Outlook and Policy

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THE INTERNATIONAL ECONOMIC ENVIRONMENT

Developments in 2003

The global economy strengthened considerably in 2003, led by the United States (US). Growth has also been synchronised across major industrial economies, with the recovery in Japan and Europe adding support to global growth. Growth in 2003 was characterised by two distinct phases, with the first half-year dampened by uncertainties related to the Iraq war and the Severe Acute Respiratory Syndrome (SARS) outbreak in Asia. Since mid-2003, however, revival of growth in Japan and euro zone and stronger growth in the US led to a better-than-expected global growth of 3.2% for the year. Expansionary fiscal and accommodative monetary policies in the advanced economies and Asian countries supported growth. At the same time, the sources of growth have broadened from consumption-led to include an upturn in investment and inventory rebuilding.

Table 3.1
World Economy : Key Economic Indicators

	Real GDP Growth (%)			Inflation (%)		
	2002	2003*e*	2004*f*	2002	2003*e*	2004*f*
World Growth	**3.0**	**3.2**	**4.1**	–	–	–
World Trade	**2.9**	**3.5 - 4.5**	**5.0 - 6.0**	–	–	–
Major Industrial Countries						
United States	2.4	3.1	3.9	1.6	2.1	1.3
Japan	-0.4	2.7	2.0	-0.9	-0.3	-0.6
Euro Area	0.9	0.4	1.6	2.3	2.0	1.6
United Kingdom[1]	1.7	2.3	2.3	2.2	2.8	2.5
East Asia	**6.2**	**6.2**	**6.6 - 6.8**	**1.3**	**1.8**	**2.4 - 2.7**
Asian NIEs	**4.5**	**2.9**	**5.0 - 5.2**	**0.8**	**1.2**	**1.4 - 1.5**
Korea	6.3	2.9	5.2	2.7	3.5	3.0
Chinese Taipei	3.6	3.2	4.7	-0.2	-0.3	0.4
Singapore	2.2	1.1	3.5 - 5.5	-0.4	0.5	0.5 - 1.5
Hong Kong China[2]	2.3	3.3	6.0	-3.0	-2.6	-1.0
The People's Republic of China	**8.2**	**9.1**	**8.3**	**-0.8**	**1.2**	**3.0**
ASEAN[3]	**4.0**	**4.5**	**4.9 - 6.0**	**5.3**	**3.8**	**3.0 - 4.3**
Malaysia	4.1	5.2	6.0 - 6.5	1.8	1.2	1.5
Thailand	5.4	6.7	6.3 - 7.3	0.7	1.8	1- 2
Indonesia	3.7	4.1	4.0 - 5.0	11.9	6.6	4.5 - 6.5
Philippines	4.4	4.5	4.9 - 5.8	3.1	3.4	4.0 - 5.0

[1] Refers to retail price excluding mortgage interest.
[2] Refers to composite price.
[3] Includes Singapore.
e Estimate
f Forecast

Source: International Monetary Fund, Datastream, OECD Economic Outlook, National Sources

The global recovery was accompanied and supported by improvements in international trade and financial markets. World trade grew by 3.5-4.5% in 2003, largely attributable to import demand from developing countries. Reflecting the rising global demand, the international prices for non-oil primary commodities rose during the year. In the financial markets, major equity markets rallied, supported by rising investor confidence and improved corporate financial positions. The lower cost of capital amidst sustainable demand led to a revival in the global investment cycle. During the year, the global foreign exchange markets were dominated by the significant weakening of the US dollar due to the concerns on the widening US fiscal and current account imbalances. In Asia, there was strong expansion in domestic demand resulting in a significant increase in intra-regional trade.

In the **US**, the pace of recovery gained strong momentum in the second half to register a growth of 5.8% (first half: 2.1%). Despite weak labour market conditions, household spending remained an important driver of growth, with consumption increasing strongly by 4.9% in the second half-year. While the tax cuts provided a significant stimulus, spending also benefited from the low interest and mortgage rates as well as rising household wealth from renewed strength in the stock market. More important, business spending on equipment and software recovered following productivity-driven increases in profits and improved corporate balance sheets. Latest data showed real GDP sustaining its growth momentum to expand by 4.1% in the final quarter of 2003. Overall, the growth was well supported by positive contributions from consumption, investment, exports and inventory increases.

Growth in **Japan** picked up in the second quarter of 2003 and accelerated in the fourth quarter, led by strong growth in exports from rising regional trade and recovery in investment spending. The **euro area** recovered gradually, supported by fiscal spending and improvement in net exports. In the **United Kingdom** (UK), growth remained resilient, underpinned by both private and public consumption.

In the **Asian region**, despite geopolitical uncertainties and the negative impact of SARS in the first half of 2003, regional growth was sustained at 6.2%, twice the global average. The main impetus to growth emanated from exports, driven mainly by the upturn in the global electronics cycle and sustained favourable prices for non-oil primary commodities reinforced by strong domestic demand. In tandem with improvements in the global economic environment, the trade momentum accelerated in the second half, resulting in a doubling of the export growth rate to 18.6% for the year (2002: 9.5%). Of significance, intra-regional trade accounted for about half of the regional economies' export growth, with exports to the People's Republic of China (P. R.China) accelerating by 33%.

Global prospects have improved, supported by reinforcing and broad-based growth across major industrial countries.

During the year, regional growth was reinforced by the underlying strength in domestic demand, supported by accommodative monetary and fiscal policies. In several countries, economic stimulus packages that were introduced to mitigate the impact of SARS led to the broad recovery in private consumption and travel-related industries in the second half of the year. Of importance, financial indicators in the region improved during the year. Bank balance sheets strengthened while corporate sector debt levels were lower and external debt positions improved. The improved assessment of credit risk in the region in 2003 was reflected in the raising of ratings for P. R. China, Indonesia, Malaysia, Singapore and Thailand by international credit rating agencies.

Among regional countries, growth continued to be led by P. R. China, with a strong expansion of 9.1%, followed by Thailand and Malaysia at 6.7% and 5.2%, respectively. While growth was higher in Hong Kong China, the growth of the Asian Newly Industrialised Economies (NIEs) as a whole slowed down to 2.9% (2002: 4.5%), due mainly to a contraction in private consumption in Korea and the adverse impact of SARS on the economies of Singapore and Chinese Taipei.

Prospects for 2004

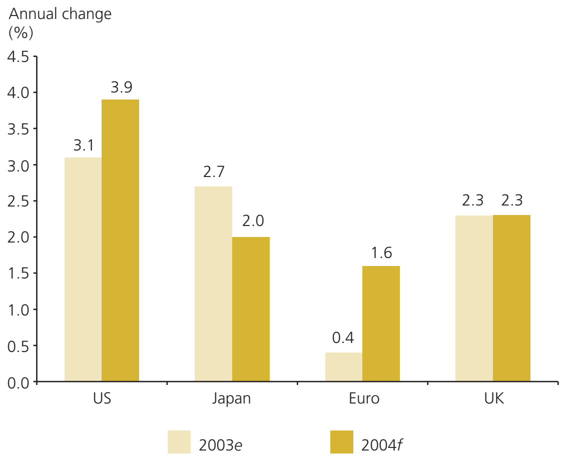
The outlook for the global economy has become increasingly optimistic, following the strong upturn in the second half of 2003. Amidst improved prospects, most growth projections have been revised upwards. For 2004, world output and world trade are projected to grow at a faster pace of 4.1% and 5-6%, respectively. The Asian regional economies' share in global trade has also increased. Measured in terms of the share of world exports of goods and services, the region's share has increased from 16.3% in 1994 to 19.6% in 2002. Favourable export performance, continued growth in private consumption and expansion in investment are expected to lead to higher growth for the Asian regional economies in 2004.

Amidst a low inflation environment, the growth momentum in the US is expected to be supported by expansionary monetary and fiscal policy that have been in place for some time, as well as productivity gains, investment and inventory rebuilding. Growth in the euro area is expected to recover gradually as expansionary fiscal policies continue to be adopted in major euro area economies. While the economic recovery in Japan is affected by long-term structural problems, deflationary pressures have begun to ease and signs of sustainable recovery have emerged since the second half of 2003. In the UK, economic growth is expected to remain resilient, underpinned by public and private consumption.

Industrial Countries

In 2004, growth of the **US** economy is expected to remain strong and more broad-based, with real GDP

Graph 3.1
Major Industrial Countries: Real GDP Growth (2003-2004)



e Estimate
f Forecast

growth strengthening to 3.9% from 3.1% in 2003. Consumption growth is expected to continue, albeit at a more moderate pace as benefits of mortgage refinancing and tax cuts abate. Investment is expected to provide a higher contribution to growth although excess capacity still remains in certain sectors of the economy. The upturn in equipment and software spending is expected to lead investment growth. Gains in corporate profits and capacity expansion are expected to stimulate business expenditure, while expected inventory rebuilding from decade low levels is expected to add to growth.

In the **euro area**, real GDP is expected to expand by 1.6% in 2004. Domestic demand has remained subdued due to weak labour markets and uncertainties related to social welfare reforms. However, the low interest rate environment coupled with rising real disposable income should provide some impetus for growth. In addition, investment activity is expected to recover owing to improvements in global demand and further inventory rebuilding. Despite improvements in business confidence, growth in Germany is expected to remain modest due to weak labour market conditions and moderate private consumption growth. While euro area exports are expected to grow further with strengthening global demand, a sharp and sustained appreciation of the euro could adversely affect exports, corporate profitability and growth. Sustainable recovery in the euro area would largely be dependent on a revival in domestic demand.

