

## MALAYSIA ECONOMIC UPDATE (April 2007)

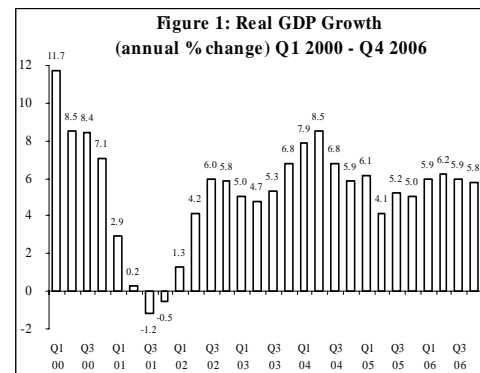
*The Malaysian economy remained robust in 2006 with a 5.9 percent GDP growth, compared with 5.2 percent in 2005, despite a slowdown in the second half (H2) resulting from high stocks and weaker external demand. Growth took place in all key sectors with the fastest-growing products being electronic and electrical (E&E), petroleum, rubber, and metal products and was mainly fueled by strong private consumption and investment and favorable export performance. Looking forward, the Malaysian economy is expected to grow by 5.6 and 5.8 percent in 2007 and 2008 respectively. Although the external sector is likely to moderate this year, growth should be sustained by solid domestic demand, supported by low inflation, stable interest rates, high commodity prices, strong stock market performance, and expansionary fiscal policy.*

### Growth performance

The Malaysian economy remained strong in 2006 with a 5.9 percent GDP growth compared with 5.2 percent in 2005. On the supply-side, the expansion in output was broad-based. The agricultural sector registered a notable growth of 6.4 percent (2005: 2.5 percent), reflecting higher production of natural rubber, crude palm oil, and cocoa. The services sector continued to grow at about 6.5 percent, supported by the growth in government services as well as finance, insurance, real estates and business services. The manufacturing output expanded by 7.0 percent (2005: 5.1 percent), with roughly the same growth rates in industrial production indices for export-oriented and domestic-oriented industries. Fastest-growing products were electronic and electrical (E&E) products (+7.9 percent), petroleum products (+13.8 percent), rubber products (+6.9 percent), fabricated metal products (+27.2 percent), and paper products (+13.2 percent). Meanwhile, the two smaller sectors registered a slight decline in output: mining sector (2006: -0.2 percent, 2005: +0.8 percent) and construction sector (2006: -0.5 percent, 2005: -1.6 percent).<sup>1</sup>

The Malaysian economy moderated slightly in the second half (H2) of 2006 (Figure 1). In Q3 and Q4 2006, output grew 5.8 and 5.7 percent respectively (Q1 and Q2 2006: 5.9 and 6.2 percent respectively). At the sectoral level, the overall picture was mixed. After several consecutive quarters of lower output, the

construction sector grew 4.8 percent in H2 2006 compared with H1 2006, supported by a pickup in the non-residential sector (new spaces for retail trade) and the disbursement of a much larger Federal Government's development expenditure (see below). As a result of higher crude oil and natural gas, the mining sector also made a turnaround and recorded a growth of 5.4 percent. However, while the agricultural and services sectors continued to grow at high rates, the manufacturing output slowed down to +3.4 percent in H2 2006. When compared with Q3 2006, the production indices of the following products, among others, declined in Q4: E&E products (-4.1 percent), chemical products (-2.3 percent), textiles and wearing apparel (-3.1 percent), food manufacturing (-10.1 percent), and transport equipment (-12.2 percent). Much of the declines in export-oriented products, especially E&E products, reflected weaker external demand and high stocks.



<sup>1</sup> In 2006, the services sector accounted for about 54 percent of the GDP. The contribution of other sectors was approximately 30 percent for manufacturing, 8 percent for agriculture, 6 percent for mining, and 2 percent for construction sectors.

On the demand side, final consumption expenditure increased by 7.2 percent to RM 182.1 billion in 2006 (2005: 8.3 percent). Private consumption, which accounted for over 77 percent

of total consumption, rose by 7.0 percent, supported by higher household disposable income and favorable commodity prices. The figures on credit card spending, import of consumption goods, and personal loans also reflected resilient private consumption. Reflecting higher emolument, public consumption also expanded by 7.9 percent. Total consumption expenditure accelerated in H2 2006 (13.4 percent growth), supported by a 43 percent increase in public consumption.

As with consumption, total investment in 2006 remained robust. Private gross fixed capital formation rose 13.4 percent from 2005 to RM 50.3 billion. The total number of manufacturing projects approved last year amounted to 1,077 projects, a 5.0 percent increase from 2005. Their total capital investment value reached RM 46.0 billion, a remarkable 48 percent growth. Nearly two-third of this was investment for new projects. Other variables, such as capacity utilization rate<sup>2</sup>, import of capital goods, and the amount of loans approved also suggested strong private investment. Public gross fixed capital formation also expanded by 10.2 percent in 2006, reaching RM 60.1 billion. Total gross fixed capital formation however slowed down in H2 2006, which recorded a 0.5 percent growth.

The Consumer Sentiment Index (CSI) and Business Conditions Index (BCI) are in line with these improvements in consumption and investment. The CSI increased from 104.2 in Q2 2006 to 107.5 and 110.9 in Q3 and Q4 respectively. Similarly, the BCI rose from 102.4 in Q2 2006 to 107.8 and 107.2 in Q3 and Q4 respectively.

