak in mid-2004, the cyclical downturn is forecast to be modest in view of the strong Asian demand, the rapid inventory adjustments and relatively low inventory levels. Current indications point to an expected upturn in the global electronics cycle in the second half-year. In the domestic economy, the private sector would remain as the main driver of growth, as the Government remains committed to optimising expenditure in order to strengthen the fiscal position. With the core inflation projected to remain low in 2005 (1.8%), monetary policy is able to remain supportive of the further expansion in private sector activities.

Real GDP is expected to expand by 5 – 6% in 2005. The catalyst to growth would originate from the private sector, as the Government remains committed to optimising expenditure. Monetary policy remains supportive of the further expansion in private sector activities.

Domestic Demand

All demand components, except public investment, are expected to register positive growth in 2005. In particular, private sector expenditure is projected to sustain a strong expansion of 8.7% (11.1% in 2004). Both household consumption and business outlays are projected to remain resilient, thereby cushioning some of the effects of lower public investment spending arising from the Federal Government's gradual fiscal consolidation programme. Public consumption is expected to increase moderately mainly on account of higher expenditure for supplies and services.

Table 3.2
Real GDP by Expenditure (1987=100)

	2004*p*	2005*f*
	Annual change (%)	
Domestic Demand[1]	**7.3**	**4.3**
Private sector expenditure	11.1	8.7
Consumption	*10.1*	*8.5*
Investment	*15.8*	*9.6*
Public sector expenditure	1.0	-4.0
Consumption	*6.6*	*4.5*
Investment	*-3.5*	*-11.6*
Net exports of goods and services	**-22.3**	**43.1**
Exports	15.6	8.1
Imports	19.8	5.6
Gross Domestic Product	**7.1**	**5.0 ~ 6.0**

[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Private consumption is expected to increase by 8.5%. Stable labour market conditions, a supportive credit environment and high commodity prices would continue to provide support to consumption expenditure. Therefore, given the prospects for relatively strong income growth, private consumption expenditure would remain a significant source of stimulus for GDP growth in 2005. In addition to the current favourable economic conditions, long-term factors also are positive for sustained consumption growth. Malaysia presently has one of the lowest private consumption-to-GDP ratios (45.4%) in the world as well as low levels of household indebtedness by international standards. As a result, the scope for sustained growth in private consumption remains high.

Private investment spending is also expected to remain resilient. The projected increase of 9.6% is based on the assessment of higher capital outlays in all sectors except construction. Forward-looking indicators based on demand and growth of new industries suggest a continued upward trend in private investment activities. The Government has provided the enabling environment for the private sector to invest in new areas of growth by putting in place the necessary infrastructure and providing both fiscal and non-fiscal incentives as well as financing facilities. The improvement in the public sector's delivery system and the lower cost of capital will contribute to further enhancing the investment climate, which in turn will promote new FDIs and reinvestment to support domestic investment.

The manufacturing sector, which accounts for about a third of total private sector investment, is projected to record a strong positive growth for the third consecutive year. Capital expenditure for projects already committed to would extend into 2005. In periods of favourable business operating conditions, manufacturers are expected to continue to replace their old or obsolete machinery and equipment to improve their efficiency and enhance flexibility to meet changing demand.

The strongest growth in capital spending is expected in the services sector, particularly in the utilities and telecommunications sub-sectors. Capital expenditure in the utilities sub-sector is expected to be largely concentrated on the ongoing development of a coal fired power plant and water projects. In the telecommunications sub-sector, capital spending is expected to be channelled towards the integration, enhancement and upgrading of the efficiency and capacity of cellular networks. The upgrading of the existing infrastructure would allow the cellular operators to migrate to more advanced technologies, particularly third generation (3G) roaming. Significant efforts are being undertaken not only to develop new applications for these standards but also to ensure the older wireless application protocol (WAP)-based and multimedia messaging services are integrated into the improved technologies. In addition to higher expenditure in the telecommunications sector, IT spending is also expected to increase as a result of efforts by financial institutions and business enterprises to improve their operating efficiency through the adoption of faster and more sophisticated business applications.

Private sector activity would again drive domestic demand in 2005 as the Government continues to pursue a policy of gradual fiscal consolidation. Private consumption would be supported by sustained income growth and an accommodative credit environment, while private investment outlays would provide additional capacities in an environment of strong demand conditions.

Table 3.3
Contribution of Demand Components to Real GDP Growth

	2004*p*	2005*f*
	% point of contribution	
Domestic Demand[1]	**6.6**	**3.9**
Private sector expenditure	6.2	5.1
Consumption	*4.7*	*4.1*
Investment	*1.5*	*1.0*
Public sector expenditure	0.3	-1.3
Consumption	*1.0*	*0.7*
Investment	*-0.6*	*-1.9*
Change in stocks	*2.9*	*-2.3*
Net exports of goods and services	**-2.4**	**3.4**
Exports	17.0	9.6
Imports	19.5	6.1
Gross Domestic Product	**7.1**	**5.0 ~ 6.0**

Note: Figures may not necessarily add up due to rounding.
[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

With the discovery of new oil fields in 2003 and 2004, capital outlays in the oil and gas sector are projected to be higher, driven by exploration and development activities.

Growth would be supported by expansion in the manufacturing, services and commodity sectors. The diversified base of the manufacturing sector would provide support to moderate the impact of the ongoing consolidation in the electronics industry.

Meanwhile, ongoing mechanisation and automation of food production methods would continue to support outlays in the agriculture sector. In the construction sector, capital expenditure would be sustained in the residential segment.

