BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Statutory Requirements

In accordance with section 48 of the Central Bank of Malaysia Act 1958, Bank Negara Malaysia hereby publishes and has transmitted to the Minister of Finance a copy of this Annual Report together with a copy of its Annual Accounts for the year ended 31 December 2003, which have been examined and certified by the Auditor-General. The Annual Accounts will also be published in the Gazette.

Zeti Akhtar Aziz
Chairman
Board of Directors

26 March 2004

Board of Directors

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D.S.D.K.
Deputy Governor

Dato' Ooi Sang Kuang
D.M.P.N.
Deputy Governor

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Datuk Oh Siew Nam
P.J.N.

Tan Sri Datuk Amar Haji Bujang bin Mohd. Nor
P.S.M., D.A., P.N.B.S., J.S.M., J.B.S., A.M.N., P.B.J. P.P.D.(Emas)

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P.S.M., D.I.M.P., D.M.S.M., D.G.P.N.

Dato' N. Sadasivan
D.P.M.P., J.S.M., K.M.N.

Governor	Dr. Zeti Akhtar Aziz
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Deputy Governor	Dato' Ooi Sang Kuang
Assistant Governor	Datuk Zamani bin Abdul Ghani
Assistant Governor	Dato' Mohamad Daud bin Hj. Dol Moin
Assistant Governor	Datuk Latifah Merican Cheong
Assistant Governor	Dato' Mohd Razif bin Abd. Kadir
Secretary to the Board	Mohd Nor bin Mashor
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Economics	Dr. Phang Hooi Eng
International	Wan Hanisah binti Wan Ibrahim
Foreign Exchange Administration	Mahdi bin Mohd. Ariffin
Statistical Services	Chan Yan Kit
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Insurance Regulation	Donald Joshua Jaganathan
Islamic Banking and Takaful	Bakarudin bin Ishak
DFI Regulation	Che Zakiah binti Che Din
Risk Management	Teo Kee Tian
Supervision	
Bank Supervision I	Azizan bin Haji Abd Rahman
Bank Supervision II	Chung Chee Leong
Insurance Supervision	Sani bin Ab. Hamid
Payment Systems	Ahmad Hizzad bin Baharuddin
Information Systems Supervision	Ramli bin Saad
Special Investigation	Kamari Zaman bin Juhari
Financial Intelligence	Koid Swee Lian
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Investment Operations and Financial Market	Muhammad bin Ibrahim
Finance	Abdul Aziz bin Abdul Manaf
Organisational Development	
IT Services	Hong Yang Sing
Human Resource Management	Mainor bin Awang
Human Resource Development Centre	Lim Lai Hong
Corporate Services	Mohd Nor bin Mashor
Corporate Communication	Abu Hassan Alshari bin Yahaya
Strategic Planning	Mior Mohd Zain bin Mior Mohd Tahir
Currency Management and Operation	Hor Weng Keng
Security	Ahmad bin Mansur
Property and Services	Zulkifli bin Abd Rahman
Chief Representative	
London Representative Office	Lillian Leong Bee Lian
New York Representative Office	Shamsuddin bin Mohd Mahayiddin
Branch Manager	
Pulau Pinang	Ong Boon Teck
Johor Bahru	Ishak bin Musa
Kota Kinabalu	Yusoff bin Yahaya
Kuching	Nallathamby s/o Nalliah
Kuala Terengganu	Mokhtar bin Mohd Noh
Shah Alam	Hamzah bin Abu Bakar

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Governor's Statement

BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

The more optimistic global environment and stronger domestic economic conditions have enhanced Malaysia's prospects as we advance into 2004. The renewed strength of the recovery of the world economy is now supported by a more synchronised expansion of the major industrial economies and the strong growth in the Asian region. While economic and financial policies have been important in providing the stimulus to the improved overall growth performance, the increasing significance of the private sector in driving this growth has increased the prospects for the sustainability of these positive trends.

Strong domestic demand has been particularly evident in the Asian region, reflecting the increased role of the private sector in driving the growth. This strong growth in regional demand has provided a rapidly expanding market for Asian goods and services. The increased regional integration is, however, not only occurring as a result of the growth in intra-regional trade, but also in the form of financial flows, with intra-Asian investments gaining greater significance, resulting in a growing amount of the savings in Asia being reinvested in the region. As these trends become more pronounced, they would not only contribute towards greater regional integration but would also reinforce further the regional growth momentum. In addition, the growing demand from the Asian economies has also been increasingly supportive of the global recovery. Indeed, this trend would contribute towards reducing the external imbalances existing in the global economy and increase the prospects for a more balanced global growth.

The Malaysian economy in 2003 benefited from the more robust external demand and increased private sector activity in the domestic economy. A better-than-expected economic performance of 5.2% was recorded during the year. The growth momentum is projected to strengthen further in the region of 6 – 6.5% in 2004, with the private sector assuming the lead role as the engine of growth. Private consumption and investment activity are projected to be stronger, underpinned by improved economic and employment conditions and stronger balance sheets in both the corporate and financial sectors. Growth is expected to be stronger across almost all sectors of the economy, with the services and manufacturing sectors being the main drivers of growth. While the role of the Government in the economy remains important, the focus of policy has now shifted to providing an enabling environment, including enhancing the Government delivery system to reduce the cost of doing business, and to providing a stable and sound macroeconomic environment.

The underlying economic and financial fundamentals have continued to strengthen in the early part of 2004, according monetary policy the flexibility to remain supportive of private sector activity. This is reflected in the near absence of inflationary pressures in both the consumer and asset markets and excess capacity in the system, evident in the gap between actual and potential output. Price stability has also been reinforced by productivity improvements and further capacity expansion. In addition, as the globalisation process intensifies, there is increased access to goods and services at lower costs. Moreover, as the corporate sector performance improves, higher costs will not always translate into higher prices in this more competitive environment. The Government's fiscal prudence has also been a factor in reinforcing price stability. Against this environment, low interest rates can remain for some time to come.

In this stable environment, and with the much strengthened banking system and progress achieved in the development of the financial infrastructure, it is timely to transition to the new interest rate framework. The aim is to achieve greater efficiency in the operations of the financial markets and thus facilitate more effective pricing in the financial system as well as enhance the effectiveness of the monetary transmission mechanism. The window of opportunity will therefore be taken during this period when the current interest rate policy will remain unchanged. This will provide the market with the opportunity to adjust to the new monetary operating procedures to achieve the desired outcome of more efficient functioning financial markets and increased effectiveness of monetary policy.

Liquidity has remained ample in an environment of a strong external balance, a steady inflow of foreign direct investment and increased portfolio inflows. Sterilisation operations, however, have been conducted, taking into consideration the need to ensure adequate liquidity to support financing of the private sector-led growth, while at the same time, ensuring that this does not result in any risks to the financial system and to the economy. Important to this process is that the Central Bank has the instruments and the capacity to absorb this liquidity. The costs involved in these operations are essentially covered by the returns on the investment of the increased inflows. The Central Bank will absorb such immediate-term costs of monetary policy to ensure the stability and sustainability of our medium and long-term prospects. In the current environment, the net position has continued to remain positive. In managing the reserves, a well-diversified reserves portfolio is maintained. Major considerations taken into account are capital preservation and liquidity, while optimising returns. This has ensured a sound financial position for the Central Bank.

On the exchange rate, the objective of our policy remains unchanged, that is, to achieve exchange rate stability, in particular, with our trading partners. As our trade with the region becomes increasingly significant, exchange rate stability in the region becomes increasingly important. At the very outset, when the pegged exchange rate arrangement was introduced almost six years ago, we have stated that we want an effective exchange rate mechanism that will efficiently facilitate international trade and investment. While there may be trade-offs, the benefits of the present system have far outweighed any costs. Consideration for an alternative system should only be made in the event of anticipated fundamental misalignment or structural change or if new regional arrangements can be evolved.

Extreme movements and high volatility in exchange rates have always been a concern, even to the major economies. For emerging market economies, the ramifications of such movements are even more pronounced and far-reaching. Recent pronouncements and pressures on Asian economies to adopt more flexible exchange rate regimes have been based on the view that adjustments in the exchange rate would correct structural imbalances in the global economy. It needs to be recognised that the comparative advantage that Asia possesses is not due to exchange rates but reflects other factors that have resulted in lower costs. Adjustments in exchange rates are therefore unlikely to correct such structural imbalances. In addition, whether exchange rate appreciation can address any signs of overheating needs to take into account the nature of the price pressures. In situations where the pressures are sectoral or localised, other measures, including prudential measures, may be more effective in addressing these developments. Indeed, the exchange rate should not be used for the purpose for which it may not be able to yield the desired results.

In strengthening our competitiveness, Malaysia has adopted a more comprehensive strategy, addressing all dimensions that will enhance competitiveness. This includes strategies to enhance labour quality and productivity, innovation, enterprise and the public delivery system, applied not only to the manufacturing sector but to all sectors of the economy. The strategy is essentially to assess costs on a more comprehensive basis. The strategy is towards achieving an enhanced overall cost competitiveness, leveraging on our low country risk, including the economic, social and political stability, reliable intellectual property protection framework, and our industrial maturity. Moving forward, efforts will therefore be focused on developing an efficient supply chain that is reinforced with local supporting industries, and on becoming more knowledge-based with the necessary skills and competencies.

An integral part of the strategy on competitiveness is to develop a robust Small and Medium-Scale Enterprises (SME) sector that will be able to contribute more significantly to the economy. Two years ago, Bank Negara Malaysia proposed a comprehensive framework for the development of SMEs to provide an enabling environment and to strengthen the infrastructure for SME development. The progress of the work achieved thus far will be deliberated by the National SME Development Council. The Council, which is being set up by the Government, will function as the highest policy-making body that will chart the future direction and strategies for SME development and ensure coordination and comprehensiveness of the policies.

As part of the efforts to enhance overall cost competitiveness, reduce country risks and sustain our position as a destination of choice for both local and foreign investors, a gradual liberalisation of rules and regulations will be undertaken by Bank Negara Malaysia to improve the delivery systems and reduce regulatory costs to business. Leveraging on technology to improve the surveillance system on capital flows has improved the ability to monitor the risks associated with these flows. This has therefore enabled the further deregulation and liberalisation of foreign exchange rules. In addition to the liberalisation in early 2003, further liberalisation of foreign exchange rules will take effect from 1 April 2004 to improve efficiency in the delivery system, while further reducing the cost of doing business.

In the development of the financial system, significant progress has been achieved during the first three years of the Financial Sector Master Plan. The efforts to evolve a more diversified financial structure that is complemented with the development of strengthened financial institutions have now yielded positive results. While the banking sector is still the main mobiliser and provider of financing, the more diversified financial infrastructure has increased the potential for new and alternative channels to mobilise savings as well as increased the alternative sources of financing. Financing from the capital market, in particular, the private bond market, specialised financial institutions and the insurance sector, have now become more significant. The provision of financial services to micro-enterprises has also been strengthened, while venture capital as an alternative form of financing has provided increased support to the new areas of growth that are more technology and knowledge intensive.

Significant progress has been achieved on institutional development and capacity building. The level of capitalisation, the capacity to lend to a wider range of activities, the level of operational efficiency, the level of skills, the more differentiated scope of business, the level of innovation, the standards of service quality and the risk management capacity have shown significant improvements. This is reflected, in particular, in the lower operating costs, the narrowing of margins, and the wider range of new products and services. These improvements are also reflected in the ability of the domestic institutions to maintain market shares in an environment of increased competition and narrowing margins.

The supporting infrastructure has also been strengthened to reinforce this trend. These include the consumer education programme, the strengthening of the Credit Guarantee Corporation, the establishment of the International Centre for Leadership in Finance to develop world-class leaders in the financial services sector and the new Financial Mediation Bureau to be established this year. Work is also underway to develop a deposit insurance scheme that will add another layer to the consumer protection framework, representing a further building block in our financial infrastructure. Of significance is that it is designed to take into account the structure and conditions in our financial system and economy. The deposit insurance system will have a broader mandate that will integrate the financial restructuring processes and structure within its operations. The system will also be the first to provide for the protection of Islamic deposits in line with Shariah principles. These developments have also been complemented by improvements in the regulatory and supervisory framework to ensure the soundness and resilience of the financial system.

Access to financing to a wider range of activities in the private sector, in particular, to the SMEs, continues to improve. Outstanding loans to SMEs grew at an annual rate of 10% in 2003. Financing to the private sector and to the SMEs is expected to remain robust in 2004. Other measures that have supported this trend include the establishment of the Small Debt Resolution Committee, supported by Bank Negara Malaysia's SME Special Unit and continued availability of Bank Negara Malaysia's special funds that currently amount to RM5.6 billion. New avenues are also being developed to increase the SMEs' access to capital market funding.

As the financial sector evolves to meet the needs of increasingly sophisticated consumers, attention has been directed to ensure that basic banking facilities are widely available and that these facilities are offered at minimal costs to all segments of society. In addition, as banking consumers become more empowered by their awareness of financial products and facilities, they will exercise their rights and ability to select between products and services offered by different institutions. This, combined with the transparency requirements, will ensure that pricing is commensurate with the financial products and services. The competitive process is also expected to result in more competitive pricing of products and services and encourage greater innovation.

The insurance industry continued to perform an important role in supporting economic growth as a mobiliser of long-term funds and as a risk transfer mechanism. An important aspect in the development of the insurance industry is also the increasing socio-economic role of insurance in meeting the demand for healthcare financing support. This is being realised through the increasing provision of medical and health insurance products. As major institutional investors, insurers have an increasingly important role in the development of the capital markets. The insurance fund assets have increased significantly in 2003 to account for the largest share of the total fund assets of the industry. During the year, the framework governing insurance market practices, including claims handling practices, standards of product disclosure and dispute resolution mechanisms, were further strengthened to ensure greater consumer protection. A comprehensive consumer education programme was also launched to promote a larger role for consumer activism in the insurance business and practices and to ensure competitive prices to consumers.

The comprehensiveness of the Islamic financial system in Malaysia, in terms of both the pool of Islamic financial players as well as the broad spectrum of innovative Islamic financial products have enhanced the role of the Islamic financial system as a financial intermediary and enabler of economic growth. Further progress in the development and expansion of the Islamic financial system was achieved in 2003. Policy initiatives have focused on liberalising the domestic Islamic banking system, increasing the level of competition, and promoting financial innovation. Other measures were also directed towards strengthening and broadening the legal framework for Islamic banking and finance. On the global front, the Islamic Financial Services Board (IFSB) has drawn wide participation and has made significant progress in fulfilling its mandated role. The promulgation of standards on the capital adequacy and risk management is progressing rapidly and work on establishing standards for corporate governance has already been initiated. The year has also seen further Islamic-based issues accessing the international capital markets. Cumulatively, these developments have enhanced the role of Islamic finance as an integral component of the international financial system.

Bank Negara Malaysia has continued its developmental role during the year, over and above our core mandate of monetary and financial stability. This broader mandate is outlined in our Financial Sector Master Plan and essentially takes a holistic approach in the development and management of the financial system. While efforts to address areas of vulnerability and identifying emerging risks are important, these need to be complemented with efforts to build the financial infrastructure. Institutional and capacity building are necessary foundations for the financial system. It is in this context that the Central Bank drives the development of the financial sector.

Zeti Akhtar Aziz
Governor

26 March 2004

The Malaysian Economy in 2003

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The Malaysian Economy in 2003

The Malaysian economy demonstrated greater resilience in the face of uncertainties to expand by 5.2%, more rapidly than previously forecast.

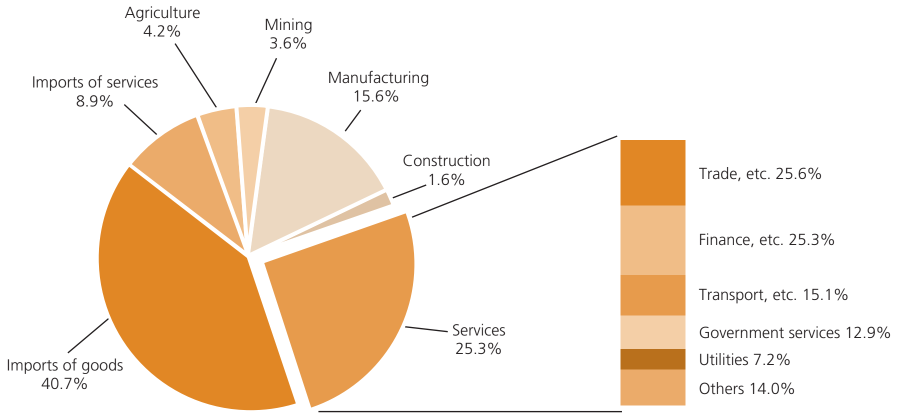
OVERVIEW

While events in the first half of the year had an impact on growth, the mutually reinforcing combination of strong economic fundamentals, supportive monetary and financial policies and decisive Government action provided the platform for growth to accelerate in the second half. For the year as a whole, real gross domestic product (GDP) expanded by 5.2% (2002: 4.1%), exceeding the official forecast of 4.5%.

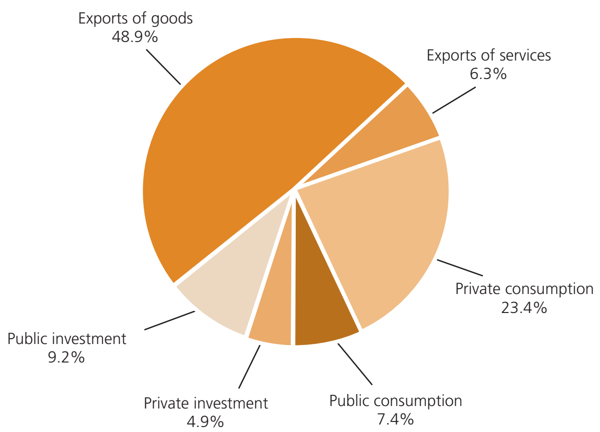
Growth in 2003 was broad based and balanced across sectors. The manufacturing sector grew by 8.2% on the back of strong production growth, both in the export-oriented and domestic-oriented industries. Export-oriented industries, particularly the electronics and chemicals industries, benefited from the recovery in the global electronics sector as investment demand picked up in most major economies. This growth was also seen in the strong expansion in manufactured exports (8.2%) and capacity utilisation levels that exceeded 80%. In

Graph 1.1
The Economy in 2003 (at 1987 Prices)

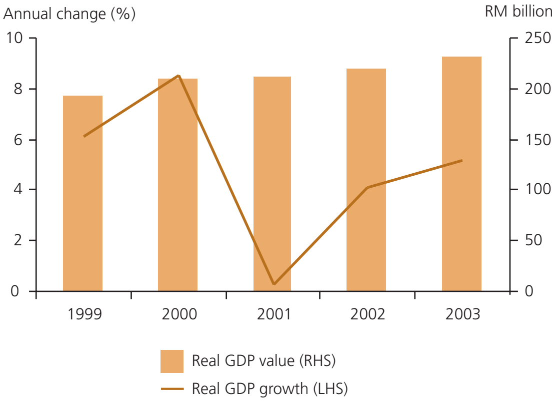
Supply of goods and services (RM458.3 billion)



Demand for goods and services (RM458.3 billion)



Graph 1.2
Real GDP

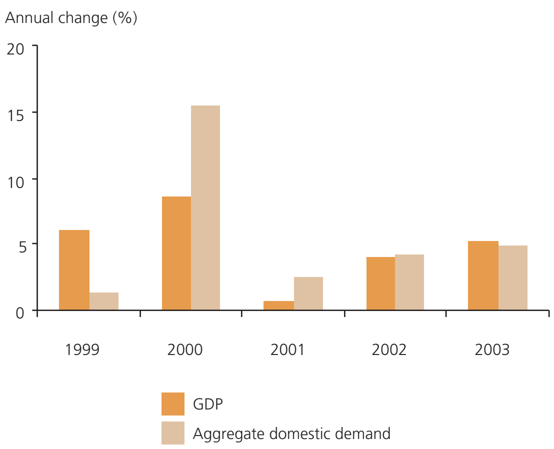


certain industries, the 90% utilisation level was breached in 2003, prompting an increase in capital expenditure.

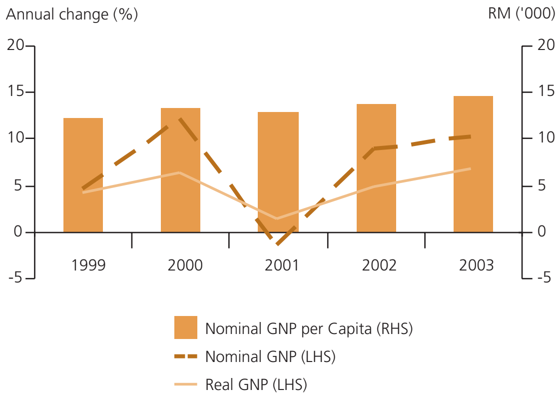
The agriculture sector also enjoyed higher growth of 5.5% as higher production and prices, mainly of palm oil and rubber, drove growth. The mining sector, which grew by 4.8%, also enjoyed the benefits of higher prices. In addition, the production capacity in the sector was enhanced with the MLNG Tiga plant and four new oil and gas fields each coming on-stream. Higher prices and improving external demand conditions led to the strong growth in exports of primary commodities (30.4%).

The services sector experienced the greatest impact from the uncertainties in the first half, most notably the impact of the severe acute respiratory syndrome (SARS) outbreak on tourism and travel-related

Graph 1.3
Real GDP and Aggregate Domestic Demand



Graph 1.4
GNP Growth and Nominal GNP per Capita



activities. The wholesale and retail trade, hotels and restaurants sub-sector and air passenger travel segment, in particular, were severely affected as the number of tourist arrivals dropped significantly from a pre-SARS monthly average of one million to about half that number in April. However, the impact of SARS proved transitory and these sub-sectors recovered rapidly in the second half. In addition, the strong loan growth, increased use of new services in the cellular telecommunications segment and sustained volume of international trade ensured that growth in the sector remained resilient. The sector recovered rapidly and for the year as a whole expanded by 4.1%.

Growth in the construction sector moderated to 1.9% due to slower growth in the civil engineering sub-sector as a result of the completion of several privatised projects. On the other hand, strong

Graph 1.5
Contribution to Real GDP Growth:
Domestic Demand and Net Exports

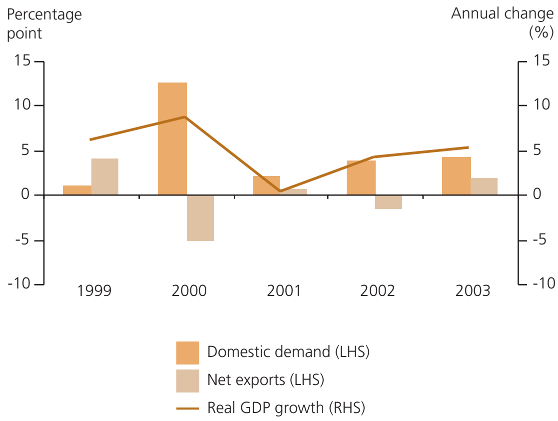


Table 1.1: Malaysia – Key Economic Indicators

	2001	2002	2003*p*	2004*f*
Population (million persons)	24.0	24.6	25.1	25.6
Labour force (million persons)	9.9	10.2	10.5	10.9
Employment (million persons)	9.5	9.8	10.2	10.5
Unemployment (%)	3.6	3.5	3.5	3.4
Per Capita Income (RM)	12,855	13,683	14,592	15,376
(US$)	3,383	3,601	3,840	4,046
NATIONAL PRODUCT (% change)				
Real GDP	0.3	4.1	5.2	6.0 – 6.5
(RM billion)	210.6	219.3	230.7	244.6
Agriculture, forestry and fishery	-0.9	3.0	5.5	2.6
Mining and quarrying	-0.8	3.7	4.8	5.5
Manufacturing	-5.8	4.0	8.2	10.2
Construction	2.1	2.3	1.9	1.5
Services	5.8	4.1	4.1	5.2
Nominal GNP	-1.6	8.7	10.1	6.5
(RM billion)	308.7	335.6	369.4	393.3
Real GNP	1.2	4.7	6.6	5.6
(RM billion)	193.0	202.1	215.4	227.5
Real aggregate demand[1]	2.5	4.2	4.8	5.0
Private expenditure[1]	-3.3	0.7	4.3	8.7
Consumption	2.4	4.4	5.1	8.1
Investment	-19.9	-13.1	1.1	11.5
Public expenditure[1]	15.6	10.8	5.5	-1.3
Consumption	17.0	12.2	7.9	4.2
Investment	14.5	9.8	3.6	-5.7
Gross national savings (as % of GNP)	34.9	34.4	36.9	35.8
BALANCE OF PAYMENTS (RM billion)				
Goods	69.9	72.1	97.7	96.4
Exports (f.o.b.)	334.3	357.7	398.9	443.3
Imports (f.o.b.)	280.2	303.1	317.7	366.8
Services balance	-8.4	-6.0	-15.0	-11.9
(as % of GNP)	-2.7	-1.8	-4.1	-3.0
Income	-25.6	-25.1	-22.6	-24.7
(as % of GNP)	-8.3	-7.5	-6.1	-6.3
Current tranfers	-8.2	-10.6	-9.3	-9.8
Current account balance	27.7	30.5	50.8	50.0
(as % of GNP)	9.0	9.1	13.7	12.7
Bank Negara Malaysia reserves, net[2]	117.2	131.4	170.5	–
(as months of retained imports)	5.1	5.4	6.8	–
PRICES (% change)				
CPI (2000=100)	1.4	1.8	1.2	1.5
PPI (1989=100)	-5.0	4.4	5.7	–
Real wage per employee in the manufacturing sector	1.6	3.2	2.6	–

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

	2001	2002	2003*p*
FEDERAL GOVERNMENT FINANCE (RM billion)			
Revenue	79.6	83.5	92.8
Operating expenditure	63.7	68.7	75.2
Net development expenditure	34.2	35.1	38.5
Overall balance	-18.4	-20.3	-20.9
Overall balance (% of GDP)	-5.5	-5.6	-5.3
Public sector net development expenditure	59.7	69.1	72.0
Public sector overall balance (% of GDP)	-0.3	-0.7	-0.4
EXTERNAL DEBT			
Total debt (RM billion)	173.4	185.6	187.2
Medium and long-term debt	149.3	153.6	152.8
Short-term debt[1]	24.1	32.1	34.5
Debt service ratio (% of exports of goods and services)			
Total debt	6.8	6.7	6.1
Medium and long-term debt	6.6	6.5	6.0

	Change in 2001		Change in 2002		Change in 2003	
	RM billion	%	RM billion	%	RM billion	%
MONEY AND BANKING						
Money Supply M1	2.5	3.2	8.3	10.3	13.0	14.6
M2	7.8	2.2	21.0	5.8	42.5	11.1
M3	13.0	2.9	31.6	6.7	48.5	9.7
Banking system deposits	8.6	1.8	25.3	5.3	49.5	9.8
Banking system loans[2]	16.1	3.9	19.8	4.6	21.8	4.8
Manufacturing	…	…	-1.2	-2.0	-0.2	-0.3
Broad property sector	12.4	8.2	10.8	6.6	14.7	8.4
Finance, insurance and business services	0.7	2.2	-2.5	-7.7	-0.6	-1.9
Loan-deposit ratio	85.9%		84.9%		80.9%	
Financing-deposit ratio[3]	95.7%		95.1%		91.7%	

	2001	2002	2003
	%	%	%
INTEREST RATES (AVERAGE RATES AS AT END-YEAR)			
3-month interbank	3.27	3.13	2.87
Commercial banks			
Fixed deposit 3-month	3.21	3.20	3.00
12-month	4.00	4.00	3.70
Savings deposit	2.28	2.12	1.86
Base lending rate (BLR)	6.39	6.39	6.00
Finance companies			
Fixed deposit 3-month	3.22	3.20	3.00
12-month	4.01	4.00	3.68
Savings deposit	2.94	2.65	2.18
Base lending rate (BLR)	7.45	7.45	6.90
Treasury bill (3-month)	2.73	2.82	2.77
Government securities (1-year)	2.93	2.94	2.93
Government securities (5-year)	3.18	3.15	4.28

	2001	2002	2003
	%	%	%
EXCHANGE RATES			
Movement of Ringgit (end-period)			
Change against composite	3.5	-3.4	-3.2
Change against SDR	3.8	-7.3	-8.5
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.
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demand for housing sustained activity in the residential construction segment.

