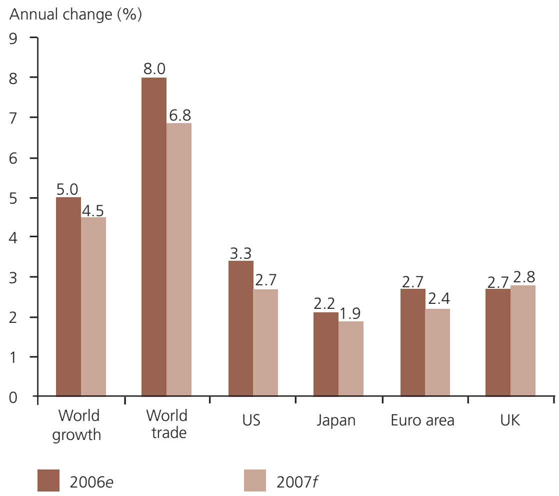
Outlook and Policy

THE INTERNATIONAL ECONOMIC OUTLOOK

The outlook for global performance remains fairly optimistic. Global growth in 2007 is forecast to be sustained at above 4% for the fifth consecutive year. A growth of 4.5% is anticipated in 2007 (5.0% in 2006), with further easing of inflationary pressures and with some moderation in growth of world trade. The adjustment in the US housing market is expected to gradually have a broader impact on consumption. Recovery in Japan would continue, albeit at a more measured pace, while prospects for the euro area now look brighter following signs of a broad-based recovery in the major member countries. Notwithstanding the more moderate pace of expansion in external demand, growth in the Asian region is expected to remain encouraging, supported increasingly by domestic demand, particularly in PR China and India.

Chart 4.1
World Growth, World Trade and Growth in Major Industrial Countries (2006-2007)



e Estimate
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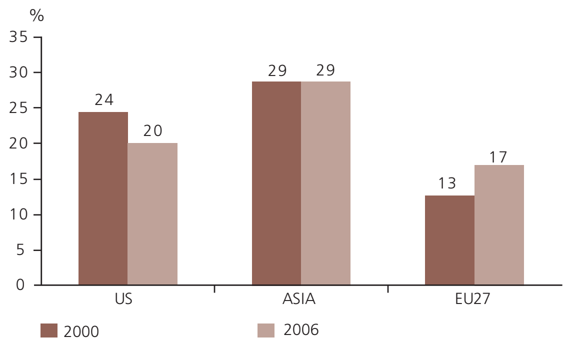
Source: International Monetary Fund and Bank Negara Malaysia

Global growth in 2007 is to be sustained at above 4% for the fifth consecutive year. While a moderation in growth is forecast for the US, the recovery in Europe and Japan is expected to be sustained. Growth in the Asian region will be supported by domestic demand. Strong capital flows to the region would continue to pose a challenge to monetary management

In the **US**, the prospect for further housing market weakness lingers as the ratio of residential property investment to GDP remains above its historical average while oversupply persists as evident from the high housing inventories and homeowner vacancy rates. There may be some spillover effects into consumption activity and other sectors of the economy in the early part of the year. Import demand may also be more broadly affected, given the moderating domestic demand. This anticipated outcome would contribute to a further improvement in the US external imbalance, which has been a major area of concern associated with the adjustment of global imbalances.

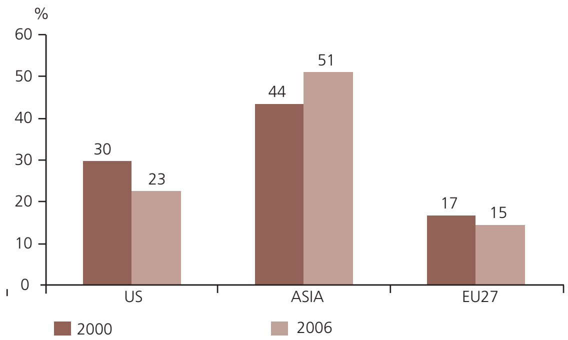
The impact of the moderation of growth in the US on global economic momentum in 2007 depends significantly on the sustainability of the recovery in Europe and Japan and the strength of domestic sources of growth in the rest of Asia. However, while these economies have relied on external demand to support growth and recovery, the share of European and Japanese exports to the US has declined noticeably (EU-15: 24% in 2000 to 20% of total exports in 2006; Japan: 30% in 2000 to 23% of total exports in 2006). With respect to domestic demand, the **euro area** economy appears to be better positioned to sustain its expansion. Labour market conditions are expected to continue improving in line with stronger economic activity and higher wage settlements supporting consumer spending. Germany's recovery is also seen to be contributing

Chart 4.2a
Export Shares of EU15 by Destination



Source: World Trade Atlas

Chart 4.2b
Export Shares of Japan by Destination



Source: World Trade Atlas

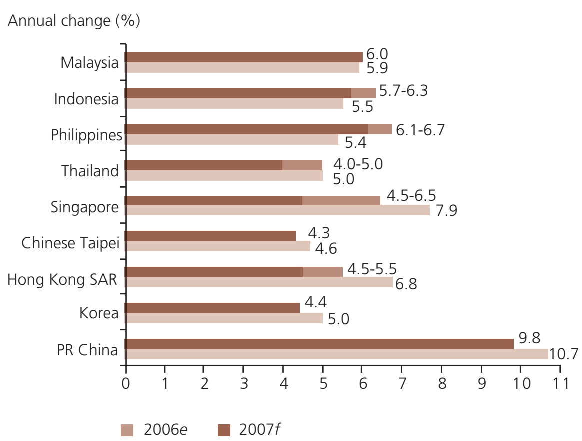
to global demand, as reflected in the trend of a stronger rise of German imports from economies outside the euro area.

In **Japan**, however, concerns persist on the prospects for a stronger recovery in private consumption. Enhanced consumption activity needs to be supported by a sustained uptrend in wage and income growth. Nonetheless, the strength in investment spending is expected to prevail as Japanese corporations are well-positioned to benefit from the continued expansion of global and regional demand.

With an anticipated moderate softening in external demand, especially in the first half of 2007, regional economies are projected to expand at a slightly less rapid pace in 2007. Domestic demand is expected to play a central role in cushioning the impact of the moderation in external demand. In addition, flexibility in monetary and fiscal policy following the easing of inflationary pressures and improving fiscal positions of regional economies, would provide further support to growth in domestic demand. This development is evident given the more accommodative monetary policy stance in Indonesia, Thailand and the Philippines. Higher consumption activity is also increasingly supported by rising income levels amid improving labour market conditions as seen in the lower levels of unemployment and rising real wages. Recent developments suggest a revival in investment trends. Several large infrastructure projects have been announced or have commenced operations. Such projects include the relocation of the administrative centre and the expansion of public housing supply in Korea, the building of the integrated resorts in Singapore, and public infrastructure projects in Thailand and the Philippines.

