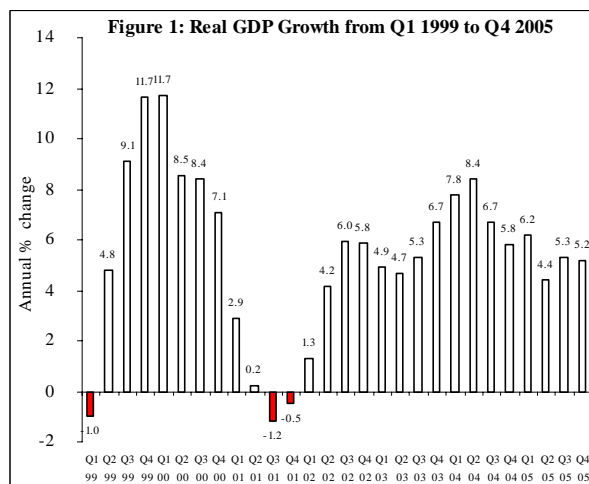


MALAYSIA

Growth performance

The Malaysian economy recovered in the second half of 2005, posting an annual growth rate of 5.3 percent, and the near-term outlook remains broadly positive. Real GDP expanded by 5.2 percent in Q4 2005 (5.3 percent in Q3 2005), supported mainly by strong growth in manufacturing output and sustained activity in the services sector (Figure 1).

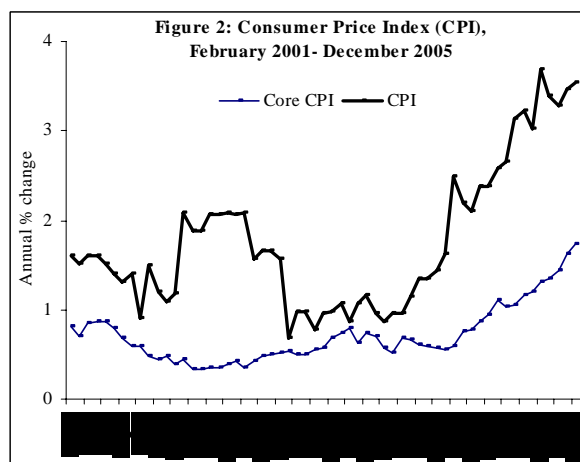


Value-added in the manufacturing sector picked up sharply in Q4 2005 (7.3 percent), spurred by the anticipated recovery in the electronic and electrical (E&E) products, which was reinforced by stronger expansion in chemical products, textiles and wearing apparel, transport equipment, and petroleum products. In addition to the pick up in production of E&E products, export-oriented industries received a boost from the imposition of new quotas by the U.S. on China's exports of textiles and wearing apparel. Output of domestic-oriented industries contracted further in Q4 2005 (-1.0 percent) as the increase in the production of petroleum products and transport equipment (mostly from higher car sales) was more than offset by further declines in fabricated metal products and iron and steel and non-ferrous metal. The overall capacity utilization index of the manufacturing sector remained broadly stable over the year, with the small decline in the domestic-oriented industry index compensated by a pick-up in that of the export-oriented industry index. The services sector continued to expand at a healthy rate during Q4 2005 (6 percent), underpinned by robust growth in consumption, and in trade and business services, including an expansion in new Islamic banking services (see below). Meanwhile, agricultural, mining, and construction activities all contracted in Q4 2005, owing to (partly weather-related) lower production of key commodities, especially palm oil, rubber, crude oil and natural gas, and continued

subdued activity in the civil engineering sub-sector. Construction activity continued to decline (but at a slower rate), reflecting subdued activity in civil engineering. From the expenditure side, exports of goods and services grew strongly in Q4 2005 (10.4 percent), supported by higher manufacturing exports, most notably E&E (14.7 percent), rubber (19.4 percent), and chemical (4.7 percent) products, the expansion of mineral exports (22.7 percent), especially crude oil and LNG, and higher growth in tourism receipts. Imports of goods and services continued to expand at a rate of around 8 percent. Aggregate domestic demand expanded by 7.3 percent in Q4 2005 (9.4 in Q3 2005), reflecting sustained growth in private consumption (9 percent) and sharply higher public consumption (12.8 percent). Growth in gross fixed capital formation declined sharply in Q4 2005 (0.4 percent). Looking ahead, despite some anticipated softening in aggregate domestic demand, from rising inflation and higher interest rates, a further increase in the global demand for E&E products is expected to raise overall growth to at least 5½ percent in 2006 and 5.7 percent in 2007.

