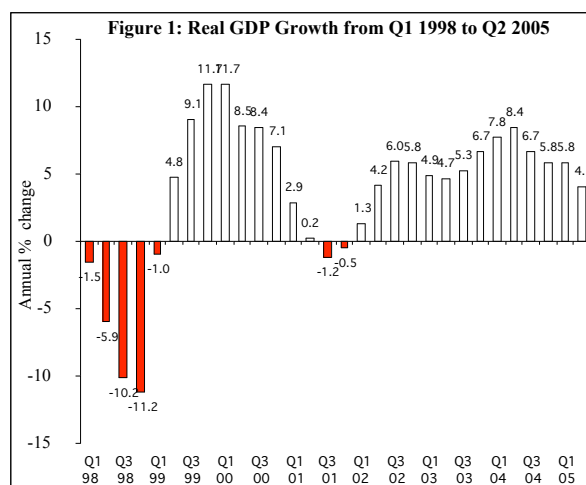
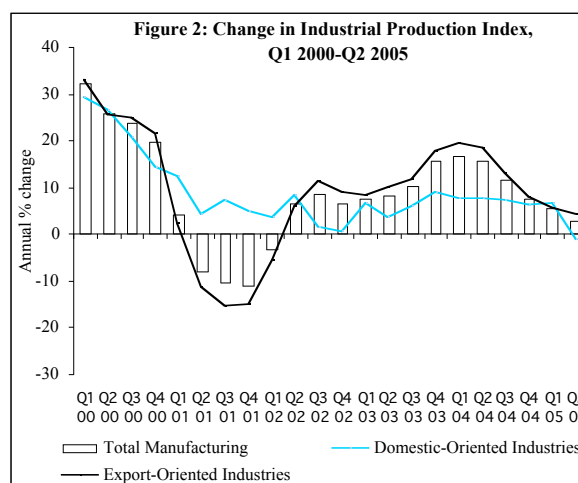


The Malaysian economy slowed sharply in the first half of 2005, but the outlook for the year as a whole and over the medium-term remains broadly favorable. The slowdown in the pace of economic activity, which began in the third quarter of 2004, continued in 2005.<sup>1</sup> Year-on-year growth was sustained at 5.8 percent in Q1 2005, (Q4 2004 5.8 percent) and declined to 4.1 percent in Q2 2005, below market expectations (Figure 1). As a result, **real GDP growth declined to 4.9 percent in the first half of 2005**. On a year-on-year basis, the decline in economic activity was affected by negative contributions from mining (-1.6 percent) and construction (-2 percent), and a sharply lower positive contribution from manufacturing output (3.2 percent), and growth was driven mostly by the services sector (5.4 percent). On the expenditure side, the lower contribution to overall growth from external demand was partially offset by buoyant domestic demand, which expanded by 5.8 percent, underpinned by continued strong growth in private consumption (8.7 percent) and gross fixed capital formation (4.5 percent). A recovery in external demand for electronic and electrical (E&E) products is expected in the second half of 2005, and domestic demand will receive a further boost from the mild stimulus measures announced in the 2006 Budget.<sup>2</sup> Thus, medium-term prospects remain broadly positive, with the economy expected to grow by 5 percent in 2005, 5\_.5\_ percent in 2006, and 5\_-6 percent through 2008.



## Production

In the first half of 2005, growth was driven mostly by services. Within the sector, the highest contributions were made by transport, storage, and communications (8.1 percent); wholesale and retail trade, hotels and restaurants (7.4 percent); and the three utilities (5.9 percent). The sector was also supported by a modest increase in tourist arrivals (4.6 percent in Q1 and 2.5 percent in Q2, respectively). Growth in value added in the **manufacturing** sector continued to slow, to 3.2 percent in Q2 2005. As a result, growth in the first half of 2005 (4.4 percent) was sharply lower than in the corresponding period last year (12.2 percent), reflecting slower growth in both export- and domestic-oriented industries.



Output growth of **export-oriented industries** was lower mostly because of the very low growth in the manufacture of E&E products (Figure 2). The output of electronic products expanded by a mere 1.4 percent in H2 (down from 33.6 percent in the first half of 2004, while production of electrical products continued to contract, by 8.2 percent. Also, growth in rubber production declined to 5.3 percent, while the production of wood and wood products declined by 5 percent. Only the resource-based industries, namely chemical products and off-estate processing, sustained double-digit growth, of 13.3 percent and 21.6 percent, respectively. The output of **domestic-oriented industries** contracted in Q2 2005 (by 1.3 percent). The output of iron and steel and non-ferrous metals, and non-metallic mineral products

<sup>1</sup> Real growth was 7.1 percent in 2004.

<sup>2</sup> The 2006 Budget was announced on September 30, 2005.

continued to contract in the first half of the year (by -5.0 percent and -3.8 percent, respectively), while that of fabricated metal products contracted by 12.5 percent in Q2. All were affected by the continued subdued performance of the construction sector. Only the production of food manufactures picked-up in Q2 (6.2 percent) while the production of transport equipment moderated to 9.7 percent and petroleum products to 5.9 percent. **Agricultural** output grew by 4.5 percent in the first half of 2005, as a strong expansion in crude palm oil and crude palm kernel oil production (20.3 percent and 26.1 percent, respectively) was partially offset by a further decline in value added from rubber production (-8.1 percent) and saw logs (-10.2 percent). The output of the **mining** sector was flat in the first half of 2005. Output of crude oil and condensates contracted by 7.2 percent, following the shutdown of the oil fields and plants for maintenance purposes, while the growth in natural gas production slowed from 19.8 percent in Q1 to 12.1 percent in Q2.<sup>3</sup> Finally, the **construction** sector continued to contract (by 2 percent in Q2, following a contraction of 2.4 percent in Q1), reflecting fewer infrastructure projects, and in line with the Government's intention of further fiscal consolidation.

**For 2005 as a whole, real growth will be driven mostly by services and an expected pick-up in manufacturing.** Looking ahead, real growth is projected at 5.0 percent for 2005 as a whole, at the lower end of the Government's projected range of 5-6 percent. Value added from the services and agricultural sectors are projected to grow at 5.8 percent and 4.8 percent, respectively, while mining output is to expand by about 1\_ percent, following completion of maintenance operations. Construction activity is expected to contract slightly over the year as a whole. Based on sustained increase in the North American book-to-bill ratio of computer equipment since the beginning of the year, value added from the manufacturing sector is projected to recover in H2 2005, and expand by 4.8 percent in 2005.<sup>4</sup>

<sup>3</sup> See Box 1 for an assessment of the impacts on growth and inflation from higher international oil prices.

