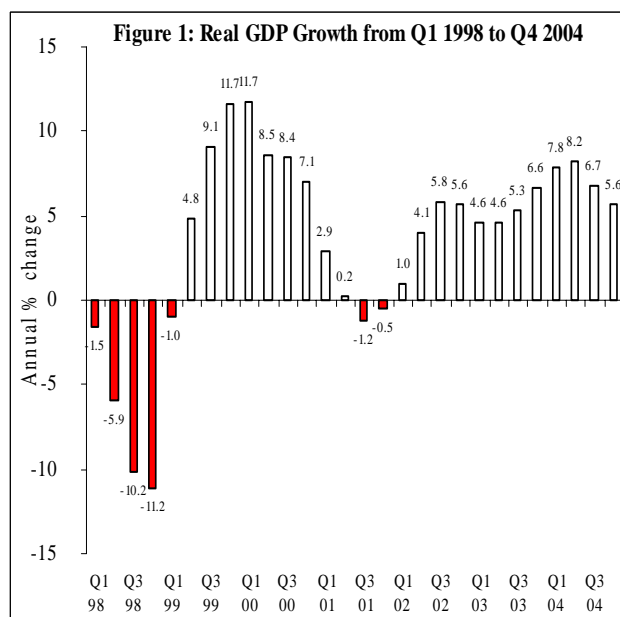


MALAYSIA

The Malaysian economy expanded strongly in 2004, but the outlook is for more moderate growth in 2005 and 2006¹. Real growth rebounded strongly in 2004 (7.1 percent) from the relatively low 5.3 percent recorded in 2003. However, following robust growth in the first half of 2004, averaging 8 percent, the pace of economic activity began to slow in the third quarter, to 6.7 percent, and decelerated further in the last quarter, to 5.6 percent. The slowdown reflects both a moderation in the growth rate of domestic demand and in the global demand for electronic and electrical (E&E) products, as well as more subdued world trade generally. These trends are anticipated to continue in 2005 and 2006, and lead to a return to more moderate but still respectable rates of real growth of around 5¼ percent in both years.²

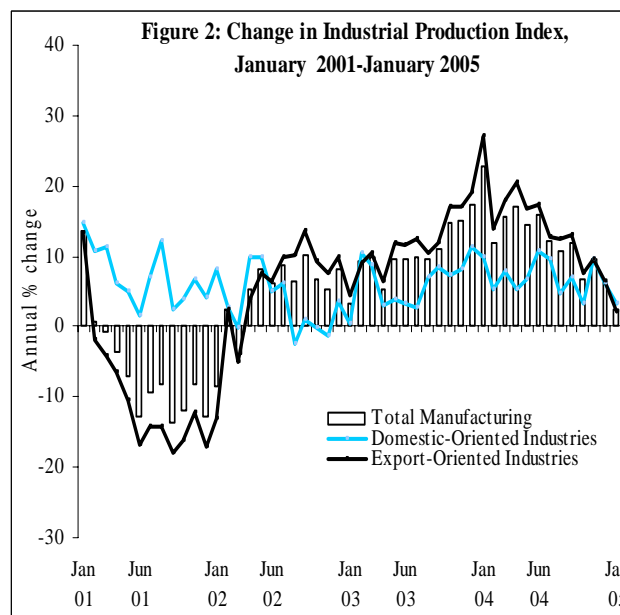


¹ This Update on Malaysia is issued by the Bank twice a year – in spring and autumn – together with the *Regional Update* for East Asia and the Pacific. Similar updates on other countries are also issued.

² The tsunami which struck South and Southeast Asia and beyond on December 26, 2004, devastating many areas of the Andaman and Nicobar Islands, Bangladesh, India, Indonesia, Maldives, Sri Lanka, and Thailand, inflicted relatively minor material damage on Malaysia, and is not expected to exert a negative impact on overall real growth. Though 68 people lost their lives, disruption to economic activities and damage to infrastructure were minimal, and mostly limited to around 1,000 fishermen living in the affected areas (especially Penang).

Production

Manufacturing production moderated in the second half of the year, reflecting the slowdown in global demand in semiconductors. After strong growth in the first half of the year, as anticipated in the last *Economic Update* (November 2004), manufacturing production moderated sharply from mid-year onward, reflecting a slowdown in external demand, particularly from the U.S. and China and adjustments in inventories in the global electronics sector.