Prices

Average consumer price inflation accelerated to 3.0 percent in 2005, more than double the rate in 2004 (1.4 percent) (Figure 2).¹ Consumer prices increased



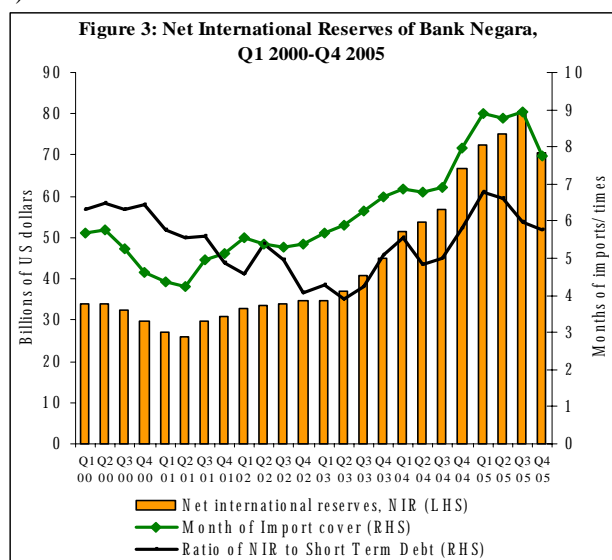
by 3.4 percent in Q4 2005, the same rate as the previous quarter, reflecting mainly the lingering effects on transportation and gross rents, fuel, and power

¹ The consumer price index (CPI) has been rebased from 2000 to 2005, following the revision of the CPI basket. Rates of change in the index prior to and including 2005 are measured relative to the former base period. The January 2006 increase is measured relative to the new base.

categories from the upward adjustment in retail prices of petroleum products in August and increases in most of the other categories, but especially in transportation and communications and food items. The rate of increase in consumer prices moderated slightly in January 2006, to 3.2 percent (year-on-year), but is expected to pick-up again in the coming months, following further retail price increases in petroleum products in late February 2006 and possible increases of 5-10 percent in power tariffs later on in the year.² It is estimated that core inflation doubled in 2005, but still remained low at between 1½ - 2.0 percent. The annual rate of increase in producer prices slowed to 7.1 percent in Q4 2005 (9 percent in Q3 2005), reflecting more moderate increases in crude oil prices and in prices of food, live animals, and manufacturing- and chemical-related products.

Financial account, reserves, and external debt

International reserves declined by about 12½ percent in the last months of 2005, but have since partly recovered. Net international reserves of Bank Negara Malaysia (BNM) fell from their August 2005 peak of RM304.3 billion (\$80.7 billion) to RM266.4 billion (\$70.5 billion) at end-December 2005 (Figure 3).



The decline reflected in large part slower gross inflows of portfolio investment, particularly into debt securities, as well as much higher gross outflows from the acceleration in the liquidation of debt and equity

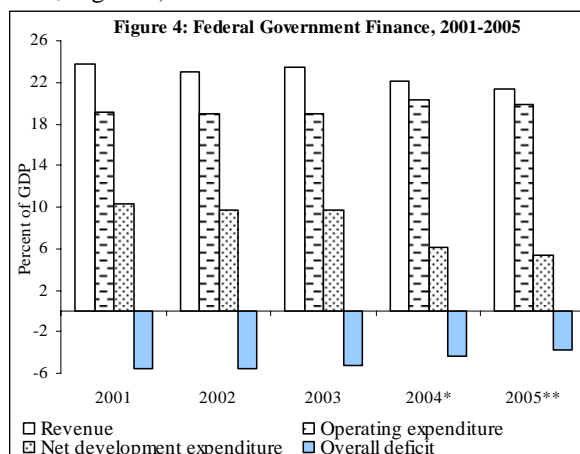
² Effective February 28, 2006, the retail prices of petrol and diesel were raised by 18½ percent and 23.4 percent, respectively—the sharpest increases in two years—while the retail price of LPG was raised by 20.6 percent. The Government has pledged not to increase fuel product prices again this year.