In 2003, GDP growth was private sector-driven. Private expenditure contributed 2.5 percentage points of the 5.2% growth rate. Both households and the corporate sector benefited from rising disposable incomes, the improving terms of trade for commodities and strengthening external demand. While household incomes increased as a result of growth in wages and higher commodity prices, the corporate sector generated higher profits and cash flows from rising productivity and higher export earnings. From a sample of 300 non-financial companies listed on the Kuala Lumpur Stock Exchange (KLSE), 54% recorded higher cumulative profits for the first three quarters of 2003 compared with the same period a year earlier and the annualised return-on-equity rose from 5.4% in the third quarter of 2002 to 7.3% in the third quarter of 2003.

As a result of higher disposable income, especially for households, private consumption increased by 5.1%. In addition, the low interest rate environment, coupled with the high savings rate, provided the impetus for households to increase their borrowings for consumption expenditure. Measures unveiled in the Economic Package in May improved consumer confidence, further supporting consumption expenditure.

A significant development in 2003 has been the turnaround in private investment, which increased by 1.1% after two years of contraction. The improved economic outlook, particularly in the second half, stronger corporate balance sheets and cashflow positions and high capacity utilisation, especially in the manufacturing sector, prompted increased capital spending. In addition, the low interest rate environment and the steps taken to improve companies', especially the small and medium enterprises' (SMEs), access to finance, provided the impetus for capital expansion.

The public sector continued to play an important role in sustaining domestic demand, especially in the first half. Real public consumption increased by 7.9% due to higher spending on supplies and services. On the other hand, real public investment growth moderated to 3.6% in line with the moderate increase in Federal Government development expenditure and lower capital spending by the non-financial public enterprises.

As a result, real aggregate domestic demand (excluding change in stocks), increased more rapidly by 4.8%. However, this pick-up in demand did not lead to an increase in inflation. The Consumer Price Index (CPI) increased more moderately by 1.2% during the year (2002: 1.8%), with core inflation – inflation that excludes price-volatile and price-administered items – amounting to 0.6% in spite of higher commodity prices. While stronger economic growth led to a narrowing of the output gap, it was not completely eliminated and reflected excess capacity in selected sectors.

In 2003, the external sector's contribution to growth turned positive (2 percentage points; 2002: –1.3 percentage points), primarily due to the acceleration of exports of goods in the trade account by 11.5% (2002: 7%). The trade surplus increased to RM81.1 billion (2002: RM54.6 billion). Sustained consumer demand and the pick-up in investment activity in the major industrial economies as well as higher commodity prices spurred the growth in exports of manufactures and primary commodities. On the other hand, import growth moderated to 4.8% (2002: 8.1%) as exports of primary commodities, unlike manufactured exports, had a low import content. Further, the changing pattern of investment, especially foreign direct investment (FDI), into the services sector were smaller in scale but had higher potential to generate value added. As a result, imports of capital goods remained relatively stable (0.7%).

The large trade surplus, coupled with a smaller income account deficit brought about by the repatriation of earnings from overseas investments by Malaysian firms, more than compensated for the larger services account deficit (RM15 billion) due to lower tourism receipts. As a result, the current account surplus increased to RM50.8 billion, equivalent to 13.7% of gross national product (GNP) (2002: 9.1% of GNP).

The financial account in the balance of payments remained stable, recording a deficit of RM12.1 billion (2002: -RM11.9 billion). Stronger inflows of funds for investment were balanced by higher repayments and prepayments of external debt by the public sector and overseas investments by Malaysian companies. FDI into Malaysia remained significant while funds for portfolio investment turned around to record an inflow as the KLSE staged a markedly improved performance, especially since the third quarter.

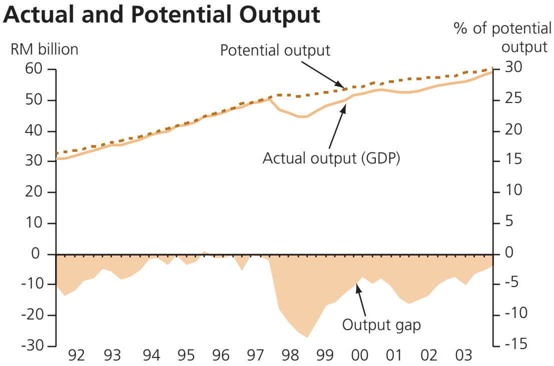
Potential Output of the Malaysian Economy

Potential output is output derived from the full use of available capital and potential employment, which is the level of employment that is consistent with the "natural" or "long run" rate of unemployment. Therefore, the potential output is defined as the maximum capacity of output that the economy can achieve without experiencing either inflationary pressures or external imbalances. The output gap is the difference between actual and potential output and is measured as a percentage of potential output. When actual output is lower than its potential, the output gap is negative and, theoretically, output can sustain an increase without exerting undue inflationary pressures on the economy.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential output	Investment	Labour	Output Gap
	Annual change (%)				(% of potential output)
1992-1997	9.2	8.2	14.1	3.9	-1.9
1998	-7.4	3.7	-43.0	-2.1	-11.4
1999	6.1	2.4	-6.5	3.7	-8.3
2000	8.5	4.0	25.7	4.3	-4.3
2001	0.3	3.2	-2.8	3.3	-6.9
2002	4.1	1.7	0.3	3.1	-4.8
2003	5.2	3.4	2.7	3.3	-3.1

Graph 1
Actual and Potential Output



During the high growth years of the early 1990s, actual output closely followed its potential, as shown in Table 1 and Graph 1. Amidst the pronounced contraction in output experienced after the Asian financial crisis, the output gap had widened significantly in 1998 but as the economy recovered, the gap narrowed. In 2002, the output gap was 4.8% compared to 6.9% in 2001. Subsequently, in 2003, the stronger pickup in economic activity compared to the growth in potential output led to a further narrowing of the output gap. Bank Negara Malaysia's latest estimates of potential output indicated that actual GDP increased at a faster pace (5.2%) compared to potential GDP (3.4%). Nevertheless, the faster growth of GDP did not exert inflationary pressures as actual GDP would have to increase by more than 8% before the output gap could be bridged in 2003.

The potential growth rate doubled in 2003, due mainly to stronger growth in capital investment (2.7%; 2002: 0.3%) as business sentiment improved amidst higher capital utilisation rates in selected sectors of the economy.

The estimated short-run elasticity of capital is significantly higher than the short-run elasticity of labour, implying that changes in capital have a greater impact on output and that returns to capital have continued to improve. This has encouraged firms to accelerate their investment activities, including the upgrading of technological capabilities that, in turn, could have had an immediate impact on output.

In line with previous findings, the long-run elasticity of capital, which is estimated to be 0.50, is higher than its short-run counterpart. This higher return to capital implies more efficient capital utilisation, as calculated by the ratio of output to capital, which has had a faster rate of increase compared to the ratio of output to labour. Previous supportive infrastructure investments, which have long gestation periods, have begun to show positive returns, while stronger investment activities were visible in the services sector, mainly in technology and logistics infrastructure. With the greater focus and emphasis placed on a knowledge-driven economy, expectations are for potential output to expand further.

As a result of the large current account surplus, sustained inflows of funds for investment, including FDI, and revaluation gains from the translation of non-US dollar assets into ringgit terms, the net international reserves of Bank Negara Malaysia increased to RM170.5 billion, or equivalent to US$44.9 billion at the end of 2003. This represented an increase of RM39.1 billion or US$10.3 billion during the year. The increasing trend in reserves continued into 2004. By 15 March, the reserves rose to RM194.9 billion or US$51.3 billion, sufficient to finance 7.8 months of retained imports and was 5.2 times the short-term external debt.

Malaysia's external debt position remained stable in 2003, standing at RM187.2 billion or 50.7% of GNP (2002: RM185.6 billion or 55.3% of GNP) in spite of a RM4.1 billion revaluation adjustment that resulted mainly from the appreciation of the euro and yen. Malaysia's external debt position remains sustainable with the debt service ratio improving from 6.7% in 2002 to 6.1% in 2003. In addition, the nation's debt profile remains healthy, with short-term debt accounting for only 18.4% of total external debt.

The health of the banking system improved in 2003, in tandem with stronger economic growth. Banks continue to be well capitalised with the risk-weighted capital ratio sustained at a high level at 13.4%, well above the prescribed 8% mark. The trend for non-performing loans (NPLs) also reversed with the ratio, on a 6-month basis, declining from 7.5% as at end-2002 to 6.8% as at end-2003.

Macroeconomic Management

Coming into 2003, the Malaysian economy was already in a strong position. Private sector activity was exhibiting an upward trend. Commodity prices remained high, providing a significant positive multiplier effect on rural incomes. Further, both the monetary and fiscal stance were conducive to sustaining growth without increase in risk, given the benign inflation outlook, strong external position and the sustainable public sector finances. Given this strength, it was assessed that the economy had the resilience to absorb the impact of uncertainties that could adversely affect growth prospects. Hence, the macroeconomic policy stance was left unchanged in the early part of the year.

By the second quarter, however, the unforeseen SARS outbreak and the weaker-than-expected global economic conditions prompted new policy measures. Economic and financial indicators for the first half-year also indicated that growth in the United States remained well below trend, mainly due to subdued investment. Deflationary concerns and continued financial market volatility cast doubt on the strength of global economic activity. This prompted the authorities to take pre-emptive measures in order to support economic activity. On 21 May, Bank Negara Malaysia reduced its policy rate, the 3-month Intervention Rate, by 50 basis points to 4.5%. This move was aimed at mitigating the effects of a more adverse external environment on domestic demand. A comprehensive economic stimulus and relief package, encompassing fiscal and financing measures, was announced by the Government. The package was designed to provide immediate relief to affected sectors, diversify economic activity and improve long-term competitiveness.

In the short term, the main stimulus measures were designed to provide relief to affected sectors and encourage private consumption in order to diversify the sources of growth. Hotels and restaurants were exempted from service taxes and received a discount on utility charges. Income tax payments for travel agencies were suspended, the road tax on taxis was reduced and import duties on selected items were lowered. In addition, a Special Relief Guarantee Fund of RM1 billion was set up by Bank Negara Malaysia to provide working capital to affected companies while existing funding facilities, especially for SMEs, were enlarged. To encourage consumer spending, employees' contribution to the Employees Provident Fund was reduced by two percentage points and civil servants were given an interim half-month bonus. In addition, measures targeted at construction activities, particularly measures to provide affordable housing to the lower income group, also had a positive effect on consumption.

With the additional expenditure, coupled with revenue foregone arising from the relief measures implemented, the overall Federal Government deficit was revised from the budgeted 4% of GDP to 5.3% of GDP. However, the higher deficit did not exert pressure on domestic consumer prices and interest rates as the high savings rate and excess liquidity in the banking system made it possible for the bulk of the deficit to be financed from non-inflationary domestic sources. While the deficit led to higher Federal Government debt (48.2% of GDP as at end-2003), this level was sustainable. Debt servicing remained low (14% of operating expenditure). Similarly, the Federal Government external debt declined to 9.5% of GDP, thus lowering exposure to external risks. Given the Government's target to achieve a balanced budget in the near term, the debt-to-GDP ratio is expected to decline in the medium term as growth accelerates.

The immediate effect of the measures was to strengthen domestic demand and hence, growth. After recording a 4.5% growth in the first half, real GDP accelerated to 5.2% in the third quarter. As conflict in the Middle East was resolved and SARS abated, domestic consumer and business sentiment improved markedly in the third quarter. Further favourable signs started to emerge from September as growth in the United States exceeded the trend rate in the third quarter following a recovery in investment and a build-up in inventories. In tandem, the other major economies also recorded stronger growth. The mutually reinforcing combination of fiscal expansion and monetary easing provided the platform on which the domestic economy was able to leverage on the accelerating global and regional growth momentum. In the fourth quarter, growth accelerated to 6.4%, the fastest rate since the fourth quarter of 2000.

The reduction in interest rates spurred loan growth, prompted by increased demand from both households and businesses, particularly SMEs. As a result, total financing from the banking system through loans and holdings of private debt securities increased by 5.9%. The demand for credit intensified in the latter part of the year as global economic conditions improved, consequently leading to a strengthening of the growth momentum in Malaysia. In particular, funding to the SMEs increased strongly with a large proportion of new loans directed to this segment. By end-2003, loans to SMEs had expanded by 10% and accounted for 38.4% of all loans outstanding to business enterprises.

As a result of the reduction in the Intervention Rate, ample liquidity and a competitive lending environment, lending rates charged by the banks declined during the year. The average lending rate charged by commercial banks declined further, and at end-year was 39 basis points lower than the end-2002 level. Liquidity remained ample during the year as BNM's operations stabilised inter-bank interest rates at low levels.

The ringgit peg has provided stability and predictability during a period of increased uncertainty in financial markets, thereby facilitating trade and investment activities. While the US dollar depreciated during the year, Bank Negara Malaysia's estimates indicate that the ringgit remains close to its fair value. The surplus in the current account remains large while reserves continue to rise. Domestically, inflation remains low at 1.2% and there appears to be no significant imported inflation. Hence, economic fundamentals continue to support the current exchange rate arrangement.

The proactive monetary and fiscal measures implemented by the Government in response to uncertainties in the first half supported growth and provided the platform for the private sector to take the lead in generating growth. For the longer term, Malaysia has formulated a comprehensive strategic framework to meet new challenges.

The importance of strong fundamentals was demonstrated in 2003. They allowed the Government to implement a wide-ranging and comprehensive response to adverse conditions without creating undue risks. In addition, the successful corporate sector restructuring undertaken in recent years provided the enabling conditions for a positive private sector response to the measures. Equally important, the comprehensive and balanced approach, with fiscal and monetary policy reinforcing each other, increased the likelihood of achieving the aims of the measures.

The May Economic Package did not only serve as a short-term stimulus package but was also an integral part of longer-term initiatives to meet emerging challenges. The Mid-Term Review of the Eighth Malaysia Plan (2001-2005) clearly identifies two major challenges that are becoming increasingly apparent: dealing with the changing dynamics of global competition and increasing capacity to manage risks from greater volatility. Thus, the May Economic Package and the 2004 Federal Government Budget laid out the following strategies to ensure that growth is sustained over the longer term while fundamentals are strengthened:

- **Increase competitiveness by enhancing productivity**
  Integral to achieving this objective is the move towards a knowledge-based economy. Some important strides have been made in enhancing the knowledge content of economic activity in 2003, especially by enhancing education and training and promoting higher value-added industries.

- **Strengthen resilience through sound economic fundamentals and strong financial and corporate sectors**
  The financial sector restructuring process undertaken following the Asian financial crisis has been completed and the corporate sector has begun to increase investments and expand operations. A major milestone in 2003 was Danamodal Nasional Berhad's redemption of bonds with a nominal value of RM11 billion on 21 October. Currently, Danamodal still has assets with a book value of RM2.2 billion. As proceeds from their disposal is expected to exceed book value, the net cost incurred by Danamodal in recapitalising the banking sector is estimated to be 0.15% of GDP. Notwithstanding the successful completion of the restructuring process, regulatory agencies will continue to ensure that Malaysian companies and financial institutions continuously upgrade governance and reporting standards.

- **Stimulate private domestic investment as well as attract quality FDI**
  To promote private investment, a number of measures were directly targeted at SMEs by improving their access to financing as well as making several tax and non-tax incentives available to them. The focus on domestic sources of investment, however, is not at the expense of foreign investors. A number of measures were announced under the economic package that liberalised regulations governing foreign investment.

- **Promote new sources of growth in the manufacturing and services sector**
  Apart from making Malaysia a more conducive location for existing businesses, several sectors were earmarked as new sources of growth. These included education, tourism and health services in the services sector; Islamic finance; and high-technology manufacturing.

- **Revitalise the agriculture sector**
  The agriculture sector recorded the fastest growth after manufacturing in 2003. While high commodity prices provided the incentive for higher production, the sector has deep and strong links with the rest of the economy. As such, measures taken to improve productivity and returns in this sector and develop new downstream activities will have a significant multiplier impact on the rest of the economy.

- **Pursue sound macroeconomic management with fiscal prudence**
  The Government is committed to a programme of gradual fiscal consolidation. Similarly, monetary policy has remained supportive of growth while ensuring risks, either in the form of inflation or external imbalances, are contained.

- **Improve the delivery system of the Government to create a pro-business environment**
  Improved efficiency, especially in the public sector, will effectively reduce costs, thereby boosting competitiveness. Therefore, the final strategic prong was aimed at enhancing the efficiency in the delivery of public services and effectiveness in implementing national development policies and strategies. These included eliminating bureaucratic delays, streamlining regulations and procedures, reducing duplication and shortening waiting periods.

Banking sector policies in 2003 were aimed at enhancing the infrastructure and environment for banking institutions to deliver quality products and services, encouraging greater innovation while maintaining financial stability. In addition, an important strategy was to ensure that the banking system continued to be a facilitator of growth, particularly in providing financing and other ancillary services to the SMEs.

- **Strengthening the capacity of domestic banking institutions**
  During the year, efforts were directed at developing and enhancing the quality of human capital in the banking sector. As the business

environment and consumer demands are constantly evolving, continuous upgrading of skills is necessary, particularly at the top management level. Recognising this, Bank Negara Malaysia initiated two important measures to enhance the quality of human capital in the banking sector. The International Centre for Leadership in Finance was established to accelerate the development of skilled and competent leaders of financial institutions and corporations. Work has also been initiated to reposition Institut Bank-Bank Malaysia to better meet the needs of the financial sector through more focused training and accreditation, particularly in specialised areas.

To provide a conducive environment for banking conglomerates to further improve their group structures, rationalise their operations and improve efficiency, the Banking and Financial Institutions Act 1989 was amended to allow the merger of the commercial bank and finance company within a domestic banking group into a single legal entity.

- **Safeguarding financial stability and fortifying the financial system**
  During the year, steps were taken to strengthen corporate governance practices in the banking institutions. These included enhancing the role of the board of directors, especially independent directors, and regulations covering the appointment of external auditors.

  To ensure that the activities of banking conglomerates do not introduce risks to the financial system, Bank Negara Malaysia is formalising and strengthening the existing infrastructure and regulatory framework. To strengthen the legal framework, the Central Bank of Malaysia Act 1958, the Banking and Financial Institutions Act 1989, the Islamic Banking Act 1983 and the Takaful Act 1984 were amended in 2003. A new Payment System Act 2003 was also enacted to formalise the Bank's oversight authority of the payment system.

- **Ensuring that all sectors of the economy have adequate access to finance**
  Policies were directed at facilitating improved access to credit for the various sectors of the economy, particularly the SMEs. In addition, a micro-financing programme that has an extensive outreach was also established for micro enterprises.

- **Strengthening the consumer awareness and protection framework**
  Active consumerism is a critical prerequisite in the transition towards greater market orientation. Therefore, an effective consumer education and protection framework is being developed to allow banking consumers to eventually take greater responsibility for their financial decisions. To assist consumers in making their decisions, the Bank is currently finalising the product transparency and disclosure rules. Bank Negara Malaysia has also initiated work on establishing a framework on basic banking services, which aims to ensure that the banking public, especially the low-income group, would have access to affordable basic banking services. To enable consumers to seek redress on a broad range of retail consumer issues raised against financial institutions regulated by the Bank, the Financial Mediation Bureau, a one-stop center for the resolution of these issues, will be established in the first half of 2004.

  The increased strength and resilience of the banking system has provided a positive environment for the effective implementation of a deposit insurance scheme in Malaysia. The implementation of the system will further strengthen the consumer protection framework by providing for the explicit protection of deposits as well as greater incentives for sound financial and business practices among banking institutions.

The rapid development of the domestic Islamic financial system, accentuated by significant progress on the global front in recent years, have set the stage for it to play a more prominent role in the economy. Currently, 33 banking institutions, including two Islamic banks, offer a comprehensive range of Islamic financial products and services to the Malaysian public. Similarly, the takaful industry has progressed rapidly, accounting for 5.6% of assets in the insurance sector in 2003. During the year, policy focused on strengthening the institutional infrastructure, enhancing the regulatory framework, strengthening the Shariah and legal infrastructure and developing intellectual capital and consumer education. In 2003, Bank Negara Malaysia brought forward liberalisation in Islamic banking to allow full-fledged foreign Islamic banks in Malaysia.

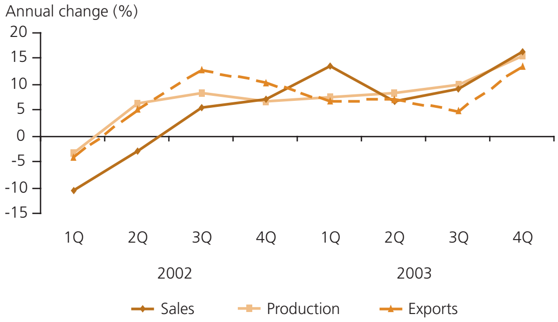
The strategies laid out for sustaining long-term growth will continue to be complemented by appropriate short-term measures. Conversely, taking steps to ensure the long-term sustainability of growth and strength of fundamentals would provide both the resources and platform on which shorter-term corrective measures may be taken. Thus, the interaction between short- and longer-term macroeconomic policies in Malaysia aims to be complementary in nature, one reinforcing the other, to achieve sustained economic development.

SECTORAL REVIEW

Manufacturing Sector

In 2003, output growth in the manufacturing sector gained momentum especially in the second half-year, following the broad-based recovery in the global economy and strengthening domestic demand. Manufacturing production growth strengthened to 10.5% (2002: 4.5%), with expansion across a wide range of products in both the export- and domestic-oriented industries. Consonant with the pick-up in production activities, value-added growth of the manufacturing sector doubled to 8.2% (2002: 4%), and contributed significantly to overall GDP growth. Consequently, the share of the manufacturing sector in GDP rose slightly to 30.9% (2002: 30.1%). The capacity utilisation rate in the manufacturing sector remained high at 82% in 2003 (2002: 82%), with the export- and domestic-oriented industries operating at 86% and 77% respectively (2002: 83% and 81% respectively).

Graph 1.6
Manufacturing Sector: Sales, Production and Exports



Export-oriented industries expanded by 11.9% in 2003, with stronger expansion in the second half-year, led by the cyclical upturn in global electronics demand, and further enhanced by the strong performance of the chemicals and rubber products industries. Given the strong inter-linkages, the chemical industry also benefited from the spillover effects of the upsurge in the electronics industry. Demand for chemical and rubber products were strong, particularly from the US and the Asia-Pacific region. Overall, the outbreak of SARS in the region during the early part of the year had a minimal impact on export-oriented industries, notwithstanding some slowdown in the regional economies.

Pick-up in exports and strengthening domestic demand led to stronger expansion in the manufacturing sector.

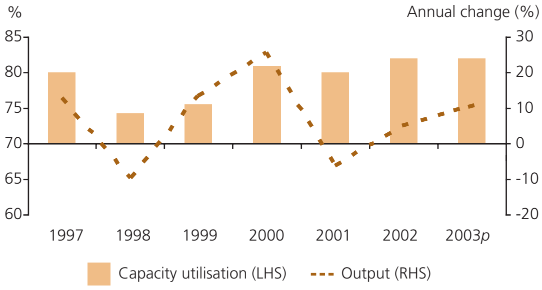
While the SARS outbreak had affected consumer demand, the Economic Package introduced in May

Table 1.3
Manufacturing Sector: Value Added and Production

	2002	2003
	Annual change (%)	
Value added (Constant at 1987 price)	**4.0**	**8.2**
Overall Production	**4.5**	**10.5**
Export-oriented industries	**5.0**	**11.9**
of which:		
Electronics	13.4	15.1
Electrical products	-5.1	-7.0
Chemicals and chemical products	2.7	20.8
Wood and wood products	-6.0	0.9
Textiles and wearing apparel	-6.2	-2.2
Off-estate processing	7.1	11.8
Rubber products	2.0	18.7
Domestic-oriented industries	**3.4**	**6.1**
of which:		
Construction-related products	3.8	10.2
Fabricated metal products	0.8	7.4
Food products	8.7	8.8
Transport equipment	6.2	-5.5
Petroleum products	-4.1	2.3

Source: Department of Statistics, Malaysia.

Graph 1.7
Capacity Utilisation in the Manufacturing Sector



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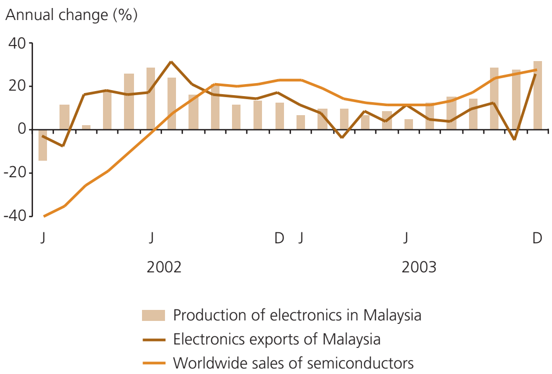
helped to stimulate domestic demand and support the growth of the **domestic-oriented industries** (6.1%). Output was higher in all sub-sectors, except for the transport equipment industry. Of significance, growth strengthened in the fabricated metal products, construction-related materials and food and beverages industries. These industries benefited largely from the improved domestic demand and continued growth in the construction sector. Only the automobile industry recorded lower output, affected by subdued sales of motor vehicles.

The **electronics industry** recorded another year of strong growth following the broad-based expansion in global demand across all geographical regions and products. Expansion in the first-half year was moderate and picked up strongly in the second-half year. Growth emanated mainly from the expansion in the wireless and personal computer (PC) markets as well as consumer electronics products. While growth in wireless products was driven by the rising demand for wireless applications and cell phones, the demand for PCs was led by the PC replacement cycle, which took place in the latter half of the year as companies invested to replace their equipment acquired during the Y2K period. The consumer electronics products experienced strong growth due to growing consumer interest in adopting new technology and multi-functional devices such as camera phones, personal digital assistants (PDAs) and digital video decoders (DVDs). In terms of export markets, the Asia-Pacific region continued to spearhead growth and remained the largest market for the global semiconductor sales. Demand was especially strong from the People's Republic of China (P.R.China), which became the largest importer of chips in the world.

Graph 1.8
Production and Exports of the Electronics Industry



Malaysian manufacturers were able to benefit from the emerging global electronics up-cycle, in view of the diversity in product mix and export markets. Local semiconductor manufacturers continued to move up the value chain from assembly and packaging activities to become full turnkey providers to maintain their competitiveness.

Amidst increased global competition, the performance of the **electrical products** sub-sector continued to deteriorate. The decline was mainly in the audio-visual and telecommunication products as producers who emphasised on low labour cost had relocated elsewhere. Nevertheless, output of air conditioners, refrigerators and other ventilating devices continued to increase in tandem with the improving external demand. Overall, the performance of the industry was also affected by lower offtake from most of the major importers of Malaysia's electrical products, particularly from the US, Japan, Hong Kong China, the United Kingdom and Netherlands. Nevertheless, exports to P.R.China increased strongly.

