

## Section I



# ECONOMIC OUTLOOK

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# The Malaysian Economy

## CHAPTER 1

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The Malaysian economy is expected to grow by 6% in 2007, benefiting from resilient domestic demand and favourable growth performance in Europe, Japan and Asia. The services sector is expected to remain the key driver of growth, with continued growth from the manufacturing, agriculture and construction sectors. Domestic demand will continue to be driven by robust consumption demand and private investment activity, and reinforced by the implementation of the Ninth Malaysia Plan projects by the public sector.

## 1. The Malaysian Economy in 2006

In 2006, Malaysia's real gross domestic product expanded by 5.9%, driven mainly by the domestic demand, while the favourable global growth resulted in strong demand for exports.

Aggregate domestic demand recorded a strong growth of 7% driven mainly by the private sector activities. Private consumption remained strong, increasing by 7.1% in 2006. The main factor that contributed to the strength in consumer spending was a steady income growth arising from favourable employment conditions, strong export earnings, and firm commodity prices.

The continued high prices of major commodities (such as rubber and crude palm oil) as well as the stable labour market conditions benefited both the rural and urban households' disposable incomes, and supported consumers' optimistic outlook.

### Real GDP by Expenditure (at year 2000 prices)

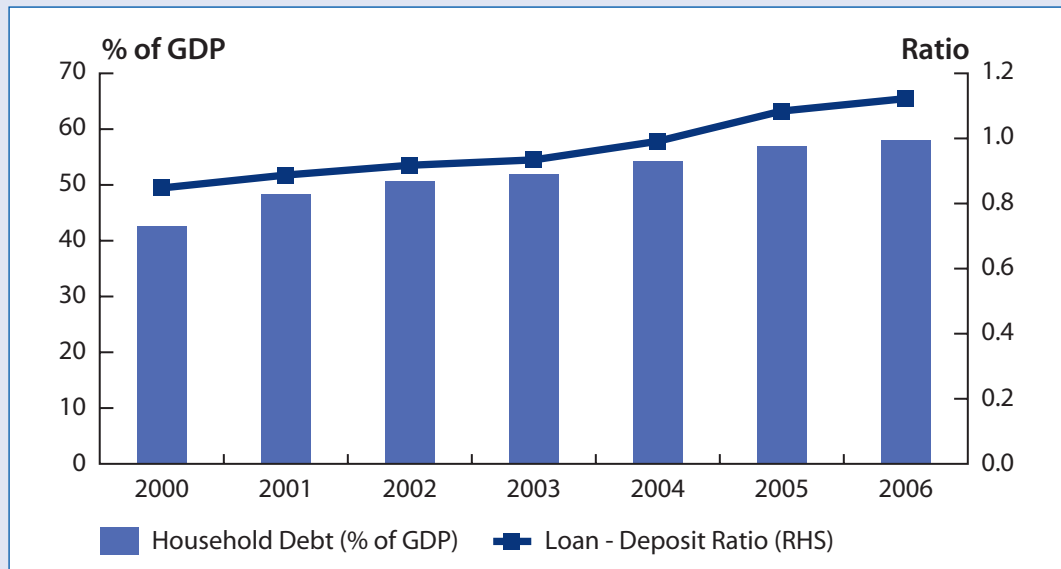
	2005	2006
	<b>Annual Change (%)</b>	
Domestic Demand <sup>1</sup>	7.3	7.0
Private sector expenditure	7.6	7.0
Consumption	8.7	7.1
Investment	3.3	7.0
Public sector expenditure	6.6	6.8
Consumption	6.4	5.0
Investment	6.8	8.9
Net exports of goods and services	2.1	0.1
Exports	7.9	7.4
Imports	8.9	8.6
<b>Real Gross Domestic Product</b>	<b>5.0</b>	<b>5.9</b>

<sup>1</sup>Exclude Stocks

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Although the Overnight Policy Rate was raised twice in 2006, household credit continued to expand as the interest rates continued to be at relatively low levels. Household debt, however, remained within prudential limits as their financial positions remained relatively sound.

## Household Debt Indicators



Source: Bank Negara Malaysia Annual Report 2006

Private investment recorded a stronger growth of 7%, spurred by large capital expenditure in the following sectors:

- Manufacturing sector due to strong demand for resource-based products from abroad and sustained high capacity utilisation levels;
- Services sector due to investments in the transportation and communications sub-sector, attributed mainly to the expansion of port facilities, investment in the air and sea transportation segments as well as to the enhancement of the telecommunications network; and
- Oil and Gas sector where capital spending remained robust, driven by exploration and production projects as deepwater exploration intensified during the year.