<sup>4</sup> The book-to-bill ratio is calculated by dividing the three-month moving average of North American headquartered computer equipment manufacturers' bookings by the three-month moving average of actual billings for the same period.

## Domestic demand

**Real domestic demand remained buoyant in the first half of 2005.** Real domestic demand expanded by 5.8 percent in the first half of 2005, underpinned by continued strong **private consumption** (8.7 percent) and higher gross fixed capital formation (4.5 percent). **Public sector consumption** contracted by -2.4 percent, mainly on account of lower defense expenditures. Exports of goods and services expanded by 8.6 percent, supported by higher exports of minerals, manufactured goods, and agricultural commodities (sawn timber and logs, and palm kernel oil), while imports of goods and services grew by 7.3 percent. Growth in private sector consumption remained robust but declined compared to Q1 2005 (to 7.4 percent, from 10.1 percent), partly on concerns about rising prices. This was reflected in the latest **Consumer Sentiment Index** (CSI), which declined to 109.8 points in Q2, from 120.9 points in Q1.

**Gross fixed capital formation was higher.** Total **gross domestic fixed capital formation** (including changes in stocks) strengthened to 6.7 percent in Q2, from 2 percent in Q1. **Federal Government investment** activities continued to decline, in line with fiscal consolidation. With regard to **private investment**, while some investment indicators suggest a recent pick-up in pace, including imports of capital goods, sales of commercial vehicles, and the overall **Business Conditions Index** (BCI), which rose to 106 points from 104.1 in Q1, the overall **capacity utilization index** of the manufacturing sector has yet to turn the corner, and remained unchanged at 75 percent. In particular, in Q2, while the index of the export-oriented industries rose to 78 percent, it was fully offset by the decline in the domestic-oriented industries index to 72 percent. Gross inward **foreign direct investment** (FDI), based on a cash basis, increased to RM8.7 billion (US\$2\_ billion) in Q2, about half the total recorded in 2004. More than a third of the inflows were directed into oil and gas sector, particularly in the form of loans extended by a foreign company to its subsidiary in Malaysia. FDI inflows into services were channeled mainly into financial, insurance, and

North American equipment suppliers represent about 60 percent of the global market. A book-to-bill ratio above one is a leading indicator of an expanding market, while a ratio below one is an indicator of a contracting market.

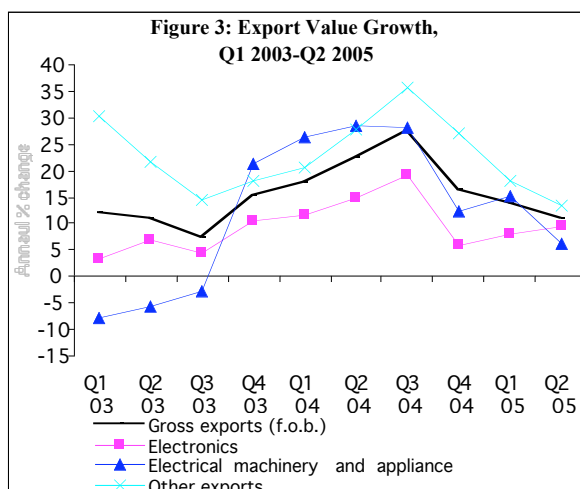
business services as well as wholesale and retail trade, and hotels and restaurants. In the manufacturing sector, inflows were directed to petroleum products, photographic and optical products, as well as E&E products.

**External demand**

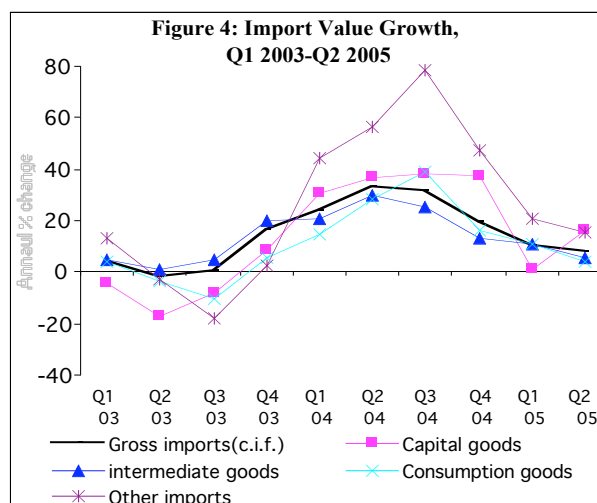
**Net external demand increased moderately.**

Gross external demand was sharply lower in the first half of 2005 (12.2 percent, compared to 20 percent in H1 2004), reflecting the joint effects of some moderation in the growth rates of the major players, including China, persistently high oil prices on the global economy, and the decline in the demand for E&E products. At the same time, import growth also declined (to 9 percent, compared to 28.2 percent in H1 2004), reflecting the slower pace of economic activity. As a result, the trade surplus increased by 20 percent in the first eight months of 2005, to RM63.7 billion (\$16.8 billion).

the contraction in crude oil production noted above. Within manufactured exports, the growth in the export of E&E products slowed to 9.3 percent in H1 2005, reflecting the contraction of export of semiconductors in Q2 and sharply lower growth in the export of electrical appliances, which more than offset the pick-up in exports of electronics (Figure 3). The growth in exports of all other manufactured products was significantly lower in H1 2005 over H1 2004, except that of petroleum products, because of the price effect, and transport equipment. Growth of agricultural exports was supported by sawn timber (35.1 percent), saw logs (25.2 percent), cocoa beans (18.1 percent), and palm kernel oil (14.1 percent), while exports of palm oil and rubber declined by -1.2 percent and -0.5 percent, respectively. The former was affected by sharply lower prices (-18.6 percent), from the exceptionally high levels in 2004, but this was largely offset by robust volume sales in response to strong demand from the European Union for producing bio-diesel. The decline in rubber prices (2\_ percent) was also partially compensated by higher volumes.