In **UK**, the economy is expected to remain resilient as the global economic recovery becomes more entrenched. Growth is estimated at 2.3%, growing above trend in 2004. Investment is expected to recover with increased corporate profitability, while fiscal expenditure is expected to rise modestly. Consumption is expected to continue to grow, but at a more moderate pace with the slowdown in growth of disposable income. Recovery of export growth will be influenced by exchange rate movements and demand conditions in the euro area. While house prices have been rising at a rapid rate, recent increases in borrowing costs are expected to mitigate further price increases.

Recovery in **Japan** is expected to be sustained. Major contributory factors are the robust exports, stronger investment activity supported by improved business confidence, corporate profitability as well as increased consumption arising from personal income growth and more stable employment conditions. Deflationary conditions and long-term structural weaknesses in the corporate and banking sectors are still being addressed.

Inflation is expected to remain benign in major industrialised countries in 2004. While inflation is projected to remain low at 1.3%, higher global crude oil prices could exert upward inflationary pressures, particularly in the US. Meanwhile, in the euro area, the stronger euro would contribute to offsetting the impact of higher crude oil prices. Despite improving growth prospects, deflationary pressures are expected to remain in the Japanese economy.

Overall, for 2004, oil prices are expected to remain marginally higher than the OPEC band (US$22-28 per barrel), attributable mainly to rising demand in tandem with the strengthening of global growth. In February 2004, OPEC announced that with effect from 1 April 2004, the production ceiling will be lowered by one million barrels per day, given a projected supply surplus in the second quarter of the year due to seasonally low demand. Also, uncertainties in oil production, particularly in Iraq, and positive investor sentiments on the commodities market, are expected to contribute to price increases.

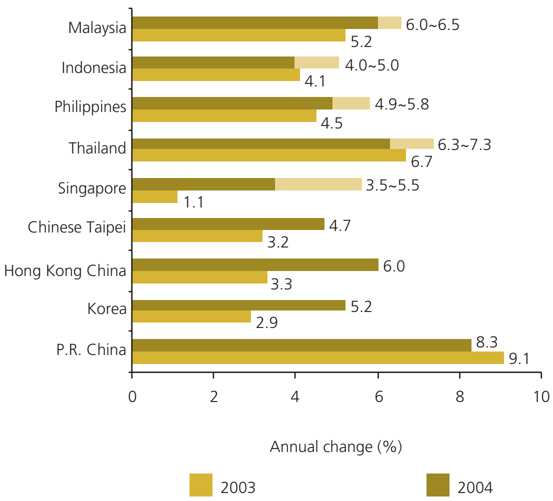
Growth momentum to continue in US, with recovery gaining strength in Japan and Europe and growth in Asia to be driven by recovery in investment.

East Asian Economies

Prospects are for **growth in the Asian region to be stronger** between 6.6-6.8% in 2004. The majority of regional countries are expected to register faster growth, with P. R. China leading growth in the region. Overall, regional growth is expected to be broad based, with both external and domestic demand providing the impetus to faster growth.

On the external front, growth is expected to benefit from the further strengthening of the electronics upcycle. Besides demand for consumer electronics, which was the main factor for growth of semiconductor sales in 2003, higher business spending on IT replacement and a revival of investment are projected to enhance sales. On the

Graph 3.2
Regional Countries: Real GDP Growth



supply side, the industry is expected to register strong capacity expansion, particularly in equipment investment, which was last seen during the electronics upturn in 2000. With capacity utilisation above 90% in 2003, investment in equipment and machinery is forecast to increase by 36-42% on an annual basis in 2004 (2003: 12.4%). The rise in investment activity during the year is envisaged to emanate from stronger foreign direct investment inflows and the further strengthening of regional production networks. Therefore, intra-regional trade is expected to continue expanding.

Higher and broad based regional growth in 2004, with expansion in exports, consumption and investment.

On the domestic front, private consumption is expected to strengthen further in 2004, supported mainly by rising disposable incomes and low interest rates in most regional countries. With the exception of Korea, lending to the household sector in most other regional countries remains below pre-crisis levels, implying the potential for further expansion. The impact of the bird flu on economic growth would be marginal as the livestock industry accounts for a small share of GDP, ranging from 0.1% in Japan to 15% in Cambodia. A key development during the year is the expansion in investment activity, which began to pick up in the second half of 2003. The benefits of past restructuring of the corporate sector have led to higher profitability as well as increased bank lending and equity capital, all of which are expected to enhance investment activity during the year. Reflecting efforts to diversify the economy, a key measure taken in recent years by most regional countries is to spearhead investments in the services sector. Of importance, domestic investments through the promotion of small and medium enterprises (SMEs) are expected to pick up during the year. Consonant with higher growth, most regional countries are forecast to record fiscal improvements.

For 2004, the global outlook is biased on the upside, with stronger recovery in demand. Growth is expected to be supported by continued expansion in consumption and private investment and the strengthening of the labour market in the US and the positive impact of tax and labour market reforms in Europe. Hence, prospects for regional growth in Asia remain favourable.

In 2004, real GDP growth of the **Asian Newly Industrialised Economies (NIEs)** as a group, is expected to strengthen to 5-5.2%, underpinned by robust export performance and a pick up in domestic demand.

In **Korea**, real GDP is projected to register growth of 5.2% in 2004. Exports would remain the main driver of economic expansion. Tax incentives, increased investment expenditure, and measures to improve labour-management relations as well as nurture SMEs are expected to lead to the improvement in job prospects. Hence, private consumption is expected to improve in the second half of the year.

Growth in **Hong Kong China** is forecast to pick up further in 2004 to reach 6%, the highest in four years. A boost to economic expansion is expected to emanate from the Closer Economic Partnership Arrangement (CEPA) with P.R.China, which came into effect on 1 January 2004. The agreement, covering a wide range of goods and the opening up of 17 services sectors, is the first extensive bilateral FTA in the region. Further strengthening of the domestic economy and strong demand from P.R.China would support employment and the services sector including the tourism and financial sectors.

Led by investment and exports, growth in **Chinese Taipei** is expected to be higher at 4.7%. Higher investment spending is forecast for the year, due to government expenditure on construction projects and a rebound in private investments in the manufacturing sector. In line with the strengthening of the global electronics upcycle, exports are poised to benefit from the country's competitive advantage in contract manufacturing, namely in wafer fabrication, notebooks and consumer electronics.

In **Singapore**, growth is expected to strengthen in the range of 3.5-5.5% in 2004, attributable mainly to the recovery in global IT spending. A revival in consumer demand is projected to emanate mainly from positive sentiments arising from improvements in labour market conditions and the low interest rate environment.

The **ASEAN** economies as a whole is expected to expand at a faster pace of 4.9-6% in 2004, with higher contribution from the domestic and external sectors. Within the group, **Thailand** is forecast to record the strongest growth in output, with growth of 6.3-7.3%. Following rising capacity utilisation, faster investment growth is expected, with the bulk of investments comprising private sector investments in the manufacturing sector, and reinforced by public sector infrastructure projects.

In the **Philippines**, real GDP growth is projected to expand by 4.9-5.8%, attributable mainly to higher electronics exports. Continued strong overseas remittances as well as favourable farm output are expected to contribute to growth in private consumption. Growth in **Indonesia** is expected to increase between 4-5%, with private consumption to remain as the primary source of growth. With increased access to financing at lower interest rates amidst declining inflation, private consumption is expected to register a sustained rise.

P. R.China is forecast to register the highest growth of 8.3% in 2004. While exports and private consumption are expected to increase, investment expenditure is expected to moderate in line with the government's policy to achieve a more balanced and sustainable growth.

In 2004, inflation in the **regional countries** is expected to remain low between 2.4-2.7%. Inflation in the **Asian NIEs** as a group, however, is expected to increase marginally to between 1.4-1.5%. In Korea, inflation is projected to moderate, reflecting a stabilisation in food and oil prices and receding demand pressures. In all other NIEs, consumer prices are forecast to trend upwards, attributable to the pick up in general economic activity. While deflationary pressures are expected to ease in Hong Kong China, a turnaround is forecast for Chinese Taipei, with price increases in 2004, compared with price declines registered in the last two years.

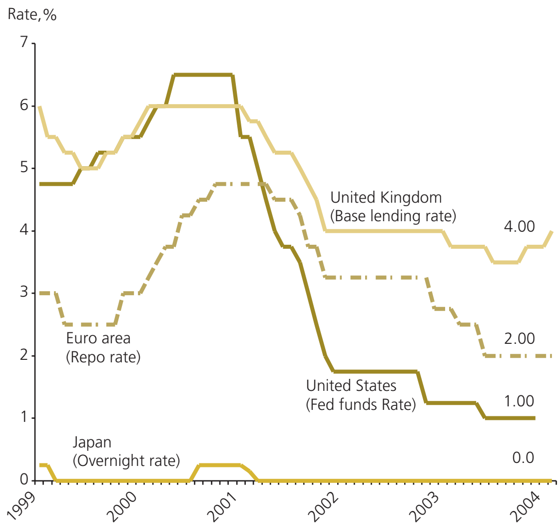
Meanwhile, inflation in the **ASEAN countries** as a group is expected to remain stable in the range of 3-4.3% in 2004. In Indonesia, price pressures are projected to subside further, with slower growth in wages amidst excess capacity conditions. In contrast, inflation in the Philippines is estimated to increase further, reflecting rising demand pressures as economic growth strengthens. In Thailand, modest price pressures are forecast, arising from continued buoyant domestic demand conditions.

Interest Rates and Exchange Rates

In 2003, the major industrial countries continued to maintain accommodative monetary policies. Weak economic conditions, particularly in the first half of the year, led several major central banks to reduce interest rates.

