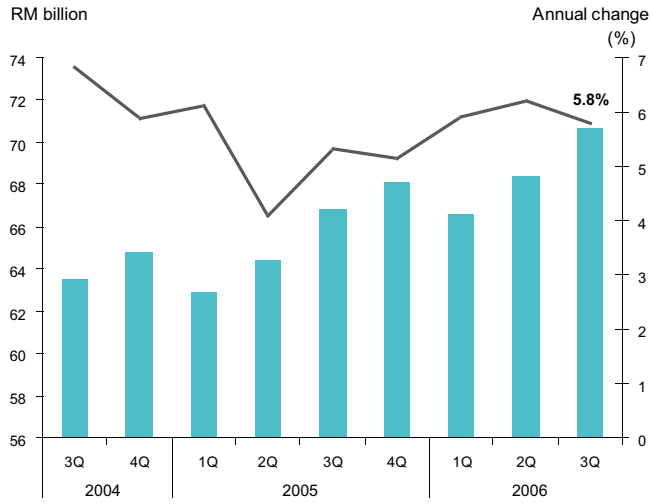
ECONOMIC AND FINANCIAL DEVELOPMENTS IN MALAYSIA IN THE THIRD QUARTER OF 2006

OVERVIEW

Growth momentum sustained

The Malaysian economy continued to remain on a steady growth path, with real gross domestic product expanding by 5.8% in the third quarter (2Q: 6.2%). 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 contribution to growth from the external sector was also stronger in the third quarter.

Steady GDP Growth in 3Q 2006



The services sector expanded at a strong pace of 6.5% during the quarter. The expansion was led by consumption, tourism, finance and trade-related activities. These activities supported stronger growth in the finance, insurance, real estate and business services; transport, storage and communication; and the utilities sub-sectors as well as sustained growth in the wholesale and retail trade, hotels and restaurants sub-sector. Value added growth in the manufacturing sector expanded by 7.1% (2Q: 8.4%), reflecting the expansion in both the export- and domestic-oriented industries. The export-oriented industries were mainly supported by growth in selected resource based industries. Meanwhile, the electronics and electrical (E&E) industry registered a growth of 5.4% during the quarter (2Q: 8.3%), supported by sustained growth in semiconductors and more moderate expansion in computers and computer peripherals. Strong growth in the fabricated metal products and food-related products industries and a turnaround in the construction-related materials industry contributed to the double-digit expansion in the domestic oriented industries.

Growth in the agriculture sector was stronger (6.2%), underpinned by a broad range of activities, including palm oil, rubber, paddy, fisheries, fruits and vegetables. Production in the mining sector, meanwhile, declined by 1.2% (2Q: -1.2%) due entirely to lower output of crude oil. In the construction sector, the decline was marginal (-0.4%) reflecting a more moderate contraction in civil engineering activities and renewed interest in the non-residential segment. At the same time, activity in the residential segment was supported by demand in prime locations.

The growth in consumption expenditure was sustained at 7.1% while private investment activities and increased public development spending supported the growth in gross fixed capital formation by 3.5%. The positive economic outlook and higher capacity utilisation in the manufacturing sector were among the factors accounting for the increased investment activity.

At the same time, Federal Government development expenditure increased with the bulk of the expenditure during the quarter being channelled into agriculture and rural development; education and public utilities.

Private consumption expenditure increased by 6.8% supported by stable labour market conditions, stronger export earnings and firm commodity prices. As expenditure on emoluments, supplies and services and defence was higher during the quarter, public consumption registered a stronger growth of 8.3%. Given the higher total expenditure during the quarter, the overall fiscal position turned to a deficit of 4.1% of GDP (2Q: +4.8% of GDP).

For the third quarter of 2006, headline inflation, as measured by the Consumer Price Index (CPI), moderated to 3.6% (2Q: 4.1%). The moderation was due mainly to the lower inflation for items in the *transport* category following the lapse of the upward revision in the prices of retail petrol and diesel that had taken place in August 2005. For the first nine months of the year, the headline inflation rate averaged 3.8% (2.9% during the corresponding period in 2005). This trend has continued in the fourth quarter with inflation moderating further to 3.1% in October. Labour market conditions continue to remain stable as job creation remained high and retrenchments declined significantly. Labour productivity in the manufacturing sector also turned around to record positive growth (0.7%).

On the external front, the trade surplus amounted to RM28.9 billion (2Q: RM22.9 billion) as growth in gross exports (13.6%) was higher relative to gross imports (11.5%). Growth in gross exports was led mainly by the stronger expansion in manufactured exports (14.2%) and agricultural exports (20.4%). The manufactured exports reflected increases in exports of E&E and resource-based products. Exports of E&E products expanded strongly by 10.3% (2Q: 5.6%). The agriculture exports reflected the sharp increase in palm oil (24.5%) and rubber exports (53%). The significant strength in rubber exports was on account of higher prices, while the robust performance of palm oil exports was due to higher volume (11.4%) and price (11.7%). Receipts from mineral exports increased by 1.3% on account of lower export volume of crude oil. The export price of crude oil remained high averaging USD72.18 per barrel in the third quarter and that of liquefied natural gas increased to an average of RM1,114 per tonne.

Gross imports remained strong, reflecting the increase in imported inputs for manufactured exports and domestic consumer spending. Growth in imports of intermediate goods (12.4%) and consumption goods (15.3%) was higher compared with the previous quarter. Imports of capital goods amounted to RM15.9 billion. Selected capital imports continued to record growth as capacity expansion and upgrading for fuel efficiency in the manufacturing sector was accelerated. This was most evident in the petrochemicals industry for which the growth in imports reflected the increased imports for machinery, generators, turbines and electric motors. Increased exploration activities in the oil and gas industry led to higher imports of construction and mining equipment.

