INTERNATIONAL ECONOMIC ENVIRONMENT

Strong growth performance in the global economy

Global economic growth strengthened in the first quarter. The US economy rebounded strongly from the moderate growth rate in the fourth quarter of 2005. In addition, growth in the Asian region remained strong, supported by the electronics upcycle and stronger growth in PR China.

The **US** economy grew at its fastest pace in 2½ years at 5.3% during the first quarter and the expansion was broad-based. Consumption was robust, supported by strong job growth. Nevertheless, the US housing market continued to slow as home sales fell and the number of homes for sale hit a new record high. Government spending rose given the expenditure on reconstruction efforts after the hurricanes on the Gulf Coast in 2005 while business investment was largely driven by spending on equipment and software.

Industrial countries: Real GDP Growth

	2005			2006	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q[p]	
	Annual change (%)				
US[1]	3.8	1.7	3.5	5.3	Broad-based expansion, supported by strong spending and business investment.
UK	1.9	1.8	1.8	2.2	Supported by growth in industrial production, in particular the manufacturing sector.
Euro zone	1.2	1.8	1.4	2.0	Growth was supported by higher domestic spending in Germany and improved growth in Italy.
Japan[1]	5.9	4.3	2.6	1.9	Supported by firm domestic demand, namely capital spending and private consumption.

[1] Annualised basis
[p] Preliminary
Source: National authorities

In **Japan**, economic indicators continued to largely reflect steady economic recovery. The Tankan Survey showed that the outlook for business conditions, especially for large firms, remained favourable for the first half of 2006, with growth in capital expenditure and employment. In the **euro area,** economic activity expanded by 2.0%. Germany, the region's largest economy grew 1.4% during the quarter following increased domestic demand. This was led particularly by high fixed capital spending as well as increased household consumption spending. Italy also saw improved growth during the quarter, expanding 1.5% due to higher industrial production. Meanwhile, economic activity in the **UK** expanded by 2.2% in the first quarter and was supported mainly by expansion in the manufacturing and services sectors.

Global **monetary policy** remained biased towards tightening. The **US Federal Reserve Board (Fed)** continued to raise interest rate by 25 basis points in January, March, April and May, bringing the Fed funds rate to 5%. The latest statement indicated that some further policy firming may continue to address inflation risks but emphasized that future moves would depend on how the economic outlook unfolds. The **Bank of Japan** removed the quantitative easing framework on 9 March 2006 and is now targeting the overnight call rate. The **European Central Bank (ECB)**, meanwhile, raised its main refinancing rate by 25 basis points in March, bringing its key rates to 2.50%.

Global **crude oil prices** edged up towards the end of first quarter, closing at USD67.30 per barrel on 30 March, the highest level in two months amid concerns over supplies in Nigeria as well as potential supply disruptions in Iran and Iraq and strike threats by energy workers in Europe (France and Norway). Oil prices recorded a new peak in April, reaching USD75.35 per barrel on 21 April after the US government reported a larger-than-expected drop in gasoline inventories. Thus far, the surge in oil costs has yet to significantly slow the growth in oil demand and the global growth.

In the **Asian region**, economic activity remained strong with growth in the first quarter strengthening further in PR China, Singapore and Korea. Meanwhile, continued pick-up in demand for electrical and electronic goods contributed to strong export performance. High oil imports, however, led to a lower trade surplus in some regional countries.

Regional Countries: Real GDP Growth

	2005			2006	Key contributing factors for 1Q growth
	1Q	4Q	Year	1Q	
	Annual change (%)				
PR China	9.9	9.9	9.9	10.3	Driven by strong growth in investment.
Singapore	3.4	8.7	6.4	10.6	Buoyed by strong expansion in the manufacturing and services sectors.
Hong Kong	6.0	7.5	7.3	8.2	Driven by exports, consumer spending and investment in machinery and equipment.
Korea	2.7	5.3	4.0	6.2e	Supported by strength in exports as well as private consumption.
C. Taipei	2.5	6.4	4.1	4.9	Supported by electronic exports and the manufacturing sector.
Indonesia	6.1	4.9	5.6	4.6	Supported by the services and mining sectors.

e Advance estimates
Source: National authorities

Inflation trends in the region were mixed. Inflation in Thailand and Indonesia edged downwards slightly, compared with 4Q 2005 following moderation in food prices. However, inflation has risen in Hong Kong, Singapore and the Philippines mainly due to higher housing rentals, utilities and tighter labour markets. To contain inflationary expectations and limit second-round effects, Korea, Thailand and India have raised interest rates. On 27 April, PR China also raised its one-year lending rates by 27 bps to 5.85% (first increase since October 2004), aimed at slowing strong growth in credit and investment.

In the **foreign exchange market**, the US dollar weakened against most currencies during the quarter. Among the major currencies, the US dollar depreciated against euro and sterling. The euro benefited from the ECB's rate increase and market expectations of reserve diversification by some central banks. Meanwhile, regional currencies appreciated, supported by continued inflows from abroad and optimism about economic growth. The Indonesian rupiah recorded the strongest appreciation due to growing investor confidence in the economy and foreign investor interest in Indonesia's high-yielding bonds.

Going forward, the pace of expansion in the global economy is expected to be sustained. However, the risks to growth remain, mainly from the effect of higher oil and commodity prices.

DEVELOPMENTS IN THE MALAYSIAN ECONOMY

Sustained growth, led by the manufacturing and services sectors

In the first quarter of 2006, the Malaysian economy expanded by 5.3% (4Q 2005: 5.2%). Growth continuing to be driven by the manufacturing and services sectors. The manufacturing sector registered a stronger growth, mainly benefiting from the upward trend in the global semiconductor cycle, while growth in the services sector remained firm, supported by trade, consumption and tourism-related activities. Meanwhile, the performance of the primary commodity sector was mixed. The agriculture sector recorded a strong expansion due to better performance in most of the sub-sectors which more than offset the decline in crude palm oil production. Activity in the mining sector, however, declined due to lower output of crude oil and natural gas.

Quarterly GDP by Kind of Economic Activity at 1987 Prices

	2005			2006
	1Q	4Q	Year	1Q
	Annual Change (%)			
Agriculture	6.1	-1.5	2.5	7.3
Mining	3.4	-2.0	0.8	-3.5
Manufacturing	5.7	7.9	5.1	8.0
Construction	-2.4	-0.6	-1.6	-1.8
Services	6.8	5.9	6.5	5.2
Real GDP (Ann. Chg.)	**6.1**	**5.2**	**5.2**	**5.3**
Real GDP (Preceding Chg.)	**-2.9**	**1.8**	**5.2**	**-2.8**

Source: Department of Statistics, Malaysia