Growth in the **chemical products industry** accelerated in 2003, benefiting from the spillover effects of the strong pick-up in the electronics industry as well as the improved external demand for organic chemicals, and resins and plastic products. The expansion was further reinforced by the higher output of industrial gases following the commencement of the new MLNG plant in Sarawak. The resins and plastic products sub-sector continued to experience strong growth, driven by stronger domestic demand from the food, construction and packaging industries as well as increased demand from the Asia-Pacific region. In particular, exports of Malaysia's chemical products to major markets, namely P.R.China, Singapore and Japan, continued to expand strongly during the year.

The stronger performance of the **off-estate processing industry** was supported mainly by higher activity in palm oil processing, arising from improved offtake for processed palm oil products, particularly from Japan and Europe. Production of **rubber products** also increased strongly, driven by higher external demand for rubber gloves for medical examinations and surgery. Expansion in production capacity enabled the industry to meet the increased global demand for gloves following tensions in the Middle-East and outbreak of SARS. The industry's aggressive promotions to expand to new export markets also contributed to the increase in demand for gloves. While the US remained as Malaysia's largest export market for rubber products, exports to other countries, namely P.R.China, Hong Kong China, Japan and Singapore, also grew strongly to account for a bigger market share.

Output of **petroleum products** recovered, driven by strong demand from Asian countries, especially from P.R.China, Japan and Singapore. Similarly, output of **wood products** turned around to record positive growth due to higher output of plywood and particleboard. The increase was largely attributable to higher export demand for veneer and plywood arising from the recovery in construction activities in Malaysia's traditional markets, especially Japan, P.R.China and Chinese Taipei. Exports of furniture also increased due to higher demand from the US, Singapore, Saudi Arabia, Australia and P.R.China. While the export performance remained favourable, the furniture and wood products industries faced keen competition from other countries in the region and cheaper substitute products, such as PVC and steel.

The **textiles and wearing apparel industry** registered another year of lackluster performance due mainly to intensive competition from low cost countries. Shipments by major importers, particularly the US, the largest buyer of Malaysian textiles and apparel, continued to contract. Production in the **transport equipment industry** was subdued in 2003 due entirely to lower assembly of motor vehicles. Demand for motor vehicles in the domestic market slowed down as consumers held back purchases due to uncertainty over car prices following the phase-in of the automotive industry into the AFTA framework. The decline in assembly of motor vehicles was, to some extent, offset by higher production of motor vehicle parts and accessories, and assembly of motorcycles and scooters arising from the higher demand for locally-assembled motorcycles and scooters.

Output in the **construction-related materials industries** expanded strongly, supported by higher export demand and continued expansion in construction activity. Growth was particularly strong in the second half-year due to sharply higher production of iron and steel as manufacturers increased their exports to take advantage of the strong demand and higher prices in the export market. As a result, exports of metal products increased strongly, particularly to the US, P.R.China, Japan, Singapore, Thailand and Australia. Production of non-metallic mineral products also increased during the year due to increased demand from the construction sector, especially for production of cement, fabricated construction materials and structural clay products. However, production of glass declined as it was affected by lower export demand as well as subdued demand from the domestic car industry.

Production in the **fabricated metal products industry** increased further, reflecting higher production of structural metals, wire and wire products as well as tin cans and metal products. The expansion was supported mainly by on-going activity in the construction sector and increased demand for packaging materials from the food processing industry. On the other hand, production of brass, copper and aluminium declined due to the lower demand from the electrical products industry.

Meanwhile, growth in the **paper products industry** moderated during the year due to lower production of pulp, paper and paperboard, while the manufacture of containers, boxes of paper and paperboard remained flat. Performance of both the sub-sectors was affected by the oversupply in the market. Nevertheless, the production of the pulp, paper and articles sub-sector continued to expand strongly. Notwithstanding the moderation in production, exports of paper and pulp products increased further due to higher exports to Thailand, P.R.China, the Philippines, Australia and US. Output in the **food and beverages sub-sector** was higher, supported by consumer spending and higher demand from Singapore and Brunei.

Construction Sector

In 2003, the **construction sector** expanded at a more moderate pace of 1.9% (2002: 2.3%) due mainly to a slowdown in the civil engineering sub-sector following the completion of several privatised projects. Growth was mainly supported by the residential sub-sector, while activity in the non-residential sub-sector remained subdued amidst the continued overhang of office and retail space, although the excess supply was reduced during the year.

Activity in the **residential sub-sector** was higher as demand for houses remained strong, especially with the incentives introduced in the Economic Package. Favourable financing conditions, namely low interest rates and attractive loan packages offered by the banking institutions, helped support interest in the residential sub-sector both for new property as well as the secondary market. Construction of new houses gained momentum during the first nine months of the year, as reflected in a 17% increase in housing starts. Reflecting house purchasers' preference for bigger houses due to a rise in affordability following higher disposable income and lower interest rates, the average price of residential units transacted was higher at RM139,700 (2002: RM130,300). Prices of residential properties, including terraced houses as well as high-rise units, remained firm during the year, supported by continued demand for houses in prime locations.

Construction sector grew at a moderate rate due to slower growth in the civil engineering sub-sector.

Demand for residential houses was stimulated by innovative financing packages with attractive terms provided by financial institutions. To encourage home ownership, the Economic Package announced by the Government on 21 May 2003 provided the following incentives for one year, beginning 1 June 2003:

- Stamp duty waiver on the Sale and Purchase Agreements, loan and transfer documents for houses costing RM180,000 and below;
- Income tax relief on interest payments for new buyers of completed houses, and first time owners of houses costing between RM100,000 to RM180,000;
- Subsidy of RM600 for new buyers of houses costing below RM100,000; and
- Exemption from real property gains tax.

Table 1.4
Residential Property Indicators

	2002	2003
	Units	
Residential property transactions		
Units	162,269	164,723
Value (RM billion)	21.1	23.0
Approvals[1]	198,970	205,518
Developers' licences		
New	1,170	1,062
Renewals	397	436
Sales and advertising permits		
New	1,134	1,103
Renewals	1,666	1,707
Loans by banking system - Value (RM billion)		
Outstanding	100.4	116.6
Approvals	29.2	30.0

[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

In line with the Government's objective to provide affordable houses to the low-income group, Syarikat Perumahan Negara Berhad (SPNB) has targeted to build at least 150,000 units of medium-cost and affordable houses within a five-year period. With the liberalisation of the Foreign Investment Committee (FIC) guidelines in 2001, the FIC has approved the purchase of 1,617 units of residential properties (representing an increase of 30.1%) valued at RM771 million by foreigners in Malaysia during the year. However, the purchase of commercial properties by foreigners declined.

To reduce the cost of purchasing low-cost houses and to improve purchasers' access to financing, the following measures were announced during the year:

- EPF contributors who purchase low-cost houses built by SPNB will be provided with end financing from the Malaysia Building Society Berhad;
- State governments will exempt land premiums for the construction of low-cost houses; and
- The exemption from stamp duties in respect of Sale and Purchase Agreements for low-cost houses executed between the purchaser and the developer on or after 1 July 2002 was gazetted in February 2003. In this connection, loan and transfer documents associated with the Sale and Purchase Agreements were eligible for exemption.

On the supply side, housing units approved for construction by private developers in Peninsular Malaysia increased by 3.3% in 2003, with approvals picking up by 23% in the second half-year as developers anticipated higher demand in response to the incentives in the Economic Package. At the same time, new sales and advertising permits issued recorded a strong pick-up of 18% in the second half of the year (first half: -20.1%). However, renewals of permits continued to increase in 2003, reflecting a longer duration required to sell the properties.

In the **civil engineering sub-sector,** growth was significantly slower due to the completion of several privatised projects, mainly power generation plants. Nevertheless, ongoing road projects such as the Kajang Ring Road, Guthrie Corridor Expressway,

Table 1.5
Incoming Supply and Planned Supply of Property

	Incoming Supply[1]	Planned Supply[2]	Incoming Supply[1]	Planned Supply[2]
	June-03*p*		Sept-03*p*	
	Units/'000 sq.m.		Units/'000 sq.m.	
Residential (units)	573,117	533,784	569,994	537,919
Purpose-built office ('000 sq.m.)	1,969	1,890	1,945	1,865
Shopping complexes ('000 sq.m.)	1,479	1,715	1,535	1,639
Retail shops (units)	31,424	34,537	32,507	34,413
Industrial properties (units)	8,616	22,236	8,299	22,174

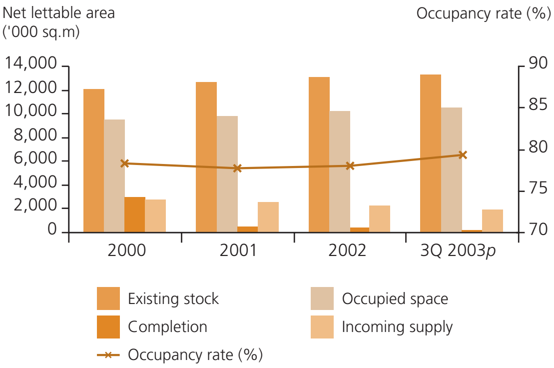
[1] Consists of properties that are under construction, including those where certificates of fitness/temporary certificates of fitness have not been issued.
[2] Approved but not started.
p Preliminary

Source: NAPIC, Valuation and Property Services Department

Penchala Link of the SPRINT Expressway, New Pantai Expressway, Kajang-Seremban Expressway and the Butterworth Outer Ring Road, supported civil engineering activity during the year. Construction work was also ongoing for projects related to water, ports, sewerage and power generation plants. In view of the experience acquired in the domestic civil engineering sub-sector, Malaysian construction companies have diversified their earnings base and expanded overseas, particularly in the construction of highway projects and other infrastructure projects. These companies are able to compete in the global market, particularly in India and the Middle East. Infrastructure projects by the public sector, as reflected in the Federal Government development expenditure, remained strong during the year, especially in the transportation sub-sector. Among the major ongoing public projects supporting growth was the SMART Intelligent Tunnel for Flood Mitigation in Kuala Lumpur and the Kuala Lumpur Convention Centre.

Construction activity in the **non-residential sub-sector** remained subdued as reflected in lower ongoing activity in projects related to purpose-built office and shopping complex. In particular, completion of new office space in the Klang Valley slowed down during the last three years. In the first nine months of 2003, only 93,000 square metres of office space were completed compared with 200,000 square metres in 2002 (2001: 178,000 sq. m; 2000: 1.4 million sq. m). Large shopping complexes that were completed in the Klang Valley include the Berjaya Times Square, Ikano Power Centre, IKEA, Maju Junction and the Great Eastern Mall. The share of new starts to total incoming supply for Malaysia as a whole increased from 2% to 8% in the first nine months of 2003. The average occupancy rate for office space and retail complexes stabilised at 79% and 78% respectively as at end-September 2003, reflecting continued demand, particularly for projects located in choice locations.

Graph 1.9
Supply and Occupancy Rate of Purpose-Built Office Space in Malaysia: 2000 - 2003



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Graph 1.10
Supply and Occupancy Rate of Retail Space in Malaysia: 2000 - 2003

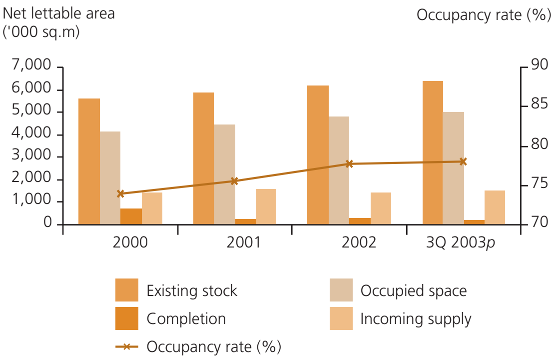

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Table 1.6
Office and Retail Space - Unoccupied Space, Incoming Supply and Planned Supply by State (as at end-September 2003*p*)

	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	1,414	1,085	1,028	286	746	649
Selangor	488	55	0	186	138	63
WP Putrajaya	0	295	155	0	66	0
Johor	260	140	493	326	228	789
Pulau Pinang	292	45	39	279	172	52
Negeri Sembilan	24	28	118	41	61	64
Perak	41	49	6	50	4	0
Melaka	25	0	0	56	0	0
Kedah	21	34	1	64	51	14
Pahang	14	15	9	33	0	8
Terengganu	10	0	0	6	7	0
Kelantan	9	4	16	2	63	0
Perlis	1	34	0	0	0	0
Sabah	112	142	0	25	0	0
WP Labuan	38	0	0	15	0	0
Sarawak	57	20	0	40	0	0
Total	**2,806**	**1,946**	**1,865**	**1,409**	**1,536**	**1,639**

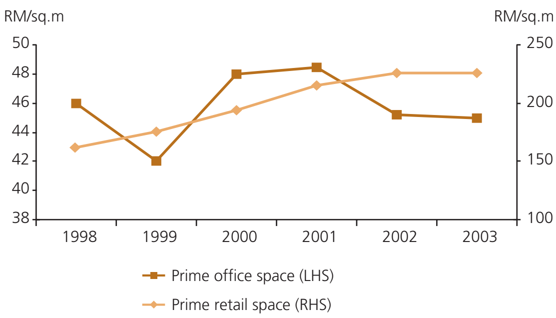
[1] Consists of properties that are under construction, including those where certificates of fitness/temporary certificates of fitness have not been issued.
[2] Approved but not started.
p Preliminary

Source: NAPIC, Valuation and Property Services Department

Rentals for prime office space in the Klang Valley stabilised at RM45 per square metre per month during the year. In the case of shopping complexes, the average monthly rental rates of prime retail space also remained stable at RM226 per square metre. Rentals of office and retail space in secondary locations remained low to attract tenants.

In the case of **hotels**, there were 111 new hotels completed during the year, providing 7,838 additional rooms. However, the hotel industry was adversely affected by SARS, especially during the second quarter of 2003, when tourist arrivals fell by 59% to below 500,000 in April. Arrivals for the year as a whole declined to 10.6 million from 13.3 million in 2002, thus resulting in the average occupancy rate of hotels declining to 53% (2002: 58%).

Graph 1.11
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.

Availability of adequate financing continued to play an important role in supporting growth of the construction sector. In recent years, there has been a discernible shift in the source of financing for the civil engineering sub-sector. The civil engineering sub-sector has increasingly tapped the capital market by issuing private debt securities (PDS) and also through recourse to Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB) to meet its financing requirements. PDS issued for infrastructure projects amounted to RM6 billion out of the total RM42.8 billion PDS issued for the year, representing 14% of total PDS issued (2002: 8%). Similarly, total loans approved by BPIMB for infrastructure projects rose to RM5 billion in 2003 (2002: RM2.8 billion). However, loans outstanding of the banking system for infrastructure projects declined to RM3.4 billion (2002: RM5.2 billion). For residential property, the banking system continued to be the main source of financing. Total housing loans approved by the banking system increased by 2.9% to RM30 billion.

In addition, loans approved by other housing credit institutions as a group also increased during the year. In tandem with higher approvals, housing loans outstanding of the banking system as well as other housing credit institutions rose by 16.1% and 10.4% respectively.

In 2003, construction activity was higher with the return of foreign workers who were repatriated in 2002. Nonetheless, over-dependence on foreign labour remained an issue in raising productivity in the sector. Meanwhile, the Construction Labour Exchange Centre Berhad was set up in 2003 to act as a centre for training and screening of foreign workers as well as supplying and transferring excess foreign workers to contractors who require these workers from time to time.

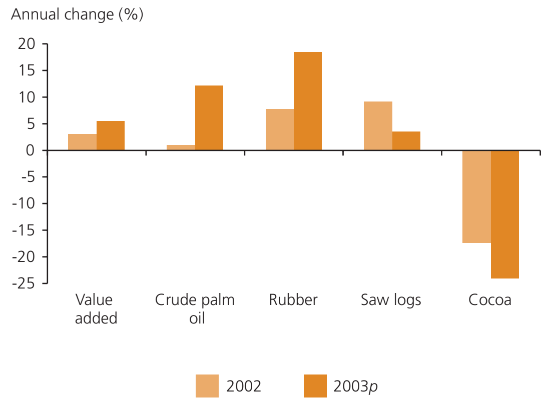
Another development during the year was the launch of the Building Materials Cost Index by the Construction Industry Development Board in collaboration with the Department of Statistics, Malaysia. The Index gives an indication of pressures arising from input cost. While the Index showed that overall prices of building materials have remained steady from the second half of 2002 until September 2003, some construction companies faced shortages of building materials. The shortage was mainly in steel bars as millers preferred to export their products to take advantage of the higher prices overseas.

In line with the Government's efforts to streamline the approval and delivery process of the Government machinery, the Ministry of Housing and Local Government implemented a two-tier One-Stop Centre at the local authority and state government levels for building plan approvals and issuance of Certificate of Fitness for Occupation (CFO). In addition, the number of technical departments involved in certifying CFOs was also reduced from seven to four.

Agriculture sector

In 2003, the **agriculture, forestry and fishery** (agriculture) sector recorded the strongest growth in 11 years against a backdrop of robust exports and high prices. Value added growth picked up to 5.5% driven mainly by significant increases in crude palm oil and rubber output. Growth was also supported by increases in production of saw logs and, to a lesser extent, other agricultural commodities, namely vegetables, fruits, livestock and fish, reflecting the positive effects of measures taken by the

Graph 1.12
Agriculture Production



p Preliminary

Government to increase domestic sources of growth through increased food production. Meanwhile, cocoa output declined significantly during the year. Given the substantial increases of between 11-42% in the prices of major commodities during the year and improved export volume, export receipts from agricultural commodities rose significantly by 28.1%. Thus, the share of agriculture exports to total exports rose from an average of 6.5% in the period 2000-2002 to 8.4% in 2003.

The strong performance of the agriculture sector during the year was attributable to both supply and demand factors. Crude palm oil and rubber registered double-digit growth as farmers maximised production by increasing yields through good agriculture practices (including higher usage of fertilisers), encouraged by more favourable prices. Production of palm oil was also supported by favourable weather conditions as well as the coming on stream of new mature areas with high yielding

Graph 1.13
Agriculture Exports

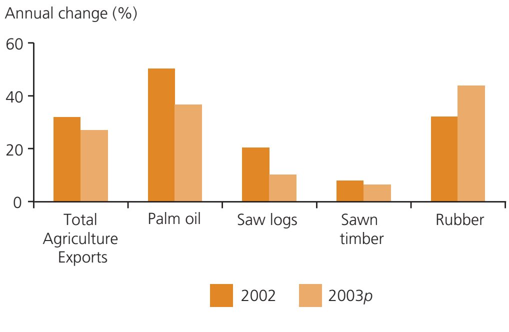


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Table 1.7
Agriculture Sector: Value Added, Production and Exports

	2002		2003*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value Added (RM million at 1987 prices)	**18,438**	**3.0**	**19,453**	**5.5**
Production[1]				
of which:				
Crude palm oil	11,909	0.9	13,355	12.1
Rubber	589	7.7	698	18.4
Saw logs	20,649	9.1	21,381	3.5
Cocoa beans	48	-17.4	36	-24.0
Exports (RM million)	**26,327**	**31.9**	**33,728**	**28.1**
of which:				
Palm oil				
('000 tonnes)	10,854	3.7	12,509	15.2
(RM/tonne)	1,367	44.9	1,617	18.3
(RM million)	14,838	50.2	20,224	36.3
Rubber				
('000 tonnes)	928	12.9	945	1.9
(sen/kilogramme)	269	17.0	379	41.0
(RM million)	2,492	32.1	3,582	43.8
Saw logs				
('000 cubic metres)	5,104	5.6	5,508	7.9
(RM/cubic metre)	359	13.9	366	1.9
(RM million)	1,832	20.3	2,015	10.0
Sawn timber				
('000 cubic metres)	2,474	2.6	2,816	13.8
(RM/cubic metre)	990	5.0	926	-6.5
(RM million)	2,450	7.8	2,607	6.4

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

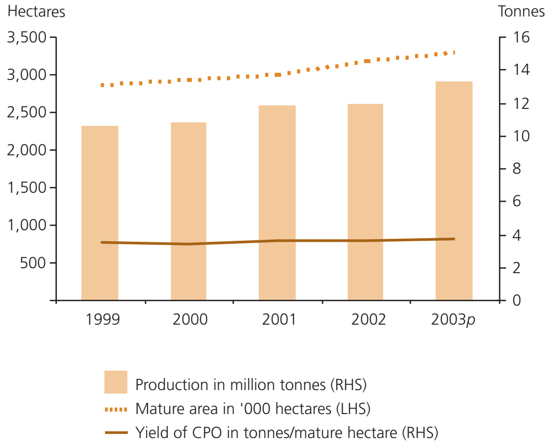
Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board

trees. Meanwhile, higher rubber production was due to intensive tapping, including in areas that were previously abandoned. At the same time, external demand for these commodities was strong amidst supply shortages in the global market.

The stronger performance of the agriculture sector in 2003 generated significant spill-over effects, particularly on the rural population. Given that the agriculture sector employs about 14% of the total workforce in Malaysia and that a sizable proportion of them are smallholders, the higher incomes helped support the increase in consumption among the rural community. The plantation sector also benefited from the stronger economic performance, resulting in sharp increases in profits.

Crude palm oil (CPO) remained as the major commodity, accounting for about 4.1 percentage points of the increase in the value added of the agriculture sector in 2003. CPO recorded a bumper production of 13.35 million tonnes or an increase of 12.1%. Growth was primarily due to expansion in total mature area (3.1%), mainly in Sabah (6.3%) and Sarawak (13%) as well as good agriculture practices.

Graph 1.14
Oil Palm: Area, Production and Yield



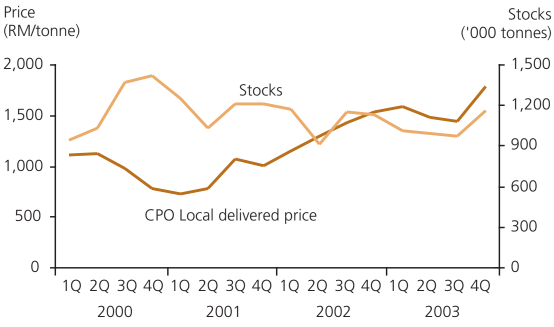
p Preliminary for mature area and yield

As a result, CPO output, which usually peaks in the third quarter in a normal year, recorded monthly production of above one million tonnes for an extended period during April – December 2003. On a regional basis, Peninsular Malaysia accounted for almost 60% of total national output, or 7.94 million tonnes of CPO, while Sabah and Sarawak produced the remaining 5.41 tonnes. In terms of global ranking, Malaysia maintained its position as the leading palm oil producer and exporter in 2003, accounting for 49% of the world's output and 58% of total exports.

Average export prices of Malaysian palm oil rose by 18.3% to RM1,617 per tonne in 2003. Against a backdrop of supply shortages in the global oils and fats markets, prices of most oilseeds, oils and meals rallied in 2003, especially since August 2003. In line with these developments, Malaysian CPO local prices averaged RM1,577 per tonne in 2003 (2002: RM1,364). The stronger prices reflected mainly imbalances in the global vegetable oils and fats markets arising from a marginal increase in output of major oilseeds, especially soybean, amidst stronger demand from major consumers of edible oils. Soybean harvest in the United States was adversely affected by drought during the year. The shortages in soybean, rapeseed and sunflower oils led to large price premiums of these oils over palm oil and this triggered import substitution by price sensitive buyers. Export demand for palm oil from the major buyers of soybean oil (palm oil's closest substitute), namely P.R.China, the European Union (EU) and Middle East, picked up strongly during the year.

Demand from P.R.China, the EU, Pakistan and emerging markets in the Middle East, rose between 4% and 29% during the year, on account of lower domestic production amidst an expansion in their

Graph 1.15
Palm Oil Price and Stocks



refining capacities. In the case of P.R.China, the higher offtake was also due to its higher import quota for palm oil following its accession into WTO. However, imports by India, which is one of Malaysia's major buyers, declined in 2003 due to higher tariffs for palm oil products and imposition of new import regulations, which made palm oil less competitive against other major oilseeds. Nonetheless, with double-digit increases in price and export volume, palm oil generated an additional export revenue of RM5.4 billion in 2003, with total export receipts amounting to RM20.2 billion. Despite the strong external demand, Malaysian palm oil stocks remained almost unchanged at 1.17 million tonnes (end-2002 stocks: 1.14 million tonnes) given that output had also increased significantly during the year.

The palm oil industry made significant strides during the year. Malaysia gained market shares for palm oil-based products in five new markets, namely Chechnya, Antigua, Mayotte, Cape Verde and the Central African Republic. In the area of research and development, the Malaysian Palm Oil Board (MPOB) launched 35 new technologies and products for commercialisation in the palm oil industry in 2003. To enhance utilisation of palm oil products, MPOB together with local palm oil related agencies conducted research in collaboration with research organisations and institutional users in several consuming countries. Joint venture projects have been conducted with P.R.China, Egypt, Oman, Poland, Russia, Ukraine, South Africa, Pakistan, Turkey and Kuwait. In addition, Malaysia participated actively in the international scientific and trade meetings to promote facilitation of international trade for palm oil products.

Natural rubber production, which recorded its first positive annual growth in seven years in 2002, continued to expand strongly by 18.4% in 2003, to reach nearly 700,000 tonnes. Smallholders accounted for almost 90% of total national output as remunerative prices motivated intensive tapping activities, which led to a substantial increase in output of 23.3%. The increase in production was also contributed by tapping of trees that were previously abandoned. In contrast, production by estates declined further by 10.8% (2002: -14.7%) due mainly to continued conversion of rubber land into other economic activities during the year. Total tapped area for Malaysia expanded by about 48,000 hectares or 7% to 737,600 hectares.

In line with developments in the global natural rubber industry, the Malaysian rubber prices (RSS1) strengthened significantly by 37% to 401 sen per kilogramme in 2003 (2002: 292 sen). The increase in prices gained momentum during the course of the year, rising from 364 sen in the first quarter to 486 sen by the fourth quarter. RSS1 price peaked in November to record a monthly high of 512 sen, with the highest daily traded price at 543 sen on 5-6 November before consolidating to close the year at 473 sen. The strong price performance during the year was due to the surge in demand from P.R.China, active purchases by European traders as well as tight supplies in the major producing regions, which were affected by the wet weather, especially in the latter part of the year.

Purchases by P.R.China picked up significantly for the second consecutive year (60.2%; 2002: 51.4%), fuelled mainly by strong demand from the local automotive industry. The market was further supported by the decision of the Chinese government to raise the import quota for natural rubber by an additional 200,000 tonnes to accommodate the higher demand by the major tyre manufacturers. P.R.China remained as Malaysia's largest export market to account for 21.9% share of total rubber exports (2002: 13.9%). Besides P.R.China, the other major buyers were Korea, Germany and the Middle East, which together accounted for 52% of total rubber exports. Reflecting both higher prices and export volume, export receipts rose by 43.8% to RM3.6 billion in 2003.

A significant development in the international natural rubber sector in 2003 was the signing of the agreement for the establishment of the International Rubber Consortium Limited (IRCo) on 6 October by Malaysia, Thailand and Indonesia. IRCo was formed with the objective to undertake strategic market operations, as and when deemed necessary, as well as to complement agreed measures by these countries under the Supply Management Scheme and the Agreed Export Tonnage Scheme, which were endorsed earlier in 2001. These schemes have contributed positively to improving the overall sentiment of the rubber market.