securities purchased by foreign investors since July 2005 (when the peg to the U.S. dollar was abandoned), as the subsequent appreciation of the ringgit turned out to be much less than expected. On a net basis, overseas inflows amounted to RM1.9 billion (\$504 million) in Q4 2005, reflecting the acquisition of a telecommunications company in Indonesia and overseas investment in the electronic, ship-building, and repair-related industries. For the year as a whole, gross FDI inflows increased slightly over 2004, to RM25 billion, or 5.1 percent of GDP, while portfolio investment declined by RM11.9 billion (about \$3¼ billion). By mid-March 2006, net international reserves had recovered to RM275.2 billion (\$72.9 billion), equivalent to an import coverage of 7.9 months of retained imports and over 6.7 times short-term external debt.

Total external debt declined in Q4 2005 to \$51.3 billion, from \$53.4 billion in Q3 2005, equivalent to 39.8 percent of GDP. In net terms, medium- and long-term external borrowing declined by \$0.8 billion to \$39.2 billion, as a repayment of Federal Government debt, following the maturity of a Euro bond in November 2005, and repayments by non-financial public enterprises (NFPEs) in the oil and gas, utilities, and transportation sectors, more than offset higher external loans by the private sector. Short-term external debt also declined, to \$12.1 billion, mainly reflecting lower short-term borrowing by the banking sector. At end-2005, the outstanding stock of short-term debt accounted for just under a quarter of total external debt and 17.3 percent of net international reserves.

Fiscal developments

Fiscal consolidation continued in 2005, despite lower revenues. The overall fiscal deficit of the Federal Government in 2005 was 3.8 percent of GDP, in line with the revised budget (from 4.3 percent of GDP in 2004; Figure 4).



Note: *Estimated actual and **Revised estimate

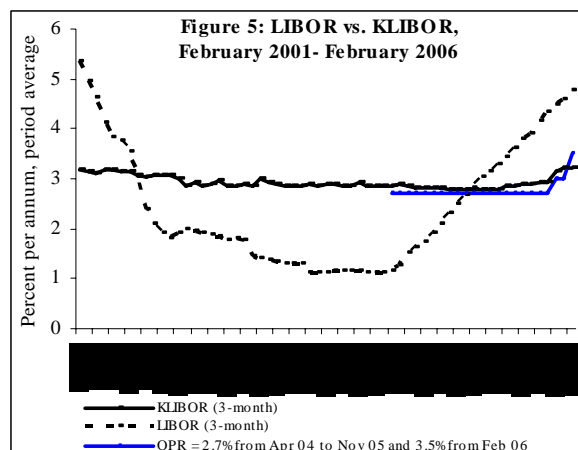
While total revenues declined by 0.6 percentage points of GDP over 2004, to 21½ percent of GDP, operational and net development expenditures (i.e. including net lending) declined by 0.7 percentage points of GDP, to 19.8 percent of GDP and 6.2 percent of GDP, respectively. The lower revenues reflected for the most part sluggish corporate income tax receipts. The overall fiscal deficit of the Federal Government was financed from domestic borrowings and the drawdown of realizable assets of the Federal Government. As a result, at end-2005, total outstanding debt of the Federal Government amounted to RM225.8 billion, or 45.7 percent of GDP (48.2 percent of GDP at end-2004), of which RM194.7 billion (39.4 percent of GDP) in domestic debt (40.5 percent at end-2004). Looking ahead, the increase in the retail price of petroleum products at the end of February 2006 is expected to lead to lower subsidies and help the Government meet the budget target of further reducing the overall fiscal deficit of the Federal Government in 2006, to 3.6 percent of GDP.³ The Government has recently announced the indefinite postponement of the introduction of a goods and services tax (GST) to replace the existing sales and service taxes. The introduction of the GST, which was announced in the 2005 Budget, was to have been made effective January 1, 2007. The specially formed Tax Review Panel, which has discussed a proposed model with the public and business community across the country over the last year, has asked for more time to modify the proposed model in light of comments received and allow more time for the necessary preparations.

