# The Malaysian Economy in 2006

## THE INTERNATIONAL ECONOMIC ENVIRONMENT IN 2006

The global economic environment was favourable in 2006, sustaining its fourth consecutive year of expansion of above 4%. While there was some moderation in the United States (US), especially towards the latter part of the year, global growth momentum remained firm. This resilience was attributed to several factors. First, the moderation of growth in the US economy was largely centred on the weak housing and automobile-related sectors. Second, although the contribution of the US economy to world growth was still significant, there was a broadening of growth across the major economic regions, specifically with growing economic impetus in Europe, continued recovery in Japan, and stronger expansion in the East Asian region[1] as well as other developing economies. Third, the strength of commodity markets throughout most of the year favoured resource-based producers, thus benefiting a large number of emerging economies through improved terms of trade and foreign exchange earnings.

## Global growth broadened in 2006, with continued recovery in Europe and Japan and sustained expansion in Asia despite some moderation in the United States

The **US** economic slowdown thus far has been modest, reflecting a "soft landing" scenario with domestic demand remaining largely intact despite the downturn in the US housing market. Consumption activity remained steady with encouraging labour market conditions and favourable income positions. Since September 2003, the US labour market has continued to tighten amid steady job creation and rising real wages. In addition, the marked decline in gasoline prices towards the end of the year provided additional support to disposable incomes. Furthermore, despite the slower appreciation in house prices in 2006, household wealth was sustained by continued wealth-creation from the favourable equity market performance. More importantly, US non-residential property investment activity remained robust amidst favourable profit growth and healthy corporate balance sheets. The encouraging corporate performance mainly benefited from the sustained strength in external environment and the globalised operations of US firms, as well as favourable financing conditions. The US external position improved with a narrowing of the trade deficit since September 2006. The slowing US

**Table 1.1**
**World Economy: Key Economic Indicators**

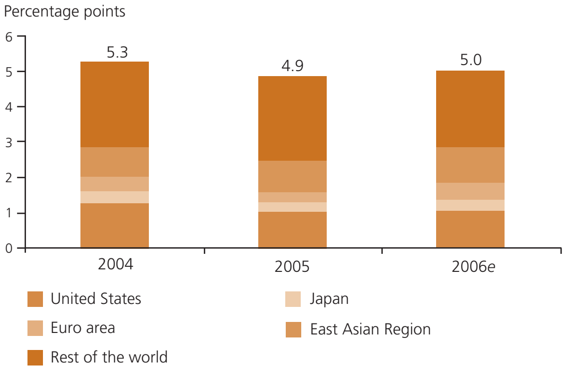
| | Real GDP Growth (%) | | Inflation (%) | |
|---|---|---|---|---|
| | 2005 | 2006e | 2005 | 2006e |
| **World Growth** | **4.9** | **5.0** | – | – |
| **World Trade** | **7.4** | **8.0** | – | – |
| **Major Industrial Countries** | **2.6** | **2.9** | **2.3** | **2.3** |
| United States | 3.2 | 3.3 | 3.4 | 3.2 |
| Japan | 1.9 | 2.2 | -0.3 | 0.2 |
| Euro area | 1.4 | 2.7 | 2.2 | 2.2 |
| United Kingdom[1] | 1.9 | 2.7 | 2.1 | 2.3 |
| **East Asia** | **7.5** | **7.9** | **3.1** | **3.0** |
| **Asian NIEs** | **4.8** | **5.4** | **2.2** | **1.6** |
| Korea | 4.0 | 5.0 | 2.7 | 2.2 |
| Chinese Taipei | 4.1 | 4.6 | 2.3 | 0.6 |
| Singapore | 6.6 | 7.9 | 0.5 | 1.0 |
| Hong Kong SAR[2] | 7.5 | 6.8 | 1.0 | 2.0 |
| **The People's Republic of China** | **10.4** | **10.7** | **1.8** | **1.5** |
| **ASEAN[3]** | **5.4** | **5.8** | **5.9** | **6.8** |
| Malaysia | 5.2 | 5.9 | 3.0 | 3.6 |
| Thailand | 4.5 | 5.0 | 4.5 | 4.7 |
| Indonesia | 5.6 | 5.5 | 10.4 | 13.3 |
| Philippines | 5.0 | 5.4 | 7.6 | 6.3 |

[1] Inflation based on Eurostat's harmonised index of consumer prices
[2] Inflation refers to composite prices
[3] Includes Singapore
e Estimates

Source : International Monetary Fund, national authorities and Bank Negara Malaysia estimates.

[1] The East Asian region ex-Japan refers to PR China, Chinese Taipei, Hong Kong SAR, Indonesia, Korea, Malaysia, the Philippines, Singapore and Thailand.

**Chart 1.1**
**Contribution to World Growth**




e Estimate
Source: Bank Negara Malaysia estimates based on World Bank and International Monetary Fund data

imports were mainly due to lower oil prices and a moderation in the demand for oil-related imports.

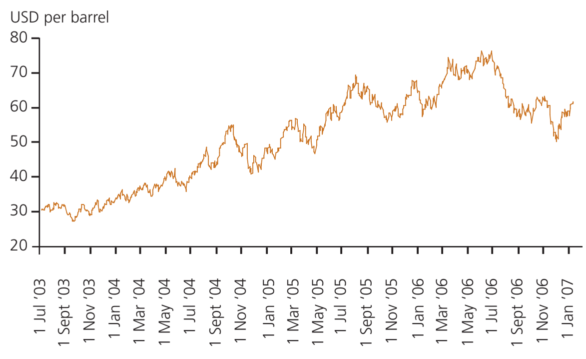
The year 2006 also witnessed clearer signs of a rebalancing of global growth among the major industrial economies. Up to November 2006, **Japan** had experienced its longest stretch of sustained economic expansion since the 57-month *"Izanagi"* boom of the late 1960s, although the strength of the recovery had remained modest and uneven. Strengthening business conditions as reflected in the *Tankan* surveys and improved corporate profits encouraged capital expenditure. Stronger external demand, especially for automobiles and machinery, also contributed significantly to growth, with exports to PR China recording double-digit growth. However, household spending was still restrained as wage growth was modest.

Meanwhile, economic recovery in the **euro area** had become more entrenched. The recovery was underpinned by stronger growth in Germany, which had positive reinforcing effects on the other member economies. The structural reforms undertaken in Germany over several years now had begun to benefit the domestic economy as seen in the improving competitiveness of German firms. For the euro area as a whole, while investment spending and export demand remained important for growth, there was a noticeable acceleration in private consumption. Consumption activity benefited from rising consumer confidence and the significant improvement in labour market conditions, with the unemployment rate falling to its lowest level in five years. Elsewhere in Europe, the economy of the United Kingdom expanded at a robust pace, driven by the recovery in the housing market, expanding job creation and the strong performance of business and financial services.

Despite a softening global environment in the latter part of 2006, the **East Asian region** remained resilient. Growth was sustained at a strong pace, with continued support from both external and domestic demand. Growth also benefited from greater regional integration as reflected in the continued expansion in intra-regional trade. Higher commodity prices had also enhanced growth, particularly in resource-based countries, contributing to large current account surpluses. PR China remained the key contributor to regional expansion, with its economy growing at 10.7%, its fastest pace since 1995. Concerns over the sustainability of growth, however, led to measures by the Chinese authorities aimed at achieving more balanced growth, away from exports and investment, and more towards consumption activity.

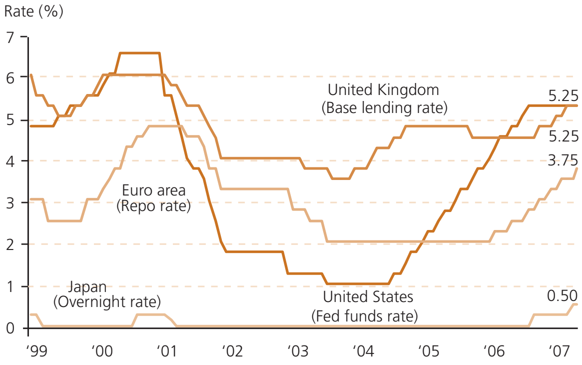
Globally, headline inflation remained elevated throughout most of 2006 due to the impact of oil prices. Oil prices rose, particularly in the first half-year, due to uncertainties over supply amid robust demand conditions and geopolitical

**Chart 1.2**
**Crude Oil Prices: WTI 1-Month**




Source: Reuters

**Chart 1.3**
**Major Industrial Countries: Official Interest Rates**




Source: National authorities

tensions affecting some of the key oil-producing countries. However, pressures on inflation eased when oil prices began to decline in August 2006, partly reflecting the diminishing risks to supply. Expectations of slowing US growth in the second half of the year together with a build-up in US inventories following warmer-than-expected weather played a role in easing short-term supply concerns. These developments, together with some reallocation of speculative funds to other markets, accentuated the downward trend in oil prices, despite production cuts by OPEC.

The need to mitigate the potential pass-through from oil prices to overall inflation and to manage inflationary expectations led most central banks to pursue a tightening bias in their **monetary policy** stance. In the US, the Federal Open Market Committee (FOMC) of the Federal Reserve Board gradually raised rates to 5.25% by June 2006. The FOMC maintained its monetary policy stance for the rest of the year despite indications of slowing growth amidst higher core inflation, tighter resource utilisation and rising unit labour cost. Meanwhile, signs that the Japanese economy had finally emerged from a prolonged deflationary period allowed the Bank of Japan (BOJ) to end its quantitative easing policy in March 2006, and subsequently, to remove its zero interest rate policy in July 2006. Thereafter, however, the lack of a clear upward trend in inflation limited the scope for the BOJ to undertake further rate increases. In Europe, both the European Central Bank and Bank of England raised interest rates, citing concerns that rapid money and credit growth would fuel inflationary pressures.

In the East Asian region, inflation trends varied across countries. In the ASEAN-4, inflationary pressures eased due to the waning effects of the removal of fuel subsidies, allowing the authorities in Indonesia, Thailand and the Philippines to adopt a more accommodative stance in their monetary policy. However, inflation in the NIEs[2] trended upwards, due to tight labour market conditions and strengthening conditions in the property markets. While oil price-induced inflationary pressures eased, several concerns remained. In particular, food prices remained high in most East Asian countries due to shortages caused by weather conditions.

## OVERVIEW

The Malaysian economy strengthened in 2006, with real gross domestic product (GDP) expanding by 5.9%. The robust global growth during the year resulted in strong demand for electronics and primary commodities. This strong external environment was supported by strong domestic activity as private consumption rose in line with incomes and private investment increased to expand productive capacity to meet demand. As a result of the expansion in domestic and external

**Chart 1.4**
**Real GDP, World Trade and Inflation Rate**


[2] Newly Industrialised Economies (NIEs) refers to Chinese Taipei, Hong Kong SAR, Korea and Singapore.

**Table 1.2 Malaysia - Key Economic Indicators**

| | 2004 | 2005 | 2006*p* | 2007*f* |
|---|---|---|---|---|
| Population (million persons) | 25.6 | 26.1 | 26.6 | 27.2 |
| Labour force (million persons) | 10.8 | 11.3 | 11.5 | 11.8 |
| Employment (million persons) | 10.5 | 10.9 | 11.1 | 11.4 |
| Unemployment (as % of labour force) | 3.5 | 3.5 | 3.5 | 3.5 |
| Per Capita Income (RM) | 16,638 | 18,040 | 19,764 | 20,900 |
| (USD) | 4,378 | 4,763 | 5,388 | 5,806 |
| **NATIONAL PRODUCT (% change)** | | | | |
| Real GDP | 7.2 | 5.2 | 5.9 | 6.0 |
| (RM billion) | 249.3 | 262.2 | 277.7 | 294.4 |
| Agriculture, forestry and fishery | 5.0 | 2.5 | 6.4 | 3.2 |
| Mining and quarrying | 3.9 | 0.8 | -0.2 | 2.8 |
| Manufacturing | 9.8 | 5.1 | 7.0 | 6.6 |
| Construction | -1.5 | -1.6 | -0.5 | 3.0 |
| Services | 7.0 | 6.5 | 6.5 | 6.3 |
| Nominal GNP | 14.2 | 10.7 | 11.7 | 7.9 |
| (RM billion) | 425.6 | 471.3 | 526.5 | 567.9 |
| Real GNP | 7.4 | 5.5 | 6.4 | 5.3 |
| (RM billion) | 233.4 | 246.2 | 261.9 | 275.7 |
| Real aggregate demand[1] | 7.5 | 7.3 | 7.4 | 7.4 |
| Private expenditure[1] | 13.9 | 9.1 | 7.6 | 7.2 |
| Consumption | 10.5 | 9.2 | 7.0 | 6.4 |
| Investment | 30.2 | 8.5 | 9.7 | 10.4 |
| Public expenditure[1] | -3.3 | 3.6 | 7.2 | 7.7 |
| Consumption | 6.2 | 5.4 | 7.9 | 4.1 |
| Investment | -11.0 | 1.9 | 6.5 | 11.4 |
| Gross national savings (as % of GNP) | 37.3 | 37.0 | 38.1 | 38.1 |
| **BALANCE OF PAYMENTS (RM billion)** | | | | |
| Goods balance | 104.5 | 125.6 | 135.0 | 137.7 |
| Exports (f.o.b.) | 481.2 | 537.0 | 589.6 | 638.5 |
| Imports (f.o.b.) | 376.8 | 411.4 | 454.6 | 500.9 |
| Services balance | -8.8 | -9.0 | -7.4 | -6.7 |
| (as % of GNP) | -2.1 | -1.9 | -1.4 | -1.2 |
| Income, net | -24.5 | -23.9 | -19.8 | -22.1 |
| (as % of GNP) | -5.8 | -5.1 | -3.8 | -3.9 |
| Current transfers, net | -14.6 | -17.0 | -16.6 | -16.2 |
| Current account balance[2] | 56.5 | 75.7 | 91.2 | 92.7 |
| (as % of GNP) | 13.3 | 16.1 | 17.3 | 16.3 |
| Bank Negara Malaysia international reserves, net[3] | 251.6 | 265.1 | 290.4 | - |
| (in months of retained imports) | 7.9 | 7.7 | 7.8 | - |
| **PRICES (% change)** | | | | |
| CPI (2005=100)[4] | 1.4 | 3.0 | 3.6 | 2.0 - 2.5 |
| PPI (2000=100)[5] | 8.9 | 6.8 | 6.7 | - |
| Real wage per employee in the manufacturing sector (% change) | 3.7 | -0.02 | -1.4 | - |

Note: Figures may not necessarily add up due to rounding
[1] Exclude stocks
[2] Figures for the year 2006 are estimates
[3] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account
[4] Effective from 2006, the Consumer Price Index has been revised to the new base year 2005=100, from 2000=100 previously
[5] Effective from 2006, the Producer Price Index has been revised to the new base year 2000=100, from 1989=100 previously
*p* Preliminary
*f* Forecast

**Table 1.3 Malaysia - Financial and Monetary Indicators**

| | 2004 | | 2005 | | 2006*p* | |
|---|---|---|---|---|---|---|
| **FEDERAL GOVERNMENT FINANCE (RM billion)** | | | | | | |
| Revenue | 99.4 | | 106.3 | | 123.5 | |
| Operating expenditure | 91.3 | | 97.7 | | 107.7 | |
| Net development expenditure | 27.5 | | 27.3 | | 35.0 | |
| Overall balance | -19.4 | | -18.7 | | -19.1 | |
| Overall balance (% of GDP) | -4.3 | | -3.8 | | -3.5 | |
| Public sector net development expenditure | 56.7 | | 64.5 | | 84.4 | |
| Public sector overall balance (% of GDP) | 4.1 | | 1.8 | | 3.7 | |
| **EXTERNAL DEBT** | | | | | | |
| Total debt (RM billion) | 200.6 | | 197.7 | | 179.4 | |
| Medium- and long-term debt | 156.8 | | 150.7 | | 138.1 | |
| Short-term debt[1] | 43.7 | | 47.0 | | 41.3 | |
| Debt service ratio (% of exports of goods and services) | | | | | | |
| Total debt | 4.6 | | 5.4 | | 4.7 | |
| Medium- and long-term debt | 4.4 | | 5.2 | | 4.4 | |
| | **Change in 2004** | | **Change in 2005** | | **Change in 2006** | |
| | **RM billion** | **%** | **RM billion** | **%** | **RM billion** | **%** |
| **MONEY AND BANKING** | | | | | | |
| Money Supply M1 | 12.2 | 11.9 | 9.8 | 8.5 | 17.1 | 13.8 |
| M3 | 68.0 | 12.4 | 49.7 | 8.0 | 82.4 | 12.3 |
| Banking system deposits | 70.1 | 12.7 | 68.6 | 11.0 | 116.1 | 16.8 |
| Banking system loans[2] | 40.1 | 8.5 | 44.2 | 8.6 | 34.9 | 6.3 |
| Loan-deposit ratio (end of year) | 78.4% | | 77.5% | | 70.8% | |
| Financing-deposit ratio[3] | 87.7% | | 85.7% | | 79.1% | |
| | **2004** | | **2005** | | **2006** | |
| | **%** | | **%** | | **%** | |
| **INTEREST RATES (AVERAGE RATES AS AT END-YEAR)** | | | | | | |
| Overnight Policy Rate (OPR) | 2.70 | | 3.00 | | 3.50 | |
| Interbank rates | | | | | | |
| 3-month | 2.80 | | 3.20 | | 3.65 | |
| Commercial banks | | | | | | |
| Fixed Deposit 3-month | 3.00 | | 3.02 | | 3.19 | |
| 12-month | 3.70 | | 3.70 | | 3.73 | |
| Savings deposit | 1. 58 | | 1.41 | | 1.48 | |
| Base lending rate (BLR) | 5.98 | | 6.20 | | 6.72 | |
| Treasury bill (3-month) | 1.96 | | 2.96 | | 3.37 | |
| Government securities (1-year) | 2.24 | | 3.30 | | 3.55 | |
| Government securities (5-year) | 3.64 | | 3.73 | | 3.70 | |
| | **2004** | | **2005** | | **2006** | |
| | **%** | | **%** | | **%** | |
| **EXCHANGE RATES** | | | | | | |
| Movement of Ringgit (end-period) | | | | | | |
| Change against SDR | -4.3 | | 8.9 | | 1.8 | |
| Change against USD[4] | 0.0 | | 0.5 | | 7.0 | |

[1] Excludes currency and deposits held by non-residents with resident banking institutions
[2] Includes loans sold to Cagamas
[3] Adjusted to include holdings of private debt securities
[4] Ringgit was pegged at RM3.80=USD1 on 2 September 1998 and shifted to a managed float against a basket of currencies on 21 July 2005
*p* Preliminary

demand, employment also strengthened as reflected in the decline in retrenchments and the acceleration in job creation. The unemployment rate remained unchanged at 3.5% while nominal wages increased.

## Real GDP strengthened in 2006, underpinned by robust domestic demand and continued strong exports

In spite of the robust growth in output and wages, the economy remained on a balanced growth path in 2006. A number of indicators confirmed the sustainability of the growth momentum. The output gap was negligible in 2006 and productivity growth exceeded wage growth and hence helped contain inflationary pressures. The only significant source of inflation in 2006 was from supply factors, most notably, the adjustments to a number of administered prices as subsidies were partially removed. As the impact of these adjustments receded during the course of the year, the headline inflation rate also moderated.

### DOMESTIC DEMAND CONDITIONS

**Aggregate domestic demand** recorded a stronger growth of 7.4% in 2006, driven mainly by the continued expansion in private sector activity. Consumer spending remained strong, benefiting from higher disposable incomes arising from strong export earnings, high commodity prices and favourable labour market conditions. Private investment continued to increase, with significant capital expenditure in the manufacturing, services and oil and gas sectors. Meanwhile, the public sector continued to support growth with the Government committed to improving the infrastructure and the provision of Government services mainly in education and health especially for the rural areas.

**Private consumption** expenditure remained resilient, increasing by 7% in 2006 (2005: 9.2%), in spite of concerns over rising prices, especially during the first half of the year. Major consumption indicators confirmed the strong trend in spending, with double-digit growth rates recorded for consumption imports, loans approved and disbursed for consumption credit, as well as credit card spending. The main factor that contributed to the strength in consumer spending was a steady income growth arising from firm commodity prices, strong export earnings, and stable employment conditions. Prices of major commodities such as rubber and crude palm oil (CPO) were sustained at high levels throughout 2006. Labour market conditions continued to be stable, with job vacancies rising and retrenchments declining. These developments benefited both the rural and urban households' disposable incomes, and supported consumers' optimistic outlook.