Labor market conditions were resilient. The unemployment rate stayed at a relatively low level of 3.5 percent in 2006, which is the same level as 2005. The average number of monthly job vacancies during H2 2006 increased to 72,988 vacancies from 43,403 during H2 2005. The more favorable conditions were also reflected in the Malaysia Institute of Economic Research (MIER) employment index, which rose significantly from 102.4 in Q2 2006 to 113.2 and 114.8 in Q3 and Q4 respectively.

The near-term outlook on economic growth remains positive. Real GDP growth rates

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<sup>2</sup> The overall capacity utilization rates of the manufacturing sector in Q3 and Q4 2006 were 76 and 73 percent respectively. This was slightly changed from 74 percent in Q2.

in 2007 and 2008 are expected to be 5.6 and 5.8 percent respectively, a slight decline from 5.9 percent in 2006.<sup>3</sup> This moderation is largely due to a concern over lower U.S. demand for E&E products. Growth in 2007 will remain broad-based. Bank Negara forecasts (in March 2007) a 6.6 percent growth in the manufacturing (2006: 7.0 percent), 6.3 percent in services (2006: 6.5 percent), 3.2 percent in agriculture (2006: 6.4 percent), and 3.0 percent in construction sectors (2006: -0.5 percent). A significant recovery in the construction sector is likely through an expansionary fiscal policy as part of the Ninth Malaysia Plan. For the services sector, the Visit Malaysia 2007 campaign could potentially raise the number of tourist arrivals to 20.1 million (2006: 17.5 million). Partly fueled by this tourism boom, retail sector income is expected to be RM 64 billion, an 8 percent increase from 2006.

While external demand for E&E products tends to deteriorate, economic expansion is likely to be sustained by domestic demand. Consumer spending should remain strong, underpinned by lower inflation, high commodity prices, stable interest rates, strong stock market performance, and higher wages.<sup>4</sup> Similarly, robust private investment is likely through more privatized projects under the Private Finance Initiative, high manufacturing projects approvals, and larger spending on exploration in the oil sector. An accommodative fiscal policy should also help to strengthen the domestic demand.

### **External trade**

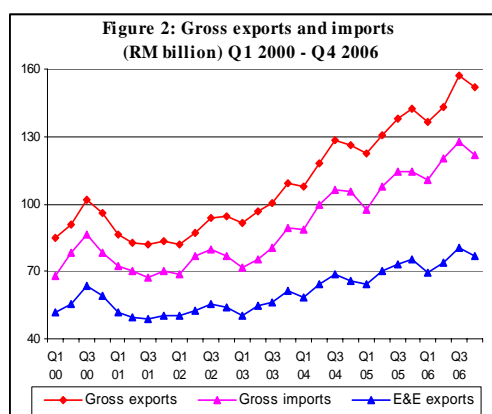
Gross exports in 2006 rose 10.3 percent to RM 588.9 billion (Figure 2). As with output, exports growth was broad-based. Manufactured and major agricultural and mining exports grew

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<sup>3</sup> In March 2007, the Consensus Forecast estimates that the growth rates would be 5.5 and 5.7 percent in 2007 and 2008 respectively. The MIER also forecasts the rates of 5.2 and 5.5 percent. This is in line with the TEC-MIER Confidence index in Q4 2006 which showed that the surveyed CEOs were less optimistic about expected economic conditions.

<sup>4</sup> According to the survey by the Hewitt Associates, wages in Malaysia rose by 6.2 percent in 2006 (2005: 5.6 percent). The evidence so far in January 2007 showed that private consumption continued to grow. The sales of passenger cars registered a positive m-o-m growth (7.8 percent) for the first time in 7 months. Consumer credit and outstanding balance of credit cards also yield a similar picture.

10.1 and 11.7 percent respectively. E&E exports, which accounted for about 51 percent of total exports in 2006, increased by 6.4 percent supported by sustained global demand (Box 1 discusses an increasing reliance of Malaysia's overall export performance on E&E exports). As a result of increase in both volumes and prices, natural rubber and palm oil exports expanded notably (42.3 and 13.9 percent respectively).<sup>5</sup> Mining products export performance was also strong (crude oil +8.2 percent and liquid natural gas +12.0 percent). Taken together, natural rubber, palm oil, crude oil and natural gas accounted for over 14 percent of total exports in 2006.



Gross imports also increased by a similar magnitude as exports (+10.7 percent to RM 480.5 billion), leaving trade balance at RM 108.4 billion, an 8.7 percent increase from 2005. Over 80 percent of these imports were intermediate and capital goods, reflecting overall robust manufacturing sector during the year.

Despite strong full-year performance, gross exports fell 3.3 percent in Q4 2006 from Q3. This was preliminary because E&E exports fell by 4.7 percent, while other key exporting products also recorded a decline (petroleum products -18.3 percent, natural rubber -20.2 percent, and crude oil -4.5 percent). Gross imports also fell 4.8 percent, mainly attributed to lower intermediate goods imports (especially

industrial supplies), which potentially reflected future weaker external demand for manufactured products.

As evident in lower gross exports in Q4 2006, moderation in export performance, especially for E&E and other manufactured products, in 2007 is likely. Although private consumption in the U.S. tends to be supported by strong job creation, higher wages, lower fuel prices, and favorable corporate profits, a key concern is construction sector and housing market recessions which could be seen more clearly since H2 2006.<sup>6</sup> Despite a U.S. economic slowdown, the Semiconductor Industry Association estimates that semiconductor sales in 2007 will still grow by 10 percent. The World Bank forecasts that U.S. GDP growth will be lower from 3.3 percent in 2006 to 2.4 percent in 2007.