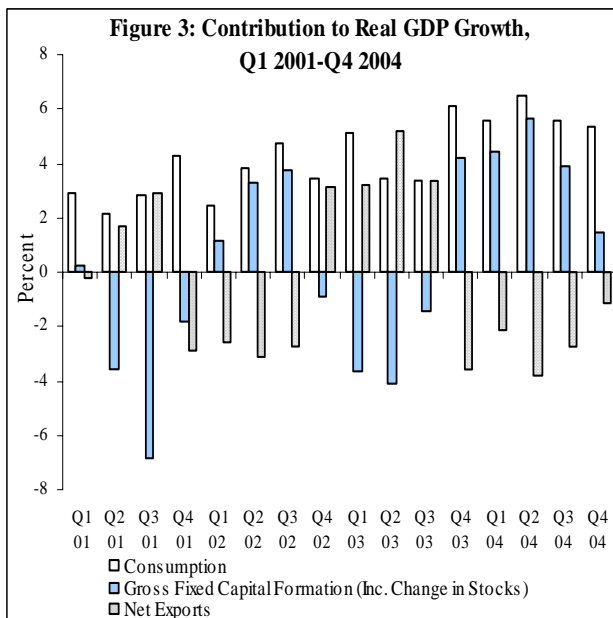


The growth rate in the production of electronic products slowed down sharply, from an average of 31.4 percent in the first three quarters of the year to 9½ percent in the last quarter, while the production of electrical components continued to decline, falling by just under 10 percent for the year as a whole. Despite the slowdown in the demand for E&E products in the last quarter of 2004, other export-oriented industries, especially resource-based industries such as chemical, wood and rubber products industries continued to perform well during the year. Overall, the export-oriented industries grew by 14.2% in 2004. Higher exports of wood products to Japan and the U.S., increased production of rubber products on the back of a higher external demand for surgical and medical gloves and rubber auto parts, and higher production of natural gas and plastics, more than offset the continued decline in output of textiles and apparel. The rate of growth of output of domestic-oriented industries moderated in the second half of the year, despite significantly higher production of fabricated metal items and higher production of transport equipment. Value-added in the *services* sector remained buoyant, rising by 6.7 percent in 2004, spurred by higher activity in transport, storage, and communications; finance, insurance, real estate and business services; and utilities; sub-sectors as well as revival in the wholesale and retail trade, restaurants and hotels sub-sector from the effects of SARS

in the previous year. The expansion in the *mining* sector (4.1 percent) was driven by higher production of natural gas and crude oil, the latter driven by higher prices and domestic and external demand for petroleum products. Growth in *agricultural* production (5 percent) was underpinned by strong performance of the palm oil sector especially in the last quarter and higher rubber production, as continued high prices encouraged increased tapings by small holders. Higher production in the fishing and forestry sub-sectors also boosted agricultural growth during the year. The *construction* sector contracted by 1.9 percent in 2004, as the completion of several large projects and sharply lower civil engineering activities more than offset sustained growth in both the residential and non-residential property segments.

Domestic demand

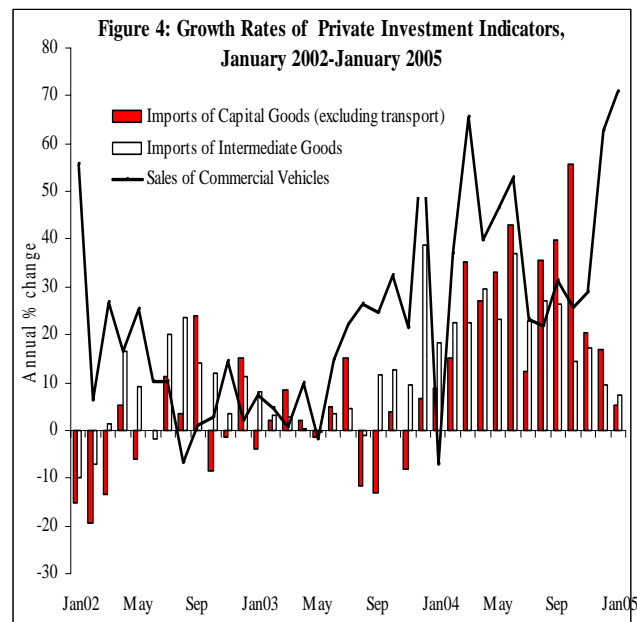
In 2004, real growth was driven by private domestic demand. Real domestic demand grew by 7.3 percent over 2003 on the back of robust consumption and a strong rebound in private domestic investment, although growth rates of both abated in the second half of the year, following their respective peaks in the second quarter.



Private consumption grew by 10.1 percent in 2004, contributing 4.7 percent of the 7.1 percent real growth for the year. The increase in the propensity to consume of the private sector continued to be driven by a combination of income effects from continued firm commodity prices and export earnings; wealth effects from improved employment prospects and healthy returns from the Bursa Malaysia (see below) and higher household debt financing (credit cards and consumption

credit) in an environment of sustained low interest rates. Looking ahead, although the consumer sentiments index (CSI) declined by 4.6 points to 109.3 in Q4 2004, other indicators (sales of passenger cars, imported consumer goods, and growth in consumer loans) point to sustained private consumption. As a result, in real terms, private consumption is expected to grow by about 8½ percent in 2005 and 7 percent in 2006. *Public sector consumption* grew by 6.6 percent in 2004, down from 10 percent in 2003, and the trend rate of real growth in public consumption continued to decline each quarter. Real public consumption is projected to rise by 4½ percent in 2005 and by 3 percent in 2006.

Private domestic investment rebounded strongly in 2004. In real terms, total gross domestic fixed capital formation (excluding changes in stocks) grew by 3.1 percent in 2004, contributing 0.9 percent to the overall growth rate for the year. Though from a relatively low base (see Box 1 for a brief review of “Trends in Investment”), real private investment grew by 15.8 percent, and substantially offset the decline in real public investment of 3½ percent. However, the growth rate of imports of capital and intermediate goods declined sharply in the last quarter.



In the manufacturing sector, a large share of new investments was channeled to export-oriented industries, although their capacity utilization declined marginally, to 79 percent in 2004 (2003: 80 percent). Total proposed capital investments of approved projects in the manufacturing sector declined slightly in 2004, to just under RM29 billion, but overall investment in the manufacturing sector rose because of the staggered implementation of previously approved projects. After having risen in the second quarter of 2004, to 124 points, the business confidence index (BCI) declined to 97.3 points in the fourth quarter, below the 100-point threshold level. Thus, real private domestic investment is projected to rise more moderately in the years ahead; by about 9.6 percent in 2005 and by 7 percent in

2006. Real growth in public investment is projected to decline by about 11.6 percent in 2005 and 6½ percent in 2006, in line with further fiscal consolidation. Inward foreign direct investment (FDI) almost doubled in 2004, to US\$4.6 billion (RM17.6 billion), with broad-based flows to all major sectors, namely services, manufacturing, and oil and gas sectors. The services sector continued to be a major recipient of new FDI flows, particularly in the new growth areas such as business support and shared services. Significant inflows were recorded in the financing, insurance, real estate, and business services sub-sector as well as in the wholesale and retail trade, hotels and restaurants sub-sector. In the manufacturing sector, FDI was mainly for upgrading equipment and technology, expanding capacity, and establishing new product lines. Oil and gas investments were directed at upstream activities following the discovery of new oil fields.