Private investment received an additional boost from improved corporate balance sheet position which also provided the means for firms to invest.

Public consumption grew by 5% in 2006, due mainly to high expenditure on supplies and services for maintaining and improving public delivery system.

Public investment increased further by 8.9% in 2006, reflected by higher expenditure on developmental projects to provide adequate and improved infrastructure as well as better essential services, particularly in the less developed areas.

#### Real GDP by Sector (at year 2000 prices)

	2005	2006
	<b>Annual Change (%)</b>	
Agriculture	2.6	5.2
Mining & Quarrying	-1.3	-0.4
Manufacturing	5.3	7.1
Construction	-1.8	-0.5
Services	6.7	7.2
<b>Real Gross Domestic Product</b>	5.0	5.9

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

On the sectoral front, the services, manufacturing and agriculture sectors were the key contributors to growth during the year:

- The services sector expanded by 7.2%, supported mainly by higher trade-related activities, finance and tourism as well as increased contribution from new areas of growth in the business services segment, including shared services and outsourcing and IT services and Islamic finance;
- Value added in the manufacturing sector recorded a stronger growth of 7.1%, underpinned by the continued upturn in the global electronics cycle which began in the second half of 2005 and the strong external demand for resource-based products; and
- The agriculture sector expanded by 5.2%, supported by higher growth in industrial crops and recovery in the food-related activity.

## Consumer Prices

The headline annual inflation rate, as measured by the Consumer Price Index (CPI), increased to 3.6% (2005: 3%). While other key categories also registered some price increases, the main contributor to the higher inflation in 2006 was the rising cost of transport due to higher fuel prices. This was due to the one-off increase in the prices of retail petroleum products in March 2006, following the reduction in fuel subsidies, as the high global oil prices in early 2006 had significant implications on the Government's operating expenditure.

Despite the initial spike in the inflation rate in March 2006, inflation expectations were broadly well-anchored throughout the year. The Government's assurance that the increase in retail fuel prices in March would be a one-off occurrence helped limit the price pressures cascading into the overall price level. The appreciation of the ringgit exchange rate during the year had also mitigated some inflationary pressures by reducing the cost of imports.

## Inflation and Unemployment (%)

	2005	2006 <sup>p</sup>
Inflation		
Consumer Prices Index (2000=100)	3.0	3.6
Core Consumer Prices Index <sup>1</sup>	2.0	2.1
Unemployment	3.5	3.5

<sup>p</sup> Preliminary

<sup>1</sup> Excludes price-controlled items and price-volatile items as well as items that are subject to one-off price adjustments

Source: Bank Negara Malaysia Annual Report 2006

## Job Growth

A key to understanding consumer sentiment is job growth. Consumers feel more at ease when the job market is expanding. In 2006, the domestic labour market continued to strengthen as demand for workers rose during the year amidst faster economic growth:

- The unemployment rate remained low at 3.5% of labour force;
- Total employment expanded by 2.3%, outpacing the 2.2% expansion in the labour force, while total retrenchments declined for the fifth year to 15,360 persons; and
- Vacancy trends also pointed to more positive employment conditions, as reflected in the significantly higher number of new job vacancies reported via the Electronic Labour Exchange (ELX).

Stronger demand for labour was recorded in all key sectors, especially the manufacturing sector, amidst a backdrop of strong domestic and external sales, revival in construction activity and the opening of more retail and other services outlets.

While demand for labour increased in 2006, the number of available workers also rose. Active jobseekers registered with the Manpower Department rose by 16% to 84,046 persons. A notable development was the significant presence of job seekers who were already employed but had reentered the job market in the expectation that they could find better jobs.

## Wages

Despite the better economic performance, wage pressures were relatively subdued due in part to the presence of a large number of unemployed graduates and availability of migrant workers.

The Salary and Fringe Benefits Survey undertaken by the Malaysian Employers Federation showed that average private sector salary increment was 5.8%, the same as in the previous year.

## Productivity

Labour productivity, as measured by the real value added per worker, improved significantly to 4% (2005: 2.1%), boosted by higher productivity growth in the agriculture, manufacturing and the services sectors. Increased use of capital and improvement in business processes and higher values of products and services, resulted in improved productivity.