The prospect for other main exports markets remains positive. Economic recovery in Japan tends to continue (GDP growth 2006: 2.1 percent, 2007: 2.0 percent) while growth momentum in the Euro Area should be sustained (GDP growth 2006: 2.6 percent, 2007: 2.3 percent). After years of double-digit growth, the Chinese economy tends to slow down slightly to a healthy 9.6 percent growth in 2007.

As for commodity, natural rubber prices are on a downward trend over the medium term as a result of lower oil prices<sup>7</sup> and lower Chinese demand for rubber tires (China consumes about a quarter of the global rubber production). Rubber prices were however significantly higher in January 2007 due to drought in Thailand and flooding in Indonesia, the other two major world rubber producers. In contrast, palm oil prices are expected to continue an upward trend reflecting higher demand from the EU and U.S., which use palm oil to manufacture alternative fuels.

<sup>6</sup> The United States is Malaysia's single largest export destination, which imported nearly 19% of total exports in 2006. Other important exports markets (and their export shares) were six large ASEAN countries (25.9 percent, 15.4 percent with only Singapore), the EU (12.7 percent), Japan (8.9 percent), and China (7.2 percent).

<sup>7</sup> The average, spot crude oil price was US\$ 53.39/barrel in 2005 and US\$ 64.29/barrel in 2006. The World Bank estimates that the 2007 price could fall to US\$ 53.52/barrel. Crude oil price fell 12.3 percent in January 2007 (to near US\$ 50/barrel) due to high stocks and mild weather. By early February, colder weather in the U.S. caused a price rebound to around US\$ 57/barrel.

<sup>5</sup> According to the World Bank Commodity Review in February 2007, natural rubber price (U.S. price) in 2006 rose to US\$ 2.31/kg (2005: US\$ 1.66/kg). Natural rubber price has increased continuously since 2001, underpinned by strong rubber demand and higher oil prices (which raised the production cost of substitute synthetic rubber). In 2006, palm oil price was US\$ 478.4/tonne (2005: US\$ 422.1/tonne).

Expected drought in Indonesia later in 2007 will also lower global supply.<sup>8</sup>

Looking forward, greater export products and market diversification are highly desirable. Malaysia's overall export basket is more concentrated than most other East Asian countries see Box 2. The country's export performance has become heavily dependent on electrical and electronics (E&E) exports. E&E exports, which only accounted for 5.5 percent of total exports in 1975, reached their peak at 61.7 percent in 2000 before retreating to 51.1 percent in 2006. In terms of markets, the share of Malaysia's top three export markets in total exports was 44.6 percent in 2005. Japan, USA, and Singapore have been the top three export markets for Malaysia since the late 70s. Most importantly, Malaysia's export performance has become increasingly dependant on the U.S. economic conditions. In 2005, the U.S. was the largest supplier and buyer of Malaysia's E&E equipment. In 2006, it imported nearly 20 percent of total Malaysian exports. Malaysia will need to fully realize its diversification potential and make the transition to high-tech products to avoid the "middle-income trap", see Box 2.

### Financial account, reserves, and external debt

The balance of payments in the first three quarters of 2006 registered a surplus of RM 27.9 billion, a 44.0 percent decline compared to the same period in 2005. While the current account was 11.1 percent higher (RM 65.3 billion), the balance on capital and financial accounts swung from a surplus of RM 9.7 billion to a deficit of RM 23.5 billion.

Gross FDI inflows increased steadily over 2006, reaching RM 18.1 billion in Q4 (Q3: RM 12.4 billion, Q2: 9.1 billion).<sup>9</sup> This was mainly attributed to larger inflows of equity capital (particularly in the manufacturing, oil and gas, and services sectors) and stable inflows of inter-company loans. Much of total FDI inflows were in the E&E sector. Despite higher FDI inflows, capital and financial accounts deficit arose from a significant increase in the short-term loans

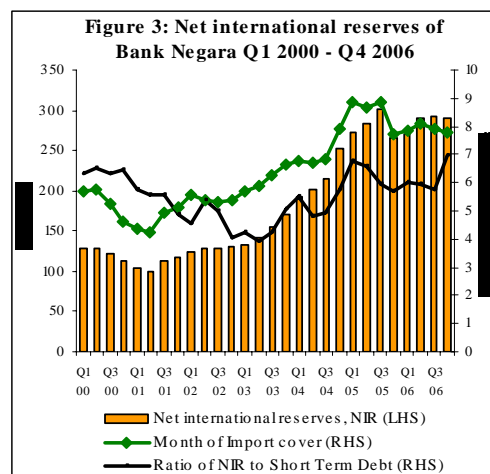
<sup>8</sup> Indonesia and Malaysia each produced over 40 percent of total global palm oil output in 2006.

<sup>9</sup> Here, the definition of FDI inflows is based on a cash basis, which reflects new financial flows, and does not include retained earnings and investment on machinery and equipment.

extensions by non-resident controlled companies to their related companies aboard (as part of their centralized treasury operations).

Supported by sustained export earnings, higher tourism receipts, larger portfolio capital and FDI inflows, and strong stock market performance, net international reserves increased steadily in 2006 (Figure 3). At end-2006, the reserves amounted to RM 290.4 billion, up 9.5 percent from end-2005. As of 15 February 2007, this rose further to RM 299.8 billion, which could finance 8 months of imports and was 6.6 times of the short-term external debt. Part of these funds will be transferred to financial markets, enabling accommodative monetary policy (e.g. loan growth) in 2007.