**Chart 1.5**
**Real Domestic Demand Aggregates**

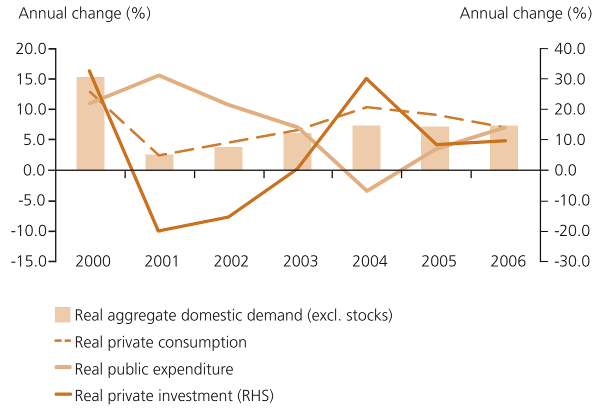
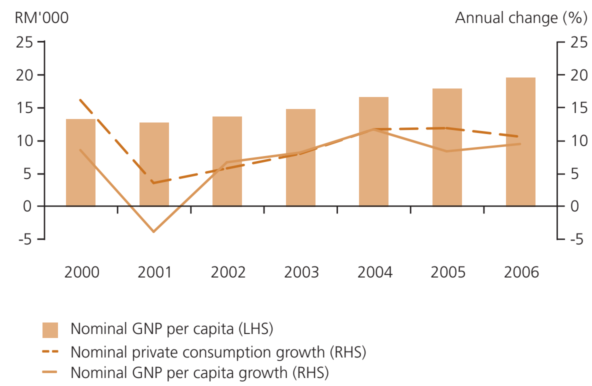



**Chart 1.6**
**GNP per Capita**

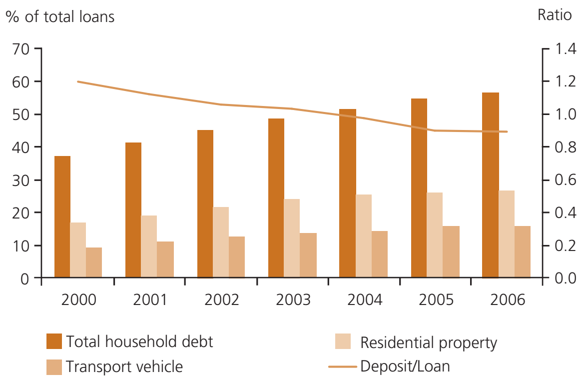


## Robust domestic demand was driven mainly by continued expansion in private investment activity, particularly in the manufacturing and oil and gas sectors. Public sector continued to provide a supportive environment

As income and job prospects improved, consumer confidence and spending also strengthened. The Malaysian Institute of Economic Research (MIER)'s Consumer Sentiment Index (CSI), which measures consumers' assessment of their personal finances and the economy, reflected the improving sentiments during the year. The CSI dipped below the 100-point confidence threshold level in the first quarter of 2006, reflecting concern over higher prices, mainly from the impact of the 30-sen increase in the retail price of fuel in March and the adjustment made to electricity tariffs. To cushion the impact of these changes on consumers, the Government reduced the road tax and limited the number of consumers affected by the electricity tariff revision in the middle of the year. Further, the Government's assurance that the increase in retail petrol prices in March 2006 would be a one-off occurrence ensured that consumer confidence would not be significantly undermined. As a result, following a period of adjustment, consumption activity picked up again. Over the course of the second half of the year, stable labour market conditions, coupled with bonus payments to civil servants, provided a positive impetus to consumer confidence. As a result, the CSI rose to 110.9 points in the fourth quarter, the highest level for the year.

Although the Overnight Policy Rate (OPR) was increased twice in 2006 (February and April 2006), the rates remained at relatively low levels. In this environment, household credit continued to expand although the deposit-to-loan ratio for households has remained below parity for the third consecutive year. Moreover, despite the increase in loans to the household sector,

**Chart 1.7**
**Household Debt and Deposit/Loan Ratio**




household debt remained within prudential limits as their financial positions remained relatively sound. Their holdings of financial assets, including deposits with financial institutions, life insurance savings, unit trust funds, and EPF contributions, continued to exceed their liabilities, which, when coupled with the strong growth in incomes, led to the non-performing loan (NPL) ratios for both consumption credit and credit card debt to decline further to 6% and 3.7% respectively in 2006 (2005: 7.3% and 4.5% respectively).

In spite of some concern regarding business prospects early in the year due to higher crude oil prices, the sustained favourable economic conditions supported a 9.7% growth in **private investment**. MIER's Business Conditions Index, which has remained above the 100-point threshold level since the first quarter of 2005, underscored the positive business sentiments. The positive investment climate was also reflected in the higher gross FDI inflows in 2006, with the manufacturing and oil and gas sectors being the main beneficiaries. Favourable corporate earnings over several years now have left companies with stronger financial positions, enabling them to fund the bulk of their capital expenditure internally. In addition, the financial system continued to support private investment activity. In 2006, private debt securities (PDS) issued for new activities during the year increased to RM21 billion (2005: RM17.7 billion), and formed the bulk of the total PDS issued. The bulk of the

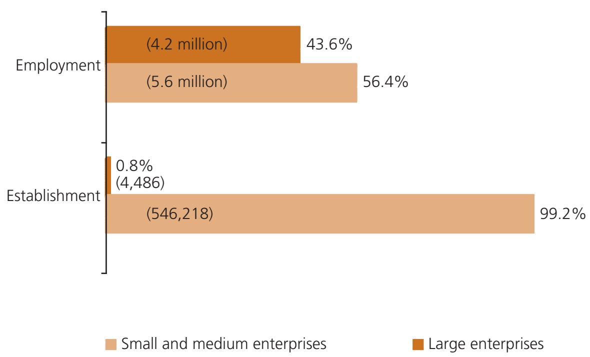
## DEVELOPMENT OF SMALL AND MEDIUM ENTERPRISES

The development of a strong and dynamic SME sector is an important economic agenda of the Government. During the year, the National SME Development Council[1] (Council) had taken several key initiatives to promote the development of SMEs including strengthening the enabling infrastructure for SME development, building SMEs' capacity and capabilities, and improving the access to financing by SMEs.

**Profile and Contribution of SMEs to the Economy**

As the availability of data on the status and performance of SMEs is critical to facilitate the formulation of effective strategies and policies to support the development of SMEs, the Census of Establishment and Enterprise (Census) was conducted in 2005. Based on the response of 550,704 business enterprises in the agriculture, manufacturing and services sectors, the findings of the Census indicated that 99.2% or 546,218 of the business establishments are SMEs, of which 433,517 or about 80% are micro enterprises.

**SME's Contribution to the Economy**




The Census results also showed that SMEs are a major source of employment, providing jobs for over 5.6 million workers and accounting for 56% of total employment. While SMEs account for the bulk of business enterprises and employ the majority of workers, their contribution to the economy is relatively small. The SMEs contributed only about 19% to the total export value and 32% of gross domestic product. Similarly, productivity levels in the SMEs were found to be significantly lower than large enterprises as they generated an average value added per employee of just RM14,740, far lower than the RM47,830 generated by large enterprises.

**Major Initiatives for SME Development**

**(i) National SME Development Blueprint 2007**

The 2007 National SME Development Blueprint, which was endorsed by the Council in January 2007, provides an assessment of the major SME programmes implemented in 2006 as well as identifies programmes that will be implemented in 2007.

***(a) Assessment of major SME development programmes in 2006***

A total of 213 major programmes, involving a total expenditure of RM7.8 billion, were

1 The National SME Development Council is chaired by the Prime Minister and comprised Ministers and Heads of 18 key Ministries and Agencies involved in SME development. Bank Negara Malaysia is the Secretariat to the Council.

implemented in 2006. The focus of the programmes was on enhancing the capacity and capabilities of SMEs, particularly in the areas of entrepreneurship development, marketing and promotion, product development and technology enhancement. These programmes benefited more than 287,000 SMEs. The major outcomes from these programmes were:

- More than 128,000 SMEs, women entrepreneurs, graduates and students received entrepreneurship and technical training;
- Advisory services were provided to about 34,000 SMEs by various Government agencies;
- More than 5,100 SMEs were provided with industrial and business premises;
- About 780 SMEs benefited from business matching and expansion programmes such as the Industrial Linkage Programme and SMIDEX 2006; and
- A total of 272 SMEs received grants and financial assistance to improve and upgrade their technology and business processes through the Technology Acquisition Fund, Grant for Certification and Quality Management System, and Grant for Product and Process Improvement.

To enhance access to financing by SMEs, Bank Negara Malaysia increased the allocation for the Fund for Small and Medium Industries 2 and the New Entrepreneur Fund 2 by RM2.5 billion in 2006, established a RM1 billion Special Fund for Overseas Project Financing and introduced two new trade financing products. Additionally, a RM150 million venture capital fund for the agriculture sector was established by Bank Negara Malaysia with a banking group. SMEs also benefited from financial advisory services provided by Bank Negara Malaysia, Bank Perusahaan Kecil & Sederhana Malaysia Berhad (SME Bank), Export-Import Bank of Malaysia Berhad (EXIM Bank) and commercial banks.

***(b) Major Programmes for SME Development in 2007***

The Council approved the implementation of 189 major programmes for SME development in 2007 (213 in 2006), with RM3.7 billion committed. Of the 189 major programmes, 135 programmes are aimed at building the capacity and capabilities of SMEs. Another 27 programmes will be implemented to enhance SMEs' access to financing, while 27 programmes are to strengthen the enabling infrastructure to further support the growth of SMEs.

These programmes cover all sectors, including SMEs in agriculture and agro-based industries, and those involved in knowledge-based industries. Efforts would also be directed to promote Bumiputera participation in the SME sector. To provide infrastructure to support SMEs' growth, business premises, factories and workshops will be provided for SMEs in the rural areas. In addition, product packaging, distribution and marketing centres will be established to ensure efficient and effective distribution of agriculture and agro-based products of SMEs. On strengthening the capacity and capabilities of SMEs, programmes will focus on entrepreneur and human capital development, marketing and promotion, and the provision of advisory services to SMEs. Highlights include the implementation of the New Franchise Scheme, Biotechnology Entrepreneur Development and ICT SME Development programmes. Various training programmes will be implemented, including in the areas of financial management and accounting, as well as to develop SMEs in the retail and agriculture industries.

In the area of financing, banking and development financial institutions will continue to be the main provider of funds to the SME sectors. These financial institutions are expected to approve a total of RM51 billion in loans to about 110,000 SME accounts in 2007. This will be complemented by a target to approve 37,000 loans under the various Government schemes. Forty new companies in the ICT sector are expected to be financed under the ICT Fund, while the Biotechnology Commercialisation Grant aims to establish 35 projects.

**(ii) Enhancing Awareness and Information Available to SMEs**

***(a) Launched of Inaugural SME Annual Report 2005***

On 7 August 2006, the Council released the inaugural SME Annual Report 2005. The Report is an important initiative to enhance the dissemination of information on SMEs in Malaysia. It provides a comprehensive review on the status and performance of SMEs and highlights major programmes of the Government to promote SME development.

***(b) Enhancements to SMEinfo Portal***

The SMEinfo Portal (www.smeinfo.com.my), launched in January 2006, provides a wide array of information required by SMEs, including details on Government programmes, financial products, training programmes, and tips on how to start and manage a business. The Portal also contains the SME Business Directory, a platform for SMEs to advertise and showcase their products. The Portal is accessible in Bahasa Malaysia, English and Mandarin for greater outreach to the local and international business community. The SMEinfo Portal is used widely by domestic SMEs and foreign businesses, recording an average of about 205,000 hits a month, including visitors from over 70 countries. As at the end of February 2007, more than 14,000 SMEs have registered in the SME Business Directory Portal. In 2007, a number of new value-added services will be introduced, including the creation of an SME Bulletin Board to provide an avenue for public and private sector organisations to advertise SME related events and the SME Financial Product Directory, which will allow SMEs to search for suitable financial products to meet their business needs.

**(iii) Establishment of the SME Business Adviser Network (SME-NET)**

The SMEs have ranked the need for advisory services as high among the areas in which assistance is required. This includes advisory services in a wide range of areas including product development, technology adoption, business and financial management, marketing and promotion. In an effort to further strengthen the ability and quality of advisory services provided by the agencies and financial institutions, the Council approved the establishment of the SME-NET, a one-stop web-based directory in the SMEinfo Portal that contains the profiles and contact details of SME business advisers in the various Government agencies, commercial banks and development financial institutions. The SME-Net connects SME business advisers and experts across these organisations, and highlights specific areas of expertise, hence, enabling advisers to leverage on each other. The SMEs will benefit from the high quality and better delivery of advisory services in the areas of marketing, technology and operations management, human resource, financing, business development and product development.

**(iv) Marketing and Promotion of SMEs' Products and Services**

Following approval by the Council, the SME Marketing Committee, an inter-Ministry

Committee chaired by the Ministry of International Trade and Industry, has been established to develop a comprehensive marketing strategy and implementation approach to effectively market the SMEs' products and services overseas. The Malaysian External Trade Development Corporation (MATRADE) has been tasked to coordinate the implementation of international marketing programmes and activities. This two-pronged approach is aimed at enhancing the synchronisation of Government initiatives in planning and implementing overseas marketing strategies while optimising the utilisation of resources and expertise. The SME Marketing Committee has identified 14 strategies to further increase the penetration of the domestic SMEs' products and services in the global market. Comprehensive programmes will be implemented in 2007 by various Ministries and Agencies to assist in capacity building, promotion, information management and provision of financial support to facilitate our SMEs in marketing their products and services overseas.

**Enhancing Access to Financing by SMEs**

Lending by the financial institutions to SMEs has shown an increasing trend since 1998. In 2006, banking institutions, the main provider of funds to the SMEs, approved RM39.6 billion of financing to more than 84,000 SME accounts, an increase of 10.7% from 2005 (2005: RM35.8 billion). Loan disbursements increased by 19.9% to RM132.6 billion (2005: RM110.7 billion), while loans outstanding to SMEs expanded by 4.2% to RM104.6 billion as at end-2006 (end-2005: RM100.3 billion). Loans to SMEs accounted for 44.5% of total outstanding business loans as at end–2006 (end-2005: 44.5%). On a sectoral basis, lending to SMEs was diversified, with almost two-thirds being channelled to the wholesale and retail trade, hotels and restaurants, manufacturing and construction sectors.

In 2006, six development financial institutions (namely SME Bank, EXIM Bank, Bank Simpanan Nasional, Bank Kerjasama Rakyat Malaysia Berhad, Bank Pembangunan Malaysia Berhad and Bank Pertanian Malaysia) approved RM6.9 billion of financing to more than 18,000 SME accounts (2005: RM2.3 billion to 5,222 SME accounts) and disbursed RM3.7 billion to SMEs (2005: RM1.5 billion). The loans outstanding of development financial institutions to SMEs increased by 9.9% to RM13.2 billion as at end-2006 (end-2005: RM12 billion). Since its establishment in October 2005, the SME Bank approved and disbursed RM2.5 billion and RM1.6 billion in loans respectively. Its loans outstanding to SMEs stood at RM2 billion as at end-2006. Leasing and factoring companies, an alternative mode of financing equipment investment and working capital requirements, extended RM862.7 million of new financing in 2006 (2005: RM819 million). For newly established businesses, especially in the ICT sector, financing could also be obtained from venture capital companies. The total funds available for venture capital investments increased by 27.8% to RM3.3 billion as at end-2006 (end-2005: RM2.6 billion). These funds were invested in 460 companies compared with 380 companies as at end-2005.

**Special Funds for SMEs**

Currently, there are 94 Government funds and schemes with a total allocation of about RM25 billion to assist the SMEs. Five of these special funds were established by Bank Negara Malaysia with a total allocation of RM11.4 billion, to allow viable and eligible SMEs to have access to financing at reasonable costs (lending rates range from 3.75% to 6%). These funds are channelled through participating institutions comprising banking institutions, development financial institutions and ERF Sdn. Bhd. The five funds are:

- Fund for Small and Medium Industries 2 (fund size: RM6.75 billion);
- New Entrepreneurs Fund 2 (fund size: RM2.85 billion);

- Fund for Food (fund size: RM1.3 billion);
- Rehabilitation Fund for Small Businesses (fund size: RM200 million); and
- Bumiputera Entrepreneurs Project Fund (fund size: RM300 million).

Due to strong demand, allocations for the Fund for Small and Medium Industries 2 (FSMI2) and New Entrepreneurs Fund 2 (NEF2) was increased in 2006 by RM2 billion and RM500 million to RM6.75 billion and RM2.85 billion respectively. To ensure that these funds had a wider outreach, Bank Negara Malaysia revised the eligibility criteria of the FSMI2 and NEF2 in April 2006.

**Initiatives to Improve Access to Financing by SMEs**
The policy on enhancing access to financing by SMEs during the year continued to focus on strengthening the existing infrastructure to ensure a more effective channelling of funds to SMEs, provision of financial advisory support, as well as enhancing awareness on financial products and assistance programmes available to SMEs. Among notable initiatives introduced in 2006 were:

**(i) Sustainable Microfinance Framework**
The findings of the Census indicated that about 80% of SMEs are micro enterprises and most of them relied on their own sources of funding. Recognising this, the Council approved a comprehensive microfinance institutional framework to promote the development of a sustainable microfinance industry in Malaysia in order to ensure that micro enterprises have adequate and continuous access to financing. Within this framework, banking institutions, development financial institutions and credit cooperatives have been identified to provide microfinance products to complement the existing Government-sponsored microfinance programmes such as Amanah Ikhtiar Malaysia and Yayasan TEKUN Nasional.

With the introduction of the microfinance framework, several financial institutions have started to provide individuals and micro enterprises with fast, flexible and convenient access to financing for business purposes. Banking institutions have now launched microfinance products since December 2006. Microfinance products offered by the financial institutions have attractive features, with loans sizes ranging from RM500 to RM50,000. To provide the widest accessibility, flexible collateral requirements, fast loan approvals (ranging between 5 to 11 working days) and incentives to encourage good repayment practices by borrowers are incorporated into the microfinance products.

The Council also agreed that a common microfinance logo will be developed to create awareness on microfinance. Financial institutions that offer microfinancing will display this logo to enable and enhance public awareness on financial institutions that offer these services. Recipients or borrowers of microfinancing facilities will also be encouraged to display this logo at their business premises. Bank Negara Malaysia is also facilitating the development of a “Graduation Programme” to enable the larger micro enterprises to obtain the right amount and type of financing. Through this structured programme, micro enterprises that require larger amount of funds to finance business growth will be assisted in obtaining financing from the appropriate financial institutions.

**(ii) Venture Capital Funds for the Agriculture Sector**
To support the objective of developing the potential of the agriculture sector as the third engine of growth, two venture capital funds totaling RM350 million were jointly

established in September 2006 by Bank Negara Malaysia, Khazanah Nasional Berhad and a banking group. The aim of these funds is to create and develop an integrated agricultural business, particularly in farming, fisheries and livestock as well as to finance new technology-intensive agriculture projects. Another agriculture venture capital fund will be launched with a banking group amounting to RM150 million in the first half of 2007.

**(iii) Overseas Project Financing**

Bank Negara Malaysia established a RM1 billion Overseas Project Fund at EXIM Bank in December 2006 to facilitate Malaysian companies with projects overseas in obtaining financing from the domestic banking institutions through the guarantee and co- financing facilities under the Fund. Under the guarantee facility, EXIM Bank will provide guarantees to loans obtained by eligible companies to finance overseas projects from the domestic banking institutions. With this credit guarantee facility, Malaysian companies, contractors and professional service providers will have an easier access to financing to support their business ventures abroad. Currently, four domestic banking groups are participating in the guarantee scheme.

**(iv) SME Bank's Advisory Services**

The SME Bank established the SME Bank Advisory Centre (SAC) to help SMEs grow, innovate and achieve excellence in their business activities as well as to overcome financial problems. The advisory services provided by the SAC include advice on marketing, business development, operations and customer service.

**(v) New trade finance products**

Two new trade finance products for SMEs were introduced in January 2006, namely the Multi Currency Trade Finance and Indirect Exporter Financing Scheme. These products are aimed at encouraging SMEs to export their goods and services, particularly to non-traditional markets such as members of the Organisation of Islamic Conference. Under the arrangement, SMEs can obtain financing without collateral from the banks, with the credit risk being shared between the bank and EXIM Bank. Financing approved to the SMEs under the two products amounted to RM26.1 million as at 31 December 2006. Islamic trade finance products are expected to be available to SMEs in 2007.

**Financial Advisory Services**

The LINK (Laman Informasi Nasihat dan Khidmat) in Bank Negara Malaysia provides financial advisory services to SMEs in the following areas:

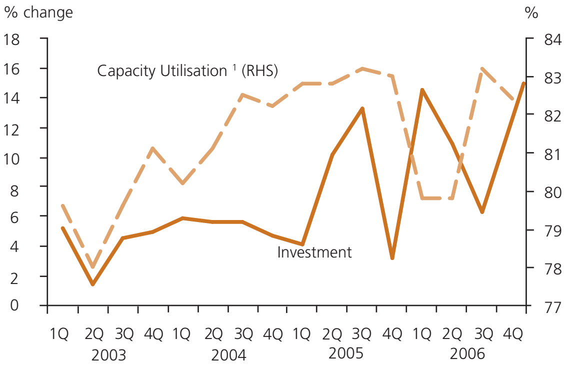
- information on various sources of financing;
- assistance in facilitation of the loan application process; and
- advice on financial requirements and problems of SMEs.

In 2006, the number of enquiries and assistance sought by SMEs totalled 4,186 (2005: 4,037) reflecting continued awareness among SMEs of availability of such services at the Bank. Of these, 77% were enquiries on special funds provided by the Government and advice on loan matters, while 23% were requests for assistance, mainly for loan restructuring and rejections.

**Performance of the Small Debt Resolution Scheme**

The Small Debt Resolution Scheme, established on 1 November 2003, continued to facilitate the restructuring of non-performing loans (NPLs) of SMEs with on-going businesses. As at end-2006, 562 applications for restructuring, with NPLs of RM405 million, were received under the scheme (end-2005: 394 applications with NPLs of RM278 million). Of these, 424 applications or 75.4% of the total applications, involving NPLs of RM267 million, have been approved for restructuring. In terms of applications for new financing, RM301 million in new funding was requested (end-2005: RM244 million), of which RM18 million was approved under the Rehabilitation Fund for Small Businesses. The performance of the scheme indicates that the restructuring of NPLs continues to be the mainstay in supporting the viability and sustainability of financially distressed SMEs, with new financing being selectively provided mainly to SMEs with new projects in hand.