Exchange rate and monetary developments

Following the shift to a more flexible exchange rate regime last July, the monetary policy stance has been tightened recently. Reflecting the recent increases in consumer price inflation, prospects for a possible further increase in the coming months, a widening interest rate differential with the U.S. (Figure 5), and a surge in outflows of short-term capital in the second half of 2005, the BNM raised its Overnight Policy Rate (OPR) twice in the last three months. The initial increase of 30 basis points—the first increase in the central bank's policy rate in seven years—was made on November 30, 2005, and was followed by a 25 basis points increase on February 22, 2006, raising the OPR to 3.25 percent.⁴

³ The 2006 Budget announced in September 2005 targeted a budget deficit of 3½ percent of GDP. Since then however, the authorities have estimated that the tax cuts included in the Budget are expected to lead to a revenue loss of about RM1 billion.

⁴ Recently, the BNM has signaled a more explicit commitment to maintain low inflation and anchor



As a result of these increases, the daily weighted average overnight interbank rate moved within a range of 3.24 percent – 3.28 percent in late February-early March. Also, contrary to the previous 8 months, the BNM conducted expansionary liquidity operations in the period September-November 2005 to offset the contractionary impact of the decline in international reserves. As reserves began to rise again, small contractionary operations resumed in December 2005. Feeling some pressure on their liquidity positions, at end-January 2006, the average lending rate (ALR) of commercial banks had risen to 6.15 percent, while base lending rates (BLR) had been adjusted to 6.21 percent. With regard to the exchange rate, the appreciation of the ringgit against the U.S. dollar accelerated recently (and by 2.2 percent since July 22, 2005), possibly reflecting renewed inflows of short-term capital.

Financial sector developments

The asset quality of the banking system strengthened further in 2005, and profitability improved modestly. The overall asset quality of the banking system, as measured by the ratio of non-performing loans (NPLs), continued to improve during the year as the ratio declined further to 5.8 percent, from 7.5 percent at end-2004.⁵ In level terms, NPLs declined RM6.8 billion (\$1.8 billion) to RM53.6 billion. However, through September 2005, NPLs of commercial banks (including Islamic banks) rose RM2.1 billion, reflecting higher NPLs in the property

expectations, including through the issuance of Monetary Policy Statements (used to announce the recent increases in the OPR) and the announcement of the schedule of Monetary Policy Committee meetings for 2006, each to be accompanied by a press statement.

⁵ On a net basis; i.e. total non-performing loans minus interest in suspense and specific provisions. NPLs are classified on a 3-month overdue basis. The NPL ratio edged up marginally in January 2006, to 5.9 percent.

sector (which rose from a share of 23½ percent of total NPLs to 27.7 percent), consumption credit (5½ percent share), vehicle purchases (4.6 percent share), and “other” NPLs (4 percent share). NPLs in the manufacturing sector continued to decline, to RM6 billion (12.8 percent share), while NPLs in the construction sector remained stable at RM5.6 billion (around 12 percent share). NPLs of both finance companies and merchant banks continued to decline, to RM4.7 billion. The capital position of the banking system also remained strong, with the risk-weighted capital ratio (RWCR) ending the year at 13.1 percent, from 14.4 percent at end-2004, on account of stronger growth in risk-weighted assets driven by the inclusion of market risk in the capital adequacy framework (effective April 1, 2005) and higher lending. The core capital ratio (CCR) improved to 10.2 percent, from 11.4 percent at end-2004. Meanwhile, gross operating profits of the banking system increased only modestly from last year’s level, to RM13.1 billion (RM12.6 billion in 2004). The annualized returns on average assets and equity of the banking system in 2005 were 1.4 percent (same as in 2004) and 16.9 percent (16.6 percent in 2004), respectively. Finally, as a post script, Danaharta was wound up in December 2005, marking the end of the financial sector rehabilitation measures implemented in the aftermath of the Asian financial crisis. The total cost incurred by Government for the financial rehabilitation efforts through Danaharta and Danamodal amounted to 2½ percent of GDP, considerably less than other crisis-hit countries.⁶