Given the importance of the natural rubber sector in terms of employment of the rural community as well as its strong linkages to the downstream rubber-based industries, rubber has been identified as one of the strategic crops for sustainable growth of the Malaysian agriculture sector. In 2003, further measures were taken to develop the natural rubber sector, including a study on the medium-term master plan. An interim report of the study has been completed. Apart from traditional planting of rubber to produce latex to sustain the encouraging growth of the rubber wood-based industries, the Government has announced incentives to encourage private sector investment. This includes encouraging cultivation of latex-timber clone rubber for both latex and timber production. This clone would also assist in reducing anticipated shortage in the supply of rubber wood for the manufacture of furniture, as 80% of earnings from Malaysian furniture exports are rubber wood-based.

Logging activities in all regions, namely Sarawak, Sabah and Peninsular Malaysia, intensified in 2003. Total production of **saw logs** increased by 3.5% to 21,381 cubic metres in response to stronger external and domestic demand. Demand from the domestic wood-based industries turned around to record a growth of 0.9% in 2003 (2002: -6%), whilst shipments of logs increased by 7.9%. Exports increased despite strong competition from other hardwood producing countries such as Indonesia, Vietnam, Brazil and Africa. Purchases by the major regional buyers, namely Thailand, India, P.R.China and Chinese Taipei, which accounted for about 63% of total exports, rose by 24%. Amidst the strong regional demand and keen competition in the international markets, prices of Malaysian logs remained relatively stable at RM366 per cubic metre (2002: RM359). Consequently, export revenue from saw logs increased by 10% in 2003. Meanwhile, export volume of sawn timber rose by 13.8%, especially to markets in the EU, but growth in export receipts moderated during the year due entirely to lower export prices (-6.5%).

On the international front, the Malaysian timber industry continued to face pressures by the "green" sentiment in Europe, especially in the Scandinavian countries. This was reflected in the unilateral restriction imposed by the Norwegian government on imports of tropical timber for public projects, unless certified by the Forest Stewardship Council (FSC). The timber industry has also to contend with new regulations and standards that are imposed by developed countries ostensibly to protect the environment as well as the safety and health of consumers. Since October 2001, the Malaysian timber industry has responded to the "green" sentiment with the setting up of its own certification scheme operated by the Malaysian Timber Certification Council (MTCC). By end-2003, seven states have been awarded the Certificate for Forest Management, and 38 timber companies have been given permits to use the MTCC logo to provide the assurance of sustainable and legal source of forest products to buyers of Malaysian timber and timber products. Another significant development during the year was the acceptance of the MTCC scheme by Denmark as one of the accepted certification schemes in its Environmental Guidelines for Purchasing Tropical Timber. Given the wider acceptance and recognition of Malaysia's timber certification efforts, a total of 6,629 cubic metres of MTCC-certified sawn timber (2002: 732 cubic metres) and 45 cubic metres of mouldings were exported to a number of countries, particularly to Europe, in 2003.

Production of other **agriculture commodities**, comprising vegetables, fruits, livestock and fishery, registered a mildly positive growth during the year. The increase in vegetables (4.5%) and fruits (3.1%) production was supported mainly by an expansion in the cultivated area. The increase in cultivated area for these crops was in line with the expansion in the area allocated for the Permanent Food Production Park (PFPP) scheme. As at end-2003, more than 2,160 hectares of land were developed under the scheme, with the bulk or 1,681 hectares allocated for the planting of vegetables. Similarly, growth in the livestock sub-sector increased by 5.5%, mainly on account of higher poultry production, as demand, particularly from the domestic food processing industries was higher. The fishery sub-sector also expanded further by 2.6%, supported mainly by higher landings of marine fish.

Output of **cocoa beans** declined sharply by 24% to 36,240 tonnes, attributable mainly to lower cultivated area from 48,035 hectares in 2002 to an estimated 46,395 hectares in 2003. The reduction reflected mainly conversion of cocoa land to other crops as well as adverse effects from the wet weather conditions, particularly in the final quarter of 2003. Cocoa yields were lower as the higher amount of rainfall affected the fruit-setting period for the main crop and intensified the black pod infection. Amidst the need to increase production of cocoa beans to meet the requirements of local cocoa grinders as well as to reduce dependency on imported cocoa beans, rehabilitation programmes involving mainly smallholders continued during the year. Under the Cocoa Smallholders' Development Programme, a total of 6,916 hectares or 15% of total acreage under the cocoa smallholdings area were developed as at end-2003.

Export prices of cocoa rose further by 20.9% during the year to RM6,314 per tonne due to supply disruptions in a major producing country following unfavourable political developments. However, the Malaysian cocoa sector was unable to capitalise fully from the high prices of cocoa as domestic production also fell during the year. Hence, export revenue from cocoa declined to RM83 million (2002: RM110 million).

Mining Sector

The **mining sector** expanded by 4.8% in 2003, as strong domestic and external demand amidst expansion in production capacity stimulated higher production of crude oil and natural gas. Following higher shipments of oil and gas as well as the significant increase in export prices, gross foreign exchange revenue from exports of minerals increased substantially by 33.1% in 2003.

Crude oil production (excluding condensates) rose by 5% to 625,800 barrels per day (bpd) compared with 2002, close to the year's production target of 626,000 bpd under the National Depletion Policy. The increase in production during the year was driven by increased domestic demand for petroleum products and higher external demand, particularly from India, Australia, Thailand, P.R.China and US, which together accounted for about 65% of Malaysia's total export of oil. Exports to these countries increased by 34% during the year. Higher output emanated from existing oil fields as well as four new oil fields that came on stream during the year. The increase in export volume and sharply

Graph 1.16
Mining Production

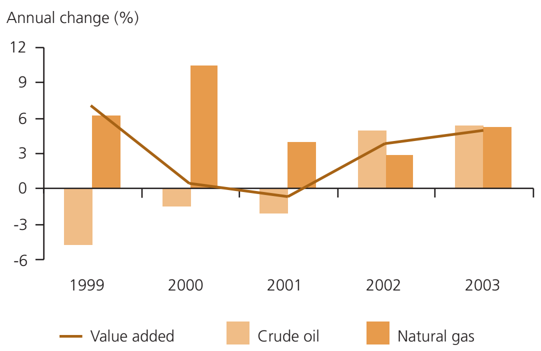


Table 1.8
Mining Sector: Value Added, Production and Exports

	2002		2003*p*	
	Volume and Value	Annual change (%)	Volume and Value	Annual change (%)
Value added (RM million at 1987 prices)	**15,826**	**3.7**	**16,581**	**4.8**
Production				
Crude oil and condensates (barrels per day)	698,462	4.9	736,000	5.4
of which: *Crude oil (barrels per day)*	*596,216*	*2.9*	*625,775*	*5.0*
Natural gas - net (million standard cubic feet)	1,706,141	2.9	1,794,388	5.2
Tin-in-concentrates (tonnes)	4,215	-15.2	3,606	-14.2
Exports (RM million)	**22,364**	**-4.6**	**29,777**	**33.1**
of which:				
Crude oil				
('000 tonnes)	16,192	7.4	17,913	10.6
(US$/barrel)	24.81	-2.8	30.27	22.0
(RM million)	11,600	4.3	15,662	35.0
Liquefied natural gas				
('000 tonnes)	15,007	-2.7	17,402	16.0
(RM/tonne)	659	-8.6	766	16.2
(RM million)	9,888	-11.1	13,328	34.8
Tin				
('000 tonnes)	27,076	-0.7	15,164	-44.0
(RM/tonne)	15,713	-7.0	18,732	19.2
(RM million)	425	-7.7	284	-33.2

p Preliminary

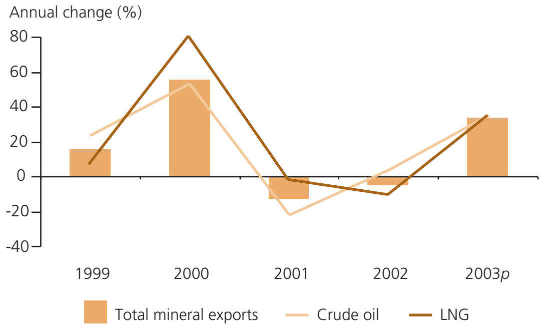
Sources: PETRONAS
Department of Statistics, Malaysia
Department of Minerals and Geoscience, Malaysia

higher export prices (22%), lifted gross receipts from crude oil exports by 35% to RM15.7 billion (2002: RM11.6 billion), to account for 4% of gross exports.

Malaysian crude oil prices (Tapis Blend) strengthened significantly to average US$29.79 per barrel (2002: US$25.55) in tandem with higher global crude oil prices. Prices during the year were, to a large extent, driven by market sentiments as well as fundamental factors. In early 2003, geopolitical concerns in the Middle East, supply disruptions in the major producing countries, namely, Venezuela, Nigeria and Iraq, and lean inventories in the major consuming countries, especially in the US, sustained Malaysian export prices at a high level of above US$30 per barrel in the first quarter of the year. In the second half-year, Malaysian crude oil prices averaged US$30 per barrel, in line with the international oil prices of West Texas Intermediate and North Sea Brent, which averaged US$30.64 and US$28.96 per barrel, respectively.

Decisions by the Organisation of Petroleum Exporting Countries (OPEC) in managing global oil supplies was a dominant factor in determining oil prices, particularly during the post-Iraq war period. In the first half of 2003, OPEC, which accounts for about

Graph 1.17
Mineral Exports



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40% of world supply, raised its output quota twice, by 1.3 million bpd and 2.4 million bpd respectively to 25.4 million bpd to ease the shortfall in supply. Subsequently, in November, OPEC reversed part of its earlier increases by cutting the output quota by 900,000 bpd to 24.5 million bpd amidst concerns of increasing supplies by non-OPEC members. This, together with the pick-up in global growth and the seasonally higher demand during the fourth quarter, helped to sustain the high oil prices towards end-year. P.R.China accounted for almost 35% of the increase in global oil demand during 2003. Reflective of these developments, the Malaysian crude oil prices remained relatively strong during the year to close at US$32.15 per barrel as at end-December.

Natural gas production expanded by 5.2% in 2003 as the sector was able to respond to the higher demand given an increase in production capacity, especially with the commencement of the MLNG Tiga plant in May 2003 and the coming on stream of four new gas fields during the year. Domestic demand remained favourable, particularly from the power generation sub-sector, which consumed 66% of total domestic gas production. Higher offtake by all LNG buyers, namely Japan, Korea and Chinese Taipei as well as the increase in export prices (RM766 per tonne; 2002: RM659) led to the sharp increase of 34.8% in export receipts generated from LNG.

Production of **tin-in-concentrates** declined by 14.2% in 2003, despite higher prices and an increase in the number of active tin mines. Decline in production was due mainly to depleting tin reserves in existing tin mines, which resulted in low productivity.

During the year, four new oil fields, two each in Peninsular Malaysia and Sarawak, commenced operations, thus bringing the total number of oil fields in production as at end-2003 to 51. With the commencement of four new gas fields in Peninsular Malaysia and Sarawak, a total of 18 gas fields were in operation by end-2003.

A significant development in the Malaysian oil sector in 2003 was the discoveries of deepwater oil reserves in offshore Sabah towards the latter part of the year. Prior to these discoveries, oil was also found in offshore Sabah in July 2002. A total of six new production-sharing contracts were signed in 2003.

Services Sector

In 2003, the **services sector** remained resilient, recovering rapidly from the adverse effects of the Severe Acute Respiratory Syndrome (SARS) that occurred in the early part of the year. Overall, the effects of SARS were found to be transitory and affected the retail, tourism and travel-related sectors, mainly in the second quarter of the year. Tourist arrivals fell significantly for a brief period in April-May (average of 500,000) before gradually picking up in the following months to reach the pre-SARS level of above one million tourists by November. Amidst the sharp decline in tourist arrivals and weaker consumer sentiment, growth in the services sector slowed down to 2.9% during the second quarter. The quick containment of the disease globally and the pro-active measures undertaken by the Government to assist the affected industries and to boost consumer confidence, contributed to the recovery in the services sector in the second half-year, which grew by 4.5% (first half-year: 3.7%). While growth in final services moderated largely due to the impact of SARS, growth in the intermediate services was more robust, supported by stronger trade-related activities. Overall, growth in the services sector was sustained at 4.1% during the year, but its share to GDP declined slightly to 56.4% from 57% in 2002.

Within the final services sector, growth in the **wholesale and retail trade, hotels and**

The services sectors remained resilient despite the occurrence of SARS. Activity picked up strongly in the second half-year, largely due to stronger domestic demand, aided by the Economic Package.

Table 1.9
Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at end	
	2002	2003*p*
Crude oil		
Reserves (billion barrels)	3.61	3.69
Reserve/Production (year)	16.0	16.0
Natural gas		
Reserves (trillion standard cubic feet)	87.76	89.67
Reserve/Production (year)	35.7	30 - 40

[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

Table 1.10
Growth in the Services Sector at Constant 1987 Prices

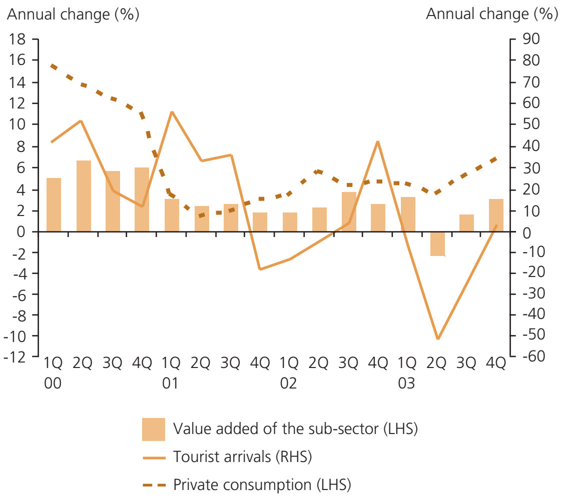
	2002	2003*p*			2002	2003*p*
		1H	2H	Year		
	Annual change (%)				% share of GDP	
Services	**4.1**	**3.7**	**4.5**	**4.1**	**57.0**	**56.4**
Intermediate services	4.3	4.2	6.1	5.2	22.8	22.8
Transport, storage and communication	2.6	4.5	6.6	5.6	8.5	8.5
Finance, insurance, real estate and business services	5.3	4.1	5.7	4.9	14.3	14.3
Final services	4.1	3.3	3.4	3.4	34.2	33.6
Electricity, gas and water	3.9	7.3	5.1	6.2	4.0	4.0
Wholesale and retail trade, hotels and restaurants	2.6	0.6	2.4	1.5	14.9	14.4
Government services [1]	6.7	6.4	4.9	5.6	7.2	7.3
Other services [2]	4.6	3.3	3.2	3.2	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

restaurants sub-sector moderated to 1.5% in 2003. The sub-sector contracted in the second quarter by 2% as consumers avoided public places, whilst the hotel occupancy rate in some areas fell to 30% due to a decline in tourist arrivals and the cancellation of several meetings, incentives, conventions and exhibitions (MICE). Nevertheless, the Economic Package introduced in May helped the tourism and travel-related industries to tide over the difficult period as well as stimulate domestic demand. The strong pent-up demand, amidst the improving consumer confidence and recovery in tourist arrivals to the pre-SARS level, helped support the recovery in the sub-sector. By September, the average hotel occupancy rate rose above 50%. In addition, the upward trend in the equity market amidst stable employment conditions, disbursement of bonus payments and year-end festivities, further reinforced consumer sentiment, resulting in the expansion of the sub-sector in the second half-year.

Graph 1.18
Trends in Wholesale and Retail Trade, Hotels and Restaurants Sub-sector vis-a-vis Private Consumption and Tourist Arrivals



Value added growth was also affected by greater competition among retailers especially hypermarkets. Although the trend of lower prices had benefited consumers in general, the price competition had squeezed retailers' margins. Coupled with the evolving consumer preference to shop in hypermarkets and large multi-concept shopping centers, the year saw the exit of several small- and medium-sized retailers and rationalisation of existing retailers through mergers and acquisitions.

The **other services sub-sector** which includes community, social and personal services as well as imputed rent from owner-occupied dwellings, expanded at a moderate rate of 3.2% (2002: 4.6%). The moderation reflects slower growth in the community, social and personal services as entertainment and gaming activities were affected by SARS during the second quarter. Education and private healthcare services were also affected, albeit to a lesser extent. These sectors performed better for the year as a whole. The total number of students pursuing higher private education in Malaysia rose to almost 300,000 as at end-2003 (end-2002: 294,600), reflecting increases in students from both Malaysia and abroad. Similarly, the private healthcare industry continued to expand in response to increased demand by locals and foreigners for better healthcare services. The survey by the Association of Private Hospitals in Malaysia showed that the number of foreign patients treated in the private hospitals rose to 102,946 as at end-2003 (end-2002: 84,585).

The **Government services sub-sector** expanded by 5.6% in 2003 (2002: 6.7%). The growth reflected higher expenditure on emoluments following the salary adjustment for civil servants with the implementation of the *Skim Saraan Malaysia* in the last quarter of 2002. Consonant with the strengthening economic activity, the **utilities sub-sector** registered a higher growth of 6.2% (2002: 3.9%), reflecting mainly increased electricity demand, as well as higher gas and water consumption. The coming on stream of five power plants by the Independent Power Producers also contributed to the increase in electricity generation during the year.

Within the intermediate services sector, growth in the **transport, storage and communication sub-sector** picked up strongly by 5.6% in 2003 (2002: 2.6%), owing largely to robust activities in the telecommunications industry. The telecommunications industry benefited from economies of scale following the rationalisation of the cellular industry as well as the various measures undertaken to promote new areas of growth in telecommunications. In the cellular segment, growth accelerated in 2003 due to further expansion in the subscriber base (11 million; end-2002: 9 million) as well as increased usage of both traditional voice telephony and new applications in mobile data. During the year, Short Messaging Service (SMS) traffic rose significantly, boosted by the wider usage of SMS in various applications, such as entertainment and ticket reservation as well as the downloading of data and other information. Growth in mobile data was further reinforced by the introduction of the Multimedia Messaging Service (MMS) in the second half-year, which allows mobile phone users to enhance their messages by incorporating sounds and images. With the continued popularity of mobile phones, fixed line subscribers declined further.

Table 1.11
Selected Indicators for the Services Sector

	2002	2003*p*
	Annual change (%)	
Electricity production index	10.3	5.8
Loans outstanding in the banking system	4.6	4.8
Insurance premiums	13.3	14.0
KLSE (turnover, volume)	12.0	101.7
LRT ridership[1]	3.5	8.8
Tourist arrivals	4.0	-20.4
Airport passenger traffic	4.2	1.3
Air cargo handled	16.3	6.9
Bulk cargo throughput at five major ports[2]	4.9	9.7
Container throughput at six major ports[3]	23.8	14.9
	%	
Hotel occupancy rate	57.9	53.3
Penetration rate:		
- Internet dial-up	10.5	11.4
- Broadband	0.08	0.44
- Mobile phone	36.9	43.9
- Fixed line	18.8	18.1

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

Source:
Department of Statistics, Malaysia; Malaysia Airports Holdings Berhad; Kuala Lumpur Stock Exchange; Malaysian Communications and Multimedia Commission; Ministry of Finance; Port authorities; Syarikat Prasarana Negara Berhad; Malaysia Tourism Promotion Board; and Bank Negara Malaysia

Various measures undertaken to promote new areas of growth in the telecommunications industry, such as greater usage of e-commerce and on-line services for the purchase of goods and services, supported growth in the industry. In addition, the reduction in the access fee for broadband and strong demand for high-speed Internet access resulted in the number of broadband subscribers rising five fold to 110,400 as at end-2003, while the number of Internet subscribers increased by 10.1% to 2.9 million.

In the transportation industry, lower tourist arrivals affected the air passenger segment. Growth in the other segments was supported by higher trade and domestic tourism activities, particularly in the second half of the year. Following the increase in both indigenous and transhipment cargo, activity at the ports continued to remain strong. Total container cargo handled at the six major ports increased by 14.9% in 2003 (2002: 23.8%). Air cargo business was also enhanced by the introduction of the I-port programme in the two major ports, facilitating more efficient transfer of goods between ports and airports in the country. Aggressive campaigns undertaken by the Government to promote domestic tourism as well as the rapid expansion of the no-frills budget airline to many local destinations led to the continued increase in domestic passengers, compensating for the decline in international passengers during the year.

Growth in the **finance, insurance, real estate and business services sub-sector** was sustained at 4.9% in 2003 (2002: 5.3%). Growth emanated from increased bank lending amidst lower lending rates, more robust insurance activities, as well as the pick-up in the stock market and real estate activities in the latter part of the year. The low interest rates and attractive financing packages offered by financial institutions, additional funds provided by the Government under the Economic Package, as well as improved infrastructure for the small- and medium-enterprises stimulated lending activities during the year. Value added growth in the finance sector was supported by interest income and strong growth in fee-based income of financial institutions. The significant increase in insurance premiums from both conventional insurance and takaful products further supported the growth in the sub-sector.

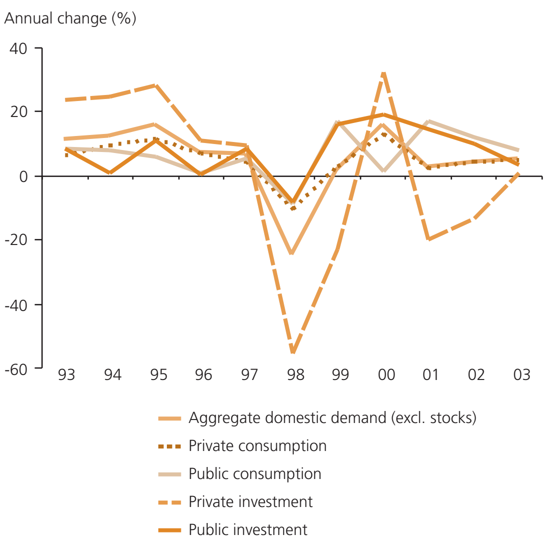
DOMESTIC DEMAND CONDITIONS

Domestic demand conditions strengthened further in 2003, as the economy successfully weathered the uncertainty in the external environment, including the outbreak of SARS and the geopolitical tensions in the first half of the year. Growth was driven mainly by stronger private sector activities and supported by public sector expenditure. The improved external environment in the second half-year, which led to rising consumer and business confidence, as well as the positive effects of the Government's Economic Package translated into higher private sector activities. The low interest rate environment, stable employment prospects, high commodity prices, improvement in corporate cash flow positions as well as further liberalisation of foreign equity ownership in the manufacturing sector reinforced the positive spill-over benefits from the Economic Package. As a result, the private sector resumed its role as the main driver of growth in 2003, led by the strengthening in consumer spending and a recovery in private investment. Meanwhile, growth in public sector expenditure moderated with the Government continuing to provide an enabling environment to support private sector activities. Overall, growth in **aggregate domestic demand** (excluding stocks) strengthened to 4.8% from 4.2% in 2002.

The **public sector** continued to play an important role in stimulating the economy. The pro-growth measures taken in early 2003 were instrumental in mitigating the impact of SARS and contributed towards the momentum of growth in the second half-year. Overall, the pace of expansion of public sector expenditure moderated to 5.5% in 2003, in line with the move towards gradual fiscal consolidation.

Domestic demand conditions strengthened further in 2003. The private sector resumed its lead role in driving growth, supported by higher consumption and the turnaround in private investment. Growth in public sector expenditure moderated but was supportive of private sector activities.

Graph 1.19
Real Domestic Demand Aggregates



Public consumption was sustained, increasing by 7.9% in 2003, due mainly to the continued high expenditure on supplies and services, emoluments and defence. The higher expenditure on supplies and services was largely due to the measures to improve the public sector delivery system. Meanwhile, the higher expenditure on emoluments was partly due to the implementation of the Malaysian Remuneration System for employees in the public sector (effective November 2002) as well as the special critical allowance for staff in Government hospitals who were directly involved in addressing SARS-related cases.

Reflecting the public sector's role of providing a supportive environment for private sector activities, **public investment** continued to increase in 2003, albeit moderately. The increase in public investment reflected higher outlays to improve and upgrade the country's infrastructure, including roads and highways, and rail, port and airport facilities. Higher outlays were also expended on the construction and upgrading of hospitals as well as rural and health clinics. In addition, expenditure on agriculture and rural development increased in 2003 in line with the Government's effort to modernise the agriculture sector and to narrow income disparities between urban and rural areas by encouraging agro-based industries. A large share of the expenditure continued to be channelled towards education and training, especially skills development and training in technical fields and on information and communication technology to facilitate the move towards a knowledge-based economy.

Total capital expenditure of the NFPEs remained high in 2003, on account of upgrading and capacity expansion programmes. Petroliam Nasional Berhad (PETRONAS) continued to invest in exploration and production projects as well as the construction of liquefied natural gas tankers and petroleum tankers. In the case of Tenaga Nasional Berhad, the bulk of the expenditure was for upgrading of the transmission system and power generation, while a large portion of Telekom Malaysia Berhad's expenditure was focussed on upgrading and capacity expansion to improve telecommunication infrastructure and services.

The private sector resumed its role as the main engine of growth for the Malaysian economy in 2003, contributing 2.5 percentage points to real GDP growth. **Private sector expenditure** increased significantly by 4.3% (2002: 0.7%), reflecting the up-turn in private investment and a further strengthening of consumer spending. **Private consumption** increased at a faster pace of 5.1% in 2003, after a hesitant start, particularly at the height of the geopolitical tensions and the SARS outbreak during the second quarter. Private consumption, which was less robust in April and May, regained strength from June as confidence improved following the containment of the SARS threat and the announcement of the Economic Package to promote domestic demand. Measures to enhance household disposable income included a voluntary reduction in the EPF contribution rate for employees and various tax exemptions. Lower interest rates following the reduction in the policy rate by Bank Negara Malaysia further improved consumer confidence. As a result, consumer spending gathered momentum and returned to its normal trend in the third quarter. The rise in consumer spending also reflected the effects of pent-up demand, with increased purchases of cars

Table 1.12
Private Consumption Indicators

	2002	2003				
		1Q	2Q	3Q	4Q	Year
Sales of passenger cars (incl. 4WD)						
'000 units	375.4	85.1	83.2	89.6	76.5	334.4
Annual change (%)	9.4	-7.4	-14.9	-9.5	-11.7	-10.9
Tax collection						
Sales tax (RM billion)	9.2	1.5	2.1	2.0	2.4	8.0
Service tax (RM billion)	2.2	0.4	0.7	0.4	0.6	2.0
Narrow Money (M1)						
Annual change (%)	10.3	8.4	10.0	11.9	14.6	14.6
Loans disbursed by banking system						
Consumption credit (excl. passenger cars) Annual change (%)	38.1	11.2	5.9	12.3	11.4	10.2
Retail trade, restaurants and hotels Annual change (%)	-1.4	6.5	7.8	6.9	12.1	8.4
MRA retail sales						
Annual change (%)	3.0	-0.1	-2.9	3.9	8.4	3.6
Credit card operation						
Turnover spending (RM billion)	26.8	7.2	7.1	8.0	8.6	30.9
Annual change (%)	25.0	18.8	13.8	15.5	14.2	15.5
MIER Consumer Sentiments Index	-	105.2	106.9	112.8	115.5	-
KLSE Composite Index	646.3	635.7	692.0	733.5	793.9	793.9
Commodity prices						
CPO (RM/tonne)	1,364	1,585	1,486	1,444	1,793	1,577
Crude oil (USD/barrel)	26	33	28	28	32	30
Rubber (sen/kg)	292	364	367	387	486	401

and consumer durables as well as higher expenditure on hotels and restaurants during the quarter. Retail sales also turned around to register a positive growth in the third quarter and strengthened further in the latter part of the year, reinforced by seasonal factors such as festivities, year-end bonus payments and back-to-school shopping. Other factors supporting higher consumer spending during the year included the positive wealth effect from the improved stock market performance as well as higher rural income due to the large multiplier impact of higher commodity prices.