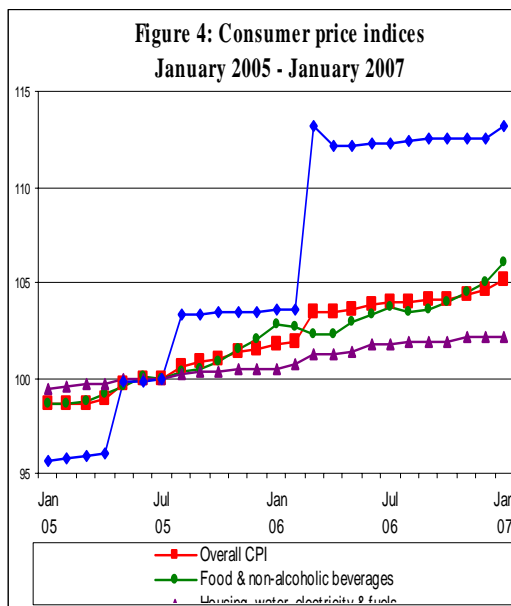
At end-2006, the total external debt amounted to RM 179.5 billion, an 8.3 percent lower from end-2005. Short-term debt also declined by 10.1 percent to RM 41.5 billion, underpinned by an over 25 percent decrease in banking sector debt. The long and medium-term debt also improved due to debt repayment by the public sector. This same trend also appeared in H2 2006 when compared with H1. As the Ringgit continues its upward trend, this will have a positive impact on debt servicing which is largely denominated in the U.S. dollar.



### Prices

Headline inflation, as measured by the Consumer Price Index (CPI), in 2006 rose to 3.6 percent (2005: 3.0 percent), reflecting higher prices of beverages and tobacco (+6.9 percent) and transport and communication (+11.0 percent). Headline inflation moderated in Q3 and Q4 2006 to 3.6 and 3.0 percent (y-o-y) respectively (Q1:

3.8 and Q2: 4.1 percent, Figure 4) due to lower international oil prices and inflation rates in trading partners. In January 2007, the inflation increased to 3.2 percent. Core inflation or CPI without food and non-alcohol beverages items rose 3.8 percent in 2006.



As with consumer price, the producer price index (PPI) in 2006 also increased to 7.7 percent (2005: 6.9 percent), reflecting higher crude materials prices, while the prices of mineral fuels, lubricants, and related materials remained high. PPI moderated in H2 2006, underpinned by lower prices of food and animals-related items and slower increase in the fuel prices.

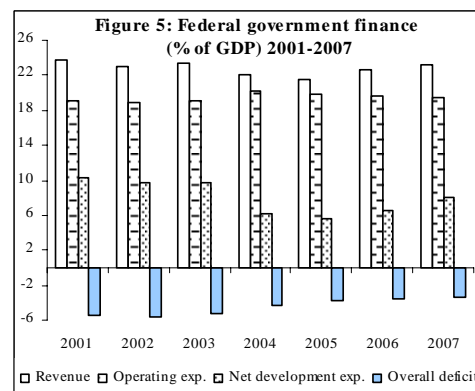
The inflation rate tends to moderate in 2007 as a result of lower international oil prices. Since 2005, the government has also set up an oil subsidy and tax forgone fund (valued at RM 16 billion in 2007) to reduce the impact of rising price. Moreover, as the Ringgit is likely to appreciate against the major currencies, this should help to reduce the cost of importing goods. However, the government recently allowed various highway tolls to rise by 10 to 60 percent while water tariff rates were also lifted by about 18 percent in November 2006.

### Fiscal developments

The federal government revenue reached RM 123.5 billion in 2006, a 16.2 percent increase from 2005. The revenues were particularly higher

from petroleum-related revenues, individual income taxes, and interests and returns on investment. In terms of federal government expenditure, operating expenditure grew moderately to RM 107.7 billion, a 10.2 percent increase due to higher grants and transfers, supply and services, and emoluments. Meanwhile, net development expenditure rose 27.8 percent to RM 34.9 billion. This large increase in spending was mainly used in areas such as transport, education and training, defense, and trade and industry.

On the overall balance, the federal government recorded a budget deficit of RM 19.1 billion or 3.5 percent of GDP in 2006, compared with a deficit of RM 18.7 billion or 3.8 percent of GDP in 2005 (Figure 5<sup>10</sup>). The federal government debt was RM 244.4 billion in 2006, up nearly 7 percent from 2005. Net domestic borrowing also rose by nearly 40 percent to RM 17.8 billion. On a wider scale, the overall public sector balance increased to 3.2 percent of GDP (RM 17.7 billion) in 2006 from 1.8 percent of GDP in 2005 (RM 8.9 billion).



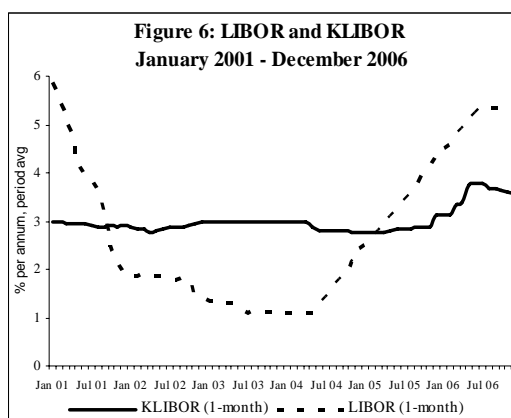
To lessen the adverse effect of a global economic slowdown in 2007, the government implements an expansionary fiscal policy in 2007 as part of the Ninth Malaysia Plan (2006-2010). This year, the government budget is set at RM 159.4 billion. Approximately 71 percent of this is allocated as operational expenditures (a 12 percent increase from 2006) while the rest is development expenditure (a 31 percent increase). Given the large increase in development expenditure and expected decline in international oil prices, the overall budget deficit could expand to 3.6 percent of GDP.

