BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

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# PRESS RELEASE

## Bank Negara Malaysia Annual Report 2006

### Malaysian Economy in 2006

In 2006, the Malaysian economy was stronger and more resilient. Real gross domestic product (GDP) expanded by 5.9%, up from 5.2% a year ago. Domestic activity, particularly in the private sector, continued to propel economic expansion amidst high export demand for electronics and primary commodities.

**GDP by Expenditure Components (% change)**

| | 2005 | 2006*p* | 2007*f* |
|---|---|---|---|
| Gross Domestic Product | 5.2 | 5.9 | 6.0 |
| Private sector expenditure[1] | 9.1 | 7.6 | 7.2 |
| Consumption | 9.2 | 7.0 | 6.4 |
| Investment | 8.5 | 9.7 | 10.4 |
| Public sector expenditure[1] | 3.6 | 7.2 | 7.7 |
| Consumption | 5.4 | 7.9 | 4.1 |
| Investment | 1.9 | 6.5 | 11.4 |
| Net exports of goods and services | 16.7 | -5.0 | -9.6 |
| Exports | 8.6 | 6.3 | 6.3 |
| Imports | 8.0 | 7.2 | 7.4 |

[1] Exclude stocks

*p* Preliminary

*f* Forecast

During the year, aggregate domestic demand recorded a stronger growth of 7.4%, with the private sector continuing to be the principal driver of growth while the public sector provided a supportive environment to promote economic activity. Private investment strengthened during the year, spurred by significant capital outlays in the manufacturing, services and oil and gas sectors. A period of sustained economic expansion, high capacity utilisation, resilient business sentiments, improved corporate financial positions and favourable financing conditions were among the contributing factors to the robust investment activity. Meanwhile, private consumption expenditure remained resilient, supported by a steady income growth arising from favourable commodities prices, strong export earnings and stable labour market conditions. Reflecting Government's continued commitment to provide adequate and improved infrastructure as well as better essential services, particularly in the less developed areas, public investment rose considerably in 2006. A significant development during the year was the release of the Ninth Malaysia Plan (9MP) in March 2006. Over the lifetime of the Plan, the Federal Government has targeted a 17.6% increase in spending on development and infrastructure projects. Similarly, public consumption was higher, due to higher expenditure on supplies and services for maintaining and improving public delivery system.

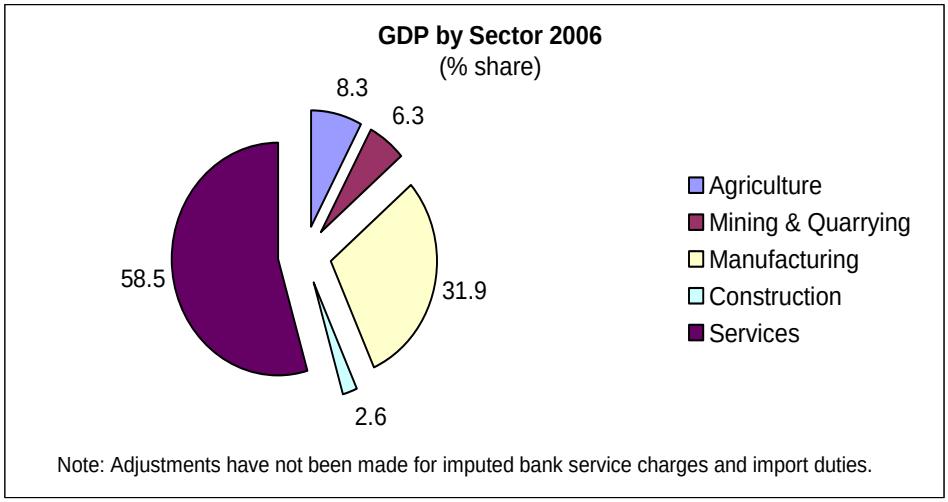
**GDP by Kind of Economic Activity (% change)**

| | 2005 | 2006*p* | 2007*f* |
|---|---|---|---|
| Real GDP | 5.2 | 5.9 | 6.0 |
| (RM billion) | 262.2 | 277.7 | 294.4 |
| | | | |
| Agriculture | 2.5 | 6.4 | 3.2 |
| Mining & Quarrying | 0.8 | -0.2 | 2.8 |
| Manufacturing | 5.1 | 7.0 | 6.6 |
| Construction | -1.6 | -0.5 | 3.0 |
| Services | 6.5 | 6.5 | 6.3 |