In 2005, public sector expenditure is expected to decline by 4% due to the Federal Government's fiscal consolidation programme. **Public investment** is estimated to register a decline of 11.6%. While Federal Government development expenditure will be lower, spending will be reprioritised to focus on smaller-sized projects with lower costs, including projects to revitalise the agriculture sector and higher spending on education and training; health; and housing. This would benefit a larger section of the population, especially the lower income group, thereby ensuring a more balanced distribution of the benefits of development among the different segments of society. **Public consumption** is expected to increase, albeit moderately by 4.5%, largely on account of higher spending on supplies and services.

Sectoral Outlook

On the supply side, growth would be supported by expansion in all sectors, except construction. Following the strong output expansion in 2004, the manufacturing sector is expected to grow at a moderate pace of 4.5% in 2005, in tandem with developments in the global semiconductor industry. The services sector would remain firm supported by consumption and tourism activities as well as strong expansion in the telecommunication, finance and business services activities. The primary commodity sector would continue to benefit from higher production of crude palm oil, rubber, natural gas and crude oil, as well as increasing contribution from other miscellaneous agriculture, mainly food-related activities. Meanwhile, the construction sector is expected to remain weak due to a decline in activities in the civil engineering segment.

In the **manufacturing** sector, strong external demand for chemical and rubber products as well as sustained growth in the output of domestic-oriented industries, led by the transport equipment and fabricated metal industries, would provide support for growth in the sector. The diversified base would moderate the impact of the ongoing consolidation in the electronics industry.

In the electronics industry, the latest assessment is that the global semiconductor down-cycle would be modest, with the impact mainly felt in the first half of

Table 3.4
Real GDP by Sector (1987=100)

	2004*p*	2005*f*
	Annual change (%)	
Agriculture	5.0	3.3
Mining	4.1	5.0
Manufacturing	9.8	4.5
Construction	-1.9	-1.0
Services	6.7	5.7
Real GDP	**7.1**	**5.0 ~ 6.0**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

2005. Forward-looking indicators in the US including new orders, unfilled orders and the inventory-to-shipment ratio for electronics support the view of a modest downturn. Taking cognisance of the increase in inventories of electronics arising from some over-production in the first half of 2004, manufacturers have responded early to rationalise and reduce their inventories. However, the speed in inventory adjustment varies across the segments. The personal computer (PC)-related segment is positioned to resume growth sooner than the other segments as major global PC producers have succeeded in reducing their inventories significantly since the fourth quarter of 2004.

Meanwhile, global demand for electronics is expected to remain favourable in 2005 supported by the relatively strong global growth. The PC segment would also continue to benefit from the strong demand in the Asia-Pacific region. The growth in the electronics sector would be further reinforced by the continued trend towards increased application of chips in consumer appliances due to the increasing convergence in computing, digital media and wireless technology. Malaysia is therefore expected to benefit from these positive factors, given the diversity in the electronics and electrical products manufactured in the country. More importantly, major multinational companies have been migrating production lines for some of the high value-added products to Malaysia to leverage on the cost-efficiencies in production.

Growth in the **services** sector is projected to be sustained at 5.7%, reflecting expansion across all sub-sectors. The increased resilience is a result of the services sector becoming more diversified over the years. The sector has shifted from depending on a narrow range of activities related to trade and manufacturing to a broader range of activites supported by domestic consumption and growth in new services activities related to tourism and business support services.

The wholesale and retail trade, hotels and restaurants sub-sector is expected to remain strong, in line with the relatively strong consumption activities as well as higher tourist arrivals. The higher travel activities and strong growth in the telecommunications industry is expected to drive growth in the transport, storage and communication sub-sector. Growth would be further supported by port-related activities, including transhipment, in line with the moderate increase in trade. In the telecommunications industry, growth will be driven by a further increase in the subscriber base and introduction of new products and services in the cellular segment. The expansion of the cellular services coverage to the entire country by major cellular providers and increasing convergence of technologies between the cellular and other IT and Internet services will also benefit the industry. The finance, insurance, real estate and business services sub-sector is expected to see another year of strong expansion, led mainly by increased bank lending, continued expansion in fee-based income and robust insurance activities. The pick-up in momentum in ICT-related services and shared services such as business process outsourcing and insourcing activities should see an increase in the business services segment.

The **agriculture** sector is projected to expand further by 3.3% in 2005 following two successive years of strong growth. Growth would be supported by higher palm oil and rubber production as well as miscellaneous agriculture. The increase in palm oil production would be driven by both higher yields and expansion in mature areas, particularly in East Malaysia. Farmers are also envisaged to continue with Good Agriculture Practices, reflecting utilisation of agricultural inputs to increase productivity encouraged by the relatively favourable prices. Following the strongest output growth in more than 30 years to 1.19 million tonnes in 2004, natural rubber production is projected to increase marginally to 1.2 million tonnes in 2005, with smallholders continuing to account for the bulk of the production amidst the firm prices. Growth in the agriculture sector is also expected to emanate from newly promoted areas, such as food crops and food-related activities, particularly fisheries, livestock, fruits and vegetables.

Growth in the **mining** sector meanwhile is expected to strengthen to 5% in 2005, supported mainly by higher production of natural gas in view of the anticipated rise in capacity utilisation of the MLNG plants in Sarawak to meet the increasing global demand. Despite already achieving relatively high production levels in 2004, crude oil production (including condensates) would continue to increase by 1.5% to reach 776,250 barrels per day in 2005 (2004: 762,300 bpd) amidst the strong global demand and relatively high crude oil prices forecast for the year.

