Outlook and Policy

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THE INTERNATIONAL ECONOMIC ENVIRONMENT

Developments in 2005

In 2005, global economic expansion was sustained at a strong pace of 4.3%. Growth was remarkably resilient against the backdrop of higher oil prices, rising interest rates, large balance of payment imbalances and disruptions from natural disasters. While the economies of the United States (US) and PR China remained major drivers of global growth, the recovery in Japan and the euro area in the second half-year gained momentum, providing additional support to the global economy. Consumer spending was sustained, reinforced to a significant extent by wealth effects, particularly from robust housing markets in several major economies. Reflecting robust demand conditions, stronger corporate financial positions and rising capacity utilization, investment spending expanded further. Meanwhile, growth in the Asian region strengthened in the second half-year as the uptrend in the global electronics cycle became evident. Overall, higher global growth was reflected in the continued expansion in world trade, which rose at a strong pace of 7%.

Strong global demand was also a key factor in driving higher global commodity prices in 2005. While the relatively tight supply conditions and Hurricane Katrina drove oil prices to new peaks in the third quarter, the strong growth performance of the global economy also sustained demand. Overall, global growth exhibited greater resilience to energy shocks, with the effects in large part offset by productivity gains, continued income growth and wealth creation in tandem with improved energy efficiency and technological improvements during the recent two decades. Hence, while higher oil and commodity prices did have some impact on headline inflation, the effect was relatively modest as sustained improvements in productivity, the globalisation of production and the emergence of competitive sources of supply from several regions of

Table 3.1
World Economy: Key Economic Indicators

	Real GDP Growth (%)			Inflation (%)		
	2004	2005*e*	2006*f*	2004	2005*e*	2006*f*
World Growth	**5.1**	**4.3**	**4.3**	–	–	–
World Trade	**10.3**	**7.0**	**7.4**	–	–	–
Major Industrial Countries	**3.3**	**2.6**	**2.6**	**2.0**	**2.2**	**2.0**
United States	4.2	3.5	3.3	2.7	3.4	2.8
Japan	2.3	2.8	2.5	0.0	-0.3	0.0
Euro area	2.1	1.3	1.7	2.1	2.2	1.8
United Kingdom[1]	3.2	1.8	2.0	1.3	2.1	1.9
East Asia	**7.9**	**7.2**	**7.0 ~ 7.2**	**3.4**	**3.1**	**3.3 ~ 3.6**
Asian NIEs	**6.0**	**4.8**	**4.6 ~ 4.9**	**2.3**	**2.2**	**2.3 ~ 2.4**
Korea	4.6	4.0	5.0	3.6	2.7	3.0
Chinese Taipei	6.1	4.1	4.3	1.6	2.3	1.7
Singapore	8.7	6.4	4.0 ~ 6.0	1.7	0.5	0.5 ~ 1.5
Hong Kong China[2]	8.6	7.3	4.0 ~ 5.0	-0.4	1.1	2.3
The People's Republic of China	**10.1**	**9.9**	**9.4**	**3.9**	**1.8**	**3.0**
ASEAN[3]	**6.4**	**5.4**	**5.1 ~ 5.9**	**3.8**	**5.9**	**4.8 ~ 6.0**
Malaysia	7.1	5.3	6.0	1.4	3.0	3.5 ~ 4.0
Thailand	6.2	4.5	4.8 ~ 5.8	2.7	4.6	3.5 ~ 5.0
Indonesia	5.1	5.6	5.0 ~ 5.7	6.1	10.4	7.0 ~ 9.0
Philippines	6.0	5.1	5.7 ~ 6.3	6.0	7.6	8.0 ~ 8.5

[1] Based on Eurostat's harmonized index of consumer prices.
[2] Inflation refers to composite prices.
[3] Includes Singapore.
e Estimate
f Forecast

Source: International Monetary Fund, Datastream, OECD Economic Outlook, National Sources the world helped to mitigate the pass-through effects. The relatively restrained inflationary environment allowed monetary authorities across the world to raise interest rates at a gradual and measured pace. Financial market activity generally benefited from the abundant liquidity conditions and sustained economic growth. Reflecting prospects for ongoing economic recovery and improved corporate performance, equity markets in Japan and Europe recorded strong gains. Meanwhile, rising interest rates in the US supported the US dollar against the other major currencies.

Among the major industrial countries, the **US** continued to lead growth in 2005. Growth was broad based, with strong momentum in domestic demand, owing significantly to the strong contribution from consumption spending, underpinned by the buoyant housing market. In addition, improving labour market conditions provided further stimulus to consumer spending. Strong corporate financial positions, housing-related investment spending and a tax measure to encourage repatriation of funds provided impetus for a further expansion in private investment activity. Despite the impact of the hurricanes in the Gulf Coast and record gasoline prices, US economic performance remained resilient in the second half-year. Consumer confidence, labour markets and business activity rebounded shortly after the impact of Hurricane Katrina. In the government sector, the fiscal deficit improved on higher tax revenue and some expenditure reduction. However, strong domestic demand combined with high oil prices led to a further widening of the current account deficit.

Economic recovery in **Japan** was evident throughout the course of 2005, underpinned by stronger domestic demand and reinforced by external demand in the later part of the year. Domestic demand in Japan was mainly supported by an expansion in investment while recovery in consumption was underpinned by favourable developments in labour market conditions. Meanwhile, export performance picked up in the second-half year, in line with the pick-up in the global electronics cycle.

Economic recovery in the **euro area** was significantly stronger in the second half of 2005, supported largely by stronger exports. This led to a modest increase in investment spending while industrial production gathered momentum. Although business confidence, as reflected by the German Ifo and ZEW indicators, improved markedly towards the end of 2005, consumer sentiments remained weak, reflecting a persistently high level of unemployment. Nonetheless, labour reforms have shown some results in terms of improving labour market flexibility as seen in the rising level of part-time and contract employment.

Meanwhile, growth in the **UK** slowed in 2005 as both consumers and firms held back on consumption and investment spending amidst weaker domestic conditions following the slower housing market.

In the **Asian** region, growth remained strong at 7.2% in 2005 following a milder-than-expected slowdown in the electronics sector. Growth, nevertheless, moderated slightly from the high base of 7.9% in 2004 in the face of surging oil prices, monetary tightening cycle and some slowdown in global IT demand. PR China continued to drive regional expansion with a revised growth estimate of 9.9%. Regional growth was broad based, underpinned by both external and domestic demand.

In 2005, exports grew by 20% (2004: 28.5%). After some slowing down in the first half-year, export performance picked up in the second half-year as the global technology cycle revived. Private consumption continued to grow at a stable pace in the region, with rising incomes offsetting the impact of higher oil prices and tighter monetary policies. In Korea, private consumption increased steadily, following the strengthening of household balance sheets since the burst of the credit bubble in 2002. Fixed investment, on the other hand, grew at a more modest pace in several of the regional economies. However, fixed investment in PR China continued to grow strongly despite measures by the authorities to moderate overheating in selected sectors.

The current account surplus in the region remained strong but showed divergent trends. The surplus was significantly larger in PR China, reflecting continued strong exports but narrowed in a number of regional countries due partly to the impact of high oil prices. This, together with trends in capital flows, led to a moderation in the pace of accumulation in foreign reserves in the second half of the year.

Prospects for 2006

Going forward, the outlook for 2006 is for global expansion to remain positive. World output and world trade are projected to expand at a firm pace of 4.3% and 7.4% respectively in 2006. Global growth is expected to broaden across the major economies, with the economies of Japan and Europe playing a more significant role. Another notable feature is the stronger investment uptrend seen in several major economies. For the Asian region, the global electronics up-cycle is expected to strengthen further following higher ICT-related spending in the industrial economies and stronger intra-regional demand. While monetary stimulus has been reduced due to increased interest rates, monetary conditions continue to remain accommodative to growth.

The global economy is expected to expand at a strong pace of 4.3% in 2006, emanating from a more balanced growth across major industrial countries. Growth will be supported by an uptrend in investment and electronics cycle as well as continued favourable liquidity conditions.

Graph 3.1
Major Industrial Countries: Real GDP Growth (2005-2006)

e Estimate
f Forecast

Industrial Countries

In 2006, the **US** economy is expected to sustain the growth momentum from 2005, with real GDP expanding by 3.3%. Investment is expected to emerge as a stronger driver of growth. Strong corporate positions, rising capacity utilisation and lean inventory levels are expected to further spur capital expenditure, especially for spending related to ICT upgrading and replacement as well as in the energy sector for post-Katrina rebuilding. Meanwhile, despite expectations for a slight moderation due to a cooler housing market, US consumer spending would continue to expand as job creation and income growth are expected to strengthen further in 2006. On the fiscal front, spending on post-hurricane reconstruction is also expected to provide further stimulus to the US economy. The large US current account deficit is, however, expected to widen further, exacerbated by high oil prices, sustained domestic demand and higher interest payment outflows.

