MALAYSIA ECONOMIC UPDATE
(November 2006)

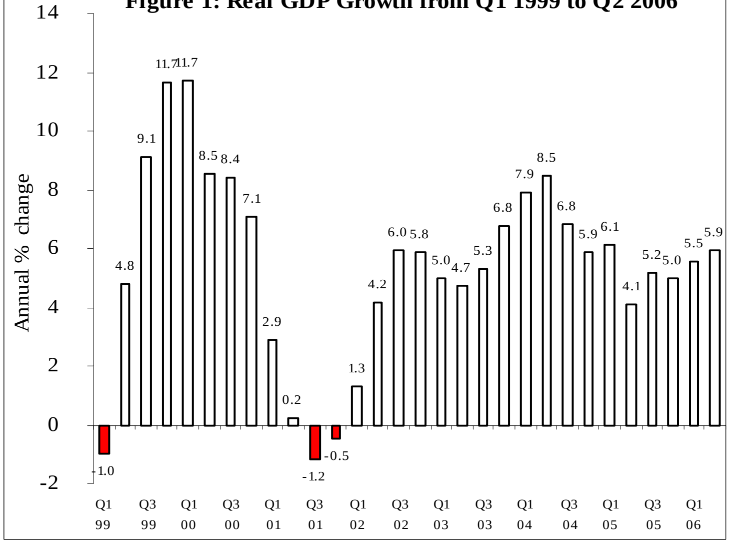
The Malaysian economy has done remarkably in the first half (H1) of 2006 with real GDP growing at 5.5 and 5.9 percent in the first and second quarters respectively. Looking forward, medium-term prospects remain broadly positive. Malaysia is expected to grow by 5.5 percent in 2006 and 2007, and 5.5-6 percent through 2008, though more recent numbers and projected budgetary disbursements suggest that 2006 growth could be higher. Among the factors contributing to growth next year are likely to be increased public investment spurred by rapid implementation of the twenty high-impact projects, the private investment response to infrastructure investments and other reforms measures and continued strong demand for commodity products.

Growth Performance

Year-on-year growth increased to 5.5 percent in Q1 2006, higher than in Q4 2005 (5.0 percent), and increased further to 5.9 percent in Q2 2006, above market expectations (Figure 1). As a result, real GDP growth increased to 5.7 percent in the first half of 2005. The rebound in economic activity was mainly driven by the strong growth in manufacturing output (8.4 percent) contributing 46.3 percent to real GDP growth. Growth in manufacturing was spurred by a recovery in external demand for electronic and electrical (E&E) products started in the second half of 2005. Also, driven by a strong demand for commodity products, agriculture performed well in H1 2006, achieving 6.6 percent growth, and contributing 9.3 percent of GDP growth. The services sector remained the largest contributor to total real GDP growth (56.7 percent), despite a slight slowdown. Growth was however affected by negative contributions from mining (-1.0 percent) and construction (-0.5 percent).On the expenditure side, domestic demand expanded by 9.4 percent underpinned by a rebound in gross fixed capital formation (5.4 percent).

Looking ahead, despite prospects of a softening of the external demand in the second half of 2006, economic growth for 2006 could actually be above market expectations, in part due to increased government disbursements in the second half of this year and the resulting boost in domestic consumption. Also, Medium-term prospects remain broadly positive. Malaysia is expected to grow by 5.5 percent in 2007, and 5.5-6 percent through 2008. The major impetus for Malaysian growth in 2007 will be public investment and stronger demand for commodity products. The global demand for palm oil and rubber, Malaysia's top two largest commodity products, is expected to continue its momentum.