The **construction** sector is expected to remain weak (-1%) due to lower civil engineering activity following the completion of several privatised projects as well as lower public spending on infrastructure projects. Nevertheless, activities in the residential and non-residential segments are expected to remain firm. Growth in the residential segment is expected to continue to be driven by sustained demand for houses, encouraged mainly by the continued favourable economic conditions. In the non-residential segment, growth is envisaged to be supported by rising demand for office and retail space, amidst the strong expansion in service-related business activities.

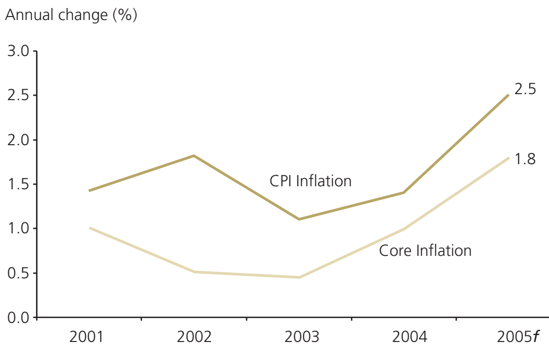
Prices and Employment

Headline **inflation** is projected to average 2.5% in 2005. Inflation is expected to edge up in the first half of the year, reflecting the continuing one-off impact of price adjustments to retail petroleum products as well as higher taxes on cigarettes and tobacco that were implemented in 2004. There may also be some pass-through from higher commodity prices and other developments in the external sector. However, the impact of these factors on headline inflation is expected to be transitory and once the effects wear off, inflation is expected to moderate in the second half of 2005. The continued improvements in productivity and the capacity expansion that have been taking place are also likely to mitigate any build-up of inflationary pressures. Given the lack of significant general demand pressures, core inflation is projected to increase to 1.8%.

The favourable economic growth environment will provide greater **employment** opportunities across most major sectors of the economy in 2005. Unemployment is, therefore, forecast to remain low at 3.5%. Meanwhile, efforts to develop human capital as a catalyst of productivity growth would continue to be pursued. The training opportunities provided would continue to lay emphasis on developing skills and enhancing the value-added contribution from the labour force.

The surplus in the current account of the balance of payments is expected to remain large due to the large trade surplus and smaller services deficit. FDI inflows would be mainly from reinvested earnings by multinational companies, and channelled to higher value-added activities in Malaysia.

Graph 3.5
Consumer Prices



f Forecast

Balance of Payments

On the external front, the **current account** surplus is projected to remain large at 14.9% of GNP as a result of the sustained large surplus in the trade account and the smaller deficit in the services account. The trade surplus is expected to remain large as the moderation in export growth (7%) would be offset by slower

Table 3.5
Balance of Payments

	2004*e*	2005*f*	2004*e*	2005*f*
	RM billion		US$ billion	
Goods	104.5	114.8	27.5	30.2
Trade account	81.1	89.5	21.3	23.6
Exports				
(% annual change)	*20.8*	*7.0*	*20.8*	*7.0*
Imports				
(% annual change)	*26.3*	*6.3*	*26.3*	*6.3*
Services	-8.8	-8.0	-2.3	-2.1
Balance on goods and services	**95.7**	**106.8**	**25.2**	**28.1**
Income	-24.5	-26.4	-6.4	-6.9
Current transfers	-14.6	-14.1	-3.9	-3.7
Current account balance	**56.6**	**66.3**	**14.9**	**17.4**
(% of GNP)	***13.4***	***14.9***	***13.4***	***14.9***
Financial account	15.4		4.0	
Errors and omissions	11.1		2.9	
of which:				
Exchange revaluation gain	*8.0*		*2.1*	
Overall balance	**83.1**		**21.9**	

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

Source: Department of Statistics, Malaysia and Bank Negara Malaysia growth in imports (6.3%). In the services account, receipts are expected to increase with the continuing growth in tourist arrivals. In the financial account, sustained inflows of long-term capital, particularly foreign direct investment (FDI) would also strengthen the overall balance of payments.

In line with the consolidation in the global semiconductor sector, growth in **manufactured exports** is expected to expand at a more moderate pace of 8.6% (2004: 19.7%). Electronics exports are projected to expand by 4.5% in 2005 (2004: 12.7%), with some segments growing at a faster rate, particularly the PC sector, thus providing support to the overall performance of the sector. Exports of non-electronic goods would continue to register a strong growth (12.5%; 2004: 27%), supported by continued demand from PR China, mainly for resource-based products, particularly for petroleum, chemical and rubber products, as well as metal products.

Mineral exports are projected to register a positive growth of 2.2%, as receipts from liquefied natural gas (LNG) and crude petroleum exports would be higher amidst the higher export volume, offsetting the effects of declining prices. Export prices of Malaysian crude oil are expected to stabilise at around US$40 per barrel (2004: US$40.81). Malaysian crude oil prices would be largely influenced by trends in the global oil markets in 2005, as global supply and demand remain finely balanced amidst bullish sentiment supported by geopolitical concerns. Export volume of LNG is projected to increase as the MLNG Tiga plant continues to expand its capacity utilisation on the back of higher offtake from major buyers in 2005.

