

Malaysia

A pickup in investment has been a bright spot so far in 2006, with investment the main contributor to GDP growth in the first half of the year. This was timely because consumption growth has eased in the face of higher than expected inflation and rising interest rates. GDP is now projected to expand by 5.2% this year, slightly below the prediction of 5.5% made in *Asian Development Outlook 2006 (ADO 2006)* in April this year. The growth forecast for 2007 is revised down more sharply, to 5.0% from 5.8%, on expectations that the United States (US) economy and global demand for information technology products will soften.

Updated assessment

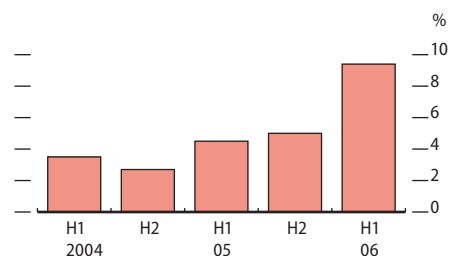
The economy expanded by 5.7% in the first 6 months of 2006, up from 5.1% in the year-earlier period. Fixed investment, spurred by capacity utilization of 78% in export-oriented manufacturing and by solid expansion for some export lines, rose by 9.4%, much faster than in the past 2 years (Figure 2.5.1). Total investment was the main driver of aggregate growth in the first half, with about equal contributions from fixed investment and an increase in inventories. Private sector investment performed particularly well. Private consumption grew by 7.4%, slowing from near double-digit rates in the past 2 years as inflation and rising interest rates took a toll (Figure 2.5.2). Government consumption rose slowly and made little contribution to growth, and net exports contracted.

On the supply side, industry made the biggest contribution to aggregate growth in the first half of 2006. The manufacturing subsector grew by 8.4%, accelerating from 2005, with strong expansion in production of electronics, chemical and petroleum products, and textiles and footwear. In contrast, mining production declined a little, reflecting the temporary shutdown of some liquefied natural gas facilities to expand capacity. Construction also contracted, damped by cutbacks in public works and by slowing residential building after a boom in recent years.

Growth in services decelerated to 5.7%, affected by the moderation in private consumption, though the services sector remained a major contributor to growth. Agriculture recorded a sizable 6.5% production gain, buoyed by a jump in rubber production as global prices have surged. Natural rubber benefits from rising prices of synthetic rubber, which, made from petrochemicals, is heavily influenced by global oil prices.

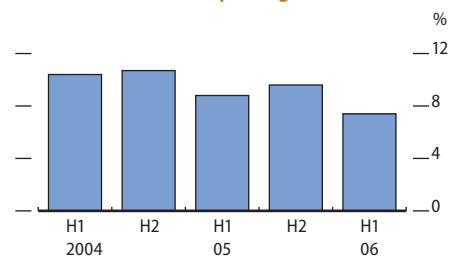
In the second half of the year, a softening US economy and weakening leading indicators for information technology demand point to slowing export growth, which, combined with flagging consumer demand, is likely to cause GDP growth to dip slightly. This would leave full-year growth at around 5.2%, compared with an estimate of 5.5% in *ADO 2006*.

2.5.1 Fixed investment growth



Source: Bank Negara Malaysia, available: <http://www.bnm.gov.my>, downloaded 31 August 2006.

2.5.2 Private consumption growth



Source: Bank Negara Malaysia, available: <http://www.bnm.gov.my>, downloaded 31 August 2006.

Consumer inflation picked up to average 3.9% in January–July. Factors included reductions in fuel subsidies (which led to a 23% jump in fuel prices in February), higher duties on cigarettes and liquor, and steeper highway toll charges. An average 12% rise in electricity tariffs in June will feed through into the general price level in the second half. Electricity accounts directly for 3% of the consumer price index, and the indirect impact of the price rise will be significant for some industries' production costs. Inflation for all of 2006 is forecast to average 4.0%, up from 3.5% penciled in by *ADO 2006* and the highest rate in 8 years.

To combat inflationary expectations, Bank Negara Malaysia, the central bank, raised the benchmark overnight policy rate by 80 basis points to 3.5% between November 2005 and April 2006, but this still left the policy rate negative in real terms (Figure 2.5.3). The authorities believe that the rate is below its “neutral” level and is still supportive of growth. Yet despite these rate increases, the differential between Malaysian and US interest rates widened. Still, foreign reserves rose by over \$8 billion in the first half to \$78 billion, with the current account surplus outweighing net outflows on the capital account.

Federal spending got off to a slow start in 2006, so that the budget was in surplus by RM11.3 billion, or 4.3% of GDP, at end-June. Traditionally, government spending is stronger in the second half of the year, and if this is the case once more, a fiscal deficit of 3.5% of GDP for the full year, in line with *ADO 2006*, is expected.

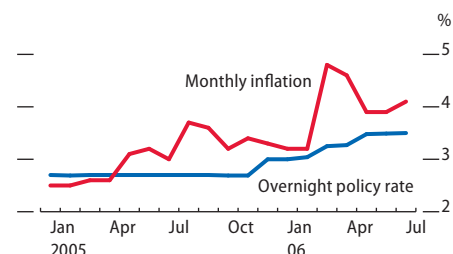
Merchandise exports rose by 14.3% in US dollar terms in the first 6 months of 2006, lifted by higher global prices for export commodities such as oil and rubber. Imports grew by 16.3% (Figure 2.5.4) as the pickup in investment spurred imports of capital equipment. Accelerated investment will likely maintain a higher growth rate of imports than exports, lowering slightly the trade surplus in 2006. The current account surplus will also decline modestly, but remain substantial at about 14.5% of GDP, revised up from 13.0% in *ADO 2006*. (The upward revision is due to softer than expected consumer spending, resulting in a steeper increase in saving relative to investment.) Despite net capital outflows from direct and other investments, the overall balance of payments was in surplus by \$1.4 billion in the first quarter of 2006. The ringgit appreciated from a monthly average of RM3.75/\$ in January to RM3.63 in May, but then consolidated at RM3.68 in late August (Figure 2.5.5).