In the US, the **Federal Reserve Board (Fed)** reduced interest rates by 25 basis points on 25 June 2003 following heightened risk of deflation. The Fed's actions had brought the Federal funds rate to 1.0%, its lowest level in more than 40 years, and marked a cumulative reduction of 550 basis points since the Fed began its easing cycle in early 2001. By end-year, however, amidst a stronger recovery in growth, the threat of falling inflation had receded. Meanwhile, signs of economic weakness in the euro zone especially in early 2003 prompted the

Graph 3.3
Major Industrial Countries: Official Interest Rates



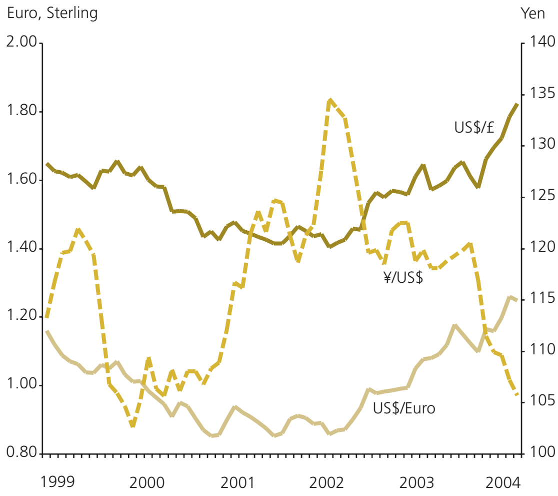
European Central Bank to reduce rates by 25 basis points in March 2003 and a further 50 basis points in June 2003. Consequently, the benchmark repo rate declined to 2%, reflecting a cumulative 275 basis point reduction since May 2001 to counter the slowdown in the euro area.

In the UK, the **Bank of England** (BOE) eased its base lending rate twice by 25 basis points in February and July 2003 on concerns about the downturn in the manufacturing sector and that domestic and external demand would be lower than earlier anticipated. However, with the sharp increases in house prices and rapid growth in consumer loans seen in the second half-year, the BOE raised rates in November 2003 and again in February 2004, mainly to constrain the pace of household debt accumulation. Meanwhile, in Japan, with official short-term interest rates virtually at zero, the **Bank of Japan** continued to engage in quantitative easing measures throughout 2003 to inject liquidity into the banking system in order to counter deflation and lend support to the economic recovery.

For the remaining part of 2004, while growth has gathered momentum, excess capacity still exists in the global economy. Excess capacity in the industrial sector and high unemployment in the labour markets are reflective of output gaps. Thus, despite rising commodity prices, inflation levels remain subdued in many economies. Nonetheless, in some countries, house price increases and excessive credit growth have surfaced to influence the stance of monetary policy. Overall, the timing and magnitude of monetary policy actions would depend on country-specific factors, including the strength of economic growth, inflation trends and developments in the currency and financial markets.

In the **foreign exchange markets**, the US dollar depreciated further against all major currencies in **2003**, extending its decline, which began in early 2002. Consequently, by end-2003 the US dollar depreciated further by about 20% against the euro and about 11% against both the Japanese yen and pound sterling. Underlying the depreciating trend has been the pressure from a widening current account deficit and declining capital inflows into US dollar assets. Against the backdrop of a weaker US dollar, the euro appreciated in 2003 and ended the year at a record high of E1=US$1.2595. This trend continued into early 2004, with the dollar weakening further against the other major currencies.

Graph 3.4
Movement of the US Dollar against Major Currencies



MALAYSIAN ECONOMY IN 2004

The Malaysian economy is expected to strengthen further in 2004, building on the strong growth momentum in the second half of 2003 and brighter prospects for global growth in 2004. Real GDP is expected to expand by 6-6.5% (2003: 5.2%), underpinned by stronger domestic demand and reinforced by more favourable external demand. Growth will mainly be private sector-driven, while the public sector gradually consolidates. The growing consumer and business confidence since the second quarter of 2003, strengthened economic fundamentals and the positive impact of pro-growth fiscal and monetary measures are expected to mutually reinforce robust consumer spending and the upturn in private investment activities.

The projections for growth in 2004 are based on a stronger global economic growth of 4.1% and led by synchronised recovery across all regions, an upturn in the global electronics cycle and firm prices for crude palm oil and crude oil. With the growth in Asia stronger than the global average, Malaysia is also expected to benefit from the continued expansion in intra-regional trade. The expectation of the stronger pace of growth is also premised on the strength and dynamism of the private sector performance, especially the strength of the upturn in domestic investment. Evidence of higher new investments and capacity expansion are indicative that the recovery in economic growth is sustainable.

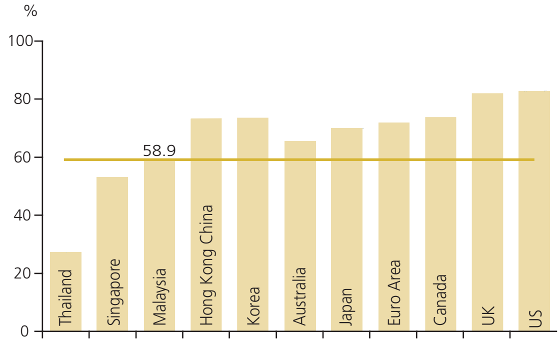
While possible downside risks remain, the strong underlying fundamentals will provide strong foundations for economic resilience and future growth.

While the external environment has improved significantly, Malaysia will continue to fine-tune the strategies to strengthen the domestic sources of growth to reduce vulnerability to external risks and strengthen economic resilience. Hence, while continuing to promote exports and foreign direct investment, greater focus has been directed at enhancing the contribution of domestic consumption and investment to growth.

Private consumption has become an important component of the economy. Measures to promote domestic consumption have resulted in a higher share of private consumption to GDP (46.4%; 1999: 43.6%). However, the share of private consumption to GDP is relatively low compared to other countries in the region, which have higher shares of between 50-70% of GDP. In terms of the average propensity to consume (APC), Malaysia's APC is also lower (within the range of 0.45-0.49 in the last five years) compared with that of the other countries in the region (above 0.55). Thus, given the steady income levels and the high savings rate, there is potential to further enhance the contribution of domestic consumption to growth, without increased risks to the economy.

As at end-2003, household debt to GDP accounted for 58.9% (end-2002: 56.8%). This level remains comparatively low compared with other countries. The debt service burden accounted for only 16.4% of GDP. Including credit card repayments, the ratio would be 24%. While household debt has increased, the repayment capability of households has continued to improve. This is reflected in the continued decline in the household NPLs to 8% as at end-2003, from 8.5% as at end-2002. The ability of the household sector to service their debts is also reflected in the sustained increase in disposable income and accumulation of savings. Household deposits, as a percentage of GDP, remained high at 66.6% at end-2003 (end-2002: 67.3%).

Graph 3.5
International Comparison - Household Debts[1]
(% of nominal GDP, 2003)



[1] Financial liabilities of households with the banking system

Meanwhile, private investment is expected to be an increasingly important driver of growth. Several measures have been implemented recently to enhance the contribution of investment to growth, particularly investment by the SMEs. The SME sector will continue to be developed and integrated into the mainstream of industrial and technological development to actively support the domestic industries. This will strengthen the inter-linkages in the economy and contribute towards the development of a more vibrant domestic economy.

In this regard, the key strategies in the 2004 Budget reinforced the measures in the Economic Package to strengthen the domestic sources of growth and to facilitate the private sector to assume its lead role as the engine of growth. The thrust of the 2004 Budget strategies focused on providing a supportive environment for private sector initiatives, while gradually cutting back public expenditure. Towards this end, various tax and non-tax incentives were directed at enhancing domestic sources of growth in niche areas, with continuing emphasis on the services sector (especially private education, health and tourism), developing SMEs as a key growth catalyst, and agriculture as the third engine of growth. Additional incentives were provided to encourage manufacturers to move up the value chain to undertake higher value-added activities such as research and development. Measures also continue

Real GDP to expand by 6-6.5% in 2004, underpinned by stronger domestic demand and reinforced by robust external demand. Private sector will lead growth, while the Government continues to provide a supportive environment.

to focus on enhancing the country's efficiency and productivity and overall competitiveness to enable Malaysian companies to compete globally. These include incentives directed at reducing the cost of doing business and increasing innovation through higher research and development activities.

Reflecting the gradual fiscal consolidation, the Government's fiscal deficit is expected to narrow to 4.5% of GDP in 2004 from 5.3% in 2003. With inflation remaining subdued, monetary policy in 2004 would continue to be directed at sustaining the growth momentum. The current low interest rate environment will remain to reinforce the private sector-led growth. In this regard, efforts would continue to focus on improving the flow of credit to sectors with growth potential, particularly the SMEs and to new growth areas. In addition to the banking system, new avenues are also being developed to increase the SMEs' access to capital market funding.

In 2004, growth would also be supported by higher productivity. Given the infrastructure in place and efforts to improve skills to better leverage on technology, productivity is expected to increase. An important factor that would enhance productivity is the efficiency of the delivery system for public sector services. In this regard, Bank Negara Malaysia further liberalised the foreign exchange rules as part of its continuous effort to reduce regulatory cost and improve overall efficiency of both businesses and banking institutions. The changes are to achieve three main objectives:

- To promote efficiency and risk management;
- To facilitate management of funds and risk diversification; and
- To deepen the capital market.