Of significance, **private investment** turned around to record positive growth beginning from the third quarter of 2003. For the year as a whole, private investment increased by 1.1% following two years of contraction. The expansion in private sector investment reflected the improvement in business confidence, particularly in the second half-year. In addition, improved capacity utilisation due to rising external demand and higher production underpinned

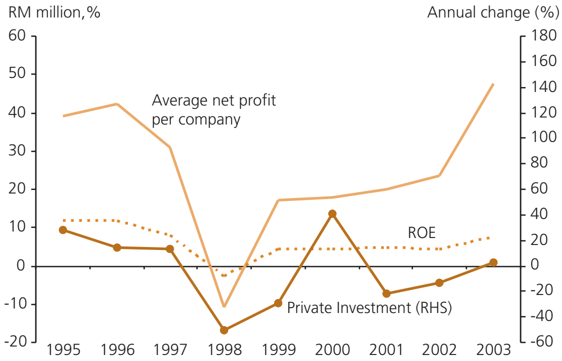
Table 1.13
Private Investment Indicators

	2002	2003				
		1Q	2Q	3Q	4Q	Year
Sales of commercial vehicles (incl. 4WD)						
'000 units	59.6	14.9	16.2	19.4	20.1	70.6
Annual change (%)	12.2	4.2	7.4	24.5	37.2	18.5
Applications to MITI						
No. of projects	878	208	225	272	228	933
Capital investment (RM billion)	18.8	12.2	5.1	4.2	4.3	25.8
Foreign	11.7	5.7	1.7	1.8	2.3	11.6
Local	7.0	6.4	3.4	2.4	2.0	14.1
Approvals by MITI						
No. of projects	792	292	199	261	213	965
Capital investment (RM billion)	17.9	5.3	2.7	12.0	9.1	29.1
Foreign	11.6	2.1	1.7	6.0	5.8	15.6
Local	6.3	3.2	0.9	6.0	3.3	13.5
MSC-Status Companies						
No. of companies	191	41	42	39	39	161
Approved investment (RM billion)	2.7	0.3	0.4	0.3	0.5	1.6
Loans disbursed by banking system						
Manufacturing sector Annual change (%)	0.9	1.9	3.0	7.3	7.0	4.8
Construction sector Annual change (%)	41.8	-1.3	-34.3	11.2	3.5	-8.5
Business services Annual change (%)	-7.4	7.4	-20.6	27.1	22.9	6.7
Private Debt Securities						
Total funds raised (RM billion)	26.7	16.2	12.0	6.4	8.3	42.8
Initial Public Offerings (KLSE)						
Total funds raised (RM billion)	6.8	0.2	0.2	0.6	3.0	4.0
MIER Business Conditions Survey						
Business Conditions Index	-	99.3	104.9	109.8	109.9	-
Capacity Utilisation Rate (%)	-	79.6	78.0	79.6	81.1	-

capital spending activities, particularly in the manufacturing sector. Other factors supporting the improvement in investment activities were the low interest rates as well as improved profitability and cash flow positions of companies in line with higher sales and profits.

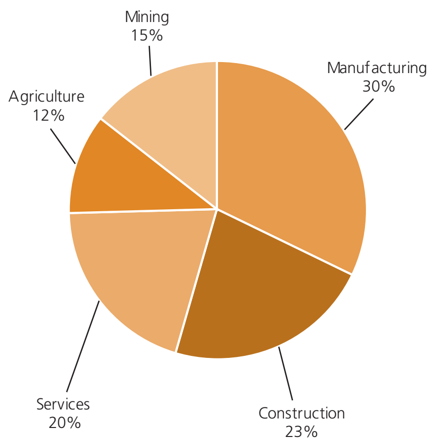
Business investment improved in most sectors of the economy except for the transportation sector where capital outlays had tapered off following the completion of large projects, and the telecommunication sector. **Manufacturing investment** turned around significantly to register a positive growth of 3.2% in 2003 (2002: -32.8%), reflecting the improvement in business conditions and the high capacity utilisation rates (82% in 2003).

Graph 1.20
Higher Investments with Higher Profits



Graph 1.21
Private Investment by Sector (% share)

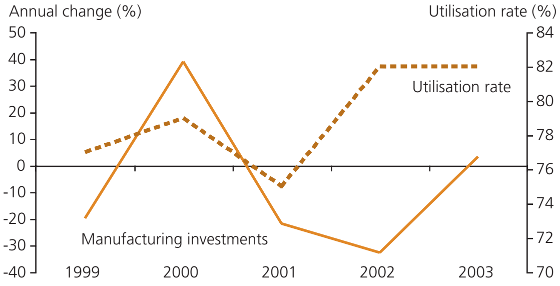
2003



Capital outlays in the manufacturing sector were mainly in the form of investment in machinery and equipment as industries needed to expand productive capacity in response to high demand and utilisation rates.

A positive development during the year was the significant improvement in the value of proposed investment applications and approvals in the manufacturing sector, signalling the improved business confidence and the need to add new capacity. The total value of applications received increased by 37.1% to RM25.8 billion, while the value of approved investment increased significantly by 62.8% to RM29.1 billion. Of the total value of investment approvals, approximately 77% was for new investment, while the balance was for reinvestment. Unlike in the past years when the electrical and electronics industry accounted for a large share of the total approved investment, a large

Graph 1.22
Manufacturing Investments and Capacity Utilisation Rates



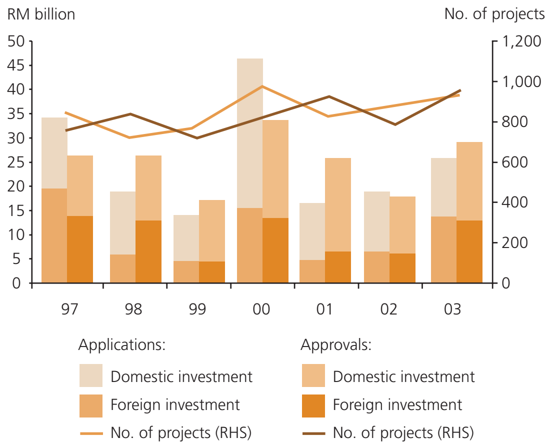
proportion of the approved investment in 2003 was in the basic metal products industry, which accounted for a significant share of 30% of total approved investment. This was followed by the transport equipment sector (24%) and the electrical and electronics industry (17%).

There has been some shift in the pattern of investment towards higher value added and higher technology projects, involving highly-skilled manpower and higher capital investment. For example, in the consumer electronics sub-sector, companies have shifted production from traditional products to higher value added products, such as digital audio-video equipment, multimedia speakers, plasma television sets and home theatres, while in the electronics sub-sector, approved projects were for high-end computer and computer peripheral products and high-end telecommunications equipment. Some companies have also set up their own research and development centres to improve design capabilities and reduce costs. This shift towards higher value added and higher technology is reflected in the gradual rise in the capital intensity as measured by the ringgit value of capital investment per employee (CIPE). The CIPE has increased from RM0.08 million in the 1980s to RM0.24 million in the 1990s and RM0.38 million in 2003.

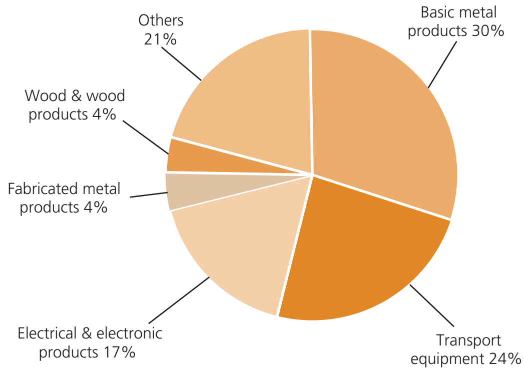
Reflecting the increased confidence of foreign investors, the value of approved foreign investment increased significantly by 35.1% to RM15.6 billion and accounted for 53.7% of the total approved investment. Of this amount, 28% was reinvestment by the existing foreign investors and 72% was for new activities. This indicated that Malaysia remained an attractive investment location despite the emergence of competition from other regional countries. The five most important sources of foreign investments in Malaysia in 2003 were United Arab Emirates, United Kingdom, the United States, Japan and Singapore, which together accounted for 80% of total foreign investments in approved projects. One of the approved projects includes a high technology project from the United Kingdom to develop a stratosphere-based high altitude surveillance and communication platform, which may eventually be a worldwide system of surveillance and communications as it complements contemporary satellite aerial infrastructure.

Meanwhile, local manufacturers have become more aggressive in their business expansion plans as their share of the value of investment applications have exceeded that of their foreign counterparts for the first time since 1997. The value of approved domestic investment more than doubled to RM13.5 billion, reflecting the positive response to the Government's

Graph 1.23
Private Investment in the Manufacturing Sector



Graph 1.24
Approved Manufacturing Investment by Industry, 2003 (% share)



policy to encourage domestic investment to drive growth. This development also reflected the success of the government's efforts in encouraging local manufacturers to upgrade their productive capacity as well as collaborate with foreigners in new business ventures. Excluding a single large investment in the basic metal products industry, local investments were concentrated in the high value-added non-resource based industries, namely, the transport equipment, electrical and electronics products and fabricated metal products industry.

Investment in the **construction sector** continued to register a moderate increase during the year. A large part of construction investment reflected activities in the residential sub-sector, which was supported by the conducive property market environment in response to the low interest rates offered by the banking institutions and the Government's Economic Package for the property sector. Meanwhile, capital investment in the sector was also supported by activity in several ongoing privatised road projects, namely the New Pantai Expressway, Kajang Ring Road, Guthrie Corridor Expressway, SPRINT Highway (Penchala Link), Kajang-Seremban Expressway, Jelutong Highway and Butterworth Outer Ring Road.

Stronger investment activities in the **services sector** were visible in the utilities as well as the retail, wholesale and business sub-sectors. Capital spending in the utilities sub-sector continued to increase in 2003, supported by activities in water supply projects as well as the development works of several power plants. The power plants that came onstream during the year included the Teknologi Tenaga Perlis Power Plant, Prai Power Plant and Panglima Power Plant, while the construction of the new 2,100MW power plant in Tanjung Bin was in progress. The consolidation of the telecommunications industry affected investment in this sub-sector. The rationalisation exercises of telecommunication operators and the merger of service providers contributed to lower capital spending. Investment in the sub-sector was mainly towards improving the existing network quality and increasing coverage areas in response to intense competition, particularly in the cellular services sector. Investment in the transport sub-sector was largely supported by the development of ports, reflecting mainly the capacity expansion of Port of Tanjung Pelepas, West Port and Kuantan Port. In recent years, capital spending in the sub-sector had been on a declining trend due to the completion of several major rail projects. The KL Monorail was completed and started commercial operations in the second half of 2003.

Capital spending in the retail business reflected the establishment of new outlets in the expansion programmes by major hypermarket operators and established retailers. Various incentives introduced by the Government have attracted companies to establish shared services centres in Malaysia, which provide information technology services, software development, customer management and data processing for the companies' global or regional operations. The setting up of these shared services centres includes additional capital spending in technology and logistic infrastructure. A major development project during the year was the intensification of the Proton City mixed development project.

New capital expenditure in the **mining sector** was largely by the oil and gas sub-sector, boosted by higher upstream activities in exploration and production. Higher demand for crude oil, coupled with the increase in crude oil prices, encouraged companies to increase capital expenditure for production facilities. Sustained investment in the **agriculture sector** was largely attributed to activities in crop plantation, with a larger contribution from palm oil plantations, buoyed by stronger demand for crude palm oil and high prices. The capital expenditure was mainly to improve efficiency in crop harvesting processes and for new planting as well as replanting activities. The increase in investment in the agriculture sector was also reflected in higher imports of agricultural equipment during the year. In addition, higher investment committed under the National Agricultural Policy continued to encourage participation from the private sector, primarily for food production.

Notwithstanding stronger consumption spending in 2003, **gross national savings (GNS)** increased by 18.1%. Higher incomes from the improvement in external demand and strong export earnings from high commodity prices led to a significant expansion in gross national income in nominal value.

In the private sector, both households and the corporate sector enjoyed stronger cash flows, benefiting from higher disposable incomes as a result of the measures in the Economic Package, the significant improvement in domestic activities and external demand, and sharply higher commodity prices. This enabled private consumption to strengthen further in 2003, while private sector savings registered a strong increase of 34.7% during the year, with the main contributor being corporate

Table 1.14
Savings-Investment Gap

	2002	2003*p*
	(RM million)	
Public gross domestic capital formation	53,698	56,304
Public savings	63,496	66,313
Deficit / surplus	9,798	10,009
Private gross domestic capital formation[1]	31,317	29,329
Private savings	52,013	70,081
Deficit / surplus	20,696	40,752
Gross domestic capital formation	85,015	85,633
(% of GNP)	25.3	23.2
Gross national savings	115,509	136,394
(% of GNP)	34.4	36.9
Balance on current account	30,494	50,761
(% of GNP)	9.1	13.7

[1] Includes the change in stocks. Previously, the change in stocks was distributed between the public and private sector gross domestic capital formation.
p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

savings. Higher corporate savings was reflected in a marked increase of RM13.9 billion in new deposits placed by businesses in the banking institutions, compared with a net withdrawal of RM154 million in 2002. Despite higher public consumption, public sector savings increased further by 4.4% due mainly to better revenue performance of both the Federal Government and the non-financial public enterprises.

Overall, the share of GNS to GNP rose to 36.9% in 2003 compared with 34.4% in 2002. This high rate of savings has enabled Malaysia to finance its economic growth from domestic sources. With the recovery in investment still in its early stage, gross domestic capital formation (including stocks) registered modest growth. The savings-investment balance as reflected in the current account of the balance of payments, therefore, recorded a higher surplus of RM50.8 billion or 13.7% of GNP. The savings-investment surplus is expected to moderate as the recovery in investments would strengthen in line with stronger economic growth.

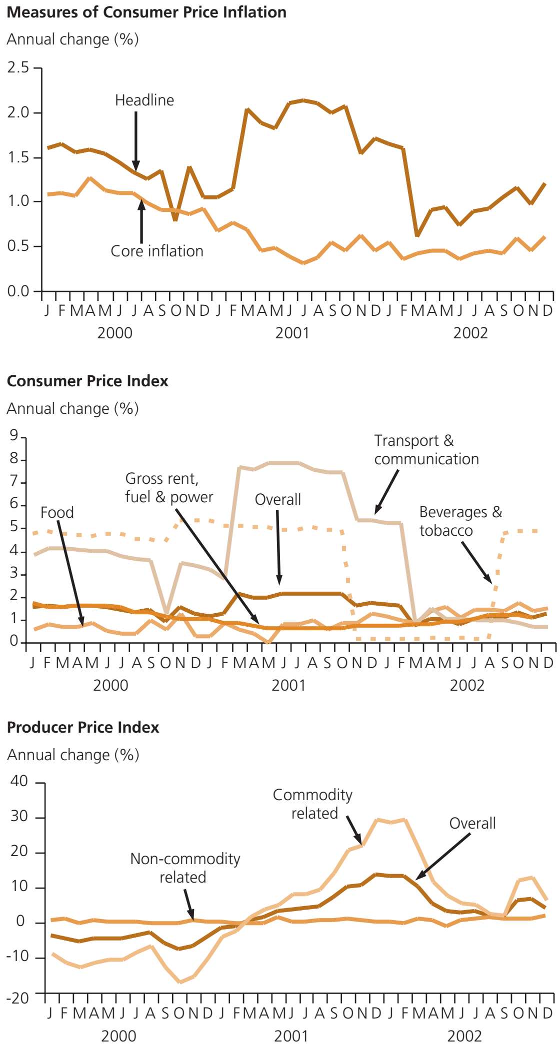
PRICES AND EMPLOYMENT

Consumer Prices

Inflation remained low and stable in 2003. The overall inflation rate, as measured by the annual change in the Consumer Price Index (CPI), was slightly lower at 1.2%, compared with 1.8% in the previous year. Core inflation, which is inflation excluding price-controlled and price-volatile items as well as items that are subject to one-off price adjustments, remained broadly stable at 0.6% in 2003 (2002: 0.5%). Several factors combined to ensure that inflation was benign. While domestic demand strengthened, excess capacity in selected sectors and the absence of wage cost pressures, amidst improving labour productivity, helped to contain price pressures. Small price adjustments, in March 2003, in retail prices of petrol, diesel and cooking gas and telephone rental contributed to about 0.4 percentage point to the overall inflation during the year.

Transport and communication prices moderated significantly in 2003 due in part to the higher base in 2002, despite higher prices of petroleum and petroleum-related products. Prices for clothing and footwear, furniture, furnishing and household equipment continued to decline during the year

Graph 1.25
Inflation: Annual Rate of Change



Graph 1.26
Contribution to Annual Change in the Consumer Price Index

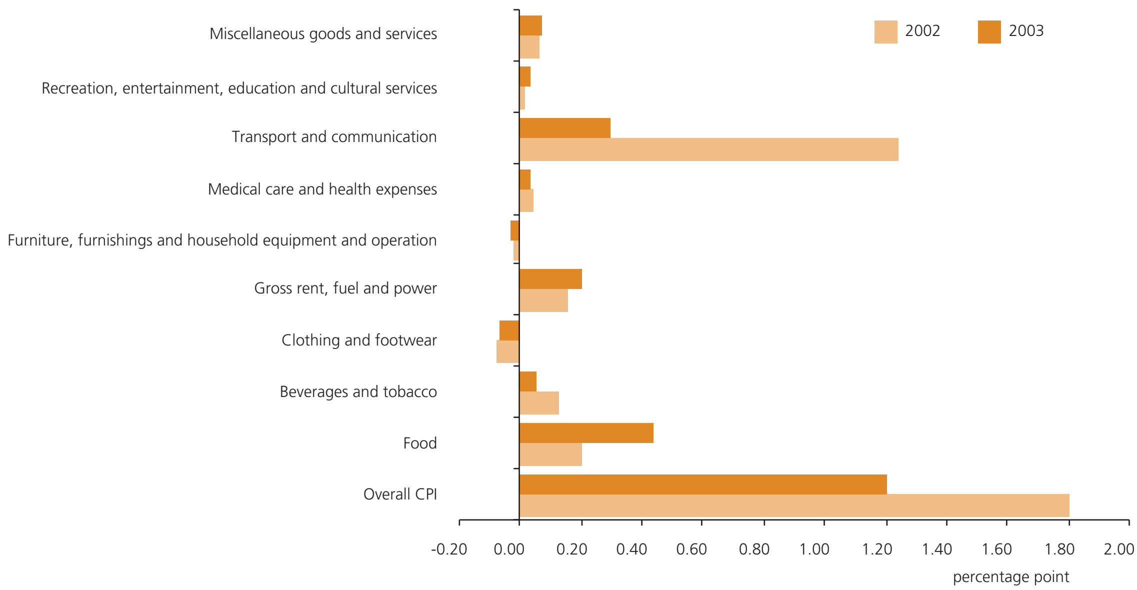


Table 1.15
Price Indicators

	Weight	2002	2003
Consumer Price Index (2000=100)	Annual change %		
	100.0	**1.8**	**1.2**
of which:			
Food	33.8	0.7	1.3
Beverages and tobacco	3.1	4.2	1.6
Clothing and footwear	3.4	-2.3	-2.0
Gross rent, fuel and power	22.4	0.7	0.9
Furniture, furnishings and household equipment and operation	5.3	-0.4	-0.6
Medical care and health expenses	1.8	2.4	1.7
Transport and communication	18.8	6.6	1.6
Recreation, entertainment, education and cultural services	5.9	0.2	0.6
Miscellaneous goods and services	5.5	1.1	1.3
Consumer Price Index			
Durable Goods	9.4	-0.8	-1.1
Semi-Durable Goods	5.4	-1.6	-1.4
Non-durable Goods	40.2	1.6	1.6
Services	45.0	3.0	1.3
Producer Price Index (1989=100)	**100.0**	**4.4**	**5.8**
of which:			
Local Production	79.3	5.7	7.0
Imports	20.7	-0.7	0.8
House Price Index (1990=100)		**-0.6**	**-**
of which:			
Klang Valley		-0.3	-
Johor Bahru		-6.0	-
Penang Island		-5.2	-

Source: Department of Statistics, Malaysia
NAPIC, Department of Valuation and Property Services

amidst increased capacity and rising competition from imported goods.

Stronger demand was reflected mainly in higher prices for food, rental, fuel and power. Generally, higher prices for food items reflected stronger demand amidst higher commodity prices, and higher prices for selected imported food items. Meanwhile, the increase in rental was moderate. Rental for lower-end houses rose by 1%, while the increase for the higher-end houses was 0.8%.

Producer Prices

Producer prices, as measured by the Producer Price Index (PPI), rose at a higher annual rate of 5.7% in 2003 (2002: 3.7%), reflecting largely higher prices for commodity-related products, following higher prices of crude palm oil, rubber and crude petroleum. Excluding commodity-related products, producer prices remained subdued, increasing by 0.5% (2002: 0.1%). Prices paid for imported goods increased by 0.8% (2002: -0.7%), reflecting mainly higher petroleum prices and the appreciation of major currencies against the ringgit.

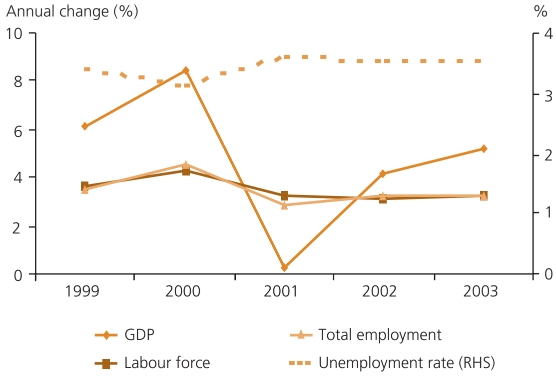
Labour Market Developments

The domestic **labour market conditions** remained stable and healthy. In 2003, overall growth in total employment and the labour force expanded moderately by the same rate of 3.3% to 10.2 million workers and 10.5 million persons respectively. The unemployment rate remained low at 3.5%. Further measures were undertaken in 2003 to improve the quality of labour, narrow the skills mismatches and address the changing demands of the economy.

The Beveridge Curve, which tracks the pattern of unemployment and vacancies in the labour market, shifted downwards and inwards in 2003, indicating lower turnover in the labour market and increased efficiency in the worker-job matching process. This was corroborated by the findings of other surveys. 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 was lower at 1.76% in 2003 (2002: 4.1%). Similarly, the Salary and Fringe Benefits Survey undertaken by the Malaysian Employers Federation (MEF), which also included firms from the non-manufacturing sectors, showed that the overall average monthly turnover rate remained low at 1.76% in 2003 (2002: 1.66%).

The low turnover in the labour market was also reflected in data on vacancies and retrenchment for 2003, while data on placements and unplaced job seekers mirrored the efficiency in the job matching process. Growth in the number of vacancies reported, which were mainly in the manufacturing, agriculture, services and construction sectors, moderated by 40% to 96,918 (2002: 162,787). Retrenchments, which occurred mainly in the manufacturing and tourism-related sectors, were also lower by 20% (21,206 persons; 2002: 26,452). The main reasons for retrenchment included reduction in demand for products, company reorganisation and closure of company. Other reasons included completion of projects, reduction in production and

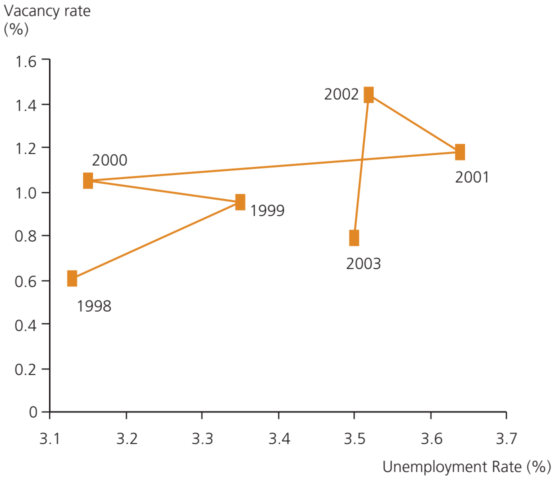
Graph 1.28
Output and Employment



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

Labour market conditions remained favourable, supported by higher growth in productivity.

Graph 1.27
Beveridge Curve for Malaysia (1998 - 2003)



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

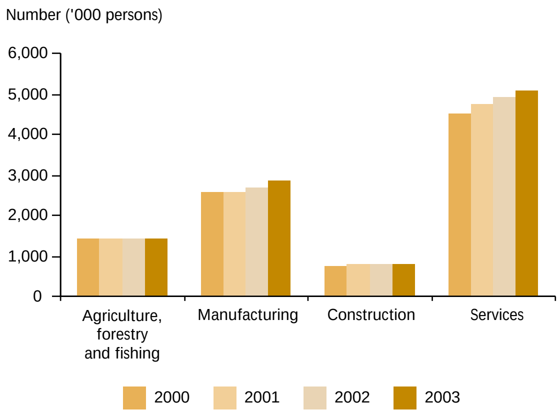
Table 1.16
Labour Market Indicators

	1999	2000	2001	2002	2003e
Labour force ('000)	9,177.8	9,572.5	9,892.1	10,198.8	10,535.3
(annual change in %)	3.7	4.3	3.3	3.1	3.3
Employment ('000)	8,869.6	9,271.2	9,532.5	9,840.0	10,166.2
(annual change in %)	3.5	4.5	2.8	3.2	3.3
Unemployment rate (%)	3.4	3.1	3.6	3.5	3.5
Labour productivity (GDP/Employment) (annual change in %)	2.6	3.9	-2.4	0.9	2.0
Real wage per employee in manufacturing sector (annual change in %)	3.1	5.0	1.6	3.2	2.6

e Estimate

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

Graph 1.29
Total Employment by Sector



Source: Economic Planning Unit

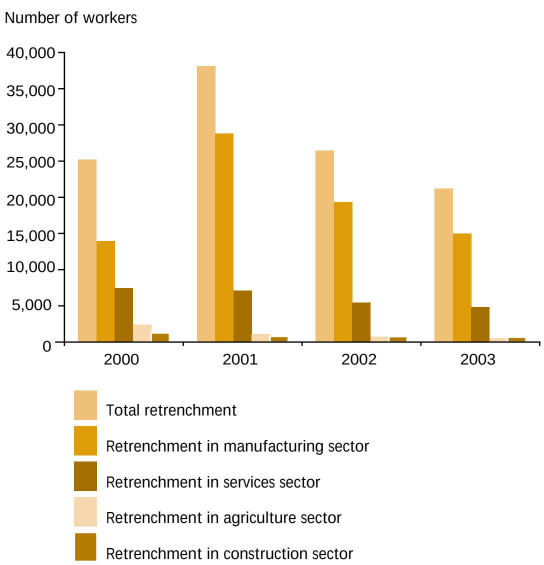
employment, and outsourcing. Growth in the number of placements during the year moderated by 16%, although the slowdown in the growth of vacancies was higher. Concurrently, the number of registered unplaced job seekers reached 28,404 at end-2003, the lowest since January 2001. Both developments indicate greater efficiency in the matching of workers to jobs available.