## Balance of Payments

Malaysia's external position strengthened in 2006 due to a larger current account surplus:

- The current account recorded a larger surplus of RM93.4 billion, equivalent to 16.8% of GNP, attributable to a large trade surplus as well as improvements in the services and income accounts;
- In line with the improved external environment, growth in gross exports was sustained at a double-digit rate of 10.3% in 2006, supported by continued strong demand for primary commodities and manufactured goods;
- Exports of primary commodities, which have become an important source of foreign exchange earnings to the country, expanded by a double-digit rate due entirely to higher prices while the export volume declined by 2.4%;
- The expansion in exports of manufactured goods was due to strong performance of selected resource-based industries, as well as continued growth in exports of electronics and electrical (E&E) products;
- Gross imports expanded by 10.8% in 2006, reflecting higher imports of intermediate goods to support production and exports of manufactured goods, as well as strong domestic consumer and investment spending; and
- The services account recorded a lower deficit due mainly to a larger inflow of tourism receipts and commissions earned from procurement of goods for resale to non-residents.

Meanwhile, the improvement in the income account deficit reflected higher profits and dividends accruing to Malaysian companies from their overseas investments and higher returns from external reserves.

The financial account recorded a larger net outflow of RM43.5 billion as larger direct investment abroad and higher outflows in other investment more than offset the inflows of foreign direct investment (FDI) and portfolio investment. During the year, the gross FDI increased significantly to RM37.3 billion, supported mainly by reinvested earnings and inflows of new equity capital to acquire interests in Malaysian companies. This trend reflected the sustained confidence and commitment of foreign investors operating in Malaysia.

Malaysia's external debt position improved further in 2006 to RM183.1 billion (or USD51.4 billion) from RM197.7 in 2005, equivalent to 33% of GNP reflecting the lower short-term debt attributed to the unwinding of inter-bank borrowings by the banking sector, and improvements in the medium and long-term debt due to continued net loan repayment by the public sector. The revaluation gain following the appreciation of the ringgit against major currencies also contributed to a lower medium and long-term debt position.

## 2. The Malaysian Economy in 2007

Looking ahead, growth for the Malaysian economy is expected to expand by 6% in 2007. The growth will be supported by resilient domestic demand and favourable growth performance in Europe, Japan and Asia.

Real GDP is projected to grow moderately in the first half of the year due to expected slower growth in external demand, but with the global electronics industry expected to pick up in the second half-year due to higher demand for new products, the Malaysian economy is anticipated to expand more favourably.

On the domestic front, a number of major developments are expected to impact growth, during the second half of the year. These include:

- More rapid implementation of projects under the Ninth Malaysia Plan (9MP);
- The start at the production of Kikeh Oil Field in the fourth quarter; and
- And the expected significant increase in tourist arrivals for the Visit Malaysia Year 2007 during the peak summer travel season.

### Real GDP by Expenditure (at year 1987 prices)<sup>1</sup>

	2007f
	Annual Change (%)
Domestic Demand <sup>2</sup>	7.4
Private sector expenditure	7.2
Consumption	6.4
Investment	10.4
Private sector expenditure	7.7
Consumption	4.1
Investment	11.4
Net exports of goods and services	-9.6
Exports	6.3
Imports	7.4
<b>Real Gross Domestic Product</b>	<b>6.0</b>

f Forecast

<sup>1</sup> As released in BNM 2006 Annual Report, prior to the rebasing to 2000 prices

<sup>2</sup> Exclude stocks

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

*Growth for the Malaysian economy is expected to expand by 6% in 2007. The growth will be supported by sustained global growth and resilient domestic demand*

Aggregate domestic demand is expected to remain resilient at 7.4% in 2007, supported by sustained private sector activities and higher public sector expenditure.

Private investment, which is expected to expand further by 10.4%, will play a major role in sustaining growth. Ample liquidity in the financial system ensuring adequate funding will support new investment activities. The reduction of corporate income tax to 27% announced in the 2007 Budget is also expected to stimulate private capital spending.

The public sector's contribution to growth is expected to increase further in 2007 due mainly to higher public investment which is forecast to grow significantly by 11.4%, driven by higher development expenditure by the Federal Government for the implementation of the 9MP projects.

Private consumption is expected to remain resilient in 2007 at 6.4%, supported by sustained income growth and favourable employment conditions.

Public consumption is expected to increase moderately by 4.1%, following continued high operating expenditure on supplies and services to improve the delivery system in support of private sector activity.



On the sectoral front, growth is expected to be broad based, reflecting expansion in all economic sectors. The services sector is expected to remain the key driver of growth, led mainly by intermediate services, while the final services segment is projected to expand at a more moderate pace, in tandem with private consumption activity during the year.

In the intermediate services segment, the stronger growth in the finance, insurance, real estate and business services sub-sector will be driven mainly by new areas of growth, particularly in Islamic financial services and the newly-formed investment banks.