External demand

Import growth outpaced that of exports in 2004. In the first three quarters of the year, external demand was strong, boosted by the somewhat synchronized economic recoveries in the three major players (U.S.A., Japan, and Europe), stellar growth in China, expanding intra-regional trade, and robust international commodity prices. However, external demand waned sharply in the last quarter, reflecting the joint effects of some moderation in the growth rates of the major players, including China, persistently high oil prices on the global economy, and the decline in the demand for E&E products.³ At the same time, although the gap narrowed sharply in the last quarter, import growth outpaced that of exports throughout the year, driven by higher private sector demand, especially for capital and intermediate goods. In nominal terms, the trade surplus remained around RM 81.1 billion (\$21.3 billion).

Exports were buoyant through the third quarter of 2004, but moderated significantly in the last quarter. After growing by 22.6 percent in the year through end-September 2004, *merchandise export* growth declined to just over 16 percent in the fourth quarter of 2004 despite continued strong expansion of mineral exports, reflecting moderation in manufactured exports (13½ percent) stemming from the slowdown in the global electronics cycle (see Box 2 for “Trends in Exports, 1991-2004”). Over the year, exports expanded by 20.8 percent in value terms, supported by both higher export volumes (16.1 percent) and prices (3.6 percent). Exports of manufactures were bolstered by a 14.6 percent increase in the demand for E&E products

(accounting for over 53 percent of total exports), while wood products, steel and metal products, chemicals and chemical products and transport equipment also recorded robust growth. Higher oil prices caused a sharp rise in exports of crude oil (43.3 percent), reflecting higher prices which strengthened by 34.8 percent to an average of \$40.8 per barrel. Exports of LNG also rose sharply mainly on account of higher volume amidst the greater demand from Japan, Korea and Chinese Taipei. Agricultural exports rose by a moderate 13.4 percent as earnings from exports of palm oil, which make up more than half of agricultural exports, increased 7.5 percent to a value of RM25.02 billion with volume increasing from 12.27 million tons in 2003 to 12.58 million tons in 2004. Exports of rubber also posted very strong growth (45.1 percent), supported by rising prices and higher volumes, including from higher demand from EU and China. Overall, exports continued to shift toward regional countries, especially China, Korea, and Australia. Looking ahead, in view of the anticipated moderation in the growth of external demand for E&E products and the expected decline in commodity prices (crude oil, palm oil and rubber), export growth is projected to moderate quite significantly in 2005 to 7½ percent and to 7 percent in 2006.

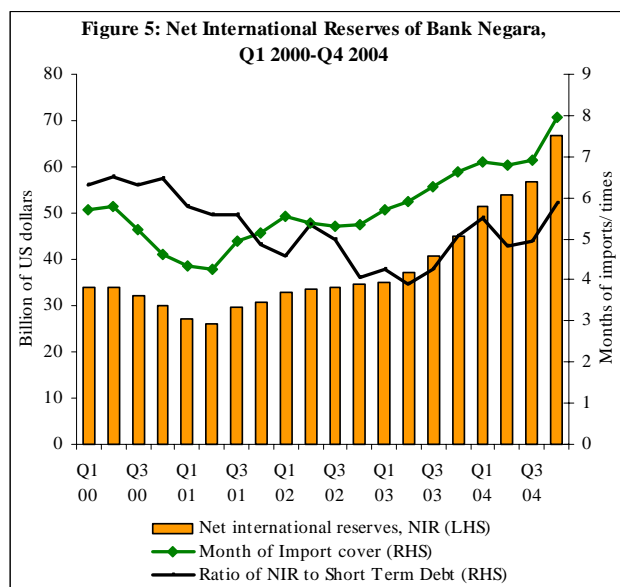
Imports increased sharply in 2004, reflecting the strong export growth, the rebound in private domestic investment, and the increase in private consumption. *Merchandise imports* rose by 26.4 percent in value terms, spurred by a surge in imports of capital goods (36.0 percent), mostly reflecting higher demand in the manufacturing and services’ sectors, especially for machinery, generators, turbines, electric motors, and telecommunication and office equipment, and by sharply higher imports of consumption goods (24.1 percent), especially food and beverages. The annual rate of growth of total imports declined sharply in the last quarter, to 19.1 percent, reflecting moderation in the growth of imports of capital and intermediate goods. Imports of intermediate goods, which are used mostly as inputs in the production of manufactured exports, especially E&E products, rose by 22.2 percent in the year, but the rate of growth moderated to 12.8 percent in the last quarter, reflecting lower anticipated demand for E&E products. In terms of the origin of Malaysian imports over the last few years, while the share of total imports from the EU has remained stable at around 12 percent, the combined share of imports from Japan and the U.S. has declined from 37.6 percent in 2000 to 30.4 percent in 2004, while the share of imports from China has risen from 4 percent to 9.8 percent. Looking ahead, import growth is projected to average about 6½ percent in 2005 and 6 percent in 2006, in line with the anticipated moderation in investment and export growth.

Tourism rebounded strongly in 2004. Tourist arrivals recovered sharply during the year from the sharp decline registered in 2003 on account of the outbreak of SARS, surging by 48½ percent, to 15.7 million. Tourists from Singapore, Thailand, Indonesia, and China accounted for just below 80 percent of total arrivals, and increases in excess of 50 percent were recorded in tourist arrivals from Brunei, China, Korea, Singapore, the Middle East, Italy, and the U.K.

³ Estimates of the effects on Malaysia of changes in external demand in the major players and China, and higher oil prices, were presented in the last *Economic Update* (November 2004).