The financial system is becoming more diversified, including through the development of Islamic financial institutions and products. The Islamic financial system has grown rapidly since 2000, and comprises Islamic banking institutions, takaful (insurance) companies, and non-banking institutions, as well as Islamic money and capital markets (see below for recent developments in the latter).⁷ At end-2005, Islamic banking system assets accounted for 11.3 percent of total banking system assets, while deposits accounted for a 11.7 percent share. Recently, the sub-sector has been further liberalized by allowing for the entry of new foreign players and increasing the potential for foreign participation in the domestic financial markets.⁸ This diversification of the financial system has also been accompanied by new risks, which

⁶ Danaharta was established as a commercial entity to acquire and resolve NPLs, while Danamodal was set up to identify weak but viable banks in need of capital injections (see Box 3 in *Malaysia Economic Update*, November 2004).

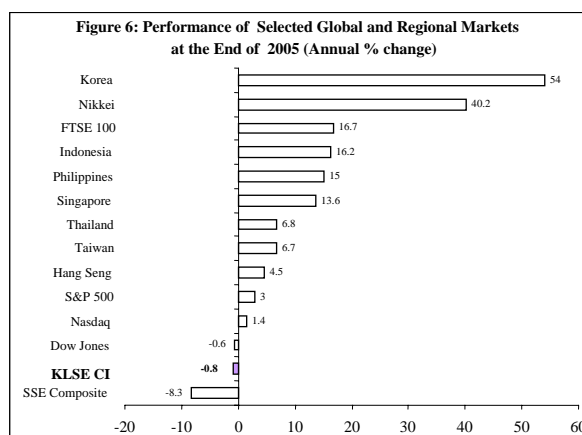
⁷ Malaysia has the largest Islamic banking, capital, and takaful markets in the world.

⁸ See *Malaysia Economic Update* (October 2005).

are generally more complex and could have profound systemic implications. As a result, the authorities are strengthening regulations and supervision in this area. While the Basel II initiatives on the identification of credit, market, and operational risks can be assimilated into Islamic banking, these initiatives are being complemented by Shariah compliant measures specific to Islamic financial transactions.⁹ All Islamic banking institutions are required to have a Shariah Committee to ensure that products and services are Shariah-compliant and an appropriate internal audit function. In addition, the Islamic Financial Services Board (IFSB) is developing prudential, regulatory, and disclosure standards for Islamic finance with a view to promoting uniformity in the best practices on the governance of Islamic financial institutions worldwide. In that connection, the IFSB has recently issued two prudential standards on risk management and capital adequacy for institutions offering Islamic financial services, which are recommended for implementation in 2007. The IFSB has also made progress in developing three other standards; on corporate governance, transparency and market discipline, and the supervisory review process.

Corporate sector developments

The performance of the corporate sector was lackluster. In particular, the stock market was subdued in 2005, as share prices in the Kuala Lumpur Composite Index (KLSE CI) listed on Bursa Malaysia ended 2005 at 899.79, 0.8 percent lower than a year earlier (Figure 6).