**Chart 1.8**
**Investment and Capacity Utilisation**



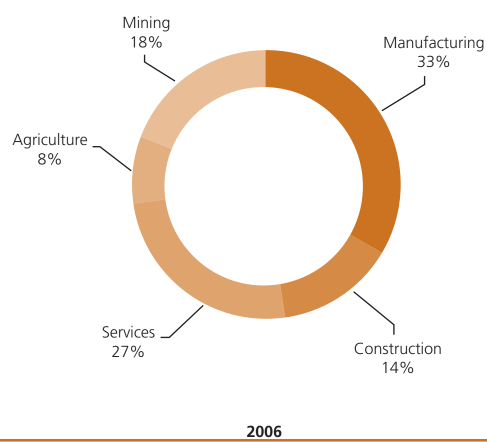

[1] Source: Malaysian Institute of Economic Research (MIER)

expansion in capital spending occurred in the manufacturing, services and upstream oil and gas sectors.

Manufacturers' expenditure on new machinery and equipment remained strong, as reflected in the higher imports of these items during the year. In view of the strong demand for resource-based products from abroad and sustained high capacity utilization levels, manufacturers undertook a significant expansion in capacity. The expansion of production capabilities in the off-estate processing industry also reflected a strong expansion in the commodities-related downstream sector in expectation of strong demand. In 2006, the Ministry of International Trade and Industry (MITI) approved 1,077 manufacturing projects worth RM46 billion (2005: RM31.1 billion), mainly for investment in the petroleum products, chemical products and electrical and electronics products industries. The bulk of the approved projects were new and mainly concentrated in biodiesel production, which is in line with Government's aspiration to promote the development of biofuels. At the same time, there was an increase in capital spending to expand current production lines, mainly in the electronics sector, where foreign participation is more prominent. For the projects approved during the year, capital investment per employee also rose, pointing to the shift towards more capital-intensive and higher value-added projects.

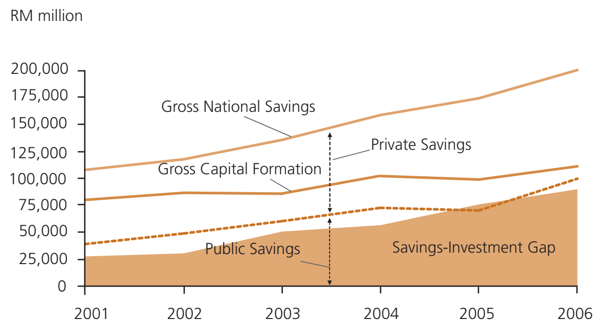
Capital spending in the oil and gas sector remained robust, driven by exploration and production projects as deepwater exploration intensified during the year. In the services sector, investment was most notable in the transportation

**Chart 1.9**
**Private Investment by Sector (% share)**



and communications sub-sector. Higher capital spending was mainly attributed to the expansion of port facilities, investment in the air and sea transportation segments as well as on the enhancement of the telecommunications network. Meanwhile, in the agriculture sector, rising CPO prices and stronger demand for commodities have encouraged additional capital spending in crop expansion. Following the implementation of the Ninth Malaysian Plan, capital expenditure for road infrastructure picked up in 2006, where ongoing projects have been intensified while preliminary development works for some new highways have started.

**Chart 1.10**
**Gross National Savings and Savings-Investment Gap**




**Public consumption** grew at a stronger rate of 7.9% in 2006 (2005: 5.4%), due mainly to continued high expenditure on emoluments and supplies and services. The increase in emoluments expenditure reflected the Government's continued effort to enhance human capital development in order to strengthen the nation's productivity and competitiveness. Meanwhile, expenditure on supplies and services rose largely due to the Government's emphasis on improving the public sector's administrative machinery and delivery system.

In spite of higher public consumption, public sector savings rose significantly to RM101.7 billion or 19.3% of GNP (RM70.5 billion or 15% of GNP in 2005) due to the larger operating surpluses generated by the non-financial public enterprises (NFPEs). This contrasted with the more stable pattern in private sector savings. As a result, **gross national savings** (GNS) rose by 15.1% to RM200.7 billion or 38.1% of GNP. In the private sector, the high level of savings (RM99 billion or 18.8% of GNP) was due to higher disposable incomes and cash flows arising from strong export earnings, firm commodity prices and stable employment conditions during the year. Banking sector deposits held by individuals rose significantly by RM25.4 billion during the year (RM15.2 billion in 2005), underlining the strength of household balance sheets.

**Public investment** rose by 6.5% in 2006 (2005: 1.9%). During the year, the Federal Government remained committed to implementing development projects that improved socio-economic conditions, both in the rural and the urban areas. Of importance, capital spending for the provision of roads and utilities and the upgrading of educational facilities in rural areas has been accelerated. The bulk of the expenditure in the economic services sector were mainly channelled into improving the transportation and industrial infrastructure as well as broadening the agriculture base. Capital expenditure on the social services sector was mainly for improving essential services such as education and health, with a larger allocation for higher education, industrial training as well as medical facilities and equipment.

Capital expenditure by the NFPEs remained high, due mainly to allocations for capacity expansion and operational efficiency improvements by the three largest NFPEs: Petroliam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB) and Telekom Malaysia (TM). PETRONAS' capital expenditure was mainly devoted to upstream oil exploration and production activities. TNB continued to spend on upgrading power generation and transmission systems in order to improve the distribution of power supply, and to cater for rising electricity demand during the year. Similarly, capital expenditure by TM was largely for the enhancement of the communication network. Despite the high mobile penetration rate, TM, through its mobile subsidiary unit, continued to spend on optimising the existing network and upgrading the broadband infrastructure to remain competitive. In addition, the company also concentrated on upgrading and expanding internet services, particularly broadband access.

Nevertheless, in spite of higher investment by both the private and public sectors, the more significant increase in the GNS led to a larger savings-investment balance in 2006. The balance, which is equivalent to the current account on the balance of payments, recorded a larger surplus of RM91.2 billion or 17.3% of GNP.

## SECTORAL REVIEW

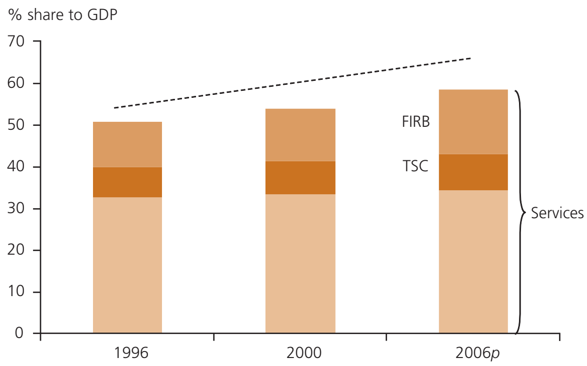
### Services Sector

In addition to supporting the expansion in the economy, the **services sector** has evolved to become an important contributor to growth. The sector grew at a faster pace than the overall economy, which resulted in its share of GDP increasing to 59% (2000: 54%). The growth was mainly driven by two key sub-sectors that experienced rapid expansion during this period, namely the finance, insurance, real estate and business services; and the transport, storage and communication sub-sectors. These two sub-sectors now account for close to one-quarter of the overall GDP.

## Services sector growth increasingly driven by financial services and other new activities

The shift in the profile was characterised by a major transformation in the financial services sector, and emergence of new activities such as Islamic banking, takaful, telecommunications, IT services, and shared services and outsourcing. The financial services sector has now become more diversified and competitive due to deregulation, liberalisation, industry consolidation and the entry of new players, particularly in Islamic finance. Improved financial inclusion and technological advancements amidst the increased competition also gave rise to a wider range of products and services, thus contributing to increased value-add during this period.

**Chart 1.11**
**Services Sector Share to GDP**




*p* Preliminary

FIRB refers finance, insurance, real estate & business services sub-sector
TSC refers transport, storage & communication sub-sector

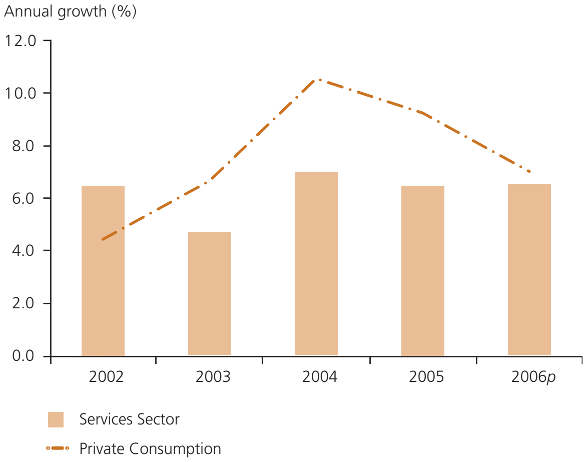
Source: Department of Statistics, Malaysia

Meanwhile, significant strides were also made in promoting other new areas of growth in the services sector. These are mainly knowledge-intensive activities which have high value-add. Telecommunications is one of the new areas that experienced rapid growth arising from rationalisation of cellular players as well as introduction of new applications and services, such as data services; on-line services related to e-commerce, entertainment and leisure industries; and the launching of third generation (3G) services.

In 2006, the services sector remained on a steady growth path and expanded by 6.5%. As growth in private consumption gradually returned to normal trends of close to GDP growth, the services sector was supported by higher trade-related activities, finance and tourism as well as increased contribution from new sources of growth.

Of significance, the **finance, insurance, real estate and business services** sub-sector recorded a favourable performance. The sector grew at a faster pace of 7.1% to contribute 1.1 percentage points to the overall GDP growth during the year. Increased financial intermediation activity, product innovation and emergence of new services such as financial advisory and fund

**Chart 1.12**
**Annual Growth of Services Sector and Private Consumption**




*p* Preliminary

Source: Department of Statistics, Malaysia

and wealth management, resulted in higher interest and fee-based income. Growth was also supported by higher insurance activity led mainly by medical and health insurance and investment-linked products from the life insurance segment. The sector was further reinforced by expansion in emerging areas. Islamic banking and takaful activities gathered momentum as eight new players commenced operations. During the year, the Malaysia International Islamic Financial Centre (MIFC) initiative was launched to promote Islamic financial products and services in international currencies for the global market. Over the period 2002 to 2006, the share of revenue from lending and fee-based activity from Islamic banks has tripled to account for 6.4% of revenue from the total banking system in 2006. Similarly, the takaful industry recorded an increase in revenue (contributions less claims) with the share rising to 8.2% of the total insurance industry revenue for the year (2002: 6.6%).

The other emerging area with strong growth is the business services segment, spurred by demand for IT services, outsourcing activities and professional services arising from the rapid expansion in the oil and gas and financial services segments. During the year, 307 new Multimedia Super Corridor (MSC) status companies were approved, of which 27 were in shared services and outsourcing activities. The extension of the MSC to specific areas in Melaka, Johor and Kuala Lumpur supported the growth in the IT-related activities.

Similarly, the **transport, storage and communication** sub-sector saw an improved performance during the year driven mainly by telecommunication activity, particularly in the cellular segment. A large subscriber base induced by declining prices of cellular phones as well as higher usage of both voice and data services due to the attractive promotions by the telecommunication players supported the expansion in the segment. The telecommunication sector was further supported by growth in the broadband and Internet segments due to the introduction of wireless broadband in residential areas and new wireless broadband products via 3G technology. The launching of the Malaysian Internet Exchange

**Table 1.4**
**Growth in the Services Sector at Constant 1987 Prices**

| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | |
| **Services** | **6.5** | **6.5** |
| Intermediate services | 5.9 | 6.8 |
| Transport, storage and communication | 6.2 | 6.3 |
| Finance, insurance, real estate and business services | 5.7 | 7.1 |
| Final services | 6.9 | 6.3 |
| Electricity, gas and water | 5.6 | 4.9 |
| Wholesale and retail trade, hotels and restaurants | 8.0 | 5.9 |
| Government services [1] | 7.6 | 9.6 |
| Other services [2] | 4.9 | 4.5 |

[1] Include general public services (general public administration; external affairs; and public order and safety), defence, health, education and others.

[2] Include imputed rent from owner-occupied dwellings; community, social and personal services; products of private non-profit services to households and domestic services of households.

*p* Preliminary

Source: Department of Statistics, Malaysia

**Table 1.5**
**Emerging Areas of Growth in the Services Sector**

| | End-2005 | End-2006*p* |
|---|---|---|
| **Islamic-based Financial Services** | | |
| Islamic Banks[1] | 6 | 10 |
| Takaful companies[1] | 4 | 8 |
| **IT Service Industry** | | |
| No of MSC-status companies approved | 1,421 | 1,728 |
| Amount of approved private investment in MSC | 18.2 billion | 21.2 billion |
| **Manufacturing-related services** | | |
| Operational Headquarters (OHQ) | 106 | 131 |
| International Procurement Centres (IPC) | 177 | 191 |
| Regional Distribution Centres (RDC) | 10 | 17 |
| **Private Higher Education Services** | | |
| No. of private higher educational institutes (IPTS) | 559 | 515 |
| No. of students in IPTS (Year) | 292,728 | 313,900 |
| No. of foreign students in IPTS (Year) | 33,903 | 38,900 |
| **Private Healthcare Services** | | |
| No of private hospitals participating in promoting health tourism | 35 | 35 |

[1] Refers to institutions in operation
*p* Preliminary

Source: Multimedia Development Corporation, Malaysian Industrial Development Authority, Ministry of Higher Education, Association of Private Hospitals of Malaysia, Bank Negara Malaysia

by a consortium of 17 Malaysian internet service providers during the year created more activity locally.

Meanwhile, growth in the transportation segment was closely linked with the strengthening manufacturing and trade activity that resulted in increased usage of local haulage and port-related services. Revenue from transhipment activity, that is, the routing of cargo from regional countries via the major ports in the country, also saw rapid expansion during the year. Increased travel activity from both higher inbound tourists as well as more Malaysians travelling for leisure given the aggressive promotions by airlines, especially the low-cost carrier, supported the air transportation segment. During the year, the low-cost carrier recorded higher activity, as reflected by capacity expansion, increased flight frequency and the introduction of new destinations. Airport activity was further enhanced by the opening of the new low-cost carrier terminal in the first quarter of 2006.

After two consecutive years of strong expansion, the **wholesale and retail trade, hotels and restaurants** sub-sector reverted to a more moderate growth of 5.9%, influenced mainly by the normalisation in private consumption trends. Nevertheless, the impact was partially offset by higher tourism activity. Increased tourist arrivals, particularly from the high spending markets such as the Middle East, supported the hospitality segment and retail industry, especially the luxury goods segment. This was further enhanced by domestic tourism activity, encouraged by the aggressive promotions from the low-cost carrier and the five-day working week for the public sector.

During the year, the distributive trade industry was also affected by narrowing margins due to keen competition among the players. Hypermarkets and large retailers strategised on obtaining higher market shares. Discounts and the opening of new retail outlets in high-catchment areas and in new malls were among the efforts for a wider outreach to gain market share. In addition, retailers offered interest-free instalment plans and attractive payment schemes to entice purchases of consumer durables. To some extent, the narrowing margins affected the value-added growth in the sub-sector. Meanwhile, activity in the automotive trade industry, which accounts for about 11% of the total distributive trade industry, was subdued during the year, dampened by the low resale value of second-hand vehicles.

The **other services** sub-sector continued to expand steadily, supported by growth in other private services, namely entertainment, advertising, private education services and private healthcare services. The entertainment segment benefited from changing consumer behaviour and increased emphasis on leisure. Besides the entertainment segment, advertising and broadcasting services were supported by the

World Cup event and Visit Malaysia Year 2007 campaigns and aggressive promotions undertaken by the financial services, telecommunication and retail industries.

New areas of economic activity that have received greater policy attention in recent years are the private education and private healthcare services. These services continued to expand in 2006. The total number of students attending private higher education institutions increased by 7.2%, supported by foreign students from regional countries as well as Malaysians. During the year, there was an increase in the number of courses accredited by the Malaysian National Accreditation Board and higher number of institutions seeking the MSC status. As of end 2006, 35 private hospitals participated in health tourism, attracting foreign patients, mainly from Indonesia, Japan and the European countries. The foreigners sought treatment in Malaysia, attracted by the competitive rates, medical expertise and up-to-date facilities.

**Table 1.6**
**Selected Indicators for the Services Sector**

| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | |
| **Utilities** | | |
| Electricity production index | 5.8 | 5.1 |
| **Wholesale and Retail Trade, Hotels and Restaurants** | | |
| Consumption credit outstanding | 18.7 | 14.9 |
| Tourist arrivals | 4.6 | 6.8 |
| Total sales of motor vehicles | 13.3 | -11.2 |
| **Finance, Insurance, Real Estate and Business Services** | | |
| Loans outstanding in the banking system | 8.6 | 6.3 |
| Insurance premiums | 7.7 | 5.5 |
| Bursa Malaysia turnover (volume) | -4.7 | 93.3 |
| **Transport, Storage and Communication** | | |
| Total cargo handled at the six major ports (tonnes)[1] | 7.6 | 5.8 |
| Airport passenger traffic | 4.8 | 2.2 |
| Air cargo handled | 4.3 | 5.7 |
| SMS traffic | 130.8 | 51.6 |
| | % | |
| Penetration rate: | | |
| - Internet dial-up | 13.9 | 14.0 |
| - Broadband | 1.9 | 3.3 |
| - Mobile phone | 74.1 | 72.3 |
| - Fixed line | 16.6 | 16.1 |

[1] Both container and bulk cargo at Port Klang, Johor Port, Port of Tanjung Pelepas, Penang Port, Sabah Ports and Bintulu Port.
*p* Preliminary

Source: Department of Statistics, Malaysia; Malaysia Airports Holdings Berhad; Bursa Malaysia Berhad; Malaysian Communications and Multimedia Commission; relevant port authorities; Malaysian Automotive Association; Malaysia Tourism Promotion Board and Bank Negara Malaysia.

The **Government services** segment recorded stronger growth as a result of the introduction of the cost of living allowance and increases in salaries and bonuses paid to civil servants, while the **utilities** sub-sector was supported by the expansion in economic activity.

### Manufacturing Sector

Growth in the **manufacturing sector** strengthened, underpinned by the continued upturn in the global electronics cycle which began in the second half of 2005. The performance was further enhanced by the strong external demand for resource-based industries such as petroleum, rubber and off-estate processing, which experienced better terms-of-trade due to higher export prices. The domestic-oriented industries also showed a marked improvement during the year. Overall, the manufacturing sector recorded a growth of 7%, resulting in its share to GDP remaining at 32%. Amidst the favourable performance, the capacity utilisation rate in the manufacturing sector remained stable during the year due to investments to expand and upgrade facilities in a number of industries.

**Growth in the manufacturing sector strengthened, supported by the global electronics upcycle and improved performance in domestic-oriented industries**

The domestic **electronics and electrical** sector was able to ride on the cyclical semiconductor

**Table 1.7**
**Performance of the Manufacturing Sector**

| | 2005 | 2006 |
|---|---|---|
| | Annual change (%) | |
| **Value-added (at constant 1987 prices)** | **5.1** | **7.0** |
| **Overall Production** | **5.1** | **7.5** |
| **Export-oriented industries** | **5.7** | **7.5** |
| *of which:* | | |
| Electronics and electrical products (E&E) | 3.5 | 7.9 |
| Chemicals and chemical products | 11.0 | 3.2 |
| Petroleum products | 10.8 | 13.6 |
| Rubber products | -0.4 | 7.2 |
| Off-estate processing | 8.1 | 5.7 |
| **Domestic-oriented industries** | **2.8** | **7.2** |
| *of which:* | | |
| Construction-related products | -0.5 | 3.2 |
| Fabricated metal products | -4.9 | 26.5 |
| **Exports** | **10.0** | **10.1** |

Source: Department of Statistics, Malaysia

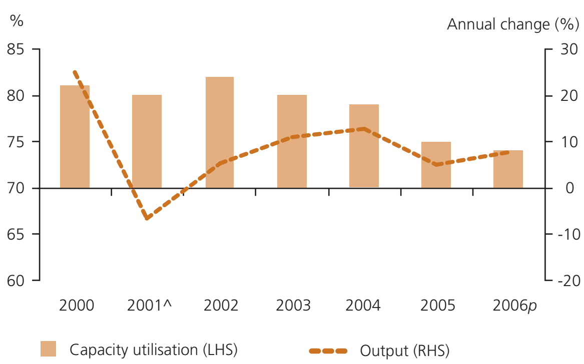
upturn resulting in strong growth, particularly in the first half-year. The global semiconductor recovery was broad based, supported by demand for all product segments, including computers, consumer electronics, telecommunications and automotives. Multinational companies located in Malaysia took the opportunity to produce newer products incorporating new technological advancements.

Increasing demand for laptops in the US market and the introduction of new microprocessors during the year supported the growth in computers and related products. Domestic manufacturers also increased production of telecommunication equipment and in the consumer electronics segment, some manufacturers moved up the value chain to produce flat screen televisions and DVD recorders.

After a favourable performance in the first three quarters of the year, the manufacturing sector expanded at a more moderate pace towards the year-end. Domestic data on exports and production as well as the indicators in the US showed some signs of weakness in the electronics and electrical sector. Nevertheless, the effects are expected to be transitory as the current global electronics upcycle is expected to continue into 2008.