Financial account, reserves, and external debt

The overall balance of payments strengthened considerably in 2004. *Net international reserves* of Bank Negara Malaysia rose by \$21.9 billion in 2004, to \$66.7 billion. By mid-April 2005, they had risen further, to \$72.8 billion, equivalent to over 8½ months of retained imports and 6¾ times short-term external debt. Reserves have continued to be bolstered by higher repatriation of export earnings, and inflows of foreign direct investment and portfolio investment. *Net inflows of direct investment* were significantly higher in 2004, as gross FDI inflows rose to RM17.6 billion and net direct investment abroad increased to RM7.8 billion. Net *portfolio inflows* surged by RM 33.8 billion, from RM4.2 billion in 2003, reflecting renewed active foreign participation in both Malaysian equities and debt securities—notwithstanding further narrowing of the positive yield differential with U.S. short-term interest rates—partly reflecting the anticipation of a revaluation of regional currencies, including the ringgit by some market participants during the year.⁴ *Total external debt* rose by \$2.8 billion to \$51.9 billion by end-2004, or 44.1 percent of GDP. Medium- and long-term external debt of the private sector and non-financial public enterprises rose by just over \$1 billion, while Federal Government external debt declined by \$0.7 billion to \$9.1 billion. Federal Government external debt represents 22.5 percent of total outstanding medium- and long-term external debt. Short-term external debt rose by \$2½ billion, to \$11.3 billion, as a result of higher interbank borrowings.



⁴ Increasing market speculation about whether the ringgit would be revalued was quelled on February 25, 2005, when the current Prime Minister Abdullah Badawi, who is also the Minister of Finance, stated that following a review of the arrangement, the peg would remain.

Prices

Consumer price inflation continued to edge higher through early 2005. Following a gradual increase since early 2004 through September, annual (year-on-year) *consumer price inflation* rose in the last quarter of 2004 to 2.1 percent by end-December 2004, as a result of the imposition of higher excise duties on cigarettes and alcohol, and the reduction in subsidies on fuel products, as presaged in the 2005 Budget.⁵ Food prices (meat, eggs, and chicken) also increased in the last quarter of 2004. As a result, annual average inflation edged up to 1.4 percent in 2004, from 1.2 percent in 2003. The increase in year-on-year annual inflation continued through end-February 2005, reaching 2.4 percent. However, *core inflation* (i.e. excluding price-controlled, as well as price-volatile, items and items subject to one-off price adjustments) remained subdued in 2004, averaging 1 percent, and there is little evidence of either demand or capacity constraint driven causes. *Producer price inflation* rose steadily throughout 2004, to an average of 8.9 percent (from 5.7 percent in 2003), on account of rising crude oil and palm oil prices. In January 2005, the increase in producer prices increased marginally over December 2004, to 3.6 percent, reflecting slightly higher commodity prices.

Financial policies

Financial policies continue to be prudent and conducive to economic growth. As explained in the last *Economic Update* (November 2004), the Government has taken advantage of the recent economic upswing to pursue fiscal consolidation, while the central bank is continuing its accommodative monetary policy in a bid to further encourage the domestic private sector to sustain its role as the main engine of economic growth. Indeed, as explained above, robust domestic demand in the second half of 2004 more than offset the dampening effects on growth from the softening in external demand for E&E products.

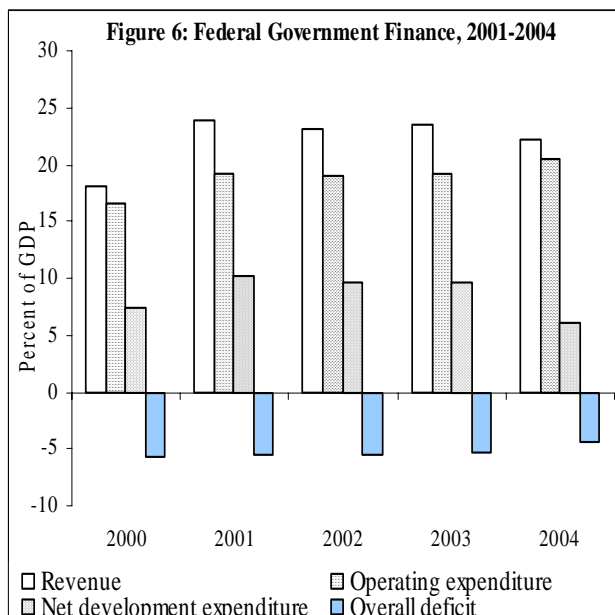
Fiscal policy and public debt developments

Fiscal consolidation continued in 2004. The overall fiscal deficit of the Federal Government declined further in 2004, to 4.3 percent of GDP, from 5.3 percent of GDP in 2003, and slightly lower than 4½ percent of GDP projected in the 2004 Budget.⁶ The overall tax burden on the economy fell, as *total revenues* increased by only 7.3 percent (significantly less than nominal GDP), notwithstanding large increases in receipts petroleum taxes, and excise and export duties, owing to lower contributions from corporate taxes as a result of tax concessions for SMEs in the 2004 Budget, and lower nominal receipts from sales taxes. *Operating expenditure* surged by 21.4 percent,

⁵ In the Budget for 2005 approved on September 10, 2004, the Government raised excise duties on cigarettes by 40 percent and on liquor by between 20-100 percent. The fiscal year starts January 1.

⁶ The progress in fiscal consolidation prompted Fitch to upgrade the country's foreign currency rating from BBB+ to A- in November 2004, and Moody's to upgrade its ratings from BAA1 to A3 in December 2004.

owing to substantially higher subsidies for petroleum products (55 percent of total subsidies), and significantly higher grants and transfers to state governments, and public agencies and enterprises, partly related to refunds of excess taxes collected prior to 2004. However, *development expenditures* declined by 26.7 percent, to 6.4 percent of GDP, from 10 percent of GDP in 2003. The sharpest declines in development expenditure were recorded in defense and security outlays, and spending on all categories of social services. The overall deficit of the Federal Government was financed almost entirely from domestic sources. As a result, the total debt of the Federal Government (domestic and external) rose to RM216.6 billion, equivalent to 48.4 percent of GDP, while total public sector debt (including non-financial public enterprises) declined slightly to 67 percent of GDP, including 20.6 percent of GDP in external debt.