In the financial account, foreign direct investment (FDI), as monitored by Bank Negara Malaysia's Cash BOP system, recorded a larger net inflow of RM5.4 billion. These inflows were broad based and channelled mainly into the manufacturing, oil and gas; as well as services sectors. 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, there was a net outflow of portfolio investment amounting to RM3.1 billion. For overseas investment, there was a net outflow of RM2 billion.

The international reserves of Bank Negara Malaysia amounted to RM293.1 billion (USD79.5 billion) as at 29 September 2006. As at 15 November 2006, the reserves

amounted to RM294.1 billion (USD79.8 billion), sufficient to finance 8.1 months of retained imports and was 6.7 times the short-term external debt.

Monetary policy remained supportive of economic activity

With inflation moderating and as available data point towards a sustained steady expansion in the domestic economy, the Overnight Policy Rate (OPR) was left unchanged at 3.50% throughout the third quarter.

The average quoted fixed deposit (FD) rates of commercial banks (CBs) remained relatively stable in the third quarter. As at the end of the quarter, the average FD rates ranged between 3.13% and 3.77%, for FDs with 1-month and 12-month maturities respectively (2Q: 3.11% and 3.77%). Of significance, the real average FD rates for the 6-month, 9-month and 12-month maturities have been positive since August as inflation moderated. Meanwhile, the average base lending rate (BLR) of CBs remained unchanged at 6.72%, while the average lending rate (ALR) peaked at 6.63% in July (end-2Q: 6.55%) and remained stable at that level for the remainder of the quarter. The average overnight interbank rate was close to the OPR for most of the quarter, except for a brief period in early September when several money market participants sourced funds in preparation for the Malaysian Government Securities (MGS) auction, which resulted in slightly higher rates.

Banking system loans and private debt securities (PDS) outstanding expanded at a combined annual rate of 7.9% at end-3Q (end-2Q: 9.1%). Banking system loans outstanding increased at an annual rate of 7.5%, with loans outstanding to businesses and households growing at 3.3% and 11.4% respectively (end-2Q: 4.2% and 13.3% respectively).

Gross funds raised from the PDS market amounted to RM9.2 billion during the third quarter (2Q: RM10.6 billion). The funds were mainly raised through the issuance of medium-term notes and long-term bonds. On a net basis, the funds raised through the PDS market, excluding Cagamas bonds, amounted to RM2.4 billion during the quarter (2Q: RM3.3 billion).

Both M1 and M3 expanded at a faster pace in the third quarter. M1, or narrow money, grew by 11.5% on annual basis (2Q: 10.1%), reflecting higher placements of demand deposits and currency held by the private sector. Meanwhile, M3, or broad money, increased at an annual rate of 7.9% (2Q: 6.4%).

Movements of the ringgit exchange rate continued to reflect market demand and supply conditions, as well as developments in the currencies of the regional and major industrialised economies. The ringgit depreciated against the US dollar during the quarter, as the US dollar was supported by safe-haven flows in reaction to geopolitical developments in the Middle East and North Korea, as well as some positive US economic data. The ringgit, however, appreciated against the Japanese yen as the Japanese currency weakened amidst reduced expectations for further interest rate increases. The ringgit depreciated against most regional currencies in the range of 0.4% - 6% during the third quarter.

During the period 1 October – 21 November 2006, the ringgit appreciated against most of the major currencies, amidst continued trade and investment flows. The ringgit also appreciated against most regional currencies in the range of 0.1% - 0.5%, the exception being against the Thai baht (1.6%) and Singapore dollar (0.9%).

The banking system remained strong

The banking system remained strong in the third quarter. As at end-September, the risk- weighted capital ratio (RWCR) improved to 13.2%. Pre-tax profits for the quarter amounted to RM3.8 billion. Net

interest income from stronger loans- and financing-related activities and net trading and investment income were higher. The level of non-performing loans (NPLs) of the banking system continued to improve as a reduced number of loans were classified as non-performing. As a result, the net NPL ratio reduced to 5.1% based on the 3-month classification.

Underlying growth momentum remains positive

Going forward, prospects for the global economy continue to be favourable. Despite the uncertainties on the growth momentum in the US, the direction of oil prices and the stance of monetary policy in the major industrial countries, the improved resilience of the global economy has produced less volatility in the international financial markets. Overall, global growth continues to be positive and broad-based. In the US, the economic slowdown during the quarter was primarily due to the significant decline in residential property investment and the high price effect of imported oil. The broader economy continues to remain resilient. Overall consumption spending and investment activity remained favourable, sustained by the stable labour market conditions, strong growth in non-residential property investment and high imports of both capital and consumer goods. In Japan, planned higher capital spending underscores the prevailing positive business sentiment and lends support for economic expansion to continue. In the euro area, the growth momentum is building and is expected to carry forward the expansion in economic activity. In the Asian economies the sustained strong performance would continue to provide support for mutually reinforcing growth as intra-regional trade and investment gains significance. In addition, the lower global oil price in the 3Q would have significant implications on the outlook for future inflation.

In the domestic economy, forward-looking indicators are also positive. The Business Conditions Index, Consumer Sentiments Index as well as the Employment Index continue to show an increasing trend thereby providing an indication of continued expansion in private investment activity and household consumption activities going forward. The latest six-month smoothed growth of the DOSM leading index was also close to 8%. This continued rise in the DOSM leading index over several months now suggests that growth in the Malaysian economy would be sustained into next year. Growth would continue to be driven by domestic demand, both by private sector and public sector activity and by the external sector amidst firm commodity prices. The contribution from the public sector reflects the continued disbursements of the development outlay with the acceleration in activity of the on-going projects and the progress in the implementation of the new high impact projects in education, agriculture, and rural development under the Ninth Malaysia Plan.