In the **resource-based segment**, the rubber products industry turned around to record a positive growth of 7.2% (2005: -0.4%) led by the strong expansion in output of rubber gloves. For a number of years now, the major rubber glove manufacturers have been expanding aggressively through mergers and acquisitions, and investments in new production lines to meet increasing global demand induced by health-related factors. Despite the sharp increase in

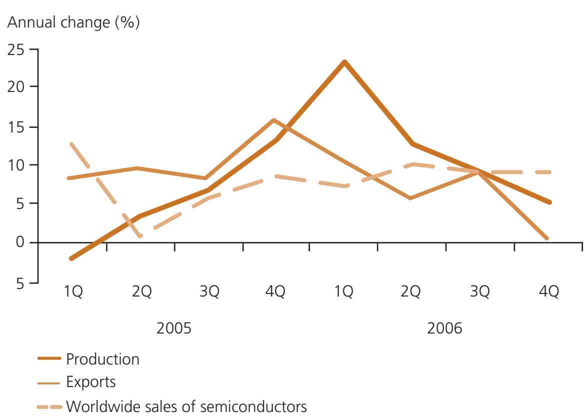
**Chart 1.13**
**Capacity Utilisation in the Manufacturing Sector**




*p* Preliminary
^ Output data from 2001 onwards were based on the new Industrial Production Index (2000=100)

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

**Chart 1.14**
**Production and Exports of Electronics**



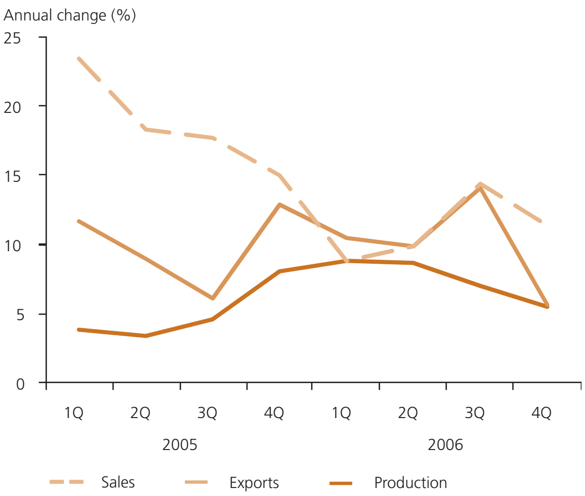

Source: Department of Statistic Malaysia
Semiconductor Industry Association (SIA)

the input prices of latex, the major players remained competitive and increased their market shares.

The petroleum products industry exhibited stronger growth due largely to increased refinery activity during the year. The growth was encouraged by strong external demand for petroleum products. Similarly, the performance of off-estate processing remained favourable arising from the strong growth in the output of crude palm oil and rubber.

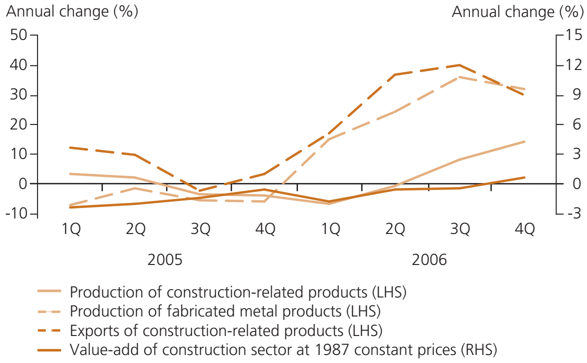
In the chemical and chemical products industry, growth was more subdued during the year due to lower production of industrial gases, in line with the lower output of natural gas. The industry was also partly affected by weaker demand for intermediate plastic products from China due to reduced reliance on imports as their domestic producers increased production. Nevertheless, the plastic products segment continued to expand due to growing demand from the electronics and electrical industry, as well as demand from the European Union. Malaysia, being one of the major producers of intermediate oleochemicals in the world, also benefited from the growing demand for beauty and household products.

**Chart 1.15**
**Manufacturing Sector: Production, Exports and Sales**




Source: Department of Statistics, Malaysia

**Chart 1.16**
**Industries Related to the Construction Sector were Supported by Domestic and External Demand**




Source: Department of Statistics, Malaysia

Over the years, the chemical industry has become more diversified, with its products ranging from industrial gases to plastic products to oleochemical products and more recently moving on to biofuels. The biofuel is mainly to cater to the European Union market, where there is growing demand for renewable sources of energy in light of the high oil prices and increasing environmental awareness.

The manufacturing sector in 2006 was also supported by the **domestic-oriented industries**, which grew at a faster pace of 7.2% (2005: 2.8%). This growth was mainly attributable to better performance by industries related to the construction sector, namely iron and steel, non-metallic products, and to some extent fabricated metal products, benefiting both from the gradual improvement in the construction sector as well as the strong external demand from regional countries. Meanwhile, the transport equipment industry recorded a mild decline, affected by the lacklustre demand for new motor vehicles.

### Agriculture Sector

The agriculture, forestry and fishing **(agriculture) sector** recorded the highest growth rate since 1992 with an expansion of 6.4% in 2006. The growth was broad based across both the industrial and food crops. The former was supported by higher growth in palm oil, rubber and cocoa output, while food-related activity such as fisheries, livestock, paddy, fruits and vegetables recovered from the adverse weather conditions in the previous year. Growth was mainly supported by an increase in yields, amidst the high commodity prices and favourable weather conditions. The good agriculture practices adopted by the farming community with the application of agriculture inputs, fertilisers and usage of high yielding clones also contributed to the increased yields during the year.

## The agriculture sector recorded a strong performance reflecting broad based expansion across both industrial crops and food-related activity, amidst the higher yields and favourable commodity prices

The Government's efforts to optimize the potential of the agriculture sector and to transform it into an important engine of growth continued to show results. The sector was the third largest contributor to economic activity, in terms of its share to GDP (8.3%), export revenue (7.1%) and employment (12.5%). Increased profits reaped by plantation companies influenced the upward trend in their stock prices. The Bursa Malaysia Plantation Index rose to 4,316 points at end-2006, an increase of 54% compared to end-2005 (2,799 points).

The agriculture sector also has strong spillover effects on the rural community. Incomes of farmers and smallholders increased strongly. Incomes of rubber smallholders increased by 45% to an average of RM2,900 per month (2005: RM2000; 1990s: RM600), leading to higher consumption activity among the rural population. In order to improve yields and maximise their incomes, smallholders intensified their tapping activity, adopted better exploitation technologies such as the low frequency tapping system (LITS) and used stimulants. Measures taken by the Government to provide replanting grants to encourage farmers to replant with high-yielding clones have also helped to raise the incomes of smallholders.

**Crude palm oil** production continued to expand by 6.1% to 15.9 million tonnes, representing the fourth consecutive year of strong growth. The increase in production was a result of expansion in matured areas (2% to 3.7 million hectares), and the rise in yields in terms of fresh fruit bunches (FFB) by 3.8% to 19.6 tonnes per hectare. Better harvesting management and the efficient application of agricultural inputs led to the higher yields. In terms of region, Peninsular Malaysia, which accounted for more than half of the total production, was responsible for the higher increase in output during the year, while output in Sabah grew at a more moderate pace.

Prices of palm oil remained supportive of the industry in 2006 with the crude palm oil local delivery price averaging RM1,521 per tonne, or an increase of 8.8%. The increase was fuelled by strong demand for new uses, namely in the

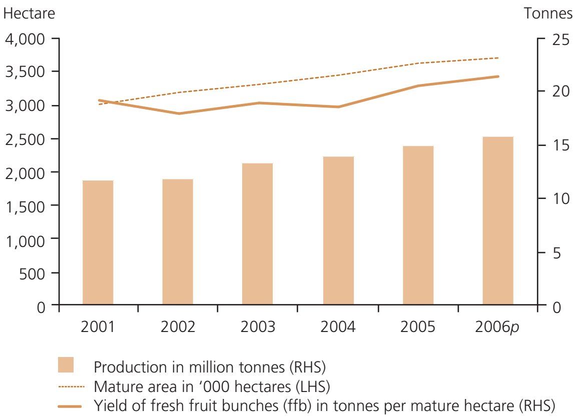
**Table 1.8**
**Agriculture Sector:**
**Value Added, Production and Exports**

| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | |
| **Value added** | **2.5** | **6.4** |
| **Industrial crops** | **4.0** | **6.2** |
| *Production of which:* | | |
| Crude palm oil | 7.0 | 6.1 |
| Rubber | -3.7 | 11.9 |
| Saw logs | 1.6 | -4.2 |
| Cocoa beans | -16.3 | 14.2 |
| **Food crops** | **0.2** | **6.7** |
| *Production of which:* | | |
| Fish | -7.6 | 8.3 |
| Livestock[1] | 9.1 | 17.6 |
| Vegetables | -2.8 | 3.8 |
| Fruits | -18.7 | 5.3 |
| **Exports (value)** | **0.6** | **12.5** |

[1] Refers to Peninsular Malaysia only
*p* Preliminary

Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Malaysian Rubber Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board
Fisheries Department, Malaysia
Veterinary Services Department, Malaysia
Department of Agriculture, Malaysia

**Chart 1.17**
**Oil Palm: Area, Production and Yield**

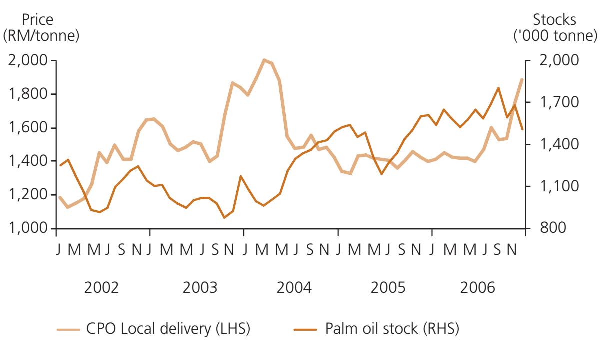



*p* Preliminary
Source: Malaysian Palm Oil Board (MPOB)

production of biodiesel as well as demand from food producers in the US to substitute palm oil for other edible oils containing *trans fatty* acids. While prices remained range-bound in the region of RM1,400 – RM1,550 per tonne in the first 10 months of the year amidst the strong increase in supply and higher stocks, prices subsequently trended higher to close at RM2,000 at end-2006. Nevertheless, crude palm oil remained competitive against the other major edible oils, with the price discount to soybean oil and rapeseed oil widening further during the year to USD121 per tonne and USD316 per tonne, respectively.

Growth in output was matched by a strong export performance during the year. Palm oil exports to PR China increased substantially due

**Chart 1.18**
**Palm Oil Price and Stocks**



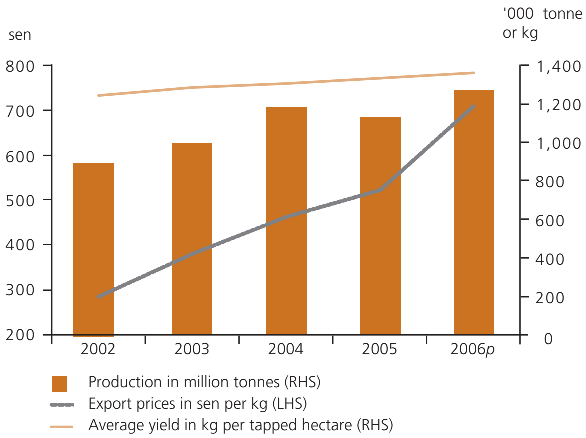

Source: Malaysian Palm Oil Board (MPOB)

primarily to the abolition of quotas on edible oils as well as the imposition of a flat tariff structure (9% rate) across imports of all edible oils effective 1 January 2006. This amendment to the tariff structure has enabled palm oil to compete on a level playing field with other edible oils in the market. Consequently, the share of exports to PR China increased to account for about one-quarter of total exports. Meanwhile, purchases by India declined further due to changes in the import tariff structure that favoured other oils such as soybean and rapeseed. Demand from the US continued to register strong growth for the third consecutive year, as US food manufacturers increasingly used palm oil in the food industry.

A major development in the palm oil industry during the year has been the strong interest in palm oil-based biodiesel, mainly for the export market. Among the renewable energy resources, palm oil has distinct advantages over other sources both in terms of price competitiveness as well as readily available supply. During the year, the industry had attracted significant investments given the strong external demand for biodiesel and attractive tax incentives provided. As of end-2006, the Government had approved 84 biodiesel plants with a total annual capacity of 9.45 million tonnes. By the end of 2007, annual biodiesel capacity is expected to reach approximately 1 million tonnes, all of which meets the international standard known as EN 14214. This would enable the palm oil industry to move up the value chain toward downstream processing, creating a new source of export earnings and stabilising palm oil price movements in future.

In recent years, **natural rubber** has regained its status as one of the key agriculture commodities. It recorded a strong performance, with output expanding at a double-digit rate to 1.26 million tonnes. Thus, for the third consecutive year, output breached the key threshold of 1 million tonnes. Of significance, Malaysia was the most responsive among all natural rubber producers in the world, as it recorded the highest increase in output (140,000 tonnes) during the year. The strong performance was driven mainly by increased output from smallholders, who account for almost 95% of the total rubber output in the

**Chart 1.19**
**Natural Rubber: Production, Prices and Yield**




*p* Preliminary
Source: Malaysian Rubber Board (MRB) and Department of Statistics, Malaysia

country. The high prices combined with increased yields due to favourable weather conditions led to the improved performance. The positive development took place despite the declining trend in the total acreage during the year (-2% to 1.23 million hectares). While Malaysia maintained its position as the third largest producer of natural rubber after Thailand and Indonesia, its share of world output rose further to 13.8% (2005: 13%).

Prices of SMR20, the Malaysian benchmark, rose significantly to record an historic high of above 700 sen per kilogramme in 2006 from around 285 sen in 2002. Prices peaked at 895 sen per kilogramme on 3 July 2006, around the period when international crude oil prices reached USD78 per barrel. Since then, prices have moderated in line with the downward trend in oil prices and rising rubber production. The sharp increase in prices was driven by several factors. Global stocks reached historically low levels amidst persistent demand, particularly from PR China. In addition, prices of synthetic rubber also reached new highs in line with the strong crude oil prices. Besides PR China, the other major buyers were the European Union (EU) countries (particularly Germany and France), accounting for 28.6% of total rubber exports.

**Food-related activity**, comprising fisheries, livestock, as well as other agriculture commodities (which include paddy, fruits and vegetables) performed well in 2006. The value added growth of 6.7% was driven by a combination of better weather conditions and stronger domestic demand. The livestock sub-sector continued to expand further, led by higher output of poultry, due to the utilisation of modern farming techniques and stronger demand from the food processing downstream industries.

In the **forestry** sector, logging activity declined in 2006 in line with the conservation efforts implemented as part of sustainable forest management. Correspondingly, exports of logs and sawn timber decreased substantially. These developments, coupled with the continued ban on exports of logs and sawn timber by Indonesia, resulted in the average Malaysian log price reaching a record high of RM474 per cubic metre, with sawn timber prices increasing by 18.8% during the year.

As part of the strategy on implementing sustainable forest management, as well as to ensure a continuous supply of raw materials for downstream activities, particularly furniture-making, the Government accelerated its efforts to promote forest plantations. Forest plantations are attractive value propositions as timber species in the forest plantation scheme require a shorter reforestation period of 10-15 years compared to that of tropical timber species which require 30-50 years. The Government established a special purpose vehicle with an initial fund of RM200 million in October 2006 to manage and fund forest plantation schemes undertaken by private entities, with the aim of harvesting 25,000 hectares of reforested timber to produce 5 million cubic metres of wood every year. Approximately 50% of the area under forest plantations would be planted with rubberwood, with the rest to be planted with other timber species, such as acacia, teak and *sentang.*

Output of **cocoa** turned around to register a strong performance. The double-digit growth was a result of measures taken in the past few years to address the declining production. Rehabilitation of cocoa fields, reduction in conversion of cocoa fields to other crops, as well as the active encouragement to replant cocoa through the

Cocoa Smallholders' Development Programme yielded positive results. At the same time, the assistance given to farmers in the form of high-yielding clones and disease-resistant planting materials also contributed towards reducing the incidence of black pod infection.

**Mining Sector**

The **mining sector** registered a mild contraction of 0.2% in 2006 due to lower production of crude oil and natural gas. The shutdown of a number of oil fields for maintenance, as well as the phased upgrading to expand capacity at the MLNG 2 plant, led to lower activity in the mining sector during the year. Nevertheless, the sector's contribution to the overall economy was significant in terms of foreign exchange earnings from exports, revenue to the Government and investments in exploration and downstream activities. Malaysia remained a net energy-exporting nation. Export earnings from minerals rose further due entirely to higher oil prices, as the export volume declined during the year. Over the years, the share of mineral exports to total gross exports has increased gradually from 7.2% in 2000 to 9.7% in 2006.

The shutdown of oil fields for maintenance as well as the phased upgrading to expand capacity at the MLNG 2 plant led to lower activity in the mining sector

In 2006, **crude oil** production (including condensates) averaged 699,796 barrels per day (bpd), representing a decline of 0.5%. The lower production of crude oil (excluding condensates: -3.5% to 548,487 bpd) was a result of the shutdown of several oil installations during the year for repairs and maintenance. This was mitigated to some extent by the rising contribution of condensates to overall oil production. Condensates, which in its natural state is in a gaseous form but is condensed into liquid during production, shares the same high quality properties as Malaysian light, sweet crude oil. During the year, output of condensates rose further at a double-digit rate (12%) to an increased share of 21.6% of total crude oil output (2001: 13%).

**Table 1.9**
**Mining Sector:**
**Value Added, Production and Exports**

| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | |
| **Value added** | **0.8** | **-0.2** |
| **Production** | | |
| *of which:* | | |
| Crude oil and condensates | -8.0 | -0.5 |
| Natural gas | 11.3 | -0.4 |
| **Exports** | **26.4** | **8.6** |

*p* Preliminary

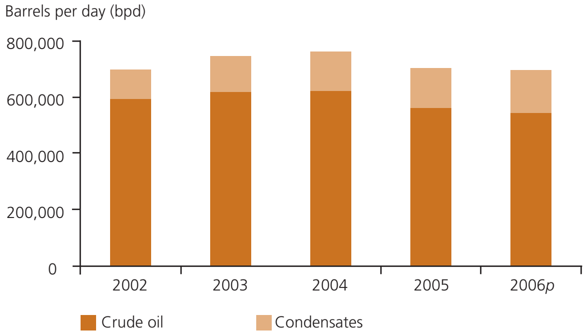
Source: PETRONAS
Department of Statistics, Malaysia

Following six continuous years of growth in the sector, output of **natural gas** declined marginally by 0.4% in 2006. Activity was influenced by the sequenced shutdown of facilities at the MLNG 2 plant in Sarawak for upgrading to expand capacity. The increase in capacity is to meet future demand from Malaysia's traditional buyers as well as from the new market, PR China. Currently, Malaysia is a major supplier of LNG to Japan and Korea, capturing one-fifth of the domestic gas market in these two countries.

The oil and gas sector continued to benefit from the strong global oil prices that have prevailed since 2004. The price of the Malaysian benchmark oil grade, the Tapis Blend, rose by 20% to an average of USD68 per barrel in 2006. The price of the Tapis Blend strengthened steadily from USD64 per barrel at the beginning of the year to briefly breach USD80 per barrel in August before consolidating thereafter to around USD60 per barrel towards end-year.

The global oil market was characterised by strong demand from the US and emerging economies. Given the continued constraints on global supply as production in the major oil-producing countries reached close to full

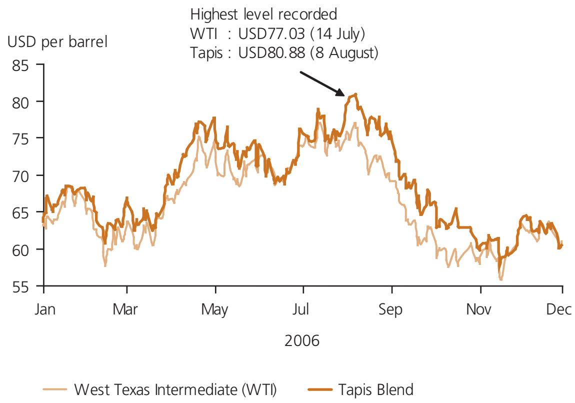
**Chart 1.20**
**Production of Crude Oil and Condensates**




*p* Preliminary

Source: PETRONAS

**Chart 1.21**
**Crude Oil Prices (1-Month Futures) in 2006**




capacity, and the inadequate refining capacity, especially in the US, demand factors had taken precedence over supply factors in influencing the direction of oil prices. Prices during the year were also influenced by the significant involvement of hedge funds in the global oil futures market. In addition, the market continued to be sensitive to geopolitical risks in the oil producing regions. Given these factors, oil prices have established a new 'persistence' level of USD50 per barrel, over and above the 'persistence' level of USD20 per barrel experienced throughout the 1990s. In line with developments in crude oil prices, the export price of LNG also increased further by 14.2% to RM1,081 per tonne during the year.

**Table 1.10**
**Malaysia: Crude Oil and Natural Gas Reserves [1]**

| | As at end | |
|---|---|---|
| | 2005 | 2006*p* |
| **Crude oil (including condensates)** | | |
| Reserves (billion barrels) | 5.25 | 5.25 |
| Reserve/Production (year) | 20 | 21 |
| **Natural gas** | | |
| Reserves (trillion standard cubic feet) | 87.95 | 87.95 |
| Reserve/Production (year) | 34 | 34 |

[1] The National Depletion Policy was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).

*p* Preliminary

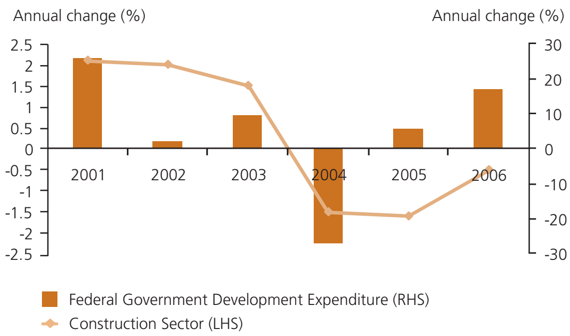
Source: PETRONAS

Overall, the production level of crude oil in 2006 was within the target set under the National Depletion Policy, which has been implemented since 1980 to ensure sustainable development of the country's oil resources. The depletion policy and the discovery of new oil and gas fields have contributed towards increasing the lifespan of the country's oil and gas reserves. Since 2002, 20 deepwater oil and gas fields in the offshore areas of Sabah have been discovered, in partnership with foreign oil companies through production sharing contracts (PSCs). Consequently, Malaysia's oil reserves have risen to 5.25 billion barrels with a longer lifespan of 21 years based on current production levels. These discoveries have also led to a significant increase in investments in the last two years, particularly in the form of foreign direct investment in the oil and gas sector and related services. In addition, the sector's strong inter-linkages with the manufacturing sector were evident from the rapid development of downstream activities such as the production of petrochemicals, gas processing and oil refining. This lent further support to growth in the resource-based industries.