**Export growth declined across all of the main sectors. Merchandise exports of manufacturing goods** expanded by 10.6 percent, compared with 19.0 percent in H1 2004, while exports of **agricultural products** recorded an even sharper decline in growth, to 5.7 percent, from 12.9 percent in H1 2004. Moreover, although the value of exports of **minerals** expanded strongly (by 33.1 percent), this was due to the surge in Malaysian Tapis crude oil export prices, which increased by 40 percent, to an average of about US\$55 per barrel. The volume of mineral exported declined during this period (by 3.2 percent), consistent with



**Import growth abated even more sharply.** The growth in **merchandise imports** slowed across all main categories, except capital goods (Figure 4). The expansion in imports of **intermediate goods** slowed to 8 percent, compared to 25.6 percent in H1 2004, while growth in **imports of consumption goods** fell to 7.2 percent, from 21.5 percent in H1 2004. The growth of **imports of capital goods** declined to 9.2 percent, from 34 percent in H1 2004, reflecting the large increase in Q2. Within intermediate goods, higher international oil prices

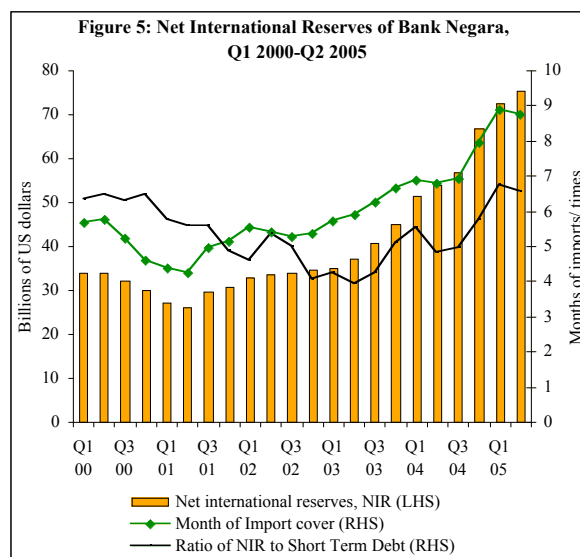
led to higher value growth in imports of fuel and lubricants, while continued expansion in the motor assembly industry translated into strong growth in imports of parts and accessories of transport equipment. Growth in the import of consumption goods was sustained by strong demand for consumer durables (16 percent) and non-durables (11.9 percent), which more than offset the sharp decline (-18.5 percent) in non-industrial transport equipment. Imports of transport equipment rose by 147.2 percent in Q2, reflecting purchases of aircraft and ships. Excluding these lumpy items, imports of capital goods grew at a steady pace of 8.5 percent, mainly for office equipment, generators, turbines, and electric motors.

**For 2005 as a whole, real growth will be supported by robust private consumption.** Looking ahead, private consumption is projected to expand at a rate of 7.5 percent, higher than the rate in H2, following the measures announced in the 2006 Budget to support domestic demand. Total investment (excluding changes in stocks) is projected to grow by about 4.9 percent. Exports of goods and services are projected to expand by 7.7 percent, as exports of E&E products and tourism both recover in the second half of the year. Meanwhile, imports of goods and services are projected to grow by 6.7 percent, as the pace of economic activity picks up.

### Financial account, reserves, and external debt

**The overall balance of payments strengthened further in 2005.** From a level of \$66.7 billion at end-2004, *net international reserves of Bank Negara Malaysia* increased to \$75.2 billion at end-June 2005. By July 29, reserves had increased further to \$78.7 billion, and about two-thirds of the inflows in July occurred on the day following the announcement of the change in the exchange rate regime to a managed float, on the expectation of further appreciation in the rate. By mid-October 2005, they had increased further, to \$79.4 billion, equivalent to about 8.9 months of retained imports and over 5.7 times short-term external debt (Figure 5). *Portfolio inflows* increased by RM 7.3 billion (\$1.9 billion) in H1 2005, reflecting sustained foreign participation in Malaysian debt securities. *Total external debt* declined in H1 2005, from \$52.8 billion by end-2004 (equivalent to 44 percent of GDP), to \$51.6 billion at end-June

2005. *Medium- and long-term net borrowing* by the private sector and non-financial public enterprises fell by just over \$1 billion. *Short-term debt* declined marginally, as did *total Federal Government external debt*, to \$8.9 billion, or 22.1 percent of total outstanding medium- and long-term external debt.



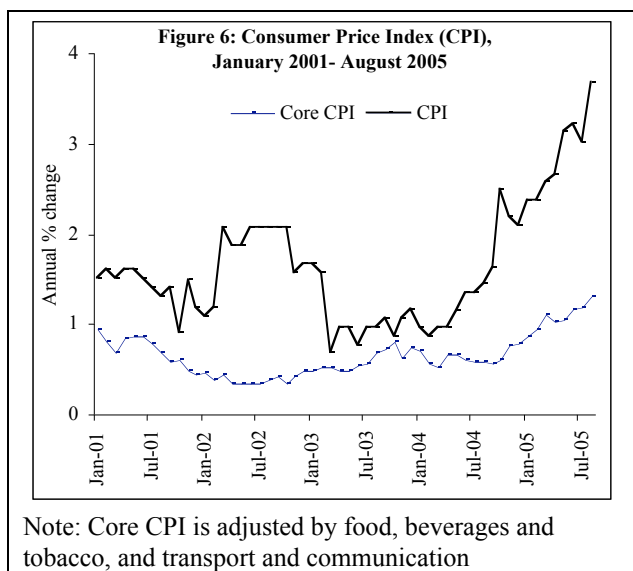
### Prices

**Inflation accelerated mostly on account of rising retail prices for fuel products.** *Consumer price inflation* rose by 3.4 percent (year-on-year) in September, compared with 3.7 percent in August and increases of 3.2 percent in June and 3 percent in July, respectively (Figure 6). The increase in August was the highest monthly increase since February 1999. As a result, average inflation in 2005 rose to 2.9 percent, compared to 1.2 percent over the first nine months of last year. The increase in inflation in recent months was driven mainly by the higher prices for transportation (7 percent) and food (3.9 percent).<sup>5</sup> The increases in prices of transportation reflected both increases in bus and taxi fares, and especially hikes in retail prices of petroleum products on May 5 and again on August 1, following a reduction in subsidies (see Box 2).<sup>6</sup> Food prices

<sup>5</sup> Food items; transportation and communications; and gross rents, fuel, and power have, respectively, weights of 33.8 percent, 18.8 percent, and 22.4 percent in the national CPI.