In **Japan**, economic recovery is expected to remain intact, with growth sustained above 2% for a third consecutive year in 2006. Domestic demand would remain the driver of growth, led by investment and accompanied by sustained expansion in private consumption. The expansion in private consumption would be supported by stronger improvements in employment, wage and income conditions, despite constraints due to a planned reduction in individual tax allowances and a rise in pension contributions. Recovery in exports to the major markets since the second half of 2005 is expected to continue this year. Meanwhile, the continued recovery in the domestic economy is also reflected in improvements in the health of the banking sector as well as the asset markets.

In the **euro area**, economic recovery in Germany, France, Italy and Spain are expected to pick up pace in 2006. With Italy emerging from its recessionary conditions and growth in Germany and France strengthening further, real GDP as a whole is expected to expand by 1.7%. Nonetheless, recovery – particularly in Germany, which accounts for almost 30% of the euro area's GDP – continues to be supported primarily by external demand as the growth in private domestic consumption remains modest. While business sentiments have improved, weak consumer sentiments coupled with a persistently high unemployment level may constrain prospects for stronger domestic growth in the euro area.

In the **UK**, real GDP growth is expected to remain modest, projected to expand by 2% in 2006. Household consumption is expected to remain subdued as household debts have reached record levels and the wealth effect from rising house prices has tapered off. Government spending, though expected to moderate in 2006, will continue to support economic expansion in the UK as private sector investment remains cautious despite strong corporate profitability. However, as recovery in the euro area picks up, the UK is expected to benefit as exports, which are largely channelled into the euro area, start to recover.

While global growth is expected to be sustained at a steady pace in 2006, several **risks** could adversely affect the outlook. The risk of a sharp and prolonged spike in oil prices remains a concern as the supply-demand balance tightens further and geopolitical uncertainties persist, but high oil prices alone are not expected to destabilize growth. A prolonged and sustained rise in inflation, possibly resulting from a further surge in oil prices, could lead to sharply higher global interest rates. In the financial markets, a disorderly realignment of the major currencies could dampen trade and investment flows. However, thus far, the international financial system and markets have shown an improved capacity for orderly recycling of capital flows. In addition to these concerns, the spread of avian flu could also alter the global and regional prospects. Nevertheless, following the experience with SARS, regional countries are better prepared in coping with the threat.

East Asian Economies

In line with the expected pick-up in world trade and continued favourable global environment, the projection is for growth in the East Asian region to be sustained at a strong pace of 7.0-7.2%. Growth will be supported by the recovery in the electronics sector and continued strength in domestic demand. PR China's growth is expected to remain strong based on the favourable export sector and government measures to rebalance growth by promoting rural development and private consumption. Growth in the other Asian countries is also projected to improve following a more positive outlook of the export sector, strengthening fundamentals and prospects for higher investment.

In the external sector, the global electronics cycle is expected to trend upwards after reaching its trough in mid-2005, sustaining a stronger growth in regional exports. The recovery is expected to be broad based, emanating from stronger demand for major end-products such as consumer electronics, PCs, mobile phones and display devices. Similarly, regional trade is poised to gain from a firmer recovery and increasing openness of the domestic market in Japan.

In the domestic sector, aggregate demand remains stable, underpinned by favourable economic fundamentals amid continued strong growth. The rise of a younger generation with high discretionary spending power and strong taste for consumer electronic gadgets will drive consumption further. Private demand will also benefit from the rise of a modern retail sector characterized by large global retail giants in response to changing spending patterns. Other positive developments include the huge potential in

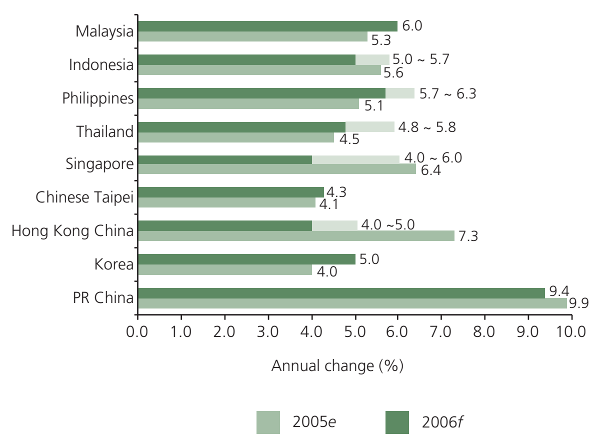
A robust growth of 7.0-7.2% is projected for the East Asian economy, based on a stronger recovery in the global electronics cycle and continued strength in domestic demand.

tourism following rising income, large untapped markets, notably PR China and India as well as the proliferation of budget airlines. For some countries, rising worker remittances have been positive in supporting spending, reducing poverty and facilitating development in home countries. While investment rates in many countries remain low, recent signs suggest a pick-up in investment trends. These include high capacity utilisation, growth in import of capital goods, investment plans to increase infrastructure spending, revival of the property sector and continued FDI inflows.

In 2006, the **Asian Newly Industrialized Economies (NIEs)** as a group is projected to record a real GDP growth of 4.6-4.9%, supported by continued strength in domestic demand and stronger exports. Export growth is expected to strengthen in response to further recovery in the global electronics sector.

The **PR China** will continue to drive growth in the region, with an expected real GDP growth of 9.4% in

Graph 3.2
Regional Countries: Real GDP Growth



e Estimate
f Forecast

2006. While exports will remain a key driver, domestic demand will play an increasing role in the economy. In particular, favourable tax policies such as income tax reform and removal of agriculture tax, and other supportive measures are expected to boost consumption. Furthermore, rural development is projected to accelerate, with the implementation of PR China's 11th Five-Year Programme beginning in 2006. However, concern remains over a rebound in the growth of fixed asset investments and an overcapacity in several sectors, despite policy-cooling measures.

In **Korea**, real GDP is projected to expand at a stronger rate of 5% in 2006. Economic expansion is expected to be propelled by exports and the revival of domestic demand. Recovery in private consumption is expected to continue, benefiting from further progress in restructuring of household balance sheets, positive wealth effects from a rising stock market and strengthening consumer confidence.

Growth is forecast to be at 4 - 5% in **Hong Kong SAR**, led by exports and private consumption. A strong labour market and rising wages as well as an improving housing market are expected to underpin consumer spending, mitigating the negative impact of higher interest rates. Meanwhile, **Chinese Taipei**'s real GDP growth is expected to pick up to 4.3%, reflecting higher exports and steady domestic consumption. Export performance will likely improve in 2006 due to an upturn in the technology sector and the continuing strength of US and Chinese demand.

In **Singapore**, growth is expected to reach 4 - 6%, supported by strong global demand for electronics and an improvement in the labour market, higher asset prices and sustained tourist arrivals. In terms of industrial origin, the manufacturing sector is projected to be boosted by new capacity coming onstream in the pharmaceutical industry. The building of the integrated resorts, new financial centre and the revamp of shopping areas are expected to spur growth in construction activity, its first expansion in seven years.

The **ASEAN-4**[1] economies as a group are expected to grow by 5.3 – 5.9% in 2006. Growth in **Indonesia** is expected to moderate slightly within the range of 5 – 5.7%. Consumer spending will remain supported by stable employment and rising disposable income amid higher inflation and interest rates. Another key growth factor is the pick-up in investment, following measures to support infrastructure spending and continued progress in reforms in the regulatory framework and tax law to improve the investment climate. In **Thailand**, real GDP growth is expected to remain around 4.8 – 5.8%. Economic expansion will be supported by the recovery of the global electronics industry, together with prospects of higher agricultural exports following improved weather conditions and a recovery in tourism. Meanwhile, investment is also expected to pick up with the implementation of mega projects over the next few years. Meanwhile, real GDP growth in the **Philippines** is projected to expand by 5.7 – 6.3%. Agricultural output is expected to recover from the droughts last year, while private consumption is expected to be sustained by strong inflows of remittances from overseas workers. The fiscal gap is projected to narrow further to 2.2% of GDP in 2006 following the introduction of the expanded value-added tax.