### Construction Sector

**Construction activity** improved further, registering only a mild contraction of 0.5% in 2006, led by a gradual recovery in civil engineering activity, as well as increased activity in the non-residential segment. Meanwhile, growth in the residential segment returned to a more moderate pace following several years of strong expansion.

**Chart 1.22**
**Construction Sector Growth versus Federal Goverment Development Expenditure**




Source: Department of Statistics, Malaysia and Accountant General Department

During the year, the Government announced several crucial policy decisions that would influence construction activity going forward. This includes the announcement of higher Federal Government spending on infrastructure projects under the Ninth Malaysia Plan (9MP). The 17.6% increase in spending is mainly for the construction of highways, bridges, schools and water-related projects. Emphasis would also be given for developmental projects outside the Klang Valley, including the Second Penang Bridge and the Penang Monorail, as well as the establishment of the Iskandar Development Region (IDR) to support economic growth in southern Johor. Towards the latter part of the year, key regulations were also liberalized. These included the relaxation of regulations pertaining to purchase of property by foreigners as well as amendments to the Strata Titles Act and Housing Development Act to facilitate more efficient regulatory approval in the construction sector.

## Steady improvement in construction activity led by the civil engineering and non-residential segments

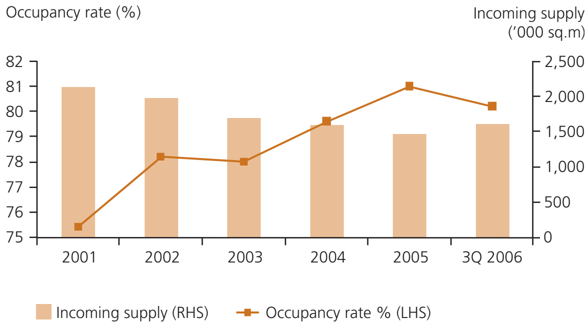
The **civil engineering** sub-sector began to show encouraging signs, as activity gradually recovered to register a positive growth by the final quarter of the year. In addition to the

**Table 1.11**
**List of Major Ninth Malaysia Plan Projects**

| | |
|---|---|
| Third lane of the North South Expressway between Rawang-Tanjung Malim | **Iskandar Development Region (IDR), Johor** |
| Subang-Klang Link Project | State Administrative Centre, Nusajaya |
| Upgrading of KLIA to accommodate the new Airbus A380 aircraft | Tanjung Langsat Technopolis |
| East Coast Highway Phase 2, Terengganu | Development of Free Access Zone |
| Upgrading of Kota Kinabalu International Airport, Sabah | Cleaning of Sungai Segget, Sungai Skudai and Sungai Tebrau |
| Development work at Jalan Tun Razak | Rail track to Port of Tanjung Pelepas |
| Penang Prison Complex | Johor Bahru Inner Ring Road Interchange |
| Students' Quarters at Kolej Universiti Islam | Upgrading of Jalan Ulu Tiram-Kota Tinggi to four lanes |
| Railway development at Batu Gajah, Perak | Skudai Interchange |
| Vacuum Sewerage System I, Mukim Kelang | Upgrading of Johor Bahru-Kota Tinggi and Pasir Gudang Interchange |
| Industrial Training Institute (Miri, Sarawak) | Upgrading of Jalan Tampoi to four lanes |
| | Two elevated interchanges in Jalan Tampoi |
| **High-Impact Projects** | Road linking Nusajaya and Malaysia-Singapore Second Link Bridge |
| Second Penang Bridge | Senai Interchange to Senai International Airport |
| Penang Outer Ring Road | Upgrading of drainage system |
| Penang Monorail | Senai-Skudai Highway |
| West Coast Expressway | Second Permas Jaya Interchange |
| Pahang Selangor Water Transfer Project | Upgrading of infrastructure at Senai International Airport |
| Langat 2 Water Treatment Plant | Upgrading of Perling Interchange |
| Sewerage and pipe replacement | New security infrastructure and police station |
| Kajang-Seremban Highway | Senai-Desaru Highway |
| | Upgrading of traffic dispersal system |

Source: Economic Planning Unit

**Chart 1.23**
**Incoming Supply and Occupancy Rate of Retail Space in Malaysia (as at end period)**



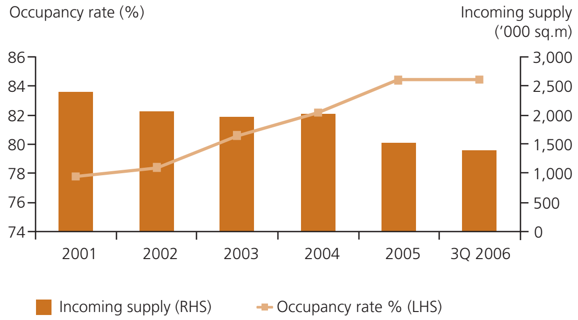

Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

ongoing projects, the Government announced 880 new projects totalling RM15 billion, with 425 of these projects to be financed through the Private Finance Initiative. The civil engineering segment was also supported by construction activity in the oil and gas industry, mainly in the development and production of new facilities following discoveries of new offshore fields in Sabah. Meanwhile, several large civil engineering companies continued to secure projects abroad. They undertook highway, airport and hydropower plant projects in Asia, particularly in India and the Middle East.

Activity in the **non-residential** sub-sector trended higher during the year in line with robust business activity. Growth was backed by strong demand for both commercial and office space as reflected by the high occupancy rates and higher rentals during the year. In particular, incoming supply of shopping complexes during the year recorded a significant increase due to 10 large malls being constructed in the Klang Valley. These shopping complexes are expected to add 4 million square feet to the existing stock of 36 million square feet in 2007. Retailers have expanded their business activity in the key catchment areas while new malls have different concepts tailored towards the targeted consumer segments.

The office space segment was supported by new business activities, particularly in the city areas. The tenants comprise mainly multinational

**Chart 1.24**
**Incoming Supply and Occupancy rate of Purpose-Built Office Space in Malaysia (as at end period)**

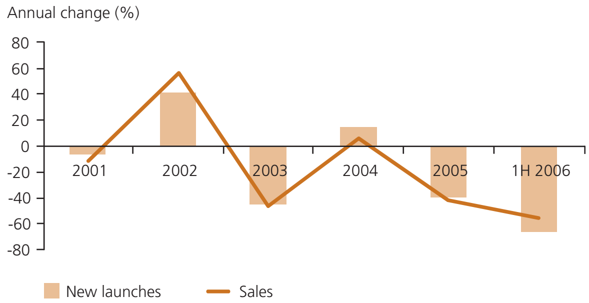



Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

companies, financial institutions, outsourcing and IT-related companies as well as services companies related to the oil and gas business. Average rental rates in the Klang Valley rose by 20% to RM5.90 per square feet, amidst a high occupancy rate of 84%.

In line with the improving prospects in the non-residential sector, both in terms of yields and capital appreciation, the **Malaysian Real Estate Investment Trust (M-REIT)** sector continued to expand, with six new M-REITs listed on Bursa Malaysia. This brought the total number of M-REITs to nine as of end-February 2007. As a new asset class with defensive qualities, the M-REITs offer another opportunity for diversification of risk. While the market capitalisation of the REIT industry in Malaysia is relatively small when

**Chart 1.25**
**Sales and New Launches in the Residential Sub-sector**




Source: National Property Information Centre (NAPIC), Valuation and Property Services Department compared to other regional countries (around USD850 million; Singapore: USD13.5 billion), the potential for further expansion is large.

Activity in the **residential** segment grew at a moderate pace as demand eased following the strong performance in previous years. This was reflected in the moderation in loan applications during the year. Housing developers also responded to changing market conditions by reducing launches of new properties and adapting to the changing requirements of consumers. Despite these efforts, the overhang of residential properties increased to 28,827 units by end-September 2006. In line with the overall market conditions, the Malaysia House Price Index rose at a more moderate pace of 2% in the first half of 2006. Despite the overall cautious attitude of consumers, demand for residential properties near the city area remained strong.

During the year, the Government undertook a number of important measures to facilitate the growth of the residential segment. The Strata Title Act and related bills were amended in December 2006, to enable a faster and more transparent approval process for strata titles, as well as to provide clearer oversight of property managers on the management of funds collected and disbursed. Amendments were also made to the Housing Development Act, whereby the Certificate of Fitness for Occupation (CFO), previously given by the local authorities, will be replaced with the Certificate of Completion and Compliance (CCC). The CCC will be issued by private architects and engineers, thus facilitating early occupation of buildings. The Government also liberalized rulings on foreign ownership of residential properties. Foreigners no longer need to obtain prior approval from the Foreign Investment Committee to purchase houses above RM250,000. Through these initiatives, property transactions are expected to increase.

**Chart 1.26**
**Malaysian House Price Index**


*p* Preliminary
Source: National Property Information Centre (NAPIC) , Valuation and Property Services Department

## PRICES AND EMPLOYMENT

### Consumer Prices

Globally, inflation remained a key macroeconomic issue in 2006. The robust performance of the global economy in recent years has driven up the demand and contributed to the upward pressure on the prices of commodities. At the same time, competition and the lower cost of production in China and India had helped to moderate the increase in goods and services prices worldwide. Malaysia, as a small open economy has not been

**Table 1.12**
**Overhang of Residential Property in Malaysia by Price Range**

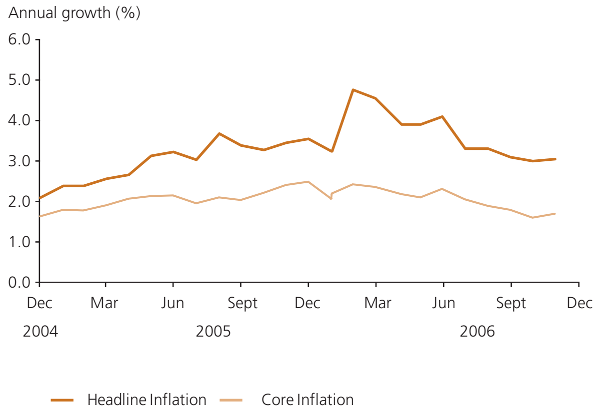
| Residential Price Range | Units | Share (%) | Units | Share (%) |
|---|---|---|---|---|
| | As at end-2005 | | As at end-Sept 2006*p* | |
| RM50,000 or less | 3,777 | 19.3 | 4,539 | 15.8 |
| RM50,001 - RM100,000 | 5,806 | 29.7 | 7,554 | 26.2 |
| RM100,001 - RM150,000 | 3,813 | 19.5 | 6,116 | 21.2 |
| RM150,001 - RM200,000 | 2,666 | 13.6 | 4,327 | 15.0 |
| RM200,001 - RM250,000 | 1,554 | 7.9 | 2,305 | 8.0 |
| More than RM250,000 | 1,961 | 10.0 | 3,986 | 13.8 |
| **Total** | **19,577** | **100** | **28,827** | **100** |

*p* Preliminary
Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

insulated from the factors that had influenced global prices.

The headline annual inflation rate, as measured by the Consumer Price Index (CPI), increased from 3% in 2005 to 3.6% in 2006. The level of headline inflation was within the Bank's forecast range of 3.5 – 4.0%. The core inflation rate rose at a more modest pace of 2.1% (2% in 2005) over the same period. The core inflation rate, a measure of CPI inflation which excludes transitory factors such as price-volatile items and price-administered items, reflects the underlying changes in prices induced by demand pressures. The divergence between headline inflation and the core inflation rate over the course of the year suggests that transitory factors were significant contributors to the buildup of price pressures. In particular, the adjustments to the administered prices of retail petroleum products and utilities during the year had a significant impact on the rate of inflation.

**Chart 1.27**
**Consumer Price Index**




The steeper increase in the headline inflation rate during the year was due largely to the increase in the prices of fuels and lubricants in the transport category. The sharp uptrend

**Chart 1.28**
**Contribution to Headline Inflation**

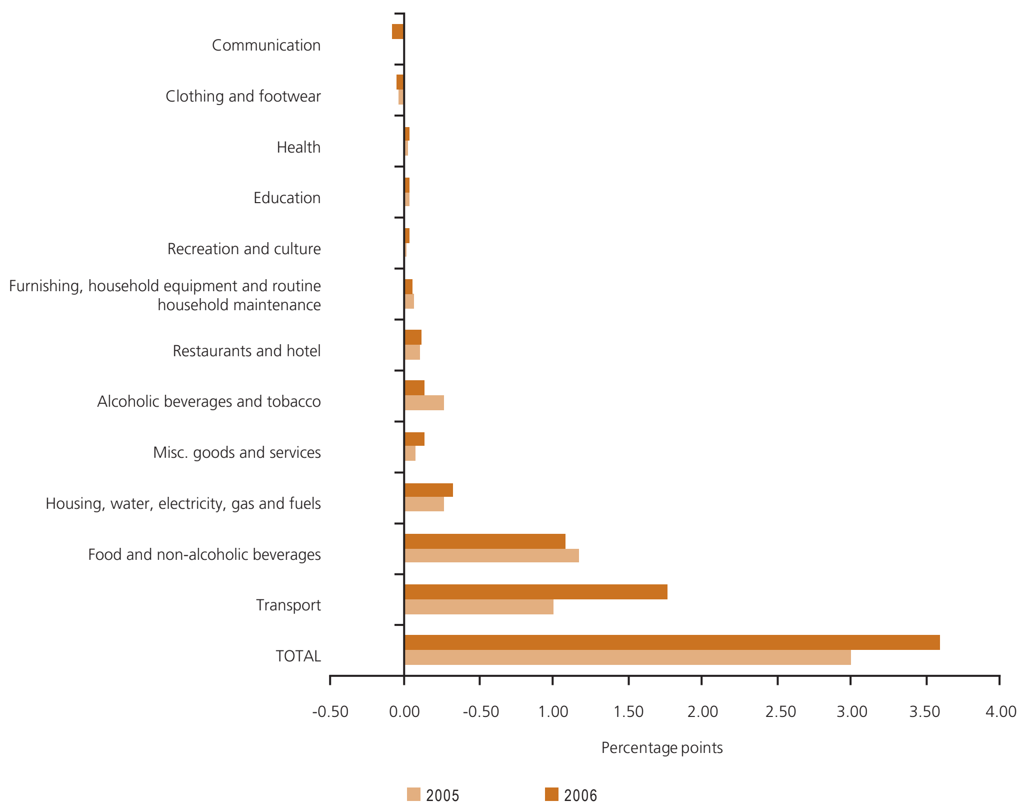


**Table 1.13**
**Price Indicators**

| | Weight | 2006 Annual growth (%) |
|---|---|---|
| **Consumer Price Index (2005=100)** | **100.0** | **3.6** |
| *of which:* | | |
| Food and non-alcoholic beverages | 31.4 | 3.4 |
| Alcoholic beverages and tobacco | 1.9 | 6.9 |
| Clothing and footwear | 3.1 | -1.3 |
| Housing, water, electricity, gas and other fuels | 21.4 | 1.5 |
| Furnishing, household equipment and routine household maintenance | 4.3 | 1.1 |
| Health | 1.4 | 2.1 |
| Transport | 15.9 | 11.0 |
| Communication | 5.1 | -1.4 |
| Recreation services and culture | 4.6 | 0.7 |
| Education | 1.9 | 1.6 |
| Restaurants and hotels | 3.0 | 3.7 |
| Miscellaneous goods & services | 6.0 | 2.2 |
| **Consumer Price Index** | | |
| Durable goods | 8.0 | -1.5 |
| Semi-durable goods | 4.3 | -0.9 |
| Non-durable goods | 40.6 | 6.8 |
| Services | 47.1 | 2.1 |
| **Producer Price Index (2000=100)** | **100.0** | **6.7** |
| *of which:* | | |
| Local Production | 65.7 | 9.0 |
| Imports | 34.3 | 2.2 |

Source: Department of Statistics, Malaysia

in international oil prices in early 2006 exerted a heavy burden on the Government's operating expenditure. As subsidies grew, the Government undertook a one-off increase in the prices of retail petroleum products in March 2006 by an average of 18.5%. Following this, the headline inflation rate rose sharply to 4.8% in March 2006 and remained elevated during the rest of the first half of 2006. The direct impact of the higher prices of retail petroleum products contributed 1.1 percentage points to the average headline inflation rate in 2006, compared with 0.31 percentage points in 2005.

Apart from the higher prices for retail petroleum products, the high oil prices had a notable impact on the cost of air travel through the increase in the fuel surcharges imposed by airlines. Other utility prices such as electricity tariffs and water charges in selected states were also adjusted upwards. Nevertheless, the cumulative impact of these adjustments was relatively small and thus, had only a minor impact on the headline inflation rate.

The key issue that arose following the adjustments of administered prices was the scale and pace of the pass-through to prices of other goods and services in the economy, as well as to wages. The broad evidence suggests that the indirect impact on the prices of other goods and services was limited. The underlying inflation rate that excludes the direct impact of retail petroleum products had begun to moderate since January 2006. Further, while a higher proportion of items in the CPI basket exhibited price increases in the wake of the rise in the prices of the retail petroleum products, this impact moderated in the second half-year, indicating that inflationary pressures were not wide-spread across the broad range of goods and services in the economy. Finally, there was no strong evidence of wage-price pressures in 2006 with measures of wage growth remaining relatively subdued. The annual growth rate of nominal private sector wages in 2006 was unchanged at 5.8%, according to the latest Salary and Fringe Benefits Survey undertaken by the Malaysian Employers Federation. This increase in wages was partly offset by improvements in labour productivity. The stronger annual increase in real labour productivity of 3.5% in 2006 (2005: 1.2%) kept overall cost pressure in the labour market relatively low throughout the year.

Despite the initial spike in the inflation rate in March 2006, inflation expectations of the public were broadly well-anchored throughout the year. The Government had indicated that the increase in retail petrol prices in March 2006 would be a one-off occurrence for the year, thus limiting the extent to which price pressures cascaded from production costs into the overall price level. This was supported by Government agencies undertaking active surveillance and ensuring that prices of controlled essential goods and services were transparent. The appreciation of the

**Chart 1.29**
**Direct Impact of Retail Petroleum Product Inflation to Headline Inflation**

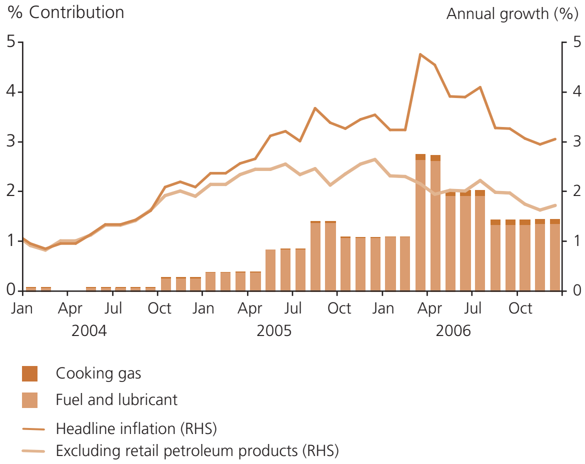



**Chart 1.31**
**Food Inflation**

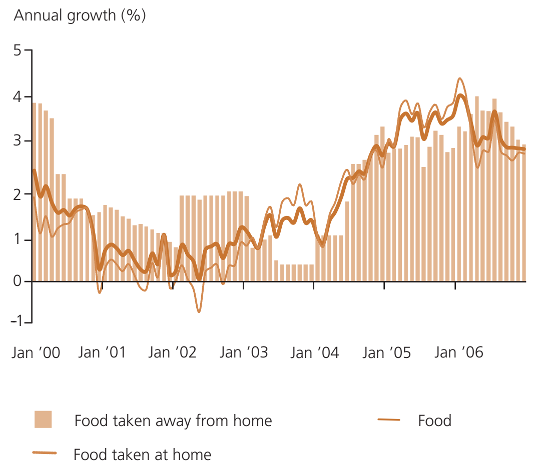
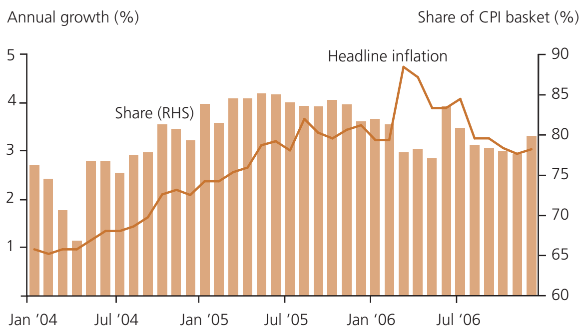



**Chart 1.30**
**Share of Items in CPI Basket that Exhibited Annual Price Increases**



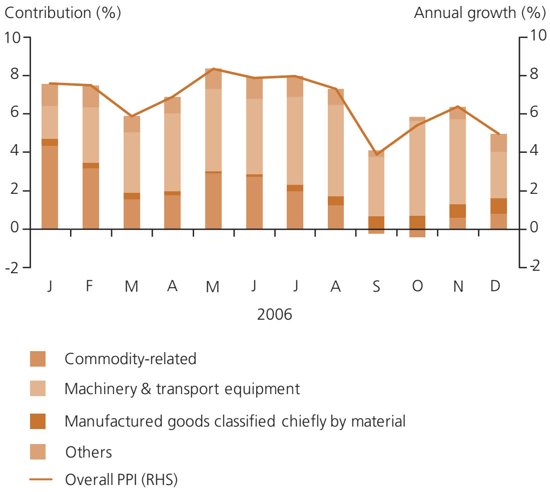

ringgit exchange rate had also mitigated some inflationary pressure during the year by reducing the cost of imports.