<sup>6</sup> On September 7, the Government announced that there would be no further increases in retail prices of fuel products

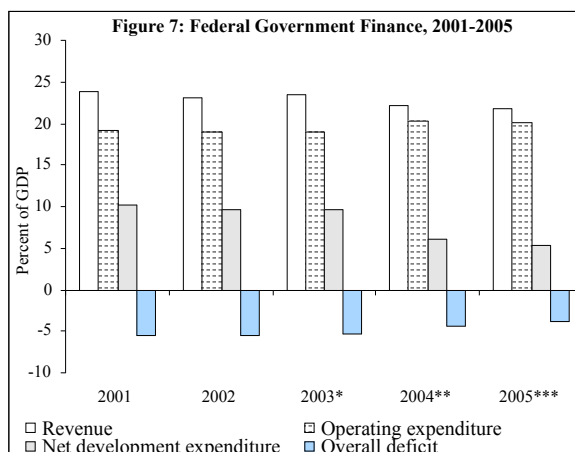
increased due largely to the higher prices of meat and fish. However, core inflation (excluding food, beverages, and transportation) remained subdued. **Producer price inflation** increased at an annual rate of 9.0 percent in August, driven by continued higher prices of crude oil and a recovery in rubber prices, which more than offset the decline in the price of crude palm oil.



**Fiscal policy and public debt developments**

**Fiscal consolidation is proceeding, mostly through a reduction in net development expenditure.**<sup>7</sup> Preliminary figures indicate that the **overall budget balance of the Federal Government** registered a small deficit in the first half of 2005, and the budget target of limiting the deficit to 3.8 percent of GDP for the year (from 4.3 percent of GDP in 2004) remains achievable (Figure 7). The Government projects that **total revenues** will increase by 6 percent for the year, reflecting higher collections from petroleum income tax and most major categories of indirect taxes, especially excises from strong growth in car sales and higher rates on cigarettes and liquor in the 2005 Budget, and increased export duty receipts from higher commodity prices. Meanwhile, non-tax revenues are expected to increase significantly, mostly reflecting higher dividend payments from Petronas. **Operating**

**expenditures** are expected to rise by 7.6 percent in 2005 (less than total revenues), reflecting the steep rise in subsidies to offset higher international oil prices. The total subsidies bill is expected to rise to RM11.8 billion in 2005, equivalent to 2.4 percent of projected GDP (see Box 2). **Gross development expenditures** are projected to increase by 5.7 percent in 2005, as higher spending on economic services, security, and general administration offset a further decline in spending on social services. Loan recoveries are anticipated to rise sharply, and as a result, net development expenditures are expected to decline by 4.4 percent. As in the past, the overall deficit of the Federal Government will be financed almost entirely from domestic sources. As a result, the **total domestic debt** of the Federal Government is projected to rise to RM207 billion (42.5 percent of projected GDP), while **total external debt** is expected to decline to RM31.5 billion (6.5 percent of GDP). The financial position of the general government is projected to show a deficit of 3.6 percent of GDP, slightly lower than in 2004 (-3.9 percent of GDP). The expected continued overall surplus of non-financial public enterprises (NFPEs), reflecting the strong performance of Petronas, Tenaga Nasional Berhad, and Telekom Malaysia Berhad, is projected to result in a surplus of 8.9 percent of GDP in the consolidated public sector financial position.<sup>8</sup>



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

this year or in highway toll rates up to end-2006, and that the road tax had been reduced, effective September 12, 2005.

<sup>7</sup> The 2006 Budget, *Strengthening Resilience, Meeting Challenges*, was announced on September 30, 2005.

<sup>8</sup> The financial position of the consolidated public sector improved very sharply in 2004, registering an overall surplus of 8.9 percent of GDP compared to a deficit of 1.2 percent of GDP in 2003, mostly reflecting the increase in the current surplus of NFPEs and the sharp decline in public sector development expenditures, including those of NFPEs.

**The recently announced 2006 Budget targets further fiscal consolidation, but at a reduced pace.**

The 2006 Budget aims to strike a balance between continuing on the path of fiscal consolidation and supporting aggregate domestic demand. The overall budget deficit of the Federal Government is budgeted to decline further in 2006, to 3\_ percent of GDP. Total revenues are budgeted to rise by 9.2 percent (excluding tax measures), operating expenditures by only 3.1 percent, and net development expenditures by 24.6 percent.<sup>9</sup> Revenues are budgeted to increase mostly from higher non-tax revenues, while budgeted operational expenditures include lower allocations for subsidies and grants to state governments, but higher allocations for education and to vulnerable groups. Higher development expenditures are budgeted for agriculture and rural development, trade and industry, and education and training.

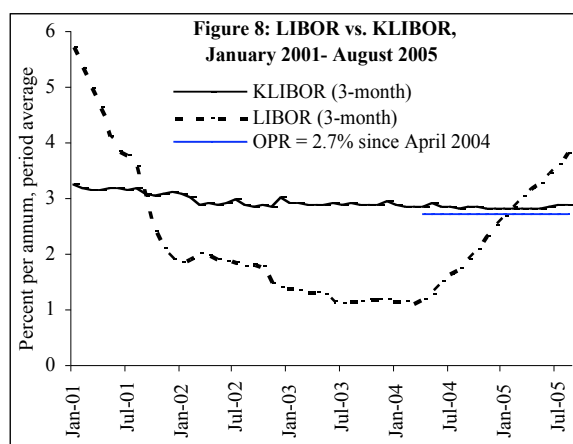
**Exchange rate and monetary policies and developments**

**The pegged exchange rate regime was replaced by a managed float.** On July 21, 2005, the Central Bank of Malaysia announced that the ringgit peg to the U.S. dollar, which was introduced in September 1998, was replaced by a managed float. The primary motivation for the exchange rate regime shift was to be in the best position to deal with structural changes occurring in the region, arising from the shift in China's exchange rate policy and the ensuing changes in regional exchange rates. These regional countries are important because they are Malaysia's close trading partners. After initially appreciating by 1.3 percent against the U.S. dollar during the week following the float, the rate of appreciation then slowed, and by end-August, the ringgit had appreciated by 0.8 percent in nominal terms.