<sup>10</sup> In Figure 5, the 2006 data are preliminary, and the 2007 data are based on the 2007 Budget.

## Exchange rate and monetary developments

The Malaysian Ringgit has continuously appreciated against the U.S. dollar since July 2005 when the central bank replaced a fixed exchange rate system (RM 3.80/US \$) with a managed float system. At end-2006, the exchange rate reached RM 3.53 from RM 3.78 per dollar at end-2005, mainly attributed to weaker U.S. dollar and portfolio inflows into emerging countries.

Malaysia has implemented a tight but stable monetary policy since November 2005. The Overnight Policy Rate (OPR) increased from 2.70 percent at end-Q3 2005 to 3.25 percent at end-Q1 2006. In April 2006, the rate rose to 3.50 percent, which is still the current OPR level. The average overnight interbank rate rose from 2.72 percent in 2005 to 3.38 percent in 2006, which is about the same rate of increase in interbank rate of other maturities. The average lending rate of commercial banks also increased from 6.12 to 6.57 percent. This lending rate increased steadily in 2006 from an average of 6.37 percent in H1 to 6.60 percent in H2. Meanwhile, the interest rate differential with the U.S. widened gradually over 2006 (Figure 6).



As inflationary pressure from higher international oil prices subsides and external demand softens, the central bank is likely to maintain the OPR at 3.50 percent throughout H1 2007 to boost domestic demand. It is expected that the Ringgit will continue to appreciate against the U.S. dollar, reflecting weaker U.S. dollar, large international reserves, sustained current account surpluses, and strong stock market performance (see below). At end-June 2007, the Consensus Forecast predicts that the exchange rate tends to

be RM 3.48/US\$ and RM 3.42/US\$ at end-March 2008. Stronger Ringgit is however not expected to dampen Malaysia's export competitiveness as other Asian currencies gained more value than the Ringgit in 2006.

In late March 2007, Bank Negara Malaysia announced further liberalization of the foreign exchange administration policies. These measures taking effect from 1 April 2007, can be classified into four groups according to their objectives: (i) expanding the scope of foreign currency business conducted by licensed onshore banks by cancelling the limit on foreign currency accounts held by residents, and allowing investment banks in Malaysia to engage in foreign currency business; (ii) promoting investments in Ringgit assets by non-residents by lifting the limit on the number of residential and commercial property loans that non-residents can hold; (iii) improving business efficiency and investment opportunities for residents by raising the limit on the amount of foreign currency borrowing obtainable by resident corporations as well as the amount of investment in foreign currency assets invested by resident individuals, corporations, and institutional investors; and (iv) strengthening the development of capital market by allowing resident and non-resident corporations to use proceeds obtained from the listing of shares through Initial Public Offering on Bursa Malaysia aboard.

Further liberalization of the foreign exchange policies will provide greater flexibility for businesses to actively manage financial risks and further develop the financial and capital markets. BNM's new measures to facilitate the development of the domestic financial and capital markets and investments in Ringgit assets by non-residents to promote Malaysia as an investment destination are expected to enhance liquidity and efficient allocation of funds.

Foreign exchange rules liberalization is also expected to increase investment opportunities by opening-up new locations and playing to the locations' strengths by offering a specially tailored incentive and support package starting with certain zones within the Iskandar Development Region<sup>11</sup>.

<sup>11</sup> On March 22, 2007, the Prime Minister unveiled a generous package of fiscal and non-fiscal incentives for the Iskandar Development Region (IDR), targeting six sectors including: creative industries, educational, financial advisory, healthcare, logistics, and tourism

## Financial sector developments

The asset quality of banking system improved continuously last year. Based on the 3-month definition, the non-performing loans (NPLs) of banking system at end-2006 fell to RM 50.4 billion (2005: RM 53.6 billion). The NPLs ratio declined to 4.8 percent of total loans from 5.8 percent in 2005 (at end-January 2007, this dropped further to 4.6 percent). During H2 2006, most sectors enjoyed lower NPLs. Sectors with particularly good performance were retail trade (-15.0 percent), primary agriculture (-12.6 percent), real estate (-11.2 percent), and construction sector (-9.5 percent). In contrast, renting and business activities (+ 832.8 percent) and financial intermediation (+56.3 percent) recorded much higher NPLs.

The banking sector remained healthy. As a result of higher fee incomes and net trading and investment incomes, the pre-tax profits of the banking sector rose to RM 13.9 billion, a 12.7 percent increase from 2005. The annualized rate of return on assets was sustained at 1.4 percent. The capital position of banking system (including Islamic banks) remained strong in 2006. A risk-weighted capital ratio of the banking system, which indicates the degree of capital adequacy, fell slightly from 14.4 percent at end-2005 to 13.0 percent at end-2006, due to a 24 percent increase in total risk-weighted asset value. The core capital ratio during the same period also dropped from 11.4 percent to 10.3 percent.

The role of Islamic financial instruments continued to expand in Malaysia, which is the world's largest Islamic capital market (see Box 2). The share of Khazanah bonds, guaranteed by the government, in the net funds raised by the public sector rose from 5.3 percent in

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services. Conditional on starting operations in the IDR by 2015, firms will be eligible to a 10-year corporate tax exemption, a 10-year withholding tax exemption on certain payments, exemption from Foreign Investment Committee rules, unrestricted employment of foreign workers, and exemption from the obligation to avail 30% of the equity to the Bumiputera, a center piece of the New Economic Policy (NEP). However, firms will be requested to contribute to a social fund to mitigate the impact of rapid urbanization of the region on the poor. Over 4 billion Ringgit are allocated under the Ninth Malaysia Plan to develop infrastructure in the IDR.