Nevertheless, higher fuel prices had some impact on certain sectors of the economy. In particular, the higher utility costs have increased the operating expenditures of food retailers. Food prices tended to respond more quickly to changes in the costs of raw materials. However, the competitive environment had contained the pace of food price inflation, which eventually moderated in the second half of 2006. For the year as a whole, food inflation moderated to 3.4% from 3.6% in 2005.

The impact of the higher commodity prices was, however, significant from the producers' point of view, notably those in the resource-intensive industries. In the first half of the year, the increase in producers' prices was mainly driven by inflation in the commodity-related categories. However, this trend reversed in the second half-year when international spot crude oil prices declined. Overall, the average rate of producer price inflation moderated slightly to 6.7% in 2006 (2005: 6.8%).

Notwithstanding the fact that oil and other commodities are important inputs into the production process and significant movements in their prices had affected producers' overall costs and induced cost-push pressures, their importance for producer price inflation has diminished over time. In 2006, the Department of Statistics of Malaysia announced a rebasing of the Producer Price Index (PPI) to year 2000 (previously 1989=100) and a revision of the weights of items in the PPI basket in proportion to their contribution to the total value of output in the economy. Compared to the previous weights, the weights of non-commodity related items, such as machinery and transport equipment; and manufactured goods were significantly higher in the new Producer Price Index. The new weights are therefore more reflective of the current state of the Malaysian economy, which has evolved

**Chart 1.32**
**Producer Price Index**




from one based on commodities, to one which is based on manufacturing.

All things considered, inflation was reasonably benign in light of the limited pass-through impact from high oil prices. To some extent, this reflects the broad global phenomenon in which improvements in product market efficiency and greater global competition have reduced the pricing power of producers and created greater flexibility in product and labour markets, driving global inflation rates to historically low levels. Consequently, the impact of shocks on inflation going forward is likely to be less persistent.

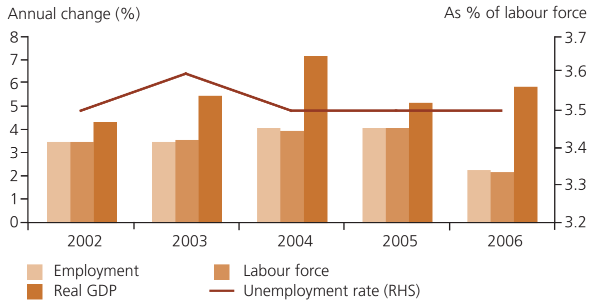
**Labour Market Developments**

The domestic labour market continued to strengthen in 2006 as demand for workers rose during the year amidst faster economic growth. The unemployment rate remained low at 3.5% of labour force, as job creation was robust. Labour force participation improved further and fewer retrenchments were recorded during the year.

## Stronger labour market conditions

Total **employment** expanded by 2.3%, outpacing the 2.2% expansion in the labour force. As such, the labour force participation rate also

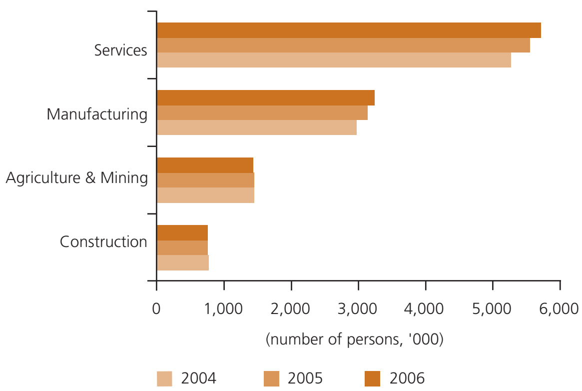
**Chart 1.33**
**Output and Employment**




Source: Department of Statistics, Malaysia
Economic Planning Unit

increased during the year. The MIER Employment Index rose from 98.9 points in the first quarter to 114.8 points in the fourth quarter, reflecting the sustained improvements of the job market. Overall, the services sector continued to be the largest employer in the country (51% share), with the distributive trade, hotel and restaurants sub-sector (18% share) remaining the biggest employer in the sector. Compared to the other sectors, the manufacturing sector recorded the highest employment growth during the year (3.3%), in line with the strong expansion in manufacturing activity (7%). Nevertheless, the sector's share of employment remained stable at 29%. The construction sector recorded smaller job losses this year compared to the previous year (-0.6% and -1% respectively), as construction activity picked up towards end of the year and on

**Chart 1.34**
**Total Employment by Sectors**




Source: Economic Planning Unit

the expectations that more development projects were in the pipeline.

In 2006, the rate of increase of **foreign workers** in Malaysia moderated significantly. By end-year, the total number of foreign workers (including foreign expatriates) employed in Malaysia had risen by 3% in contrast with the 22% increase recorded in 2005. Nevertheless, the number of migrant workers remains significant, accounting for 17% of all persons employed. During the year, the Government approved the recruitment of 1,869,208 new migrant workers and another 33,567 foreign expatriates to work in Malaysia. The majority of the migrant workers were hired by employers in the manufacturing and agriculture sectors (35% and 26% respectively) to alleviate shortages for semi-skilled and unskilled labour. In the agriculture and domestic services sector, the workers mostly tended to originate from Indonesia, while those in the manufacturing sector were mainly from Indonesia, Nepal and Vietnam. Most foreign expatriates in Malaysia were engaged in the services (55% share) and manufacturing (37% share) sectors. Foreign expatriates from India, Japan, PR China, United Kingdom and Singapore, accounted for more than half of the total foreign skilled professionals in Malaysia.

Total **retrenchments** in 2006 declined for the fifth year to 15,360 persons, affecting mainly non-executives in areas such as plant and machine operators and assemblers, craft and related trade, and general workers. More than half of the retrenchments occurred in the manufacturing sector, following several retrenchments by companies in the E&E industry (27% share of the sector). The services sector as a whole retrenched more workers this year, accounting for 36% of the layoffs. The retrenchments occured in the transport, hotel and distributive trade industries. In general, most of the retrenchments were attributed to the sale and closure of companies as well as difficulties arising from high cost of production and reductions in demand.

**Vacancy** trends also pointed to more positive employment conditions. The number of new job vacancies reported via the Electronic Labour Exchange (ELX) rose significantly during the year. Stronger demand for labour was recorded in all key sectors, especially the manufacturing sector (42% share), amidst a backdrop of strong domestic and external sales, revival in construction activity and the opening of

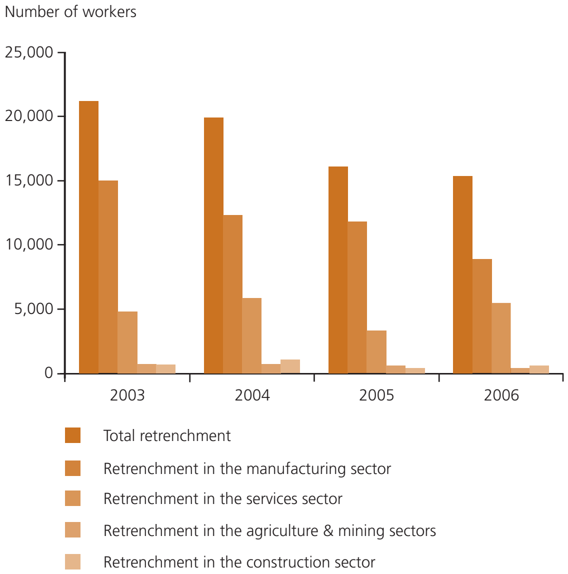
**Table 1.14**
**Selected Labour Market Indicators**

| | 2002 | 2003 | 2004 | 2005 | 2006*e* |
|---|---|---|---|---|---|
| Employment ('000 persons)[1] | 9,709.0 | 10,047.2 | 10,463.7 | 10,892.8 | 11,144.1 |
| Labour force ('000 persons)[1] | 10,064.3 | 10,426.4 | 10,846.0 | 11,290.5 | 11,544.5 |
| Retrenchments (persons) | 26,452 | 21,206 | 19,956 | 16,109 | 15,360 |
| Active jobseekers (persons) | 32,305 | 28,404 | 27,227 | 72,573 | 84,046 |
| New vacancies (positions) | 162,787 | 96,918 | 49,975 | 304,500 | 834,675 |
| Unemployment rate (%)[1] | 3.5 | 3.6 | 3.5 | 3.5 | 3.5 |
| Labour force participation rate (%)[1] | 65.2 | 65.6 | 66.1 | 66.7 | 66.9 |
| Real labour productivity growth (%)[2] | 0.8 | 1.9 | 2.9 | 1.2 | 3.5 |

[1] Based on estimates by Economic Planning Unit
[2] Based on estimates by Bank Negara Malaysia
*e* Estimate

Source: Bank Negara Malaysia
Economic Planning Unit
Ministry of Human Resources

**Chart 1.35**
**Retrenchment by Sectors**




Source: Ministry of Human Resources

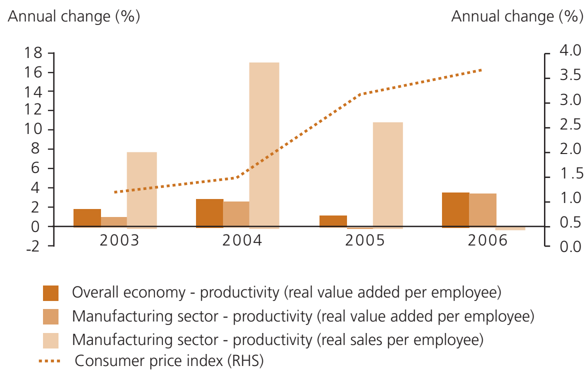
more retail and other services outlets. Most of the job positions advertised in the ELX were elementary occupations (60% share), which are more suitable for non-executives. For higher-skilled jobs, employers preferred to draw on the expertise and reach of private employment agencies and print media. Thus, total vacancies available in the economy were likely to be much higher than that reported by the ELX.

While demand for labour increased in 2006, the number of available workers also rose. **Active jobseekers** registered with the Manpower Department rose by 16% to 84,046 persons. A notable development was the significant presence of job seekers who were already employed but had reentered the job market in the expectation that they could find better jobs. This group accounted for 44% of registered jobseekers and signalled the more optimistic outlook of the job market. Meanwhile, graduates (diploma and degree holders) accounted for about 48% of the total active jobseekers, with 45% of this group possessing some work experience. These jobseekers were mainly graduates in ICT, Trade and Business Management, Electrical and Mechanical Engineering, and Accounting.

Despite the better economic outturn, **wage pressures** were relatively subdued due in part to the presence of a large number of unemployed graduates and availability of migrant workers. The Salary and Fringe Benefits Survey undertaken by the Malaysian Employers Federation showed that average private sector salary increment was 5.8%, the same as in the previous year. Generally, executives received a higher salary increase compared to the non-executives. On a sectoral basis, employees in the manufacturing sector benefited from the robust pace of manufacturing activity during the year. Salary increments in the manufacturing sector averaged 6%, higher than that of the non-manufacturing sector (5.5%). Similarly, the Salary, Benefits and Employment Conditions Survey in the manufacturing sector conducted by the Federation of Malaysian Manufacturers also revealed that average salary increase paid out to employees was 6% (2005: 6.3%).

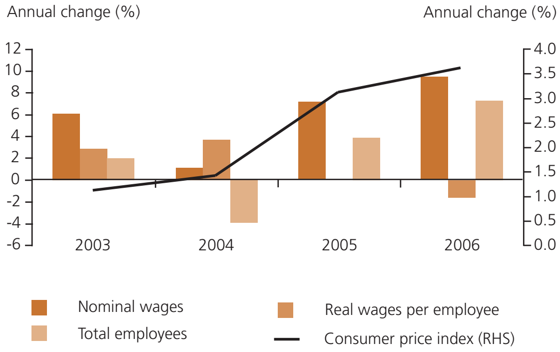
**Labour productivity,** as measured by the real value added per worker, improved significantly to 3.5% (2005: 1.2%), boosted by higher productivity growth in the agriculture, manufacturing and the services sectors. Increased use of capital and improvement in business processes, as well as higher values of products and services, resulted in the better productivity outturn. Estimates by Bank Negara Malaysia showed that

**Chart 1.36**
**Productivity Trends**




Source: Bank Negara Malaysia
Department of Statistics, Malaysia

**Chart 1.37**
**Wage Costs in the Manufacturing Sector**




Source: Bank Negara Malaysia
Department of Statistics, Malaysia

total factor productivity growth recorded an increase of 2.3% (2005: 2.1%), signifying better productivity gains arising from improvements in the utilisation of factor inputs through technological progress and overall efficiency improvement. The agriculture sector benefited from good weather conditions, which facilitated higher yields, as well as improved agricultural practices and increasing mechanisation. Data from the Monthly Manufacturing Survey published by the Department of Statistics revealed that manufacturing sales grew by 11.1% in nominal terms during the year. However, real sales value per worker recorded a marginal decline of 0.2% as total headcount and inflation increased at a faster pace (7.3% and 3.6% respectively) compared with the previous year (3.9% and 3% respectively).

Against a backdrop of favourable international economic conditions and an increasingly mobile workforce, the competition for talent and skilled workers has intensified. Workers who are equipped with the right technical and managerial expertise are now deemed critical and integral to any nation's bid to be competitive, to enhance productivity and increase value-add. The competition for talent is fiercest in the high-technology manufacturing industries, but has increasingly spread to the services industries too. Malaysia is not alone in facing the problem of **skills shortages** as even in developed countries, as well as the fast-growing economies of India and PR China[3], skill shortages are fast emerging as a critical business issue. In Malaysia, the recently announced Ninth Malaysia Plan, which is the blueprint for development spanning the period 2006-2010, has identified human capital development as the second of the five key thrusts that required urgent attention. Specifically, the second thrust of the Plan is to raise the country's capacity for knowledge and innovation. Programmes that will be undertaken include a comprehensive improvement of the education system, ranging from pre-school to tertiary and vocational institutions; improvement of access to the education system; creating more avenues for skills development, training and lifelong learning; and to promote innovation by nurturing high quality research and scientific capability. Generally, the Plan emphasised the need to enlarge the pool of suitably-skilled indigenous labour to drive the transformation towards a knowledge-based economy.

The skills shortage problem is most apparent from the large number of unemployed graduates in Malaysia. Latest available data from the Department of Statistics showed that there are 66,900 unemployed diploma and degree-level graduates as at end-September 2006, which is equivalent to about 4% of the graduate labour force or 20% of total unemployed workers. Among key factors cited as the main barriers to securing jobs include the lack of work experience (about 45% of the unemployed graduates are without working experience), the lack of communication and IT skills, and fields of study that is not in demand. In light of this, the Government has formed a Cabinet Committee to address this issue.

Immediate short-term measures include retraining the unemployed graduates, absorption of qualified graduates into vacant positions in

[3] In Britain, the shortage of applicants with the right skills has resulted in four of every 10 employers facing difficulties in filling graduate vacancies (Association of Graduate Recruiters, 2006). A survey conducted by Deloitte Consulting in 2005 revealed that more than 80% of American manufacturers experienced an overall shortage of qualified workers that cut across industry groups. Studies by the McKinsey Group revealed that Bangalore, India is already experiencing rising wages and high turnover among IT engineers, while in PR China, companies will have difficulties in finding enough suitable employees in key service and managerial occupations.

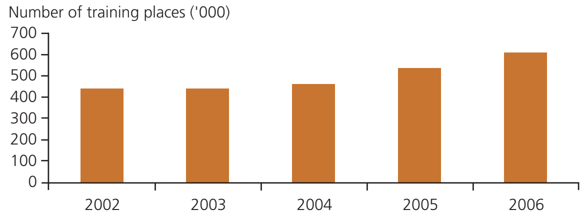
the civil service, and to facilitate the graduates' entry into entrepreneurship programmes. In 2006, 8,510 unemployed graduates underwent the Third Graduate Training Scheme or SLG III (2005: 7,992), taking up various courses such as English (45%), Executive Development Programme (22%), and web publishing and application development (9%). So far, the SLG programme has been quite successful in retraining the graduates and equipping them with the right skills as about 61% of them were gainfully employed upon completion of the course. In addition, there has been increased corporate involvement, especially from the government-linked companies (GLCs) and other corporations, to train unemployed graduates.

In the public sector, bottlenecks that are delaying the filling of more than 70,000 vacancies (30,000 of which are graduate-level positions) are being addressed. Latest data showed that about 24,378 unemployed graduates have been qualified to take on management and professional positions within the government sector.

At the same time, there are plans to increase and enhance collaboration between industries and universities as well as reforming parts of the academic curriculum to ensure that they are relevant to market needs. The recent Education Blueprint has put more emphasis on technology, science, mathematics, language proficiency and ICT to ensure a future pool of skilled and competent workforce. Meanwhile, the public universities have introduced a "soft-skills module" starting in 2007 and this module covers communication; critical thinking and problem solving; teamwork; leadership; entrepreneurship; lifelong learning and information management; and professional ethics and morality.

Employers have been quick in implementing measures to improve human capital strategies and to deal with the skills gap. Generally, the approaches undertaken can be grouped into three categories: focused recruitment; better in-house management of human capital assets; and collaborations with schools, colleges

**Chart 1.38**
**HRDF: Number of Training Places Approved**




Source: Pembangunan Sumber Manusia Berhad

and universities to enhance aspects of the curriculum. Focused recruitment ensures that the right talent and skills are identified and secured at an early stage. For skills that are difficult to locate in the domestic labour market, companies have ventured into the international labour market and recruited foreign professionals. This is reflected in the diverse group of expatriates who are currently engaged in various industries such as manufacturing, oil and gas, construction, transport and communications, IT, distributive trade and education.

In addition, companies are also putting more emphasis on training and career development to meet the changing attitudes regarding careers and job satisfaction in addition to financial benefits. Apart from "buying talent in the market", the philosophy of "building talent from within" is gaining emphasis, as reflected in the increased share of companies' investment in training and career development. In this respect, the Human Resource Development Fund continues to play an important role in encouraging training of staff by employers. In 2006, total financial assistance approved by the Pembangunan Sumber Manusia Berhad (PSMB) for training rose by 20% to RM289.2 million. With the exception of courses conducted abroad, reimbursements for all other promoted courses were increased to the full amount of the levy. During the year, popular training programmes that were approved by the PSMB include technical- and quality-related courses (30%), supervisory and management (16%), computer (13%) and safety and health (8%).

## EXTERNAL SECTOR

### Balance of Payments

Malaysia's external position remained strong in 2006. The **overall balance of payments** registered a higher surplus due to a larger current account surplus. The larger current account surplus reflected the strong trade surplus, attributable to continued expansion in both manufactured and commodity exports, as well as improvements in services and income accounts. The deficit recorded in the services account was lower due mainly to higher tourism receipts. Increased profits and dividends accruing to Malaysian companies investing abroad led to a lower income account deficit. In the financial account, there were significant inflows of both direct and portfolio investments into Malaysia. However, these net inflows were offset by higher direct investment abroad by Malaysian companies as well as outflows of other investment, reflecting the higher net repayment of external loans by the public sector and the higher placement of assets abroad by banks. After taking into account the errors and omissions, which include the foreign exchange loss arising from revaluation of Bank Negara Malaysia's international reserves as a result of the strengthening of the ringgit against major currencies, the net international reserves increased by RM25.3 billion to RM290.4 billion (or USD82.5 billion) as at 31 December 2006. As at 28 February 2007, reserves amounted to RM305.9 billion (or USD86.9 billion). This level of reserves is adequate to finance 8.2 months of retained imports and is nine times the short-term external debt.

### Current Account

In 2006, the **current account** recorded a larger surplus of RM91.2 billion, equivalent to 17.3% of GNP (2005: RM75.7 billion or 16.1% of GNP), attributable to a large trade surplus and improvement in the services and income accounts. Expansion in gross exports reflected the continued growth in manufactured and commodity

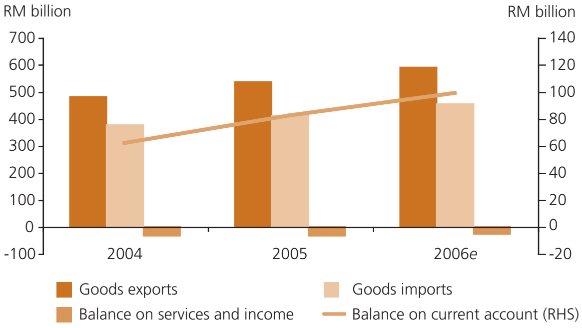
**Table 1.15**
**Balance of Payments**

| Item | 2005 | | | 2006*e* | | |
|---|---|---|---|---|---|---|
| | + | - | Net | + | - | Net |
| | RM billion | | | | | |
| Goods | 537.0 | 411.4 | 125.6 | 589.6 | 454.6 | 135.0 |
| *Trade account* | *533.8* | *434.0* | *99.8* | *589.0* | *480.8* | *108.2* |
| Services | 74.1 | 83.1 | -9.0 | 78.0 | 85.3 | -7.4 |
| **Balance on goods and services** | **611.1** | **494.5** | **116.6** | **667.6** | **539.9** | **127.7** |
| Income | 20.3 | 44.3 | -23.9 | 30.5 | 50.3 | -19.8 |
| Current transfers | 1.1 | 18.1 | -17.0 | 1.1 | 17.7 | -16.6 |
| **Balance on current account** | **632.6** | **556.9** | **75.7** | **699.1** | **607.9** | **91.2** |
| **% of GNP** | | | **16.1** | | | **17.3** |
| Capital account | | | - | | | - |
| Financial account | | | -37.0 | | | -39.9 |
| Direct investment | | | 3.8 | | | 4.3 |
| Portfolio investment | | | -14.2 | | | 14.7 |
| Other investment | | | -26.6 | | | -59.0 |
| **Balance on capital and financial account** | | | **-37.0** | | | **-39.9** |
| Errors and omissions | | | -25.1 | | | -26.0 |
| *of which:* | | | | | | |
| *Exchange revaluation gain (+) or loss (-)* | | | *-15.5* | | | *-6.9* |
| **Overall balance** | | | **13.6** | | | **25.3** |
| **Bank Negara Malaysia international reserves, net** | | | **265.1** | | | **290.4** |
| **USD billion equivalent** | | | **70.2** | | | **82.5** |

Note: Numbers may not necessarily add up due to rounding
*e* Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

**Chart 1.39**
**Current Account**




e Estimate

exports. A larger inflow of tourism receipts and the improvement in commissions earned from procurement of goods for resale to non-residents, contributed to a lower services account deficit. The improvement in the income account reflected higher profits and dividends accruing to Malaysian companies from their overseas investments and higher returns from external reserves.