Trends also suggest that the global semiconductor industry, a key export sector of the region, is poised to record another favourable year with forecast growth of 9.5 - 10%. Demand for electronic products with advanced features has driven technology

Chart 4.3
Regional Countries: Real GDP Growth



e Estimate
f Forecast
Source: National authorities

enhancement in the semiconductor industry, leading to the production of high-performance microprocessors, graphics processors and memory chips. The new Microsoft operating system, Vista, is expected to lend support to sales in the PC segment in the second half of 2007 as demand increases. Meanwhile, in the broad commodity markets, despite some recent corrections, indications are that demand and prices would be generally sustained at elevated levels.

In **PR China**, rebalancing growth away from investment and export-related activities towards private consumption remains a key focus for policy makers. GDP growth in PR China is expected to ease moderately in 2007 due to slower exports and policy measures undertaken to restrain over-investment and promote economic rebalancing. Ongoing infrastructure projects related to rural development and several significant events like the Olympics 2008, Shanghai World Expo and Guangzhou Asian Games 2010 would continue to support strong investment growth.

Global inflation has started to stabilise amid easing oil prices. However, underlying demand conditions for commodities remain firm, especially in fast-growing regions, which suggests that prices would remain supported in the longer term. Going forward, while easing oil prices and slowing global growth may generally prompt some degree of monetary easing, monetary policy responses are expected to vary based on country-specific circumstances and conditions.

Global financial markets have grown significantly, driven by expanding capital flows and growth of new financial intermediaries. These developments have increased volatility and potential mis-pricing of risks across a number of asset classes and markets. Persistently strong capital inflows have also prompted policy responses by selected monetary authorities in the region. The large increase in carry trades and derivative trades and increased integration of global financial markets have raised the risks of sudden and large adjustments in financial markets and asset prices. Markets remain vulnerable to a sharp correction that could be triggered by a significant change in expectations. The recent developments at the end of February and early March in the global, regional and domestic equity markets reflect the potential for contagion. Nonetheless, the capacity to absorb the volatility from time to time would depend on the resilience and fundamentals of the underlying economies.

While global growth is expected to remain favourable in 2007, several key risks could affect this outlook. One risk is a sharper-than-expected US moderation. Although oil prices have declined from their recent peaks, geo-political developments could suddenly reverse this trend with implications for slower global growth and renewed inflationary pressures. Furthermore, while recent developments suggest that the US current account deficit is improving, the risk of a disorderly adjustment still remains. In addition, events that prompt the unwinding of carry trades could also contribute to destabilising developments in the international financial system.

MALAYSIAN ECONOMY IN 2007

Supported by sustained global growth and resilient domestic demand, the Malaysian economy is expected to register solid growth in 2007, with real GDP expanding by 6%. This pace is consistent with the expansion in productive capacity following the strengthening of the recovery in capital formation.

In 2007, investment, particularly private investment, is expected to play a major role in sustaining growth as strong domestic and external demand, coupled with high levels of capacity utilisation, induced firms to expand capacity. In addition, investment activity by the public sector is also expected to expand substantially with the commencement of work on infrastructure and other projects under the Ninth Malaysia Plan (9MP). Firm-level investment is also expected to benefit from the reduction in the corporate tax rate that was announced in the 2007 Budget, while ample liquidity in the financial system will ensure funding would be adequate.

Real GDP to expand by 6% in 2007, supported by sustained global growth and resilient domestic demand

The year will also see broad-based growth as the mining and construction sectors, which had contracted in 2006, are expected to register positive growth. The construction sector, in particular, will benefit from higher public expenditure as well as strong demand in the non-residential properties segment. In the mining sector, growth would be driven by a recovery in natural gas output after major upgrading work on the MLNG2 plant is completed. In addition, the Kikeh oil field in Sabah, which was discovered in 2004, is expected to start production in the fourth quarter of the year.

The growth momentum during the year will be influenced by both external and domestic factors. The global economy is expected to expand more moderately in the first half of the year, mirroring the slower growth expected in the US during this period. In addition, the global electronics industry is expected to see demand remain stable in the first half of the year before new products boost demand in the second-half year. On the domestic front, a number of major developments are expected to impact growth, mainly towards the latter part of the year. These include the more rapid implementation of public projects, the start of production at the Kikeh oil field and the significant increase in tourist arrivals for the Visit Malaysia Year 2007 during the peak summer travel season. Reflecting these factors, the Malaysian economy is expected to enjoy stronger growth in the second half-year.

Inflation is expected to remain benign during the year. After having increased in 2006 following the partial reduction of fuel and other subsidies, inflation is expected to trend downwards during the year. Price pressures from demand conditions are expected to remain subdued, given that the economy would be on a balanced growth path during the year. In addition, lower oil and energy prices would mitigate imported inflation. As a result of these factors, the average inflation rate for 2007 is expected to be in the range of 2 - 2.5%.

The current account is forecasted to record a surplus, driven by the trade surplus and improved services receipts arising from the tourism sector. Inflows of foreign direct investment are expected to remain substantial. Balancing these inflows, however, would be the strong outflows that are characteristic of a highly open economy. The nation’s external indebtedness is expected to decline as the public sector will continue to register net repayment of its external obligations. Similarly, the strong performance of the trade, oil and gas and financial sectors would see significant repatriation of profits and dividends by foreign direct investors back to their home offices. In addition, Malaysian investors and firms are expected to intensify the diversification of their portfolios by investing abroad. These healthy two-way flows will combine to improve Malaysia’s fundamentals while enhancing the economic integration with the regional and global economies.

Domestic Demand Conditions

Aggregate domestic demand is projected to remain resilient, with a growth rate of 7.4% in 2007. The private sector will remain as the main driver. However, the public sector is expected to play a more significant role as public investment projects under the 9MP are implemented.