Domestic Demand

The positive factors that supported domestic demand in 2003 are expected to continue to drive the growth momentum in 2004. The pace of growth of private investment, which had turned positive in 2003, is expected to accelerate this year, with a more significant contribution to growth. Private consumption would strengthen further. The growth enhancing effects of fiscal policy and low interest rates will continue to support private sector activities.

Growth would also be reinforced by the improvement in external demand with the strengthening of the economies of Malaysia's main trading partners. While a more robust growth of exports is anticipated, the contribution from net exports to growth would be modest as a stronger increase in imports is expected with the recovery in private investment and stronger economic expansion. Against this backdrop, the private sector is expected to resume the lead role, with its contribution to growth doubling from 2.5 percentage points in 2003 to 4.9 percentage points in 2004. Reflecting the policy of fiscal consolidation, public expenditure would show a modest decline.

Growth in **private consumption**, which displayed resilience in 2003, is expected to strengthen to 8.1% in line with growing consumer confidence. The propensity to consume would be further enhanced by continued firm commodity prices,

Table 3.2
Real GDP by Expenditure (1987=100)

	2003*p*	2004*f*
	Annual change (%)	
Domestic Demand[1]	**4.8**	**5.0**
Private sector expenditure	4.3	8.7
Consumption	*5.1*	*8.1*
Investment	*1.1*	*11.5*
Public sector expenditure	5.5	-1.3
Consumption	*7.9*	*4.2*
Investment	*3.6*	*-5.7*
Net exports of goods and services	**20.5**	**0.8**
Exports	6.3	12.1
Imports	5.0	13.3
Gross Domestic Product	**5.2**	**6.0 - 6.5**

[1] Excluding stocks.
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 3.3
Contribution of Demand Components to Real GDP Growth

	2003*p*	2004*f*
	% point of contribution	
Domestic Demand[1]	**4.3**	**4.5**
Private sector expenditure	2.5	4.9
Consumption	*2.4*	*3.7*
Investment	*0.1*	*1.1*
Public sector expenditure	1.8	-0.4
Consumption	*1.1*	*0.6*
Investment	*0.7*	*-1.0*
Change in stocks	-1.1	1.5
Net exports of goods and services	**2.0**	**0.1**
Exports	6.9	13.3
Imports	4.9	13.2
Gross Domestic Product	**5.2**	**6.0 - 6.5**

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

Source: Department of Statistics, Malaysia and Bank Negara Malaysia higher export earnings, the low interest rate environment, stable job market and the positive wealth effect of higher equity prices. The income levels of households are also expected to increase in line with the improvement in business conditions and productivity gains. The stimulus measures already in place would continue to filter through with positive effects on consumer spending capacity. The reduction in EPF contribution by employees would continue to enhance the disposable income of individuals in the first half-year. In addition to the improving income levels, the high savings rate would also provide the support for higher spending capacity.

gas sector is expected following the discovery of deep sea oil and for ongoing exploration work by the oil companies.

New investment activities are also expected in the new growth areas in the information and communications technology and shared services sub-sectors (such as operational headquarters and back-room operations) with the additional allocation of funds under Malaysian Venture Capital Management (MAVCAP), the expansion of Multimedia Development Corporation's role as a one-stop agency for selected services sectors and the additional incentives for operational

Robust external demand, improved cash flow position of companies, higher capacity utilisation and low interest rates will reinforce and strengthen the pace of private investment, while firm commodity prices and stable job market continue to drive private consumption.

Private investment is expected to expand at a stronger pace of 11.5% in 2004 as the rise in private capital spending gains further momentum due to more positive business sentiment, improved corporate cash flow positions and high capacity utilisation rates. The IT replacement cycle would also lead to increases in investment in equipment and software. Private sector capital formation would be supported by higher capital outlay, particularly in the manufacturing, oil and gas and services sectors. Investments would also be supported by a steady inflow of new foreign direct investment and reinvestment.

Positive developments in the manufacturing sector, including the markedly higher approvals of manufacturing projects by the Ministry of International Trade and Industry (MITI) and high capacity utilisation rates are expected to drive investment activities in the sector. A contributory factor is the additional tax incentives given to local companies to reinvest in the production of machinery and equipment and heavy industries. Investment in the construction sector would be sustained, mainly from the development of several residential housing projects as well as ongoing privatised road projects. In addition, large capital spending would emanate from other major infrastructure projects in the transport and utilities sub-sectors such as building of new power plants, expansion of port facilities and development of water projects. Higher investment in the oil and

headquarters. Meanwhile, investment in the agriculture sector is expected to be sustained with the measures announced in the Economic Package and the 2004 Budget to promote large-scale mixed farming and further modernise the agriculture sector.

In 2004, a modest decline in public sector expenditure is expected. The public sector, while gradually consolidating, would remain supportive of growth. **Public sector consumption** is budgeted to increase moderately by 4.2% due to increased spending on supplies and services to improve the quality and delivery of public services. Meanwhile, **public investment** would be reduced by 5.7% to a more sustainable level in 2004 following the accelerated implementation of development projects in 2001-2003. Although development expenditure would decline, its impact on growth would be compensated by private sector expenditure, which has a larger multiplier impact on the economy. Also, increased efficiency in expenditure allocation and improved effectiveness in the delivery of Government services would generate positive multiplier effects on private sector activities. More importantly, the Federal Government's development expenditure will be mainly channelled to projects and programmes with strong linkages and value added potential, including infrastructure facilities, agriculture and rural development as well as education and human resource development.

Liberalisation and Simplification of Foreign Exchange Administration Rules

Malaysia maintains a liberal foreign exchange administration system. Within this liberal system, approval requirements for inflows and outflows are mainly prudential in nature to ensure financial stability. Regulations are implemented in a transparent and pragmatic manner. Foreign exchange administration regulations are also applied where appropriate to prevent any recourse to the Malaysian banking system for money laundering and terrorism financing.

In line with the policy of gradual and progressive liberalisation of the financial sector, liberalisation and further simplification of several major foreign exchange administration policies aimed at enhancing the business environment as well as efficiency and competitiveness of business operations in Malaysia were made effective from 1 April 2004. These changes form part of Bank Negara Malaysia's (the Bank) on-going initiatives towards contributing to the deepening of the capital market and enhancing efficiency of the regulatory delivery system.

(i) Rules Affecting Reporting of Foreign Exchange Transactions

While maintaining the requirement for exporters to repatriate receipts arising from export of goods (export receipts) when contractually due, which must not exceed six months from the date of export, the rules on reporting of such transactions are being abolished or simplified to reduce the administration cost to businesses.

- completion of Forms P (for payments abroad) and R (for receipts from abroad) by residents was discontinued since 1 January 2004. Information as contained in Forms P and R is being provided by the remitting or receiving banks to the Bank through an on-line system.

- In simplifying business operations, the reporting requirement to the Bank is further relaxed effective 1 April 2004. The requirement for submission of annual reports for export of goods by all exporters is abolished. Only exporters with annual gross exports exceeding RM50 million need to submit quarterly reports. The process for submission of such reports is being simplified further. The reporting mechanism will be designed taking into account business operations of companies.

(ii) Foreign Currency Accounts of Residents

Rules on maintenance of foreign currency accounts (FCA) are liberalised further following the relaxation implemented in April 2003. The liberalisation of limits for companies is aimed at enhancing the cash flow management for supporting value chain expansion in Malaysia. Rules on FCA of individuals are also relaxed to provide flexibility in the management of income and saving.

- Effective 1 April 2004, the overnight export FCA limit for Approved Operational Headquarters is increased further to USD100 million from USD70 million.

- The overnight limits for export FCA of other resident exporters are also raised. The revised limits, based on the average monthly export receipts are as follows -

Average monthly export receipts	Overnight limits (USD million)
Exceeding RM100 million	100
Exceeding RM50 million up to RM100 million	60
Up to RM50 million or for new exporters	30

- In addition, resident exporters are given the option to merge their export and non-export FCA in accordance with overnight limits imposed on export FCA.

- Resident companies with domestic borrowings may also open FCA for non-export receivables (receivables other than from export of goods) to retain such receipts with onshore licensed banks with no overnight limit. For resident companies that do not have domestic borrowings, they may also maintain non-export FCA with licensed offshore banks in Labuan, but up to an aggregate overnight limit of USD500,000.

- In the case of resident individuals, FCA remains permitted to facilitate education and employment overseas. However, effective 1 April 2004, the limits for these FCA are increased from USD100,000 to up to an aggregate overnight limit of USD150,000 each with onshore licensed banks and licensed offshore banks in Labuan.

- Resident individuals with funds abroad (no conversion from ringgit) may maintain non-export FCA, onshore or offshore, including licensed offshore banks in Labuan, without any limit.

- Resident individuals in Malaysia who have foreign currency funds are free to invest in any foreign currency products offered by onshore licensed banks.

(iii) Ringgit Credit Facilities to Non-Residents

Rules on lending in ringgit to non-residents are liberalised effective 1 April 2004 to facilitate non-resident businesses in Malaysia. This liberalisation does not impact current rules on non-internationalisation of ringgit:

- To enhance access to ringgit funds for business requirement in Malaysia, all permitted ringgit lending limits for various purposes, by banking institutions to a non-resident (excluding stockbroking company, custodian bank and correspondent bank) are consolidated into one aggregate limit and raised to RM10 million.

  The non-resident may use the ringgit credit facilities for any purpose in Malaysia, excluding for financing or refinancing the purchase or construction of immovable properties.

- Effective 1 April 2004, residents (banks and non-banks) may extend ringgit credit facilities in aggregate up to three property loans to a non-resident to finance or refinance the purchase or construction of immovable properties in Malaysia, excluding the purchase of land only.