2005 to 9.6 percent in 2006 (reaching RM 2 billion). The share of private sector's Islamic bonds in the net funds raised by the private sector also increased from 36.8 to 51.5 percent (reaching RM 4.8 billion). On a broader perspective, the outstanding value of Islamic securities<sup>12</sup> increased steadily in 2006, registering RM 149.5 billion at the year-end, which is a 22.3 percent increase from 2005. Islamic securities turnover also expanded by 16.3 percent and reached RM 206.3 billion. Islamic bond market prospect remains positive in 2007. In November 2006, Malaysia allowed Islamic bonds to be issued in other currencies apart from the Ringgit. This tends to attract funds from other Muslim countries, especially the Middle East where income has risen from higher oil prices.

## Stock market developments

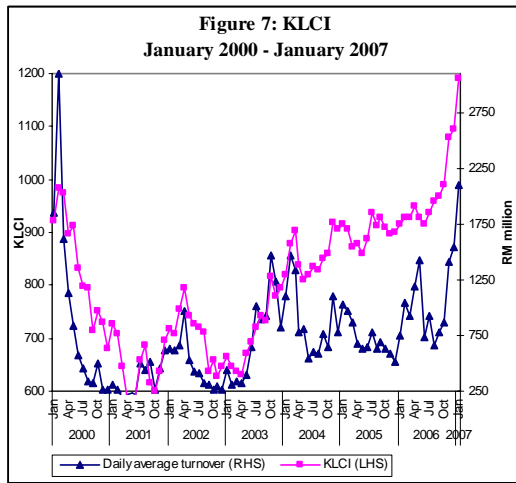
The stock market was bullish in 2006, especially in H2 (Figure 7). At end-2006, the Kuala Lumpur Composite Index (KLCI) reached 1,096, a 21.8 percent increase from end-2005 and is the highest level since 1996. The daily average turnover also rose by about 41 percent to RM 1,019.8 million. Market capitalization at end-2006 jumped to RM 848.7 billion from RM 695.27 at end-2005, although the number of listed companies increased only slightly from 1,021 companies in December 2005 to 1,026 in January 2007. This stock market boom was underpinned by stable inflation rate, robust corporate earnings, and large equity investment inflows. The KLCI continued to rise in early 2007 but recently affected by the worldwide stock market turbulence in late February. The index fell nearly 13 percent from 1,273 on 26 February to 1,111 on 5 March 2007.

The recent liberalization of the foreign exchange administration rules is expected to improve investor sentiment and further boost the current bullish outlook of the Kuala Lumpur's stock market. The establishment of Exchange Traded Funds (ETF) which will be listed on Bursa Malaysia by the end of 2007 with the initial fund size of at least RM 35 billion to improve liquidity and promote retail investor participation is

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<sup>12</sup> Islamic securities include financial instruments such as Islamic bonds, notes, commercial papers, and treasury bills.

expected to further add to the current positive outlook.



Foreign exchange rules liberalization is expected to increase investment opportunities by opening-up new locations and playing to the locations' strengths by offering a specially tailored incentive and support package starting with certain zones within the Iskandar Development Region.

## Box 1: The Challenge of Economic Diversification

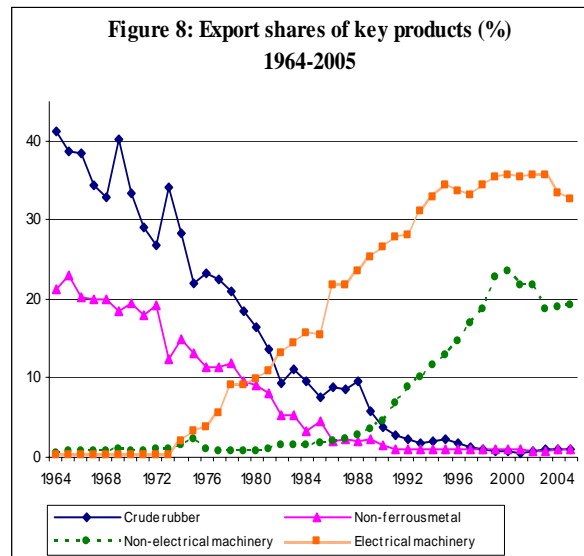
This box offers presents a preliminary exploration of the Malaysian export diversification process. Its objective is to raise awareness on the following policy-relevant questions that would require further research. At what stage of the economic diversification process is Malaysia? Can Malaysia avoid the “middle-income trap”? In other words, what would it take to Malaysia to achieve economies of scale in production, and to transition to high-tech production and exports just like Finland and Sweden have over the last century<sup>i</sup>?

Recent research suggests that countries with more diversified export baskets tend to grow faster because they are less subject to term of trade and external demand shocks see Hesse (2006)<sup>ii</sup>. This positive correlation is however non-linear. High-income economies that specialize in producing certain products seem to growth faster. This tends to reinforce Imbs and Wacziarg (2003)<sup>iii</sup> conjecture that, as countries move through economic development process, they tend to experience three stages of economic diversification. In the first stage, economic activities (such as production and exports) will concentrate around primary or resource-based products. In the second stage, economic activities will become more diversified, as the primary sector tends to shrink while manufacturing and service sectors start to grow. In the third stage, countries are likely to specialize in producing certain types of products or in providing some services, which will be reflected in more concentrated economic activities.