Table 3.6
Exports and Imports

	2004*p*	2005*f*
	RM billion	
Gross exports	**480.7**	**514.4**
(% annual change)	***20.8***	***7.0***
Manufactures	**390.4**	**424.2**
(% annual change)	*19.7*	*8.6*
of which:		
Electronics	188.6	197.2
(% annual change)	*12.7*	*4.5*
Electrical products	68.4	73.3
(% annual change)	*23.4*	*7.1*
Chemical & chemical products	27.8	32.9
(% annual change)	*31.0*	*18.6*
Minerals	**41.2**	**42.1**
(% annual change)	*38.2*	*2.2*
Agriculture	**36.2**	**30.7**
(% annual change)	*7.4*	*-15.2*
Gross imports	**399.6**	**424.9**
(% annual change)	***26.3***	***6.3***
Capital goods	**55.5**	**57.3**
(% annual change)	*36.1*	*3.1*
Intermediate goods	**287.2**	**305.0**
(% annual change)	*22.0*	*6.2*
Consumption goods	**23.2**	**25.4**
(% annual change)	*24.1*	*9.4*

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Following two successive years of strong performance, **exports of agriculture products** are forecasted to decline by 15.2%, as lower prices more than offset the increase in volume. Export prices of major agriculture commodities are expected to consolidate in line with global developments after two years of strong performance. In particular, the export price of palm oil would be lower at RM1,200 per tonne (2004: RM1,706 per tonne) due to the expected increase in harvests of competing oilseeds, especially soybean oil, as well as higher domestic stocks of palm oil carried over from 2004. While rubber prices are also expected to soften to 440 sen per kilogramme in 2005, this remains a relatively lucrative price level for rubber producers and is in line with expectations of continued demand growth in the international markets. The exports of palm oil and rubber account for the bulk of agricultural exports (63% of total agriculture exports).

Growth in **imports** of 6.3% is expected to be supported by the continued growth in imports of intermediate and capital goods. Intermediate import growth will stem from continued demand for imported components for expansion in manufacturing production, in response to the growth in external demand. Growth in capital imports will be supported by ongoing investment activity and will emanate from upgrading of equipment for new technology and capacity expansion in the manufacturing and services sectors. Higher capital imports in the services industry is expected to be led by capacity expansion in power generation and improvements in network capacity and quality by telecommunication companies. Increased exploration in the oil and gas industry in the wake of discoveries of new fields will also induce growth in capital imports.

The **services account** deficit is envisaged to improve further to 1.8% of GNP. Attractive promotional campaigns targeted at medium- and long-haul tourists are expected to enhance tourism earnings. Capacity expansion by the airlines is expected to contribute to higher export earnings from cargo and passenger services. The expansion in the shared services industry and new products in the ICT sector will continue to underpin the growth in exports of computer and information and financial services. Meanwhile, payments for transportation are expected to be higher, in line with the higher volume of trade and increases in the freight rate. Higher outflows are expected for royalties and licence fees, reflecting the acquisition of new technologies by companies for the production of higher value-added products.

The **income account** deficit is projected at 5.9% of GNP, reflecting larger profits and dividends accruing to multinational companies (MNCs). Profits and dividends accruing to Malaysian companies operating abroad are also expected to be higher. The higher contribution to income is expected mainly from Malaysian companies participating in the oil and gas, plantation and infrastructure sectors.

The **financial account** is expected to remain favourable, supported by long-term capital inflows, in particular FDI. Based on the potential investments announced by MNCs, FDI is anticipated to be channelled to higher value-added activity in the manufacturing sector. The bulk of the FDI will continue to be in the form of reinvestment by the MNCs. Inflows into the services sector, such as the wholesale and retail trade and business and support services are likely to remain high, given Malaysia's advantages in terms of excellent infrastructure, educated and skilled human resources as well as customised fiscal incentives. In the oil and gas sector, recent discoveries of new oil fields are likely to spur greater investment in exploration and extraction activities as well as investment in downstream activities.

Overseas investment by Malaysian companies is expected to remain large, with investment decisions continuing to be driven by companies' desire to gain access to new markets and natural resources, to diversify their earnings and to support domestic activities through vertical integration. In 2005, investments abroad will continue to be broad based, involving both greenfield investments and acquisitions of foreign interests, particularly in the oil and gas, services and manufacturing sectors. Investment abroad by companies in the construction sector is expected to increase following the award of several contracts for large-scale infrastructure projects as well as customised housing and commercial projects to Malaysian companies, particularly in India, Africa and West Asia.

MONETARY POLICY IN 2005

The accommodative monetary policy stance, amidst the low and stable inflation, has positively supported the stronger expansion of domestic economic activity. The stability of the exchange rate, accorded by the pegged exchange rate regime, has also ensured strong external performance and reinforced the expansion in domestic economic activity. Against the prospect of sustained growth in domestic demand and the continued positive external outlook, domestic monetary conditions remain conducive for a sustained expansion in household consumption and provide support for business activity and capacity expansion. On the inflation front, consumer prices are expected to edge up in the early part of the year because of the one-off effect of changes in administered prices, taxes on tobacco and alcoholic products, and possibly some pass-through from the external sector. However, these factors are expected to have a transitory effect and inflation is expected to moderate during the rest of the year. Of importance, the continued sustained growth in productivity, capacity expansions, and the lack of significant general demand pressures would mitigate any inflationary tendencies.

The monetary policy stance in 2005 will continue to take into consideration both global and domestic developments. On the external front, sustained global growth will ensure that the external sector continues to contribute positively to domestic growth. While the pace of global growth is expected to moderate, it will, nonetheless, remain strong. Indicators of economic activity in the major and regional economies continue to remain positive and point towards further expansion in global economic activity. Of importance, the adverse effects from the high crude oil prices on both global growth and inflation have been modest and have not threatened the prospect for continued global growth. While several major and regional countries have pre-emptively tightened their monetary policies, the pace of tightening has been gradual and overall monetary conditions continue to support growth. The inflation outlook in most of these countries has stabilised and any further monetary tightening is likely to be gradual and modest.