  Prior to 1 April 2004, only financial institutions and employers may extend property loans to a non-resident.

- In the case of non-resident stockbrokers or custodian banks, onshore licensed banks are now allowed to extend up to an aggregate overnight overdraft facility of RM200 million (RM10 million previously) to facilitate settlement for purchase of shares listed on Malaysia Securities Exchange Berhad.

(iv) Investment Abroad by Resident Individuals

- Effective 1 April 2004, to provide flexibility for better management of funds, resident individuals employed or staying abroad with own foreign currency funds may invest in any foreign currency assets, including those offered by onshore licensed banks and licensed offshore banks in Labuan.

(v) Investment Abroad by Domestic Institutions

- For greater geographical diversification and in simplifying approval process, unit trust management companies may, effective 1 April 2004, invest abroad up to the full amount of

Net Asset Value (NAV) subscribed by non-residents and up to 10% of the NAV per fund subscribed by residents. Different funds of a unit trust management company or of different companies may also be pooled to benefit from economies of scale when investing abroad. Such investments abroad are required to be in compliance with the Securities Commission's prudential guidelines.

- Insurance companies and takaful operators may also invest abroad up to 5% of their Margin of Solvency (MOS) and up to 5% of their total assets respectively. In addition, insurance companies and takaful operators may also invest abroad up to 10% of the NAV of investment-linked funds that they market. These investments are required to be in compliance with prudential insurance and takaful regulations issued by the Bank Negara Malaysia.

- Fund/asset managers may invest abroad up to the full amount of investments by their non-resident clients and up to 10% of investments by resident clients. These funds may be pooled to benefit from economies of scale when investing abroad. Such investments are required to be based on the mandate of their clients and in compliance with the Securities Commission's prudential guidelines.

(vi) Issuance of Bonds Denominated in Ringgit by Multilateral Development Banks and Foreign Multinational Corporations

To deepen the development of the domestic bond market, Multilateral Development Banks (MDB), where Malaysia is a member, and foreign multinational corporations (MNC) may, based on the merits of each case, issue ringgit-denominated bonds in Malaysia.

(vii) Forward Foreign Exchange Contracts

Effective 1 April 2004, rules on hedging are liberalised to facilitate overall economic management of currency risks as follows:

- MDB and MNC issuers of ringgit-denominated bonds, will be allowed to enter into forward foreign exchange contracts with onshore licensed banks to hedge their currency risks.

- Similarly, non-resident investors subscribing to these ringgit-denominated bonds issued by MDB and MNC can also enter into forward foreign exchange contracts with onshore licensed banks to hedge their currency risks arising from the investment in these ringgit-denominated bonds.

- Forward sales by residents of any foreign currency receivables for ringgit with onshore licensed banks or approved merchant banks can now be undertaken up to the tenure of the underlying transaction as long as the transaction is supported by firm underlying commitment to receive such currency (previously foreign currency receivables, other than export receipts, could be sold forward up to 12 months only).

- Residents may also enter into forward foreign exchange contracts to sell foreign currency yet to be received for another foreign currency with onshore licensed banks and approved merchant banks up to the tenure of the underlying transactions.

- Resident companies may temporarily retain up to the amount of foreign currency receipts received earlier than the maturity date of the forward foreign exchange contract in their onshore FCA, pending maturity of the forward foreign exchange contract.

- Residents may enter into interest rate swaps with onshore licensed banks, approved merchant banks and licensed offshore banks in Labuan.

Sectoral Outlook

On the production side, growth is expected to be supported by stronger performance across all sectors, except agriculture and construction. The manufacturing and services sectors are expected to remain as the main drivers of growth. The agriculture sector is also projected to expand although at a more moderate pace following the strong performance in 2003. Growth in the construction sector would be moderate amidst weaker civil engineering activities.

In the **manufacturing sector**, ongoing structural shift has become more evident as the sector's competitive advantages adjust from labour-intensive to higher technology-driven manufacturing processes. Greater efficiency in the use of resources is being realised through manufacturing companies operating more at a regional level, as seen in the relocation of some of the more labour-intensive industries to lower-cost countries. Key indicators such as the contribution of the manufacturing sector in terms of value added and employment, flows of investment as well as the retrenchment trend clearly suggest that the manufacturing sector continues to remain resilient.

The recent trend in overseas investment is a reflection of Malaysian companies seeking greater synergy based on locational advantages. Consequently, notwithstanding the investments abroad, the share of the manufacturing sector in terms of value added (GDP) and total employment have remained significant at 31% and 28% respectively in 2003. Employment in the manufacturing sector continues to expand, while retrenchments have moderated further in 2003. While retrenchments due to relocation accounted for one-fifth of total retrenchments in the manufacturing sector, it only amounted to 0.2% of total employment in the manufacturing sector for the period 2001-2003. Furthermore, new jobs created by approved foreign investment in the manufacturing sector (2003: 77,182 workers) have outpaced the retrenchment in the sector (2003: 14,967 workers). More importantly, outflows of overseas investment in the manufacturing sector (2003: RM2.3 billion) remain small compared with approved FDI in the sector in Malaysia (2003: RM15.6 billion).

Table 3.4
Real GDP by Sector (1987=100)

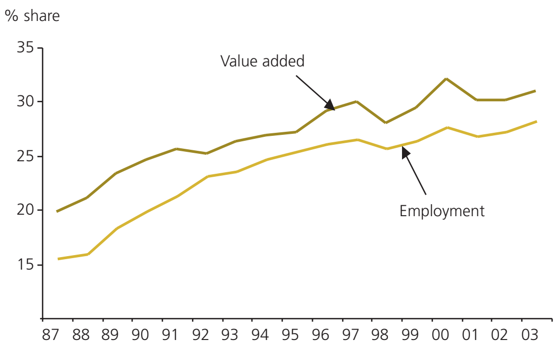
	2003*p*	2004*f*
	Annual change (%)	
Agriculture	5.5	2.6
Mining	4.8	5.5
Manufacturing	8.2	10.2
Construction	1.9	1.5
Services	4.1	5.2
Real GDP	**5.2**	**6.0 - 6.5**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

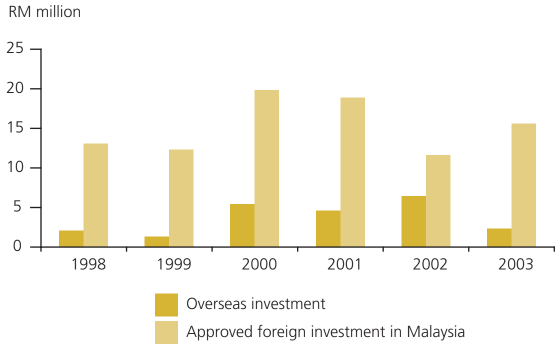
Broad based growth across sectors benefiting mainly from strengthening global electronics cycle, higher trade and tourist arrivals, as well as firm commodity prices.

Graph 3.6
Manufacturing Sector: Share of Value Added and Employment



Source: Department of Statistics, Malaysia
Economic Planning Unit

Graph 3.7
Manufacturing Sector: Overseas investment and Approved Foreign Investment in Malaysia



Source: Ministry of International Trade and Industry
Bank Negara Malaysia

Table 3.5
Approved Manufacturing-related Services

	2000	2001	2002	2003
	End-Period			
Operational Headquarters (OHQs)	41	50	59	71
International Procurement Centres (IPCs)	55	78	109	141
Regional Distribution Centres (RDCs)	-	-	-	4
Regional Offices	357	404	436	473
Representative Offices	673	783	872	1,006

Source: MIDA

As part of the efforts to expedite the structural shift, promotion of manufacturing-related services was intensified with the establishment of the Manufacturing Related Services Division in both MITI and MIDA. Consequently, there was an increase in the number of applications received and approvals in 2003 for the establishment of OHQs, IPCs, RDCs and regional offices (Table 3.5). Going forward, the manufacturing sector will continue to move away from labour-intensive production and give greater emphasis to higher value added production with knowledge-based labour of higher productivity and skills.

Value added in the manufacturing sector is projected to pick up further to 10.2% in 2004 (2003: 8.2%), supported by the pick up in the global electronics industry and improved domestic demand. Of significance, the global semiconductor industry is expected to strengthen, supported by broad-based expansion across all geographical regions and products. This is premised on expectations of a strong increase in the global semiconductor capital and investment spending of 27.9% in 2004 (2003: 5.7%). Most industry experts are more optimistic on the prospects for the industry and have revised upward their growth forecast for 2004. In the recent dialogues between Bank Negara Malaysia and the private sector, manufacturers in the electronics sector in Malaysia also expressed a more optimistic outlook for the industry in 2004.

Latest indicators suggest an upturn in the global semiconductor cycle. Global semiconductor sales, which have been expanding since the latter part of 2002, have strengthened sharply to register a growth of above 20% in the last quarter of 2003. In the US, shipment and sales of semiconductors have risen strongly, while the book-to-bill ratio has improved to above one since the fourth quarter of 2003. The unfilled orders of electronic products and communication devices in the US have also risen steadily since early 2003.

Growth in the electronics industry would be driven mainly by the wireless and PC markets, due to rising demand for wireless applications as well as the PC replacement cycle, as companies invest again following their huge spending prior to the Y2K period. This would be further augmented by the growth in the consumer electronics products segment as demand for new technology and multi-functional devices such as camera phones, PDAs and DVDs gains momentum.

Consonant with the pick up in the global electronics industry and the spillover effects on the chemical products industry, growth in the export-oriented industries is projected to expand at a more rapid rate of 13.8% (2003: 11.9%). Similarly, growth in the domestic-oriented industries is expected to strengthen to 8.3% (2003: 6.1%), due to improved demand for motor vehicles and construction-related materials.