Figure 1: Real GDP Growth from Q1 1999 to Q2 2006

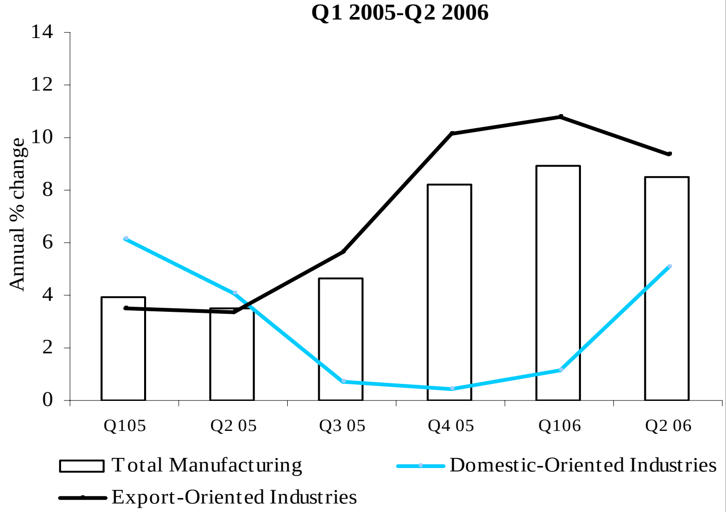


Production

Manufacturing sector picked up in the first half of 2006. The manufacturing sector in GDP grew by 8.4 percent y-o-y, twice the pace of last year, and contributed around 46 percent to total real GDP growth in the first six months of 2006. Value added of Manufacturing also picked up as it grew by 8.5 percent in Q2 2006. This expansion was supported mainly by the export-oriented industries (9.4 percent in Q2 2006).

The output growth of export-oriented industries registered a better performance in Q2 2006, relative to last year (See Figure 2). The major impetus was a recovery in electronics sector which grew by 11.7 percent in Q2 2006 (3.2 percent in Q2 2005). In addition to E&E, the production of chemicals and chemical products; petroleum products; and textiles and wearing apparel enjoyed a double-digit growth (11.1 percent, 15.8 percent, and 13.9 percent in Q2 2006, respectively). A favorable weather condition also helped rubber production to increase by 8.4% in Q2 2006 relative to a contraction of -0.7 percent in Q2 2005. While output growth of export-oriented industries was robust in Q2 2006, it declined compared to Q1 2006 (to 9.4 percent, from 10.8 percent), mainly reflecting the slowdown in the demand for Electronics which contracted by half from 23.1 percent in Q1 to 11.1 percent in Q2 2006.

Figure 2: Change in Industrial Production Index, Q1 2005-Q2 2006



The output of domestic-oriented industries also gained momentum in Q2 2006, growing at 5.1 percent, supported by growth in non-metallic mineral products (1.2 percent), food manufacturing (2.2 percent), fabricated metal products (25.1 percent), and paper products (8.2 percent). Agriculture performed well in H1 2006, achieving 6.6 percent growth, better than the previous period (5.1 percent in H1 2005), while mining sector contracted in the first half of 2006 (-0.9 percent). Although, services sector slightly slowed down in the first half of 2006 (5.6 percent in H1 2006 against 6.4 percent in H1 2005), it remained the largest contributor to total real GDP growth (56.7 percent). This slowdown occurred in all services except finance, insurance, real estates and business services. Finally, the construction sector continued to contract (by -1.1 percent in H1 2006) but improved slightly from H1 2005 when it contracted by -2.2 percent.

Domestic demand

Real domestic demand remained buoyant in the first half of 2006, spurred by a pickup in investment. Despite a slowdown in private consumption (7.4 percent from nearly 9 percent in H1 2005) due to increasing inflation and interest rates, Malaysian real domestic demand expanded by 7.2 percent in H1 2006. The major impetus was a strong growth in gross fixed capital formation which posted a solid 9.4 percent growth, its highest rate since 2004. Also, exports of goods and services expanded by 4.9 percent, supported by higher exports of manufactured goods and agricultural commodities, while imports of goods and services grew by 7.7 percent, slightly higher than Q2 2005.

Growth in gross fixed capital formation came in even higher in the first quarter of 2006 at 11.4 percent, the best performance in many years; in the second quarter, it declined to 7.3 percent, but for H12006 as a whole it remained the best since 2004. Fixed investment and inventories contributed equally to this investment growth, reflecting improving business confidence in the first half of the year. Private investment did well too as overall capacity utilization increased to around 78 percent.

The rebound in total investment is most welcome, especially since private investment has been remained particularly weak in Malaysia after the 1997 crisis.

There are several reasons explaining the weakness in private investment recovery in Malaysia. Several studies including World Bank (2005)[1], UBS (2006)[2] have emphasized the role of structural factors in the slump in private investment. Regulatory barriers, especially for services, and skill shortages are identified as the two most binding constraints to private investment recovery. These constraints increase the cost of doing business and reduce expected profitability of future investments, in the face of more intense competition from other emerging economies. Malaysia needs to move up the value-chain through domestic innovation and value-addition to remain competitive, and focus is increasingly towards a more knowledge-based economy. Moving forward, accelerating the pace of reform in the areas of economic regulation, education and labor market will be critical for Malaysia to attract more skill-intensive and technology-investments in both goods and services sectors and to improve productivity. The Malaysian government is well aware of the situation and the Ninth Malaysia Five-year Plan (2006-2010) identifies these issues; efforts are already underway to address them through reform and through specific high-impact projects.

