BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Ref. No.: 08/06/12

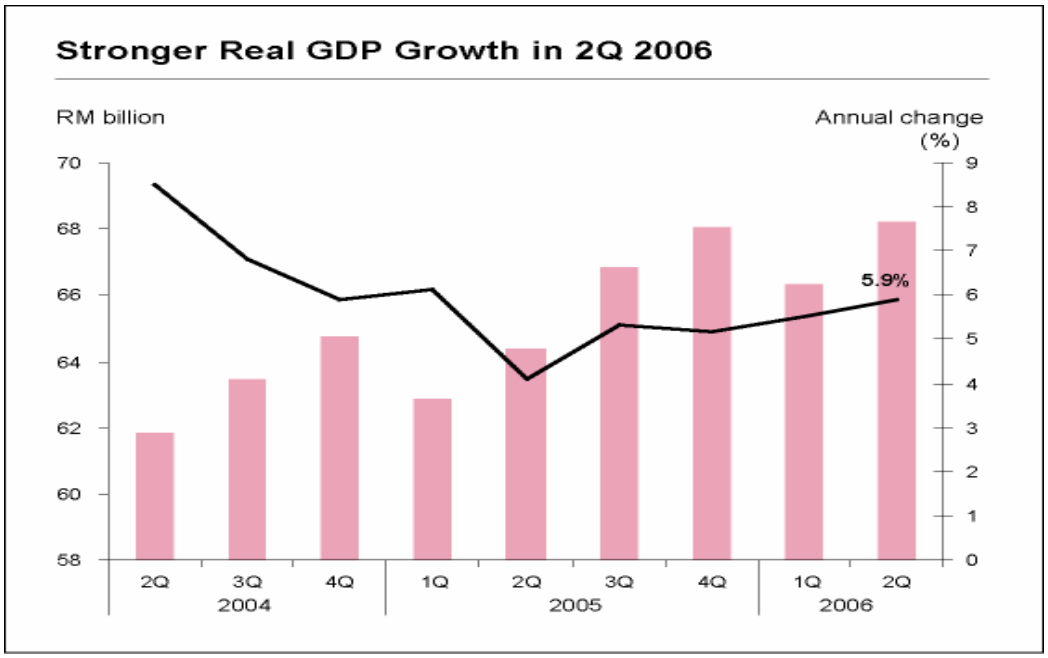
EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 30 August 2006

PRESS RELEASE

Economic and Financial Developments in Malaysia in the Second Quarter of 2006

Growth momentum remained sound

The Malaysian economy strengthened, with real gross domestic product expanding at 5.9% in the second quarter (1Q: 5.5%). Economic activity continued to be driven by the private sector. The services, manufacturing and agriculture sectors were the key contributors to growth during the quarter.



The services sector expanded at a faster pace of 6% during the quarter, driven primarily by the stronger growth in the finance, insurance, real estate and business services and the wholesale and retail trade, hotels and restaurants sub-sectors. Value added in the manufacturing sector continued to expand strongly by 8.4% (1Q: 8.5%), supported by the robust performance of resource-based industries and continued expansion in the electronics and electrical (E&E) products industry. Of significance, the chemical and chemical products industry recorded a double-digit growth (11.1%) given the strong external demand. In addition, output of both rubber products and off-estate processing industries rebounded by 8.4% and 7.4% respectively. In the domestic-oriented industries, output of the construction-related materials improved, while the fabricated metal products recorded a stronger double-digit growth.

For the second consecutive quarter, growth performance of the agriculture sector continued to be strong (5.8%), underpinned by broad-based expansion across the major sub-sectors. Meanwhile, signs of recovery in activities in the construction and mining sectors were evident with only marginal declines recorded during the quarter. Improving civil engineering activities and moderate growth in the residential segment reflected the performance of the construction sector. In the mining sector, the decline in growth was due entirely to lower production of natural gas (-1.2%; 5,575 million standard cubic feet per day) due to the phased shutdown of the MNLG 2 plant for expansion purposes.

Domestic demand remained strong registering a growth of 6.9%. Private investment activities as well as higher capital spending by several non-financial public enterprises supported the strong growth of 7.6% in gross fixed capital formation. Businesses continued to invest as favourable economic sentiments were sustained. The strong investment pattern was reflected in the major financial and non-financial indicators. Imports of capital goods recorded strong growth. Issuance of private debt securities for new activities, loans approved to businesses and loans disbursed to the manufacturing and construction sectors were also higher. Meanwhile, Federal Government development expenditure was lower. During the quarter, the focus of public investment continued to be on essential projects, such as transportation, agriculture and rural development, public utilities, education and health services.