The **services sector** is expected to expand at a faster rate of 5.2%, reflecting higher expansion across most sub-sectors. Growth would be supported by higher trade and tourism activities and improved consumer spending. Of significance, growth in the wholesale and retail trade, hotels and restaurants sub-sector is expected to pick up. Similarly, growth in the transport, storage and communications sub-sector is expected to trend higher in line with the robust expansion in trade, increased number of business and leisure passengers as well as the expected strong growth in the cellular segment of the telecommunications industry mainly induced by new innovations. With the expected increase in bank lending and other financial and business services activities, the finance, insurance, real estate and business services sub-sector is expected to record a stronger growth in 2004. The services sector will also be supported by the rapid expansion in new growth areas, such as the shared services industry, namely call centres, data centres, operational headquarters, regional distribution centres and international procurement centres, as well as specialised types of ICT services.

The **agriculture sector** is expected to expand further, albeit at a more moderate pace of 2.6% in 2004 as growth in the major commodities, particularly palm oil and rubber, is expected to moderate following the double-digit growth in 2003. While yields are likely to remain strong amidst sustained high prices for palm oil, increased production would emanate mainly from the expansion in mature areas. Rubber production is forecast to increase to above 700,000 tonnes, with the bulk of the increase contributed by the smallholdings sector, as continued high prices are likely to induce increased tapping activity. Within the other agriculture group, production of selected commodities is expected to increase, led by cocoa (24.3%) and livestock (6.5%). Growth is also expected to emanate from some of the food crops, such as vegetables and fruits, reflecting the efforts by the Government to increase domestic food crops production through the Permanent Food Production Park scheme. Meanwhile, paddy production is estimated to be higher on account of wider usage of high yielding paddy seeds.

Growth in the **mining sector** is expected to strengthen to 5.5% in 2004, led by higher gas output. The new Malaysian Liquefied Natural Gas (MLNG) plant is expected to operate at a higher capacity utilisation to meet the increased demand. Meanwhile, production of crude oil (including condensates) is expected to remain stable at 733,000 barrels per day (2003: 736,000 bpd).

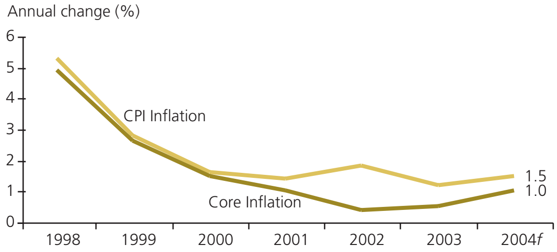
Growth in the **construction sector** is envisaged to increase at a moderate rate of 1.5%, due to lower activity in the civil engineering sub-sector following the completion of several infrastructure projects by both the Government and the private sector. Meanwhile, activities in the residential sub-sector is expected to remain strong in view of the increase in new housing starts during the first nine months of 2003, as well as ongoing work on projects under construction. Demand for residential property, especially for affordable housing, would remain favourable, encouraged by the incentives granted under the Economic Package, especially the stamp duty exemption, tax relief and the waiver on the real property gains tax until the first half of 2004. Meanwhile, activity in the non-residential sub-sector is expected to remain subdued, although on an improving trend, as the average occupancy rates for office space and retail complexes have stabilised since the third quarter of 2003.

Prices and Employment

Inflation is expected to remain low at 1.5% in 2004, while core inflation is estimated at 1%. Adequate capacity, increasing competition and low inflation abroad are expected to keep domestic inflation benign.

In line with the stronger GDP growth in 2004, overall growth in **employment** is also expected to strengthen with encouraging growth in new job opportunities. Consequently the unemployment rate is expected to improve to about 3.4%. Meanwhile, efforts would continue to be focused on improving the quality and productivity of labour to ensure workers are constantly prepared to meet challenges associated with structural changes taking place in the economy, in particular with regard to enhancing skills in the higher value added manufacturing-related services as well as services-led and knowledge-led growth areas.

Graph 3.8
Consumer Prices



f Forecast

Balance of Payments

The balance of payments is expected to remain strong in 2004, with a sustained high **current account** surplus, reflecting the continued large surplus in merchandise trade and improvement in the services account. The current account of the balance of payments is expected to remain large at 12.7% of GNP in 2004 despite the projected stronger growth in imports (15.4%). Strong export growth (11.1%), underpinned by the systemic upswing in global demand, is expected to contribute to a large surplus in the trade account. The impetus to this growth stems from the strong expansion in manufactured exports (12%), in particular electronics exports, and continued growth in agriculture exports. The continued high level of agriculture and mineral exports, which have low import content, will provide further support to the large trade surplus.

In tandem with the pick up in global semiconductor demand and expanding intra-regional trade, growth in **manufactured exports** is expected to strengthen further to 12% in 2004 (2003: 8.2%), with higher exports from both electronics and non-electronics products. Exports of electronic products would expand at a more rapid rate of 14.7%, underpinned by increased demand for PC, wireless products and consumer electronic products such as DVDs and digital cameras. Similarly, non-electronics exports are

Table 3.6
Balance of Payments

	2003*e*	2004*f*	2003*e*	2004*f*
	RM billion		US$ billion	
Goods	97.7	96.4	25.7	25.4
Trade account	81.1	76.5	21.4	20.1
Exports (% change)	*11.5*	*11.1*	*11.5*	*11.1*
Imports (% change)	*4.8*	*15.4*	*4.8*	*15.4*
Services	-15.0	-11.9	-4.0	-3.1
Balance on goods and services	**82.7**	**84.5**	**21.8**	**22.2**
Income	-22.6	-24.7	-6.0	-6.5
Current transfers	-9.3	-9.8	-2.4	-2.6
Current account balance	**50.8**	**50.0**	**13.4**	**13.2**
(% of GNP)	***13.7***	***12.7***	***13.7***	***12.7***
Financial account	-12.1		-3.2	
Errors and omissions	0.4		0.1	
of which:				
Exchange revaluation gain	*11.9*		*3.1*	
Overall balance	**39.1**		**10.3**	

e Estimate
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

demand, particularly from the tyre manufacturers. In addition, the upliftment of import quotas by P.R.China, effective January 2004 in line with their commitments under the WTO, would lend further support to the international rubber market.

Exports of minerals are projected to grow marginally by 1.8%, as the higher receipts from LNG would be largely offset by the sharp decline in crude oil exports. Despite the relatively high crude oil prices of US$28.50 per barrel, prices would still be lower than in 2003. Malaysian crude oil prices would be broadly in line with trends in the global oil markets in 2004, which would be characterised by a more balanced demand and supply situation. Strict management of oil supplies by OPEC members would also influence global oil prices during the year. Meanwhile, LNG exports are projected to remain strong, expanding by 15.3%. The MLNG Tiga plant would be operating at a higher capacity to accommodate the increased demand.

Sustained balance of payments position with continued large current account surplus and long-term capital inflows. Trade surplus to remain large due to strong expansion in electronics exports and continued growth in agriculture exports.

expected to increase further by 9.2%, reflecting expansion in exports of rubber products, chemicals, paper and pulp products, and furniture and parts. Notwithstanding the strengthening external demand, export prices would continue to remain subdued due to global competition.

Exports of commodities, comprising agriculture and minerals, are expected to moderate to 5.5% in 2004, following two successive years of strong export growth averaging above 20%. **Agriculture export** earnings are projected to grow by 8.8% in 2004, supported by high prices and increases in volume. Palm oil and rubber exports will be the main contributors, accounting for almost 70% of total agriculture exports. Export prices of major agriculture commodities are expected to remain high due to favourable global demand amidst continued supply shortages of some commodities, especially during the first half-year. Of significance, export price of palm oil is projected to remain strong, averaging RM1,650 per tonne given the expected shortage in global supplies of major oilseeds, especially soybean oil. Similarly, rubber prices are expected to record a higher average of 385 sen per kilogramme in line with expectations of continued strong pick up in global rubber

Import growth is expected to emanate mainly from higher imports of intermediate goods (15.5%), consonant with forecast of stronger production and exports in the manufacturing sector, in particular the electronic segment. Capital imports are expected to make a strong recovery (12.7%) in line with the revival in investment activity. Higher capital goods imports are mainly for capacity expansion in the manufacturing, oil and gas, the airlines and shipping sectors. The stronger growth in consumption imports would reflect the projected higher consumer spending. The higher growth would also reflect the low base in consumption imports in 2003 due to the impact of SARS.

The large surplus in the goods account will be more than adequate to finance the net payments in the services, income and current transfers accounts. The **services account** deficit is envisaged to narrow to 3% of GNP, reflecting mainly the expected improvement in performance of the tourism sector. Earnings from the export of education and healthcare services are expected to be higher with improved quality of services and closer collaboration between the Government and the private sector in export promotion. Port earnings are expected to

Table 3.7
Exports and Imports

	2003*p*	2004*f*
	RM billion	
Gross exports	**398.9**	**443.3**
(% change)	***11.5***	***11.1***
Manufactures	327.0	366.3
(% change)	*8.2*	*12.0*
of which:		
Electronics	167.6	192.3
(% change)	*6.3*	*14.7*
Electrical products	55.9	60.8
(% change)	*1.9*	*8.7*
Chemical & chemical products	21.2	23.6
(% change)	*23.3*	*11.3*
Minerals	29.8	30.3
(% change)	*33.1*	*1.8*
Agriculture	33.7	36.7
(% change)	*28.1*	*8.8*
Gross imports	**317.7**	**366.8**
(% change)	***4.8***	***15.4***
Capital goods	43.5	49.0
(% change)	*0.7*	*12.7*
Intermediate goods	233.0	269.1
(% change)	*6.4*	*15.5*
Consumption goods	18.9	22.6
(% change)	*1.1*	*19.9*

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

increase in line with the increase in transhipment cargo, while freight income is expected to improve following the capacity expansion by Malaysian shipping companies and airlines. The higher volume of trade and increases in freight rates are also expected to lead to higher payments for transportation. Gross receipts in the other services account are expected to increase in line with the increasing trend in export of ICT products and services such as software and business process outsourcing services. The tax incentives for Operational Headquarters and International Procurement Centres and the widening of the range of activities to include research and development, design, marketing, distribution, quality control, testing, labelling and packaging that can be undertaken in free industrial zones or licensed manufacturing warehouses are expected to encourage higher export of value added services.