Private investment, in particular, will be a major driver of growth and is expected to increase by 10.4%, due mainly to higher capital spending in the manufacturing, services and oil and gas sectors. The reduction of corporate income tax to 27% announced in the 2007 Budget would also stimulate private capital spending. Capital spending in the manufacturing sector would largely be driven by efforts to improve efficiency and expand capacity, especially in higher value-added projects that employ higher levels of technology and a more knowledge-based workforce. In the services sector, sustained high capital expenditure is expected in the utilities, telecommunications, and transportation sub-sectors. The expenditure would

Table 4.1
Real GDP by Expenditure (1987=100)

	2006p	2007f	2006p	2007f
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic demand [1]	**7.4**	**7.4**	**6.8**	**6.8**
Private sector expenditure	7.6	7.2	4.7	4.5
Consumption	*7.0*	*6.4*	*3.5*	*3.3*
Investment	*9.7*	*10.4*	*1.2*	*1.3*
Public sector expenditure	7.2	7.7	2.1	2.3
Consumption	*7.9*	*4.1*	*1.2*	*0.6*
Investment	*6.5*	*11.4*	*1.0*	*1.7*
Change in stocks			**-0.5**	**-0.1**
Net exports of goods and services	**-5.0**	**-9.6**	**-0.4**	**-0.8**
Exports	6.3	6.3	7.7	7.6
Imports	7.2	7.4	8.1	8.4
Real Gross Domestic Product	**5.9**	**6.0**	**5.9**	**6.0**

Note: Figures may not necessarily add up due to rounding
[1] Excluding stocks
p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

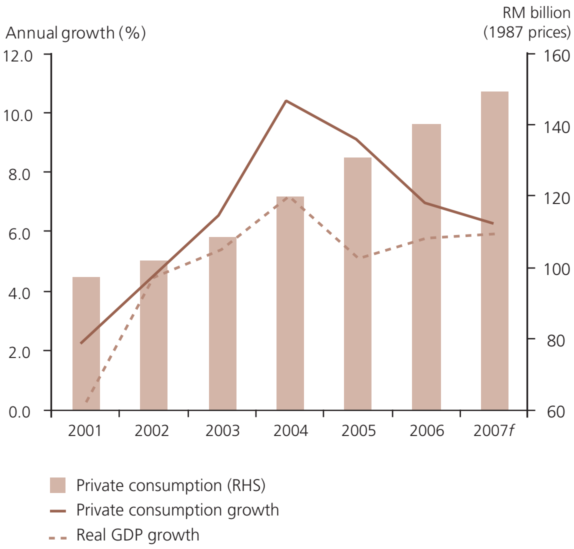
be for the development of power plants and water-related improvement projects, enhancement of network quality and providing additional broadband facilities. In the transportation sector, shipping and air services providers are expected to spend on fleet expansion. Meanwhile, higher capital spending is expected in the oil and gas sectors with the discovery of new oil and gas fields in recent years as well as continued exploration and survey activities in the deepwater areas.

Cognisant of the important role played by the public sector in encouraging investment by the private sector, the Government has introduced a number of investment initiatives to enhance the public service delivery system to attract both foreign and local investors. In particular, the introduction of the Private Financing Initiatives (PFIs), where the Government identifies projects for completion but the private sector would source the funds and implement them, would see greater private participation in public sector projects. A PFI Facilitation Fund of RM5 billion has been established to support 9MP projects being undertaken by the private sector. Projects implemented through this mechanism include the construction of government schools, quarters and office buildings. The implementation of the 9MP projects is also expected to boost capital expenditure in the construction sector. As a result of these new projects and the on-going road projects started in 2006; construction activity is expected to expand significantly in the second half of 2007.

The public sector's contribution to growth is expected to increase further in 2007 due mainly to higher public investment. **Public investment** is forecasted to grow significantly by 11.4%, driven by the higher development expenditure of the Federal Government on the 9MP projects. The Federal Government's allocation for development expenditure in the economic services sector is mainly for improving the agriculture sector, providing support for industrial growth and infrastructure development. In the social services sector, the bulk of expenditure is for the provision of essential services such as education and health and the development of housing projects. To promote more equitable development between regions, emphasis will be given to investment projects in the Northern Economic Corridor, East Coast Corridor and Southern Johor Economic Region.

In addition to investment undertaken directly by the Federal Government, public investment would gain further support from the strong planned capital outlays by the non-financial public enterprises (NFPEs). Tenaga Nasional Berhad is expected to continue investing in its electricity transmission and distribution infrastructure, as well as expanding its power generation capacity. Similarly, Telekom Malaysia Berhad will be upgrading the communications infrastructure. In the oil and gas sector, a large part of PETRONAS' capital spending will be in the upstream oil and gas segment, in collaboration with companies with whom it has entered into production sharing contracts.

Chart 4.4
Real GDP and Private Consumption



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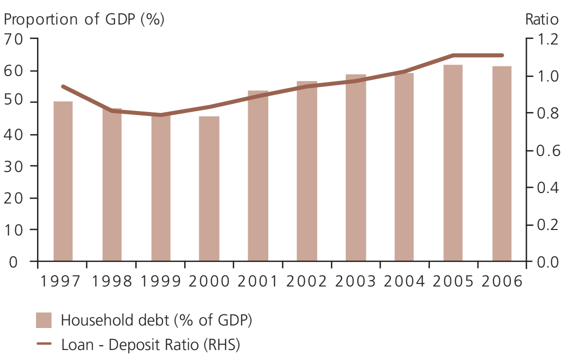
Private consumption is expected to remain resilient, increasing by 6.4% in 2007. As a result of sustained growth in recent years, which has increased job creation, households are expected to enjoy income growth and better employment prospects. In addition, high commodity prices have significantly boosted rural incomes and spending. These same trends are expected to be sustained in 2007. Apart from sustained income growth, other factors that will provide support for sustained household consumption include the lower inflation rate, a conducive financing environment

Chart 4.5
Household Debt Indicators



of low and stable interest rates, and the high rate of savings. In particular, the households' balance sheet remains relatively strong, as shown by the stable debt levels and the decreasing debt-service burden. As a result, consumption growth can be expected to remain robust, exceeding overall GDP growth for the eighth consecutive year.

The sustained improvement in the demand for labour would ensure that the economy operates near full employment, with the **unemployment rate** remaining at 3.5%. As a result, wages are expected to rise in 2007. The latest Malaysian Employers Federation Survey indicated that on average, salaries are expected to increase by 5.5% for executives and 5.4% for non-executives. Nevertheless, the increase in average salaries for executives in industries that are dependent on higher skilled workers such as insurance, banking and investment; business services and consultancy; education; F&B and chemical-related industries; and ICT, media and advertising, are likely to be higher than the industry average of 5.5%. For these industries, employers are expected to offer salary increments of up to 6.8%. Meanwhile, improvements in productivity, which have been significant in recent years, are expected to be even stronger as more companies implement performance- and productivity-linked wages and increase mechanization and automation to achieve higher efficiency. On the other hand, **public consumption** is expected to increase more moderately by 4.1% in 2007, particularly for expenditure on supplies and services. The increase is due, in part, to the Government's emphasis on improving the delivery system to support private sector activity.