While high oil prices remain a concern, its impact thus far on the region has been modest. However, inflationary pressures remain due to the potential pass-through from stronger producer price index (PPI) especially in the ASEAN countries. In addition, despite some recent price increases, the pass-through from higher oil prices remains incomplete in a number of regional countries that offer fuel subsidies.

The growth outlook in 2006 is also subject to the risk of an avian flu pandemic. The overall economic impact is expected to be small if the epidemic is contained, as the poultry sector accounts for a small share of GDP in the affected countries. However, there are concerns that the strain of flu might mutate into a form in which human-to-human transmission occurs and cause human casualties and other economic costs. Its impact on regional growth could be significantly greater than Severe Acute Respiratory Syndrome (SARS) in view of the higher mortality rate and the prevalence across wider geographical areas. In the event of a pandemic, countries with higher degree of trade openness, dependence on tourism as well as population density will be most affected.

Interest Rates and Exchange Rates

In 2005, **monetary policy** in the major industrial countries remained accommodative. In view of sustained economic growth and an upturn in inflation caused primarily by higher energy prices, several central banks initiated consecutive increases in interest rates from low levels towards a more neutral stance.

In the US, against the backdrop of robust growth and concern on inflationary pressures, the **US Federal**

[1] Refers to Indonesia, Thailand, Malaysia and the Philippines.

Reserve Board (Fed) raised interest rates eight times by 25 basis points each time during the year, bringing the Fed funds rate to 4.25% by year-end. In its December statement, the Fed dropped the often repeated phrase 'accommodative' in its policy statement, thus signaling that rates have risen closer to neutral levels from the low of 1% since mid-2004. In the euro area, the **European Central Bank** raised interest rates by 25 basis points to 2.25% in December 2005 amid expansions in the money supply and credit growth to the private sector. In contrast, in the UK, slower consumer spending amid a weaker housing market led the **Bank of England** to lower interest rates in August 2005 by 25 basis points to 4.50%.

Throughout 2005, with official short-term interest rates (uncollateralized overnight call rate) in Japan at around zero percent, the **Bank of Japan (BOJ)** continued to use quantitative easing measures, introduced five years ago, to inject liquidity into the banking system in order to counter deflationary pressures. As at end-2005, the quantitative easing target for current account balances of the commercial banks and financial institutions held at the BOJ stood between 30–35 trillion yen (2001: 6 trillion yen).

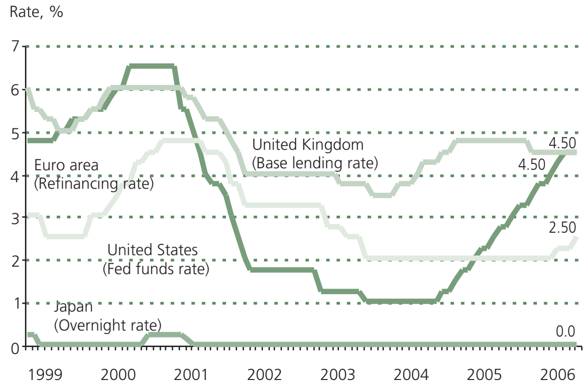
During the year, regional countries have raised interest rates broadly in line with global developments. While rate hikes vary across countries, the moves were aimed at containing inflationary pressures and limiting second-round effects in the face of rising oil prices as well as removal of fuel subsidies. Countries that have raised rates include Indonesia, Thailand, India, Philippines and Chinese Taipei while Singapore maintained its policy of a `modest and gradual appreciation' of the Singapore dollar.

In **2006**, the timing and magnitude of monetary policy actions would depend on country-specific factors, including the strength of economic growth, inflationary expectations, movements in exchange rates and the performance of the financial markets.

In the **foreign exchange** markets, during the course of 2005, the US dollar appreciated strongly against three major currencies, notably the euro, pound sterling and yen, reversing the depreciation recorded in 2004. The main factors that contributed to the US dollar strength were the yield differentials in favour of the US dollar and the relatively stronger economic performance in the US.

Overall, measured on a trade-weighted basis[2] , the US dollar appreciated by 3.5% in 2005. Specifically, the appreciation was most prominent against the euro (10%), pound sterling (13%) and the yen (13%). The double-digit

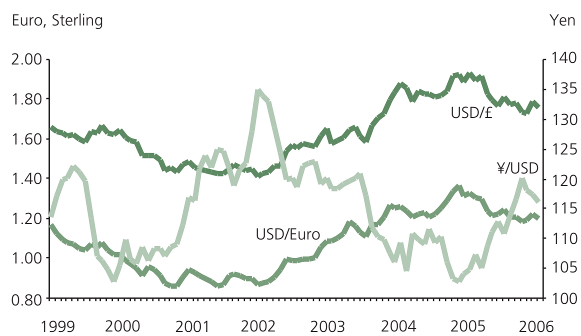
Graph 3.3
Major Industrial Countries: Official Interest Rates



rate of appreciation recorded by the US dollar against the three major currencies was the strongest since 1999. Against the backdrop of a stronger US dollar, the euro ended the year at E1=USD1.1849 while the yen ended the year at USD1=¥117.75. The depreciation of the yen was also further affected by the strong resident outflows following increased risk appetite for foreign financial assets as investors' confidence rose with continued recovery in the Japanese economy.

In the Asian region, while the exchange rate performance was mixed, regional currencies continued to display increased flexibility against the US dollar. Among regional currencies, the Philippine peso recorded the strongest appreciation of 6% against the US dollar, supported by record inflows of remittances and an improvement in the country's fiscal position. The Korean

Graph 3.4
Movement of the US Dollar against Major Currencies



[2] US Federal Reserve Board's broad nominal index.

won and the RMB appreciated by about 2.6% and 2.5% against the US dollar respectively. For the RMB, after the initial 2.1% appreciation following the change in the exchange rate regime, the RMB gained a further 0.5%. The other regional currencies, however, depreciated against the US dollar, with the Indonesian rupiah recording the largest depreciation of 6%.

In **2006**, the movement of the US dollar against the three major currencies is expected to be driven by a number of factors. These include investors' perception on interest rate differentials and growth performance, the path of adjustment of global imbalances, performance of the equity and bond markets, and global asset reallocation among the major currencies. In addition, country-specific issues that relate to inflationary trends and geo-political risk premiums could also affect sentiments on the major currencies.

MALAYSIAN ECONOMY IN 2006

The Malaysian economy is expected to strengthen further in 2006. Real GDP is projected to grow at a faster rate of 6%, driven by strengthening exports and resilient domestic demand. The global semiconductor upcycle, sustained global growth and higher prices for primary commodities are expected to have positive effects on exports, as well as private consumption and investment.

Growth is expected to strengthen further in 2006. Underpinned by strengthening exports and resilient domestic demand, real GDP is forecast to expand at a faster rate of 6%. The private sector would provide the main impetus to growth for the fourth consecutive year.

Current indicators suggest that the upturn in the global semiconductor industry, which began in the second half of 2005, would gain momentum in 2006. Malaysia is expected to benefit from this favourable development with a stronger growth in manufactured exports, particularly in the computer and semiconductor segments. Domestic demand would be driven by the private sector for the fourth consecutive year as household spending remains an important source of growth. Equally significant, the continued expansion in private investment would ensure the long-term sustainability of growth by expanding the stock of productive capital. In this regard, efforts will be intensified to enhance the contribution of private investment to growth.

The Government will continue to focus on strengthening the fiscal position with the ultimate aim of supporting economic growth without compromising long-term fiscal sustainability. In 2006, prices are expected to increase, driven largely by cost-push factors. Nevertheless, inflation is expected to remain at manageable levels during the year as capacity expansion and productivity improvements in the domestic economy will help contain price pressures. Monetary policy will, therefore, remain supportive of growth. While downside risks remain, the strong macroeconomic fundamentals and diversified economic structure will provide economic resilience.

Domestic Demand

The factors that supported domestic demand in 2005 are expected to continue to provide further stimulus in 2006. Aggregate domestic demand is projected to increase further, by 5.9% in 2006, with private sector expenditure remaining the main driving force. **Private consumption** is expected to increase by 6.8%, exceeding the overall growth rate for the seventh consecutive year. Consumers are expected to benefit from higher income following the expected improvement in the economy and employment conditions, as well as higher primary commodity prices. While interest rates have risen, the ability of households to borrow has not been impaired as rates continue to remain at low levels. Further, although household debt has been on an increasing trend, the ability of the household sector to service its debt remains sustainable amidst continued growth in household disposable income. Malaysia's relatively large young working population with higher propensity to consume will further underpin consumer demand. Therefore, consumption growth is expected to be driven mainly by income growth and demographic factors, with credit conditions playing a supportive role. Notwithstanding the sustained high consumption growth, Malaysia's nominal private consumption-to-GDP ratio (43.7%) continues to be one of the lowest in the world. These indicators point to sustained increases in private consumption.