## Malaysia's external position remained strong. The larger current account surplus was driven mainly by stronger trade surplus, reflecting expansion in both manufactured and commodity exports

In line with the improved external environment, growth in **gross exports** was sustained at a double-digit rate of 10.3% in 2006. The growth was supported by continued strong demand for primary commodities, as well as the sustained expansion in exports of manufactured goods.

The expansion in exports of **manufactured goods** was due to strong performance of selected resource-based industries, as well as continued growth in exports of **electronics and electrical (E&E) products**. The upturn in the global electronics cycle resulted in increased shipments of computers and parts and semiconductors

**Table 1.16**
**Gross Exports**

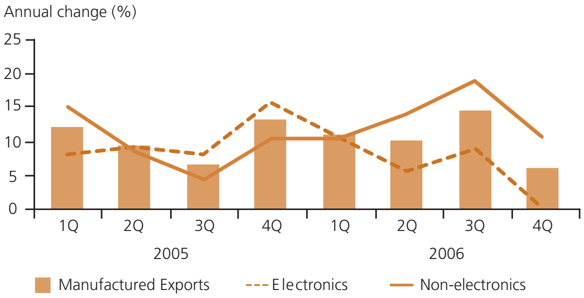
| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | |
| **Gross exports** | **10.9** | **10.3** |
| **Manufacturing** | **10.0** | **10.1** |
| *of which:* | | |
| *Electronics and electrical products* | *9.9* | *6.4* |
| *Chemicals & chemical products* | *6.8* | *10.7* |
| *Manufactures of metal* | *7.4* | *33.0* |
| *Petroleum products* | *24.7* | *27.2* |
| **Agriculture** | **0.6** | **12.5** |
| *of which:* | | |
| *Palm oil* | *-8.7* | *13.7* |
| *Rubber* | *11.2* | *42.3* |
| **Minerals** | **26.4** | **8.6** |
| *of which:* | | |
| *Crude oil and condensates* | *32.6* | *8.1* |
| *LNG* | *21.0* | *12.0* |

*p* Preliminary
Source: Department of Statistics, Malaysia

especially in the first half of the year. The demand for semiconductors was also induced by the introduction of new microprocessors during the year. Exports of telecommunications equipment also saw a discernable increase, due to capacity expansion by major producers in response to strong global demand. The positive impact from the increased export volume of electronics and electrical products was partly offset by falling export prices of selected products due to keen competition among major global producers.

Exports of **resource-based industries**, particularly wood, petroleum and rubber products as well as chemicals performed strongly during the year. The growth was supported by higher prices of these products as well as strong demand from the regional countries. Products that are related to the construction sector, namely metal and non-metallic mineral products, also saw a significant rise in exports during the year. The higher proceeds were due partly to the improvement in global steel prices, and in part due to the strong demand for pipes and glass as intermediate inputs

**Chart 1.40**
**Export Performance of Electronics and Non-electronics Industries**




Source: Department of Statistics, Malaysia

for industries in the regional countries. In addition, newer products such as the floating structures for the oil and gas industry continued to underpin the rapid increase in the transport equipment segment. Meanwhile, exports of furniture and parts were supported by the favourable demand from the United States, Japan and Australia.

Exports of **primary commodities** continued to expand at a double-digit rate due entirely to higher prices as the export volume declined by 2.4%. Primary commodity exports have over the years become an important source of foreign exchange earnings to the country, benefiting mainly from the strong commodity prices and demand from the emerging markets in the region. The value of commodity exports has doubled over the last six years to about RM99 billion and its share to total exports has increased to 16.8% (2000: 13.3%).

Export receipts from **agriculture** rose by 12.5% in 2006, led mainly by higher exports of palm oil and rubber. Palm oil exports turned around from a decline in 2005 to record a positive growth of 13.7%, due to both higher export prices and volume. The positive development was due to the diversification of the uses of palm oil from vegetable oil to non-edible uses, particularly for the production of biodiesel, which led the strong increase in exports to the European Union. Meanwhile, exports of palm oil to the US market continued to perform strongly as food manufacturers gradually substituted palm oil for other edible oils containing *trans fatty* acids. This was complemented by the continued rise in demand from traditional buyers, especially PR China. On the price front, the positive sentiment of potential demand for biofuel purposes, changes in domestic stock levels as well as the increase in soyabean oil prices, palm oil's closest substitute, had led to a gradual upward trend in prices during the year. Meanwhile, rubber exports also witnessed a sharp increase during the year led mainly by higher prices due to low global stocks amidst the supply constraints in the major producing region, rising demand from PR China as well as the increase in synthetic rubber prices in line with the prices of crude oil.

**Mineral** exports grew at a more moderate pace of 8.6% in 2006 after three consecutive years of strong performance. The growth was due to lower export volume of both crude oil and LNG in line with lower production during the year. The export performance was also influenced by the moderating energy prices towards the latter part of the year. Several key factors that influenced the price trends included the increase in inventories in the US as well as the weaker demand due to warmer-than-expected winter in the major industrial countries.

**Gross imports** expanded by 10.8% (2005: 8.6%). Imports of **intermediate goods**, which were the main component of import growth, expanded by 8.8%. Global demand for E&E products underpinned the demand for imported components, particularly parts and accessories for electronics and telecommunication products. These components were sourced mainly from PR China, Korea and Thailand. Imports of industrial supplies, such as chemicals used by the E&E industry increased. Sustained consumer spending led to higher imports of primary and processed materials used by the food and beverages industry. Meanwhile, higher imports of fuels and lubricants reflected mainly higher oil prices.

Consonant with strong business sentiment and the pick up in investment activity, imports of **capital goods** rose by 7.4%. Investment in machinery and equipment in areas such as

**Table 1.17**
**Imports by End-Use**

| | 2005 | 2006*p* |
|---|---|---|
| | Annual change (%) | Annual change (%) |
| **Capital goods** | **9.5** | **7.4** |
| Capital goods (except transport equipment) | 11.5 | 5.4 |
| Transport equipment | -4.5 | 23.5 |
| **Intermediate goods** | **7.1** | **8.8** |
| Food and beverages, mainly for industry | -4.9 | 24.9 |
| Industrial supplies, n.e.s. | 7.4 | 11.1 |
| Fuel and lubricants | 42.6 | 25.7 |
| Parts and accessories of capital goods (except transport equipment) | 1.9 | 5.1 |
| **Consumption goods** | **7.5** | **13.4** |
| Food and beverages, mainly for household consumption | 4.1 | 4.8 |
| Consumer goods, n.e.s. | 10.0 | 18.8 |
| **Re-exports** | **26.1** | **50.6** |
| **Gross Imports** | **8.6** | **10.8** |

Note: Numbers may not necessarily add up due to rounding
n.e.s. Not elsewhere specified
*p* Preliminary

Source: Department of Statistics, Malaysia

bio-diesel, metals and high-end electrical and electronics industries lifted imports of machinery, metal tools as well as generators, turbines and electric motors for power generation. Increased exploration and development activity in the oil and gas industry led to higher imports of construction and mining equipment. Of significance, imports of ships, offshore support vessels, and aircraft were driven by strong external demand for commodity exports, oil and gas exploration as well as the expansion in intra-regional travel arising from high demand generated by the availability of low-cost air carrier services.

In tandem with sustained private consumer spending, and consumer confidence, imports of **consumption goods** increased by 13.4%. The growth in imports of consumption goods reflected mainly higher imports of semi-durables, particularly clothing and footwear as well as non-durables, such as medicines, soaps and cosmetics. Higher growth was also recorded for imports of food and beverages.

A notable development was the robust growth of 50.6% in **imports for re-export**, arising mainly from activities carried out in the free commercial zones at the ports and airports. These activities included trading, break bulking, grading, repacking, relabelling, transit and logistics. These imports were largely re-exported to Singapore, US, Thailand, PR China and Hong Kong SAR. Office machines and automatic data processing equipment, electrical machinery and parts and telecommunication equipment accounted for about half of the total imports for re-export. Exploration activity in the oil and gas industry also contributed to the growth as iron and steel pipes were imported, coated for anti-corrosion and re-exported.

Better economic linkages and measures taken to diversify into other non-traditional markets have brought about changes in the pattern of trade. Accordingly, the exports and imports diversification indices measured by the normalised Herfindahl-Hirschmann index improved to 0.14 and 0.13 respectively in 2006 (2000: 0.18 and 0.18, respectively). Malaysia's trade with the major trading partners, namely the United States (US), Singapore, Japan and the European Union (EU), declined to 52.6% (2000: 64.3%) of total trade. In contrast, trade with PR China, Korea, India and Australia recorded a rising trend and accounted for a larger market share.

**Chart 1.41**
**Exports and Imports Diversification Indices**


The exports and imports diversification indices are modified version of Herfindahl-Hirschmann index. It is normalised to obtain a numeric range from 0 to 1. A lower index signifies a higher degree of diversification.

The **US** continued to be Malaysia's largest trade partner. Nevertheless, the share of Malaysia's trade with US has declined to 16% of total trade in 2006 from 18.7% in 2000. **Singapore** remained as Malaysia's second largest trade partner with trade mainly in E&E products, petroleum related products, manufactures of metal and chemical products. Meanwhile, **Japan** maintained its position as the third largest trading partner as export growth strengthened, underpinned by liquefied natural gas (LNG) exports. The Japan-Malaysia Economic Partnership Agreement (JMEPA) has spurred the growth of palm oil exports which have preferential access under the Agreement. Japan remained as Malaysia's most important source of imports although its market share has declined, reflecting the growing diversification in the sources of imports.

Stronger economic activity in the **EU** together with improved business and consumer confidence resulted in trade with the EU strengthening and accounting for a higher market share. The major trading partners within the group were Germany, Netherlands and the United Kingdom (UK) which together accounted for more than half of Malaysia's trade with the EU. The trade surplus in Malaysia's favour increased substantially to RM20.3 billion, attributable to the trade surplus with Netherlands, the UK, Spain and Finland.

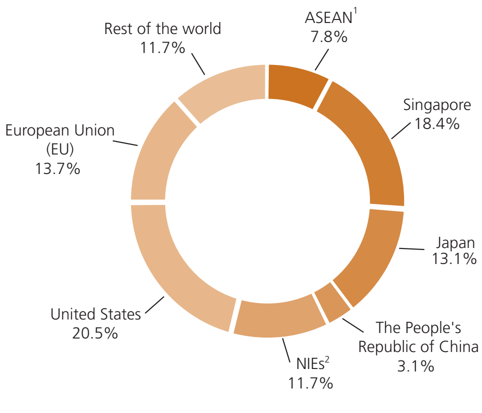
**Table 1.18**
**Direction of External Trade**

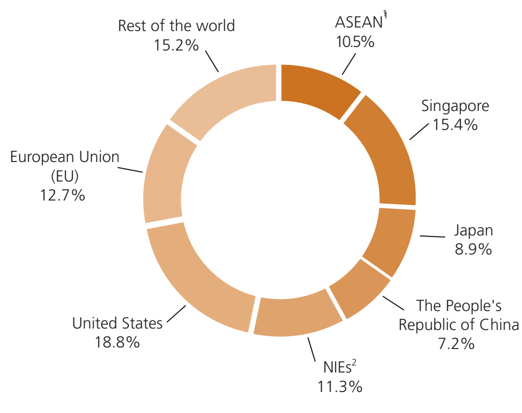
| | 2006*p* | | | | |
|---|---|---|---|---|---|
| | Exports | | Imports | | Trade balance |
| | RM billion | Annual change (%) | RM billion | Annual change (%) | RM billion |
| **Total** | **589.0** | **10.3** | **480.8** | **10.8** | **108.2** |
| *of which:* | | | | | |
| **United States** | **110.6** | **5.3** | **60.2** | **7.7** | **50.4** |
| **European Union (EU)** | **74.9** | **19.7** | **54.6** | **8.2** | **20.3** |
| **Selected ASEAN countries**[1] | **152.5** | **10.7** | **116.7** | **9.7** | **35.8** |
| **Selected North East Asia countries** | **109.1** | **10.0** | **123.0** | **15.8** | **-13.9** |
| *The People's Republic of China* | *42.7* | *21.1* | *58.2* | *16.7* | *-15.6* |
| *Hong Kong SAR* | *29.1* | *-6.6* | *12.7* | *17.2* | *16.5* |
| *Chinese Taipei* | *16.0* | *8.3* | *26.2* | *9.4* | *-10.2* |
| *Korea* | *21.3* | *18.6* | *25.9* | *19.9* | *-4.6* |
| **West Asia** | **16.0** | **21.5** | **20.0** | **42.6** | **-3.9** |
| **Japan** | **52.2** | **4.6** | **63.6** | **0.9** | **-11.4** |
| **India** | **18.8** | **25.5** | **4.9** | **17.3** | **13.9** |

Note: Numbers may not necessarily add up due to rounding
[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam
*p* Preliminary

Source: Department of Statistics, Malaysia

**Chart 1.42**
**Direction of Exports (% share)**




[1] Selected ASEAN countries excluding Singapore
[2] Hong Kong SAR, Korea and Chinese Taipei

Trade with **North East Asia** (excluding Japan) expanded, supported largely by growth in imported components from PR China and Korea. Hence, PR China emerged as the third largest source of imports, consisting mainly imports of intermediate goods for the E&E sector. Exports to PR China strengthened by 21.1%, attributable to China's strong economic growth and higher demand for commodities. Higher imports from Korea were underpinned by imports of integrated circuits, office machine and parts, as well as ships. Exports to Korea grew by 18.6%, reflecting partly higher demand for LNG, which accounted for about a quarter of the exports.

Driven by strong investment performance, trade with **India** increased at a robust pace. Exports consisted of crude petroleum, E&E products and chemicals, while imports comprised chemicals, food and electrical machinery. The trade surplus, increased to RM13.9 billion. Trade with **West Asia** has been on a rising trend. Since 2005, the trade balance has shifted to favour West Asia as heavy crude oil is imported for the domestic market while about half of Malaysia's light crude oil, which commands a high premium on the international market, is exported. Exports to West Asia strengthened, reflecting mainly exports of electrical machinery, computers and components, palm oil as well as iron and steel. Promotional and marketing activities for Halal food have resulted in increased exports of processed foods, beverages, soaps and cosmetics to West Asia. The United Arab Emirates, Saudi Arabia and Iran were the major trading partners in this region.

The expansion in the services industry is mirrored in the progressive improvement in the services deficit in the balance of payments. In terms of GNP, the **services account** deficit declined to 2.3% of GNP during the period 2001-2006 from 3.9% of GNP in the period 1990-2000. This improvement was supported mainly by the significant increase in tourism receipts and, to a lesser extent, an improvement in commissions earned through international trading activities as well as exports of computers and information services. Policies to promote tourism and efforts to develop the sector led to a more than three-fold increase in tourism receipts since 2001 (2001-2006: average RM27.7 billion; 1990-2000: average RM8.6 billion) and resulted in a higher surplus in the travel account. In tandem with the expansion in trade and the active participation of Malaysian traders in the international market, commissions earned from the procurement of goods abroad for resale to non-residents have also increased. Policies to promote business process outsourcing, as well as the establishment of the Multimedia Super Corridor and the presence of large foreign-owned IT companies, led to growth in exports of computer and information services. Receipts from computer and information services were mainly from software system development and IT support services.

## The services account deficit improved, supported by higher tourism receipts and commissions earned through international trading activities. Increased profits and dividends accruing to Malaysian companies from their overseas investment led to an improvement in the income account

In 2006, the services account deficit continued to improve and narrowed to RM7.4 billion or 1.4% of GNP (2005: -1.9% of GNP). The expansion of gross receipts was attributable mainly to higher tourist arrivals and sustained large number of day-trip border town travelers, which collectively contributed about RM34.7 billion (2005: RM33.1 billion) in foreign exchange earnings. The increase in tourism receipts reflected the expansion in regional travel following rising income levels in regional countries, greater air services connectivity and relaxation of visa requirements. The establishment of the low cost carrier terminal, cheap air fares as well as attractive holiday packages offered by low cost carriers had also facilitated greater regional travel.

Greater promotional efforts through joint collaboration between the public and private sectors in niche tourism sectors such as eco-tourism, sports and recreational tourism,

**Table 1.19**
**Services and Income Accounts**

| | 2005 | 2006*e* | | |
|---|---|---|---|---|
| | RM billion | | | |
| | Net | + | - | Net |
| **Services Account** | **-9.0** | **78.0** | **85.3** | **-7.4** |
| *% of GNP* | *-1.9* | | | *-1.4* |
| Transportation | -16.4 | 16.3 | 34.9 | -18.6 |
| Travel | 19.4 | 35.3 | 13.7 | 21.6 |
| Other services | -11.7 | 26.0 | 35.8 | -9.9 |
| Government transactions n.i.e. | -0.4 | 0.4 | 0.8 | -0.4 |
| **Income Account** | **-23.9** | **30.5** | **50.3** | **-19.8** |
| *% of GNP* | *-5.1* | | | *-3.8* |
| Compensation of employees | -0.5 | 4.8 | 5.2 | -0.3 |
| Investment income | -23.4 | 25.6 | 45.1 | -19.5 |

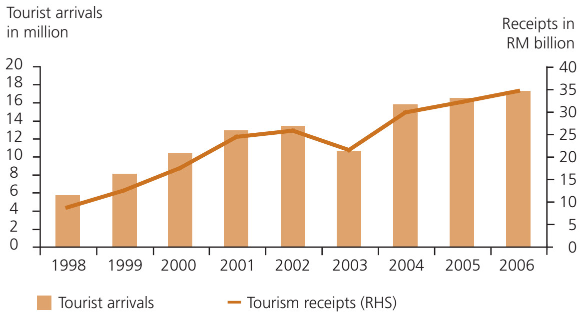
Note: Numbers may not necessarily add up due to rounding
n.i.e. Not included elsewhere
*e* Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

as well as the hosting of meetings, incentives, conventions and exhibitions (MICE) led to higher tourism receipts. While tourist arrivals from Singapore, Thailand and Indonesia continued to account for the bulk of tourist arrivals, visitors from PR China, Korea, India and long-haul tourists from the US as well as West Asia were on a rising trend.

Of significance, the MICE tourism segment had attracted long-staying and high-spending travelers. The presence of many high-end hotels with comprehensive convention centre facilities has spurred the expansion of MICE activities. Continued strong focus on promoting Malaysia as

**Chart 1.43**
**Tourist Arrivals and Tourism Receipts**




Source: Malaysia Tourism Promotion Board and Department of Statistics, Malaysia an attractive MICE destination, under the brand name of "Meet and Experience Malaysia Truly Asia" was reflected in the country being ranked as one of the top ten MICE destinations in Asia.

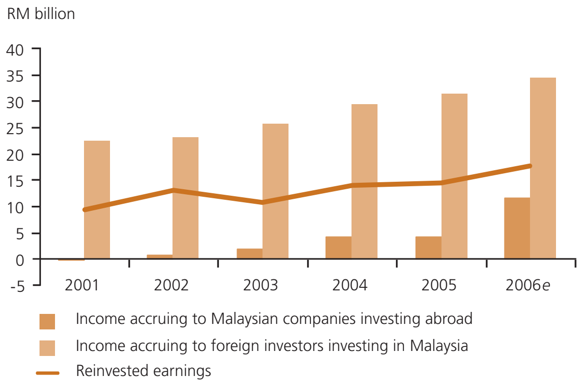
Another contributing factor to the improvement in the services account deficit was the lower net payments for other services, particularly for construction and communication services. Lower demand for imported construction services was in line with the moderation in the civil engineering sub-sector while continuing capacity expansion in networks and broadband facilities led to higher exports of communication services.

Meanwhile, commissions earned from the procurement of goods abroad for resale to non-residents grew strongly, attributable mainly to the trading of electronics and electrical goods, crude oil and petroleum related products. The bulk of these receipts were from Singapore, South Africa and the US. The expansion in business support outsourcing as well as network support services also contributed to higher export earnings in other services.

The expansion in the volume of trade, despite lower freight charges due to capacity expansion by shipping companies, resulted in higher payments for transportation services. Larger net outflows reflected the continued reliance on foreign carriers for transportation of goods. Gross receipts were higher, supported by earnings from passenger, cargo and charter services by domestic shipping and airline companies. The increase in transshipment cargo handled by Malaysian ports lent support to the growth in receipts. The transshipment cargo originated largely from Singapore, Hong Kong SAR, Japan and PR China.

The rising interest among Malaysian companies to invest abroad to diversify operations and provide synergy to domestic activities had yielded positive results. This was reflected in the improvement in the **income account** deficit, attributable mainly to the significantly higher profits and dividends accruing to Malaysian companies from their overseas investments, particularly in the mining, manufacturing and financial services sectors. Meanwhile, profits

**Chart 1.44**
**Direct Investment Income**




*e* Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

and dividends accruing to foreign direct investors increased in line with improved export performance by export-oriented industries, especially in the E&E segment and the oil and gas sector. The continuing high profits and dividends accruing to foreign direct investors reflected the successful operations of MNCs in Malaysia. Nevertheless, the actual outflows of investment income were lower since about half of these incomes were retained in the country for reinvestment. The improvement in the income account was also the outcome of higher returns on external reserves holdings.