External demand

Export grew moderately in the first six months of 2006. Merchandise exports of manufacturing goods expanded by 10.3 percent, compared with 10.6 percent in H1 2005, while exports of agricultural products[3] recorded a higher growth rate of 7.1 percent in H1 2006 relative to 4.1 percent in the same period of last year. Export growth rate of minerals[4], however, slowed down significantly from 30.1 percent in H1 2005 to 17 percent in H1 2006. Within manufacturing exports, the exports of E&E products slowed down from 9.3 percent in H1 2005 to 6.9 percent in H1 2006 due mainly to a slowdown in exports of electrical machinery and appliance (3.8 percent in H1 2006 and 10.5 percent in H1 2005).

However, export growth of other manufacturing products grew by double of H1 2005 rates. These included, for example, transport equipment (80 percent), rubber products (28.5 percent), manufactures of metal (29.4 percent), and toys and sporting goods (19.3 percent). The favorable agricultural exports were supported mainly by rubber exports as a result of a surge in world rubber prices by more than 50 percent this year. The slowdown in exports of minerals was due to a

[1] "Malaysia: Firm Competitiveness, Investment Climate and Growth", World Bank, June 2005.
[2] Sanjay Mathur "The Longer Term Issue for Malaysia" UBS, November6, 2006.
[3] Agricultural products include rubber, saw logs, sawn timber, and palm oil.
[4] Mineral products include tin, crude oil and condensates, and liquefied natural gas.

contraction in export volume of tin (-27.4 percent), crude oil and condensates (-6.3 percent), and liquefied natural gas (-5.3 percent), however, a rising oil prices helped the export value growth of the last two to sustain but at a slower pace.

Spurred by higher prices, exports of commodities have seen healthy growth in 2006. Rubber exports grew by 56 percent in January-July 2006, compared to 0.1 percent in the first seven months of 2005. This is due mainly to the surge of rubber export prices by almost 50 percent in 2006 combined with a supply constraint in major exporters like Thailand and Malaysia. Palm oil exports also grew by 2 percent in RM value terms in the first seven months of 2006, compared to -3 percent in the first seven months of 2005, driven by a 4 percent increase in export prices between January and July 2006. Going forward, although, palm oil prices are expected to stabilize, exports will continue to grow as a result of the stronger food consumption demand from China and India as well as industrial demand for the bio-fuel programs in EU-25 and China. Malaysian rubber export growth depends mainly on the global demand for automobile, in particular China's.

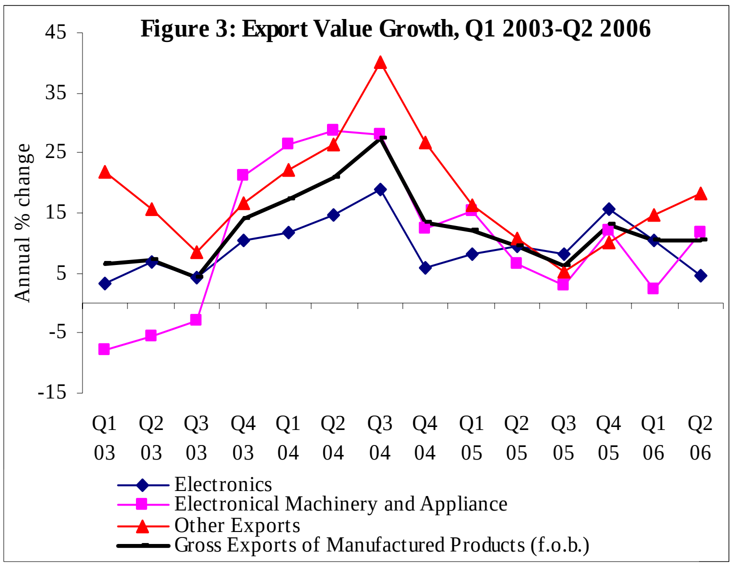


Figure 3: Export Value Growth, Q1 2003-Q2 2006

Import growth increased sharply in the first half of 2006. The growth in merchandise imports picked up across all main categories, except intermediate goods (Figure 4). The growth of imports of capital goods increased to 17.8 percent, from 8.5 percent in H1 2005, reflecting the large increase in Q1 2006. The expansion in imports of consumption goods increased to 13.4 percent, from 7.5 percent in H1 2005, reflecting the improving consumer confidence. The Consumer Sentiment Index (CSI) rebounded to 102.4 points in the Q2 2006 from a low level of 90.1 points in Q1.