While private consumption is an important source of growth in domestic demand, **private investment** is playing an increasingly strong supportive role in sustaining economic growth over the longer term. In 2006, favourable external and domestic demand would provide the impetus for private investment to grow by 10%. Given the steady improvement in corporate balance sheets, firms would continue to be able to fund

While private consumption remains an important source of growth in domestic demand, growth in private investment will be broad-based, across most sectors of the economy.

their investment activities by using internally generated funds. In addition, conditions in the financial markets continue to remain conducive for firms to use leverage or tap the capital market to fund their investments. In view of the long-term importance of private investment, efforts have been undertaken to further enhance the contribution of private investment to growth. The Government continues to place emphasis on improving the public sector delivery system and has taken measures to reduce cost of doing business. Investment incentives are customised to attract investment from high technology and knowledge-intensive industries, particularly in the new growth areas within the agriculture, manufacturing and services sectors. Greater emphasis has also been given to human resource development to meet the requirements of these new industries. Recognising the increasingly competitive global environment, the Government has also intensified the promotion of domestic investment, particularly investment by the SMEs.

Private investment growth is expected to be broad-based in 2006, with the bulk of the expenditure expected in the manufacturing and services sectors as well as in the oil and gas industry. Capital spending in the manufacturing sector, which accounts for a third of total private investment, is expected to register a strong growth, supported by the upturn in the semiconductor industry and the high capacity utilisation in the sector. Manufacturing firms, particularly from the E&E and chemical and chemical products industries, are expected to raise investment to improve efficiency and increase productivity to meet the stronger demand. In addition, the Government's emphasis on high technology and higher-skilled projects is expected to increase investment in high value-added projects. The sustained high capital intensity ratio of manufacturing projects approved in these recent three years, which averaged RM324,136 (2000-2002: average of RM315,249), is reflective of this continuous shift towards higher value-added production.

In the services sector, stronger investment is expected from the telecommunications, transportation and utilities sub-sectors. In the telecommunications sub-sector, private cellular operators are expected to continue investing to enhance network capacity and to intensify provision of broadband facilities due to the expected rise in demand for 3G services. Meanwhile, capital expenditure in the transport services industry is also expected to increase, mainly due to the continuation of the airlines' fleet expansion programmes and the development of port facilities. In the utilities sector, capital expenditure is

Table 3.2
Real GDP by Expenditure (1987=100)

	2005*p*	2006*f*	2005*p*	2006*f*
	Annual change (%)		Contribution to real GDP growth (percentage point)	
Domestic demand[1]	**7.3**	**5.9**	**6.6**	**5.5**
Private sector expenditure	9.5	7.4	5.7	4.6
Consumption	*9.2*	*6.8*	*4.5*	*3.4*
Investment	*10.8*	*10.0*	*1.2*	*1.2*
Public sector expenditure	3.1	3.0	0.9	0.9
Consumption	*5.9*	*3.2*	*0.9*	*0.5*
Investment	*0.4*	*2.7*	*0.1*	*0.4*
Change in stocks			**-2.9**	**1.0**
Net exports of goods and services	**19.3**	**-5.4**	**1.5**	**-0.5**
Exports	8.4	8.9	9.8	10.7
Imports	7.6	10.0	8.3	11.2
Real Gross Domestic Product	**5.3**	**6.0**	**5.3**	**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 expected to remain high due to the ongoing improvement of water treatment and distribution plants as well as the development of power plants, which will come on stream within the next two years.

Investment in the mining sector is expected to increase strongly, attributable to higher capital spending by the private oil companies operating in Malaysia. While spending on exploration and survey are mainly led by the companies involved in deepwater and ultra deepwater discoveries, companies involved in non-deepwater discoveries are moving from exploration activities to development activities and the setting up of production facilities. Meanwhile, capital expenditure in the construction sector will be supported by the ongoing construction of privatised roads and residential projects.

In 2006, a modest increase in public sector expenditure is expected when the implementation of the Ninth Malaysia Plan commences in April 2006. **Public consumption** is expected to increase moderately by 3.2%, due mainly to higher expenditures on supplies and services to further improve the public sector delivery system to support private sector activities. Prudent expenditure management by the Government has provided the flexibility to focus on developmental efforts in both the rural and urban areas. The largest allocation of development expenditure in 2006 has been for the economic sector, namely the development and improvement of agriculture, industry and infrastructure sectors, to achieve balanced and comprehensive economic development. Meanwhile, the provision of better essential services, such as education, healthcare and housing, remains the main agenda of development in the social sector. The capital outlays by the NFPEs are expected to increase further in 2006, albeit at a slower rate, following the strong expansion a year earlier. The bulk of the capital spending would be undertaken by the three largest NFPEs, namely Petroliam Nasional Berhad (PETRONAS), Tenaga Nasional Berhad (TNB) and Telekom Malaysia Berhad (TM). With new discoveries of oil and gas fields in recent years and new production sharing contracts signed, PETRONAS' capital outlays continue to be dominated by its upstream investment activities. Improvement and expansion of telecommunication infrastructure and power generation and distribution would be the main investment activities for TM and TNB respectively. As a result, **public investment** is projected to increase by 2.7%.

Sectoral Outlook

On the supply side, growth in 2006 is expected to be broad based and balanced, supported by expansion in all sectors of the economy, including construction. About 5.7 percentage points of the 6% GDP growth would emanate from the two key sectors, namely the manufacturing and services sectors, which account for about 90% of the economy. Growth in the manufacturing sector is expected to strengthen in line with the upturn in the global semiconductor cycle, while the services sector is expected to sustain its strong performance supported by higher trade-related activities, and continued increase in consumption and business activities. The commodities sector is expected to see a more broad-based growth, with improvements in the production of rubber, crude oil and the other agriculture segments, while crude palm oil output consolidates after three years of strong performance. The construction sector is expected to register a positive growth in line with the improvement in the civil engineering segment.

Growth in 2006 is expected to be broad-based and balanced, supported by expansion in all economic sectors, including construction.

Value-added growth in the **manufacturing sector** is expected to strengthen to 7% in 2006 (2005: 4.9%). The growth would be led by the electronics and electrical (E&E) segment, and further reinforced by the strong external demand for resource-based products such as chemical, petroleum, and rubber products. In the domestic-oriented industries, the improvement in the construction-related industries would further lend support to the expansion of the sector.

In the E&E sector, the latest assessment is that the recovery in the global semiconductor industry that began since mid-2005 will continue to gain strength into 2006. The view of an up-cycle in the industry is supported by forward-looking

Table 3.3
Real GDP by Sector (1987=100)

	2005*p*	2006*f*
	Annual change (%)	
Agriculture	2.1	2.0
Mining	0.8	5.0
Manufacturing	4.9	7.0
Construction -	1.6	1.0
Services	6.5	6.0
Real GDP	**5.3**	**6.0**

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

indicators such as the improvement in the book-to-bill ratio of semiconductor equipment since March 2005, and the sustained growth in the US new orders and unfilled orders for electronics. Industry experts also share the view that the recovery would be mild and sustained, with the global semiconductor sales projected to expand by 7.9 ~ 9.5% in 2006 and 7 ~ 10.6% in 2007 (2005: 6.8 ~ 7%). The current cycle would be supported by accelerating demand from the Asia-Pacific region, particularly for consumer electronic gadgets and the stronger ICT-related investment in the industrial countries.

The up-cycle in the global semiconductor sector in 2006 is expected to be broad-based, supported by expansion in all product segments, including computers, consumer electronics, communication and the automotive segments. The wider application of chips, particularly in the automotive segment, as well as the higher chip content in electronic devices will further support the global demand for semiconductors. Given Malaysia's competitive strength in the computer and semiconductor segments, Malaysia is poised to benefit from this broad-based growth in 2006. During the year, continued re-investment in E&E and expansion projects undertaken by existing multinational electronics companies in Malaysia would increase the production capacity and enable Malaysia to leverage on the upturn in the global semiconductor industry.

The **services sector** would continue to remain strong in 2006 recording a sustained growth of 6%. During the year, the services sector growth would be led by the intermediate services segment, while the final services segment will expand at a moderate pace in line with the trends in private consumption.