Sectoral Outlook

On the production side, growth is expected to be broad based, reflecting expansion in all economic sectors. The services and manufacturing sectors would continue to drive growth, expanding at higher rate than overall GDP growth. The manufacturing sector would be led by resource-based industries and further supported by the electronics and electrical sector. The positive effects of the Visit Malaysia Year 2007 (VMY 2007) tourist promotion campaign and the increasing contribution from new activities are expected to benefit the services sector. Meanwhile, the agriculture sector is expected to continue to expand, reflecting increases in output of all major crops, albeit at a more moderate pace. The mining and construction sectors are expected to turn around and register positive growth, with the former supported by new capacity coming on-stream, while the latter would be underpinned by the positive effects from the implementation of development projects under the Ninth Malaysia Plan (9MP).

Growth in the **manufacturing sector** is expected to be sustained at 6.6% (2006: 7%). While the electronics and electrical (E&E) sector may experience some moderation in the first half of 2007 due to the expected moderation in the US economy, the growth would be supported by other industries. In particular, resource-based industries and industries related to the construction sector are expected to lend support during the year, led mainly by sustained regional demand and more broad-based domestic activities.

In the E&E sector, towards the closing months of 2006, there were some signs of softening demand for computers and related parts from the US market. As the US is a major export destination for Malaysian E&E products, the current moderation is expected to have some impact on Malaysian exports. Furthermore, there are also indications of a mild build-up in inventories of selected products,

Table 4.2
Real GDP by Sector (1987=100)

	2006*p*	2007*f*
	Annual change (%)	
Agriculture	6.4	3.2
Mining	-0.2	2.8
Manufacturing	7.0	6.6
Construction	-0.5	3.0
Services	6.5	6.3
Real GDP	**5.9**	**6.0**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

such as the 3G wireless handsets and high-end computers.

In view of the above, the assessment is that the Malaysian E&E sector is expected to record a moderately slower growth in the first half of 2007, in line with trends in the US economy, and to pick up strongly in the second half-year, supported by the growing global demand for the new operating system, Windows Vista. Since only a small percentage of existing global computers can support the new system (estimated 15%), most users will either have to upgrade the hardware on their existing computers or purchase new computers. The increased take-up of the new operating system is expected to fuel demand for computers and related semiconductor parts such as memory products and hard disk drives. The E&E sector is also expected to continue to benefit from other product segments due to the current global electronics up-cycle, which is expected to continue into 2008.

Firm demand for selected resource-based industries such as chemicals, rubber products and petroleum products should provide support for the manufacturing sector during the year. The chemical industry is expected to see an improved performance due to impetus from the new biodiesel plants that would come on-stream during the year. The growth in the rubber products industry is also expected to remain strong, supported by continued demand for rubber gloves and the transition of the tyre industry into higher value-added products amidst the more stable input prices. Output of petroleum products is expected to be driven by higher demand, while construction-related industries would be supported by the implementation of 9MP projects.

The **services sector** is expected to remain the key driver of growth, contributing 3.7 percentage points to overall GDP growth. The growth would be led mainly by intermediate services, while the final services segment is projected to expand at a moderate pace, in tandem with private consumption activity during the year. In the intermediate services segment, the finance, insurance, real estate and business services sub-sector will play a dominant role in generating growth, driven mainly by new areas of growth. Of significance, the entry of new players in Islamic finance and the newly-formed investment banks are expected to generate increased activity with the launching of new innovative products and services to attract a wider range of customers, including foreign clients. During the year, the initiative to promote Malaysia as an International Islamic Financial Centre is also expected to gain momentum.

The business services segment is expected to benefit from increased activity as new IT, and shared services and outsourcing companies, that have been granted Multimedia Super Corridor (MSC) status in 2006, begin operations. Consonant with the strategy outlined in the Malaysian Information, Communications and Multimedia Services 886 Strategy (MyICMS 886), the IT industry is expected to undertake high value-added content development over the next few years to ensure an adequate supply of product offerings for education, entertainment, games and e-services. In addition, demand for selected professional and skilled services such as draughting, surveying, architectural and engineering services are also expected to increase due to the pick-up in construction activity and the significant investments in the oil and gas sector.

Similarly, the transport, storage and communication sub-sector is expected to record stronger growth. In particular, growth in the telecommunications industry would be especially significant, driven by increased affordability and the availability of multimedia cellular phones with advanced features amidst the greater coverage of the high-speed data network. Meanwhile, the transport segment is expected to benefit from increased tourist arrivals during the VMY 2007, as well as the capacity expansion and promotional efforts by the domestic airline companies.

The final services segment is expected to expand at a moderate pace in line with the private consumption activity during the year. Part of the impact would be muted by higher tourism related activity as 240 events and activities have been lined up in conjunction with the VMY 2007. In addition, the spillover effects from the implementation of the 9MP projects are expected to translate into higher activity in the services sector.

The **agriculture sector** is expected to expand by 3.2%, reflecting increases in output of all major crops. While output growth in the first half-year, especially of crude palm oil and crops dependent heavily on irrigation, is expected to see some moderation due to the exceptional dry conditions brought by the *El Nino* weather phenomenon, the impact is likely to be temporary. The agriculture sector would see a stronger growth in the second half-year. Output of rubber is expected to expand further by 3.2% to 1.30 million tonnes in 2007, encouraged by the favourable prices. Improved breeding techniques and firm domestic demand are also expected to result in higher output of livestock during the year.

The **mining sector** is expected to expand by 2.8%, supported by higher output of crude oil and natural gas. Crude oil production (including condensates) is expected to average 722,500 barrels per day (bpd), supported by the commencement of operations at the new Kikeh oil field located offshore from Sabah in the final quarter of the year. The Kikeh plant is expected to produce 60,000 bpd initially before increasing to 120,000 bpd by the first quarter of 2008. Output of natural gas is also expected to increase by 2.2% as the MLNG 2 plant comes into full operation in the second half of the year following a capacity upgrade exercise. The increased production is to cater to long-term contracts with Japan and Korea.