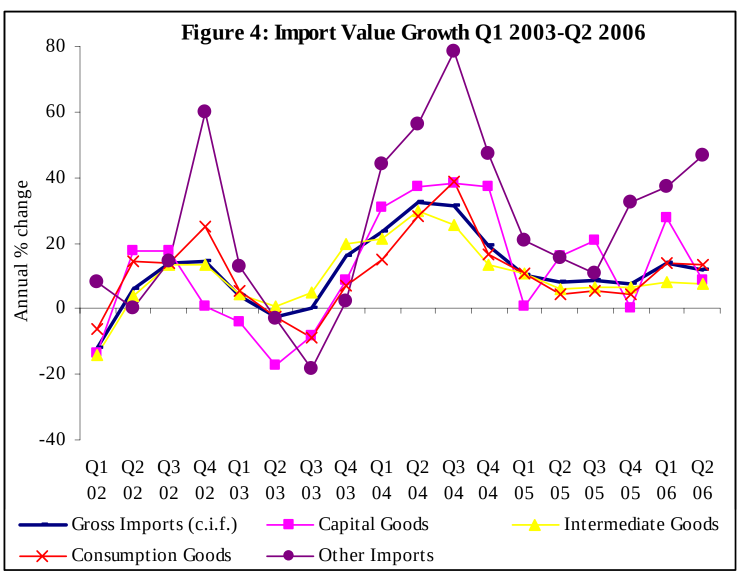
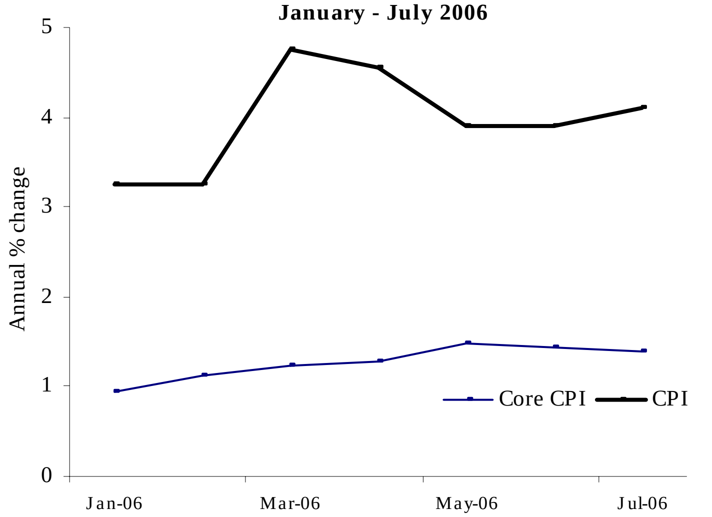


Figure 4: Import Value Growth Q1 2003-Q2 2006

Prices

As in other economies around the region, inflation has picked up and is expected to reach 4 percent in 2006, the highest in eight years. Consumer price inflation rose to 4.1 percent at the end of the second quarter of 2006 from 3.7 percent in the first quarter. The increase was driven mainly by reductions in fuel subsidies in February and the resulting 23 percent jump in fuel prices. Higher duties on cigarettes and liquor, steeper highway toll charges, and a 12 percent rise in electricity tariffs in June also contributed to higher inflation[5].

Figure 6: Consumer Price Index (CPI), January - July 2006



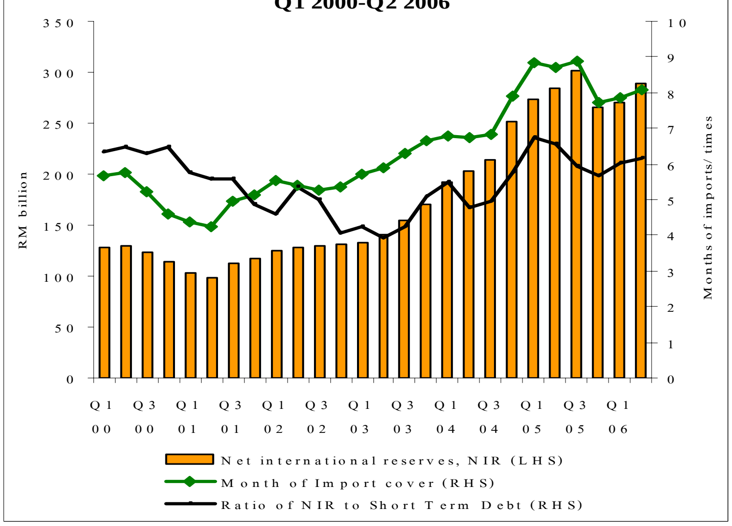
However, headline inflation seems to have peaked in H1 2006, as its rate has declined to 3.87 percent for the first eight months of the year from 3.94 percent for H1. While core inflation (excluding food, beverages, and transportation) doubled in 2005, it remained relatively low, averaging less than 2 percent.