Growth in the manufacturing sector is expected to be sustained at 6.6% in 2007, led by resource-based industries and further supported by the E&E sector as well as the construction-related industries.

The agriculture sector is expected to continue to expand, albeit at a more moderate pace of 3.2%, reflecting increases in output of all major crops.

Meanwhile, the mining and construction sectors are expected to turn around and register positive growth. The mining sector will be supported by higher output of crude oil and natural gas, benefiting from the commencement of the new Kikeh oilfield and the upgrade of the MLNG2 plant in the second half of the year.

After declining for three consecutive years, value added in the construction sector is expected to register a positive growth in 2007, underpinned by the positive effects from the implementation of development projects under the 9MP as well as strong demand in the non-residential properties segment.

#### Real GDP by Sector (at year 1987 prices)<sup>1</sup>

	2007f
	<b>Annual Change (%)</b>
Agriculture	3.2
Mining & Quarrying	2.8
Manufacturing	6.6
Construction	3.0
Services	6.3
<b>Real Gross Domestic Product</b>	<b>6.0</b>

f Forecast

<sup>1</sup> As released in BNM 2006 Annual Report, prior to the rebasing to 2000 prices

Source: Department of Statistics, Malaysia and Bank Negara Malaysia



### Balance of Payments

The balance of payments position is expected to remain strong in 2007. The current account surplus is projected at 16.3% of GNP, reflecting the continued strong trade surplus in the goods account and an improvement in the services account. Gross exports are expected to expand by 8.2% and strong growth in the export of resource-based manufactured products will partly mitigate the more moderate growth in E&E exports. Growth in commodity exports is expected to be sustained, supported by higher prices of palm oil.

Gross imports are expected to increase by 9.8%, reflecting mainly a moderation in growth of intermediate imports in line with slower growth in manufacturing exports. Meanwhile, capital imports are expected to strengthen, in line with higher investment activity.

The services account deficit is expected to improve further, attributed mainly to higher tourism receipts from Visit Malaysia Year 2007. Meanwhile, the income account deficit is projected to be sustained reflecting profits and dividends accruing to multinational companies (MNCs) for their investments in Malaysia.



## Malaysia: Balance of Payments

	2005	2006p/	2007f
	RM billion		
<b>Balance on current account</b>	<b>75.7</b>	<b>93.4</b>	<b>92.7</b>
% of GNP	15.3	16.8	16.3
Goods balance	125.6	134.6	137.7
Exports of goods	537.0	589.7	638.5
<i>Gross exports - % change</i>	10.9	10.3	8.2
Imports of goods	411.4	455.2	500.9
<i>Gross imports - % change</i>	8.6	10.8	9.8
Services balance	-9.0	-6.9	-6.7
Income account	-23.9	-17.4	-22.1
Current transfers	-17.0	-16.9	-16.2
<b>Balance on capital &amp; financial accounts</b>	<b>-37.0</b>	<b>-43.5</b>	
Direct investment	3.8	0.2	
Abroad	-11.3	-22.2	
In Malaysia	15.0	22.2	
Portfolio investment	-14.2	12.9	
Other investment	-26.6	-56.4	
<b>Errors &amp; omissions</b>	<b>-25.1</b>	<b>-24.8</b>	
<b>Overall balance (surplus + / deficit -)</b>	<b>13.6</b>	<b>25.2</b>	
<b>Net international reserves of BNM</b>	<b>265.2</b>	<b>290.4</b>	
<b>Net international reserves of BNM (USD billion)</b>	<b>70.2</b>	<b>82.5</b>	
<b>Reserves as months of retained imports</b>	<b>7.7</b>	<b>7.8</b>	