Private consumption expenditure was sustained in the second quarter, increasing by 7.3%. Favourable labour market conditions and continued growth in disposable income as a result of high commodity prices and favourable export earnings raised consumer sentiments and supported households' spending activities. This trend was also reflected in the MIER Consumer Sentiments Index which strengthened above the 100-point threshold level to 104.2 points (1Q: 90.1 points). Indicators of households' consumption, such as imports of consumption goods and credit card spending, registered sustained growth. Conditions in the labour market were generally positive with the number of vacancies remaining high and a steady improvement in job prospects. As expenditure on emoluments, supplies and services and general administration was higher during the quarter, the level of public consumption registered a growth of 4%. The overall fiscal position recorded a surplus of 4.8% of GDP (1Q: +3.8% of GDP) given higher petroleum-related revenue and income tax collection.

For the second quarter of 2006, headline inflation, as measured by the Consumer Price Index (CPI), increased to 4.1% (1Q: 3.7%). High energy prices continued to be the major source of cost-push inflation. The higher transport costs, due to the increase in retail fuel prices in March 2006, kept inflation high during the quarter.

On the external front, the trade surplus continued to narrow to RM23.2 billion (1Q: RM25.8 billion) as growth in gross imports (11.5%) was higher relative to gross exports (9.8%). Growth in gross exports was led mainly by continued double-digit expansion in manufactured exports (10.4%) and mineral exports (10.1%). The manufactured exports reflected increases in exports of resource-based products. Exports of E&E products, as a whole, expanded by 6.4% (1Q: 8.4%) despite lower prices in a number of selected segments. Receipts from mineral exports increased despite lower export volume as energy prices remained high. The export price of crude oil averaged USD71.12 per barrel in the second quarter and that of liquefied natural gas averaged RM1,033 per tonne.

Agriculture exports rose by 3.7%, mainly supported by the sharp increase in rubber exports (61.7%). The strong increase in rubber exports was in turn due to the increase in prices (53.9%). Strong global demand from the automotive sector supported the high price for natural rubber. Meanwhile, receipts from palm oil exports declined by 3.3% on lower export volume as there was an increase in domestic supplies of substitute vegetable oils in key export markets, including India and Pakistan.

Gross imports remained strong reflecting continued expansion in imported inputs for manufactured exports and sustained domestic consumer spending and private investment activity. In the second quarter, imports of capital goods expanded by 8.5%. Strong external demand for commodity exports, oil and gas exploration and expansion in intra-regional travel reflected the increased demand for aircraft, ships and offshore support vessels. Excluding these lumpy items, imports of capital goods continued to expand by 5.4%. Capacity expansion and upgrading for fuel efficiency in the manufacturing and services sectors led to the strong growth in imports of generators, turbines and electric motors as well as machinery for manufacturing. Imports of intermediate goods, comprising mainly of inputs for the E&E, food and beverage products expanded by 7.6%. Reflecting the strong private consumer spending, imports of consumption goods also increased by 13.2%.

In the financial account, foreign direct investment (FDI), as monitored by Bank Negara Malaysia's Cash BOP system, recorded a larger net inflow of RM2.5 billion. These inflows were broad based and channelled mainly into the services, manufacturing and oil and gas sectors. It should be noted that this FDI data only captures new financial flows and does not include retained earnings that have been reinvested in Malaysia. It also does not include investment in the form of imported machinery and equipment. During the quarter net inflow of portfolio investment totalled RM1.3 billion. For overseas investment, there was a net outflow of RM3.6 billion.

The international reserves of Bank Negara Malaysia amounted to RM289.3 billion (USD78.8 billion) as at 30 June 2006. As at 15 August 2006, the reserves amounted to RM291 billion (USD79.2 billion), sufficient to finance 8.1 months of retained imports and was 6.2 times the short-term external debt.

Monetary policy remained supportive of economic activity

The domestic economy grew at a sustained pace in the second quarter, amid favourable domestic demand conditions and a supportive external environment. Recent statistics indicated that inflation had peaked in the first half of 2006 and is likely to be lower for the remaining part of the year. In addition, there is limited evidence of second-round effects, with no indications of rising demand-induced inflationary pressures. These factors prompted a pause after three interest rate increases. Consequently, the Overnight Policy Rate (OPR) has remained unchanged at 3.50%.