In the labor market, the workforce expanded faster than employment, helping nudge up the unemployment rate to 3.8% in the first quarter of 2006. Of particular concern is the rising number of unemployed graduates—many with inadequate command of English, despite policies introduced to improve language abilities, and with less marketable degrees—estimated to have reached 80,000 last year.

Prospects

The combination of the expected slowdown in the US economy (the biggest market for Malaysia's exports), the softening of global information technology demand (electrical and electronic products account for 53% of total exports), as well as slower growth in domestic consumption will trim economic growth in 2007. Malaysia's deceleration will be cushioned

2.5.3 Inflation and policy rate



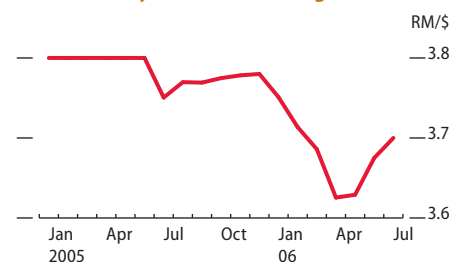
Source: Bank Negara Malaysia, available: <http://www.bnm.gov.my>, downloaded 7 August 2006.

2.5.4 Trade indicators



Source: CEIC Data Company Ltd., downloaded 15 August 2006.

2.5.5 Monthly nominal exchange rate



Source: CEIC Data Company Ltd., downloaded 15 August 2006.

to some degree by strong demand for commodity and energy exports as well as by growth in investment. Government development spending will also increase, contributing to keeping the fiscal deficit at over 3%, which reflects less emphasis on an earlier goal of moving toward a balanced budget. In this context, the GDP growth forecast for next year is revised down to 5.0% (Figure 2.5.6) from 5.8% in *ADO 2006*.

The softer economic outlook, slightly weaker employment prospects, and the higher costs of fuel, utilities, and borrowing (at a time of increased household debt) are projected to further damp growth in consumption spending. Investment will remain fairly robust in 2007, driven largely by the rise in development spending. An ongoing need for imported capital equipment is likely to continue to push up imports faster than exports, but the trade surplus is still expected to increase since exports' total value is much higher than imports'. For that reason, the current account surplus will be larger in value terms, but will probably decline slightly from 2006's level as a share of GDP to 14.1% (Figure 2.5.7).

The Ninth Malaysia Plan (2006–2010) will have an impact as 2007 progresses—tender documents for the first 880 projects, valued at RM15 billion, will be ready only late this year. With new infrastructure projects initiated under the development plan offsetting a likely pullback in residential building, construction is expected to rebound modestly in 2007. The plan projects 6% annual GDP growth over the next 5 years and a marginal narrowing in the budget deficit to 3.4% of GDP in 2010, from 3.8% in 2005. It has a different focus from the previous plan, and concentrates both on smaller-scale projects that will yield more direct economic benefits and on development outside the main population center of the Klang Valley (which should help reduce regional disparities in levels of development).

The authorities have also unveiled a Third Industrial Master Plan, which targets the development of higher value-added manufacturing as well as expansion of the services sector, such that services generate 60% of GDP by 2020, up from about 50% currently. This master plan puts the annual GDP growth goal at 6.3% on average between now and 2020, requiring growth in manufacturing and services of 7.7% a year.

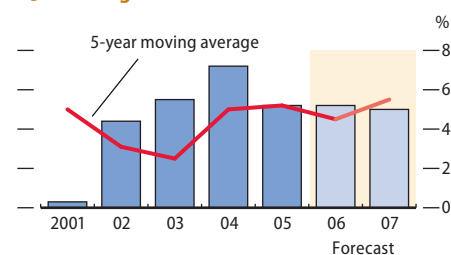
Inflation remains a domestic risk to the near-term economic forecasts. If global oil prices rise, or even stay at current lofty levels, further increases in domestic fuel prices next year are possible. Stronger than expected inflation, in turn, could prompt higher interest rates, which would further dent the growth outlook. Another threat would be delays, inefficient implementation, or a lack of transparency in government procurement for the Ninth Malaysia Plan, which should be a driver of the economy over the next few years. For the financial sector, high household debt levels and a rising glut in residential property remain potential problems.

2.5.1 Selected economic indicators, %

	2006		2007	
	<i>ADO</i> 2006	<i>Update</i>	<i>ADO</i> 2006	<i>Update</i>
GDP growth	5.5	5.2	5.8	5.0
Inflation	3.5	4.0	3.3	3.3
Current acct. bal. (share of GDP)	13.0	14.5	11.2	14.1

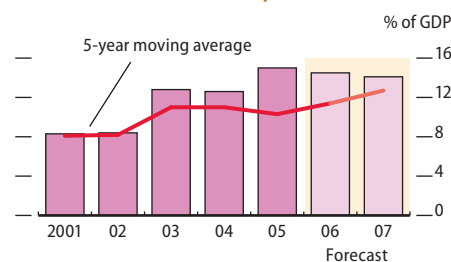
Source: Staff estimates.

2.5.6 GDP growth



Sources: Bank Negara Malaysia, available: <http://www.bnm.gov.my>, downloaded 1 August 2006; staff estimates.

2.5.7 Current account surplus



Sources: Bank Negara Malaysia, available: <http://www.bnm.gov.my>, downloaded 1 August 2006; staff estimates.