On the domestic front, economic fundamentals have strengthened further and there is greater resilience of domestic demand. Consumer spending remains strong amidst the continued increase in household disposable income, stable employment conditions and low borrowing costs. While this has led to higher household debt levels, the ability of the household sector to service its debt remains strong. There has been a continued downtrend in the non-performing loans ratio of the household sector. Therefore, household spending is expected to continue expanding and contribute towards the sustainability of domestic economic activity.

Meanwhile, the current expansion of productive capacity by businesses is expected to continue. While the capacity expansion and new business activity of the corporate sector have so far been financed largely through internal funds, signs of stronger demand for external financing are also emerging. In particular, demand for long-term bank financing by the small and medium enterprises has continued to increase at strong growth rates in recent months. Similarly, while there are strong indications that large corporations would continue to raise large amount of funds from the private debt securities and equity markets, long-term financing sourced from the banking institutions is also likely to remain important. With the steady improvement in the corporate sector's financial position, banking institutions have actively responded to the financing requirements of the business sector. These positive underlying developments are expected to support further expansion in business investment activity, while providing the flexibility for fiscal consolidation to take place without any adverse effects on the level of economic activity. The continued expansion in productive capacity and improvements in productivity would enable businesses to better meet growing demand, and help mitigate upward pressures on wages and prices.

A key development in the international financial markets has been the gradual and sustained depreciation of the US dollar against major and regional currencies on account of the growing deficits in the current and fiscal accounts of the US. While the ringgit has depreciated along with the US dollar, its overall undervaluation, taking into account the performances of the currencies of Malaysia's major trading partners, has been relatively small. Consequently, the pass-through effect into domestic prices from the depreciation of the ringgit is likely to be modest. In the absence of any substantial misalignment of the ringgit, due to external or domestic changes in fundamentals, the pegged exchange rate regime continues to accord significant benefits to the Malaysian economy by providing a stable environment to support trade and investment.

To ensure price stability and sustainable growth, monetary policy will remain flexible and responsive to emerging trends in macroeconomic conditions. While prevailing circumstances continue to warrant the maintenance of the current accommodative monetary stance, pre-emptive action will be taken if developments indicate a significant shift in growth and inflation prospects. Policies will always aim to ensure that the levels of interest rates and market liquidity remain appropriate and continue to support private sector activity.

FISCAL POLICY IN 2005

With the private sector assuming the role as the main driver of growth, fiscal consolidation is on course to further strengthen the Government's financial position in 2005. The thrust of fiscal policy in 2005 will be to progress forward with a further gradual reduction of the fiscal deficit through prudent financial management, while efforts to support private sector initiatives will focus on providing a strong enabling environment to support increasing productivity and reducing the cost of doing business. As announced in the 2005 Budget, strategies were aimed at developing human capital, increasing productivity, enhancing research and development capabilities, supporting new sources of growth and improving the quality of life for all Malaysians. The Government will emphasise efficiency in its delivery system and effectiveness in its financial management. Fiscal consolidation in 2005 will move forward through revenue enhancement and expenditure reduction.

In terms of revenue enhancement, the focus will be on streamlining tax measures, improving tax administration and enforcement. A new consumption tax will be introduced in 2007, with a shift away from the present narrow based sales and services taxes to a more comprehensive goods and services tax, based on a value-added concept. The new tax is expected to be more efficient, transparent and broad based.

Total Federal Government expenditure (excluding contingency reserves) was budgeted to be lower at RM117.4 billion, declining by 4.2% from the estimated 2004 expenditure, with development expenditure falling by 9.1% to RM28.3 billion. Overall government spending will be reduced in a prudent manner without creating adverse implications for the economy. Efficiency of expenditure will be pursued by means of cost effectiveness and the re-prioritisation of projects to benefit a larger segment of the population, especially the lower income groups and the rural population. Hence, projects aimed at reducing the rural-urban socio-economic gap and revitalising the agriculture sector will be prioritised. Special attention will also be given to developing the rural infrastructure and promoting the development of small and medium enterprises (SMEs).

Reflecting its fiscal prudence and consolidation stance, the Federal Government is expected to register a lower fiscal deficit of RM17.7 billion or 3.8% of GDP in 2005. In addition, after taking into account the potential net revenue gain of RM72 million arising from the tax measures in the 2005 Budget, the overall fiscal deficit will be marginally lower at RM17.6 billion. The bulk of financing will be raised from the domestic market given the ample liquidity in the financial system.

Key strategies in the 2005 Budget are aimed at supporting private sector activity, raising productive potential and widening the export base to support long-term sustainable growth. Towards this end, various tax and non-tax incentives were directed at accelerating the shift towards higher value-added growth in niche areas, with greater emphasis on agriculture as the third engine of growth, enhancing the services sector (especially Information and Communications Technology, Islamic banking and finance, and tourism) and strengthening the manufacturing sector. In the agriculture and agro-based sectors, tax incentives and measures were introduced to further modernise and commercialise the sector. The measures for the manufacturing sector included incentives for outsourcing manufacturing activities, relocating investments to promoted areas, especially the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak, and the development and promotion of halal products. In addition, incentives were provided to develop the SMEs as a key growth catalyst. Two special funds under the administration of Bank Negara Malaysia were enhanced, while new funds were established to increase technological capability, market penetration and training to enhance the management of SMEs.