To curb inflation, Bank Negara Malaysia (BNM) raised the benchmark overnight policy rate (OPR) by 80 basis points to 3.5 percent between November 2005 and April 2006. However, the OPR is expected to remain at 3.5 percent the rest of the year, given concerns over the global economic slowdown.

Financial account, reserves and debt

The overall balance of payments continued to be strong in 2006. From a level of $70.1 billion at end-2005, net international reserves of Bank Negara Malaysia increased to $78.8 billion as at June 30, 2006 (Figure 5). By end-October, reserves had increased further to $79.6 billion equivalent to 8.1 months of retained imports and 6.7 times the short-term external debt. Net portfolio inflows increased by RM1.3 billion in Q2 2006 (RM4.2 billion in Q1 2006), reflecting sustained foreign participation in Malaysian debt securities.

Figure 5: Net International Reserves of Bank Negara, Q1 2000-Q2 2006



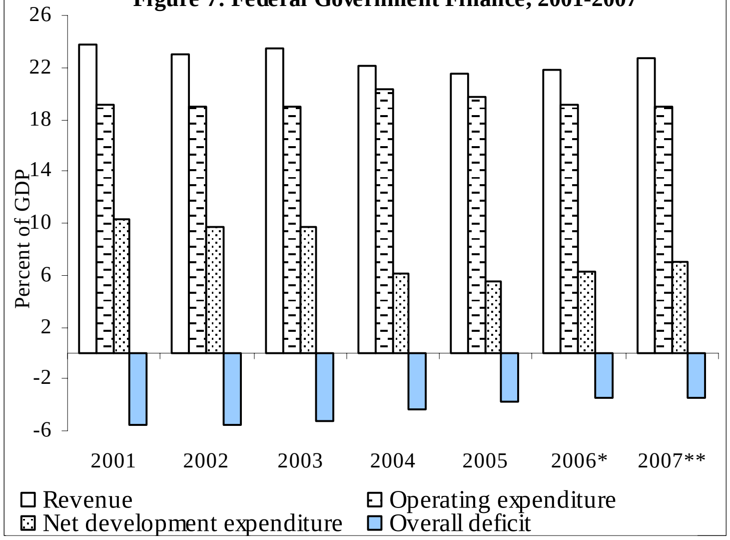
[5] Electricity accounts for 3 percent of the CPI basket.

Total external debt in RM terms declined slightly from RM197 billion at end 2005 to RM196.8 billion in H1 2006 (equivalent to $53 billion or 37.9 percent of GNP). **Medium- and long-term net borrowing** by non-financial public enterprises and private sectors in H1 2006 amounted to RM 120.7 billion, slightly higher than that at end-2005(RM120.2 billion). **Short-term debt** also increased to RM46.9 billion (or $12.7 billion) in H1 2006 resulting from the short-term borrowing by banking sector. **Total Federal Government external debt**, however, reduced by about RM 1 billion from end of 2005.

Fiscal policy

The budget for 2007 announced on September 1, 2006 is expansionary aimed at supporting domestic demand. The budget increased federal government development expenditures by 24.3 percent in 2007 compared to 17.3 percent in 2006. More than RM 100 billion is earmarked for "high-impact" projects aimed at encouraging private investment and reducing regional inequality. The budget has also lowered the corporate income tax by one percentage point. As a consequence, the financial position of the general government, which reflects the consolidated accounts of the Federal Government, state governments, local authorities and statutory bodies, is projected to show a deficit of 3.4 percent of GDP, a slight reduction from the 2005 level of 3.5 percent of GDP.

Figure 7: Federal Government Finance, 2001-2007



The Ninth Malaysia Plan (2006-2010) and the third Industrial Master Plan target the development of higher value-added manufacturing and expansion of the services sector such that services account for 60 percent of GDP in 2020 compared to 50 percent currently; this will involve higher investments in infrastructure projects, which accounts for the higher development expenditures in the budget

However, because of the expected overall surplus of non-financial public enterprises (NFPEs), reflecting the strong performance of Petronas, Tenaga Nasional Berhad, and Telekom Malaysia Berhad, the consolidated public sector fiscal position is projected to remain significantly positive, at RM33.2 billion or 5.6 percent of GDP.

Note: *Estimated actual, **Revised estimate and ***Budget estimate