The challenge facing Middle-income countries is to fully realize their diversification potential and making the transition to the third stage described above, i.e. specialization in the production of a limited number of products or services. Countries that miss the transition run the risk of being caught in a “middle-income trap”. This trap occurs when economic growth is fueled dominantly through capital accumulation. Over time, as the marginal productivity of capital diminishes, further economic expansion becomes difficult. In Gill and Kharas (2006), it is argued that, for middle-income countries to avoid the middle-income trap, achieving economies of scale in production is essential. In order to enjoy sustainable growth, both export diversification and scale economies are vital.

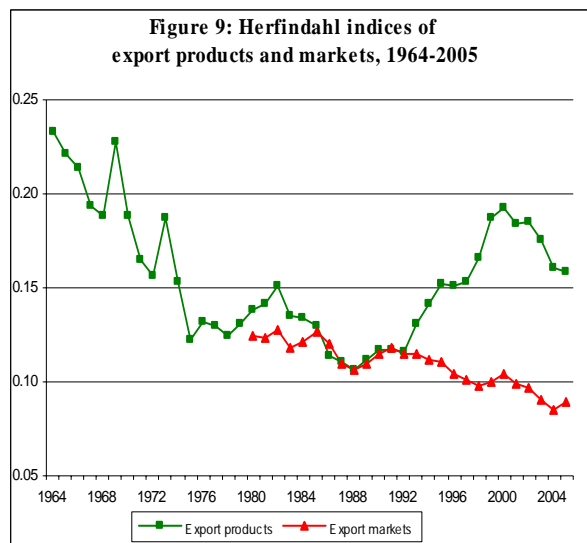
Figure 8 presents export shares of Malaysia’s key products from 1964 to 2005. The figure suggests that Malaysia has successfully transitioned from primary products exporter to a more diversified, manufacturing exporter. Over time, the steady decline of export shares of primary products such as crude rubber and non-ferrous metal (tin in particular) has been compensated by an exponential rise in the shares of electrical and non-electrical machinery, such as telecommunication equipment and office machines. While electronics exports picked up in the mid-70s, exports of non-electrical machinery rather soared after the 1997 financial crisis.

Preliminary analysis suggests that greater export products and market diversification are highly desirable. Malaysian exports are highly



concentrated. The values of the Herfindahl index<sup>iv</sup> presented in Figure 9 are over 0.15 during 1964-1974 and 1995-2005, while they are below 0.15 during 1975-1994. This finding corroborates Hesse (2006) who shows that Malaysia’s overall export basket is more concentrated than most other East Asian countries. Malaysia is indeed heavily dependent on electrical and electronics (E&E) exports. E&E exports, which only accounted for 5.5 percent of total exports in 1975, reached its peak at 61.7 percent in 2000<sup>v</sup>. Four out of five Malaysian “champion products” during 1999-2003 were E&E-related products. The International Trade Centre (ITC) defines Champion products as product types that achieved higher world market share while the world trade value for these products also grew during 1999-

2003. The question remains however if Malaysia is achieving economies of scale in the production of E&E. Economies of scale occur when the production cost of a particular product falls as its production volume rises, or when product development costs decrease as new varieties of



products are introduced.<sup>vi</sup>

In term of market diversification, the Herfindahl indices reveal some level of diversification in export destinations over time. The share of Malaysia's top three export markets in total exports has declined from 58.2 percent in 1980 to 44.6 percent in 2005. However, the magnitude of change is not very significant. In fact, Japan, USA, and Singapore have been the top three export markets for Malaysia since the late 70s. Most importantly, Malaysia's export performance has become increasingly dependant on the U.S. economic conditions. In 2006, the U.S. imported nearly 20 percent of total exports, while Singapore, which re-exports much of the Malaysia-made products to the U.S. market, also accounted for another 15 percent. In addition, the

U.S was the largest supplier and buyer of Malaysia's E&E equipment in 2005.

The case for greater diversification is strengthened by the emergence of new risks, due to the fact that E&E production in East Asia can now be viewed as a regional supply chain, where different countries supply different E&E parts and components. This implies higher role of intra-industry trade. Products such as electronic integrated circuits and parts of computers and office machines were both Malaysia's main import products and export products in 2005. About 30 percent of total exports and total imports involved these product types. Due to the nature of the chain, E&E production in East Asia is subject to a contagion effect (Gill and Kharas, 2006)<sup>vii</sup>. When one or more links in the chain have difficulties in supplying the components, the rest will also be affected. Similarly, when the global demand of E&E products falls sharply, the impact will be channeled throughout the region.

Looking forward, the medium-term prospect of Malaysian E&E exports remain positive. The potential for expanding intra-regional exports remains high, especially to China mainland, Hong Kong (China) and Singapore. Although E&E exports will continue to support the Malaysian economy, policies which encourage greater export product and export market diversification are clearly needed in order to reduce the likelihood and adverse impact of the contagion effect.

In summary, although E&E exports will continue to support the Malaysian economy, policies which encourage greater export product and export market diversification are clearly needed. There is also a need for the government to develop a financial system which can simultaneously support regional production network and reduce the likelihood and adverse impact of the contagion effect.

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<sup>i</sup> Finland and Sweden, two of the poorest countries in Europe until the middle of the 19<sup>th</sup> century, have achieved a remarkable transformation, moving from natural resources producers to high-tech exporters and from poor to highly developed economies, among the richest in the world, see Blomstrom and Kokko (2007) "From natural resources to high-tech production: The evolution of Industrial competitiveness in Sweden and Finland, Chapter 8 in Lederman and Maloney eds. The World Bank and Stanford University Press.

<sup>ii</sup> Hesse, Heiko (2006), "Export diversification and economic growth" Mimeo

<sup>iii</sup> Imbs, Jean and Romain Wacziarg (2003), "Stages of diversification", *American Economic Review*, 93, 63-86.