After declining for three consecutive years, value added in the **construction sector** is expected to turn around, led mainly by the civil engineering segment. As the projects under the Ninth Malaysia Plan are tendered out and implemented, the effects are expected to translate into real activity to support the gradual recovery in the civil engineering segment. Growth is also expected to emanate from construction activities related to the oil and gas sector. The construction sector would be further enhanced by the higher growth in the non-residential segment, supported by rising demand for office space and increase in the supply of retail space. During the year, 10 new shopping complexes are expected to commence operation in the Klang Valley. Meanwhile, the residential segment is expected to continue to expand. Launches are likely to be in small numbers and mainly concentrated in prime locations and niche segments.

Balance of Payments

On the external front, the **current account** surplus is projected to remain large at 16.3% of GNP, reflecting the continued strong surplus in merchandise trade and an improvement in the services account. Both gross exports and imports are expected to expand by 8.2% and 9.8% respectively. Strong growth in exports of resourced-based manufactured products will partly mitigate the more moderate growth in E&E exports. The growth in commodity exports is expected to be sustained, supported by the higher prices for palm oil. The continued high levels of agriculture and mineral exports, which have low import content, will provide further support to the trade surplus. Higher tourism receipts in conjunction with the VMY 2007 campaign will contribute to the improvement in the services account. In the financial account, continued inflows of foreign direct investment (FDI) would also strengthen the overall balance of payments.

Table 4.4
External Trade

	2006*p*		2007*f*	
	RM billion	Annual change (%)	RM billion	Annual change (%)
Gross exports	**589.0**	**10.3**	**637.2**	**8.2**
of which:				
Manufacturing	473.2	10.1	511.7	8.1
Agriculture	42.1	12.5	53.1	26.0
Minerals	56.8	8.6	55.1	-3.0
Gross imports	**480.8**	**10.8**	**527.8**	**9.8**
of which:				
Capital goods	65.3	7.4	71.0	8.9
Intermediate goods	335.5	8.8	361.5	7.7
Consumption goods	27.9	13.4	30.6	9.7
Trade balance	**108.2**		**109.4**	

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

Table 4.3
Balance of Payments

	2006*e*	2007*f*
	RM billion	
Goods	135.0	137.7
Trade account	108.2	109.4
Exports (% annual change)	*10.3*	*8.2*
Imports (% annual change)	*10.8*	*9.8*
Services	-7.4	-6.7
Balance on goods and services	**127.7**	**131.0**
Income	-19.8	-22.1
Current transfers	-16.6	-16.2
Current account balance	**91.2**	**92.7**
% of GNP	***17.3***	***16.3***
Financial account	-39.9	-
Errors and omissions	-26.0	-
of which:		
Foreign exchange revaluation loss	*-6.9*	-
Overall balance	**25.3**	**-**

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

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Manufactured exports are expected to expand by 8.1% in line with trends in global trade. While the moderation in growth in the US economy is expected to somewhat dampen demand for electronic products in the first half-year, particularly computers and parts, the electrical and electronic products would continue to remain the largest contributor to export earnings. The moderate growth in export volume would be partly offset by more stable prices of semiconductors, after the declining trend in 2006. Growth would be further supported by exports of resource-based products, with exports of chemicals expected to be strong due to firm demand for biodiesel products from the EU.

Exports of **agricultural commodities** are expected to continue to record double-digit growth in 2007, driven mainly by higher receipts from palm oil. The expected strong increase would be due to the improved palm oil price, while export volume would be constrained to some extent by the increase in domestic demand from producers of palm oil-based biodiesel. The price of palm oil is expected to rise to RM2,200 per tonne, underpinned by strong demand from PR China and biodiesel producers amidst the limited global supply due to weather-related factors. Meanwhile, the export price of rubber is expected to consolidate from the very high level seen in 2006, influenced by the expected lower prices of synthetic rubber in line with trends in crude oil prices.

Exports of minerals would be influenced by lower receipts from crude oil, mainly arising from lower crude oil prices. The export price of Malaysian crude oil is projected to average USD58 per barrel in 2007 (2006: USD68 per barrel). Crude oil prices are expected to consolidate after four consecutive years of strong increase, due mainly to expected increase in global supply, particularly from the non-OPEC producers. The impact will be partially offset by higher exports of LNG, in tandem with the commencement of full operations at the MLNG 2 plant after the sequenced shutdown in 2006 for capacity upgrading purposes. LNG prices are also expected to be higher at RM1,150 per tonne due to expectations of higher demand in the global LNG market.

Growth in **imports** is expected to emanate from continued growth in imports of intermediate and capital goods. Intermediate import growth will stem from sustained demand for imported components, in line with the expansion in manufacturing production. Capital imports are expected to strengthen in line with higher investment activity. Growth in capital imports will be supported by capacity expansion in the manufacturing, services and oil and gas sectors. Higher capital imports in the services sector is expected to be led by deliveries of new ships and aircraft to meet strong demand arising from commodity exports and the expansion of intra-regional travel. Growth in capital imports will also stem from increased exploration and development activity in the oil and gas sector following the discovery of new deepwater wells.

The **services account** deficit is envisaged to improve further to 1.2% of GNP. Aggressive promotional activities targeted at medium- and long-haul tourists in conjunction with VMY 2007 are expected to enhance tourism earnings. The expansion in the shared services industry and the development of new products in the ICT sector will continue to underpin the growth in exports of computer and information services. Meanwhile, payments for transportation are expected to be higher in line with the higher volume of trade. Larger outflows in other services are expected with the increase in demand for professional services, particularly for the oil and gas sector as well as the upgrading of the transportation network.

The **income account** deficit is projected to be sustained at 3.9% of GNP, reflecting profits and dividends accruing to multinational companies (MNCs) from their investments in Malaysia. The projected investment income accruing to foreign investors is due to the export performance of the E&E and oil and gas industries. The rising trend in income accruing to foreign investors indicates that Malaysia is an attractive and profitable location for foreign direct investment. Meanwhile, sustained profits and dividends accruing to Malaysian companies from overseas investment will mitigate the deficit in the income account.