*p* Preliminary
*f* Forecast

On the sectoral front, the services, manufacturing and agriculture sectors were the key contributors to growth. While the mining sector remained weak due to maintenance and upgrading work, activity in the construction sector improved with the pace of contraction moderating. The services sector, which has become an important contributor to growth, expanded by 6.5%. This represented the second consecutive year where the services sector grew faster than the overall economy. The growth was supported by higher trade-related activities, finance, tourism and increased contribution from new sources of growth. Of significance, the two key sub-sectors – the finance, insurance, real estate and business services; and the transport, storage and communications – experienced rapid expansion since 2000, following a major transformation in the financial services sector, and the emergence of new activities such as Islamic finance, telecommunications, IT services, and shared services and outsourcing. These two sub-sectors now account for close to one-quarter of the overall GDP.

Underpinned by the continued upturn in the global electronics cycle which began in the second half of 2005, the manufacturing sector strengthened further to 7%. The global semiconductor recovery was broad based, supported by demand for all product segments including computers, consumer electronics, telecommunications and automotives. In addition, strong external demand for resource-based industries and significant improvement in the domestic-oriented industries further supported the performance in the manufacturing sector. The pick-up in domestic-oriented industries was led mainly by a turnaround in the construction-related industries and fabricated metal products industry, which were supported by the gradual improvement in the construction sector and strong regional demand.




The agriculture sector registered a strong performance of 6.4%, the highest growth rate since 1992. The expansion was broad based, reflecting higher growth in both industrial (including palm oil, rubber and cocoa) and food crops. The robust growth reflected higher yields amidst the strong commodity prices, good weather conditions and wider application of good agriculture practices during the year. Meanwhile, the mining and construction sectors experienced mild contraction of 0.2% and 0.5% respectively. Slower activity in the mining sector was due to lower production of crude oil and natural gas following the shutdown of a number of oil fields for maintenance, as well as the phased upgrading to expand capacity at the MLNG 2 plant. The construction sector showed a steady improvement, despite remaining in the negative growth territory. The sector was driven by the gradual recovery in the civil engineering segment arising from higher public outlays with the commencement of several 9MP projects and increased construction activity in the oil and gas industry. Higher activity in the non-residential segment also contributed to the overall improvement in the construction sector.

Notwithstanding the increase in oil prices, inflation was relatively benign. Inflation expectations were broadly well-anchored throughout the year despite the spike in the inflation rate in March 2006. This reflected the monetary policy credibility derived from a long history of relatively low inflation in Malaysia. In

addition, the Government's assurance that the increase in retail petrol prices in March would be a one-off occurrence helped limit the price pressures cascading into the overall price level. For the year as a whole, the headline inflation rate, as measured by the Consumer Price Index (CPI), increased to 3.6% (2005: 3%). The level was within the Bank's forecast range of 3.5 – 4.0%. While other key categories also registered some price increases, the rising cost of transport was the main contributor to the higher inflation in 2006. 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 |
|---|---|---|
| Inflation (% change) | | |
| CPI (2005=100) | 3.0 | 3.6 |
| Core CPI[1] | 2.0 | 2.1 |
| Unemployment (% of labour force) | 3.5 | 3.5 |