**Monetary policy remained supportive of economic growth in the first half of 2005.**

In the view of the BNM, although inflation increased, mostly reflecting adjustments in the retail price of fuel products, demand driven increases were

moderate and allowed monetary policy to continue to remain accommodative. Consequently, the stance of monetary policy remained unchanged, and the Overnight Policy Rate (OPR) was maintained at 2.70, where it has been since it was introduced on April 26, 2004, but the ringgit-US dollar interest rate differential turned negative in early 2005 and the gap has continued to widen (Figure 8). The daily weighted average interbank overnight rate has remained stable, within a narrow margin of 2.67 percent – 2.73 percent, while the average interbank rates for the one-week to three-month tenures increased marginally, reflecting expectations of some market participants that interest rates will increase going forward.



Meanwhile, the BNM continued to conduct contractionary liquidity operations throughout the first half of the year to offset the expansionary impact of the continued increase in international reserves. With comfortable liquidity positions, **average lending rates** (ALR) of the commercial banks remained relatively stable at 5.93 percent, while the ALR of finance companies increased to 8.78 percent, from 8.63 percent in March.<sup>10</sup> Base lending rates (BLR) remained unchanged, at 5.98 percent and 6.90 percent, respectively. Gross private sector financing through the banking system increased by 8.4 percent in Q2 2005 (year-on-year), reflecting relatively buoyant credit demand from households and small and medium enterprises (SMEs). Loans disbursed to

<sup>9</sup> Specific and ad valorem excise duties on liquor and tobacco products were raised, and the sales tax was standardized at a lower rate, effective September 30, 2005. In net terms, these changes represent an increase in taxation of 9 percent and 13 percent, respectively.

<sup>10</sup> The increase in the ALR of finance companies (FC) in Q2 2005 was mainly due to the exclusion of two FC with lower than average ALRs, following mergers with their commercial banks (under the so-called "Baffin" framework; see below).

households for credit card spending, which represents 28.2 percent of total loans disbursed to households, increased by 16.7 percent, while loans disbursed for purchases of passenger cars, which represent 27.8 percent of total loans disbursed, surged by 40.5 percent. Loans disbursed to SMEs expanded by 9.2 percent, while those disbursed to large corporations increased by only 4.7 percent. **Narrow** (M1) and **broad** (M3) money supply aggregates increased moderately (M1 by 11.0 percent and M3 by 12.8 percent, respectively, on an annual basis at end-June 2005). The growth in M3 reflected the continued build-up in foreign exchange reserves, and the growth in bank lending to the private sector, which was partially offset by lower net claims on Government.

In its last Monetary Policy Statement released on 24 August 2005, the BNM indicated that the level of monetary accommodation will be balanced to ensure that the maximum sustainable growth is achieved in an environment of price stability. Given the uncertainties associated with both the inflation and economic outlook, particularly in relation to the impact of high oil prices, the balance of these risks will be closely monitored in setting the future course of monetary policy.

### Financial sector developments

**Overall asset quality of the banking system remained strong in 2005, banks remained well-capitalized, and profits are up.** At end-July 2005, total non-performing loans (NPLs) of the banking system declined to RM56.2 billion, equivalent to 6.7 percent of total loans.<sup>11</sup> However, total NPLs of commercial banks rose by RM3 billion over end-2004 levels, owing mostly to higher NPLs in the property and real estate sector, which increased by RM2.5 billion to RM16.4 billion (34.2 percent of total commercial bank NPLs). NPLS for the purchase of transport vehicles increased by RM1.0 billion to RM2.2 billion (4.6 percent of total) due mainly to the absorption of finance companies' car hire-purchase portfolio by commercial banks following their mergers. NPLs to the manufacturing sector (14 percent of total) continued to decline, to RM6.8 billion, while NPLs for consumption credit

increased marginally but remained small as a share of the total (just over 5 percent). Risk-weighted capital in the banking system remained strong. Though, both the risk-weighted capital ratio (RWCR) and core capital ratio (CCR) of commercial banks declined to 13.6 percent and 10.9 percent, respectively, at end-August 2005 (from 14.3 percent and 11.3 percent at end-2004), the decline was due primarily to the continued expansion in lending activities and the inclusion of market risk in the capital adequacy framework that was made effective on April 1, 2005. Pre-tax profits of the banking system rose by 10.9 percent in Q2 2005, to RM3.1 billion (RM5.8 billion for the first half of 2005), reflecting higher investment and net interest income. Notwithstanding a small increase in loan-loss provisions, the annualized return on average assets and equity of the banking system remained healthy, at 1.4 percent and 17.3 percent, respectively.

**The restructuring, consolidation, and internal rationalization of the banking sector are well advanced, and Islamic banking services continue to expand.** Consistent with the Financial Sector Master Plan, the BNM has recently put in place three important infrastructures for the banking sector. The first is the so-called "Bafin" framework for the merger of commercial banks and finance companies within the same banking group.<sup>12</sup> The second is the framework for the establishment of Islamic subsidiaries, reflecting the expansion of Islamic banking in the last five years.<sup>13</sup> Under this framework, conventional banks, including foreign ones that operate Islamic windows are now able to transform these operations into Islamic subsidiaries, and foreign investors are allowed to participate up to 49 percent in the equity of the newly established

<sup>12</sup> The "Bafin" framework was described in *Malaysia Economic Update* (April 2005).

<sup>13</sup> Since 2000, Islamic banking assets have grown at an average annual rate of 18 percent. At end-2004, they amounted to RM94.6 billion, equivalent to 10 percent of total banking system assets. The market share of Islamic deposits and loans also increased, to 11.2 percent and 11.3 percent, respectively. As of June 2005, there are 28 Islamic banking institutions, comprising 4 Islamic banks, and 24 conventional banking institutions (8 commercial banks, 4 foreign banks, 1 finance company, 4 merchant banks, and 7 discount houses).

<sup>11</sup> Outstanding gross loans overdue more than three months, net of interest in suspense and specific provisions.

subsidiaries.<sup>14</sup> To ensure proper governance, in April 2005, the BNM introduced the Shariah governance framework to strengthen the role and involvement of the Shariah scholars in the development of Islamic finance. The third important development was the establishment, effective September 1, 2005, of a deposit insurance system (DIS) in replacement of the implicit Government guarantee on deposits in the event of a bank failure. The DIS provides coverage of up to RM60,000 inclusive of principal and interest per depositor per bank, as well as separate additional coverage for Islamic deposits, joint accounts, trust accounts, sole proprietors and partnerships. In addition, a new and wholly state-owned specialized bank for small and medium-sized enterprises (SME Bank) began operations in October 2005.