Measures also continued to focus on enhancing the country's efficiency and productivity and overall competitiveness to enable Malaysian companies to compete globally. These incentives were directed at reducing the cost of doing business, enhancing human capital development with emphasis on increasing skilled manpower and creating capable and dynamic entrepreneurs. Incentives were also targeted at increasing innovation through greater focus on research and development (R&D) and spearheading the commercialisation of local R&D. Several measures were introduced to further strengthen the capital market.

FINANCIAL SECTOR POLICY IN 2005

In an increasingly competitive and dynamic operating environment, the thrust of financial sector policy for 2005 will continue to be directed at enhancing the competitiveness of the financial sector, as well as promoting a sound and robust financial system that is able to support economic growth and development. Emphasis would also continue to be accorded to further strengthen the consumer education and protection framework. Ensuring continuous access to financing for all segments of the economy will remain as an important endeavour in 2005. There will also be further deregulation and liberalisation with progressive infusion of competition into the financial sector. This is so as to not disrupt the system and the overall policy objectives.

For the banking sector, policy measures will continue to focus on enhancing the capacity and capability of domestic banking institutions, to prepare them for greater liberalisation and competition as outlined in the second phase of the Financial Sector Masterplan. Capacity building measures implemented over the past few years have yielded positive results and these efforts will continue to be pursued in 2005 to ensure continuous improvement in the performance of the domestic banking institutions. This includes the benchmarking initiative, which began in 2000 that has provided banking institutions with the ability to assess their performance against their peers and identify the areas of opportunities to better themselves. With the narrowing of the gap in the performance between the domestic and foreign banking institutions, policy measures will also focus on enhancing competition in the banking system. Greater operational flexibility will be accorded to the locally incorporated foreign banks to enable them to contribute more effectively to the development of the financial sector and economy as a whole.

The year 2005 will see further rationalisation within the financial sector, with more mergers of commercial bank and finance company entities within a domestic banking group taking place. The capital and regulatory, as well as the legal framework governing investment banks will be finalised. With the advent of investment banks, similar activities carried out by various entities involved in capital market activities will be integrated under one roof. This will result in synergies and economies of scale, and consumers would be able to enjoy a wider range of financial services at a 'one-stop' centre. An investment banking industry that is dynamic and competitive will act as a catalyst to the development of a vibrant and efficient capital market that can contribute towards economic transformation and growth.

Maintaining financial stability remains a priority. During the year, a number of major policies will be implemented to further enhance the prudential framework and to safeguard the soundness of banking institutions. A second concept paper will be issued on the consolidated supervision framework of financial conglomerates, the objective of which is to provide regulators with a holistic approach in assessing the financial health of the conglomerates. It will also facilitate monitoring of the activities of financial conglomerates such that the non-depository institutions within the group will not introduce excessive risk to the depository institutions in particular, and to the financial system in general. Extensive discussions with the industry will take place on the implementation of the new Basel Capital Accord in 2008 as it is critical to ensure that the necessary skills and expertise are harnessed and systems infrastructure is in place to facilitate a smooth transition to the new Basel Capital Accord. Risk management of banking institutions will be further improved with the inclusion of market risk in the Risk Weighted Capital Ratio framework that the banking institutions are required to fully comply with from April 2005.

In response to the changing financial landscape and to provide a more flexible operating environment, policies pertaining to the extension of credit by banking institutions to a single customer and connected parties, as well as guidelines on non-performing loans, are being reviewed. The shareholding policy will be further refined to encourage corporate shareholding and promote shareholder activism. Shareholders are expected to be more proactive and play a more diligent role in monitoring performance of banking institutions and the effectiveness of the board of directors and management. A review of the guidelines on anti-money laundering and 'Know Your Customer' policy will also be carried out to incorporate measures on anti-terrorism financing. It is critical to ensure that the integrity of the banking system, as the mobiliser of funds, remains intact by determining that funds flowing through the system are derived from legitimate sources and are used for legitimate purposes. In addition, effective corporate governance practices are critical to ensure the proper management of an institution. In this regard, Bank Negara Malaysia will be issuing a comprehensive guideline on corporate governance to replace the current Guidelines on Directorship in Banking Institutions (BNM/GP1), covering amongst others, the broad principles of corporate governance and minimum standards and specific requirements on the role and structure of the Board and management, as well as ensuring checks and balances. Efforts would also be focused on developing additional tools to enhance the banking system's surveillance framework. These tools would facilitate the identification of emerging vulnerabilities and state of resilience both in the system and at individual institution level.

Another primary thrust for the year will be to continue enhancing access to financing by all segments of the economy. Banking institutions will continue to be the main provider of funds in the economy through continued expansion in lending activities and remain as an important contributor to economic growth and development. Efforts will continue to encourage banking institutions to channel funds to the small and medium enterprises (SMEs), as well as to increase financing to the agriculture and agro-based industries and to microenterprises, which are potential growth areas.

Measures to enhance and further strengthen the consumer education and awareness framework, as well as the consumer protection infrastructure, will continue to be a priority in our efforts to develop an efficient, dynamic and competitive financial sector. Additional booklets and fact sheets will be issued under the consumer education programme and the programme will adopt a more targeted approach by tailoring information for specific groups. Also, with effect from 1 February 2005, banking institutions will be required to adhere to the framework on basic banking services. Another milestone that took place in January 2005 was the launching of the Financial Mediation Bureau, to serve as a one-stop centre for the resolution of a broad range of retail consumer's complaints against financial institutions regulated by Bank Negara Malaysia. It is also vital that consumers realise their growing role and responsibility in taking control of their financial decisions. Banking institutions should facilitate this process by providing consumers with accurate information regarding their products and services so that they are able to make informed decisions. In this regard, further guidelines will be issued to require product-specific and institutional transparency and full disclosure. Emphasis will also be given to the development of a structured and comprehensive framework on fair market practices that will foster greater competition and promote equitable market practices amongst banking institutions. In addition, as part of the efforts to strengthen the consumer protection infrastructure, a deposit insurance system is being established. The framework on the system has been finalised and the Deposit Insurance Bill will be tabled in the Parliament this year.