Given some underemployment in selected sectors, the pick-up in economic activity did not exert undue pressure on **wages** in 2003. Available indicators on wages showed that increases in wage rates continued to moderate in 2003:

- Data from the Monthly Manufacturing Survey conducted by the Department of Statistics indicated that, on an annual basis, real wage per employee increased by 2.6% (2002: 3.2%).
- The Salary and Fringe Benefits Survey undertaken by the MEF showed that the increase in the average private sector salary was slightly lower at 5.8% in 2003 (2002: 6%). On a sectoral basis, the average salary increase in the non-manufacturing sector was higher (6.1% in 2003 and 2002) than the manufacturing sector (5.5%; 2002: 5.9%). The average minimum monthly salary offered to those with a basic degree was marginally lower at RM1,669 (2002: RM1,675).
- 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 5.5% in 2003, while the average basic salary of a fresh graduate was RM1,861.
- There were only two industrial strikes relating to demand for higher wages in 2003, the same as in the previous year.

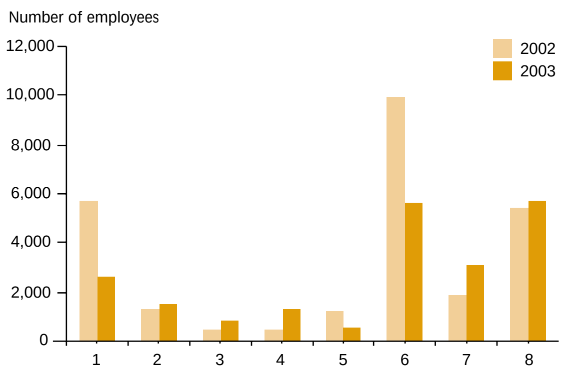
Labour productivity, as measured by the ratio of GDP to total employment, improved significantly with growth doubling to 2% in 2003 (2002: 0.9%). The productivity growth was attributed to the improvement in output across most major sectors in

Graph 1.30
Retrenchment in Selected Sectors



Source: Ministry of Human Resources

Graph 1.31
Reasons for Retrenchment



1 Closure of companies
2 Sale of companies
3 Relocation to foreign countries
4 Relocation locally
5 High production cost
6 Reduction in demand for products
7 Company reorganisation and automation
8 Others

Source: Ministry of Human Resources

line with the stronger economic activities. Of significance, productivity in the manufacturing sector turned around to register a positive growth of 3% (2002: -0.8%) due to increased use of capital. The agriculture and services sectors recorded higher productivity growth of 5.7% and 0.7% respectively (2002: 3.1% and 0.5% respectively). Higher productivity in the agriculture sector was due to good weather, which is a critical factor in determining the output of agricultural produce, improved agricultural practices and greater automation.

Over the longer term, the Government continues to encourage firms to adopt better work practices, increase mechanisation and automation as well as introduce structural changes, in order to increase efficiency and productivity to alleviate the shortage of workers, particularly for the lower end jobs. In the interim, the Government continued to approve the recruitment of new **foreign workers** from designated countries, namely Bangladesh, Cambodia, P.R.China, India, Indonesia, Kazakhstan, Kyrgyz Republic, Lao People's Democratic Republic, Myanmar, Nepal, Pakistan, the Philippines, Sri Lanka, Thailand, Turkmenistan, Uzbekistan and Vietnam. During the year, the Government concluded a total of six Memoranda of Understanding, namely, with Bangladesh, P.R.China, Sri Lanka, Thailand, Pakistan and Vietnam to regulate the recruitment process and procedures, while agreements in principle were reached with Nepal and Kyrgyz Republic.

In 2003, approval was given for the recruitment of 516,355 new foreign workers (2002: 545,725) mainly in the agriculture, manufacturing and construction sectors. A large majority of the new workers originate from Indonesia, while the rest are mainly from Nepal, Vietnam, India, Myanmar and Thailand. In total, the number of registered foreign workers in the country increased by 17% to 1,239,862 (2002: 1,057,156) constituting about 12% of the total labour force. The majority are engaged in the manufacturing sector, followed by the agriculture, services (including domestic services) and construction sectors. About 70% of the foreign workers are from Indonesia, while those from Nepal and Bangladesh constitute the second and third largest group at about 8% and 7% respectively.

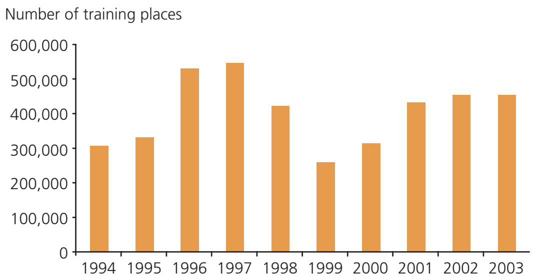
The policy on the employment of foreign nationals was further liberalized to address the need for certain specialized skills. In this regard, the period of employment of foreign workers engaged in the 3'D' areas (Difficult, Dirty and Dangerous) was extended from five years up to a maximum of ten years. Similarly, the policy on expatriate employment in the manufacturing sector was liberalised.

In view of the strategy to diversify into new growth areas, especially manufacturing related and research and design services as well as high-technology industries, employment opportunities were more abundant in higher value added sectors which require highly specialised skills. In this regard, the Brain-Gain programme was launched in 2001 to attract Malaysians overseas with special expertise in fields such as medicine and health, ICT, accountancy and finance, to return to work in Malaysia. The programme has attracted 599 professionals, of which 234 were approved.

Meanwhile, under the Economic Package, a Retraining Fund of RM100 million was established with the objective to provide **unemployed graduates** with training to acquire skills that are in demand, such as ICT and accountancy. As at end-2003, a total of 7,338 graduate trainees had benefited from training provided under the Fund, commonly known as the Graduate Training Scheme II (GTS II). Financial assistance granted to the trainees under the GTS II amounted to RM55.7 million. As funds under the earlier special schemes implemented in 2001 for unemployed graduates and retrenched workers were still available, the schemes were continued into 2003. As at end-2003, a total of 38,942 persons had participated in the various attachments and training schemes for unemployed graduates, commonly known as Graduate Training Scheme I, while another 11,135 participants benefited from the scheme for retrenched workers and the unemployed.

In line with the push for knowledge-based and services-led growth, the **Human Resource Development Fund (HRDF)** played an important role to foster increased training of staff by employers. In the period

Graph 1.32
HRDF: Number of Training Places Approved



Source: Pembangunan Sumber Manusia Berhad

1993-2003, a total of 3.9 million training places costing a total of RM1.4 billion were approved (2003: 441,721 training places with financial assistance of RM206 million). The scope of the HRDF has been expanded to meet changing demands. Reimbursement for promoted courses were increased to the full amount of the levy (85% previously), while additional schemes for smaller companies and the SMEs were introduced. The utilisation period of the HRDF by employers was extended to five years, from two years previously. The scope of the HRDF would be further expanded to include training in related services such as ports and logistics, health services, marketing, ICT and research and development.

The **Skills Development Fund (SDF)** is another skills training initiative that has been in place since 2001. Its aim is to enhance the participation of the private sector as training providers and increase accessibility to technical education and vocational training by providing financial assistance to the trainees. The SDF is open to all, including school leavers, retrenched workers as well as workers undergoing training at public and private training institutes. The objective is to ensure that the jobseekers acquire the skills required by employers. In 2003, besides an additional allocation of RM500 million under the Economic Package, guidelines on the provision of financial assistance were reviewed to enable more persons to pursue skills training under the SDF. As a result, using the existing allocation (excluding the RM500 million), the SDF was able to provide financial assistance to a total of 45,856 applicants compared with 36,700 applicants a year ago.

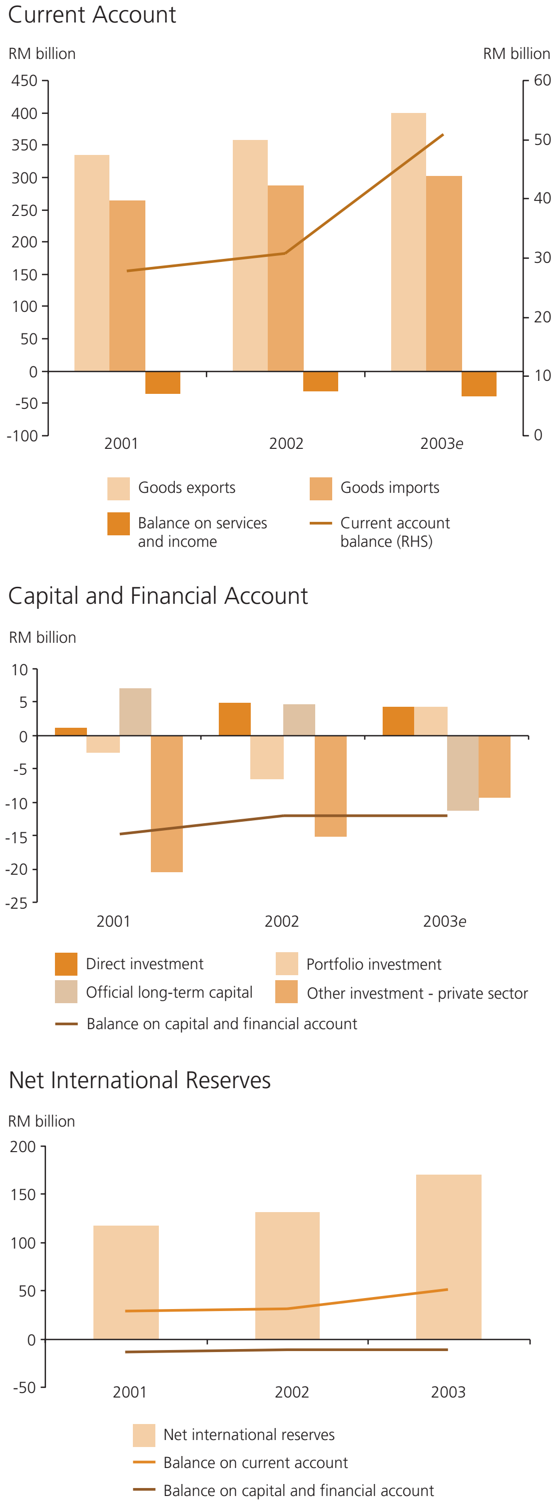
Apart from training polices, which are basically government driven, an encouraging development is that the private sector is also actively involved in the drive to raise the quality of labour through the adoption of productivity linked wage systems (PWLS). Besides embedding rewards with performance and higher productivity, such flexible practices have helped employers to better manage costs and share success with employees. The Salary and Fringe Benefits Survey undertaken by the MEF in 2003 showed that the majority of respondent companies adopted the PWLS.

EXTERNAL SECTOR

Balance of Payments

A stronger external environment and improved investor sentiment, particularly in the second half of the year, contributed to the strengthening of the external position in 2003. The **overall balance of payments** registered a significantly higher surplus on the back of a larger current

Graph 1.33
Malaysia: Balance of Payments



e Estimate

Table 1.17
Balance of Payments

Item	2002			2003e		
	+	-	Net	+	-	Net
	RM million					
Goods	358,504	286,387	72,117	398,998	301,297	97,701
Trade account	*357,682*	*303,063*	*54,619*	*398,882*	*317,746*	*81,136*
Services	56,536	62,532	-5,996	51,594	66,620	-15,026
Balance on goods and services	**415,040**	**348,919**	**66,121**	**450,592**	**367,917**	**82,675**
Income	8,129	33,190	-25,061	13,116	35,730	-22,614
Current transfers	2,513	13,079	-10,566	1,929	11,229	-9,300
Balance on current account	**425,682**	**395,188**	**30,494**	**465,638**	**414,876**	**50,761**
% of GNP			**9.1**			**13.7**
Capital account			-			-
Financial account			-11,941			-12,063
Direct investment			4,935			4,242
Portfolio investment			-6,506			4,176
Other investment			-10,370			-20,481
Balance on capital and financial account			**-11,941**			**-12,063**
Errors and omissions			-4,362			360
of which:						
Exchange revaluation gain (+) or loss (-)			*6,627*			*11,927*
Overall balance			**14,191**			**39,059**
Bank Negara Malaysia international reserves, net			**131,394**			**170,453**
(US$ million)			**34,577**			**44,856**

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

account surplus, sustained inflows of foreign direct investment and higher inflows of portfolio funds. Errors and omissions, including exchange gain from the revaluation of Bank Negara Malaysia's international reserves due to the appreciation of the major currencies against the US dollar (RM11.9 billion), was RM0.4 billion. After adjusting for the errors and omissions, the overall balance of payments recorded a large surplus of RM39.1 billion or US$10.3 billion. Consequently, the net international reserves of Bank Negara Malaysia increased to RM170.5 billion or US$44.9 billion at end-2003. The reserves increased further to RM194.9 billion or US$51.3 billion as at 15 March 2004. This level of reserves represented 7.8 months of retained imports and 5.2 times coverage of the short-term external debt. Malaysia's reserves are usable and unencumbered.

The external position strengthened further, supported by a stronger current account surplus. Inflows of FDI were sustained while inflows of portfolio investment were higher. The external debt of the official sector was reduced.

Current Account

In 2003, the **current account** recorded a larger surplus of RM50.8 billion or 13.7% of GNP due to a higher trade surplus. The stronger growth in manufacturing exports and robust expansion in export of commodities, which have low import content, contributed to the larger trade surplus. The larger surplus in the goods account generated more than sufficient foreign exchange earnings to finance the deficits in the services (4.1% of GNP), income and current transfers accounts. The services account deficit widened due to the impact of SARS, which lowered travel receipts. On the other hand, the income account deficit was reduced, reflecting higher profits and dividends accrued to Malaysian companies from their investments abroad and higher returns from other investment. Net outflows in the current transfers

Table 1.18
Gross Exports

	2003p		
	RM million	Annual change (%)	% share
Manufactured goods	**326,950**	**8.2**	**82.0**
Of which:			
Electronics, electrical machinery and appliances	223,547	5.2	56.0
Electronics	167,620	6.3	42.0
Semiconductor	*85,184*	*16.3*	*21.4*
Electronic equipment & parts	*82,436*	*-2.4*	*20.7*
Electrical machinery & appliances	55,927	1.9	14.0
Consumer electrical products	*19,747*	*-6.5*	*5.0*
Industrial & commercial electrical products	*20,414*	*3.5*	*5.1*
Electrical industrial machinery and equipment	*13,886*	*9.6*	*3.5*
Household electrical appliances	*1,880*	*36.7*	*0.5*
Chemicals & chemical products	21,236	23.3	5.3
Manufactures of metal	11,303	28.5	2.8
Petroleum products	9,416	23.6	2.4
Optical and scientific equipment	9,213	13.0	2.3
Textiles, clothing and footwear	8,771	2.3	2.2
Wood products	6,698	6.1	1.7
Rubber products	5,060	12.3	1.3
Agricultural commodities	**33,728**	**28.1**	**8.4**
Of which:			
Palm oil	*20,224*	*36.3*	*5.1*
Rubber	*3,582*	*43.8*	*0.9*
Sawn timber	*2,607*	*6.4*	*0.7*
Saw logs	*2,015*	*10.0*	*0.5*
Minerals	**29,777**	**33.1**	**7.5**
Of which:			
Crude oil	*15,662*	*35.0*	*4.0*
LNG	*13,328*	*34.8*	*3.3*
Tin	*284*	*-33.2*	*0.1*
Other exports	**8,427**	**25.5**	**2.1**
Total	**398,882**	**11.5**	**100.0**

p Preliminary

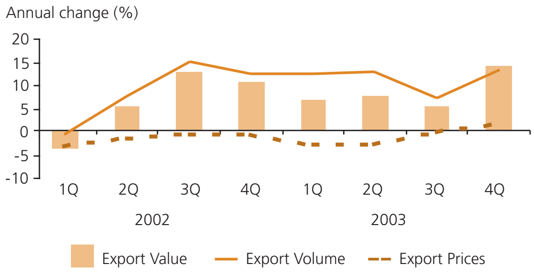
Source: Department of Statistics, Malaysia

account declined as a result of lower remittances by foreign workers.

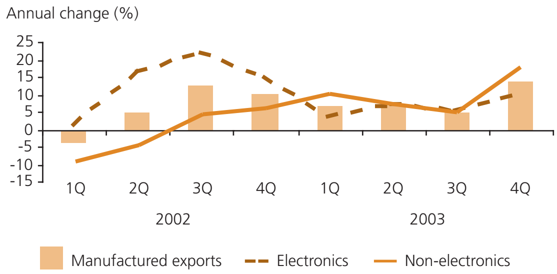
Amidst the improvement in the external environment, **gross exports** expanded strongly by 11.5% in 2003 (2002: 7%). The stronger export performance was due to higher manufactured exports, as well as robust growth in exports of primary commodities.

Growth in **manufactured exports** strengthened to 8.2% (2002: 5.9%), supported mainly by strong demand for electronics, chemical products, petroleum products, metal products and rubber

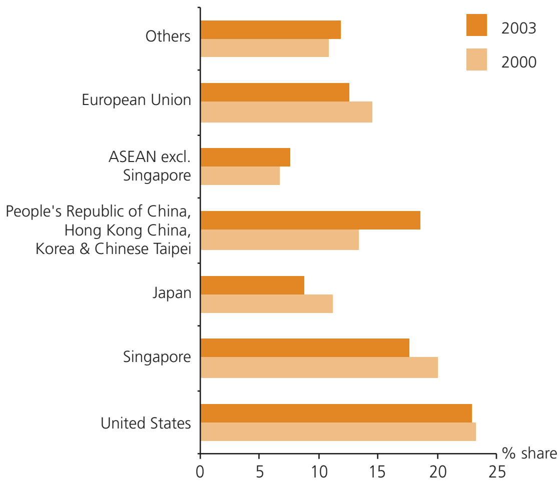
Graph 1.34
Export Performance of the Manufacturing Sector



Graph 1.35
Export Performance of Electronics and Non-electronics Industries



Graph 1.36
Export of Manufactured Goods by Destination



products. Growth in electronics exports was largely driven by the upturn in the global electronics cycle, whilst the chemical products sector benefited from the spillover effects of the strong electronics performance as well as higher demand for organic chemicals, resins and plastic products. Higher exports of rubber products were driven largely by increased global demand for rubber gloves. Exports of metal products also rose strongly as manufacturers increased their export volume to take advantage of higher export prices for iron and steel. Overall, the increase in export receipts was attributed entirely to higher volume as prices continued to decline.

The significantly large trade surplus was due to stronger growth in manufacturing exports and robust expansion in commodity exports which have low import content.

Table 1.19
External Trade

	2002	2003*p*	2002	2003*p*
	RM billion		US$ billion	
Gross export (f.o.b)	**357.7**	**398.9**	**94.1**	**105.0**
Annual change (%)	7.0	11.5	7.0	11.5
	Annual change (%)			
Volume[1]	6.1	7.2	6.1	7.2
Prices[1]	-0.4	1.0	-0.4	1.0
Gross import (c.i.f)	**303.1**	**317.7**	**79.8**	**83.6**
Annual change (%)	8.1	4.8	8.1	4.8
	Annual change (%)			
Volume[1]	6.1	1.1	6.1	1.1
Prices[1]	1.4	2.3	1.4	2.3
Trade balance	**54.6**	**81.1**	**14.4**	**21.4**

[1] Volume and prices for 2003 are estimates.

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Exports of **primary commodities** rose markedly by 30.4%, driven mainly by the strong export performance of agriculture (28.1%) and minerals (33.1%). Commodity exports was supported by stronger prices (17.1%) and higher export volume (11.9%) during the year. Strong demand for commodities amidst the tight global supplies of many major commodities during the year supported the rise in prices.

Total receipts from **agriculture** exports rose to RM33.7 billion with the main contributor to growth being palm oil, which generated RM20.2 billion foreign earnings following strong average export prices of RM1,617 per tonne and higher export volume of 12.5 million tonnes. Palm oil prices increased due mainly to imbalances in the global edible oils markets, arising from shortages in the supply of major oilseeds amidst rising demand. Malaysian palm oil also benefited from import substitution by several price sensitive buyers given the large price discounts of palm oil against other major oilseeds, particularly soybean oil, its closest substitute. The major export markets for Malaysian palm oil in 2003 were P.R.China, the Middle East, India and the EU, which together accounted for 60% of total Malaysian palm oil exports. With substantially higher revenue, palm oil accounted for about 60% of total agriculture export receipts and 5% of total gross exports. The strong agriculture exports during the year was also supported by increases in the exports of other commodities, including rubber and timber and timber products.

Export revenue from **minerals** turned around sharply to record a growth of 33.1% to RM29.8 billion, driven mainly by the significantly higher oil prices. Malaysian crude oil export prices strengthened significantly to average US$30.27 per barrel in tandem with higher global crude oil prices. In line with the upward trend in oil prices, liquefied natural gas (LNG) prices also trended upwards to average RM766 per tonne in 2003. The commencement of the MLNG Tiga plant during the year also boosted the exports of Malaysian gas. Thus, revenue from crude oil and LNG exports rose to RM15.7 billion and RM13.3 billion respectively.

Gross imports registered a moderate growth of 4.8% (2002: 8.1%) attributable to imports of capital and intermediate goods, which picked up in the fourth quarter. Import prices increased by 2.3%, reflecting higher prices of imports of manufactured goods, mineral fuel and chemicals.

Imports of **intermediate goods**, which were the main driver of import growth, continued to grow by 6.4%. Intermediate imports are inputs for the production of manufactured exports, particularly electronic and electrical products. **Capital imports**, excluding lumpy items, increased by 6%, reflecting growth in investment activity, particularly in the second half of the year. Imports of lumpy items were lower due to fewer deliveries of new aircraft. The continued strength of the services sector as well as increased automation of businesses induced the turnaround in imports of office equipment to record positive growth. Increased exploration activity in the oil and gas industry in the wake of higher prices of petroleum led to the increase in imports of construction and mining equipment. Imports of telecommunication equipment declined by 9.5% against a background of industry consolidation following the mergers of selected cellular service providers. In line with higher disposable income, imports of **consumption goods** increased by 1.1% reflecting higher imports of consumer goods and transport equipment.

The growth in intra-regional East Asian (excluding Japan) trade since 1997 has reshaped trading patterns, with P.R. China providing the main impetus to this growth. P.R. China is the sixth largest exporter in the world and 30% of the P.R. China's exports is exported to the region. Approximately 36% of P.R. China's imports are sourced from East Asia.

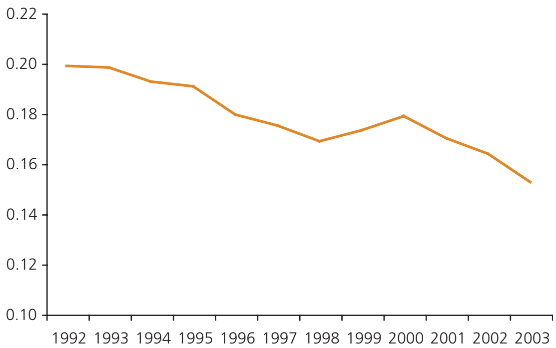
Table 1.20
Gross Imports by End Use

	2003*p*		
	RM million	Annual change (%)	% share
Capital goods	**43,508**	**0.7**	**13.7**
Capital goods (except transport equipment)	40,837	7.1	12.9
Industrial machinery and equipment	*9,862*	*-0.4*	*3.1*
Office equipment	*7,404*	*26.6*	*2.3*
Telecommunication equipment	*5,213*	*-9.5*	*1.6*
Transport equipment	2,671	-47.1	0.8
Intermediate goods	**233,046**	**6.4**	**73.3**
Food and beverages, mainly for industry	5,831	7.3	1.8
Industrial supplies, n.e.s.	66,130	3.4	20.8
Metals & metal products	*18,594*	*6.2*	*5.9*
Chemicals	*7,285*	*1.1*	*2.3*
Fuels and lubricants	13,623	23.2	4.3
Parts and accessories of capital goods (except transport equipment)	141,283	8.0	44.5
Electronics	*95,314*	*7.1*	*30.0*
Parts and accessories of telecommunication equipment	*6,587*	*-9.8*	*2.1*
Parts and accessories of transport equipment	6,179	-16.0	1.9
Consumption goods	**18,866**	**1.1**	**5.9**
Food and beverages, mainly for household consumption	6,777	-1.5	2.1
Transport equipment, non-industrial	337	90.9	0.1
Consumer goods, n.e.s.	11,752	1.3	3.7
Consumer durables	*2,646*	*-2.0*	*0.8*
Consumer semi-durables	*3,985*	*-5.1*	*1.3*
Consumer non-durables	*5,121*	*8.9*	*1.6*
Dual use goods	**7,057**	**15.2**	**2.2**
Motor spirit	2,981	17.2	0.9
Passenger motor cars	4,075	13.8	1.3
Others	**6,547**	**-4.4**	**2.1**
Re-exports	**8,722**	**-4.3**	**2.7**
Gross Imports	**317,746**	**4.8**	**100.0**

n.e.s. Not elsewhere specified.
p Preliminary

Source: Department of Statistics, Malaysia

Graph 1.37
Exports Diversification Index



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

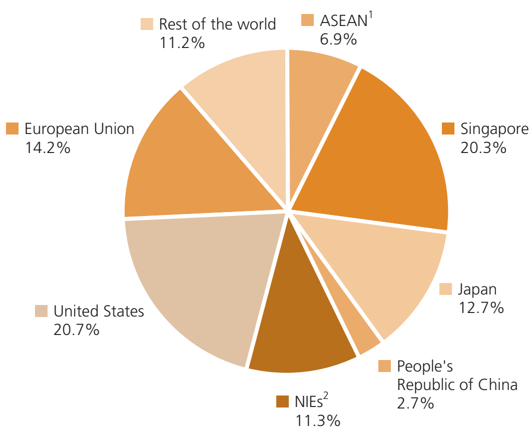
Consequently, Malaysia's share of trade with major trading partners, namely, the US and Japan, has declined, while the share with the EU remained unchanged. Malaysia's trade with the US, Japan and the EU as a group declined to account for a share of 43.1% of total trade (2002: 44.8%) while East Asian trade increased to 44.9% (2002: 44%) of total trade.

Efforts continue to be made towards diversifying markets particularly into non-traditional markets, such as the South Asia and West Asia regions, and increasing market share in East Asian countries. The diversification of markets, which is measured by the normalised Herfindahl-Hirschmann index, improved in 2003. In the normalised Herfindahl-Hirschmann index, a ratio closer to zero reflects increasing diversification. The index for exports declined to 0.15 in 2003 from 0.16 in 2002. Similarly, the index for imports also declined to 0.15 from 0.16.

The **United States** (US) remained as Malaysia's most important trading partner although its share of total trade declined to 17.7% (2002:18.8%). Exports to the US consist mainly of electronics components, in particular integrated circuits, rubber, optical and scientific instrument, furniture and parts and apparatus. Approximately 65% of imports from the US are intermediate inputs for the electrical and electronics industry. Other imports include optical and scientific instruments, plastics and chemicals. As exports to the US increased while imports declined, the bilateral trade surplus widened to RM29.2 billion (2002: RM20.1 billion).