p/ Preliminary

f/ Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

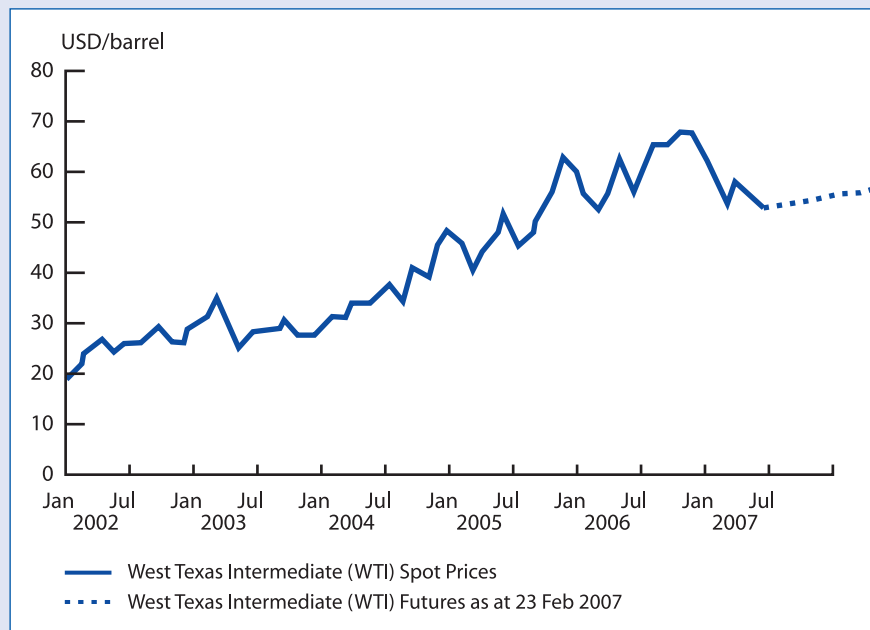
Foreign direct investment is expected to remain high, largely from retained earnings by existing MNCs operating in Malaysia, and from new FDI inflows into the manufacturing, services and oil and gas sectors. More merger and acquisition activities are also expected to attract inflows of FDI into Malaysia. Investment abroad is projected to remain significant reflecting sustained interests of Malaysian companies to expand and diversify their operations abroad.

### Inflation Outlook for 2007

Inflation is expected to remain benign during the year. Headline inflation, which increased in 2006 following the partial reduction of fuel and other subsidies, is expected to moderate in 2007 to average between 2 - 2.5%.

Over the medium-term, the new investments undertaken by corporations to expand productive capacity of the economy would ensure that growth would continue without undue price pressures. Furthermore, price pressures would continue to be dampened by increased competitive pressures arising from increased international economic and financial integration.

### West Texas Intermediate (WTI) Spot and Future Prices



Source: Bank Negara Malaysia Annual Report 2006

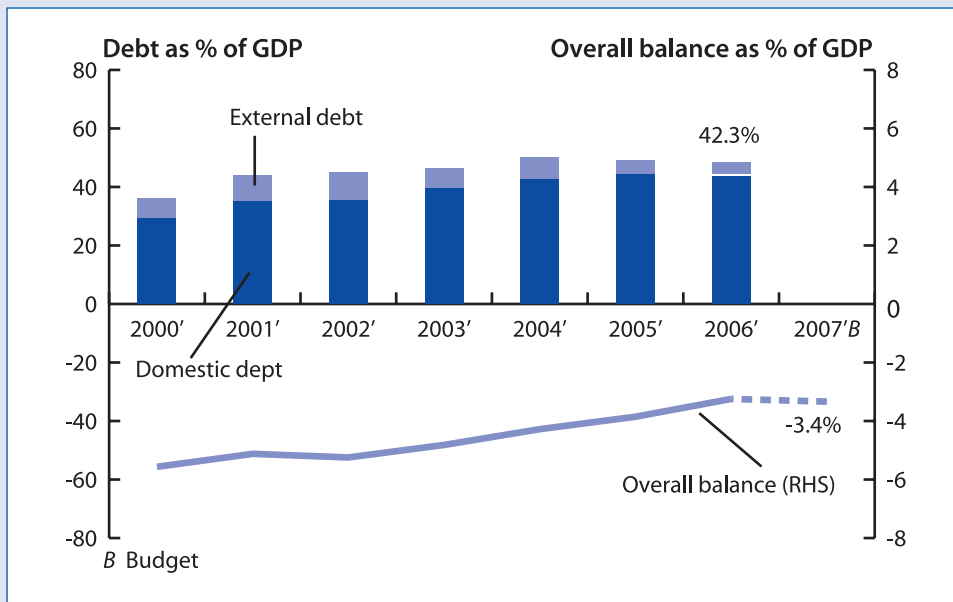
## Fiscal Policy in 2007

To create sustainable longer-term growth, the emphasis of the 2007 Budget has been placed on new areas of domestic economic activity that have high growth potential.

Accordingly, fiscal policy in 2007 is focused on facilitating the private sector in taking a greater role in economic development and in generating new sources of growth in the technology and knowledge-intensive sectors.

In addition to the incentives that have been put in place, the Federal Government would increase expenditures in 2007 to support the initiatives in generating higher value-added economic growth, developing skilled and knowledgeable manpower and programmes to reduce socio-economic and regional disparities. Overall, the budget deficit is projected to be at 3.4% of GDP in 2007 as the Government progress on its fiscal consolidation.

### Federal Government Fiscal Balance and Debt



Source: Bank Negara Malaysia Annual Report 2006