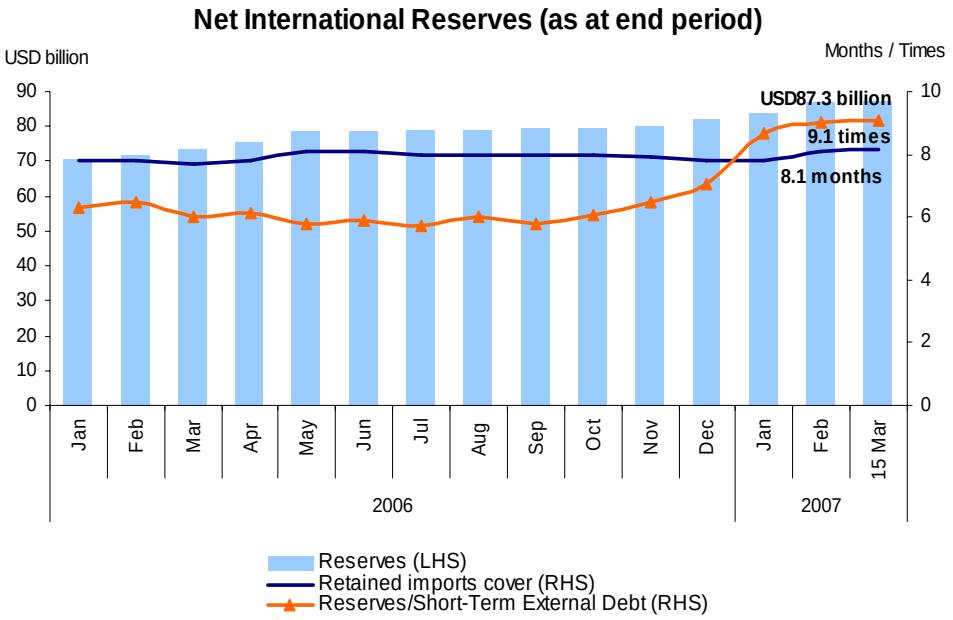
[1] Excludes price-controlled items and price-volatile items as well as items that are subject to one-off price adjustments

Malaysia's external position remained strong in 2006. The current account recorded a larger surplus of RM91.2 billion, equivalent to 17.3% of GNP, supported by a strong trade surplus and improvement in services and income accounts. Gross exports expanded by 10.3%, reflecting continued strong growth in primary commodities and sustained expansion in manufactured exports. The expansion in primary commodity exports was driven by higher prices, while the strong performance of manufactured goods was on account of higher exports of selected resource-based industries such as wood, petroleum and rubber products, and the continued growth in exports of electronics and electrical products (E&E). Gross imports strengthened to 10.8%, reflecting higher production and exports of manufactured goods, as well as strong domestic consumer and investment spending. The services account deficit improved further underpinned by higher tourism receipts and, to a lesser extent, an improvement in commissions earned

through international trading activities. Increased profits and dividends accruing to Malaysian companies from their overseas investment led to an improvement in the income account.

The financial account recorded a larger net outflow of RM39.9 billion as larger overseas investment and higher net outflows of other investment more than offset the inflows of foreign direct investment (FDI) and portfolio investment. Supported by sustained investors' confidence and continued commitment of foreign investors operating in Malaysia, gross FDI increased significantly to RM37.2 billion (7.1% of GNP). During the year, portfolio investment recorded a net inflow of RM14.7 billion, mainly for purchases of debt securities and investments in the equity market. Improved competitiveness and a strategy to diversify operations undertaken by Malaysian companies led to higher net direct investment abroad. Meanwhile, significant net outflows of other investment reflected larger outflows by both the official and private sector.

As the current account surplus was more than sufficient to finance the outflows in the financial account, net international reserves increased by RM25.3 billion to RM290.4 billion (USD82.5 billion) as at 31 December 2006. The increase in reserves occurred amidst significant two-way flows, reflecting the more robust economic activity and strong fundamentals of the Malaysian economy. As at 15 March 2007, total reserves rose further to RM307.2 billion (USD87.3 billion), adequate to finance 8.1 months of retained imports and is 9.1 times the short-term external debt.