The **financial account** is expected to be supported by continued inflows of foreign funds for investment, particularly long-term capital. **Foreign direct investment (FDI)** is expected to remain high, largely from retained earnings by the existing MNCs operating in Malaysia, as well as from new FDI flows into the manufacturing, services and oil and gas sectors. More merger and acquisition activities as well as the implementation of development projects under the 9MP are also expected to attract inflows of FDI. FDI into the manufacturing sector is expected to remain significant following the higher level of FDI approved by the MITI in 2005 and 2006 (RM17.9 billion and RM20.2 billion, respectively). Most of these inflows would be channeled into the higher value-added electrical and electronics industry, as well as chemical and chemical products and basic metal products industries. Investment in the oil and gas sector is anticipated to remain sizeable given the expected increase in upstream exploration and production activities, led by foreign private oil companies operating in Malaysia through joint ventures with PETRONAS. The rapid development of the financial sector, particularly Islamic financial services sub-sector following liberalisation, and the growing interest of global MNCs to establish outsourcing and shared services operations would lead to higher inflows of FDI into the services sector. Meanwhile, **investment abroad** by Malaysian companies is projected to remain large, reflecting the sustained interest shown by Malaysian companies to expand and diversify their operations abroad. In addition to the greenfield investments, there would also be outflows of capital to acquire interest in existing businesses abroad. Most of these investments are likely to be channeled into the services sector, particularly the finance, telecommunications and utilities sub-sectors, as well as the oil and gas, manufacturing and construction sectors.

Inflation Outlook for 2007

Headline inflation, which was driven by higher energy prices in early 2006, has since eased and is likely to moderate further in 2007. The average inflation rate is expected to moderate to 2 – 2.5% for the year as a whole. Headline inflation is expected to be significantly lower in 2007 than in 2006, and price pressures are expected to be well-contained. In the short run, the main contributing factor to the lower inflation rate would be the lapse of the impact of the upward adjustment in the prices of retail petroleum products that took place in 2006. In addition, global energy prices have declined from their peak levels, and if sustained, would contribute towards alleviating cost pressures. Importantly, the moderating trend in inflation observed during the second half of 2006 has contained the public’s inflation expectations for 2007.

Over the medium term, corporations are expected to continue to undertake new investments, which would expand the productive capacity of the economy, thereby ensuring continued growth without undue price pressures. Furthermore, price pressures would continue to be dampened by increased competitive pressures arising from increased international economic and financial integration. Barring any new upward adjustments to administered prices, it is likely that inflationary conditions will be relatively benign in 2007.

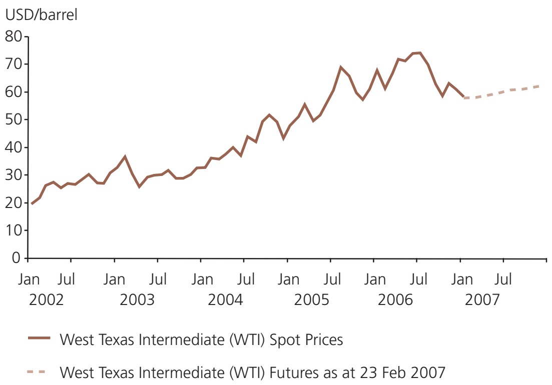
Notwithstanding the expectation for lower inflation in 2007, three key developments might generate upward pressure on consumer prices during the year. First, a favourable growth outcome coupled with increased factor utilisation could trigger stronger-than-expected wage pressures and pose an upward risk to general prices. Nevertheless, the expected improvements in labour productivity would help to contain unit labour costs. In this regard, the Bank will continue to monitor developments in the labour market closely.

Second, the inflation rate of price-volatile food items could also be affected should food supplies be disrupted due to adverse weather conditions during the year. For example, the severe flooding in Johor in late December 2006 and early 2007 had disrupted food supplies and led to an upturn in food prices. Nevertheless, the impact is likely to be transitory and should dissipate when food supplies normalise.

A third source of uncertainty for the inflation outlook is the evolution of global energy prices. Oil prices have been exceedingly volatile in recent years and renewed increases cannot be discounted based on the current pricing in the oil futures market. In February 2007, the International Energy Agency (IEA) cautioned that the high demand for oil, against the backdrop of tight supply conditions, could keep oil prices high over the medium term. As evident in previous years, shocks to energy prices would yield a direct impact on producers’ input costs and transport costs.

These upside risks, however, are counterbalanced by the more robust capacity expansion and possible further increases

Chart 4.6
West Texas Intermediate (WTI) Spot and Future Prices



in productivity, which are expected to create downward pressure on inflation. Imported inflation would also be more subdued given that global inflation is expected to be broadly lower in 2007 compared to 2006. In particular, a sharper moderation in the inflation rates of Malaysia's trade partners could reinforce the decline in domestic consumer prices. Overall, at the point of writing, the risks to the inflation outlook relative to the central projection are judged to be reasonably well balanced.

MONETARY POLICY IN 2007

In line with the objectives of monetary policy, Bank Negara Malaysia will continue to promote price stability and sustainable economic growth in 2007. Decisions on monetary policy will remain conditional upon the evolution of the Bank's assessment of domestic and global macroeconomic conditions and the prospects for inflation and economic growth.

Despite the expected softening in global growth during the first half of 2007, growth of the global economy and world trade in 2007 as a whole are likely to be sustained at above 4% and 6% respectively. Domestic growth drivers are expected to remain strong, underpinned by the momentum in private investment, as well as resilient private consumption. Public demand will also remain supportive of economic growth. Employment prospects are expected to remain positive and supportive of income growth and consumer sentiment.

The outlook for inflation is relatively benign and is not expected to pose a significant policy challenge. Inflation is expected to be significantly lower than in 2006. The Malaysian economy is expected to operate close to its potential output (Box Article), with the

Potential Output of the Malaysian Economy

Potential output is the trend level of output that is consistent with the aggregate productive capacity of an economy. It traces the sustainable growth path of the economy based on its available productive inputs. Conceptually, the growth in potential output is primarily determined by the expansion and non-inflationary utilisation of physical capital and the labour force, as well as the rate of technological progress and improvement in overall economic efficiency and productivity. Therefore, the sustainability of long-term growth of an economy depends crucially on investment in physical capital and its efficient utilisation, increases in the size and productivity of the labour force, and the improvement in the general economic environment.

The latest estimates for Malaysia show that potential output grew at 6.3% in 2006, with the output gap[1] estimated at an average of positive 0.4% of potential output. With the continuous improvement in productivity and expansion of both capital stock and labour force during the year, the output gap narrowed and closed towards the second half of 2006, resulting in the Malaysian economy growing close to its potential level at the end of the year.