The focus for the payment systems in 2005 is to further improve accessibility to electronic payment systems, enhance efficiency and improve security measures to spur the migration to electronic payments. Arising from the major accomplishments that were achieved by the financial institutions in 2004, efforts will be continued to enhance the accessibility to electronic payment systems by utilising convenient delivery channels such as internet banking and ATMs, and through extensive deployment of card acceptance devices. Bank Negara Malaysia will facilitate an industry-wide collaboration to further improve the security measures in internet banking transactions, enhance cross-border payments mechanisms, promote payment related standards to facilitate payment referencing and improve efficiency and services of the inter-bank giro system to increase its usage. The consumer protection framework in payment related services, such as measures to promote responsible lending in credit cards and to avoid over-indebtedness, will also be enhanced.

As for the Islamic banking sector, the major policy thrust in 2005 will focus on further strengthening the Islamic banking system as an integral component of the Malaysian financial system. The policy thrust will centre on the enhancement of institutional structure, regulatory and prudential structure, legal and Shariah framework, product and market development, and human capital development and consumer education. In terms of the institutional structure, it is envisaged that there will be greater dynamism in the Islamic banking market following the issuance of Islamic banking licences to foreign financial institutions and the establishment of Islamic subsidiaries by the domestic banking groups. The exercise is expected to stimulate more competition and product innovation in the market. To meet the increasing manpower requirements, an initiative is also being taken to enhance the intellectual capital and expertise with the objective of creating a larger pool of experts and high calibre professionals in Islamic banking and finance.

To enhance the effectiveness of the regulatory and prudential structure, efforts will be directed at strengthening the provisioning and liquidity framework to meet the specific requirements of the Islamic banking operations. The development of an Islamic reference rate to act as a benchmark for the pricing of Islamic banking products will be pursued. To promote sound development of the legal infrastructure, the review of the Islamic Banking Act 1983 will be accelerated and undertaken on a comprehensive basis to keep pace with the development of the Islamic banking market. Transparency in banking practices will be an important focus for the year as part of the efforts to increase customer awareness and satisfaction.

Policy thrust for the development financial institution (DFI) sector in 2005 will continue to focus on further enhancing the capacity and capability of DFIs in providing financial and non-financial support to the targeted sectors of the economy. In particular, efforts are being undertaken to implement the merger of the Export-Import Bank of Malaysia Berhad and Malaysia Export Credit Insurance Berhad, and the rationalisation of lending activities of Bank Industri & Teknologi Malaysia Berhad and Bank Pembangunan dan Infrastruktur Malaysia Berhad. The rationalisation exercise aims to enable these institutions to operate in a more focused manner, and facilitate the transformation of these institutions as specialists in rendering financial and advisory support to their respective targeted sectors. The project to enhance the advisory capability of selected DFIs for the SMEs is targeted to be completed in 2005. The expected improved capability of these DFIs to provide quality non-financial services would increase their effectiveness in serving the SMEs. To complement strategies on capacity building, continuous efforts will also be pursued in 2005 to further strengthen the financial and operational soundness, corporate governance and risk management practices, in order to create a group of sound, dynamic and efficient DFIs that supports the Government's development objectives at minimal cost.

Liberalisation of the Foreign Exchange Administration Rules

The foreign exchange administration rules are aimed at providing an appropriate framework that will influence capital flows and facilitate currency risk management to promote financial and economic stability of the country. The rules complement the overall macroeconomic policies and are reviewed regularly in line with the changing environment.

On 1 April 2004, in conjunction with the release of the Bank's Annual Report 2003, several major foreign exchange administration policies were liberalised to promote the efficiency of business operations in Malaysia and better risk management of investments.

With effect from 1 April 2005, the Bank announced further relaxations to the foreign exchange administration rules as part of its ongoing initiatives towards reducing cost of doing business, improving regulatory delivery system and encouraging better risk management activities by residents and non-residents as well as promoting the development of domestic foreign exchange market to promote stability in the financial system and economy of the country. The liberalisations are in the following areas:

(i) Forward Foreign Exchange Contracts by Residents and Non-residents

To allow businesses and individuals to effectively manage their risks, residents and non-residents may enter into forward foreign exchange contracts with licensed onshore commercial and Islamic banks (licensed onshore banks) and approved merchant banks without prior permission of the Controller of Foreign Exchange (the Controller) to buy or sell foreign currency against ringgit or another foreign currency as follows:

- **Residents** are now allowed to enter into forward foreign exchange contracts to hedge the following:
  - (a) Foreign currency exposures of permitted overseas investments;
  - (b) Payment for permitted overseas investments;
  - (c) Repayment of principal and payment of interest for foreign currency credit facilities (onshore or offshore) which are payable within 24 months; and
  - (d) Anticipatory receipts from exports and anticipatory payments for import of goods and services, based on the value of export receipts and import payments of the preceding 12 months.

  With the above flexibility, residents may now effectively hedge all committed and anticipatory inflows and outflows of their current account transactions (i.e. payments for export and import of goods, services and income) and committed inflows and outflows for capital account transactions (e.g. payments for overseas investments and extension of credit facilities to non-residents or repayments of credit facility from non-residents) as well as safeguarding the value of their overseas investments.