The **income account** deficit is projected to be sustained at 6.3% of GNP, reflecting higher profits and dividends accruing to multinational companies (MNCs) from their investments in Malaysia. The projected larger outflow in investment income is due to the strong export performance by the electronics industry as well as other export-oriented industries. Given the favourable international outlook, profits and dividends accruing to Malaysian companies investing abroad are also expected be on an upward trend.

The **financial account** is expected to improve on the back of continued long-term capital inflows, especially higher foreign direct investment (FDI). As reflected in higher approvals granted by MITI in 2003, FDI inflows are expected to remain sizeable with the implementation of major projects in the manufacturing sector. The bulk of the FDI in the manufacturing sector is expected to be in the form of reinvestment by the MNCs for capacity expansion in view of the strong upturn in electronics demand as this sector was already operating at near full capacity in 2003. The services sector is expected to continue to be a major recipient of new FDI inflows, especially in areas such as logistics, distribution and manufacturing-support services in view of the strong linkages between the growth of manufacturing and services sectors. Meanwhile, foreign investment in the oil and gas sector are likely to pick up on prospects of more joint-venture agreements with the national oil company.

Malaysia’s overseas investment is likely to remain significant. These overseas investments will continue to be broad-based and channelled into the oil and gas, services and manufacturing sectors. These funds are likely to be targeted at both developing and developed countries in the form of acquisitions and new investments to provide greater synergy to their operations in Malaysia.

MONETARY POLICY IN 2004

Prospects for the global economy in 2004 have turned more favourable. Against the more broad-based growth in the industrial countries and stronger regional economies, the Malaysian economy is expected to grow at a faster pace of 6-6.5% in 2004. The firm recovery in export demand would further reinforce sustained growth in domestic demand. The increasing level of consumer and business confidence should lead to stronger private sector activities and further consolidation in fiscal expenditure. Notwithstanding rising aggregate domestic and external demand, the existence of excess capacity and ongoing capacity expansion allow for the increase in demand and output to be met without creating pressures on supply and prices. Conditions of continued low inflation provide flexibility for monetary policy in 2004 to continue to be supportive of the stronger growth momentum. With the investment cycle in its early stage, a low interest rate environment remains important to reinforce the private sector-led expansion, while providing flexibility for fiscal consolidation and strengthening growth.

Inflation risks for Malaysia remain low, as the economy is operating in an environment of excess capacity. Stronger economic expansion in 2004 is expected to narrow the output gap in some sectors while new investments will add on to output potential. With stronger recovery in demand and the return of business confidence, signs of a revival in business investment have emerged, with the expansion in capacity taking place in sectors experiencing high capacity utilization. Meanwhile, intense competition in the product market has induced producers to increase efficiency in the use of capital, labour and technology to contain costs. The intense competitive pressure has moderated wage increases while driving high productivity growth. Overall, stepped up capital investment and ongoing productivity improvements together with low inflation abroad would contribute to sustaining low inflation. The absence of inflationary expectations has accorded greater flexibility for interest rates to continue to remain low to ensure growth is soundly entrenched.

Stronger economic growth, a large surplus in the current account of the balance of payments and some capital inflows create challenges for the Central Bank to manage liquidity to maintain stable conditions in the money market. New liquidity is expected to emanate from the strong export performance and continued inflows of long-term capital. Given these expansionary influences on domestic liquidity, monetary management in 2004 will actively balance excess liquidity to maintain stable conditions in the money market. As in 2003, the Bank will rely on market-determined instruments and direct borrowings in its conduct of liquidity operations. The overall policy thrust is to ensure a stable and predictable environment to support business expansion. Over and above this, the objective of monetary policy will also aim at improving the efficient flow of credit to productive investments in sectors and industries that have the potential to raise the overall output and competitiveness of the Malaysian economy.

Going forward, risks and uncertainties remain. The twin deficits in the US and global current account imbalances continue to pose risks, such as disruptive global capital flows and exchange rate volatilities causing large changes in relative prices that affect the pace and spread of global economic recovery. Global growth in the short term is still heavily dependent on the growth in the US despite stronger growth in the Asian region. These factors could affect the consumer and business sentiments and disrupt the momentum of global and regional growth. The challenge to monetary policy therefore would be to respond proactively to emerging signals of impending developments in the macroeconomic conditions. In this regard, Malaysia enjoys a high degree of freedom for flexible responses and more importantly, monetary policy continues to have significant room to manoeuvre to cushion the impact of possible adverse external circumstances on domestic economy.

The Monetary Policy Statement (MPS), which was first released in August in 2003, will continue to be issued on a quarterly basis together with the announcement of the GDP data. This is part of the Bank's continuing effort to provide comprehensive information to the public on the Bank's policies. The issuance of the MPS would provide a direction of the Bank's policy intent and thus contribute towards stable and efficient conditions in the financial markets. It represents another mechanism to fulfil its objectives of maintaining monetary and financial stability to achieve sustained long-term growth.

With low inflation and growth in early cycle, the thrust of monetary policy in 2004 will continue to be directed at sustaining the growth momentum. The low interest rate environment will continue to provide support for private sector-led expansion.

FISCAL POLICY IN 2004

The 2004 Budget was formulated at a time when the outlook for the global growth was improving and domestic private sector demand gaining strength. Prospects of improved business and consumer confidence were expected to pave the way for the public sector to moderate its expansionary influence and the private sector to take the lead in driving growth. The Budget strategies announced on 12 September 2003, therefore, aimed at enhancing the macroeconomic fundamentals and ensuring a more broadly balanced economic structure with new domestic economic activities contributing towards sustainable longer-term growth. The thrust of the Budget strategies, therefore, focused on facilitating the private sector to assume its lead role as the engine of growth, while engineering a gradual cut-back in expenditure. Against this background, the overall financial position was budgeted to register a smaller deficit of RM13.8 billion or 3.4% of GDP in 2004, after factoring in the potential net revenue loss arising from the tax changes introduced in the 2004 Budget.

In a recent review of the 2004 Budget, it was estimated that tax revenue collection for 2004 projected in the Budget could be on the high side, given the lower actual tax collection for 2003. Notwithstanding the downward revision in revenue collection, it was deemed appropriate to maintain the Federal Government development expenditure (excluding contingent reserves) as budgeted in September 2003. Development expenditure was already scaled down to be significantly lower, a decline of 21.1% to RM30 billion from estimated expenditure of RM38 billion in 2003. With the revision to revenue, the fiscal deficit for 2004 is expected to be 4.5% of GDP, against the fiscal deficit of 5.3% registered in 2003. While the pace of deficit reduction is more gradual, the objective of fiscal consolidation remains on track. Given the ample liquidity in the financial system, the bulk of financing would continue to be raised from the domestic market with no risk of crowding out private sector financing. Recourse to external borrowings will be determined mainly by the need to establish international market presence and for benchmarking purposes.

While development expenditure would be lower, emphasis would be on improving productivity and the delivery systems of the government to reduce the cost of doing business and to support private sector investment and initiatives. Development expenditure during the year would be targeted at enhancing the longer-term productive capacity and competitiveness of the economy. The changing composition of fiscal spending is expected to generate higher multiplier effects on the economy. Given these strategies, the decline in public sector demand is projected to be marginal in 2004 (-0.4%), while private sector demand is expected to show a stronger growth. The private sector is expected to contribute 4.9 percentage points to real GDP growth.

In terms of budget allocation, emphasis would continue to be given towards enhancing the quality of education and manpower skills. Special attention would be directed towards modernising and nurturing the agriculture and rural sectors to position them as significant growth-generating sectors of the economy. Priority would also be placed on the implementation of programmes to improve the socio-economic well-being of Malaysians, especially those in the lower income group.

The 2004 Budget measures contained wide-ranging tax and non-tax incentives directed at accelerating growth in new growth industries; reducing the cost of doing business; and increasing innovation through higher research and development activities to enhance the ability of companies to compete internationally. In order to promote private sector activities, focus continued to be placed on the development of small and medium-sized enterprises (SMEs). Measures implemented included raising the threshold for chargeable income subjected to a corporate tax rate of 20% from RM100,000 to RM500,000, establishment of a SMEs debt restructuring committee and enhancement of the size of micro-credit schemes by RM1 billion. Other measures proposed to spur further domestic-led growth included various schemes to more aggresively promote Malaysian products, establishment of a one-stop agency to promote the services sector and tax incentives and financing schemes to further modernise the agriculture sector and promote investments in related downstream activities.

The 2004 Budget also contained various tax measures to reduce the cost of doing business. Measures included allowing deduction on entertainment expenses incurred in sales promotions; reducing or abolishing import duties of selected goods such as computer batteries, wooden and plastic goods; as well as reducing or abolishing export duties on several agricultural produce and commodities.