In the intermediate services segment, the expected higher growth in manufacturing exports and intra-regional trade will further strengthen the growth of the transport, storage and communication sub-sector. Of significance, trade-related activities such as logistics and other services allied to transportation such as ports and haulage activities are forecast to support growth in the transport sector. These are also part of manufacturing-related activities that would be given emphasis under the Third Industrial Masterplan, which will be implemented beginning 2006 until 2020. The telecommunications industry, meanwhile, would continue on a sustained strong expansion driven mainly by the cellular segment amidst the increased subscriber base and expansion in third generation (3G) services by the major telecommunication companies.

Meanwhile, demand for trade financing and other types of credit by businesses, especially from the small- and medium enterprises (SMEs) are expected to increase in line with the more robust manufacturing growth and trade activities. The higher lending activities, in addition to innovative financial products and services offered by the banking sector, would result in increased interest and fee-based income. The expected establishment of more Islamic banks and takaful companies during the year would further enhance the growth in the finance, insurance and real estate and business services sub-sector. Efforts by the Government in promoting new areas of growth, such as IT-related services and shared services and outsourcing (SSO) activities, including business process outsourcing, are also expected to yield positive results and contribute to higher growth in the business services segment.

The final services segment is expected to expand at a moderate pace in line with private consumption activities during the year. Nevertheless, tourism activities are expected to gain further momentum amidst the intensification of promotional activities by both the public and private sectors in preparation for the Visit Malaysia Year (VMY) 2007. The Government plans to achieve a target of 17.5 million tourist arrivals in 2006 and more than 20 million tourists during the VMY 2007 (2005: an estimate of 16.4 million). As a result, higher spending by tourists as well as domestic households would support the wholesale and retail trade, hotels and restaurants sub-sector, which is expected to expand at a sustainable rate of 6% in 2006. Consequently, the services sector will continue to be one of the main engines of growth, besides the manufacturing sector, in supporting the overall growth of the economy.

The **agriculture** sector is expected to record a growth of 2% in 2006. Crude palm oil, which accounts for about one-third of the value-add in the agriculture sector, is expected to increase by 1.6% (2005: 7%). Output would be affected by biological yield down-cycle after three successive years of strong output growth. The moderation in output growth is also due partly to expectations of a slower expansion in matured areas (+0.9%; 2005: 5.3%). Nevertheless, output of rubber and other agriculture produce are expected to recover from the weak performance in 2005, which was affected by the poor weather conditions. Rubber production is expected to increase by 2.3% to 1.15 million tonnes in 2006 as smallholders continue to intensify tapping activities supported by the expected strong rubber prices.

In the **mining** sector, growth is expected to strengthen to 5% in 2005, driven mainly by an expected improvement in crude oil output (including condensates:

3.9%, 2005: -4.9%). Growth would also be supported by the moderate increase in natural gas output during the year (6.9%; 2005: 11.3%) as the utilisation rate at the MLNG plants in Sarawak approach close to its installed capacity.

After two consecutive years of decline, the **construction** sector is expected to turn around and register a positive growth of 1%, led mainly by the improvement in the civil engineering sub-sector. The civil engineering sub-sector would be supported by higher construction activity in the oil and gas industry as well as in public projects with the commencement of new projects under the Ninth Malaysia Plan. Meanwhile, the residential and non-residential sub-sectors are expected to expand further supported by the attractive financing conditions and brisk business activities. The residential sub-sector is expected to expand at a moderate rate following the strong expansion in the last few years, while the non-residential segment would continue to improve, benefiting from the favourable business environment which has resulted in high occupancy rates of retail and office space.

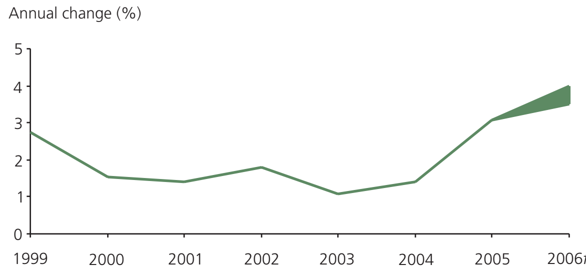
Prices and Employment

The key supply-side factors that have kept inflation up towards the end of 2005, namely the high prices of energy and non-energy commodities are expected to persist in 2006. Cost-push inflation is expected to rise following the increase in the price of petroleum products by the Government on 28 February 2006. Demand pressures could also provide some modest upward impetus to inflation as domestic economic activity is expected to be sustained in 2006. In the absence of further price adjustments, inflation is expected to peak in the first half of 2006. Subsequently, inflation is likely to ease in the third quarter of 2006 following the lapse of the effects of price adjustments that were implemented in 2005. For 2006 as a whole, the average rate of inflation is estimated to be in the range of 3.5% to 4%.

There remains however considerable uncertainty to the inflation outlook with inflation prospects affected by both external influences and domestic cost-push pressures. With no further fuel price increases during the year, the main uncertainty relates to the degree and extent of the secondary effects of the pass-through impact of previous increases in fuel prices that have yet to feed through the supply chain. The sustained high level in international oil prices could put an upward bias on input costs for domestic producers. An upward revision of electricity tariffs would also affect the inflation conditions.

To a certain extent, the upside risks to domestic inflation could be mitigated by the on-going structural improvements in the Malaysian economy. The expansion of capacity by businesses and the continued increase in productivity would augment the output potential of the economy and prevent a tightening in the markets for factor inputs. Sustained competition amongst businesses could also mitigate inflationary pressures.

Graph 3.5
Consumer Price Index



f Forecast

In tandem with the stronger growth of the domestic economy in 2006, growth in **employment** is expected to increase with more job opportunities in most sectors of the economy. Unemployment is therefore, expected to remain low at 3.5%. In addition to the ongoing efforts to improve the productivity of the labour force, the Government would also continue reviewing its policy on labour, with a view to reducing the shortage of skilled workers and closing the gap between the output of the educational system and the requirements of the job market.

Balance of Payments

The balance of payments position is expected to remain strong in 2006 with a continued large **current account** surplus (17.2% of GNP), supported by a strong trade balance. Strong export growth (12.5%) underpinned by continued expansion in manufactured exports, in particular exports of consumer electronics, will contribute to a larger surplus in the trade account. Growth in commodity exports is also expected to be sustained by high prices. In the financial account, the steady inflow of foreign direct investment (FDI) would also strengthen the overall balance of payments.

The growth in **exports of manufactured goods** is expected to strengthen to 12% in 2006 (2005: 10.1%) as the E&E sector rides on the upturn in the global semiconductor industry. Exports of E&E would be supported by the strong global demand for

The current account surplus is expected to remain large, supported by a strong trade balance. FDI inflows are expected to increase, supported by stronger demand arising from the high capacity utilisation rate as well as investments in new industries. Reflecting a greater interest by companies to diversify abroad, overseas investment by Malaysian companies is also forecast to increase in 2006.

computers, particularly for mobile computers with wireless functions, as well as the expected improvement in global semiconductor demand arising from wider applications of chips in various segments. At the same time, exports of resource-based products such as chemicals, rubber and petroleum products are also expected to perform favourably, expanding at a strong pace underpinned by the firm global demand as well as higher prices in line with the expected increase in commodity prices during the year.

Table 3.4
Balance of Payments

	2005*e*	2006*f*
	RM billion	
Goods	126.5	138.4
Trade account	99.8	108.3
Exports (% annual change)	*11.0*	*12.5*
Imports (% annual change)	*8.5*	*13.4*
Services	-10.2	-10.3
Balance on goods and services	**116.2**	**128.1**
Income	-21.5	-23.7
Current transfers	-17.0	-15.0
Current account balance	**77.8**	**89.4**
% of GNP	**16.4**	**17.2**
Financial account	-42.0	-
Errors and omissions	-23.0	-
of which:		
Foreign exchange revaluation loss	*-15.5*	-
Overall balance	**12.8**	**-**

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

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The increase in commodity prices would also be reflected in higher export receipts from **agricultural commodities**, which is expected to record a double-digit growth of 10.5% in 2006 (2005: 3.4%). Receipts from palm oil exports are expected to increase by 6.3% (2005: -5.3%) amidst the higher export price of RM1,550 per tonne in 2006 (2005: RM1,456). The increase in price would be mainly demand-driven, supported by higher global demand, particularly from new users for palm-based biodiesel, as well as from traditional buyers. The expected higher demand from PR China is also encouraged by the abolition of the import quota on palm oil and a standardized import duty structure for all edible oils beginning 1 January 2006. Similarly, growth in exports of rubber is expected to strengthen further by 21.6% (2005: 11.3%) benefiting from a significant increase in rubber prices (620 sen per kilogramme; 2005: 513 sen per kilogramme). The strong outlook for rubber prices in 2006 is a result of expectations of continued strong demand, particularly from PR China; constraints in global natural rubber output; and the impact of strong crude oil prices on the price of synthetic rubber, which is a petrochemical product. For the first two months of 2006, the price of SMR20 increased by 46.2% to average 683 sen per kilogramme.