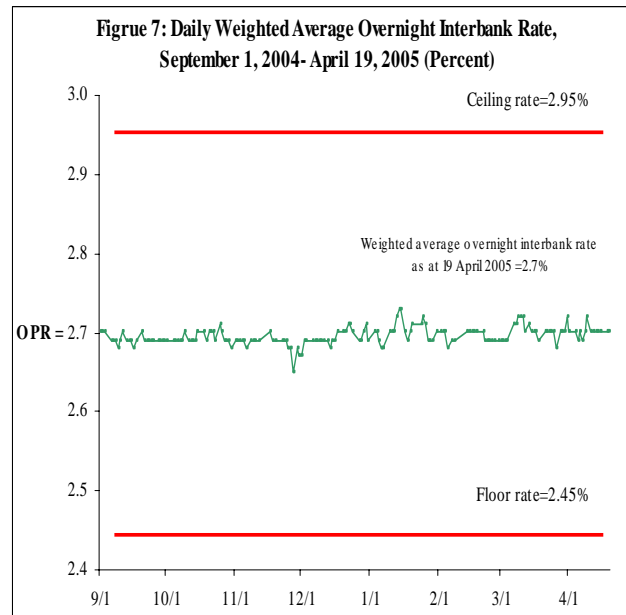


Monetary policy and developments

Monetary policy was accommodative throughout 2004, to support the growth momentum. While the BNM maintained a low interest rate environment in a bid to encourage private sector-led expansion, it conducted contractionary liquidity operations throughout the year to offset the expansionary impact of rising reserves.⁷ Since its introduction on April 26, 2004, the *overnight policy interest rate* (OPR) has remained unchanged at 2.7 percent, and the daily

⁷ The BNM conducted contractionary sterilization operations each month during 2004, except in August when a modest amount of liquidity was injected into the system.

weighted average interbank overnight rate has remained stable, within a narrow range of 2.65-2.74 percent.⁸



With comfortable liquidity positions, commercial banks and finance companies were able to lower their *average lending rates* (ALR) (to 5.98 percent and 8.78 percent, respectively), while their base lending rates (BLR) remained relatively unchanged (at 5.98 percent and 6.90 percent, respectively).⁹ *Narrow* (M1) and *broad* (M3) money supply aggregates continued to rise (M1 by 11.9 percent and M3 by 12.4 percent, respectively, on an annual basis at end-December 2004), reflecting the continued build-up in foreign exchange reserves, and the growth in bank lending to the private sector.

Financial and corporate sector developments

Malaysia's financial and corporate sectors were further strengthened in 2004. The consolidation and restructuring of the financial sector continued, and the asset quality and overall health remained strong, despite an increase in non-performing loans for residential mortgages and private vehicles. Developments in the corporate sector continued to be favorable.

Financial sector developments

Consolidation and restructuring advanced further. Malaysia's medium-term financial sector strategy is anchored on the gradual introduction of competition between domestic and foreign financial institutions. Building on the consolidation that has already taken place in the industry, an integrated commercial banks and finance company framework (the "Bafin" framework) was established under which domestic banking groups have the

⁸ The operation of the new interest rate policy framework was explained in the last *Economic Update* (November 2004).

⁹ ALR declined further in early 2005, to 5.95 percent by end-February.

option of conducting commercial bank and finance company business through a single lending entity that holds both licenses. During the year, five out of ten finance companies merged with their respective commercial bank. Increased efforts were also placed on increasing operational efficiency and meeting customer demands more closely. Initiatives include the industry-wide benchmarking exercise which begun in 2002. Financial performance and service quality indicators were shared amongst industry players, including information on profitability, productivity, and asset quality. More emphasis was also placed on promoting more “customer-centric” institutions. Findings from a nationwide survey of more than 3,000 retail, small and medium enterprises (SME) and larger corporate customers were shared with the industry to provide insights into areas for improvements and focus.

In addition, on March 23, 2005, the BNM announced a new framework on the creation of investment banks to rationalize merchant banks, stock-broking companies and discount houses within the same banking groups, along the lines of the “Bafin” framework. In the second half of 2005, the foreign equity participation limit will be increased from 30 percent to 49 percent for investment banks. In November 2004, the Asian Development Bank became the first foreign entity to issue ringgit-denominated bonds, followed soon after by the IFC, which became the first multilateral body to issue ringgit bonds that conform to Islamic principles. Finally, effective April 1, 2005, the BNM foreign exchange administration rules was liberalized further, including increases in the limits on overseas investments, retention of foreign currency accounts, foreign currency credit facilities, hedging, and domestic borrowing by non-resident-controlled companies.

Implementation of the Capital Market Master Plan was on track. By end-2004, 94 of the 152 recommendations of the Capital Market Master Plan (CMP), launched in February 2001, had been implemented. Approvals were issued to five foreign stock broking firms for establishing operations in Malaysia (CSLA, Credit Suisse First Boston, JP Morgan, Macquarie, and UBS), and to one foreign global fund manager (Aberdeen Asset Management) out of the five planned.

