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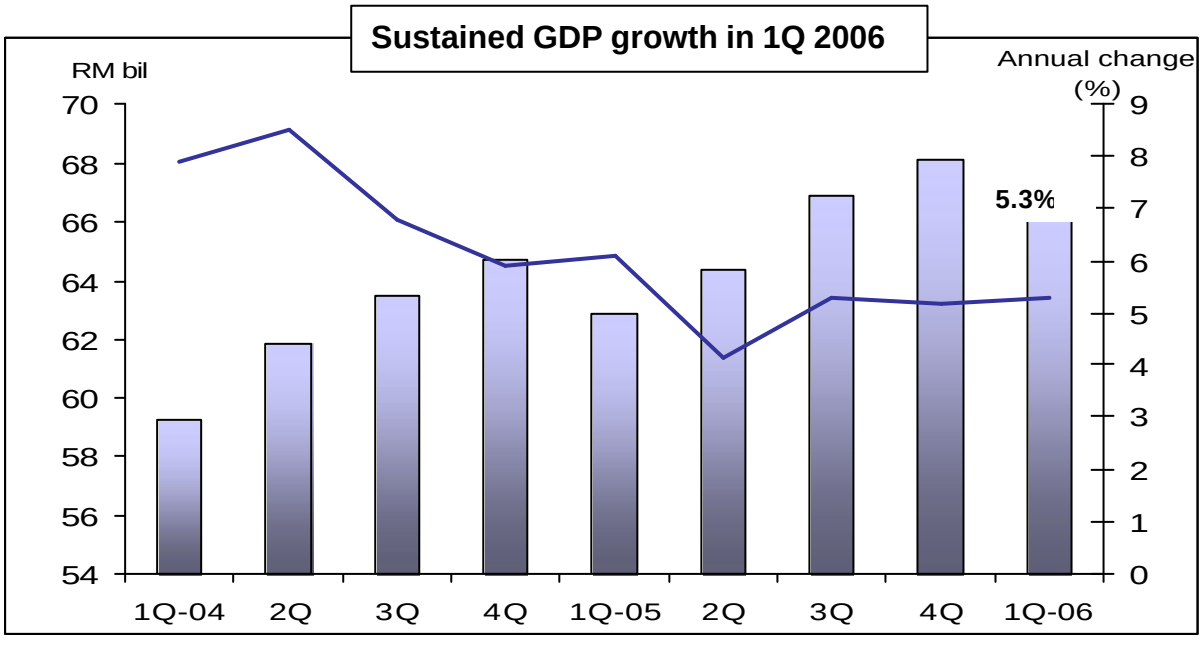
Economic and Financial Developments in Malaysia in the First Quarter of 2006

Economic activity was sustained in the first quarter

The growth momentum of the Malaysian economy was maintained with real gross domestic product (GDP) rising by 5.3% in the first quarter of 2006 (4Q 2005: 5.2%). Economic activity continued to be driven by the private sector. The key contributors to the growth were the manufacturing and services sectors, with the strong performance in the agriculture sector lending further support.



Valued-added growth in the manufacturing sector continued on its upward trend to expand by 8% (4Q 2005: 7.9%) in line with recovery in the global semiconductor cycle. This strong performance was led mainly by stronger growth in the electronics and electrical products industry (16.7%; 4Q 2005:10.5%), with all major categories of products recording growth. The computer segment in particular, benefited from strong buying interest as a result of lower prices as well as increased demand for laptops due to increasing popularity of wireless systems. Valued-added growth in the manufacturing sector was further reinforced by the stronger expansion in the textiles, wearing apparel and footwear industry (10.5%; 4Q 2005: 10.3%). Output of the chemical and petroleum products industries also expanded, albeit at a more moderate pace (4.4% and 8.9% respectively) due to slower external demand for intermediate plastic materials and lower production of natural gas.

The services sector continued to expand by 5.2% supported by trade, consumption and tourism-related activities. Of significance, the finance, insurance, real estate and business services; and wholesale, retail trade, hotels and restaurants performed favourably. Growth in the agriculture sector strengthened significantly to 7.3% underpinned by higher output of rubber, cocoa, fish, paddy, fruits and vegetables which more than offset the lower activity in the crude palm oil sub-sector. Meanwhile, the construction and mining sectors continued to decline. The construction sector was affected by weak civil engineering activities and some moderation in demand for residential properties. The decline in the mining sector was due to lower production of crude oil including condensates (-2.2%; 724,166 barrels per day) and natural gas (-5.9%; 5,974 million standard cubic feet per day).

Domestic demand remained robust registering a growth of 7.6%. Gross fixed capital formation strengthened further, registering a growth of 11.4%. Of significance, the rise was supported mainly by private investment activities. Spurred by the better business outlook and the sustained high capacity utilisation, businesses upgraded and expanded their productive capacity, and undertook new investments in downstream activities. Indicators of investment supported the strong investment pattern. Imports of capital goods and sales of commercial vehicles both recorded

strong double-digit growth. Loans approved and disbursed to businesses were also sustained. Although Federal Government development expenditure was lower, public investment continued to focus on essential projects, such as agriculture and rural development, public utilities, education and health services.