[1] The output gap is the difference between the levels of actual and potential output and the gap is measured as a percentage of potential output. A positive output gap indicates that actual output is above potential output, while a negative output gap indicates the reverse.

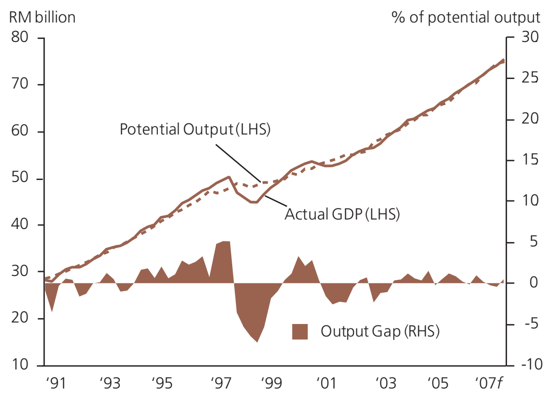
On the whole, the performance of the Malaysian economy since the year 2000 has been characterised by three clear developments. Firstly, the growth path of the Malaysian economy has been relatively balanced. Despite numerous external shocks to the region and the growing global imbalances, the economy did not experience any large deflationary or inflationary cycles, as indicated by the modest deviations between actual and potential output during the period. This provides a reflection of Malaysia's growing economic resilience. Secondly, this period also witnessed Malaysia's transition away from a factor-driven to more a productivity-driven economy. Compared to a decade before, productivity growth now accounts for a greater proportion of overall potential output expansion. This indicates that productivity levels have steadily improved.

Table 1
Actual GDP and Potential Output

Period	Actual GDP	Potential Output	Investment	Labour	Output Gap
	(Annual change in %)				(% of potential output)
1992-1999	6.7	6.7	4.5	3.1	0.1
2000	8.9	4.6	25.7	4.3	2.2
2001	0.3	3.9	-2.8	1.6	-1.3
2002	4.4	3.4	0.3	3.5	-0.4
2003	5.5	6.3	2.7	3.6	-1.1
2004	7.2	5.4	3.1	4.0	0.6
2005	5.2	4.9	4.7	4.1	0.8
2006e	5.9	6.3	7.9	2.2	0.4

e Estimate

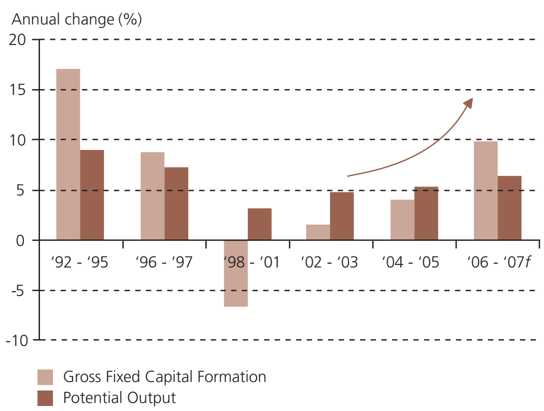
Chart 1
Actual and Potential GDP: Balanced Growth



f Forecast

Finally, the Malaysian economy also saw a recovery in investment activity from the second half of 2003 onwards, particularly in the private sector. This favourable development has contributed to the further growth of potential output in recent years (see Chart 2), thus expanding the productive

Chart 2
Investment Recovery Contributed to Continued Potential Output Expansion



f Forecast

capacity of the economy, which in turn will promote higher levels of economic activity over the near term.

Going forward, potential output of the economy is expected to grow above 6% in 2007 with the output gap remaining negligible during the year. The potential output growth would be driven by the continuous expansion of both the capital stock and labour force. This balanced expansion is expected to prevail going into the future, supported by further recovery of investment activity and the improvement in economic resilience and productivity.

output gap remaining negligible during the year. With continued investment by the private and public sector, the productive capacity of the economy would be further expanded. This implies that while demand will continue to grow, it is not expected to cause undue pressures on prices. Apart from these domestic factors, the global environment is also expected to remain relatively favourable given the lower oil and commodity prices. Importantly, inflation expectations are expected to remain well anchored.

Nevertheless, there are risks and uncertainties going forward that could have a material impact on the policy environment. The direction and volatility of oil prices in the global markets could become a source of concern. Although the current forecast is for the world economy to grow at a slightly slower pace, it is also possible that economic growth will turn out to be better than currently estimated, in which case demand pressures could emerge. Alternatively, there remain some downside risks emanating from the correction in the US housing market which could affect consumption in the US, with possible repercussions on world trade and growth of the world economy.

Capital flows could potentially pose a challenge to the management of monetary policy for most of the regional economies in 2007. As with any small open economy with liberal exchange control policies, capital flows need to be closely monitored. Such flows could result in excessive volatility in the financial markets and the economy. There would thus be continued intensive surveillance. The country is better positioned to absorb the volatility and the strategy of a gradual and sequential liberalisation of its capital account remains on course.

The conduct of monetary policy in 2007 will continue to balance between the need to ensure that interest rates remain at a level that would enable the central bank to respond to any risks of rising inflation, while remaining conducive to sustaining growth in domestic demand. At current interest rate levels, monetary policy remains accommodative. Bank Negara Malaysia will continue to assess developments in the domestic and international economies and will adjust its monetary policy stance as circumstances require.

Liberalisation of the Foreign Exchange Administration Policies

Malaysia has always undertaken a structured approach in reviewing the foreign exchange administration policies based on the readiness of the economy. Over the years, the foreign exchange administration policies have been progressively liberalised, aimed at enhancing Malaysia's competitiveness through reducing cost of doing business, increasing efficiency of the regulatory delivery system, providing a greater degree of risk management to businesses while safeguarding economic and financial stability.

In line with the country's strategic objectives and supported by progress achieved from previous liberalisations, Bank Negara Malaysia announces further liberalisation to the foreign exchange administration rules with effect from 1 April 2007 as follows:

(a) To provide greater flexibility to licensed onshore banks to undertake foreign currency business, the following foreign exchange administration rules are liberalised:

(i) Abolish net open position limit of licensed onshore banks which was previously capped at 20% of the banks' capital base.

(ii) Abolish the limit imposed on licensed onshore banks for foreign currency accounts maintained by residents.

(iii) Allow investment banks in Malaysia to undertake foreign currency business subject to a comprehensive supervisory review on the capacity and capability of the investment banks.