Overall asset quality of the banking system improved further in 2004 and banks remained well-capitalized. At end-2004, total non-performing loans (NPLs) of the banking system declined by RM5.3 billion to RM60.4 billion, equivalent to 7.6 percent of total loans.¹⁰ Among the largest borrowers from the banking system, NPLs in the residential properties

sector increased by RM1.2 billion to RM11.3 billion, but were offset by the RM1.4 billion decline in total NPLs to the manufacturing sector, to RM8.6 billion.¹¹ Risk weighted capital in the banking system remained strong at 13.8 percent of banking system assets. The RWCR of the banking system rose to 14.3 percent in mid-2004, but declined to 13.8 percent as at end-2004 due to the growth in the risk weighted assets of the banking system which outpaced the expansion in capital base, driven mainly by higher lending activities.

Danaharta has essentially completed its task. As at end-2004, Danaharta has received RM29 billion, or 94 percent of the total expected recovery of RM30.8 billion. Recoveries have been in the form of cash, restructured loans, property, and securities. RM23.6 billion has already been converted to cash to help retire Government bonds. As at end-March 2005, Danaharta had successfully redeemed the last three tranches (RM0.8 billion) of the zero-coupon Government guaranteed bonds issued to finance its acquisition of non-performing loans from financial institutions during the Asian financial crisis. Danaharta is on track to unwind its operations in 2005.

The supervisory and regulatory framework is being further enhanced. In April 2004, the BNM announced that the new Basel Capital Accord (Basel II) will be adopted in two phases in Malaysia. Banking institutions would need to implement the Standardized Approach for credit risk by January 2008, while those seeking to adopt the Internal Ratings Based approach would have until January 2010. Meanwhile, in October 2004, revised guidelines were issued on financial reporting for licensed institutions to ensure consistent disclosure to facilitate evaluation, assessment, and comparison of financial position and performance of institutions. The revised guidelines will apply to the financial statements for the financial year starting on or after 1 January, 2005.

Profits are up despite lower lending margins. The banking system posted gross operating profits of RM12.6 billion in 2004, up 3.3 percent from 2003. In the year to end-2004, returns on average assets and equity rose from 1.3 percent to 1.4 percent and from 15.3 percent to 16.6 percent, respectively. Under the new interest rate framework introduced last April, with both the ceiling base lending rate (BLR) and the maximum spread of 2.5 percentage points above the BLR removed, banking institutions have been free to better price their interest-based products. However, with lending rates remaining low, commercial banks and finance companies also continued to diversify their operations into non-lending fee-based activities, and the ratio of fee-based income to operating income of commercial banks and finance companies rose from 15.6 percent in 2003 to 17.2 percent in 2004.

The shift of lending to households continued. The marked shift in the composition of banking sector assets away from the corporate sector toward consumer lending continued in 2004. As

¹⁰ Loans overdue more than three months, net of interest in suspense and provisions.

¹¹ See Box 1 in *Economic Update* (November 2004) for details on household debt levels.

at end-2004, loans to households accounted for 51.4 percent of total outstanding loans (RM264.4 billion), up from 48.8 percent in 2003, while outstanding loans to the business sector accounted for 42.6 percent (RM219.2 billion), down from 45.1 percent in 2003. As in previous years, the bulk of household loans were for mortgages, purchases of passenger cars, and credit cards, with outstanding loans to the residential property sector accounting for 49.3 percent of total outstanding household loans. SMEs accounted for 40.3 percent of outstanding loans to businesses, up from 27 percent in 1998.¹²

Islamic Finance expanded rapidly in 2004. In line with efforts to strengthen Malaysia as a hub for Islamic financial services, assets of the Islamic banking system grew by 15 percent to RM94.6 billion during the year, equivalent to 10½ percent of total banking system assets. Loans increased to RM57.9 billion, equivalent to 11.3 percent of total banking system loans, from 10.3 percent share in 2003. Efforts were also directed at improving the corporate governance of Islamic banks, enhancing financial disclosure requirements, and preparing to adopt Basel II standards.

Corporate sector developments

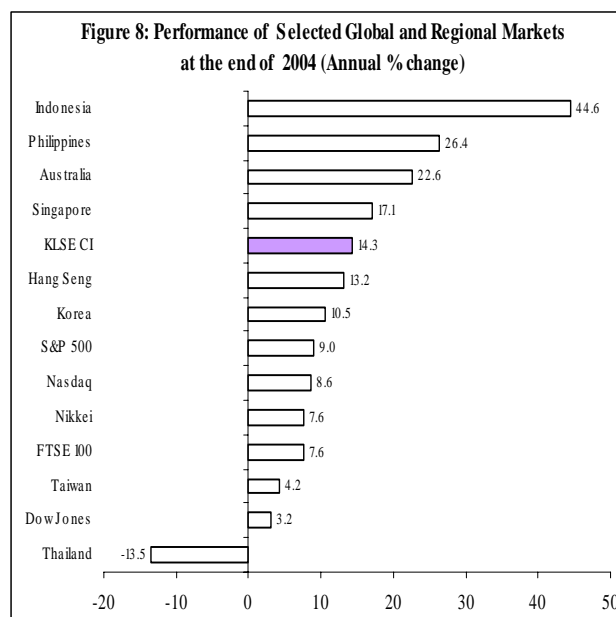
Improving corporate governance and performance. The key medium- to long-term issue in the corporate sector is to balance growth, competitiveness and fiscal consolidation. In its bid to address the challenges of transitioning into a more innovation and knowledge driven economy to move up the value-added ladder, Malaysia is actively focusing on improving national competitiveness and total factor productivity (TFP) growth, by strengthening the investment climate and enhancing corporate governance. In particular, emphasis is being placed on establishing:

- Clear industry and regulatory structure and reporting lines,
- Professional management and Board working in unison,
- Independent key decision making,
- Strong internal culture of performance and emphasis on systems and controls,
- Enhanced financial discipline and improved service delivery, and
- Disciplined access to credit and orderly competition.