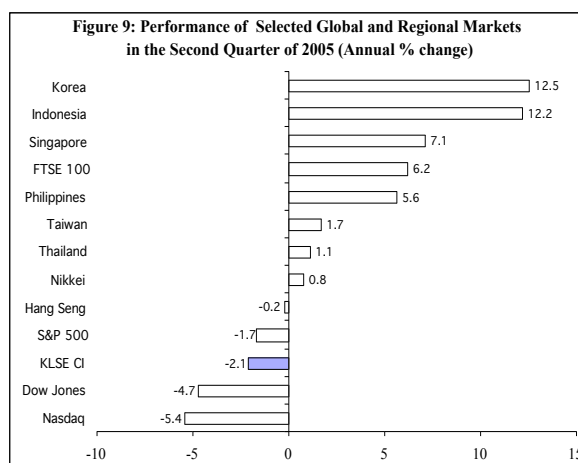
### Corporate sector developments

The equity market is now about 1\_ times the size of national income, while the corporate bond market represents about 2/5 of GDP.

### The stock market has been lackluster in 2005, but the corporate bond market has picked up.

Following a pronounced dip through end-May, to 860.7 points (5.1 percentage points lower than at end-2004), reflecting concerns over the adverse impact of rising oil prices and higher domestic inflation, the Kuala Lumpur Composite Index (KLSE CI) recovered well in the following two months (to 937.4 points at end-July), before faltering again in August (to 913.6 points). By end-September, it had recovered again, to 927.5 points, but underperformed all regional bourses (Figure 9). This see-saw pattern was reflected in the movement in the total value of market capitalization, which fell from RM722 billion at end-2004, to a low of RM665.82 billion at end-May, and recovered to RM724.97 billion at end-July.<sup>15</sup> Financing of the private sector through the equity market recovered in H1 2005, rising by RM4.4 billion. The bulk of the funds were raised through a number of Initial Public Offerings

(IPOs), including two major ones, which accounted for RM1.147 billion. Meanwhile, the total number of listings rose from 963 at end-2004 to 997 at end-July. Gross financing through private debt securities (PDS), excluding Cagamas, rose by RM2.8 billion in H1 2005, to RM12.1 billion, supported by the prevailing low yields in the Government bond market.<sup>16</sup> In Q2, PDS were issued by 26 corporations, mainly from the utilities, transportation, and storage sub-sectors, and mostly in the form of medium-term notes (49.3 percent of total) and Islamic debt securities (43\_ percent of total). Over half of the issues (52.8 percent) were raised to finance new activities, while over a third (35.4 percent) was to refinance existing debts. In an effort to expand the corporate bond market, the Securities Commission (SC) has identified asset securitization as a strategic initiative that will satisfy the market demands for innovative products as well as provide a cost-efficient source of funding. Towards this end, various measures, including the SC's Guidelines on Offering Asset-Backed Securities and favorable tax treatment, have been put in place. As at end-June 2005, the SC had approved a total of 31 asset-backed securities (ABS) amounting to RM22.4 billion (\$5.9 billion). The most notable are the residential mortgage-backed securities (RMBS), recently issued by Cagamas, based on receivables from Government staff housing loans.



**The capital market was liberalized further.** As a reflection of the increased strength of the financial system, its current excess liquidity, and its resilience to exogenous shocks, and as a

<sup>14</sup> As of June 2005, two Islamic subsidiaries of two banking groups have been established. Foreign investor participation of up to 49 percent of equity is now also permitted in the four new insurance (takaful) operators.

<sup>15</sup> By end-September, 2005, the total market capitalization had declined again, to RM715 billion.

<sup>16</sup> Cagamas is the national mortgage corporation.

complement to the liberalization of foreign exchange administration rules by Bank Negara Malaysia on April 1, 2005, the SC announced on September 15, 2005 an easing of restrictions on both local investors and foreign companies.<sup>17</sup> Domestic investors are now allowed to invest in foreign securities that are listed on foreign exchanges recognized by Bursa Malaysia; “sophisticated investors” need no longer seek SC approval to execute secondary trades in non-riding bonds; primary issues of foreign currency-denominated bonds can now be offered to “sophisticated investors”; and offerings of foreign shares in Malaysia are now allowed, subject to SC approval.<sup>18</sup> In essence, these measures will give investors greater freedom in switching to higher-yielding assets and diversify their assets, and may help reduce the excess liquidity in the financial system of around RM175 billion (\$46.4 billion) at end-June 2005. Also, two foreign stock broking companies and one foreign fund management company have started operations; three more stock broking companies are expected to begin operations before the end of the year; and three foreign futures brokers have obtained approval to trade.

**Supervision is being enhanced.** Under the Compliance and Risk-based Supervision (CRS) initiative, introduced in December 2003, Compliance and Risk Assessment Questionnaires (CRAq) were issued to a pilot group of asset management companies in January 2005.<sup>19</sup> Based on the answers, the SC developed Key Risk Scorecards (KRS) and discussed the results in an open forum with the asset management companies in mid-August, 2005. As a result, a corporate governance benchmark was suggested for the asset management industry to provide impetus for proactive improvement on corporate governance standards and practices. Looking ahead, the SC

will be conducting risk-based inspections of asset management companies, focusing on high-risk areas. In addition, the SC has recommended that asset management companies with risk elements classified as “high-risk” submit mitigating action plans to the SC, while companies with “elevated risk” would be subject to close and continuous monitoring by the SC. The individual key risk profiles will be used as a basis to identify key risk areas and subsequently implement the necessary mitigating controls. The CRS initiative will be extended to unit trusts, stockbroking, and futures broking companies, with a view to using the KRS to developing an Industry-Wide Key Risk Scorecard.

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<sup>17</sup> Some of these restrictions date back to the 1997-98 Asian financial crisis, while others are longer-standing. The liberalization of foreign exchange administration rules are detailed in *Malaysia Economic Update*, April 2005.

<sup>18</sup> Bursa Malaysia currently recognizes 51 foreign exchanges, including Hong Kong, Singapore, and Thailand. “Sophisticated investors” refer to institutional investors with minimum net assets of RM10 million, or individuals with a minimum net worth of RM3 million. The minimum value of a transaction is set at RM250,000 for each type of investor.

