

## Malaysia

The Malaysian economy achieved robust 5.9 percent GDP growth in 2006, up from 5.2 percent in 2005. Manufacturing expanded 7 percent (5.1 percent in 2005), with the fastest-growing products being electronic and electrical (E&E), petroleum, rubber, and metal products, although there was some slowing in the second half (H2), resulting from high stocks and weaker external, especially US, demand. Agricultural output increased 6.4 percent (2.5 percent in 2005), reflecting higher natural rubber and crude palm oil production. The services sector expanded 6.5 percent, supported by growth in government, finance, and business services. Spurred by higher household disposable income and commodity prices, private consumption rose by 7.0 percent. Public consumption also expanded at a similar rate, accelerating to a 40 percent increase in the second half. Gross fixed capital formation expanded by 7.9 percent (4.7 percent in 2005).

Gross exports in 2006 rose 10.3 percent to RM 589 billion. E&E exports, which accounted for about half of total exports, increased by 6.4 percent. Natural rubber and palm oil exports were also strong as a result of increases in both volumes and prices. Crude oil and liquid natural gas also strengthened mining exports. Gross imports increased by a similar magnitude as exports, leaving the trade balance at RM 108 billion, an 8.7 percent increase from 2005. Despite strong full-year performance, gross exports fell slightly in Q4 (E&E exports dropped by 4.7 percent). In Q1-Q3 2006, the current account surplus reached RM 65.3 billion (11 percent higher than the same period in 2005), while the balance on capital and financial accounts swung to a deficit of RM 23.5 billion from a surplus of RM 9.7 billion in 2005. Gross foreign direct investment inflows increased steadily in 2006, reaching RM 18.1 billion at the year-end. Despite higher FDI inflows, the swing to deficit on the overall capital account arose from a significant increase in the short-term loans extended by non-resident controlled companies to their related companies abroad (as part of centralized treasury operations). The overall balance of payments in the first three quarters of 2006 registered a surplus of RM 27.9 billion, a 44.0 percent decline from the same period in 2005. Net international reserves at end-2006 reached RM 290.4 billion, up 9.5 percent from 2005. Meanwhile external debt dropped 8.3 percent from 2005, mainly attributed to a significant decrease in banking sector debt and debt repayment by the public sector.

Fueled by higher petroleum-related revenues and individual income taxes, federal government revenue rose 20.2 percent in the first three quarters of 2006. On the expenditure side, while operating expenditure grew moderately, development expenditure expanded by nearly 26 percent, reflecting larger spending on trade and industry and public utilities. Overall, the government recorded a budget surplus of 2.7 percent of GDP compared with a deficit of 0.4 percent of GDP in Q1-Q3 2005. Meanwhile, federal government debt reached RM 245.8 billion, an 8.0 percent increase from 2005.

Consumer price inflation in 2006 picked up slightly to 3.6 percent (3.0 percent in 2005). Following lower oil prices and easing price levels in Malaysia's trading partners, inflation moderated in H2. The Malaysian Ringgit continued to appreciate modestly against the US dollar. At end-2006, the exchange rate was RM 3.53 from RM 3.78 per US dollar at end-2005. Monetary policy has been tight but stable. The Overnight Policy Rate (OPR) has remained at 3.50 percent since its last change in April 2006. The average overnight inter-bank rate rose from 2.72 percent in 2005 to 3.38 percent in 2006, while the average lending rate of commercial banks increased slightly.

Asset quality in the banking sector continued to improve. Based on the 3-month definition, the NPLs ratio declined from 5.8 percent in 2005 to 4.8 percent in 2006. Supported by higher incomes from fees, trading and investment, the banking sector enjoyed a 12.7 percent increase in its pre-tax profits, while the annualized rate of return on assets was sustained at about 1.4 percent. The capital position of banking system (including Islamic banks) remained strong in 2006. The risk-weighted capital ratio of the banking system fell modestly to 13.0 percent (14.4 percent in 2005) due to a large increase in total asset value. The core capital ratio also dropped slightly from 11.4 percent to 10.3 percent.

Underpinned by stable inflation rate, robust corporate earnings, and large equity investment inflows, the stock market was bullish in 2006, especially in H2. At end-2006, the Kuala Lumpur Composite Index (KLCI) reached 1,096, a 21.8 percent increase from end-2005 and is the highest level since 1996. The daily average turnover also recorded a 41.2 percent increase. The index continued to rise in early 2007

until the late February worldwide turbulence on stock markets, when stock prices pulled back sharply, although as of mid-March they still remained higher than end 2006 levels.

Looking forward, real GDP growth in 2007 is expected to moderate to 5.6 percent, largely due to lower growth in US demand for E&E products. The prospect for 2008 remains healthy with 5.8 percent growth. While the external sector will slow, growth should be sustained by domestic demand. Strong consumer spending is likely, underpinned by lower inflation, high commodity prices, stable interest rates, robust equity market, and rising wages. An accommodative fiscal policy, as part of the Ninth Malaysia Plan, should also help to strengthen demand. As inflationary pressure from higher fuel prices subsides and external demand softens, the central bank will likely maintain the OPR at 3.50 percent for the coming months to boost domestic demand. It is expected that the Malaysian Ringgit will continue to appreciate against the US dollar, reflecting the weaker US dollar and sustained large current account surpluses.