Recent reforms in Government-linked-companies (GLCs) are expected to improve performance and encourage private investment. More than 40 GLCs are listed, comprising less than 10.0 percent of Malaysia's GDP. Changes in management, adoption of performance based contracts for management and implementation of key performance indicators (KPIs) are some of the reforms that have been underway since April-May 2004. Shareholding of more than 30 GLCs have now been placed with *Khazanah*, a government investment company headed by a new chief executive, in order to separate the role of a shareholder (i.e. *Khazanah*) from a regulator and policy-maker (i.e. the Ministry of Finance). It is probably too early to assess and report on the impact of these reforms and the evidence so far is limited (Box 3).

Merger and acquisition (M&A) activity declined in volume terms, due to a lack of very large transactions. Nonetheless, the number of M&A transactions has remained stable over the past two years. Singapore's Temasek Holdings acquired large minority positions in Malaysian banking and plantations companies. In the automotive industry, Chery Automotive, a Chinese assembler, has announced plans to earmark Malaysia as their regional distribution hub, while Proton reached a deal to assemble Volkswagen cars and distribute them in Southeast Asia. Proton, Sime Darby, and Telekom Malaysia have all announced acquisitions of foreign companies too.

The stock market recovered in the last quarter of 2004. Total market capitalization of the Kuala Lumpur Stock Exchange (KLSE), renamed Bursa Malaysia, rose by 12.7 percent to RM722 billion in 2004, or 161 percent of GDP. Following a pronounced dip in the second quarter, the Kuala Lumpur Composite Index (KLCI) recovered well in the last part of the year, closing 14.3 percent higher than at end-2003, at 907.4 points.



¹² In August 2004, the National SME Development Council was set up. The Council is chaired by the Prime Minister and the BNM acts as the Secretariat.

Share prices were buoyed in the last quarter by speculative interest in Malaysian shares on expectations of a revaluation of the currency.¹³ The number of Initial Public Offerings (IPOs) rose by 72 during the year, bringing the total number of listed companies to 963. The amount of funds raised in the equity market however declined by RM1.3 billion to RM6.5 billion, mainly due to the smaller size of the IPOs. The largest IPO was that of AirAsia Bhd, a regional low-cost airline, which raised RM720 million.¹⁴ Other noteworthy IPOs include the property company holding the Petronas towers, and in March 2005, Bursa Malaysia.

¹³ By April 25, 2005, the KLCI was lower, closing at 871.98 points.

¹⁴ See *Securities Commission Annual Report 2004*; p. 1-12

Box 1. Trends in Investment, 1991-2004

Total investment in the post-crisis years is significantly lower than before the crisis. .

- **Total investment declined significantly in the post-crisis era.** Total gross investment fell from an annual average of 43.2 percent of GDP between 1991-96 to 28.5 percent of GDP between 1999-2004;
- **The decline in private domestic investment was the steepest.** Private domestic investment declined by close to two-thirds between the two periods, from 29.3 percent of GDP to 11.8 percent of GDP. Net foreign direct investment (FDI) inflow, as measured in the balance of payments, fell by more than half, from 7.4 percent of GDP to 3.2 percent of GDP;
- **Public investment increased.** Public investment rose from 12.7 percent of GDP to 16.7 percent of GDP, although fiscal consolidation has begun to reduce public investment share in GDP since 2003.
- **In real terms, the decline in private domestic investment was matched by the rise in public investment.** Private domestic investment declined by 42.2 percent whereas public investment increased by 80.0 percent keeping overall gross domestic fixed capital formation constant, across two periods, at RM63.4 billion;
- **The decline in total investment is correlated with lower real GDP growth.** The decline in total investment is correlated with a reduction in *potential output* and average real growth. From an average of 8 percent in the period 1994-98, the annual growth in the *potential output* of the economy has declined by half to 3.9 percent. Meanwhile, average real growth has fallen from 9.6 percent to 5.3 percent (excluding 2001, the average annual real growth between 1999 and 2004 would be 6.3 percent).

But there was a marked pick up in 2004.

- Notwithstanding the decline in overall capacity utilization, private domestic investment rose from 7.6 percent of GDP in 2003 to 7.9 percent of GDP; FDI increased to \$4.6 billion (RM17.6 billion), up sharply from \$2.5 billion (RM9.4 billion) received in 2003; and was targeted to the services, manufacturing, and oil and gas sectors;
- Most of private investment in 2003 went into manufacturing (34 percent), followed by construction (21 percent), services (20 percent), mining (15 percent), and agriculture (10 percent).
- In the manufacturing sector, although total approved investments in the manufacturing sector by the Ministry of International Trade and Investment (MITI) declined from RM29.1 billion in 2003 to RM28.7 billion in 2004, total capital outlays rose by 32.7 percent in nominal terms, reflecting the staggered implementation of previously approved projects.
 - Within the group of export-oriented industries, total approved private domestic and foreign investment rose in all major sub-sectors, except wood, with the highest increases recorded for E&E products (up by RM3.6 billion to RM8.6 billion), chemicals and chemical products (up by RM2 billion to RM3 billion; and textiles (up by RM0.5 billion to RM0.8 billion);
 - Within the category of domestic-oriented industries, total private domestic and foreign investment in transport and basic metals declined sharply (jointly by RM12.5 billion to RM3.2 billion), but rose in the petroleum sector (up by RM1.5 billion to RM1.9 billion).

Box 2. Trends in Exports, 1991-2004

Post-crisis export performance has been more modest relative to the pre-crisis period, and the overall structure of exports has changed very little. Comparing the pre-crisis period (1991-96) with the post-crisis period (1999-2004) average annual growth in total export values declined from 16½ percent to 9½ percent (13½ percent, excluding 2001). In terms of structure at the two-digit HS level, the annual average share of exports of manufactured goods increased from 74 percent to 84 percent; the share of electronic products rose from 27 percent to 43 percent during the same period, but this was at the cost of a decline in the shares of all other product groups, including major agriculture. Among the five key agricultural products, only the share of palm oil exports increased between the two periods. In the post-crisis period the top ten exports accounted for over 85 percent of total exports, with the top five exports accounting for well over 75 percent. (Electrical machinery was 38 percent, machinery 21 percent, mineral, oil, and fuel products 10 percent, fats and oils 5 percent, and wood 3 percent).