Malaysia's external debt position improved further to RM179.4 billion (or USD50.3 billion) as at end-2006, reflecting declines in both short-term and medium- and long-term debt. Total external debt now amounts to just 34.1% of GNP, significantly lower than the 41.9% recorded in 2005. The lower short-term debt was attributed mainly to unwinding of interbank borrowings by the banking sector. The improvement in the medium- and long-term debt reflected net loan repayments by the public sector, the fourth successive year of net repayments. Malaysia's capacity to meet its debt obligations and its resilience has improved significantly. Of the total external debt, short-term debt only constitutes 23%, or 7.8% of GNP. The debt service ratio also declined to 4.7%.

**Monetary and Financial Conditions in 2006**

The year 2006 was challenging, particularly on the monetary and financial front. Developments in the global financial markets during the year were driven by favourable global growth outlook and heightened inflation risks in an environment of excess liquidity. The high global liquidity motivated investors to actively search

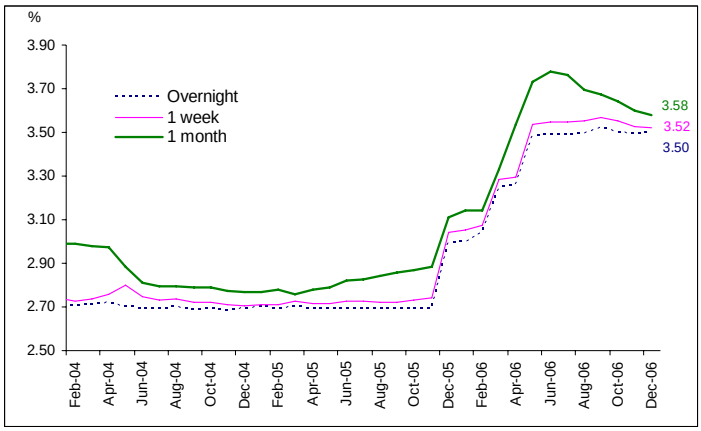
for higher returns across different asset classes and risk profiles, leading to large inflows of capital into the emerging markets throughout the year. With Malaysia having become more integrated with the global economic and financial system, these developments in the global financial markets had an important impact on domestic monetary and financial conditions.

Monetary policy in 2006 focused on attaining an appropriate balance between maintaining price stability and achieving the maximum sustainable level of economic growth. Like most countries, inflation emerged as a policy challenge amidst rising energy and commodity prices in the global markets, especially in the first half of the year. Following the fuel price revision in March 2006, the inflation rate increased to 4.8%. From the perspective of monetary policy, the key consideration was whether these supply-driven price shocks would spur secondary rounds of price increases. It was important to ensure that monetary policy was in a position to deal with such secondary pressures should they occur.

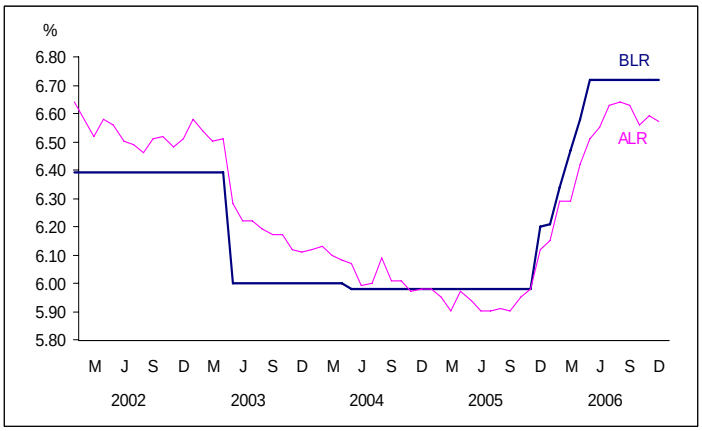
With the macroeconomic fundamentals remaining strong, Bank Negara Malaysia took the opportunity to align monetary conditions to the prevailing environment of higher inflation. The Overnight Policy Rate (OPR) was raised twice, in February and April, by 25 basis points each time. The normalization of interest rates placed the Bank in a better position to respond to any risks of rising inflation. Equally important, the adjustments had minimal impact on growth whilst minimizing the risks from a prolonged period of negative real deposit interest rates. From May onwards, the OPR was left unchanged as there had been an absence of second round effects and demand induced inflationary pressures. Also, there were emerging signs of a moderation in the outlook for global economic growth. At 3.50%, the OPR remained supportive of economic activity.