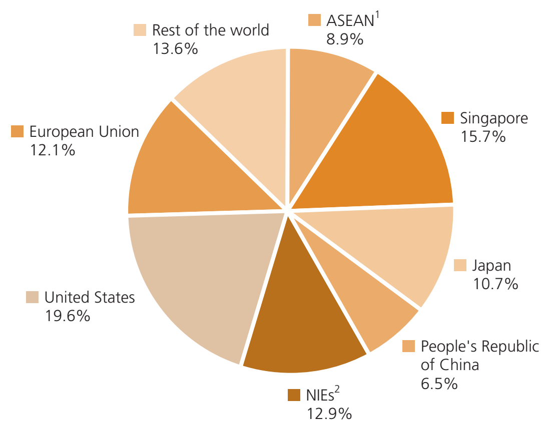
Singapore maintained its position as the second most important trading partner of Malaysia despite the decline in the share of trade to 14% (2002: 14.7%). The bulk of exports to Singapore were electronics, with integrated circuits and micro-assemblies accounting for 26%, parts and accessories 13% and diodes and transistors 4.8%. The lower share of exports to Singapore (15.7%; 2002: 17%) was attributable to the increased direct trade and usage of local ports. On the imports side, every one out of three imported products were electronics and electrical goods while petroleum and petroleum related products made up 18%. The trade surplus with Singapore increased to RM25.5 billion as exports grew at a faster pace relative to imports.

Graph 1.38
Direction of Exports: 1995



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

Direction of Exports: 2003



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

Table 1.21
Direction of External Trade

	2003p				
	Exports		Imports		Trade balance
	RM million	% share	RM million	% share	RM million
ASEAN countries	**98,225**	**24.6**	**76,345**	**24.0**	**21,879**
Singapore	62,786	15.7	37,283	11.7	25,503
Thailand	17,538	4.4	14,549	4.6	2,989
Indonesia	8,091	2.0	11,168	3.5	-3,077
Philippines	5,459	1.4	11,835	3.7	-6,376
Other ASEAN countries	4,351	1.1	1,510	0.5	2,841
European Union (EU)	**48,264**	**12.1**	**37,216**	**11.7**	**11,047**
United Kingdom	8,872	2.2	5,991	1.9	2,881
Germany	9,145	2.3	14,787	4.7	-5,642
Netherlands	13,036	3.3	2,151	0.7	10,886
Other EU countries	17,210	4.3	14,287	4.5	2,923
United States	78,007	19.6	48,757	15.3	29,250
Japan	42,643	10.7	54,273	17.1	-11,630
The People's Republic of China	25,878	6.5	27,739	8.7	-1,861
Hong Kong China	25,778	6.5	8,580	2.7	17,199
Chinese Taipei	14,351	3.6	15,698	4.9	-1,347
South Korea	11,550	2.9	17,308	5.4	-5,758
India	9,629	2.4	2,555	0.8	7,074
Australia	9,932	2.5	4,803	1.5	5,129
Rest of the world	34,626	8.7	24,473	7.7	10,153
Total	**398,882**	**100.0**	**317,746**	**100.0**	**81,136**

p Preliminary

Source: Department of Statistics, Malaysia

Supported by a higher export growth relative to imports, the trade balance with **Japan**, which has been in Japan's favour, improved to register a smaller deficit of RM11.6 billion (2002: -RM14.1 billion). Export growth of 7.4% was underpinned by increased export receipts from LNG, petroleum and chemical products on the back of higher crude oil and LNG prices. Imports grew marginally by 0.9% reflecting growth in imports of machinery and transport equipment, manufactured articles and crude materials.

Trade with the **European Union** (EU) turned around to record a growth of 9.2% in the wake of an improvement in economic performance of EU countries. Malaysia continued to record a trade surplus of RM11 billion (2002: RM9.5 billion) with EU countries. Germany remained the leading trading partner, accounting for 3.3% of total trade.

Exports to the **North East Asia** region (excluding Japan), which accounted for 19.4% of total exports, expanded by 18.3%. The impetus to this growth stemmed from the continued strong export growth of 29.6% to the P.R.China and 26.7% to Hong Kong China. The driver of this growth was the continued relocation by multinational companies to the P.R.China and increased outsourcing activity. P.R.China remained the biggest trading partner of the region. About a quarter of Malaysia's exports to P.R.China consisted of integrated and printed circuits, semiconductor devices and light emitting diodes. Another source of increase in export growth came from demand for resource exports, particularly palm oil and rubber.

Reflecting increasing intra-regional trade and better economic performance of **ASEAN** countries (excluding Singapore), the share of trade with member countries expanded to 10.4% in 2003 (2002: 9.6%). The market share of imports from ASEAN countries rose to 12.3% against a background of increasing sourcing from low cost suppliers such as Thailand, Indonesia and the Philippines.

Services Account

Policies to promote exports of services have been successful in reducing the services deficit in the balance of payments to as low as -1.8% of GNP in 2002. In 2003, however, the **services account** deficit widened to RM15 billion or -4.1% of GNP due mainly to lower tourism receipts as travel, especially into the Asian region, was severely affected by SARS. Nevertheless, gross receipts from new sources of foreign exchange income, namely education,

Graph 1.39
Tourist Arrivals and Tourism Receipts

p Preliminary

computer and information services, as well as ports and airports continued to increase.

Despite the impact of SARS, travel remained the largest contributor to services receipts in 2003, accounting for 43.4% of total services receipts. Tourist arrivals totalled 10.6 million visitors in 2003 (2002: 13.3 million visitors) with lower tourist receipts of RM21.3 billion (2002: RM25.6 billion). This resulted in the net surplus of the **travel account** declining sharply to RM11.6 billion (2002: RM17.1 billion). The outbreak of SARS caused visitor arrivals to decline by 51.6% in the second quarter. Tourist arrivals from P.R.China and Singapore declined most significantly. Tourist arrivals recovered strongly in the fourth quarter with arrivals exceeding the monthly average of one million attained in the pre-SARS period.

Table 1.22
Services and Income Accounts

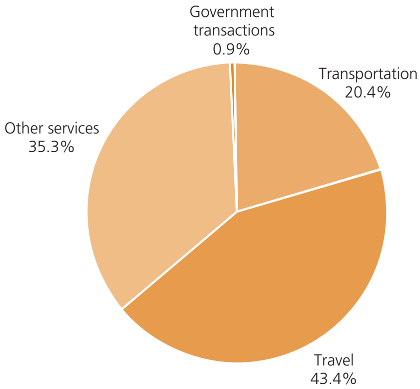
	2002	2003e		
		RM billion		
	Net	+	–	Net
Services Account				
Transportation	-11.6	10.5	23.8	-13.3
Travel	17.1	22.4	10.8	11.6
Other Services	-11.2	18.2	31.2	-13.0
Government services n.i.e.	-0.3	0.5	0.8	-0.3
RM billion	**-6.0**	**51.6**	**66.6**	**-15.0**
US$ billion	**-1.6**	**13.6**	**17.5**	**-4.0**
% of GNP	-1.8			-4.1
Income Account				
Compensation of employees	-1.2	2.2	3.1	-1.0
Investment income	-23.9	10.9	32.6	-21.7
RM billion	**-25.1**	**13.1**	**35.7**	**-22.6**
US$ billion	**-6.6**	**3.5**	**9.4**	**-6.0**
% of GNP	-7.5			-6.1

e Estimate

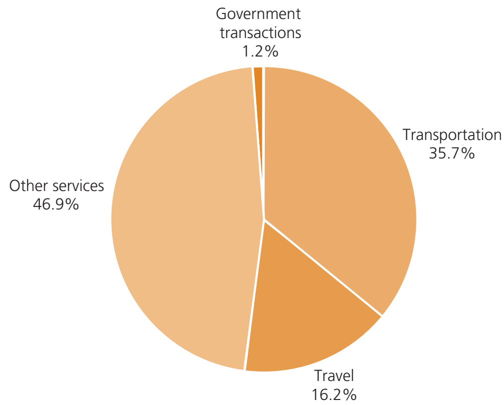
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

For 2003 as a whole, the decline in receipts from the tourism sector, however, was mitigated by new sources of services export income, namely earnings from education and healthcare services. The number of foreign students increased by 8.5% to 39,577 students in 2003. Foreign students were mainly from Indonesia and P.R.China. Receipts from education tourism are still small, accounting for about 1.4% of total travel receipts and 0.6% of total services receipts, although the spillover effects on the economy through consumption spending and travel are large. Revenue from 102,946 foreign patients seeking treatment in Malaysia in 2003 increased by

Graph 1.40
2003: Components of Gross Receipts in the Services Account (% share)



Graph 1.41
2003: Components of Gross Payments in the Services Account (% share)



64.2%. Foreign patients were mainly from Indonesia (72.5%), other ASEAN countries, West Asian countries and Japan.

On the payments front, travel outflows increased to RM10.8 billion (2002: RM9.9 billion), reflecting higher expenditure on business travel and education abroad. Payments for travel abroad by Malaysians, including business travel, expanded by 17.9% to RM7.7 billion in 2003 in line with the pick-up in economic activity. Meanwhile, education outflows increased by 1.3% with a larger number of students studying aboard.

There was a broadening of tourism products in 2003, with more niche products in areas such as sports, eco-tourism, agro-tourism and meetings, incentives, conventions and exhibitions being promoted. The main strategy of the new tourism products was to increase the length of stay of visitors. Promotion of tourism products and services was undertaken through joint collaboration by the public and private sectors. Connectivity of air services was facilitated through allowing greater use of charter flights and budget fares offered by no-frills airlines. More gateway points, such as Langkawi, Penang, Kuching and Kota Kinabalu, enabled the travel industry to expand into new as well as established markets. The new markets targeted for promotion included Pakistan and Iran.

The deficit in the **transportation account** widened to RM13.3 billion in 2003 (2002: -RM11.6 billion), as payments abroad increased while receipts were sustained. Gross outflows reflected higher freight charges as well as increased volume of trade. Gross receipts were sustained, supported mainly by earnings from cargo services and charter services provided by domestic shipping companies and airlines. The increase in cargo handled was underpinned by the increase in transhipment cargo sourced from India, P.R.China, Myanmar, Indonesia and Thailand.

In line with the improvement in the economy, the higher demand for other services led to a higher net payment of RM13 billion in the **other services account** (2002: -RM11.2 billion). In particular, imports of design, technical and project consultancy services related to infrastructure and oil and gas exploration resulted in higher payments for contract and professional charges. Payments for insurance and financial services increased as larger external trade transactions led to higher demand for imported support services. Receipts from computer and information services improved in line with the expansion in business process outsourcing and ICT services.

For the third consecutive year, the **income account** deficit declined by 9.8% to RM22.6 billion or -6.1% of GNP in 2003 (2002: -RM25.1 billion or -7.5% of GNP). This improvement was attributable to profits and dividends accruing to Malaysian companies from their investments aboard, particularly in the oil and gas and utilities sectors, which increased by 190.6% to RM2 billion (2002: RM0.7 billion). It accounted for 17.9% of the total gross investment income inflows. Secondly, income from other investments turned around to record a net inflow of RM2.4 billion (2002: -RM0.9 billion), reflecting largely the better returns from higher external reserves while interest payments on external debt declined.

Higher profits and dividends of Malaysian companies operating abroad contributed to an improvement in the income account.

On the payments side, gross profits and dividends accruing to foreign direct investors also increased. This was attributable mainly to higher earnings in the electronics and electrical industries following improved export performance, as well as the oil and gas sector on the back of higher oil prices. While profits and dividends accounted for 78.8% of the gross investment income outflow, a substantial portion is retained in Malaysia for further reinvestment. Retained earnings were estimated at 42.5% of total profits and dividends, and credited as inflows of foreign direct investment in the financial account.

In 2003, the net outflow in the **current transfers account** declined by 12% to RM9.3 billion. The significant decline in current transfers payments by 14.1% in 2003 (2002: +28%), was largely due to lower remittances by foreign workers following the return of the illegal workers under the Amnesty Program conducted in 2002. There were about 1.2 million registered foreign workers in Malaysia in 2003, more than half of whom were employed in the plantation and manufacturing sectors.

Financial Account

In 2003, the **financial account** remained stable with a net outflow of RM12.1 billion (2002: -RM11.9 billion). Outflows of short-term capital, comprising portfolio investment and other private sector investment, were significantly lower following improved investor sentiment in the equity market as well as interest differentials in Malaysia's favour. In the long-term capital account, large repayments of external loans by the official sector and modest drawdown of loans helped to contain the increase in Malaysia's external debt position. Private long-term capital, comprising mainly foreign direct investment, was sustained at a moderate level.

In terms of gross inflows, about half of the FDI continued to be in the form of reinvested earnings, particularly from the manufacturing sector. With respect to new inflows of FDI as recorded by the Cash BOP Reporting System of Bank Negara Malaysia, both the services and manufacturing sectors continued to receive significant shares of about 38% and 37% respectively, while the share of the oil and gas sector was about 15%. Large inflows into the services sector continued to be sustained. There was an increase in foreign participation in Malaysia's network of wholesale and retail trade sub-sector, ranging from automotive distribution, petrol station to hypermarkets. Foreign interests were also higher in the higher value-added services sector, especially the transport sub-sector, airlines and port management, as well as knowledge-based activities in the form of MSC-related investment and electronic data processing industries. In 2003, 219 regional facilities for foreign- and local-owned companies were established, encouraged by investment incentives provided by the Government. Of these, 12 were operational headquarters (OHQs), 37 regional offices, 32 international procurement centres (IPCs), 134 representative offices and 4 regional distribution centres (RDCs).

The financial account remained stable, reflecting sustained inflows of FDI and higher portfolio investment. The official sector reversed to record a large net loan repayment. Overseas investment generated higher profits and dividends to Malaysia.

Gross **foreign direct investment** (FDI) in Malaysia was higher in 2003 at RM21.8 billion (2002: RM20.5 billion), reflecting largely broad-based inflows into the services and manufacturing sectors, as well as the oil and gas sector. On a net basis, however, FDI moderated to RM9.4 billion or 2.5% of GNP in 2003 (2002: RM12.2 billion), due largely to the acquisition of foreign interests in the oil and gas sector by a Malaysian company upon the expiry of joint venture contracts, as well as large loan repayments to parent companies abroad.

Table 1.23
Balance of Payments: Financial Account

	2002	2003e	2002	2003e
	RM billion		US$ billion	
Financial Account	**-11.9**	**-12.1**	**-3.1**	**-3.2**
Direct Investment	**4.9**	**4.2**	**1.3**	**1.1**
In Malaysia	12.2	9.4	3.2	2.5
Abroad	-7.2	-5.2	-1.9	-1.4
Portfolio Investment	**-6.5**	**4.2**	**-1.7**	**1.1**
Other Investment	**-10.4**	**-20.5**	**-2.7**	**-5.4**
Official sector	4.7	-11.2	1.2	-3.0
Of which:				
Federal Government (net)	8.0	-3.7	2.1	-1.0
Gross borrowing	10.5	3.1	2.8	0.8
Repayment	2.5	6.9	0.6	1.8
NFPEs (net)	-3.3	-7.3	-0.9	-1.9
Gross borrowing	3.5	5.2	0.9	1.4
Repayment	6.8	12.4	1.8	3.3
Private sector	-15.1	-9.3	-4.0	-2.4

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Foreign interests in the manufacturing sector continued to remain high, with larger new FDI inflows into electrical and electronics and petroleum-related industries. Inflows were also broad-based into food processing, industrial refrigeration and printing industries as well as high-end aerospace industry.

Malaysian **direct investment abroad** remained large, albeit at a moderately lower level, at RM5.2 billion in 2003 (2002: -RM7.2 billion) after several major overseas acquisitions in 2002. Investment abroad was mainly to diversify and reinforce principal activities in Malaysia. Notably, the scope of investment has become increasingly broad-based. A large share of overseas investments was channelled into both the oil and gas and services sectors, followed by the manufacturing sector. In the oil and gas sector, Malaysia continues to operate through

Recent Trends in Foreign Direct Investment in Malaysia

Introduction

Foreign investments continue to account for about one-third of total private investment in Malaysia. The trend in gross FDI has remained stable since 2000 after a moderation during the Asian financial crisis. This stability is largely due to existing multinational companies (MNCs) expanding and diversifying their operations, with funding mainly from retained earnings. The pattern of FDI flows has also changed in favour of the higher value-added services sector, as the services sector is transformed and accounts for a larger share of GDP. As the services sector tends to be less capital intensive, the scale of the gross value of new flows tends to be smaller while the value-added and contribution to growth is higher.

The Government continues to ensure that policies remain supportive of attracting new foreign investments and that Malaysia remains a place of choice for companies seeking opportunities in the Asian region. Policy initiatives include a series of Investment Guarantee Agreements (IGA), tax and non-tax incentives, sequential sector liberalization, improving administrative processes and the delivery system of the public sector and lowering the overall cost of doing business. Equally important is the commitment to sound macroeconomic policies.

Definition, Methodology and Compilation of FDI Data

In the compilation of FDI statistics in the balance of payments, Malaysia adopts international standards in terms of definition, methodology and measurement. FDI, based on the IMF's Balance of Payments Manual, Fifth Edition, is defined as "....foreign holdings of at least 10% ownership in the enterprise with a lasting interest".

Actual FDI flows are reported in the financial account of the balance of payments, released on a quarterly basis by the Department of Statistics, Malaysia (DOS). DOS data refers to actual investments that have taken place in Malaysia in all sectors. This data differs from the data on applications and approvals released on a quarterly basis by the Malaysian Industrial Development Authority (MIDA), which records mainly investments in the manufacturing sector and covers investors who have applied for the various tax incentives. MIDA's data also does not cover investments in the oil and gas sector.

Data in the financial account of the balance of payments covers all the three components of FDI, namely equity capital, reinvested earnings and other capital (mainly inter-company loans). In addition to the quarterly survey by DOS, Bank Negara Malaysia maintains the Cash Balance of Payments (CBOP) Reporting System. Under this system, Bank Negara Malaysia is able to provide data on actual FDI flows on all cross-border transactions between residents and non-residents which are effected through the banking system, inter-company accounts and overseas accounts.

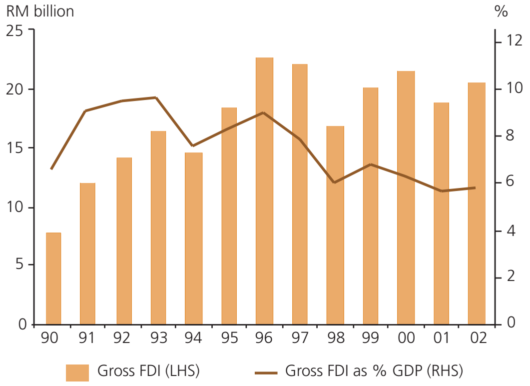
While the CBOP data does not capture the retained earnings by existing foreign enterprises in Malaysia (since there are no cross-border transfers through the banking system), it provides a good indicator on the trends of new FDI flows. The CBOP data is also available on a more timely basis, with a six-week lag.

Recent FDI Trends in Malaysia

On a **gross** basis, FDI continues to be sustained at a high level of about RM18-20 billion in recent years (Graph 1). Inflows of FDI have contributed to the establishment of new industries and products, introduction of new processes and production technology, the growth of support services, research and development and access to new markets.

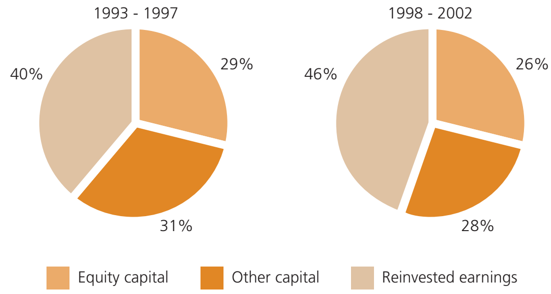
FDI flows during the post-crisis period remained stable as MNCs with operations in Malaysia continued to reinvest their retained earnings to expand, upgrade and diversify their production lines, in spite of the increased competition from low-wage economies in the region. Reinvested earnings accounted for nearly half of gross FDI for the period 1998 - 2002 (Graph 2).

Graph 1
Gross FDI Flows (1990-2002)



Source: Department of Statistics, Malaysia; Bank Negara Malaysia's estimates

Graph 2
Gross FDI Components



Source: Department of Statistics, Malaysia; Bank Negara Malaysia's estimates

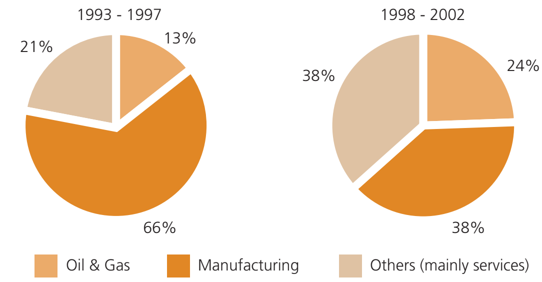
As a share of GDP, gross FDI has been sustained at 6% in the post-crisis years, compared with an average of 8% in the mid-1990s when FDI flows peaked. This was the result of two major developments:

- Between 1990 and 2002, the capital investment per employee (CIPE) in the manufacturing sector has increased by 66%, indicating a discernible trend towards higher value-added and high-technology projects and the employment of highly skilled manpower. However, in recent years (2001 - 2003), the CIPE in the manufacturing sector has declined as the **bulk of increased investment was mainly from the expansion, upgrading and diversification of existing projects.** Going forward, the growth in CIPE is likely to be sustained following the Government's efforts to promote investment in new high-growth sectors such as biotechnology and the agro-based industry.
- As a higher share of FDI flows are targeted at the higher value-added services sector and knowledge-based activities, **FDI inflows tend to be lower per investment project.** The value of FDI in services has tended to be on a smaller scale and low in import content but having a larger multiplier impact on income and employment. FDI in the services sector usually includes new technology and brings in specialised expertise that contributes towards raising productivity. The structural change in FDI flows is consistent with the transformation of the Malaysian economy towards services as another engine of growth and the move towards a knowledge-based economy.

Changing pattern of FDI flows

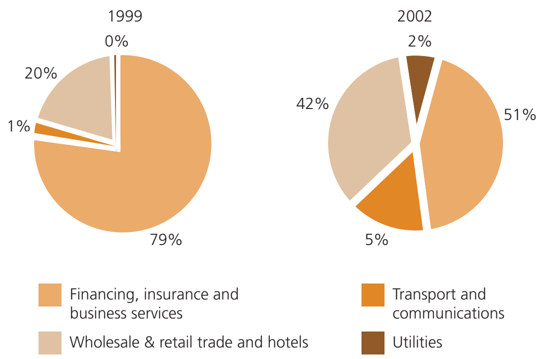
This trend, however, does not mean that FDI flows into the manufacturing sector have become less significant. FDI inflows into the manufacturing sector remain high, but the rapid growth of new inflows into other sectors has led to a relative decline in its share to 38% in 1998 - 2002, compared with 66% in 1993 - 1997 (Graphs 3 & 4). Both services and oil and gas sectors have experienced a significant increase in their share of FDI flows, accounting for 38% and 24% respectively in 1998 - 2002.

Graph 3
Gross FDI by Sector



Source: Department of Statistics, Malaysia; Bank Negara Malaysia's estimates

Graph 4
FDI in Services



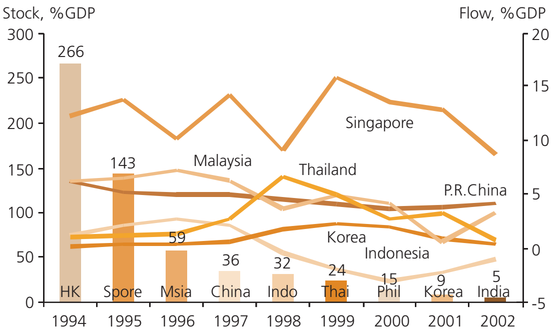
Source: Cash BOP Reporting System, Bank Negara Malaysia

FDI in services is increasingly broad-based, extending beyond the financing, insurance and business services sub-sector into other major sub-sectors such as wholesale and retail trade and hotels, transport and communications as well as utilities. In the financial sector, a number of foreign banks have set up their treasury, back-office and data processing operations in Malaysia to facilitate their group operations in this region. Malaysia already hosts a number of regional facilities for both foreign and local companies. As of end 2003, the Government has approved 1,695 regional facilities for foreign- and local-owned companies. Of these, 71 are operational headquarters (OHQs), 473 regional offices, 141 international procurement centres (IPCs), 1,006 representative offices and 4 regional distribution centres (RDCs).

In the IT sector, Malaysia's IT hub, the Multimedia Super Corridor (MSC), has continued to expand. By February 2004, there were 283 foreign companies operating in the MSC, accounting for 29% of the MSC-status companies that employed more than 20,000 knowledge workers. To continue to attract greater foreign participation, the Multimedia Development Corporation, the MSC administrator, has offered a generous package of financial incentives. MSC-status companies also enjoy privileges in terms of administrative ease to source capital and borrow funds globally.

FDI in Regional Perspective
Regionally, with the exception of Hong Kong China and Singapore, Malaysia ranks ahead of many regional economies in terms of inflows of FDI despite declining FDI flows to emerging economies

Graph 5
FDI as at end-2002: stock (bar) and flow as % GDP (line)

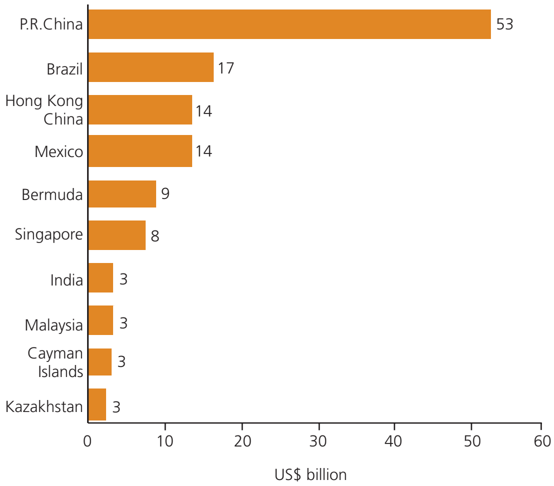


Note: HK figures were exaggerated by inflows redirected to P.R.China via Hong Kong China by Chinese Taipei investors as well as P.R.China's 'round-tripping capital' (UNCTAD)

Source: UNCTAD

(Graphs 5 & 6). The high presence of MNCs in Malaysia is testimony of the advantages Malaysia can offer in the global production or marketing chain. Based on the US data, the US non-bank MNCs have achieved a higher rate of return on their investment in Malaysia (5.6%), compared with an average of 3.5% in the Asian economies in 2000.

Graph 6
Top 10 Developing Economy FDI Recipients in 2002



Source: UNCTAD

The UNCTAD World Investment Report 2003 listed Malaysia as one of the top ten economies that had defied the global FDI slowdown in 2002. Similarly, the A.T.Kearney FDI 2003 report stated that Malaysia has enhanced its attractiveness as a destination for FDI, by improving to 23rd position (previous: 42nd) in the overall FDI confidence index. More specifically, Malaysia is in the top ten positions for FDI in primary industries as well as improving its standing in sectors such as electronics, mining, petrochemical, stone/glass and chemicals/plastics sectors and consultancy.

FDI Policies

Malaysia's strength in fundamentals such as trade openness, legal protection of patents, low tax rates, commitment to market pricing, a highly educated workforce, an efficient and diversified financial system for raising long-term capital, strong corporate governance, well-developed infrastructure and a wide array of tax incentives continue to be recognised as strong points in attracting FDI. While previous policies were more broad-based in nature, incentives have been repackaged and are increasingly customized and tailor-made for specific investors and industries. There are three broad philosophies governing policies specific to FDI:

- **Tax and non-tax incentives** to promote specific industries;
- Sequential **liberalization** of sectors in terms of market access, regulations governing employment of expatriates, equity ownership and relaxing rules and regulations; and
- **Improvement in the administrative processes and minimize costs** of establishing and operating a business enterprise in Malaysia.