Purchases of new passenger cars, an important component in consumption demand, recorded a decline during the quarter as consumers deferred purchases with the impending announcement of the National Automotive Policy. At the end of February, consumers were also affected by the increases in the retail price of fuel and gas. Despite these developments, private consumption expenditure remained strong, increasing by 7.5% during the quarter. Other major consumption indicators, such as imports of consumption goods and credit card spending, registered strong growth. Financing conditions, while normalising, remained supportive, as shown by the sustained growth in loans approved and disbursed for consumption purposes. The level of public consumption was sustained, registering a growth of 0.1%, with higher expenditure on emoluments and defence. The overall fiscal position showed a surplus of 3.8% of GDP (1Q 2005: +2.3% of GDP) as stronger revenue collection more than offset the increase in total expenditure.

The annual rate of inflation, as measured by the Consumer Price Index (CPI), increased to average 3.7% in 1Q 2006 (4Q 2005: 3.4%). This mainly reflected the 18% increase in retail fuel prices on 28 February 2006, resulting in the upward adjustment in the rate of inflation to 4.8% in March. Conditions in the labour market continued to be healthy with vacancies remaining high and both retrenchments and unplaced jobseekers declining further.

On the external front, the trade surplus narrowed to RM25.8 billion (4Q 2005: RM28.6 billion) as growth in gross imports (13.7%) was higher relative to gross exports (11.5%). Growth in gross exports was led mainly by strong growth in commodity exports, particularly minerals, and continued double-digit expansion in manufactured exports (10.6%). The manufactured exports were led by resource-based products and transport equipment. Although shipment of computers and computer-related products was robust, growth in exports of electronics and electrical (E&E) products as a whole was more moderate at 8.4% (4Q 2005: 14.7%) due to

slower growth in exports of electrical appliances. The moderation in growth in E&E export receipts during the quarter was partly attributable to lower prices of some products as a result of intense competition.

Receipts from mineral exports rose sharply by 24% due to the strong increase in energy prices. The export price for crude oil from Malaysia in the first quarter averaged USD65.32 per barrel and that of liquefied natural gas increased by 19.6% to an average of RM1,041 per tonne. Agriculture exports, meanwhile increased further by 5%, mainly supported by the sharp increase in rubber exports (48%). The strong increase in rubber exports was due to the increase in prices (43.7%). Natural rubber prices were higher on account of strong global demand from the automotive sector; the substitution from the more expensive synthetic rubber, which is made from petrochemicals, to natural rubber; and depleting global rubber stocks. Although the volume of palm oil exports increased (3.5%), receipts declined moderately (-1.3%) due entirely to lower prices compared with the corresponding period of 2005. Nonetheless, the export price of palm oil continued to remain attractive at RM1,420 per tonne.

Gross imports strengthened reflecting stronger private investment activity, domestic consumer spending as well as continued expansion in inputs for manufactured exports. Imports of capital goods, expanded at a significantly high rate of 28.8%. Strong external demand for commodity exports and expansion in intra regional travel led to an increase in deliveries of ships, aircraft and rail locomotives. Excluding these lumpy items, imports of capital goods increased by 12.3%. As shown by the imports of machinery for manufacturing, metal tools, office equipment and generators, turbines and electric motors, the increase in imports was for capacity expansion and upgrading of technology in the manufacturing and services sectors. Increased exploration and development activity in the upstream oil and gas industry also led to higher imports of construction and mining equipment. Imports of intermediate goods, particularly inputs for the E&E products, also expanded at a stronger rate of 8%. Reflecting higher demand for food and beverages for festivals celebrated during the quarter, imports of consumption goods also increased by 14.1%.

In the financial account, foreign direct investment (FDI), as captured by Bank Negara Malaysia's Cash BOP system, recorded a net inflow of RM0.9 billion. These inflows were broad based and channeled mainly into the services, manufacturing and oil and gas sectors. It should be noted that this FDI data only captures new financial flows and it does not include retained earnings that have been reinvested in Malaysia and investment in the form of imported machinery and equipment. There was also a net inflow in portfolio investment of RM3.9 billion. For overseas investment, there was a net outflow of RM1.8 billion.

The international reserves of Bank Negara Malaysia amounted to RM271.6 billion (USD73.7 billion) as at 31 March 2006. As at 15 May 2006, the reserves amounted to RM289.5 billion (USD78.6 billion), sufficient to finance 8.2 months of retained imports and is 6.6 times the short-term external debt.

Monetary policy remained supportive of economic activity

In the first quarter of 2006, economic indicators continued to point toward sustained economic growth, supported by sustained private sector demand and strong economic growth in the global and regional economies. The rate of inflation was, however, expected to remain at an elevated level for some time. Thus, to align the interest rates to current economic conditions and outlook, the Overnight Policy Rate (OPR) was raised by 25 basis points to 3.25% on 22 February 2006 and by another 25 basis points to 3.50% on 26 April 2006. Despite these two increases, interest rates continue to remain below the neutral level and thus, monetary policy continued to remain supportive of economic activity.