<sup>19</sup> The pilot group was the same as the one used for the implementation of the CRS initiative.

**Box 1. Impact of Higher International Oil Prices on Real Growth and Inflation in 2005**

As a net oil exporting country, Malaysia has benefited in the past from high international oil prices, all the more so because the low sulfur content Malaysian crude (Tapis) commands a price premium over the heavier blends in the international market. Over the last few years, production of crude oil and condensates has increased steadily from 666,000 barrels per day (bpd) in 2001 to over 760,000 bpd in 2004, and together with natural gas and tin-in-concentrates, contributed 0.2 percentage points to the average annual real growth of 4.3 percent over the period. Meanwhile, the volume of exports of crude oil and condensates has increased by 20 percent over the period, to 18.1 million tons. However, looking at 2005 as a whole, while the average export unit value of Tapis crude was 40 higher in the first eight months than in the corresponding period in 2004, the direct positive contribution to overall real growth of value added from higher oil prices is projected to be minimal, and more than offset by the indirect negative impacts from lower non-oil output and weaker demand from partner countries.

**Direct impact on growth in 2005: Oil production:** In the first half of 2005 (H1), production of crude oil and concentrates actually declined by -7.2 percent, following the shutdown of several oil fields for maintenance purposes. The volume of exports also declined over this period, by -3.2 percent. However, the value added in the overall mining sector (crude oil and natural gas) expanded by 0.9 percent owing to higher production of natural gas (16 percent). As the mining sector has a share of 7.1 percent in total real output, the contribution of the mining sector to the overall growth rate of 4.9 percent in H1 was only about 0.06 percentage points. Moreover, it would have been negative without the positive offsetting effect from higher output of natural gas. For the year as a whole, the Government projects that the production of crude oil will decline by 2.4 percent. Thus, while the value added from natural gas is projected to increase, the increase in crude oil prices this year will be substantially offset by the reduction in production of crude, and the contribution of the mining sector to real growth in 2005 is likely to be both muted and marginal, and in the range of 0.1-0.2 percentage points.

**Indirect impact on growth in 2005: Non-oil production:** While the Malaysian economy is more energy efficient nowadays (it now takes 0.4 barrel of oil to produce RM1,000 of GDP, compared to 0.9 barrel 17 years ago), increases in domestic oil prices this year will adversely impact growth in sectors that have a high oil consumption ratio, especially industry and transport. The latest available figures (for 2001) indicate that energy consumption in each of these two sectors is around 40 percent of total final consumption; with the industrial sector being more dependent on fuel oil, whereas the transport sector relies more on diesel. Also, industry and transport account, respectively, for about 31\_ percent and 8\_ percent of total real output. Assuming no strong substitution effects, some squeezing of profit margins, and bearing in mind that the higher prices were staggered over the first eight months and were not in effect for the whole year, the combined effect of the 14.5 percent increase in petrol prices and 54 percent increase in diesel prices in 2005 is projected to reduce overall real growth by 2.25-2.5 percentage points.

**Indirect impact on growth in 2005: Partner country demand:** Exports of goods and services accounted for 117 percent of real GDP in 2004. While the share of oil and gas exports in total merchandise exports has halved over the last decade and a half to 8 percent in 2004, the share of manufacturing exports has increased from just under 60 percent to 84 percent. Within manufacturing, the share of electrical and electronic (E&E) products represents about 65 percent of total exports of manufactures. Thus, the country is very dependent on foreign demand for E&E products. Two thirds of the demand for Malaysian electronics comes from the U.S. (27\_ percent), Singapore (17.7 percent), Hong Kong SAR (10.4 percent), and the EU (9.4 percent), while over half of the demand for electrical products come from the U.S. (26\_ percent), Singapore (15.4 percent), and Japan (11.1 percent). Within services, travel is the largest contributor, accounting for just under half of gross service receipts. Travel receipts, in turn, reflect the

## Box 1 (continued)

number of tourist arrivals and how much they spend in Malaysia. The main sources of visitors are Singapore (60 percent), Thailand (10 percent), and Indonesia (5 percent). Therefore, Malaysia is especially vulnerable to curbs in the appetite for imports in these seven countries to the extent that higher oil prices act to restrain their growth and demand for Malaysian goods and services. The average real growth rate of Malaysia's seven most important export markets is projected to decline by about 30 percent for 2005 as a whole, to 3.7 percent from 5.2 percent in 2004. So far this year, exports of E&E products expanded by only 8.3 percent in the first seven months of 2005, compared to 17.4 percent over the same period in 2004, while the growth in tourist arrivals has also been relatively sluggish, at only 3\_ percent in H1, compared to about 8 percent growth in H1 2004. Therefore, it is projected that the growth in external demand for Malaysian goods and services will decline by between 30-50 percent for the year as a whole, and that it will contribute only about 9 percentage points to overall growth, compared to 17.6 percentage points in 2004. Imports of goods and services are projected to contribute negatively by 7.4 percentage points, so that net external demand contribution is projected to be 1.6 percentage points to overall growth).

**Net impact on growth in 2005:** Thus, the net impact of higher international oil prices on real growth in 2005 is projected to be negative, and between -0.6 - -0.7 percentage points ( $0.1-2.25+1.6 - 0.2-2.5+1.6$ ). This range is broadly consistent with recent studies of the Asian Development Bank and Citigroup, which estimated that real growth could decline by between -0.6 percentage points or -1.1 percentage points, depending on whether the additional fiscal revenues were recycled or saved, respectively, and whether the increase in price was temporary or permanent.<sup>1</sup> The estimate is also not inconsistent with an earlier econometric study which found that a 50 percent increase in oil prices (compared to the 30 percent increase in export unit value of crude oil projected for 2005 as a whole) would exert a direct positive impact of 2.3 percentage points after four quarters, but that this would be substantially offset by the indirect negative impact of -2.1 percentage points from lower partner country demand.<sup>2</sup>

**Impact on inflation in 2005:** Consumer price inflation has increased sharply in recent months, from 2.1 percent at end-2004 to 3.4 percent at end-September 2005. Average inflation for the first ninth months reached 2.9 percent, compared to 1.2 percent over the same period last year. Though petrol and petroleum products have a weight of only 5.1 percent in the total consumer price index (CPI), the three hikes in retail prices of petroleum products, together with pass-through increases in transportation costs (bus and taxi fares, and truck fees), have been the main causes of the acceleration in the inflation rate.<sup>3</sup> However, there is no evidence of any strong demand-pull inflationary pressures in the economy at the moment. Also, the Government has pledged not to change the retail prices of petroleum products before the end of the year, and it is reasonable to assume that any increases in administered prices that may have been contemplated (e.g. electricity tariffs) are likely to be postponed to 2006. As a result, barring any further price shocks, monthly inflation rates over the last four months of the year are projected to decline gradually as fuel-related price effects peter out. Over the year as a whole, CPI inflation is projected to be around 3 percent; more than double the 1.4 percent registered in 2004, but to decline thereafter.