Within this framework, there are a wide range of measures that are specific, targeted and, most importantly, benefit investors. Further, as the investment framework is goal-oriented rather than incentive-oriented, incentives are regularly fine-tuned to meet investor needs through the existing mechanism for consultation between the Government and the MNCs. This is acknowledged by the 2003 World Competitiveness Yearbook, which ranked Malaysia as second best in the world in terms of firms' perception of the ability of the Government to adapt policy to changes in the economy. In addition to fiscal and other specific incentives, the sequential sector liberalization measures offers new opportunities to foreign investors, in both the goods and services sectors.

The Government has adopted a holistic approach to lower the cost of doing business as well as to encourage efficiency and technological enhancement through strategic alliances with foreign investors in key economic sectors. The Government also recognizes the importance of forging closer links between indigenous small and medium enterprises (SMEs) and the large foreign-owned companies. Thus, the current policy emphasis on developing a strong and vibrant SME sector should be viewed as complementary efforts to attract FDI. By broadening the indigenous industrial base, the economy stands to gain by spreading the benefits of FDI more equitably. At the same time, foreign investors will have access to high quality goods and services that are provided by the domestic economy at low cost. Going forward, a balanced growth strategy involving the synergy between domestic- and foreign-owned companies will equip the country to respond effectively to an increasingly competitive global environment.

joint ventures in exploration and extraction. During the year, Malaysia's investments in the oil and gas sector were channelled mainly into the ASEAN and selected African countries.

In the services sector, overseas investments were made mainly in the utilities, transportation, retail and travel-related sub-sectors. There were also some investments by companies in the construction industry following their success in bidding for large infrastructure, roads and highway projects abroad. While the share of the manufacturing sector in overseas investment is smaller, investments were broad-based across sub-sectors, ranging from electrical and electronics, and textiles to high value-added activities such as petroleum-related manufacturing and aerospace industry. Several multinational companies from the electrical and electronics industry in Malaysia have also invested abroad, mainly through the extension of inter-company loans to their subsidiaries in lower-cost countries. Malaysia's investment abroad has continued to yield positive results. Profits and dividends accrued to Malaysian companies from their investments abroad increased to RM2 billion in 2003 (2002: RM0.7 billion).

Portfolio investment turned around to record a net inflow of RM4.2 billion in 2003 (2002: -RM6.5 billion). In the first half of the year, portfolio investment recorded a net outflow of RM1.3 billion as sentiments in the regional markets were dampened by uncertainties over the global economic outlook due to geopolitical tensions in the Middle East and SARS. Nonetheless, the net outflow was significantly lower compared with the first and second half of 2002.

The sharp increase in portfolio investment of RM5.5 billion in the second half of the year reflected improving investor confidence following news of better growth and more favourable prospects for the Malaysian economy. The bulk of the portfolio inflows was channelled into the equity market, following the sovereign upgrade by a rating agency in October.

The **other investment account** recorded a significantly higher net outflow of RM20.5 billion in 2003, mainly due to the reversal from a net drawdown of external debt in 2002 to a large net repayment in 2003. Meanwhile, net outflows by the private sector continued to moderate for the fourth consecutive year. The **official sector** recorded a large net repayment of RM11.2 billion in 2003, in line with the Government's prudent external debt strategy and commitment towards fiscal consolidation. Taking advantage of the favourable global interest rate regime, the Government also prepaid and refinanced some loans, thereby reducing its debt servicing cost. Similarly, the Non-financial Public Enterprises (NFPEs) also recorded a higher net repayment as their earnings capacity improved during the year.

In 2003, other investment by the **private sector**, comprising mainly borrowing and lending as well as placement and withdrawal of deposits by the banking and non-bank private sector with unrelated counterparties, improved markedly to record a lower net outflow of RM9.3 billion (2002: -RM15.1 billion). Significantly lower net outflows were recorded by the non-bank private sector while the banking sector sustained a smaller net inflow. The net borrowing of foreign currency by the banking sector, albeit lower, continued to reflect the arbitrage opportunities as interest rate differentials remained in favour of Malaysia. Similarly, there were lower outflows in the non-bank private sector due largely to lower trade credits extended by Malaysian exporters to importers abroad, representing a shift in exporters' decision to take advantage of the current favourable monetary and financial environment.

External Debt

Prudent external debt management strategy remained an integral part of macroeconomic policy in 2003. Malaysia continues to maintain an active external debt management strategy, which incorporates the guiding principles that minimise risk with balanced currency and maturity profile. Corporations sourcing external funds for operations in Malaysia are generally required to utilise the funds for productive activities that will generate foreign exchange income. This will provide a natural hedge for debt servicing. They are also encouraged to raise loans with longer maturity, while short-term borrowings by the non-bank private sector to finance long-term investment is discouraged. Prudential regulations to achieve these objectives have been effective in keeping the nation's external debt low and its risk profile balanced.

In 2003, total external debt outstanding increased marginally by 0.9% to RM187.2 billion (US$49.3 billion). The increase in external debt reflected mainly a small net borrowing by the private sector and the exchange revaluation loss, arising from the weakening of the US dollar. External debt of the public sector, comprising the Federal Government and NFPEs, declined in 2003 due to significantly higher net repayment and prepayment. The external debt to GNP and exports of goods and services ratios improved further to 50.7% and 40.4% respectively (2002: 55.3% and 44.3% respectively). Accordingly, the overall debt service ratio (excluding prepayments) declined to 6.1% in 2003 (2002: 6.7%). Of significance is that the share of short-term debt to total debt continued to remain low, accounting for only 18.4% of total external debt. The ratio of short-term debt to international reserves also improved further, to account for 20.2% of reserves (end-2002: 24.4%).

External debt remained stable at a manageable level. Higher repayments and moderate new borrowings by the public sector resulted in a lower share of public sector debt to total debt.

Table 1.24
Outstanding External Debt

	2002		2003*p*	
	RM million	US$ million	RM million	US$ million
Total debt	**185,643**	**48,853**	**187,250**	**49,276**
Medium and long-term	153,587	40,418	152,788	40,207
Short-term[1]	32,055	8,436	34,462	9,069
As % of total debt	*17.3*	*17.3*	*18.4*	*18.4*
As % of international reserves	*24.4*	*24.4*	*20.2*	*20.2*
As % of GNP				
Total debt	55.3	55.3	50.7	50.7
Medium and long-term debt	45.8	45.8	41.4	41.4
As % of exports of goods and services				
Total debt	44.3	44.3	40.4	40.4
Medium and long-term debt	36.6	36.6	32.9	32.9
Debt service ratio (%)	**6.7**	**6.7**	**6.1**	**6.1**

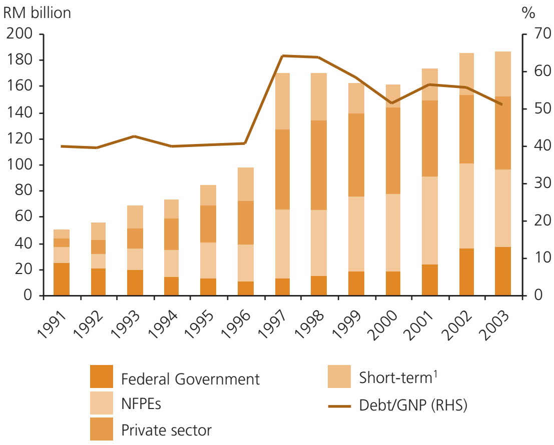
[1] Excludes currency and deposits held by non-residents with resident banking institutions.
p Preliminary

Source: Ministry of Finance and Bank Negara Malaysia

The outstanding **medium and long-term external debt** was sustained at RM152.8 billion (US$40.2 billion) at the end of 2003 (2002: RM153.6 billion). Amidst lower drawdown (-12.1%), repayment of medium and long-term loans increased significantly by 25.1%. For the first time since 1992, the public sector recorded a large net repayment of RM11 billion (2002: +RM4.7 billion), reflecting net repayments by both the Federal Government (-RM3.7 billion) and NFPEs (-RM7.3 billion). Meanwhile, the private sector debt turned around to register a net borrowing of RM3.1 billion (2002: -RM4 billion). Nevertheless, after taking into account an exchange revaluation loss of RM4.1 billion following the appreciation of major currencies, particularly the euro and yen against the US dollar, and a reclassification of a domestic foreign currency loan raised previously from an offshore bank in the Labuan International Offshore Financial Centre into an external loan, the medium and long-term loans declined only marginally by RM0.8 billion.

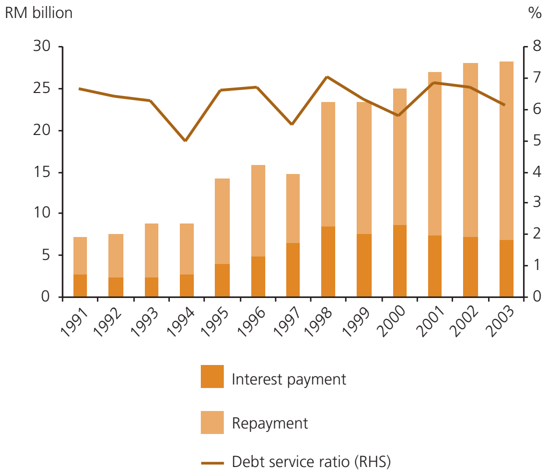
In 2003, **short-term external debt** (maturity of one year or less) rose by RM2.4 billion to RM34.5 billion (US$9.1 billion), reflecting largely the increase in external borrowing by the banking sector, particularly in the second quarter. The increase was attributed mainly to the hedging activities of banks in relation to trade-related transactions. Towards year end, as foreign currency deposits at commercial banks rose

Graph 1.42a
Outstanding External Debt



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

Graph 1.42b
Debt Servicing



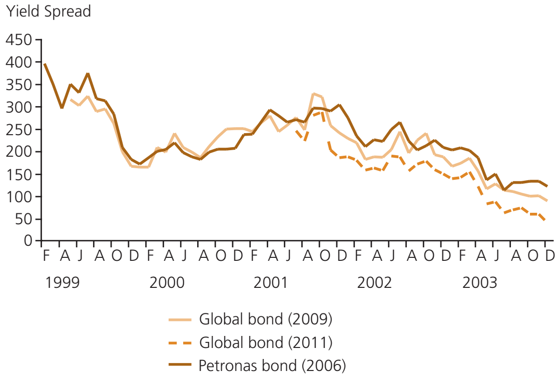
during the fourth quarter, banking institutions began to wind down the interbank foreign borrowings that were taken to cover the forward sales of foreign exchange by exporters. Meanwhile, short-term borrowings by the non-bank private sector, comprising mainly revolving credits, overdraft facilities and term loans, declined marginally in 2003. The decline was due mainly to the repayment of these facilities by several large companies, particularly from the oil and gas sector.

The bulk of the medium and long-term debt continued to be denominated in US dollars (stabilised at 77% as at end 2003), as settlements for trade and investment were mainly in US dollars. The appreciation of the yen and euro in 2003 has therefore led to only a small exchange revaluation loss equivalent to 2.6% of the total medium and long-term debt. In 2003, the share of yen denominated debt declined marginally to 13% (2002: 14%) due partly to a bullet payment of a yen denominated loan by the Federal Government, while that of the euro increased marginally to 5% (2002: 4%). The remaining 5% of the debt was denominated in other international currencies, including the pound sterling, Swiss franc and Singapore dollar.

Public sector external debt: The outstanding external debt of the public sector declined by RM3.8 billion to RM96.8 billion (US$25.5 billion), as at end 2003, reflecting higher repayment by both the Federal Government and NFPEs. Consequently, the share of the public debt to total external debt declined to 51.7% (2002: 54.2%). During the year, the Federal Government maintained its practice to source its funding requirements mainly from non-inflationary domestic sources.

In 2003, three main strategies were undertaken by the **Federal Government** to manage its external debt. Firstly, the Federal Government did not rely on new borrowings from the international capital market, despite the nation's low debt position. Thus, the Government's gross external borrowing declined significantly by RM7.3 billion (US$1.9 billion) to RM3.1 billion (US$0.8 billion) in 2003. Secondly, the Government increased its repayments, including the prepayments of external loans, to RM6.9 billion (2002: -RM2.4 billion). During the year, the Government prepaid two external loans, namely a Floating Rate Note due 2005 and a syndicated loan due 2005/07, which together amounted to RM1.6 billion. Thirdly, taking advantage of the tighter margins arising from improved credit position and investor confidence, the Federal Government refinanced a number of its more costly term and syndicated loans. In January, a ¥1.4 billion term loan due 2006 was raised at Libor + 57.5 basis points to refinance the 3.17% ¥4.1 billion term loan due 2006. In March, the Government refinanced a US$250 million and ¥54 billion dual currency syndicated loan at a lower margin of Libor + 38 basis points (previously Libor + 125 basis points). Nevertheless, after taking into account a reclassification of a domestic foreign currency loan into an external loan and the exchange revaluation loss during the year, the outstanding external debt of the Federal Government increased marginally to RM37.3 billion or US$9.8 billion (2002: RM36.3 billion).

Graph 1.43
Spread of Sovereign Bonds and Selected NFPE Bond Over US T-bills



Reflecting Malaysia's strong fundamentals, the interest spread on Malaysia's benchmark securities narrowed further in 2003. The spread on Malaysia's Global Bond due 2011 narrowed to 36 basis points at the end of 2003 (end-2002: 145 basis points). Similarly, the spread on the Global Bond due 2009 narrowed steadily in 2003 to 85 basis points at end-2003 (end-2002: 183 basis points). During the year, Standard & Poor's raised its long-term foreign currency sovereign credit rating on Malaysia to A- from BBB+ and assigned a stable outlook to the rating on 7 October 2003. Meanwhile, Moody's Investor Service, Fitch and Japan Credit Rating Agency Ltd. also reaffirmed the respective sovereign ratings for Malaysia. In addition, Rating And Investment Information Inc. upgraded Malaysia's long-term foreign currency rating to A- from BBB+, with a stable outlook on 30 January 2004. On 6 February 2004, Moody's also changed the outlook for Malaysia's foreign currency ratings to positive.

The **NFPEs**' external debt declined further to RM59.6 billion in 2003 (US$15.7 billion; 2002: RM64.3 billion). The low interest rate environment and continued strengthening of the NPFEs' earnings performance have allowed the NFPEs to streamline their debt position. The NFPEs recorded a higher net repayment of RM7.3 billion (2002: -RM3.3 billion), reflecting significantly larger repayments, including the prepayment and refinancing of several higher cost loans. These repayments (-RM12.4 billion), including the settlement of several large loans, were effected mainly by NFPEs in the oil and gas, transportation and telecommunication sectors. Inflows of external borrowing had also increased to RM5.2 billion (2002: RM3.7 billion). These loans were raised mainly to finance capital investment and overseas investment as well as for refinancing of more costly loans.

Private sector external debt: Private sector debt (including short-term debt) continued to account for a significant share of Malaysia's external debt, at 48.3% of total debt in 2003 (2002: 45.8%). The private sector medium and long-term external debt increased by 5.6% to RM55.9 billion (US$14.7 billion) as at end-2003. During the year, the larger drawdown of external debt, amounting to RM12.7 billion (2002: RM9.7 billion) was mainly by investment holding companies and companies in the manufacturing and plantation sectors. These funds were mainly to finance capital expenditure and overseas investment. Meanwhile, repayments by the private sector declined to RM9.6 billion in 2003 (2002: RM13.7 billion). While the medium and long-term external debt is marginally higher, the overall risk remains low as the bulk of private sector external debt has a natural hedge. Most of these loans were used to finance productive export-oriented activities with foreign exchange revenue to service the debt. In addition, about two-thirds of the private sector external borrowing were sourced by non-resident controlled companies from their shareholders or related companies abroad. These loans were generally provided on flexible terms, including longer maturity and at concessionary interest rates.

In addition to the existing published detailed information on external debt, Malaysia has subscribed to the **new IMF Special Data Dissemination Standard** (SDDS) on external debt since 30 September 2003. The new SDDS external debt data requirement is consistent with the framework for international investment position statistics in the fifth edition of the Balance of Payments Manual. Under the new template of external debt data, currency and deposits held by non-residents with resident banking institutions were included in the coverage of external debt. While Bank Negara Malaysia has adopted this coverage for external debt in the SDDS templates, for the time being, publications by Bank Negara Malaysia will not include currency and deposits held by non-residents with resident banking institutions. Instead, the Bank will continue to show this item as part of external liabilities of the banking system in its monthly statistics. However, to be consistent with the new SDDS format, adjustment to the external debt tables in all Bank Negara Malaysia's publications will be made during the course of 2004.

International Reserves

The **international reserves** held by Bank Negara Malaysia comprises gold and foreign exchange holdings, IMF reserves position and holdings of

Table 1.25
Net International Reserves

	As at end			Change
	2001	2002	2003	2003
	RM million			
SDR holdings	487.8	585.0	685.0	100.0
IMF reserves position	3,193.5	3,315.5	3,652.0	336.5
Gold and foreign exchange	113,542.3	127,515.1	166,139.3	38,624.2
Gross International Reserves	**117,223.6**	**131,415.6**	**170,476.3**	**39,060.7**
Less Bank Negara Malaysia external liabilities	20.7	21.9	23.8	1.9
Net International Reserves	**117,202.9**	**131,393.7**	**170,452.5**	**39,058.8**
US$ million equivalent	**30,842.9**	**34,577.3**	**44,855.9**	**10,278.6**
Months of retained imports	5.1	5.4	6.8	
Reserves/Short-term external debt (times)	4.9	4.1	4.9	

favour. The accumulation of reserves was also due to sustained inflows of foreign funds for direct investment as well as into the equity market. The net outflows of portfolio funds in the first half of the year due to geopolitical uncertainty and the SARS outbreak reversed in the second half of the year as economic performance strengthened and the corporate earnings outlook improved. The increase in reserves also reflected the net revaluation gains during the year.

The increase in reserves during the year occurred amidst higher outflows arising from larger payments for imports of goods and services and repatriation of profits and dividends underpinned by stronger economic activities. There was also a higher repayment of external loans by the public sector, including settlements of several large loans by the

The net reserves increased to US$51.3 billion as at 15 March 2004, and reflected the more robust economic activities, improved export performance and inflows of foreign direct investment and portfolio investment.

Special Drawing Rights (SDR). In 2003, net international reserves increased by RM39.1 billion, or US$10.3 billion, to a record level of RM170.5 billion or US$44.9 billion as at end-2003. This is the largest annual increase in the last decade. The significant build-up in international reserves over the course of 2003 reflected the more robust economic activities, improved export performance and inflows of foreign direct investment and portfolio investment. As at 15 March 2004, reserves increased further to RM194.9 billion or US$51.3 billion. The level of international reserves is sufficient to finance 7.8 months of retained imports and to cover 5.2 times the short-term external debt.

More significant is that the international reserves held by the Bank are 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 vis-à-vis the ringgit.

In 2003, foreign exchange inflows were largely generated by the sharp increase in trade surplus as well as early repatriation of export earnings in view of interest rate differentials that were in Malaysia's

NFPEs in 2003. The outflows in terms of overseas investments by Malaysian companies, especially in the oil and gas sector, while remaining high, have yielded returns in the form of profits and dividends and interests earned amounting to RM2 billion in 2003 (2002: RM0.7 billion) and generated export revenues from new markets.

Malaysia's reserves also yielded revaluation gains arising from quarterly adjustments of the reserves in all quarters of 2003 as a result of the appreciation of the major currencies against the US dollar during the year. Net revaluation gain for the year amounted to

Graph 1.44
Net International Reserves (End-month)

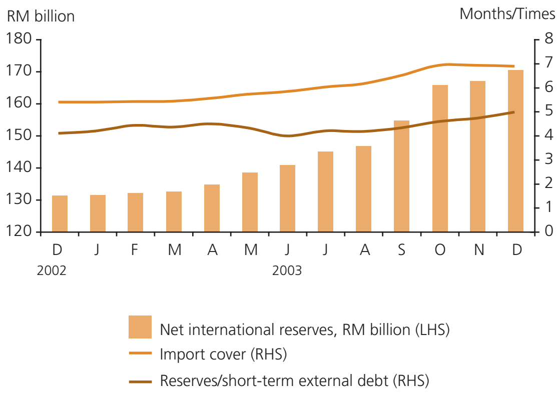


Table 1.26
International Reserves for Selected Regional Economies

Country	Reserves as at end-2003, (US$ billion)	Reserves in months of imports	Reserves as cover of short-term external debt*	Reserves as cover of total external debt*
Chinese Taipei	206.6	19.5	4.6	3.4
Hong Kong China	118.4	21.9	0.5	0.3
Indonesia	36.3	13.4	n.a.	0.3
Korea	155.4	10.4	2.6	1.0
Malaysia	**44.9**	**6.8**	**4.9**	**0.9**
Philippines	16.9	5.2	2.7	0.3
P.R. China	403.3	11.7	6.0	2.2
Singapore	96.3	9.0	n.a.	n.a.
Thailand	42.1	6.8	3.7	0.8

* Except for Malaysia, external debt data refers to amount outstanding as at end 3Q 2003.
n.a. Not available.

Source: National authorities; Asian Development Bank

reserves position. In ringgit terms, the reserves position with the IMF increased by RM336.5 million at the end of 2003. Meanwhile, the receipts of remuneration from the IMF resulted in Malaysia's SDR holdings increasing by SDR8 million to SDR121 million at the end of 2003.

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 fulfils the IMF's SDDS requirements of publishing the reserves data template at end-month with a one-month lag. The SDDS template not only covers detailed information on international reserves, but also includes the release of forward-looking information on the size, composition and usability of official reserves and

In managing the reserves, a prudent approach is adopted to achieve the objectives of ensuring capital preservation and liquidity while optimising returns.

RM11.9 billion or US$3.1 billion, compared with the net revaluation gain of RM6.6 billion or US$1.7 billion in 2002, exceeding the revaluation loss in 2001 (-RM4.1 billion or -US$1.1 billion) and 2000 (-RM5.3 billion or -US$1.4 billion).

In managing the reserves, a prudent approach is adopted to achieve the objectives of ensuring capital preservation and liquidity while optimising returns. The reserves, which comprise gold and major foreign currencies, are well diversified.

Malaysia, as a member of the IMF, can hold reserves with the Fund in the form of SDR, through participation in the Operational Budget. Under the Operational Budget, the Fund invites member countries which are viewed as 'strong' and have surpluses in their balance of payments to make resources available to members which are facing balance of payments difficulties. In return, the contributing members agree to receive a claim on the Fund (termed as the **reserves position with the IMF**) that can be drawn in the event of a balance of payments need.

During the year, reflecting Malaysia's strength in the balance of payments and gross reserves position, Malaysia was included in the IMF's Operational Budget. This was reflected in an increase in the net purchase of SDR5 million, resulting in an increase in Malaysia's net creditor position with the IMF, and the consequent increase in Bank Negara Malaysia's

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 months.

Flow of Funds

The economy registered a higher resource surplus of RM50.8 billion or 13.7% of GNP in 2003 (2002: a surplus of RM30.5 billion or 9.1% of GNP). In terms of balance of payments, the higher resource surplus reflected higher exports over imports following improved external demand in the second half of the year. While exports grew strongly by 8.6% (2002: 6.6%), imports rose at a slower pace of 5.4% (2002: 6.5%). From the perspective of the country's saving-investment gap, the higher resource surplus reflected the significantly higher net savings position of the private sector. The inter-sectoral flow of funds between various sectors of the economy for the year is shown in Tables 1.27 and 1.28.

The disposable income of the public sector increased by 5.9% to RM120.2 billion in 2003. However, this higher disposable income was offset by higher public consumption and investment expenditure arising from the government's efforts to sustain economic activity in the face of adverse external developments in the first half of 2003. Consequently, the resource surplus of the public sector was marginally higher at RM10 billion in 2003 (2002: RM9.8 billion). The resource surplus reflected entirely the surpluses from the NFPEs of

Table 1.27
Flow of Funds: 2002

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-325.0	113.5	211.5			0
Consumption	209.5	-50.0	-159.5			0
Investment	83.8	-53.7	-30.1			0
Change in Stocks	1.3		-1.3			0
Exports of Goods and Non-Factor Services	415.0				-415.0	0
Imports of Goods and Non-Factor Services	-348.9				348.9	0
Net Factor Payment Abroad	-25.1				25.1	0
Net Transfers	-10.6				10.6	0
Non-Financial Balance	0.0	9.8	20.7	0.0	-30.5	0
Foreign Financing						
Direct Investment			4.9		-4.9	0
Net Foreign Borrowings		4.7	-27.9		23.2	0
Net Change in Foreign Assets						
Bank Negara Malaysia				-14.2	14.2	0
Banking System				6.3	-6.3	0
Domestic Financing						
Change in Credit		11.5	27.7	-39.3		0
Change in Money Supply, M3			-31.6	31.6		0
Net Borrowings from Non-Bank Sector		-26.1	26.1			0
Net Errors and Omissions			-19.9	15.5	4.4	0
Sum		0	0	0	0	

Table 1.28
Flow of Funds: 2003

	National Accounts	Domestic Economy			Rest of the World	Sum
		Public Sector	Private Sector	Banking System		
	RM billion					
Disposable Income	-360.1	120.2	239.9			0
Consumption	223.7	-53.9	-169.8			0
Investment	87.1	-56.3	-30.8			0
Change in Stocks	-1.5		1.5			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 Payment Abroad	-22.6				22.6	0
Net Transfers	-9.3				9.3	0
Non-Financial Balance	0.0	10.0	40.8	0.0	-50.8	0
Foreign Financing						
Direct Investment			4.2		-4.2	0
Net Foreign Borrowings		-11.2	-12.8		24.0	0
Net Change in Foreign Assets						
Bank Negara Malaysia				-39.1	39.1	0
Banking System				7.7	-7.7	0
Domestic Financing						
Change in Credit		12.9	32.4	-45.3		0
Change in Money Supply, M3			-48.5	48.5		0
Net Borrowings from Non-Bank Sector		-11.7	11.7			0
Net Errors and Omissions			-27.8	28.2	-0.4	0
Sum	0	0	0	0	0	

RM24.7 billion, which helped offset the resource gap of the general government of RM14.7 billion. The bulk of the resource gap of the general government was financed through net domestic borrowings (RM12.9 billion). Government borrowings and the resource surplus of the NFPEs were utilised to make a net repayment of foreign borrowings of RM11.2 billion, while RM11.7 billion was transferred to the private sector during the year.

The resource surplus of the private sector increased twofold to RM40.8 billion or 11% of GNP in 2003 from RM20.7 billion or 6.2% of GNP in 2002. Higher disposable income of RM239.9 billion during the year (2002: RM211.5 billion) following continued strong growth in economic activity, enabled the private sector to increase consumption expenditure (6.5%). At the same time, private investment expenditure turned around (2.4%), the first positive growth since 2000. The resource surplus of the private sector together with net inflows of FDI (RM4.2 billion), net borrowings from the banking system (RM32.4 billion) and net transfers from the public sector (RM11.7 billion), led to a larger increase of resources amounting to RM89.1 billion (2002: RM79.4 billion) being available to the private sector.

A sizeable pool of resources available to the private sector was placed with the banking system, resulting in a net placement of deposits of RM48.5 billion. Some of the excess resources were also utilised for repayments of foreign borrowings by the private sector (RM12.8 billion). For the economy as a whole, the large current account surplus and continued inflows of FDIs, were more than sufficient to accommodate these outflows. Consequently, the net international reserves of BNM rose by RM39.1 billion to RM170.5 billion as at the end of 2003.