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<sup>iv</sup> For export products, the Herfindahl index is the sum of squared export shares of all export products at the two-digit SITC classification during 1964-2005. For export markets, the index is the sum of squared market shares of all export destinations during 1980-2005. The Herfindahl index value hence ranges between zero and one, where higher value indicates more export product or market concentration.

<sup>v</sup> The ratio has fallen since to 51.1 percent in 2006.

<sup>vi</sup> Detecting the presence of scale economies is beyond the scope of this box. Note however that there are various methods that can be used in this context. See, for example, Guala, Federico (undated), “Measuring economies of scale and scope for the Argentine bank industry”, Mimeo, for more details.

<sup>vii</sup> Gill, Indermit and Homi Kharas (2006), “An East Asian Renaissance: Ideas for economic growth”, Conference Edition, World Bank.

## BOX 2: Kuala Lumpur as the World's Leading Islamic Finance Hub

Kuala Lumpur (KL) is widely regarded as one of the leading Islamic finance hubs in the world, and Malaysia leads the market innovations on the global stage. In 2006, the total issuance volume of Islamic bonds (Sukuk) was US\$ 27 billion, of which US\$ 15 billion (56%) was originated in Malaysia.<sup>1</sup> At the same time, Dubai and Bahrain, as well as conventional financial centers such as Singapore and London, are also aspiring to be Islamic finance hubs.

Global competition among aspiring Islamic financial hubs is likely to intensify in face of competitive pressure from the increasingly integrated conventional financial markets. While KL enjoys some key advantages, such as its strong human capital and sound regulatory environment, it does not benefit from a large economic hinterland like Dubai or Bahrain, nor potential synergy with larger conventional market business like Singapore. For KL to thrive further as the leading Islamic finance hub, it calls for a solemn assessment of competitive landscape and judicious formulation of policy measures.<sup>2</sup>

Competition seems to come mostly from the hubs in the GCC region. As the global volume of Islamic finance business grows, major international banks are entering the market; and so far they are establishing their bases in Dubai or Bahrain. Experience in conventional finance hubs suggests that the key determinants of successful international financial centers are: a) size and profitability of client base, b) political stability and regulatory infrastructure, and c) available human capital.<sup>3</sup> Looking forward, Malaysia needs to retain its edges on the last two aspects and mitigate its disadvantage on the first. Here are some policy options that may be considered:

**1. Support neighboring countries to participate in the growing Islamic capital markets:** For example, Indonesia, which has the largest Muslim population in the world, has large infrastructure financing needs<sup>4</sup> and the some of the demands could be met through Islamic financing based out of Malaysia. The Malaysian experience will be highly valuable for Indonesian policy makers, not only for accessing the external funds but to develop the local market. .

**2. Ensure a favorable market environment at home and support the Malaysian professionals to retain their competitive advantages for product innovations:** For example, there is a strong demand globally for more varieties of Shariah compliant risk management tools from Islamic financial institutions. Retail investment products, such as mutual funds, will need to be developed to meet an increasing demand as individual investors start seeking more alternatives. The regulatory environment, such as adequate accounting and disclosure standards, enhanced governance rules for the Islamic financial institutions, and a clear Sharia interpretation and efficient enforcement of contracts, would contribute creating a dynamic market place and help the Malaysian professionals and institutions to retain their competitive edge.<sup>5</sup>

**3. Continue promoting the dialogue among policymakers, market participants and Sharia scholars in the international fora:** While it seems unlikely that Shariah interpretation of various Islamic finance structures in different countries would be unified anytime soon, it will be crucial to encourage and maintain the on-going dialogues among the South East Asian, GCC and other markets to ensure the unity of the Islamic financial markets.<sup>1</sup> In addition to the political and religious considerations and taking into account the much larger size of the potential client base in the GCC states, it will also be a key strategic factor for promoting KL as the world's leading Islamic finance hub.

**4. Bring in neutral policy advisors to facilitate the development process.** The Malaysian Government may consider entering into partnerships with the multilateral institutions such as the World Bank, which could help and facilitate the design and implementation of relevant projects and promote effective knowledge sharing on key policy topics, not only in Malaysia but also in regional or global frameworks.

**A key ingredient for KL's success to date has been skillful policy making.** While many other countries struggled to implement crucial policy measures such as tax neutrality, the Malaysian policy makers were highly effective thanks to their strong inter-agency coordination capacity.

<sup>1</sup> If the Islamic loan facilities (non-marketable instruments) are included, the total new issuance in 2006 was US\$ 51 billion, of which US\$ 16 billion (31%) was originated in Saudi Arabia, US\$ 15 billion (30%) in Malaysia and US\$ 11.5 billion (23%) in UAE.

<sup>2</sup> Evidently, incentives to foreign banks, such as preferential tax treatments, have little impact; none of conventional hubs (New York, London or Tokyo) provides such incentives.

<sup>3</sup> According to a World Bank estimate, Indonesia requires additional infrastructure investments of US\$ 5 billion annually to reach its 6% medium-term growth target.

<sup>4</sup> Many Malaysian bankers assume many leading positions at the Islamic finance units at global investment banks, despite that they are based in Dubai or Bahrain. Also a Malaysian bank won a few high-profile international mandates which were originated outside Malaysia, such as the IsDB's international Sukuk issue.

<sup>5</sup> Malaysian policy makers are also well represented at the international fora. Bank Negara Malaysia is internationally regarded as one of the most effective policy makers for leading capital market development initiatives. The strong presence of Malaysian talents, in the domains of both policy making of deal making, helps the liaison between the South East Asian and the GCC markets, preventing them from drifting away from each other.