The daily weighted average overnight interbank rate moved within a range of 2.98% - 3.25% during the first quarter of 2006 (4Q 2005: 2.69% - 3.01%). Following the increase in the OPR on 26 April 2006, the daily weighted average overnight interbank rate moved within a range of 3.46% - 3.50% during the period 27 April to 26 May 2006. Interbank rates of other maturities also rose. In terms of retail interest rates, the average base lending rate (BLR) of commercial banks (CBs) increased to 6.72% as at 15 May 2006 (4Q 2005: 6.20%). The average quoted fixed deposit (FD) rates of CBs for the 1-month to 12-month maturities also edged upwards to between

3.11% and 3.73% (4Q 2005: 3.01% and 3.70%). In particular, the increase was evident in rates for the 6-month and 9-month maturities, which increased to 3.31% and 3.43% respectively (4Q 2005: 3.04% and 3.08% respectively).

Growth in private sector financing was sustained in the first quarter of 2006, with banking system loans and private debt securities (PDS) outstanding expanding at a combined annual rate of 9.1% (4Q 2005: 9.3%). Bank lending activity remained firm, with total loans outstanding expanding at an annual rate of 8.4% at the end of the quarter (4Q 2005: 8.6%), driven mainly by household loans, which increased at an annual rate of 14.5% (4Q 2005: 15.1%). Loans outstanding to businesses also continued to expand, at an annual rate of 2.7% (4Q 2005: 3%).

Net funds raised by the public and private sectors through the capital market amounted to RM8 billion in the first quarter of 2006 (4Q 2005: RM12.6 billion). On a gross basis, a total of RM10.6 billion (4Q 2005: RM15.2 billion) was raised through the PDS market by 25 corporations, mainly from the construction and services sectors. Most of the funds raised (78.2%) were for the financing of new activities.

Narrow money, M1, expanded at an annual rate of 5.7% at the end of the first quarter (4Q 2005: 8.5%), while broad money, M3, increased by 6.2% (4Q 2005: 8%). The more modest pace of M3 growth mainly reflected the slower rate of increase in net external operations.

In the first quarter of 2006, the ringgit appreciated against the major currencies. The ringgit strengthened against the US dollar amidst a strong trade and capital account performance, renewed capital flows and brighter economic prospects. The ringgit, however, depreciated against most regional currencies in the range of 0.3% - 5.4%, while appreciating by 1.9% against the Chinese renminbi. Over the period 1 April – 29 May 2006 period, the ringgit continued to strengthen against the US dollar. Against regional currencies, the ringgit appreciated in the range of 1.5% - 4.8% against the Philippine peso, Indonesian rupiah and Chinese renminbi, while depreciating in the range of 0.2% -1.4% against the Korean won, Singapore dollar and Thai baht.

The banking system remained strong

The banking system remained strong in the first quarter of 2006. The risk-weighted capital ratio (RWCR) was 13.1% as at end-March 2006. Pre-tax profits for the quarter amounted to RM3.2 billion. This strong performance was on account of higher net interest and fee-based income as well as higher net gains from trading activities.

Asset quality of the banking system continued to improve primarily as loans turn performing, recoveries improved and due to write-offs. With the decline in non-performing loans, the net NPL ratio improved to 4.5% based on the 6-month classification and 5.7% based on the 3-month classification, the lowest levels since the Asian financial crisis.

Near term outlook remains positive

The strong and broad-based improvement in global economic growth in the first quarter in the face of sustained high oil price and normalisation of financial conditions demonstrates improved resilience of the global economy. The United States economy grew at its fastest pace in 2 ½ years at 5.3% during the first quarter as a result of strong spending and investment activities. 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 strengthened to 2%. In Germany, first quarter growth improved by 1.4% supported by improvements in domestic demand, particularly in fixed investment spending and final household consumption expenditure. In the United Kingdom, estimates show that the economy expanded 2.2% in the first quarter, supported by an expansion in manufacturing production and the services sector. Similarly, growth in the Asian region remained strong supported by the pick up in demand for electronics and electrical goods which led to strong export performance.

Prospects for the global economy in the remaining part of 2006 continues to remain positive. The global economy remains in a position to absorb the high oil prices. The International Energy Agency's forecast of the demand for oil in 2006, a factor driving the prices upwards, has also been lowered as near-record prices have led to some moderation in demand. In this favorable external environment, export growth for Malaysia is expected to be sustained at double digit levels in 2006 underpinned by global demand for semiconductors and higher commodity export earnings. Domestic demand is also expected to be sustained. The increased allocation for development expenditure under the Ninth Malaysia Plan, and additional funding under the Private Finance Initiatives (PFI) are also expected to lead to an improvement in the construction sector as new projects and the various PFI infrastructure and utilities projects commence.

Forward-looking indicators of domestic economic activities also suggest sustained economic expansion. Of significance is the optimism in the business community which is expected to accelerate the growth in private investment. The MIER Business Confidence Index increased by 2 points to 102.5 points in the first quarter. In addition, despite the increase in global oil price, the DOSM leading index also registered favourable growth. The latest six-month smoothed growth rate of the Leading Index at 3.7% suggests that economic growth will be sustained in the remaining part of 2006.

Bank Negara Malaysia
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