The increases in the OPR were transmitted efficiently to the market and retail interest rates. The average overnight interbank rate traded close to the OPR over the course of the year, moving within the range of 2.98% – 3.56% in 2006 as the OPR was raised from 3.00% to 3.50%. Interbank rates of other maturities also rose in line with market expectations of higher interest rates. The average base lending rate (BLR) of the commercial banks increased and subsequently stabilised at 6.72% in mid-May until the end of the year. Similarly, the average lending rate (ALR) also moved upwards, reflecting the re-pricing of existing BLR pegged loans, the extension of new loans at higher rates, as well as the maturing of older loans carrying lower interest rates. The ALR stood at 6.57% as at end-2006. Although lending rates have risen, they remained close to their historical lows and continued to be supportive of economic activity. The fixed deposit (FD) rates for tenures of between 1 to 12 months have also increased by 2 – 46 basis points since November 2005. Real FD rates, which had been negative since May 2005 when inflation first began to rise above 3%, turned positive across all maturities in October 2006 as inflation trended downwards.

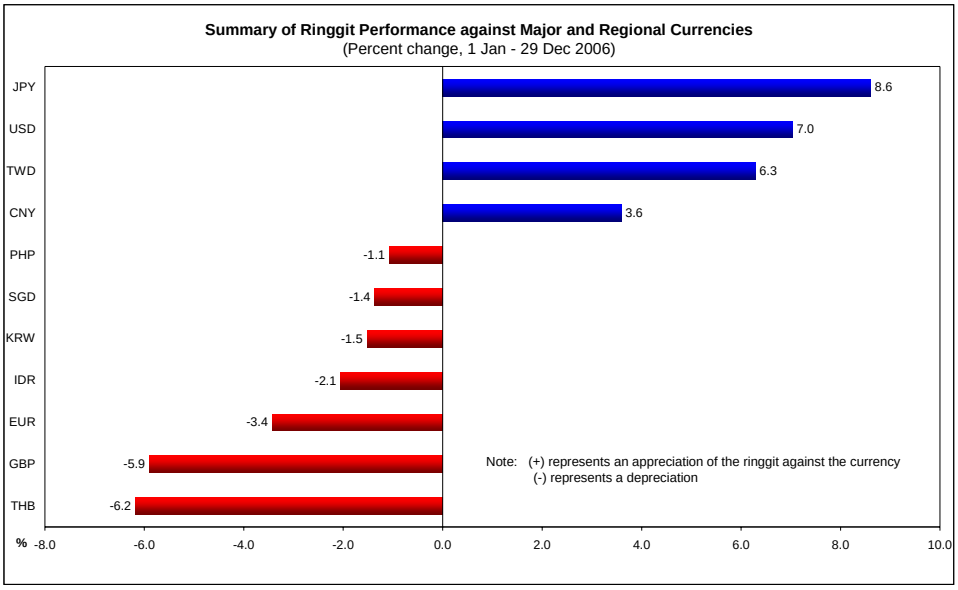
**Interbank Rates**




**Commercial Banks' Lending Rates (at end-period)**



In 2006, the ringgit exhibited greater two-way movements driven broadly by the demand and supply of ringgit in the foreign exchange market. Key factors affecting the ringgit over the course of the year were the trade surplus, investment inflows into the country arising from sound economic growth prospects, and market expectations of exchange rate appreciation. These factors were counterbalanced by the strong demand for foreign currencies for outward direct and portfolio investment, repayment and prepayment of external loans and the repatriation of profit and dividends. Such offsetting inflows and outflows enabled stability in the ringgit exchange rate for most of the year. To date, the gradual strengthening of the ringgit exchange rate has been broadly in line with the currencies of Malaysia's major trading partners and is reflective of Malaysia's strong macroeconomic fundamentals.