Mineral exports are expected to expand further by 18.6%, due to higher receipts from crude oil (including condensates) and liquefied natural gas (LNG). The increase would be supported by higher prices as well as an increase in volume, in line with the expected increase in production of these commodities. For the year as a whole, the export price of Malaysian crude oil is projected to average USD62 per barrel (2005: USD55.93 per barrel), or 10.9% higher from the level in 2005. In the first two months of 2006, the price of the Malaysian Tapis Blend had averaged USD65.40. Crude oil prices would continue to be influenced by fundamental factors as the gap between global supply and demand narrows further amidst the improved global outlook. Sentiment on oil prices would also be affected by geopolitical factors that may disrupt global supply. Similarly, in line with expectations of higher energy prices in the global market, LNG export prices are projected to rise further to RM1,120 per tonne (2005: RM947 per tonne). Amidst the higher prices, and an increase in demand from PR China, India and the United States, LNG exports are estimated to increase by 24.6%.

Import growth (13.4%) is expected to emanate from higher imports of intermediate goods, consonant with

Table 3.5
Exports and Imports

	2005*p*	2006*f*
	RM billion	
Gross exports	**533.8**	**600.6**
(% annual change)	***11.0***	***12.5***
Manufactures	**429.9**	**481.4**
(% annual change)	*10.1*	*12.0*
of which:		
Electronics	208.2	235.1
(% annual change)	*10.4*	*12.9*
Electrical products	74.5	84.7
(% annual change)	*8.9*	*13.6*
Chemicals & chemical products	29.7	32.6
(% annual change)	*7.0*	*9.6*
Minerals	**52.3**	**62.0**
(% annual change)	*27.1*	*18.6*
Agriculture	**37.4**	**41.3**
(% annual change)	*3.4*	*10.5*
Gross imports	**434.0**	**492.3**
(% annual change)	***8.5***	***13.4***
Capital goods	**60.7**	**67.7**
(% annual change)	*9.5*	*11.5*
Intermediate goods	**308.3**	**351.8**
(% annual change)	*7.2*	*14.1*
Consumption goods	**24.6**	**26.1**
(% annual change)	*5.9*	*6.0*

p Preliminary
f Forecast

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

the forecast of stronger production and exports of the manufacturing sector, in particular, the electrical and electronic segment. Capital imports are expected to strengthen (11.5%) in line with capacity expansion in the manufacturing, services and oil and gas sectors. Higher capital imports in the services industry is expected to be led by enhancement in network capacity by telecommunications companies and the expansion of investment activities by the airlines and shipping companies. Increased exploration and production activity in the oil and gas industry following the discovery of new fields will also result in an increase in capital imports.

The **services account** deficit is expected to be sustained at 2% of GNP. Outflows in the transportation account would be higher, in line with higher volume of trade. Meanwhile, tourism earnings would continue to remain as the largest contributor to services earnings. The improvement in the other services deficit is expected to emanate from exports of communications, business and computer and information services. Higher receipts from computer and information services are consonant with the increasing trend in outsourcing activities, provision of group support and back-office processing services.

The **income account** deficit is projected to be sustained at 4.6% of GNP. The deficit is attributable to higher profits and dividends accruing to multinationals from their investments in Malaysia, in line with the strong export performance of the electrical and electronics industry as well as the oil and gas industry. Profits and dividends accruing to Malaysian companies investing abroad are also expected to be higher. Malaysian companies with investments in the oil and gas, plantation, infrastructure and utilities sectors are expected to provide a higher contribution to income inflows.

The **financial account** is expected to improve, supported by long-term capital inflows, particularly FDI. FDI is expected to increase, with a large portion continuing to be in the form of reinvestment by the existing MNCs in Malaysia. Following the higher level of FDI approved by MITI in 2005 (RM17.9 billion; 2004: RM13.1 billion), particularly from the US, Japan and Singapore, FDI in the manufacturing sector is projected to increase, with the implementation of projects mainly for higher-end electrical and electronic activities. Similarly, investment in the services sector is expected to remain high, supported by further liberalisation and entry of new players in the finance, insurance, real estate and business services sub-sector, as well as the expansion of operations in the wholesale and retail trade, hotels and restaurants sub-sector. Meanwhile, the oil and gas sector will continue to receive sizable inflows, mainly for extraction and production activities, following several discoveries of new oil fields.

Investment abroad by Malaysian companies is expected to increase further in 2006 as companies diversify and position themselves globally to provide greater synergy to their corporate activities. These investments will continue to be broad-based, and channelled into the oil and gas, manufacturing, utilities, construction, and services sectors.

MONETARY POLICY IN 2006

Monetary policy in 2006 would continue to emphasise economic growth in an environment of price stability. The thrust of macroeconomic policy is thus to provide a supportive environment to promote a sustainable level of economic activity in the medium term.

Economic growth prospects for the global and regional economies are expected to remain bright despite high oil and commodity prices. This is expected to be further reinforced by the strengthening of the global electronic up-cycle. The expansionary impact from the external sector on the Malaysian economy is expected to remain strong. Building on the momentum gained in the second half of 2005, GDP growth is expected to improve further in 2006. Stronger export performance is expected to sustain domestic consumption at a strong pace while the favourable external and domestic demand conditions would in turn provide further impetus for increased investment activity.

With the economy poised to register a firm performance, the main challenge for monetary policy in 2006 is to ensure that price expectations are well contained, while financing conditions are supportive of investments. The prospects for inflation would depend on several factors, both foreign and domestic. On the international front, the direction of international oil prices will continue to be a major concern. To date, the subsidies on fuels and energy products have somewhat sheltered the economy from the full impact of global oil price shocks. While there would be no further fuel price increases during the year following the recent adjustment to fuel prices, some uncertainty remains on the degree of the second round impact on the general price level. The sustained high level in international oil prices could put an upward bias on input costs for domestic producers. However, factors such as capacity expansion and continued improvements in productivity by businesses, as well as sustained competition amongst firms are expected to mitigate inflationary pressures somewhat. Taking these factors into account, inflation pressures in Malaysia are expected to remain manageable, with the inflation rate projected to average between 3.5% to 4% in 2006.

To align monetary conditions to the current environment, the OPR was raised by 25 basis points to 3.25 percent on 22 February. The Bank will continue to conduct monetary policy in a manner that will constantly balance the need to rein in inflationary expectations while remaining supportive of growth. Monetary policy would thus respond to new developments, both domestic and international, that would have implications for the medium-term prospects for price stability and sustainable economic growth.

The shift to a managed float exchange rate regime does not entail a change in the monetary policy framework or operations. Monetary policy remains focused on domestic considerations with the OPR as the signaling mechanism to achieve policy objectives. Interest rates, therefore, will not be used as an instrument to influence capital flows or the exchange rate. Notwithstanding the two-way intervention operations to smoothen exchange rate volatility and excessive exchange rate movements induced by large short-term capital flows, the Bank would allow the ringgit exchange rate to be determined by economic fundamentals and market conditions. This is consistent with the stated exchange rate policy objective of ensuring that the ringgit does not become overvalued or undervalued in a sustained manner.

As in 2005, the Monetary Policy Committee (MPC) is scheduled to meet eight times this year, with the option to hold additional meetings when necessary. The calendar for the MPC meetings, together with the associated schedule of releases for the Monetary Policy Statement, was published on the Central Bank website in December 2005. The Bank will continue to undertake additional initiatives in 2006 to enhance communication in promoting greater understanding of the objectives, processes and conduct of monetary policy.

FISCAL POLICY IN 2006

The 2006 Budget is the first annual Budget for the Ninth Malaysia Plan (2006-10). Fiscal policy in 2006 will thus focus on initiatives to generate greater quality growth in the near term to provide a strong foundation for long-term sustainable growth. The 2006 Budget put forth various measures to enhance national resilience and the ability to meet emerging external challenges arising from rising oil prices, higher global interest rates and increasing global competition.