FINANCIAL SECTOR POLICY IN 2004

The policy thrust in 2004 will continue to focus on building capacity of domestic financial institutions and enhancing the resilience and stability of the financial sector while ensuring that all sectors of the economy continue to have adequate access to financing. Attention is also given to strengthening the framework for consumer protection and promoting greater consumer awareness on banking and insurance products and services.

The benchmarking exercise, initiated in 2000, which enables banking institutions and insurance companies to measure their performance by highlighting operational and strategic opportunities as well as areas for strategy building and skill enhancements will be further refined. Regular dialogues with the board and senior management of banking institutions will continue to be held to discuss on performance, trends and issues that may have impact on the competitiveness and overall strength of their respective institutions. Another area of focus is on improving the service quality of the banking institutions and insurance companies. The findings from the nationwide customer satisfaction survey that was conducted in 2003 will be discussed with the industry and strategies at the industry and institutional level will be formulated to elevate quality of service.

It is also expected that a number of domestic commercial banks will merge with their finance company subsidiaries with the coming into force of the amendments to the Banking and Financial Institutions Act 1989 allowing for such mergers. Domestic banking groups could improve operational efficiency by reaping higher economies of scale and enhance access to banking and finance companies business nationwide. The framework for creation of investment banks is also expected to be finalised in 2004. The framework would enable the investment banks to undertake the whole range of capital market activity under one entity, including equity brokerage business.

Initiatives to strengthen the capacity of domestic banking institutions will be complemented by enhancement to prudential regulations as well as a more comprehensive surveillance infrastructure. On the prudential front, efforts would be focused on the formulation of a comprehensive framework to regulate and supervise group structures involving financial conglomerates as well as to improve capability and expertise of the banking institutions and the supervisors to meet the challenges in implementing the new Basel Capital Accord. The surveillance infrastructure will be enhanced to provide early warning signal on any imbalances in the financial sector.

As the banking sector remains the main source of financing in the economy, initiatives would be taken to further improve access to financing by all segments of the economy. Focus would be towards strengthening existing infrastructure to enhance access to financing by the SMEs. Initiatives to encourage consumer activism and enhance the consumer protection framework would remain a priority. The Financial Mediation Bureau (FMB), would be established during the year. This is a one-stop centre to provide customers with avenue of legal redress against all financial institutions to deal with their grievances on banking institutions, insurance companies, development financial institutions under Bank Negara Malaysia supervision and payments system operators. A framework to improve the level of transparency and disclosure on all retail financial products offered by the banking institutions to facilitate a more effective and well informed decision making by customers would be introduced during the year. To further strengthen the consumer protection framework in an increasingly market-oriented financial system, the legislation that will introduce a deposit insurance system in Malaysia is expected to be tabled before Parliament in 2004.

Bank Negara Malaysia is also mandated to ensure that the payment systems and instruments in the country are safe and efficient and that there is continued public confidence in the use of payment instruments. This would entail mitigating risks in the financial system, promoting efficiency of the payment systems, enhancing security features of payment systems and instruments as well as exercising oversight over such systems and instruments. In addition, Bank Negara Malaysia will encourage and educate consumers to avail themselves of the wide variety of electronic payment facilities and products in line with the move towards a cashless society.

In the Islamic banking sector, key policy thrusts in 2004 will continue to focus on enhancing the effectiveness and efficiency of the Islamic banking system as an enabler of economic growth and development. The policy thrusts in 2003 to strengthen the financial infrastructure, enhance the regulatory framework, strengthen the Shariah and legal infrastructure as well as enhancing intellectual capital development and consumer awareness will continue to be pursued in 2004. In the development of the financial infrastructure, the window institutional structure of banking institutions participating in the Islamic Banking Scheme would be further strengthened to provide for the effective regulation of Islamic banking operations based on its unique characteristics. The Islamic banking landscape will also be transformed with the issuance of up to three new Islamic banking licences to foreign financial institutions in 2004.

To enhance the effectiveness of the Shariah governance framework, Guidelines on the Shariah Committee for Islamic banking institutions would be introduced to delineate the roles and responsibilities, qualifications and the terms of appointment of the Shariah advisory body at Islamic banking institutions. To support the sound and progressive development of the Islamic banking industry, initiatives in strengthening the legal infrastructure would continue to be pursued in 2004. These initiatives include expanding the scope of arbitration framework for Islamic banking and finance cases, the review of the Islamic Banking Act 1983 to strengthen the legal framework for Islamic banking operations and the finalisation of tax issues on Islamic banking and finance under the Law Review Committee to accord a neutral tax treatment between Islamic financial products and conventional financial products. Promoting financial soundness and building financial resilience of the Islamic banking system will be emphasised through the refinement of prudential regulatory standards to incorporate specific features of Islamic banking and enhancing market depth through the introduction of variable rate financing mechanism and the *mudharabah* and *musyarakah* implementation framework as well as the development of an Islamic reference rate.

Policy thrusts for development financial institutions (DFIs) will be guided by the strategic directions set out in the Financial Sector Masterplan. The focus of policy is to strengthen further the foundation on which DFIs can operate efficiently and effectively, through building the capacity of the DFIs and providing the enabling environment for the DFIs to operate efficiently and effectively. Emphasis will be accorded towards ensuring DFIs remain committed and focussed on mandated roles, to increase the responsiveness of DFIs to the developmental requirements, especially of the SMEs and identified priority sectors. In addition, current initiatives to enhance the capability and capacity of DFIs as specialised institutions in providing advisory services to their targeted clients, in particular, SMEs, would continue in 2004. This will be complemented with initiatives to strengthen the risk management practices of the DFIs.

Financial sector policies in 2004 will continue to focus on strengthening the resilience, stability, efficiency and effectiveness of the financial system to ensure that the financial sector continues to play an effective role in supporting economic growth as well as meeting the nation’s social objectives. Efforts are focussed not only on the creation of a sound and resilient financial sector but also on capacity building of the financial sector to elevate it to a higher level of performance, efficiency and excellence.

Report on SME Development Framework

In October 2002, an Inter-Ministry SME Steering Committee was formed to take forward the recommendations by Bank Negara Malaysia contained in its report, Proposed Comprehensive Framework for the Development of Small and Medium Enterprises (SMEs). The proposed framework outlines recommendations for the creation of an enabling environment for development of SMEs across all sectors of the economy. The proposals are aimed at strengthening the infrastructure for SME development, building the capacity of the SMEs and improving their access to financing towards increasing their capacity to contribute to the economy.

Strengthening the Infrastructure for SME Development

Since its inception, the Steering Committee has conducted assessments on the existing infrastructure for SME development. The underlying objective was to identify areas of resource duplication among the various Government ministries and agencies, and to address gaps in the existing infrastructure for SME development. This undertaking involved: -

- A review of the roles and responsibilities of the ministries and agencies involved in SME development;
- An assessment on the need to form a central coordinating body for SME development;
- An evaluation of the feasibility of enacting an SME Law to coordinate efforts for SME development.

For greater focus and enhanced coordination, the Steering Committee proposed that a permanent institutional framework be established in order to enhance the Government's capacity and ability to continuously promote the development of competitive and resilient SMEs across all sectors. Having a formal structure dedicated to the development of SMEs would result in greater synergies and synchronisation of efforts among the various stakeholders involved in SME development, while ensuring that SME development issues across all sectors are appropriately identified and addressed.

Following the Steering Committee's presentation of its recommendations to the Cabinet Committee for National Competitiveness, the Government will establish a National SME Development Council. The SME Council will function as the highest policy-making body to chart the future direction and strategies for SME development and will be chaired by the Prime Minister. Membership to this high-level SME Council will comprise Ministers from stakeholder ministries, as well as appointed representatives of private sector organisations involved in SME development, with Bank Negara Malaysia serving as the Secretariat.

Bridging the Gap

To further enhance the coordination and comprehensiveness of SME development, the Steering Committee has embarked on several initiatives to address the gaps in the current infrastructure for SME development: -

- Establishment of a standard definition for SMEs across all sectors. Currently, the definition of an SME varies amongst the various Government ministries and agencies based on their respective criteria. Standardising the definition of SMEs within the national context will enable effective policy setting to target sectors within the economy, facilitate the provision of technical assistance and improve the channeling of financial benefits and other incentives under various policies. It allows for the physical identification of SMEs at the micro-level, encourages the formation of SME associations at the macro-level, and facilitates better articulation of the problems and prospects of the sector. The standardisation of definition of SMEs will also support the collection of relevant and comparable SME data for database-building purposes.

- Establishment of a comprehensive national SME Database. The absence of a central database with relevant SME and entrepreneurship statistics makes it difficult to gauge the present stage of SME development, their operating conditions, financial viability and developmental needs. To cultivate the potential of SMEs as a source of endogenous growth, and to facilitate informed policy decision-making with regard to SME development, SME policymakers need to be able to measure, monitor and evaluate the performance and contribution of SMEs to the nation's overall economic growth process. The availability of a comprehensive national SME Database will greatly assist in the process of monitoring and evaluating the level of SME development, determining their development needs and providing critical input for the formulation of development policies.

- Formulation of a coordinated framework for the marketing and promotion of SMEs across all sectors. The emphasis is on the overall marketing and promotion of SMEs in terms of products, services, and the SMEs themselves. SMEs also need special assistance in the areas of product development and improvement, design, packaging and branding of their products. The formulation of a comprehensive and coordinated framework will ensure the efforts of the various stakeholders are concerted towards assisting SMEs to penetrate new markets, increase awareness on branding and intellectual property, enhance business networking, linkages and strategic alliances between SMEs and other larger firms.