The Malaysian bourse lagged well behind all regional comparators, except the Shanghai composite (-8.3

⁹ Under Shariah injunctions, interest or usury is prohibited, and all financial transactions have to be accompanied by genuine trade and business-related transactions.

percent).¹⁰ The average daily volume of shares traded on Bursa Malaysia was also slightly lower at 474 million shares in 2005, compared to 494 million in 2004, while market capitalization declined by 3.7 percent to RM695.3 billion. Stock market sentiment was negatively affected by higher global oil prices, increasing domestic inflation, and the ensuing expectation of higher interest rates which would dampen consumer spending and corporate earnings.¹¹ At around 7 percent, corporate earnings in 2005 were about half the rate expected by most analysts at the beginning of the year. On a positive note, efforts were continued to improve the quality of listed Malaysian companies, including by introducing incentive measures (regulatory and tax regime) to encourage mergers and acquisitions (M&As), and enhancing the corporate governance of Government-linked companies (GLCs) and improving their operational performance.¹² With regard to the latter, because of their size and the fact that they operate in key sectors of the economy, more commercialization of their operations could have a significant impact on overall corporate profitability, investment, and growth.¹³ Khazanah, the Government's investment holding company, has been entrusted with overhauling the management and functioning of the GLCs, including through changes in the boards and management, and the introduction of performance-based employment contracts. After years of weak performance, shares in GLCs outperformed the broader market in late 2004, but have slowed since to track the KLCI, reflecting the more difficult reforms ahead, including sizeable lay-offs, and the time required to translate management changes into improved operational performance. Meanwhile, the recent performance of some of the largest GLCs has been disappointing. In particular, Malaysian Airlines reported losses of RM1.3 billion (over \$347 million) in 2005, the worst performance in five years.¹⁴ In January 2006, shares in Proton Holdings plunged to their lowest level in four years after Volkswagen AG called off plans to assemble and sell vehicles via the Malaysian

carmaker. Meanwhile, the country's power monopoly, Tenaga, is grappling with debts of around RM30 billion (\$7.95 billion), making it the largest borrower in foreign currency. Despite this downturn in corporate performance, the private sector raised \$1.13 billion in fresh financing from 79 new initial public offerings (IPOs) in 2005. The largest IPOs included Titan Chemicals (\$115.3 million), Bursa Malaysia (\$43.7 million), and AXIS-real estate investment trust (REIT; \$25.9 million).¹⁵ The ringgit bond market also continued to grow strongly in the first three quarters of 2005, as companies sought to take advantage of the then low interest rate environment. By end-2005, total outstanding ringgit bonds amounted to \$109 billion, more than 20 percent higher than at end-2004, of which 56 percent were corporate bond issues.

The Malaysian Islamic Capital Market continued to exhibit strong growth. In particular, there has been a significant expansion in Shariah-compliant products, such as equity, unit trusts, and bonds. As of October 28, 2005, there were 857 Shariah-compliant stocks listed on Bursa Malaysia, with a market capitalization of more than \$105 billion, representing about 60 percent of total market capitalization. Over the last decade, Islamic unit trust funds have been growing at a compound annual rate of 25½ percent, compared to an annual rate of just over 8 percent for the unit trust industry as a whole. As of September 2005, there were 83 Islamic unit trust funds with a net asset value of \$2.1 billion, or just over 8 percent of total net asset value of the unit trust industry. Finally, there has been a significant increase in the size of the Islamic bonds issued by corporate bodies. As of November 2005, \$2 billion had been issued (26 percent of total), bringing total Islamic corporate bonds outstanding to \$31 billion (28 percent of total).

¹⁰ The Morgan Stanley Capital International Asia-Pacific Index rose by over 20 percent in 2005.

¹¹ By March 17, 2006, the KLCI had recovered to 922.62, 2½ percent higher than at end-2005.

¹² A ten-year GLC Transformation Program was launched in July 2005.

¹³ There are 57 listed GLCs (including subsidiaries), and they represent nearly 40 percent of stock market capitalization. They operate in key infrastructure and utility sectors, including electricity, telecommunications, airlines, and airport services.

¹⁴ The losses would have been even higher had the reporting period not been shortened to nine months following the change in the company's financial year from March to December.

¹⁵ By end-2005, 1,022 companies were listed on Bursa Malaysia, up from 963 at end-2004; 646 companies on the Main Board, 268 on the Second Board, and 107 on the MESDAQ (Malaysian Exchange of Securities Dealing and Automated Quotations) Market.