9 MALAYSIA

Rahamat Bivi Yusoff, *Economic Planning Unit, Prime Minister's Office*

2004: GROWTH FIRM AND BROAD BASED

Malaysia's economic growth remained strong, at 7.1% in 2004 after recording a solid 5.4% in 2003. Growth was broad based with all sectors of the economy expanding except for construction, which registered negative growth of 1.5%. The contribution of domestic expenditures to growth increased to 9.5% of GDP in 2004 compared with 3.3% of GDP in 2003.

Economic policies in 2004 were focused on achieving sustainable growth with long-term resilience and competitiveness. The objective was to improve the enabling environment for business activity to enhance the private sector contribution to economic growth, in particular to spearheading and promoting the new sources of growth. In line with this objective, the government put in place measures to revive private sector initiatives such as ensuring a more efficient public sector delivery system; reducing the cost of doing business, as well as increasing the sector awareness of and compliance with corporate governance and industry best practices, particularly among public-listed companies. As a result, private investment turned around in 2003 (up 0.4%) and accelerated in 2004 to register growth of 15.8%, enabling the private sector to resume its role as the key driver of growth. Steady inflows of foreign direct investment (FDI) in the oil and gas industry and greater interest in agricultural activity also contributed to the better performance of private investment.

The growing private sector financing need was supported by a more resilient banking system. Gross private sector financing through the banking system and capital market expanded by 6.3% from 2003 to RM522.9 billion in 2004, with the banking system contributing more than 90% of the total financing. Loan disbursements were higher for small and medium enterprises (SMEs), in line with efforts to increase access to financing for SMEs to enable them to become the catalyst of growth.

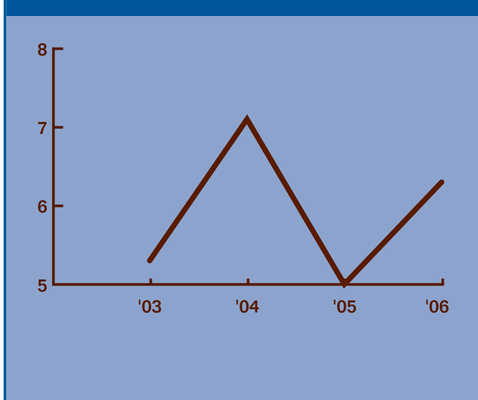
Consumer sentiment remained positive as a result of higher disposable income arising from firm commodity prices, stronger export earnings as well as better employment prospects and positive wealth effects from favourable stock market conditions. Together with low interest rates and benign inflation, these conditions led to a higher propensity to consume. Private consumption grew by 10.5% in 2004 compared with 6.6% in 2003.

Fiscal policy is geared toward a gradual and progressive reduction of the federal government deficit without constraining overall economic growth. The objective is to improve the financial position of the government as well as strengthen macroeconomic fundamentals to ensure long-term sustainable growth. In line with this, public investment declined by 3.5% in 2004, the first cutback since the 1997-98 financial crisis. The lower public sector investment, however, was compensated by more robust private investment. Public consumption also registered a moderate growth of 6.0% in 2004 compared to 11.5% in 2003.

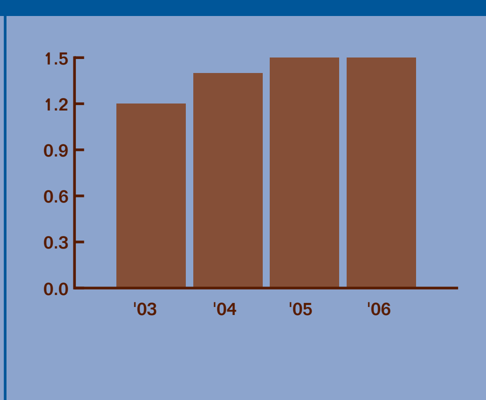
With fiscal consolidation measures in place, the Federal Government account registered a deficit of 4.3% of GDP in 2004, lower than the 5.3% of GDP recorded in 2003. The better fiscal outturn was largely attributed to higher revenue collection and lower development expenditure. Federal Government revenue increased by 7.3% to RM99.4 billion in 2004, largely due to more efficient revenue collection. Meanwhile, development expenditure declined by 26.7%, reflecting the government's decision to accelerate implementation and completion of projects in the first three years of the Malaysia's Eighth Plan, 2001-2005. Nonetheless, budgetary expenditure was directed to sectors that enhanced capacity building to improve productivity and efficiency as well as to priority sectors of agriculture, rural development, education and health. Total government expenditure in 2004 was RM120.2 billion, 2.8% lower than in 2003.