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1/ See *Impact of High Oil Prices on Growth*, Economic Report, Philippines' Senate Economic Planning Office (June 2005).

2/ T. Abeyasinghe, *Estimation of Direct and Indirect Impact of Oil Price on Growth*, Economic Letters 73 (2001), p.147-153.

3/ Transportation has a weight of 15.3 percent in the CPI. Food items, which have a weight of 33.8 percent, were also subject to higher prices recently, especially meat and fish.

### Box 2. Petroleum Product Prices and Subsidies in Malaysia

From a range of US\$24-\$36 per barrel between 2001 and 2003, the average price of West Texas Intermediate (WTI) increased by 34.90 percent in 2004, and by a further 30.54 percent in the first eight months of 2005. On August 30, 2005, the price reached a peak of \$71 a barrel, but had declined to \$66 per barrel by end-September 2005. The World Bank projects that the average international price of oil will increase by a further 4-5 percent in 2006, before gradually declining thereafter.

While the international price of oil has surged in 2005, the Government has raised the retail price of fuel products three times this year, by an average of only around 14\_ percent for both premium and regular petrol, while retail prices of diesel have increased by 54 percent. Even after the latest reduction in subsidies and sales tax exemptions (July 31, 2005), retail prices for fuel products in Malaysia remain the lowest among other ASEAN members, except Brunei (see table), and among the cheapest in the world. The wide price differential with both the border countries of Singapore and Thailand (where subsidies have been reduced sharply) is benefiting non-Malaysians, and increasing the incentives for smuggling.

Country	Premium (RM/liter)	Regular (RM/Liter)	Diesel (RM/Liter)	LPG (RM/Kg.)
Malaysia	1.62	1.58	1.28	1.45
Thailand	2.29	2.21	1.82	1.65
Singapore	3.76	3.48	2.36	-
Philippines	2.07	2.04	1.78	1.25
Indonesia	1.70	1.64	0.86	-
Brunei	1.20	1.18	0.70	1.38

Source: Economic Planning Unit, Prime Minister's Department (July 31, 2005); available at [www.neac.gov.my](http://www.neac.gov.my)

Retail prices of fuel products have been kept significantly below actual costs through the provision of subsidies to the oil producing companies and exempting them from sales tax. In the last two years, the Government has absorbed about 80 percent of the increase in international oil prices. The mechanism for setting the retail prices for petroleum products has been in effect since 1983; the one for premium petrol for Peninsular Malaysia is summarized below:

Premium (RON97)	(As of July 31 2005)
Product cost	164.21
+ Operational cost	9.54
+ Company margins	4.45
+ Petrol station commission	8.00
+ Sales tax	58.62
<b>= Actual price</b>	<b>244.82</b>
- Sales tax (exemption)	58.62
- Subsidy	24.20
<b>= Retail price</b>	<b>162.00</b>

Source: As in Table above.

Thus, even after the recent increases, the retail price of premium (and regular) petrol is still a third below the actual cost. For diesel and LPG, the differences are around 60 percent.<sup>1</sup> As a result, while total subsidies remained relatively low between 2001-2003, averaging RM1.7 billion, equivalent to 2.3 percent of total Federal Government operating expenditure in 2003, they rose by 163 percent in 2004, to RM4.8 billion, equivalent to 5.3 percent of operating expenditure. The Government projects that even after the July price increases, the total subsidy bill will rise to RM6.6 billion in 2005, equivalent to 6.7 percent of projected operating expenditure and 21.6 percent of budgeted development expenditure. Meanwhile,

## Box 2 (continued)

foregone sales tax revenue has increased from an average of RM4.4 billion during 2001-2003, to RM7.2 billion in 2004, and is projected to reach RM7.9 billion for 2005 as a whole, equivalent to 7.5 percent of projected total revenue. Thus, the total cost to Government rose by 81 percent in 2004, and is projected to increase by a further 21.3 percent in 2005 and reach RM14.5 billion.<sup>2</sup> It is worth noting that such an amount is equivalent to 3 percent of projected GDP. Without the subsidies and sales tax exemptions, the projected overall fiscal deficit of the Federal Government in 2005 would be only 0.8 percent of GDP.

Though the reported amount of subsidies provided by Government to the oil companies has declined, the mechanism for deciding the extent of the subsidy remains unclear. In particular, absent information on the precise relationship between the actual costs of producing premium, regular, and diesel fuels and the corresponding profit margins, the total net amount of subsidies provided to the oil companies remains unknown.

Finally, in addition to the explicit price subsidies and sales tax exemptions granted to oil companies, a recent analysis reports that indirect subsidies also operate in selected segments of the transport sector (river transport operators in Sabah and Sarawak, taxis, and small truck operators), in the generation of electricity, as natural gas input is provided at a quarter of the commercial price, and in the metal, textile, food, and cement sub-sectors.<sup>3</sup> This same study also suggests that implicit subsidies may also exist from Petronas' extensive downstream activities in transport (shipping, airlines), petrochemicals, chemicals, and fertilizers as these businesses may enjoy preferential rates for some of their inputs.

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1/ On September 7, 2005 the Government announced that retail prices of fuel products will be maintained at current levels for the remainder of the year.

2/ These costs are in effect being covered by contributions from Petronas, the highly profitable 100 percent Government-owned oil company. In the financial year 2004/05 (ending March 2005), Petronas contributed a total of RM31.2 billion to Government in the form of taxes, dividends, and royalties (equivalent to 53 percent of the company's gross profits). This contribution was 47 percent higher than the previous year's.

3/ Deyi Tan and Daniel Lian, *The Ugly Face of Fuel Subsidies: Playing the Devil's Advocate*, in *Southeast Asia Economics*, Morgan Stanley; September 8, 2005.