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"REGIONAL ECONOMIC AND STRATEGIC OUTLOOK –
CHALLENGES AND EXPECTATIONS"

Distinguished Guests
Excellencies
Ladies and Gentlemen

This is the 3rd consecutive year I am speaking at ASLI's Annual Strategic Outlook Conference. The fact that I've been invited back again this year can only mean one of two things: either I must have made some interesting points the last time round, or you could not find anyone else to take my place. In any case, let me begin by expressing my thanks to ASLI for your kind invitation to speak once again at this year's Annual Strategic Outlook Conference. This meeting is indeed timely as it will set the tone for the next 12 months. As you all know, our region is facing a time of great turmoil. Many countries in South and Southeast Asia have seen destruction and loss of life of unprecedented magnitude arising from the Tsunami waves on 26 December last year. The lesson of this catastrophic disaster is that no matter how well we are prepared for any eventuality, we can never be prepared for the unexpected event, the unforeseeable circumstance. It is therefore with a humbling sense of man's inability for foresight and prediction, that I share with you this morning my thoughts on the economic and strategic outlook for Asia in this coming year.

My presentation today has three objectives: to review the economic outlook of the world; to discuss in detail the resulting prospects and issues for Malaysia and lastly, to examine how Malaysia can overcome these challenges.

East Asia's Economic Outlook

1. The global economy is set for a slowdown in 2005. Global GDP is expected to grow at 3.1 percent in 2005, down from an expected 4 percent in 2004. However, this overall growth rate is still healthy and represents the fastest growth on a global basis in the last two decades. If we look at the regional landscape, we should expect to see a slow down of the US, China and the Eurozone economies. A number of other Asian countries are slowing down but as a whole, Asia's growth remains robust and leads the rest of the world. Let me touch briefly on the prospects for China, India, Japan, the EU and the United States as these represent the major economies that are most interrelated with Southeast Asia and our own economy.

2. China is forecasted to grow at a sizzling 8.8% in 2005, slowing down only slightly

from 9.4% in 2004. Adjustments in macroeconomic policies are working to prevent the economy from overheating and we should see a soft landing. Although declining slightly, China will continue to enjoy robust growth compared to the rest of Asia. With the planned liberalization of global textile markets from 2005, China's economy is set to gain further momentum from additional increases in textile exports.

3. India is set to grow at 6.8% in 2005, up from 5.9% in 2004. Growth is expected to come from the industrial sector followed closely by the services sector. For what was once a relatively closed economy, India's annual exports now stands at over US\$60 billion, fuelled by its attraction as a leading center for IT, software production and outsourcing. I just learned of the latest catchphrase among IT executives: Everyone is worried about the possibility of "being Bangalored". Make no mistake. India is set to be the next economic powerhouse in Asia along with China.

4. Japan's economy continues to show signs of robust recovery. Although driven primarily by exports, domestic demand is also making a significant contribution to growth. Given that this recovery comes on the back of significant structural adjustments to the Japanese economy, as opposed to a cyclical upturn, we should expect a strong foundation for long term, sustainable growth. While Japan is no longer a major trading partner, Japanese foreign direct investment (FDI) remains an important contributor to Malaysia's economy and a vital factor in deepening our scientific and technological base.

5. Moving westwards, prospects for Europe remain neutral for the coming year. The Euro zone's GDP growth is expected to be flat at 2.2% in 2005. However, domestic demand is expected to increase due to the recent expansion of EU. We should expect to see a significant realignment in terms of greater intra-EU trade and investment flows. This will mean more competition and effort will be required to attract European investors to our region.

6. Finally, prospects for the largest economic powerhouse. The US economy is expected to face a slowdown in 2005 due to the twin trade and budget deficits and the significant decline of the US dollar. China has been the main contributor of the trade deficit, comprising 30% of total US imports. The widening trade deficit is a major issue for the US. The US commitment to the global war against terror has meant an increase in military spending and the electoral commitment to tax cuts will both combine to worsen the budget deficit. In the absence of radical measures to reverse the trade deficit and pursue a policy of fiscal balance, we should expect the US dollar to be under threat in 2005.

7. With the external environment improving in the past six months (with the notable exception of the US), the immediate economic outlook for East Asia looks moderately positive. The recent buoyancy in intra-regional trade among East Asian countries is another factor that augurs well for the region, as does the continued strength in domestic demand in most East Asian countries.