On the supply side, output of all sectors except construction increased, partly attributed to measures put in place by the government to

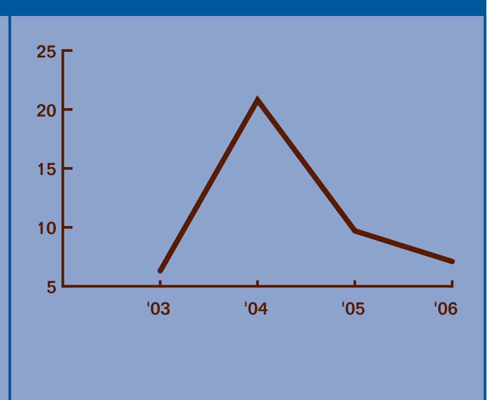
GDP GROWTH (%)



CPI INFLATION (%)



EXPORT GROWTH (%)



promote and expedite the development of new sources of growth to increase the country's economic resilience. The manufacturing sector, growing at an average rate of 9.8% in 2004, has become more diversified with higher-end, value-added and new emerging industries and products. Electrical, electronics and machinery registered the highest growth, followed by rubber and wood-based products on account of stronger global economic recovery. On the domestic front, buoyed by the expansion in domestic economic activity as well as improved consumer and business sentiments, output of transport equipment and construction-related industries expanded.

The services sector grew by 6.8% in 2004, driven by higher consumer spending and a record level of tourist arrivals. Growth emanated from strong expansion in all sub-sectors with transport and communication in the lead at 8.4% followed by wholesale and retail trade, hotels and restaurants (7.1%) and finance, insurance, real estate and business services (6.5%). Together with new growth areas in information and communications technology (ICT), the services sector was able to maintain its premier position in terms of its share of GDP at 57.4%.

In the external sector, the trade balance remained in surplus. The upswing in the global economy, coupled with the upsurge in electronics demand, as well as high prices for palm oil and crude oil, continued to propel export volume and earnings. Gross exports grew by 20.8% to RM480.7 billion. The strong growth was attributable to higher earnings from manufactured products, mining commodities and agriculture goods. Import growth was also strong, particularly for intermediate and capital goods to sustain the high levels of industrial activity and capital formation from investment initiatives, reflecting robust domestic activity. Arising from the sustained strong surplus in the goods account, as well as improvements in the services deficit, the current account of the balance of payments recorded a surplus for the seventh consecutive year, amounting to RM56.4 billion or 13.4% of GDP. Malaysia's overall balance of payments was positive for the fourth consecutive year.

Better export earnings and inflow of foreign funds increased international reserves to US$74.8 billion as at 14 May 2005, sufficient to finance 8.7 months of retained imports and 7.2 times the short-term external debt. The national resource position remains strong, with gross national savings at 37.2% of GNP, providing ample liquidity to finance both public and private sector initiatives. Inflation remained low at 1.4% despite strong domestic demand and higher commodity prices while the producer price index showed a significant increase at an average rate of 8.9% in 2004. Labour market conditions continued to be stable with the unemployment rate remaining at a low 3.5%. With stronger growth, per capita income increased to RM16,476 or US$4,336. In purchasing power parity (PPP) terms, is was at US$9,968 in 2004.

OUTLOOK FOR 2005 AND 2006

For 2005, the economy is expected to grow at 5%. On the demand side, private sector expenditure is expected to remain bullish. Private investment is projected to increase by 9.6%, reflecting improved business confidence as well as the government's effort to promote investment in new sources of growth in agriculture, manufacturing and services. Higher value-added manufacturing and ICT-related industries are also expected to attract stronger investment, particularly those that are able to provide inter and intra-linkages between multi-national companies and SMEs. In addition, the public-private partnership that is being promoted and nurtured through better collaboration in R&D and innovation is expected to further stimulate investment. In services, professional services, logistics, healthcare, education and tourism as well as other knowledge-based industries will be the sources of economic growth for 2005. In contrast to the strong pace of the private investment, public investment will be further consolidated in 2005 and will decline by 11.6%. Nevertheless, public consumption is expected to register a moderate growth of 4.5%. The Federal Government deficit is expected to decline further to 3.8% of GDP in 2005. Inflation and the unemployment rate are expected to remain low.

In 2006, the economy is forecast to record growth in line with its potential output. The positive outlook is premised on more resilient domestic demand, driven by strong private sector expenditure. The public sector, on the other hand, will continue to consolidate its overall financial position. Growth will accrue from increased activities in the manufacturing, services and agriculture sectors. Prices are projected to remain stable and low, while unemployment should also remain low.

RISKS AND UNCERTAINTIES

The downside risks to this growth are slower world economic and trade growth due to factors such as higher oil prices, lower demand for electronics products, higher interest rate and geo-political developments. On the domestic front, lower private investment may affect the growth target for 2005-2006. Nevertheless, the government will continue to put in place policies and strategies that will further enhance the long term resilience and competitiveness of the economy. Among the policies are:

- Improving the environment for doing business in Malaysia, including improving the government delivery system, reducing costs of doing business and better fiscal incentives;
- Consolidating the government fiscal deficit without constraining overall economic growth;
- Increasing the awareness of and compliance with corporate governance and industry best practices;
- Increasing the number of skilled manpower through improvement in education and skills training to match industry requirements;
- Supporting the development of the small and medium-scale enterprises by facilitating access to adequate and cost-effective financing;
- Revitalizing the agriculture sector into a modern and commercially viable sector with high returns; and
- Expanding the services sector by promoting the development of new sources of growth, particularly in the ICT and tourism sub-sectors.