

Economic Outlook

Operating Environment in 2005

1. GLOBAL ECONOMIC OUTLOOK 2005

Global economic growth is expected to moderate to 4.3% in 2005 from its recent peak of 5.0% in 2004 on the back of an anticipated worldwide slowdown in the manufacturing sector particularly the tech sector, a less accommodative fiscal and monetary policies and the lagged impact of high oil prices. In the US, real GDP is expected to register a slower growth of 3.5% in 2005 (2004: 4.4%), but this is still within its optimal growth trend. Consumer spending, the main driver of the economy, making up about 70% of GDP, is expected to slow down in 2005 (3.1% vs. 3.7% in 2004), due to the waning effects of the 2001-03 tax cuts, low interest rates and mortgage refinancing cash-outs. However, this is expected to be mitigated by strong capital spending, with real business fixed investment projected to grow by 9.4% (2004: 10.4%). Meanwhile, the Japanese economy may slow to 2.1% in 2005 after registering a growth of 2.6% in 2004, its fastest since 1996, on the back of less favourable external developments and a stronger yen. Furthermore, high private investment growth rate seen in 2004 is likely fizzle off moderately in 2005, resulting in short-lived recovery in the labour market. As a result, household spending may remain anaemic and deflationary pressure in the economy continues to prevail. In the Eurozone, overall growth to remain relatively subdued with real GDP expected to grow by 1.9% in 2005 (2004: 2.0%). Economic activity will be restrained by relatively high oil prices, a strong euro and softer global growth. In the Asian region, some moderation is anticipated in 2005 after 3 straight years of accelerating growth. Overall growth is likely to be supported by domestic demand as export growth slows down. Within the region, China is expected to lead, with real GDP growth of 8.5% in 2005 (2004: 9.5%).

Real GDP Growth for Major Economies

	2003	2004 ^e	2005 ^f
	y-o-y%		
World	3.9	5.0	4.3
US	3.0	4.4	3.5
Japan	2.5	2.6	2.1
Euro	0.5	2.0	1.9
ASIA	7.2	7.3	6.5
China	9.3	9.5	8.5

Source: IMF World Economic Outlook – September 2004, OECD Economic Outlook – November 2004, Asian Development Outlook 2004 Update, various official releases

^e estimate, ^f forecast

Inflation may tick up in most countries as the impact of high oil prices begin to trickle through to consumers, but the rates are likely to remain at non-threatening levels. The still high excess capacity, stiff price competition, slower domestic demand and tighter monetary policy environment would put a check on excessive upward pressure on prices. In the US, the core inflation is expected to remain low, though the rate may move above 2.0% from 1.6% at end of 2004. In Japan, although consumer prices may be exhibiting some inflationary pressures for the first time in a long while, any y-o-y growth is expected to be marginal. Inflation is likely to remain mild in the euro-region on the back of weak domestic demand. On the other hand, in the Asian region, inflation may edge up gradually due to the lagged effect of high oil prices.

Inflation Forecast for Major Economies

	2003	2004 ^e	2005 ^f
	y-o-y%		
US	2.3	3.0	3.0
Japan	-0.2	-0.2	-0.1
Euro	2.1	2.2	1.9
ASIA	2.5	4.3	3.9
China	1.2	3.9	4.9

Source: IMF World Economic Outlook – September 2004, OECD Economic Outlook – November 2004, Asian Development Outlook 2004 Update, various official releases

^e estimate, ^f forecast

Most major central banks with the exception of the Bank of Japan are likely to step up efforts in tightening their monetary policies.

- US Fed Fund rate likely to rise to 3.50 - 3.75% at the end of 2005 (2004-end: 2.25%).
- Bank of England may continue hiking up its base lending rate, but at a less aggressive pace than the US, bringing the rate to 5.00 - 5.50% at end of 2005 (2004-end: 4.75%).
- European Central Bank to remain focused on supporting economic recovery and may move rates upward only in the second half of 2005 (end-2004: 2.00%).
- Asian central banks are likely to push rates higher going into 2005. In its bid to bring investment spending under control, China's central bank may continue to put in place restrictive measures in 2005. The central bank may also increase its interest rate further following its rate hike of 27bp to 5.58% on October 29, 2004 – the first in 9 years. Nonetheless, the pace is unlikely to be aggressive so as to ensure the economy is still on track for a soft landing.

2. MALAYSIA'S ECONOMIC OUTLOOK 2005

REAL GDP

After expanding briskly in 2004, Malaysia's real GDP is expected to trend down slightly in 2005 on the back of weaker external demand and the public sector's commitment to consolidate its financial position. A number of external factors such as the persistent high oil prices, China's slowdown and the anticipated slow down in the US consumer spending would have a bearing on Malaysia's economic performance in 2005. Of the three factors mentioned above, the concern is more on the impact of the record high oil prices on demand which is likely to slow as consumers in our major trading partners set aside more spending on oil and energy related purchases. Nevertheless, given that Malaysia is a net oil exporter, higher earnings derived from the exports of crude oil and oil related products would likely mitigate any slowdown in external demand. The overall growth in the economy in 2005 would be supported largely by sustained domestic demand with main contribution to growth emanating from the private sector as the public sector consolidates its position. Small-and medium sized enterprises (SMEs) are expected to play an increasingly important role in driving domestic investments in key sectors of the economy in 2005. Thus, growth in real GDP is projected to moderate to 5.5-6.0% in 2005 from a high of 7.1% in 2004, which was the highest growth recorded since 2001.