Export destinations have remained broadly unchanged, though China has increased its share. Comparing pre- and post-crisis periods, the combined share of exports to the EU, Japan, and the U.S.A. declined slightly to 46 percent (U.S. share is 20 percent), while the share of exports to ASEAN declined by 4 percentage points. The most noteworthy shift was the increase in the share of exports to China, which more than doubled to over 5 percent. Whereas the annual growth of Malaysia's exports to the world market averaged 9½ percent per year in the post-crisis period, the average annual growth of exports to China was three times as high, at 27 percent. Similarly, the share of total imports from Malaysia in total Chinese imports rose from 2 percent to over 3 percent, and Malaysia now ranks as the 6th largest supplier of Chinese imports, behind Japan, Taiwan, Korea, the U.S, and Germany, and ahead of any ASEAN member, including Singapore (7th) and Thailand (10th).

The product concentration of exports to China has increased, but the composition is changing. In 2004, the top ten products accounted for 91 percent of total Malaysian exports to China, up from 87 percent in 1999. The shares of exports of electrical machinery, plastics, organic chemicals, and rubber have all risen, while the share of wood exports has fallen sharply.

Penetration of the Chinese market has been the deepest for electrical machinery and plastics. Over the post-crisis period, six of Malaysia's top ten exports have included those products in increasing demand by China (electrical machinery; machinery; mineral, fuel, and oil; optical, photo, and medical instruments; plastics; and organic chemicals), and Malaysia's has increased its share of the Chinese market in each of these products. Relative to competitor ASEAN member countries, defined as those which have also increased their product market share in the Chinese market over the period, Malaysia's performance has been strongest in electrical machinery and plastics. For the former, the share of China's imports of electrical machinery from Malaysia in China's total imports of electrical machinery rose from 3 percent to over 7 percent in 2004, and Malaysia ranked fourth behind only Japan, Taiwan, and Korea. For the latter, the share rose from 2 percent to 3 percent, and Malaysia ranked 9th overall (though behind Singapore (5th) and Thailand (6th)). With regard to the other top exports, Malaysia has been outperformed only by the Philippines in electrical machinery and machinery (although from a smaller base share in 1999); Vietnam in mineral, fuel, and oil; Singapore in organic chemicals; Indonesia and Vietnam in rubber (again, from a smaller base share); and Indonesia and Thailand in fats and oils.

Box 3 : Recent Reforms of Government-Linked Companies (GLCs)

GLCs have an important position in the Malaysian economy. There are around 40 GLCs listed at the Bursa Malaysia representing one third of market capitalization and less than 10.0 percent of the country's GDP. They operate in a large number of sectors, with some of the biggest ones in the infrastructure sector, including *Telekom Malaysia*, *Tenaga* (the national electric company), *Malaysia Airline System*, and *Malaysia Airport Holdings*. Another notable GLC is *Proton* (the car company). In these and all other GLCs, the government, either directly or indirectly, through federal agencies such as the Employee Provident Fund (EPF), exercises control over major decisions, including appointment of members of the Board of Directors and senior management, company strategy, as well as acquisitions and divestments.

Reforms announced in mid-2004 seek to enhance efficiency of GLCs and to encourage private investment into GLCs. The reform measures, announced during the April-May 2004 period, include:

--**New Management:** New chief executives with a private-sector background were appointed for *Tenaga*, *Telecom Malaysia*, and several other GLCs.

--**Key Performance Indicators (KPIs):** To assess performance of GLCs, specific KPIs were adopted including financial indicators like profitability and cost measures, strategic indicators like market share, and institutional indicators like investments in human capital and information technology (IT); and

--**Performance-linked management contracts:** Managements were under performance contracts limited to 3 years. The contracts will be renewable only after satisfactory performance vis-à-vis the agreed KPI targets. In addition management compensation levels, including bonuses and stock-options, have been linked to meeting KPIs. Finally, to ensure that the best candidates are put forward for chief executive positions, selection of non-bumiputras is now permitted.

To reduce conflicts from Government's simultaneous roles as regulator, provider of public goods, and shareholder, the following reforms were also introduced:

--Shareholdings of more than 30 GLCs were shifted from the Ministry of Finance to *Khazanah*, the Government investment company. This is expected to strengthen Government's role as investor.

--The management of *Khazanah* has been changed. The new management's performance will also be judged on the basis of agreed KPIs.

--A corporate governance committee, headed by the Chairman of the Securities Commission and reporting directly to the Prime Minister, has been established to monitor enforcement of corporate governance laws in the GLCs; and

--Regulators have been removed from the Boards of Directors of GLCs.

The objectives of these reforms are to create an arms-length relationship between federal government and GLCs, make GLCs more independent and more commercially oriented, and encourage greater private investment in the GLCs. While it is still too early to assess whether the reforms are having the desired effects on actual performance, some early wins have been observed in two of the largest. At *Tenaga*, receivables management and operating margins have improved, while average collection periods have declined. At *Telekom*, a voluntary separation program has been launched, and improved capital management has been demonstrated through the disclosure of a dividend policy and higher payouts. Since early 2005, a high-level committee, chaired by the Second Minister of Finance, meets every month to monitor implementation of the reforms. In the second half of 2005, GLCs will be expected to announce to the market "Headline" KPIs (some already have), by which their performance will be tracked. Also, the KPIs themselves are to be benchmarked against relevant best-in-class performance targets.