8. East Asia's synchronized economic growth that began in the second half of last year is expected to peak this year, close to its post-crisis high of 7.5% in 2000. With growth in the major industrialized countries and the PRC slowing to more sustainable levels in 2005, East Asia's growth is likely to moderate somewhat, but remain robust.

9. The combined GDP of East Asian countries is now forecast to grow 7.3% for 2004, about 0.7 percentage points higher than was forecast only about six months ago.

Looking ahead to 2005, East Asia is expected to post a somewhat lower, but still robust, GDP growth of 6.5%, although there will be significant differences in individual country growth trends.

Regional Policy Issues

10. The key challenge we face in East Asia over the next year or so is how to sustain robust GDP growth at a time when US interest rates and domestic inflation rates begin to trend upwards from their historical lows. This would no doubt require, among other adjustments, a tightening of macroeconomic policies. Complicating this is the continued uncertainty over oil prices, which has already put upward pressure on inflation in several East Asian economies. Any further increase in oil prices will require a greater degree of policy tightening than would be the case if oil prices retreat.

11. The outlook for continued robust growth and strong balance of payments positions also presents an opportunity for East Asian countries to reassess the recent trend of building up foreign exchange reserves, and the management of exchange rates by some countries. China has signaled that they intend to move to a more flexible exchange rate regime as they continue with restructuring of the banking system and prepare for liberalization of the capital account.

12. While a more positive growth environment could have led to some fiscal consolidation, this has not occurred so far. Fiscal deficits as a share of GDP are low in Indonesia, Thailand and Singapore. In other Southeast Asian countries, budget deficits have been sizable for many years. Public debt has also been accumulating. Policies to improve fiscal balances will need to be put in place and these measures are likely to affect the short- and medium-term outlook for Southeast Asia.

MALAYSIA IN 2004 AND OUTLOOK FOR 2005

Ladies and Gentlemen

13. Despite reporting a moderate growth rate for the third quarter of the year 2004, the Malaysian economy is expected to be on track to record a growth rate of 7% for the whole of 2004. Expecting a slowdown, the Malaysian government has set the forecast for GDP growth at 6% for 2005. Despite this projection, Malaysia continues to be one of the world's fastest-growing economies. Malaysia enters 2005 from a position of strength with solid macroeconomic foundations. High economic growth with low inflation in recent years has contributed to a stronger domestic economy particularly the private sector. More companies have healthier balance sheets now than a year ago. Economic growth was well established last year, helped by the broad based growth across all economic sectors. Our economy has only been marginally affected by the tsunami tragedy as Malaysia is a well-diversified economy and does not heavily depend on one sector. Thus Malaysia's GDP projection remains unchanged in the light of this unfortunate event.

14. Growth in 2005 will be driven mainly by the private sector, as the government remains committed to fiscal consolidation by reducing the budget deficit to 3.8% of GDP in 2005 from 4.5% in 2004. Though private-investment growth remains strong, this was offset partially by the government's lower development expenditure during 2004. While the government has cut down on spending as 2005 is the last year of the Eighth Malaysia Plan, we remain committed to ensuring the appropriate

development funding under the Ninth Malaysia Plan to achieve sustained growth in line with the objectives of Vision 2020.

15. In 2005, the manufacturing sector will remain the main engine of growth followed by the services sector. The services sector is expected to contribute to about 57% of GDP, driven by high consumer spending, increased tourism, and growth in communications and finance. The manufacturing sector is expected to register 7.5% growth in 2005, down from 10.7% in 2004 due to a softening of global demand for electronics. The mining sector on the other hand, is expected to grow by 5.3% this year, up from 5% in 2004. This is due to higher oil output driven by increased global demand. Given that Malaysia is a net exporter of oil, higher oil prices are expected to cushion the decline in global electronics demand.

16. Malaysia's gradual slowdown is also in line with regional and global economic growth trends. Although oil prices have eased from its peak, concerns still remain regarding its volatility and this will have an impact on inflation rates. Oil has a major impact on consumer confidence given its effects on the prices of goods. In 2004, net oil importers in Asia such as China, India, Taiwan and Thailand experienced upward inflationary pressure due to rising oil prices, higher commodity prices and higher capacity utilization. While Malaysia is somewhat insulated from the negative effect of rising oil prices given its net export position, the Government will carefully manage the gradual reduction in the level of domestic fuel subsidies to minimize inflationary pressure. This move is in line with the Government's overall commitment to reduce the budget deficit and return to fiscal balance in the medium term.