The average quoted fixed deposit (FD) rates of commercial banks (CBs) remained relatively stable after the increases in late April and early May. As at 31 July, the average FD rates for the 1-month to 12-month maturities ranged between 3.12% and 3.76%. In particular, the average rates for the 6-month and 9-month maturities had increased by 23 and 32 basis points respectively to 3.34% and 3.48% since the end of the first quarter. In terms of retail lending rates, the average base lending rate (BLR) of CBs remained stable after rising to 6.72% in mid-May 2006. Meanwhile, the average lending rate (ALR) of CBs rose at a slower pace over the second quarter to 6.55% at end-June (1Q: 6.29%). Interbank rates have remained relatively stable since late April.

Growth in private sector financing was sustained in the second quarter of 2006, with banking system loans and private debt securities (PDS) outstanding expanding steadily at a combined annual rate of 9.1% (1Q: 9.1%). Bank lending remained strong, with banking system loans outstanding increasing by 8.6% on an annual basis at end-2Q 2006 (1Q: 8.4%). Business loans outstanding rose at an annual rate of 4.1% (1Q: 2.7%), while household loans outstanding expanded by 13.3% (1Q: 14.5%). Major loan indicators were all higher compared to the preceding quarter, but were mixed on an annual basis. While loan disbursements to businesses and households continued to increase, loan applications by both businesses and households were lower.

Financing through the PDS market remained firm, with RM10.8 billion of gross funds raised during the second quarter (1Q: RM10.6 billion). The funds were raised mainly through the issuance of Medium-term Notes and Islamic bonds. On a net basis, total funds raised by the public and private sectors through the capital market amounted to RM10.9 billion during the quarter (1Q: RM8 billion).

Narrow money, M1, expanded at a higher annual growth rate of 10.1% in the second quarter (1Q: 5.7%), mainly reflecting higher demand deposits placed by businesses. Meanwhile, broad money, M3, increased at a sustained annual growth rate of 6.4% (1Q: 6.2%). The expansion in M3 continued to be supported by higher claims on the private sector, as both the banking system's loans outstanding, as well as its holdings of securities, increased relatively stronger compared to the previous quarter.

Movements of the Malaysian ringgit exchange rate continued to reflect the changes in the market demand and supply for the ringgit, as well as developments in the currencies of the regional and major industrialised economies. The ringgit appreciated strongly against the US dollar from April to mid-May on account of the strong current account performance and capital flows. However, the gains against the US dollar were limited, as the ringgit, and the other regional currencies were affected by the sell-down of emerging market equities and bonds, on the concern that rising US interest rates and the high commodity prices would contribute towards moderating the pace of global economic growth. For the second quarter as a whole, the ringgit appreciated marginally against the US dollar, but depreciated against the Japanese yen and euro. Against regional currencies, the ringgit depreciated against the Korean won (1.9%), Singapore dollar (1.5%) and Thai baht (1.2%), but appreciated against the Philippine peso (4.4%) and Indonesian rupiah (2.9%).

The banking system remained strong

The banking system remained strong in the second quarter. As at end-June, the risk- weighted capital ratio (RWCR) was 12.9%. Pre-tax profits for the quarter amounted to RM2.9 billion supported by continued growth in net interest and fee-based income. Asset quality of the banking system continued to improve primarily as loans turned performing and as recoveries improved. With the decline in non-performing loans, the net NPL ratio reduced to 4.2% based on the 6-month classification and 5.5% based on the 3-month classification.

Underlying growth momentum remains positive

Going forward, prospects for the overall global economy remain positive, despite the high oil prices and the high interest rates. With the recovery in Japan and Europe, and the underlying growth momentum in the regional economies, especially the large economies remaining strong, the global growth continues to be more broad based. Growth is expected to be sustained in the second half of the year. Continued favourable performance in the regional economies would lend further support to intra-regional trade and investment. In addition, global demand for commodities remains strong and broad based.

The Malaysian economy is expected to sustain its growth momentum in the second half year. Growth would continue to be driven by domestic demand, particularly private sector activity and by the external sector amidst high commodity prices. In addition, the Federal Government's development expenditure is expected to increase with the acceleration in activities of on-going projects and the launch of the new projects announced by the Government under the Ninth Malaysia Plan.

Economic sentiments for the near term remain strong, as indicated by forward-looking indicators of economic activities. The latest MIER Business Conditions Index at 102.4 points suggests a continued expansion in private investment activity. Stable labour market conditions and firm commodity prices continue to sustain household consumption activities. The DOSM leading index continues to register persistent expansion over the recent few months. The latest six-month smoothed growth of the leading index was close to 8%, which suggests that the growth in the Malaysian economy would be sustained for the remaining part of the year.

Bank Negara Malaysia
30 August 2006