(b) To widen the investor base for ringgit assets and financial products, the following foreign exchange administration rules are liberalised:

(i) Grant further flexibility for non-resident stockbroking companies and custodian banks to obtain ringgit overdraft facility from licensed onshore banks to avoid settlement failure due to inadvertent delays by:

- Removing the previous overdraft limit of RM200 million; and
- Expanding the scope on utilisation of the overdraft facility to also include ringgit instruments settled through the Real Time Electronic Transfer of Funds and Securities (RENTAS) System and Bursa Malaysia. Previously, utilisation of the facility was confined only to shares traded on Bursa Malaysia.

(ii) Abolish the limit on the number of residential or commercial property loans obtained by non-residents. Under the previous policy, non-residents were allowed to obtain a maximum limit of three property loans from residents to finance the purchase or construction of residential or commercial properties in Malaysia.

(iii) Allow licensed onshore banks to appoint overseas branches of their banking group as a vehicle to facilitate the settlement of any ringgit assets of their non-resident clients.

(iv) Allow non-resident corporations to utilise proceeds arising from the listing of shares through Initial Public Offering on the Main Board of Bursa Malaysia, abroad.

(v) Remove the restriction on Labuan offshore banks to transact in ringgit financial products on behalf of non-resident clients.

(c) To reduce cost of doing business, enhance business efficiency as well as promote Malaysia as a centre of origination, the following foreign exchange administration rules are liberalised:

(i) Increase the limit of foreign currency borrowing that can be obtained by resident corporations from licensed onshore banks and non-residents as well as through issuance of onshore foreign currency bonds, to RM100 million equivalent in aggregate and on corporate group basis from the previous RM50 million equivalent. The proceeds may be used for domestic purposes or offshore investment.

(ii) Allow residents to hedge foreign currency loan repayment up to the full amount of underlying commitment.

(iii) Enhance flexibilities for resident individuals and corporations to invest in foreign currency assets as follows:
- Increase the limit for resident individuals with domestic ringgit borrowing to invest in foreign currency assets up to RM1 million per calendar year, from the previous limit of RM100,000;
- Increase the limit for resident corporations with domestic ringgit borrowing to invest in foreign currency assets up to RM50 million per calendar year, from the previous limit of RM10 million; and
- Allow resident corporations to utilise proceeds arising from listing of shares through Initial Public Offering on the Main Board of Bursa Malaysia for offshore investment purposes.

(iv) Increase the limit for resident institutional investors to invest in foreign currency assets as follows:
- Unit trust companies: up to 50% of net asset value (NAV) attributable to residents from the previous 30% of NAV;
- Fund management companies: up to 50% of funds of resident clients with domestic credit facilities from the previous 30% level; and
- Insurance companies and takaful operators: up to 50% of NAV of investment-linked funds marketed from the previous 30% of NAV.

(v) Allow resident corporations to lend in foreign currency, the proceeds arising from listing of shares on foreign stock exchanges to other resident corporations within the same corporate group in Malaysia.

(vi) Abolish restrictions on payments in foreign currency between residents for settlement of foreign currency financial products offered onshore.

(vii) Allow resident individuals to open and maintain joint foreign currency accounts for any purpose. Previously, resident individuals were allowed to maintain joint foreign currency accounts only for purposes of education and employment overseas.

Details of the liberalisation can be obtained from the Annex.

FISCAL POLICY IN 2007

The 2007 Budget is aimed at enhancing the macroeconomic fundamentals and promoting a more broadly balanced economic structure by placing emphasis on new areas of domestic economic activity. Fiscal policy in 2007 is therefore focused on facilitating the private sector in taking a greater role in economic development as well as in generating new sources of growth in the technology and knowledge-intensive sectors.

Expected higher revenue collection has allowed the Federal Government to plan increased expenditures, while reducing the budget deficit to

Table 4.5
Federal Government Finance

	RM billion		% change	
	2006*p*	2007*B*	2006*p*	2007*B*
Revenue	123.5	134.8	16.2	9.1
Total expenditure	143.5	157.5	11.9	9.7
Operating expenditure	*107.7*	*113.0*	*10.2*	*4.9*
Gross development expenditure	*35.8*	*44.5*	*17.3*	*24.3*
Loan recoveries	0.8	2.5		
Overall balance	**-19.1**	**-20.2**		
% of GDP	**-3.5**	**-3.4**		
Sources of financing:				
Net domestic borrowing	17.8	-		
Net external borrowing	-3.1	-		
Realisable assets[1] and adjustments	4.4	-		

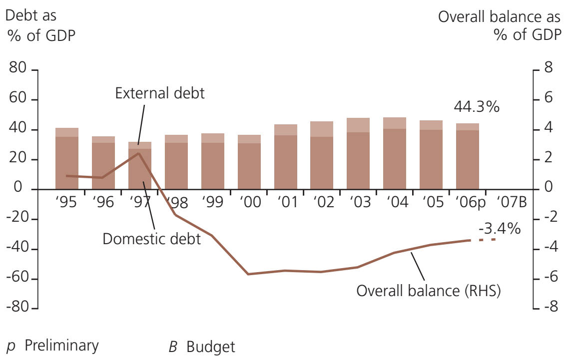
[1] A positive (+) sign indicates a drawdown in the accumulated realisable assets
[p] Preliminary
[B] Budget
Note: Numbers may not add up due to rounding
Source: Ministry of Finance

3.4% of GDP in 2007. Notably, the budgeted development expenditure was increased to support the Government's initiatives in generating higher value-added economic growth, developing skilled and knowledgeable manpower, as well as programmes to reduce socio-economic and regional disparities.

In addition to budgetary allocations, the Government has put in place various incentives for the development of industries with high growth potential including ICT, biotechnology, modern agriculture, the halal food industry, tourism and Islamic finance. The Government also enhanced the business-friendly environment to attract foreign direct investment and promote private investment by strengthening the public service delivery systems as well as improving existing incentives and taxes. In particular, corporate income tax was reduced by two percentage points in two stages, to 27% for the 2007 assessment year and 26% for 2008.

The Budget continues to embody the Government's underlying philosophy of fiscal prudence, balancing the need for fiscal flexibility within the context of sustaining long-term growth. The fiscal deficit is expected to decline gradually to achieve a sound fiscal position

Chart 4.7
Federal Government Fiscal Balance and Debt



that would provide the Government with the flexibility to respond to changing economic circumstances.

In terms of financing, the Government will continue to rely on domestic sources to finance the fiscal deficit, given the high domestic savings and ample liquidity situation. Recourse to external borrowing will be determined mainly by the need to establish international market presence and to provide benchmarks for private sector issues.