17. FDI to Malaysia remains healthy, with inflows at RM4.1 billion in the 3rd quarter of 2004. In line with long term structural changes, it is significant to note that the services sector received the most FDI inflow at 40%, followed by the manufacturing sector at 30% and the oil and gas sector at 18%. Even with FDI competition from China and India, investors have continued to show sustained confidence in Malaysia. As an example, A.T. Kearney's FDI Confidence Index for 2004 rated Malaysia in 15th position, a major improvement from the 23rd position the previous year.

18. There has been much speculation recently about the Malaysia Ringgit. Let me assure you all that the Ringgit peg will not be revised in the near future. Given an expected slowdown of the world's economy and weakening export environment, the Government believes the peg continues provides much needed predictability and competitiveness for Malaysian exports. The revision of Ringgit peg will only be considered if the Ringgit is fundamentally misaligned or if there is a significant structural change in the global financial system. Our current assessment is that the Ringgit is not significantly undervalued compared to a range of regional currencies.

THE WAY FORWARD

Ladies and Gentlemen

19. After, discussing the economic outlook for the coming year, the government is confident that Malaysia can overcome the numerous challenges that lie ahead as we have untapped capacity for growth, abundant natural resources and a highly talented workforce. Consumers, investors, businesses and government all have a role to play in our continued success. Consumers should maintain confidence in the economy as inflation remains low at a mere 2% and this will in turn allow interest rates to be maintained at reasonable levels. However, we should not be extravagant in our

spending especially on luxury goods. Where ever possible, Malaysians should buy Malaysian made products as this will serve to strengthen local companies and minimize the outflow of foreign exchange.

20. With greater competition for inward FDI, especially from China and India, we should strategize on how to attract more FDI in particular niche sectors where we can generate attractive returns for investors. These include key services sectors such as outsourcing, call centres and shared services, high-end design and development in the manufacturing value chain, and investments that serve to unlock our rich biodiversity. At the same time, Malaysian investors must look for opportunities to go global. As the domestic market becomes saturated and more competitive, going international will provide greater returns and a larger market. Factors of production, such as raw materials can become less costly. There will also be transfer of technology and know-how. In addition, in the longer term, business risks can be diversified and make Malaysian investors less prone to the market volatility of any single country, including in our home market.

21. On the government's part, we will continue to manage national resources prudently. The Government will pursue fiscal consolidation in line with achieving a balanced budget in the medium term. We will continue to provide incentives and support the private sector to increase productivity, enhance human capital and technology development. Given the increasingly competitive environment for foreign capital, improving public service delivery and transparency will remain important priorities of the government going forward, as they serve to enhance investor confidence and lower the cost of doing business. At the same time, the government will continue to pursue social development goals that are consistent with our aim to achieve balanced and equitable development among the different ethnic groups and regions.

22. 2005 is also a year of planning for the Government as we prepare to debate, prioritise and plan for the Ninth Malaysia Plan. We will need to prioritize the programs that are in line with the nation's development agenda as there are limited resources. The thrust of the Ninth Malaysia Plan is investment in Malaysia's human capital. Our aim will be to develop an efficient and talented workforce and thus increase overall national productivity and growth. It is also important that no group is left behind as Malaysia progresses to become a developed nation. In this regard, the Government will be consulting broadly with all sections of society to gather views and inputs. As the Prime Minister has indicated, the Ninth Malaysia Plan will reflect the views of the broader cross section of society. The government will take into consideration the views of other political parties and NGOs to address the needs of the people.

Conclusion

23. Let me end by saying that I am encouraged by the emerging trends in East Asia, the immediate economic outlook for the region, and the prospects for Malaysia. No doubt, there are important risks and uncertainties surrounding this outlook. The key policy challenge going forward is to ensure the continuation of robust growth over the next few years while at the same time keeping inflation under control. Let me assure you that the government is committed to charting a path that will enable Malaysia to deal effectively with these challenges and allow us to enjoy continued stability and growth as we enter this second half of our journey towards Vision 2020.

Thank you