The 2006 Budget projections were broadly in line with the Government's prudent fiscal stance. With the economy regaining its growth momentum, the Federal Government's overall financial position is expected to strengthen further in 2006. The fiscal deficit has been budgeted to reduce further to RM18.4 billion or 3.5% of GDP from 3.8% in 2005. In addition, after taking into account the potential net revenue loss of RM1 billion arising from tax measures announced in the 2006 Budget, the fiscal deficit will be at RM19.4 billion or 3.6% of GDP.

Total Federal Government expenditure (excluding contingent reserves) was budgeted at RM134.7 billion, representing a moderate increase of 5% from the actual 2005 expenditure (2005: +6.8%). In terms of development expenditure, special attention

Table 3.6
Federal Government Finance

	RM billion		% change	
	2005*p*	2006*B*	2005*p*	2006*B*
Revenue	106.3	114.6[1]	6.9	7.8
Operating expenditure	97.7	101.2	7.1	3.6
Current account	**8.6**	**13.3**		
Gross development expenditure	30.5	33.5	5.8	9.7
Loan recoveries	3.3	0.7		
Overall balance	**-18.7**	**-19.4**		
(% of GDP)	**-3.8**	**-3.6**		

[1] Includes net revenue loss of RM1 billion arising from the tax measures announced in the 2006 Budget.
p Preliminary
B Budget
Note: Numbers may not add up due to rounding.

was given to both the economic and the social sectors in an effort to reduce income disparities between the rural and urban areas. In addition to improving the efficiency and effectiveness of the public delivery system, the Government introduced several measures to stimulate private investment, including enhancing the business-friendly environment through wide-ranging tax and non-tax measures to improve business competitiveness; diversify sources of growth into new areas that have high growth potential; augment human capital development; further develop the capital market as well as strengthen the development of small and medium-sized enterprises. Key measures announced in the 2006 Budget are summarised in the white box.

The Government's primary objective for fiscal policy continues to be to ensure a sound and sustainable Federal Government financial position over the medium term. The focus would be on maintaining the fiscal deficit at an appropriate level where a balance between sustaining economic growth and preserving long-term fiscal sustainability is achieved.

Key Measures Announced in the 2006 Budget

Policy area	Measures
First Strategy: Implementing Proactive Government Measures to Accelerate Economic Activity	
Improving further the Government's delivery and procurement systems	• Allow financially autonomous statutory bodies to determine their own schemes of service. • Expedite the issuance of visas, particularly for knowledge workers and professionals in the fields of ICT and financial services. • Expand the use of ICT to facilitate dealings between the public and Government. • Introduction of new modalities of the Government procurement system in efforts to reduce cost, enhance transparency and ensure value for money.
Second Strategy: Providing a Business-Friendly Environment	
Reducing cost of doing business	• Provide group relief to all locally incorporated resident companies. • Allow accumulated losses and unabsorbed capital allowances during the pioneer period be carried forward. • Treat income of investment holding company listed in Bursa Malaysia as business income. • Allow estimated losses on low-cost houses to be offset against estimated profits of other real property development projects.
Strengthening the capital market	• Exempt stamp duty and real property gains tax on mergers and acquisitions of companies listed on Bursa Malaysia. • Allow tax deductions on legal, valuation and consultancy expenses incurred in the establishment of Real Estate Investment Trusts. • Allow tax deductions for discounts on an accrual basis until the maturity of the bonds for corporate issuing bonds.

Modernising the agriculture sector	• Increase Fund for Food by RM300 million. • Establish a new company to develop forest plantations commercially. • Khazanah Nasional to establish the National Agriculture and Food Corporation with a capital of RM500 million.
Developing the ICT and biotechnology sectors	• Set up the Malaysian Life Sciences Capital Fund, with RM100 million from the Government. • Extend tax incentives to qualifying companies operating outside MSC.
Others	• Reduction of 50% for stamp duty charged on loans of up to RM1 million taken by small and medium-sized enterprises (SMEs). • SME Bank to set up a venture capital fund of RM1 billion to finance SMEs. • Establish Bumiputera property trust foundation, Yayasan Amanah Hartanah Bumiputera with an initial capital of RM2 billion.
Third Strategy: Developing Human Capital	
Intensifying human capital development	• Automatic child relief for each child studying in local or recognised institutions of higher learning. • Extend the child relief to disabled child pursuing tertiary education. • Extend the scope of individual tax relief of RM5,000 for further education to professional courses, accountancy and law. • Allow tax deductions on expenses incurred for development and regulatory compliance of new courses by IPTS. • Double deduction to public listed companies on the allowances paid to participants under the Unemployed Graduates Training programme.
Fourth Strategy: Enhancing the Well-Being and Quality of Life of the Rakyat	
Reducing financial burden of Malaysians	• Reduction of road tax by 40% for private diesel vehicles exceeding 1,600 cc, except in Sarawak.
Others	• Allow husband and wife to each claim one property for exemption of Real Property Gains Tax. • Increase tax rates on liquor and cigarettes. • Extend tax incentives to companies providing energy conservation services.

FINANCIAL SECTOR POLICY IN 2006

Against the background of ongoing evolution and developments that are shaping the financial landscape and challenges brought about by economic and financial liberalisation, the thrust of policies for the financial sector in 2006 will focus on further strengthening the role, capacity and contribution of the financial sector in the economic transformation and, hence, the successful realisation of strategies outlined in the Ninth Malaysia Plan. Specifically, policies will be geared towards preserving the stability that has been sustained over the years by further strengthening institutional and systemic resilience and competitiveness, maintaining an efficient and effective financial infrastructure, and promoting a conducive regulatory and supervisory environment that fosters a progressive, dynamic and resilient financial system. These efforts will be complemented by the ongoing consumer education initiatives and protection framework to ensure well-informed and empowered consumers as well as fair and equitable financial dealings amidst a stable socio-economic environment. Of equal importance, particularly in light of the structural changes that are taking place in the domestic economy, emphasis would also continue to be accorded to further improving the efficiency of accessibility of various segments in the economy to financing to be able to contribute effectively to the economic development and transformation.

With the Financial Sector Masterplan already in its second phase, the locally-incorporated foreign banks (LIFBs) are expected to become more integrated within the domestic economy to meet the growing requirements of the banking public. The operational flexibility accorded to the LIFBs through the establishment of additional branches would enhance accessibility of banking services to larger segments of society including those outside the urban areas. The operational flexibility will also allow the LIFBs to better understand the requirements of the different segments of the economy thereby enabling them to play a more direct role in economic development. At the same time, the expanded network of the LIFBs would also provide the public with a broader range of products and services. As the LIFBs begin to operationalise the new branches, the Central Bank will monitor their contribution and effectiveness.

While the progress in the area of capacity and capability building has thus far been commendable, the development of a pool of talented and skilled personnel remains a priority. With the pace of evolution in the financial sector becoming faster and that there is growing demand for differentiated and more complex financial instruments by the economy, the need for the financial sector to have the intellectual and competent human resources becomes even more critical, not only in meeting these demands but in ensuring the ready availability of best talents and high calibre professionals to drive the banking industry forward. Investment in such talents will create value and improve the performance of the institution. While there is a shortage in such talents in Malaysia, in view of the fast pace of developments, the advanced financial systems and markets around the world have nurtured specialists in various aspects of banking operations. To enable the Malaysian banking industry to tap these foreign talents to strengthen the domestic industry and nurture domestic capabilities, especially in newly emerging areas, review is already underway to provide amongst others greater flexibility for banking institutions in the employment of such expertise.

The emergence of investment banks is envisaged to pave the way for further development and maturity of the Malaysian capital market. While the development will create new business opportunities, particularly cross-border activities, new risks and challenges can be expected to emerge. Given the nature of investment banking activities, efforts in 2005 have been focused towards the harmonisation of regulations and the emplacement of a mechanism for regulatory and supervisory coordination and cooperation between Bank Negara Malaysia and the Securities Commission in order to alleviate overlaps in functions and to ensure consistency in policies and regulations for the investment banks. As these have already been completed, policy initiatives in 2006 will focus on the operationalisation of the investment bank framework. Other than the merchant banks, which are existing players, prospective new players will appear arising from the transformation of universal brokers and discount houses into investment banks. Emphasis will be accorded towards assessing the strength and capability of these new players. Given the rigorous requirements which investment banks have to comply, due diligence examination will be conducted on these prospective players aimed at ensuring that the new players have the pre-requisites to assume their new roles. Apart from increasing competition, it is also envisaged that the entry of new players into the industry will increase staff mobility and thus the need for continuing human resource development. Meanwhile, the integration of the banking and capital market activities under a single entity will entail wider risks that need to be appropriately aggregated and managed in order to ensure financial sector resilience, soundness and stability.