After the relatively weak performance in 2005, the KLCI ended 2006 on a significant positive note to close at 1,096.24 points, or 21.8% higher compared to a year earlier. Among the factors that contributed to the better performance of the equity markets were renewed foreign inflows, strong corporate earnings, corporate mergers and acquisitions and expectation-driven sentiments following the announcement of the 9MP infrastructure projects.

In 2006, total net financing channeled to the economy, encompassing both public and private financing, increased by 5.9%. Given that domestic monetary and financial conditions were strongly supportive of economic activity, the private sector was able to be more selective about the avenues and structures that were most suited to their financing needs. The private debt securities (PDS) market was the main source of domestic long-term financing. While supported by diversified sources of financing, the business sector also continued to rely on internally generated funds for working capital and investment during the year.

In terms of monetary policy instruments, direct borrowing remained as the principal means to sterilize surplus liquidity due to its flexibility. In addition, there was also a greater use of repurchase transactions (repos) in order to create greater liquidity and more reflective benchmark yield curve for Government securities. This was made possible by the availability of collateral securities, primarily Malaysian Government Securities (MGS), from major institutional investors through the lending of securities via the Bank's Institutional Securities Custodian Program (ISCAP). A major development in Islamic money market operations during the year was the inaugural issuance of the Bank Negara Malaysia Sukuk Ijarah on 16 February 2006, with an issue size of RM400 million. A special purpose vehicle, Bank Negara Malaysia Sukuk Berhad has been established to issue the Sukuk Ijarah. Another significant development was the introduction of Bank Negara Monetary Notes (BNMNs) to manage liquidity in both the conventional and Islamic financial market. Going forward, BNMNs are likely to play a greater role as a monetary policy instrument given their flexibility and increasing depth of the secondary market, and the larger issuance threshold.

**Outlook and Prospects for the Malaysian Economy in 2007**

For 2007, a global growth of 4.5% is anticipated (5.0% in 2006), with further easing of inflationary pressures and with some moderation in growth of world trade. This represents the fifth consecutive year where global growth would exceed 4%. The correction of the United States (US) housing market is expected to gradually have a broader impact on consumption. Real GDP growth for the US is, therefore, expected to moderate to 2.7% in 2007, from 3.3% in 2006. Recovery in Japan would continue, albeit at a more gradual pace. Prospects for the Euro area are more optimistic following signs of a broad-based recovery in major member countries. Although some moderation in external demand is anticipated, growth in the Asian region is expected to remain favourable, supported increasingly by domestic demand, particularly in China and India.

With the sustained global growth and resilient domestic demand, the Malaysian economy is projected to expand by 6%. The growth rate is in line with that of the potential output. This pace is consistent with the expansion in productive capacity with capital formation gaining momentum. The growth pattern during 2007 would be influenced by both external and domestic factors. The global economy is expected to expand more moderately in the first half of the year with a slower growth expected in the US. 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 rapidly during that period. Growth would also be supported by domestic developments towards the later part of the year. These include, among others, the more rapid implementation of 9MP projects, the start of production at the Kikeh oil field and the increased tourist arrivals during the peak summer travel season, following intensive promotion of Visit Malaysia Year 2007.

Resilient domestic demand would continue to be the main driver of economic growth. While the private sector, particularly private investment, continues to provide the impetus to growth, the public sector is expected to play a

more significant role in 2007. Projects identified under the 9MP would be implemented more intensively during the year. Strong domestic and external demand as well as high levels of capacity utilisation would also induce firms to expand capacity. Firm-level investment is also expected to benefit from the reduction in the corporate tax rate as announced in the 2007 Budget, while ample liquidity in the financial system will ensure funding would be adequate.