Real GDP by Expenditure

	2003	2004	2005
	y-o-y %		
Private Consumption	6.6	0.4	10.0
Private Investment	3.9	6.3	5.0
Public Consumption	5.3	10.1	16.1
Public Investment	8.0	-3.7	18.6
Exports of Goods & Services	21.2	7.1	7.5
Imports of Goods & Services	10.5	4.0	-4.5
Real GDP	10.5	10.5	5.5 - 6.0

KEY SECTORS

Growth Projection for Key Sectors

	2003	2004	2005
	y-o-y %		
Agriculture	5.7	5.9	8.3
Mining	1.9	4.4	5.3
Manufacturing	5.0	4.1	9.8
Construction	-1.9	6.7	7.1
Services	3.8	5.0	7.5
Real GDP	1.5	5.5	5.5 - 6.0

Growth in the manufacturing sector is expected to moderate to 7.5% in 2005 (2004: 9.8%) on account of a weak external demand mainly for electrical and electronic products. Despite this, the sector will remain to be the key engine of growth in the economy. There is a discernible shift away from labour-intensive production to high value added production in the manufacturing sector with knowledge-based labour of higher productivity and skills. Sub-sectors which have good growth potential in 2005 include:

- Resource based industries such as palm oil products, rubber products and food products.
- Building materials, especially steel and fabricated metals industry.
- Water-related industries, such as the manufacture of pipes.
- ICT-related equipment industries.

New sources of growth to emerge in:

- food processing industries (new market segments such as halal food),
- biotechnology/pharmaceutical industry,
- marine & aerospace industry, and
- machinery & equipment industries.

Industries likely to be exposed to keener competition during the year include:

- textiles and apparels,
- automotive,
- wood based products especially furniture,
- plastic products, and
- electrical products.

ECONOMIC OUTLOOK

Operating Environment in 2005

The agriculture sector which is to be developed as the third engine of growth is expected to continue to grow, but at a more moderate pace of 3.8% in 2005 on account of lower prices and production of palm oil and rubber following a high base in 2004. Among factors affecting output of palm oil will include slower demand from importers in China and India, high stockpile brought forward from 2004 and strong output of soybean oil in 2005. Meanwhile, crude palm oil price is expected to average between RM1,300 - RM1,400 per tonne in 2005 compared with an average of RM1,650 per tonne in 2004.

The mining sector is expected to record a higher growth of 5.0% in 2005 on account of higher production in both crude oil and natural gas. Better demand, firm prices of oil and gas and expansion of new oil and gas fields would boost output of both mineral products.

The construction sector is expected to turnaround to grow by 1.5% in 2005 (2004: -1.9%) to be supported by the implementation of new and ongoing infrastructure projects (the Phase 2 of the East-West Highway, the Tanjung Bin Power Station in Johor, interstate power projects and national sewerage projects in northern area). Higher activities in residential property development would also support construction activities during the year. Activity in the non-residential sub-sectors such as commercial and industrial is expected to remain subdued.

The services sector, the second engine of growth, is projected to expand by 5.5% in 2005 (2004: 6.7%) supported by continued expansion in trade and tourism activities, communication as well as financial services. Tourist arrivals are projected to increase to 16 - 17 million in 2005 from about 15.7 million registered in 2004.

Sub-sectors likely to experience strong growth:

- wholesale & retail trade, hotels & restaurants;
- transport, storage and communication; and
- finance, insurance & business services sub-sectors.

Government promoted activities include:

- ICT-related services
- Business process outsourcing (BPO)
- Healthcare
- Private education
- Tourism

INFLATION

Inflation rate is expected to be slightly higher in 2005 following the gradual rise in the consumer price index (CPI) in the last few months of 2004. The CPI is expected to rise to above the 2.0% level averaging at about 2.5% in 2005 (2004: 1.4%) as excess capacity in the economy is being fully absorbed, and also reflecting the pass through effects of high oil prices in the economy following the gradual reduction in the government's fuel subsidy.

BALANCE OF PAYMENTS

The country's balance of payments position is expected to remain healthy in 2005. A sustaining surplus in the merchandise goods account, is expected to keep the current account in a favourable surplus position during the year, as the services account remain in deficit.

BANKING SYSTEM

In the banking sector, with real GDP expected to grow by about 5.5-6.0% in 2005, loan growth can be expected to stabilise in the region of 8.0% (2004: 8.5%), supported by a revival in business loans as investment activities continue to expand.

MONETARY POLICY

Monetary policy is expected to remain accommodative to ensure domestic demand remains healthy especially in the face of slowing external demand. Interest rates are expected to remain at current levels at least up to the first half of 2005 given the ample liquidity in the banking system and a relatively moderate inflation. Any tightening will only be in the second half of 2005 with the overnight policy rate likely to be raised by 50 bps in two steps bringing the rate up to 3.2% at the end of the year. No aggressive hike in interest rate is expected as the central bank's focus will be to ensure private sector expansion remains on track.

(Source: BCB's economic research department)