**Financial Account**

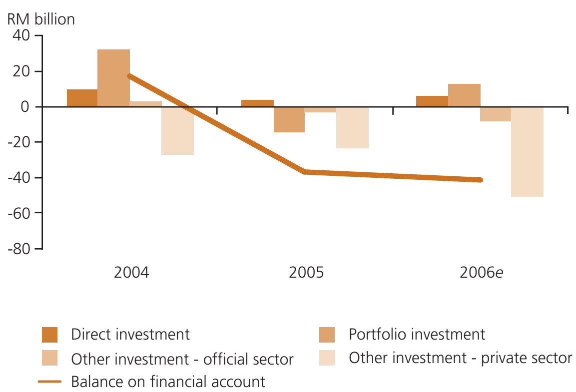
In 2006, the **financial account** recorded a larger net outflow of RM39.9 billion as higher overseas investment and net outflows of other investment more than offset the inflows of foreign direct investment and portfolio investment. The larger current account surplus was more than sufficient to finance the outflows in the financial account.

During the year, gross **foreign direct investment (FDI)** increased significantly to RM37.2 billion (2005: RM26.8 billion), equivalent to 7.1% of GNP, supported mainly by earnings retained by existing MNCs for reinvestment and the increased acquisition activity being driven by foreign investors. This trend reflects the sustained confidence and commitment of foreign investors operating in Malaysia, and is also an indication that the country remains a profit centre for global MNCs. After taking into account the adjustments for outflows due largely to loan repayments to parent companies abroad, net FDI inflows were higher at RM25.9 billion or 4.9% of GNP.

## Higher inflows of FDI and portfolio investment reflected stronger confidence of investors in the Malaysian economy. Improved competitiveness and the rising interest of Malaysian companies to diversify their operations led to higher outflows for investment abroad

FDI into the *manufacturing sector* remained large, particularly for investments to increase capacity and diversify product lines, as well as for migration to the production of more capital intensive, higher valued-added and technology-oriented components, as observed from the higher capital investment per employee ratios of these investments. Higher investments in the petroleum refining and petroleum-related products industry were undertaken to support the buoyant upstream activity in the oil and gas sector in Malaysia.

**Chart 1.45**
**Financial Account**




*e* Estimate

**Table 1.20**
**Balance of Payments: Financial Account**

| | 2005 | 2006*e* |
|---|---|---|
| | RM billion | |
| **Financial Account** | **-37.0** | **-39.9** |
| **Direct Investment** | **3.8** | **4.3** |
| In Malaysia | 15.0 | 25.9 |
| Abroad | -11.3 | -21.5 |
| **Portfolio Investment** | **-14.2** | **14.7** |
| **Other Investment** | **-26.6** | **-59.0** |
| Official sector | -3.2 | -8.0 |
| *Federal Government* | *-0.6* | *-3.1* |
| *NFPEs* | *-2.6* | *-5.0* |
| Private sector | -23.5 | -51.0 |

Note: Numbers may not necessarily add up due to rounding
*e* Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Meanwhile, FDI in the *services sector* was mainly in the finance, insurance, real estate and business services sub-sector, followed by the wholesale and retail trade, hotels and restaurants sub-sector as well as the transportation and communication sub-sector. The liberalisation of the financial sector, particularly the Islamic financial services sub-sector, attracted a significant inflow of FDI. The increased investments were reflected in the establishment of new branches and the expansion of financial services offered by foreign financial institutions in Malaysia, as well as the commencement of operations by another foreign bank which was awarded a licence for Islamic banking.

Malaysia remains an attractive destination for MNCs to locate their shared services and outsourcing (SSO) activities. During the year, 184 international and regional facilities, including those undertaking SSO activities, and 38 wholly foreign-owned Multimedia Super Corridor (MSC) status companies were given the approval to establish operations in Malaysia. The establishment of these operations would encourage higher value-added activity and reinforce linkages across the different segments in the services sector. Meanwhile, the opening of new retail outlets in emerging townships was supported by strong domestic consumption and tourism. Inflows of FDI into the *oil and gas sector* were for investment in both the upstream and downstream activities, supported by sustained high oil prices and the discovery of several offshore deepwater oil and gas fields in Sabah and Terengganu in recent years. These investments, ranging from exploration and extraction operations to development and production activities, were mostly undertaken by the national oil company in joint venture with its international partners through production sharing contracts.

While FDI remains crucial to Malaysia's long-term development in terms of capital, transfer of technology and access to global markets, the Government has also played an active role to support initiatives by Malaysian companies venturing abroad. In the 2007 Budget, the Government has approved an increase in the paid-up capital of EXIM Bank to enhance the financing available to domestic companies investing abroad, as well as the setting up of an *Overseas Investment Fund* (OIF) to finance start-up costs of domestic companies doing business overseas. In an effort to encourage Malaysian banks to expand overseas and establish a regional presence, the Government has announced that tax exemptions of up to five years will be granted on income received from new bank branches or remittances from bank subsidiaries overseas. Meanwhile, Bank Negara Malaysia has also set up an *Overseas Project Financing Fund* at the EXIM Bank to assist Malaysian companies that are bidding and securing contracts overseas by providing greater access to financing for their projects abroad.

In 2006, net **direct investment abroad** by Malaysian companies rose further to RM21.5 billion. Overseas investment in the *services sector* were led by companies in the finance, insurance, real estate and business services sub-sector. These investments included the acquisition of substantial interests in foreign financial institutions and real estate companies. In the transport, storage and communication sub-sector, investments were directed mainly to acquire interest in the telecommunication businesses and for expansion of existing operations to cater to the increasing needs of mobile telephone users in growing markets such as India, Indonesia and Thailand. Malaysian companies have also made inroads into the growing utilities sub-sector abroad particularly in large markets such as PR China via acquisition of power plants and the development of new plants. In the *oil and gas sector*, the national oil and gas company continued to conduct upstream oil and gas exploration and extraction and downstream processing activities, particularly in Africa and Central Asia. These activities are often carried out in partnerships with large foreign oil companies and the national oil companies in the host countries. In the *manufacturing sector*, overseas investments were led by companies in the electrical and electronics, automotive and shipping industries. There were also investments in palm oil processing and the manufacturing of fibre glass, furniture and rubber products. Although smaller in scale, these investments took advantage of the lower labour costs abroad and were intended to provide synergy through the establishment of an integrated supply chain with their existing Malaysian operations. In the *agriculture sector*, investments were directed primarily into oil palm plantations in Indonesia. Meanwhile, established Malaysian *construction* and engineering companies continued to invest abroad, leveraging on their expertise and experience in civil engineering and property development to secure various contracts for the construction of large infrastructure projects, residential housing and highways, particularly in the Middle East and South Asia. The successful operations of Malaysian companies investing abroad were evidenced by the significant increase in the profits and dividends accruing to Malaysian companies, from RM4.1 billion in 2005 to RM11.7 billion in 2006.

**Portfolio investment** turned around to record a net inflow of RM14.7 billion in 2006. In the first half of the year, inflows of portfolio funds were mainly for purchases of debt securities, particularly bonds and notes, including the long-term bond issued by an NFPE, and short-term money market instruments. These flows were encouraged by the high global liquidity situation and the relative attractiveness of Malaysian papers. Meanwhile, there were net outflows of equity funds as foreign investors liquidated their positions, particularly in the second quarter of 2006, following the global financial market correction in May. In the second half of the year, inflows of portfolio funds were mainly in the equity market. Foreign funds increased their exposure in the domestic equity market in line with the stronger performances of the regional bourses. A confluence of positive factors contributed to improved investor sentiments. These included the expectations of stronger earnings by Malaysian corporations, news of large mergers and acquisitions in the plantation, banking and construction sectors, an improved macroeconomic outlook and announcements on the implementation of Ninth Malaysia Plan (9MP) projects, as well as the appreciation of the ringgit, particularly in the fourth quarter of 2006. Meanwhile, there was some liquidation of investment in debt securities, as moderating inflationary pressures and lower inflation expectations influenced a downward trend on yields. This development, together with the maturity of a long term bond by an NFPE resulted in the net outflow of funds invested in debt securities.

The **other investment** account registered a significantly higher net outflow of RM59 billion in 2006, reflecting mainly larger net outflows by both the official and private sectors. The **official sector** registered a larger net loan repayment amounting to RM8 billion. Apart from the maturity of several large loans by both the Federal Government and NFPEs during the year, there were also prepayments of external loans by the NFPEs to reduce their overall debt exposure. Other investment by the **private sector,** which comprises mainly borrowing and lending as well as placements and withdrawals of deposits by the banking sector, and non-bank private sector transactions with unrelated counterparties, also recorded a higher net outflow. The outflow by the banking sector reflected mainly a higher placement of assets abroad as well as the unwinding of inter-bank borrowings by banks. Meanwhile, the higher outflows by the non-bank private sector reflected mainly higher trade credits extended by Malaysian exporters and the larger repayment of trade credits by Malaysian importers in line with the stronger trade performance.

**External Debt**

Malaysia continues to undertake a prudent debt management strategy. The prudential guidelines include efforts to minimise risk exposure against global interest rate shocks, adverse exchange rate movements and shifts in investor sentiments. The rationale for these guidelines is to allow the diversification of external borrowings by the public and private sectors in terms of currencies, maturity structure, debt instruments and creditors, in order to allow active management of risks. A comprehensive debt monitoring system

## External debt position improved further, reflecting net repayments of debt by both the Federal Government and the NFPEs. Short-term external debt remained low and accounted for only 23% of total external debt

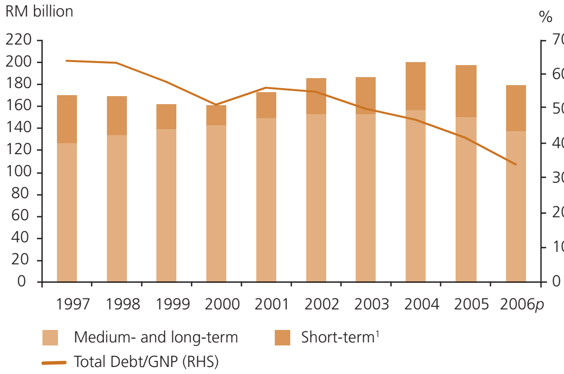
**Table 1.21**
**Outstanding External Debt**

| | 2005 | 2006*p* | 2005 | 2006*p* |
|---|---|---|---|---|
| | RM billion | RM billion | USD billion | USD billion |
| **Total debt** | **197.7** | **179.4** | **51.8** | **50.3** |
| Medium- and long-term | 150.7 | 138.1 | 39.5 | 38.7 |
| Short-term[1] | 47.0 | 41.3 | 12.3 | 11.6 |
| *As % of total debt* | *23.7* | *23.0* | | |
| *As % of net international reserves* | *17.7* | *14.2* | | |
| **As % of GNP** | | | | |
| Total debt | 41.9 | 34.1 | | |
| Medium- and long-term debt | 32.0 | 26.2 | | |
| **As % of exports of goods and services** | | | | |
| Total debt | 32.4 | 26.9 | | |
| Medium- and long-term debt | 24.7 | 20.7 | | |
| **Debt service ratio (%)** | **5.4** | **4.7** | | |

[1] Excludes currency and deposits held by non-residents with resident banking institutions
*p* Preliminary

Source: Ministry of Finance and Bank Negara Malaysia

**Chart 1.46**
**Outstanding External Debt**




[1] Excludes currency and deposits held by non-residents with resident banking institutions

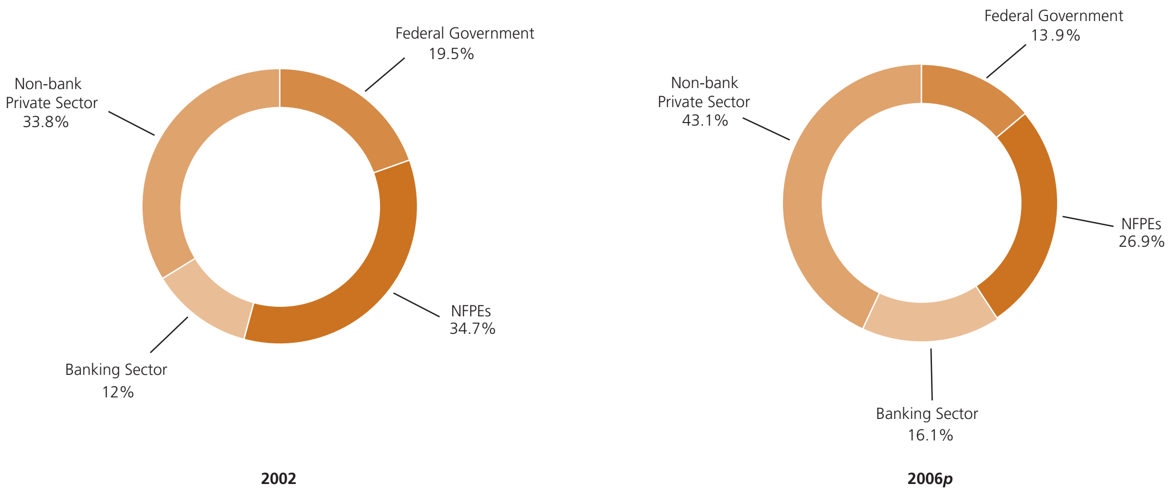
*p* Preliminary

enables the authorities to monitor the overall debt level, the structure of the debt as well as debt-servicing obligations of both the public and private sectors.

In 2006, Malaysia's total external debt declined to RM179.4 billion (USD50.3 billion) as at end-2006 (end-2005: RM197.7 billion or USD51.8 billion), equivalent to 34.1% of GNP. The nation's capacity to service the external debt has also improved. As at end-2006, the total external debt accounted for only 61.8% of international reserves (end-2005: 74.6%) and 26.9% of the exports of goods and services (end-2005: 32.4%). Similarly, the nation's vulnerability to a reversal in short-term external debt has also declined as short-term debt now accounts for only 7.8% of GNP (end-2005: 10%), 14.2% of reserves (end-2005: 17.7%) and 6.2% of the exports of goods and services (end-2005: 7.7%). The short-term debt accounted for 23% of total external debt.

The improvement in the external debt position reflected declines in both the short-term and medium- and long-term debts. The **public sector** registered its fourth consecutive year of net repayments in 2006 (-RM7.7 billion; 2005: -RM11 billion). During the year, the **Federal Government** maintained its practice of sourcing its funding requirements mainly from non-inflationary domestic sources. For the third consecutive year, no market loan was raised from the international capital market. In contrast, large loan repayments were made following the maturity of two syndicated loans amounting to RM2.9 billion, contributing to a reduction in the Federal Government's debt for the third straight year in 2006. Despite marginally larger gross borrowing to finance capital expenditure, the **NFPEs** registered a fifth consecutive year of net

**Chart 1.47**
**External Debt by Sector (% share)**




*p* Preliminary

repayments in 2006. The repayments reflected largely the maturity of several large loans as well as the prepayment of some external loans, particularly by companies in the oil and gas sector, to reduce their external debt exposure. The net repayments by both the Federal Government and NFPEs contributed to a lower public sector external debt outstanding (RM73.3 billion; end-2005: RM86.2 billion) and reduced its share of total external debt (40.8%; end-2005: 43.6%).

The **private sector** registered a net drawdown of external loans, amounting to RM3.4 billion in 2006. Both gross borrowings and repayments were lower. The lower gross borrowing reflected partly improved corporate earnings and increased financing through domestic banking and capital markets amidst a competitive financial and interest rates environment. The bulk of the repayments were done by companies in the manufacturing, oil and gas and transportation sectors. While the private sector medium- and long-term debt accounted for about 47% of the total medium- and long-term debt, about two-thirds of these borrowings were inter-company loans that have flexible terms and concessionary interest rates.

The lower short-term external debt outstanding (RM41.3 billion; end-2005: RM47 billion), reflected primarily a marked decline in the short-term debt of the banking sector. The decline in the banking sector's debt was due mainly to the unwinding of inter-bank borrowings by banks. Meanwhile, there was an increase in the short-term external debt of the non-bank private sector, which comprises mainly of term loans, revolving credits and overdraft facilities. The increase is attributable to higher inter-company loans. The short-term borrowings of the non-bank private sector accounted for 30.2% of total short-term external debt.

The strengthening of the ringgit against major currencies has had a positive impact on Malaysia's external debt. The exchange revaluation gain amounting to RM8 billion arising from the appreciation of ringgit against major currencies during the year has contributed to a lower medium- and long-term debt. In addition, the stronger ringgit has also reduced the debt servicing payments in 2006.

### International Reserves

The **international reserves** held by Bank Negara Malaysia comprise of holdings of foreign exchange and gold, its IMF reserve position and holdings of Special Drawing Rights (SDR). For the year 2006, net international reserves increased by RM25.3 billion to RM290.4 billion (USD82.5 billion) as at 31 December 2006. The increase in reserves occurred amidst significant two-way flows, reflecting the more robust economic activity and strong fundamentals of the Malaysian economy. As at 28 February 2007, reserves amounted to RM305.9 billion (USD86.9 billion). This level of reserves is adequate to finance 8.2 months of retained imports and is nine times the short-term external debt.

During 2006, the foreign exchange inflows were generated mainly from higher inflows of export earnings arising from a stronger trade performance. Inflows of foreign direct investment and portfolio funds also contributed to the accumulation of reserves. The steady inflow of foreign direct investment throughout the year reflected the sustained confidence of foreign

**Table 1.22**
**Net International Reserves**

| | As at end | | | Change |
|---|---|---|---|---|
| | 2004 | 2005 | 2006 | 2006 |
| | RM million | | | |
| SDR holdings | 765.3 | 748.3 | 756.9 | 8.6 |
| IMF reserve position | 3,068.4 | 1,186.3 | 793.4 | -392.9 |
| Gold and foreign exchange[1] | 247,786.6 | 263,235.7 | 288,871.2 | 25,635.5 |
| **Gross International Reserves** | **251,620.3** | **265,170.3** | **290,421.5** | **25,251.2** |
| *Less* Bank Negara Malaysia external liabilities | 24.5 | 22.5 | 22.9 | 0.4 |
| **Net International Reserves** | **251,595.8** | **265,147.8** | **290,398.6** | **25,250.8** |
| **USD million equivalent** | **66,209.4** | **70,169.3** | **82,450.8** | **12,281.5** |
| Months of retained imports | 7.9 | 7.7 | 7.8 | |
| Reserves/Short-term external debt (times) | 5.8 | 5.6 | 7.0 | |

[1] 'Other Foreign Currency Claims on Residents' is reclassified from 'Gold and Foreign Exchange' to 'Other Assets' of Bank Negara Malaysia

**Chart 1.48**
**Net International Reserves (end-month)**


investors in the Malaysian economy. The improved corporate performance and economic prospects also attracted inflows of portfolio funds for investment, particularly in the equity market.

## The increase in international reserves was mainly from higher inflows of export earnings and investment-related inflows. Increased economic activity and strong economic fundamentals created significant two-way flows during the year

Increased economic activity during the year led to higher outflows through import payments for goods and services as well as the repatriation of profits and dividends accruing to foreign companies operating in Malaysia. The large repayments and prepayments of external loans reduced Malaysia's external debt position and strengthened its resilience to external shocks. Overseas investment by Malaysian companies were also higher during the year, reflecting continued interests by Malaysian companies in diversifying and expanding their operations abroad.

During the year, the cumulative quarterly revaluation loss amounted to RM6.9 billion, following the strengthening of ringgit against major currencies, particularly in the first and fourth quarters.

With the growth in international reserves, Bank Negara Malaysia has progressively enhanced its reserve management strategy and practices. New asset classes and instruments are continuously assessed and reviewed for inclusion into the portfolio. At the same time, the risk management practices and infrastructure, as well as techniques of operations, have been upgraded to better manage the increasing complexity of both the portfolio and the operating environment. These initiatives are undertaken within Bank Negara Malaysia's overall investment strategy that focuses on ensuring capital preservation and the liquidity of reserves whilst optimising returns.

Malaysia, as a country with a strong balance of payments position, was included in the Financial Transactions Plan of the IMF that makes resources available to member countries facing short-term balance of payments difficulties. The **reserve position with the IMF** amounted to RM793.4 million as at end-2006. A lower reserve position was due mainly to the net repurchase of SDR69.9 million following repayment to the ringgit account by various member countries under the Financial Transactions Plan. As at end-2006, Malaysia's holdings of reserves in the form of **SDRs** increased to RM756.9 million, attributed mainly to the receipt of remuneration arising from Malaysia's net creditor position with the Fund.

The international reserves held by the Bank are usable and unencumbered. There are no foreign currency loans with embedded options; and no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks and other financial institutions. Bank Negara Malaysia also does not engage in options-related activity in the foreign currency markets.

Bank Negara Malaysia releases information on the international reserve position through a statement of the Bank's assets and liabilities on a fortnightly basis, with a one-week lag. In addition, the Bank also fulfils the IMF's Special Data Dissemination Standard (SDDS) requirements on detailed disclosure of international reserves and foreign currency liquidity information at the end of each month, with a one-month lag. The reserves data template also provides forward-looking information on the size, composition and usability of reserves and other foreign currency assets, and the future as well as potential (contingent) inflows and outflows of foreign exchange arising from the operations of the Federal Government and the Bank over the next 12-month period. On an annual basis, the Bank also discloses the currency composition of its reserves with a breakdown in terms of currencies that are in the SDR basket (comprising mainly the major currencies) and that of other currencies.