- In addition, **non-residents** are now allowed to enter into forward foreign exchange contracts for the following committed flows of funds:
  - (a) Repatriation of investment proceeds from Malaysia; and
  - (b) Purchase of ringgit assets in Malaysia.

(ii) Maintenance of Foreign Currency Accounts (FCA) by Residents and Conversion of Ringgit into Foreign Currency for Credit into FCA

The rules on the maintenance of FCA by residents are also liberalised further to facilitate effective cash flow management and to promote business efficiency.

- Residents are now free to open FCA with licensed offshore banks in Labuan and overseas banks for any purpose, except for the retention of export receipts. With this flexibility, residents may retain their foreign currency receipts (other than export proceeds) in FCA maintained with licensed onshore banks, licensed offshore banks in Labuan and overseas banks with no overnight limits imposed on these accounts.

- Resident companies maintaining FCA with licensed offshore banks in Labuan and overseas banks are required to submit monthly statement, Statement OA, to the Controller.

- Residents may also convert ringgit into foreign currency for credit into these FCA maintained with licensed onshore banks, licensed offshore banks in Labuan and overseas banks as follows:
  (a) Any amount for residents (companies and individuals) without any domestic credit facilities;
  (b) Up to RM10 million per calendar year on a corporate group basis by resident companies with domestic credit facilities; and
  (c) Up to RM100,000 per calendar year by resident individuals with domestic credit facilities.

- Residents are now free to retain any amount of export receipts in FCA maintained with licensed onshore banks. The limits imposed on export FCAs are, accordingly, uplifted.

With the removal of the limits, effectively all FCA maintained with licensed onshore banks (except for FCA for overseas education and employment purposes by residents with domestic credit facilities) are free from any overnight limits.

- The aggregate overnight limits on FCA for overseas education and employment purposes maintained by residents with domestic credit facilities remain as follows:
  (a) US$150,000 for FCA maintained with licensed onshore banks or licensed offshore banks in Labuan respectively; and
  (b) US$50,000 for FCA maintained with overseas banks.

(iii) Domestic Credit Facilities to Non-resident Controlled Companies (NRCCs)

The RM50 million limit on extension of credit facilities to a NRCC by residents as well as the 3:1 gearing ratio requirement imposed on NRCC for its domestic borrowing exceeding RM50 million are abolished. With the abolishment, residents are now free to extend any amount of ringgit credit facilities to NRCCs.

(iv) Investment Abroad

As part of efforts to further enhance management of funds and provide diversification of business opportunities, the rules on investment abroad by residents have also been liberalised.

- Residents with no domestic credit facilities are now free to invest any amount abroad. The investment may be made through the conversion of ringgit or from foreign currency funds retained onshore or offshore. Overseas investment funded by foreign currency borrowing will be limited to only RM10 million equivalent at any one time.

- Residents with domestic credit facilities are also free to invest abroad their foreign currency funds maintained onshore or offshore. In addition, they are allowed to convert ringgit into foreign currency up to the following limits for overseas investments:
  (a) Up to RM10 million per calendar year by companies on a per corporate group basis; and
  (b) Up to RM100,000 per calendar year by individuals.

For companies converting ringgit for overseas investments, they must have a minimum shareholders' funds of RM100,000 and must be operating for at least one year.

In addition, they may finance overseas investment with foreign currency borrowing up to RM10 million equivalent at any one time.

- The limit that can be invested abroad by unit trust management companies is also increased to 30% from 10% of the Net Asset Value (NAV) attributed to residents. Fund/asset managers may now invest abroad any amount of investment of resident clients without any domestic credit facilities and up to 30% of investments by resident clients with domestic credit facilities. The funds may be pooled for investment abroad. Such investments must be in line with the Securities Commission's prudential guidelines.

- Resident insurance companies and takaful operators may also invest abroad up to 30%, increased from 10%, of the NAV of the investment-linked funds that they market. These investments are subject to compliance with prudential insurance and takaful regulations issued by Bank Negara Malaysia.

- The above flexibilities are subject to prior registration of any overseas investments exceeding the equivalent of RM50,000 with the Controller.

(v) Foreign Currency Credit Facilities

To enhance expediency in managing business in Malaysia, the limit for residents to obtain foreign currency credit facilities from non-residents, licensed onshore banks and licensed merchant banks in Malaysia is increased from the current limit of RM5 million equivalent.

- Resident companies on a corporate group basis may now obtain foreign currency credit facility up to an equivalent of RM50 million in aggregate.

- Resident individuals are allowed to obtain foreign currency credit facility up to an equivalent of RM10 million in aggregate.

- The above flexibilities are subject to prior registration of any foreign currency credit facility exceeding RM1 million equivalent with the Controller.

- Residents may prepay their foreign currency credit facilities subject to the registration of such prepayments with the Controller prior to effecting the payments.

- Residents may also utilise up to an aggregate of RM10 million equivalent of their foreign currency credit facilities to finance overseas investment activities.

(vi) Activities by Approved Operational Headquarters (OHQs)

In line with the relaxation on residents for retention of export proceeds and overseas investments as well as freedom to obtain domestic credit facilities by NRCC, OHQs may now:

- Retain any amount of export receipts in their FCA maintained with licensed onshore banks;

- Obtain any amount of ringgit credit facilities from domestic sources; and

- Finance their overseas investment activities, including extension of credit facilities to non-residents, by converting up to RM10 million into foreign currency per calendar year if they have domestic credit facilities.