On the supply side, growth would be broad based, with expansion across all sectors. The mining and construction sectors, which had contracted in 2006, are expected to register positive growth. The construction sector, in particular, would benefit from higher public expenditure on the 9MP projects as well as strong demand in the non-residential properties segment. In the mining sector, growth would be higher, driven by output of crude oil and natural gas due to the commencement of production of the new Kikeh oil field towards year end and increased capacity of the MLNG 2 plant after an upgrade. The manufacturing sector is envisaged to record a sustainable expansion, supported by resource-oriented industries and industries related to the construction sector. The E&E is expected to moderate in the first half-year before picking up in the later part of the year. Meanwhile, the services sector would be underpinned by intermediate services, in particular the finance, insurance, real estate and business services sub-sector, with higher contribution from Islamic financial services and the newly-formed investment banks. The sector would also be further spurred by higher tourist arrivals during the Visit Malaysia Year 2007.

Headline inflation, which increased in 2006 due to higher energy prices, is expected to moderate to average between 2 – 2.5% for the year as a whole. The key contributing factors to the lower inflation rate would be the lapse of the impact of the increase in the retail petroleum products prices, the moderation in energy prices and the well-contained public inflation expectations. In addition, price pressures from demand conditions are expected to be subdued, given the ongoing expansion in productive capacity supported by the increased competitive

pressures arising from global economic integration. Hence, barring any new upward adjustments to administered prices, inflationary conditions would be relatively benign in 2007.

On the external front, the current account is forecast to record another surplus, driven by the trade surplus and improved services receipts arising from the tourism sector, while inflows of FDI are expected to remain substantial. Gross exports are expected to expand by 8.2%. Strong growth in exports of resourced-based manufactured products will partly mitigate the slower growth in E&E exports. Agriculture exports are expected to strengthen, driven mainly by higher prices of palm oil. The financial account is expected to be supported by continued inflows of foreign funds for long-term investment. More merger and acquisition activities as well as the implementation of the development projects under the 9MP are also expected to attract inflows of FDI. At the same time, Malaysian investors are expected to intensify the diversification of their portfolios by investing abroad.

**Economic and Monetary Management in 2007**

The 2007 Budget is oriented towards enhancing the macroeconomic fundamentals and promoting a more broadly balanced economic structure. To create sustainable longer-term growth, the emphasis will be on new areas of domestic economic activity. Accordingly, public policy in 2007 is focused on facilitating the private sector to play the lead role in economic transformation and generate new sources of growth in the technology and knowledge-intensive sectors. In addition to 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, as well as programmes to reduce socio-economic and regional disparities. Overall, the budget deficit is projected to decline to 3.4% of GDP in 2007 as the Government continues to consolidate its fiscal position.

The conduct of monetary policy in 2007 will continue to balance between the need to ensure that interest rates remain at a level that would enable the central bank to respond to any risks of rising inflation, while remaining conducive to sustaining growth in domestic demand. At current interest rate levels, monetary policy remains accommodative. Bank Negara Malaysia will continue to assess developments in the domestic and international economies and will adjust its monetary policy stance as circumstances require.

**Bank Negara Malaysia's Audited Financial Statements for 2006**

Bank Negara Malaysia's financial position in 2006 has been examined and certified by the Auditor General. Total assets of the Central Bank rose to RM323 billion as at end-2006 (end-2005: RM295.4 billion). The major increase in assets was attributed to an increase in international reserves. Bank Negara Malaysia's international reserves increased to RM290.4 billion (USD82.5 billion) as at end-2006. The Central Bank registered a net profit of RM3.5 billion for the financial year ended 31 December 2006 and declared a dividend of RM1.2 billion to the Government for the year 2006.

**Bank Negara Malaysia**
**21 March 2007**