Promoting the soundness and stability of the banking system remains high on the agenda of Bank Negara Malaysia not only for the development of the sector, but also to promote sustained growth in economic activity and national prosperity. In 2005, much emphasis had been directed at promoting sound risk management practices and corporate governance standards within the banking industry. While these efforts will continue to be pursued in 2006, greater attention will be directed towards strengthening institutional capacity of market players to withstand any potential financial shocks or macroeconomic imbalances and to have the agility to embrace future challenges. In order to prepare for this, a survey was carried out in 2005 to assess the state of readiness of the banking institutions to cope with emergencies and unexpected disruptions to their operations. The response and information gathered from this exercise has been beneficial and will be used as input in the formulation of the guidelines on business continuity management for the banking sector due for issuance in 2006. The guidelines aim at reinforcing the importance of sound business continuity management and at ensuring that banking institutions are well-equipped with recovery capabilities necessary for the near or instant continuation of their critical business functions in the event of a major disruption.

In an environment where changes are constantly taking place, the responsibility of maintaining financial system stability is no longer the sole responsibility of the Central Bank. The banking industry, together with its customers, shareholder and other stakeholders are also accountable for their actions and share the task of maintaining stability of the overall system. In realising this objective, the Central Bank has finalised the review of the shareholding policy which is expected to be implemented this year. This policy aims at broadening the role of shareholders in overseeing the performance and behaviours of their institutions and the effectiveness of management in conducting the business in a responsible, efficient and professional manner. It is envisaged that the greater participation of institutional investors in the banking sector will contribute towards further developments of these aspects of the banking institutions.

As the implementation date for the new Basel Capital Accord (Basel II) draws near, consultations and collaborative efforts with the banking industry will intensify, to allow both the regulator and banking institutions to identify and deliberate on critical issues and monitor the preparatory process to ensure the smooth implementation of Basel II. Feedback from the consultations will be used as input to the concept papers on Basel II. Given the complexity and extensiveness of Basel II requirements, a series of concept papers will be issued with the first being on the basic approaches for credit and operational risks.

Malaysia remains committed towards aligning its accounting practices to international standards through the adoption of the new and revised Financial Reporting Standards (FRS). Of significance, is the proposed FRS 139 which specifies new accounting rules on recognition, measurement and classification of financial instruments in the financial statements, rules on asset impairment and provisioning, and new requirements for the use of hedge accounting. The adoption of the FRS 139 would in practice involve a considerable degree of judgement and estimation, complex systems and procedures as well as reliance on internal valuation models by banking institutions particularly for the provisioning and measurement of financial instruments. Hence, the ability of banking institutions in implementing the FRS 139 would depend on their internal capabilities and the availability of the necessary infrastructure to ensure not only that their financial statements continue to portray a true and fair view but are sufficiently credible to be used in the context of supervisory assessment. In this regard, Bank Negara Malaysia will be issuing a guideline that outlines the key capabilities and expectations that must be met by banking institutions prior to the adoption of the FRS 139. The scope of the supervisory expectations includes requirements pertaining to credit review and impairment provisions for effective implementation of provisioning requirements in banking institutions, recognition and de-recognition for sell and buy back agreements (SBBA) and financing sold with recourse under Islamic contracts and fair value option on financial instruments.

Continuous and comprehensive surveillance is immensely crucial to ensure the accurate and timely identification and assessment of financial system vulnerability and fragility. Given the close interconnectivity between the banking sector and the economy, the approach to and scope of surveillance by the supervisors has, in recent years, been broadened to encompass macro and micro surveillance and the assessment of key financial soundness indicators. At the macro level, initiatives will be focused on further enhancing the scope and depth of the surveillance framework by employing a broader range of forward-looking tools for monitoring the financial and economic environment. This involves assimilating developments in the various components in the economy and financial markets with the banking sector and assessing the implications. An area that has gained much attention in recent periods is the growing exposure of the banking sector to the household sector and the rapid increase in household indebtedness. While this development has thus far been within prudential levels, the Central Bank will remain vigilant to ensure the sustainability of the household sector and to preserve financial stability. These include measures to further strengthen the risk management of banking institutions in managing their exposure to this sector, as well as to prevent over-leveraging by households. This is critical to ensure the continued capacity of the household sector in contributing towards sustained economic expansion.

With the ongoing introduction of new financial instruments, the task of ensuring effective surveillance by supervisors becomes more complex and demanding. Going forward, more rigorous surveillance will also have to be undertaken at the institution level. In this regard, the stress test framework will be enhanced to ensure its robustness as a tool in assessing the resilience of banking institutions to a broad range of economic and financial shocks. Anecdotal evidence has suggested that knowledge and understanding of events leading up to crises and instabilities in the past provide invaluable information to supervisors. As such, it is envisaged that with the early detection of emerging vulnerabilities and weaknesses within a banking institution, timely and appropriate intervention should be instituted to preserve the stability of the system.

The growing complexity in the group structure of financial institutions has called for a more holistic supervisory approach to facilitate more accurate assessment of a financial conglomerate's risk exposures and the adequacy of the risk management systems at the group level. Taking into consideration the feedback from the industry following the issuance of the first concept paper, a second concept paper on the framework for the consolidated supervision of financial conglomerates will be issued in 2006.

On the supervisory front, focus will also be accorded to further strengthen the capability and capacity of supervisors to better cope with the changing and more challenging environment in the financial markets and economy. This is particularly important in view of the implementation of the Basel II and as the Central Bank moves towards the adoption of principle-based regulatory framework where judgement will be a key element in the supervision and assessment of the resilience of a banking institution. The rigorousness of the analytical process under the Basel II framework is undoubtedly demanding from the supervisory perspective, particularly in developing the appropriate response and assessment framework on these processes. Supervisory attention will need to ensure that the analytical processes are undertaken to support decision making rather than merely meeting regulatory expectations or according excessive emphasis on validating the detailed quantitative and statistical procedures. It is also critical that supervisors undergo early and rigorous training to accelerate their capacity building efforts to enable the identification of the relevant issues when undertaking the supervisory assessment. In this regard, various initiatives have been put in place to accelerate the training and skill development in 2006.

Enhancement to the consumer education framework and the strengthening of the infrastructure for better consumer protection will remain a priority, both to promote a progressive banking sector as well as to foster public confidence in the financial system. With the growth in complexity of financial products and services, and greater expectation on consumers to take on more responsibility in managing their finances, efforts will continue to be directed towards elevating their financial literacy levels to facilitate more meaningful decisions appropriate to their needs and capacity for risk. More confident and financially savvy consumers will be better equipped to exercise a stronger influence on financial service providers and to drive competition and performance. Significant attention continues to be accorded to promote a higher level of disclosure and transparency as well as comparability of information in the financial system. In this regard, the work on the formulation of a more comprehensive product transparency and disclosure framework will be intensified. In principle, the framework aims at providing consumers with adequate and relevant information to make an informed decision relating to financial products and services. In furthering efforts to strengthen the consumer protection framework, issues relating to market conduct will be greatly emphasised to ensure fair and equitable treatment of all consumers. The establishment of the Credit Counselling and Debt Management Agency (CCDMA) in April 2006 will mark a significant milestone in the development of a comprehensive consumer protection infrastructure in Malaysia. As the growth momentum in household spending and household debt is expected to continue into the future, the CCDMA will provide an important avenue for individuals to seek credit counselling, debt restructuring and settlement services, and obtain financial education from expertise and professionals with regard to the management of their finances and debts.

[Please refer to the box article on the Establishment of the Credit Counselling and Debt Management Agency for details.]

Ensuring the safe and efficient operation of the payment systems will remain a key policy objective. Over the years, the banking industry has progressively introduced several electronic-based retail payment systems, completed the migration of the ATM and credit cards to chip-based infrastructure and leveraged on technology such as mobile telecommunication devices to provide more convenient payment services. Given these achievements, the policy focus in 2006 will be geared towards providing an enabling environment for more electronic payment methods to be introduced, promoting the use of formal payment channels and coordinating industry efforts in the migration to electronic payments. The efficiency in cheque processing will be improved by leveraging on the imaging technology to truncate cheques, thereby reducing the physical handling of cheques in the clearing process. At the same time, measures will be taken to improve the current electronic payment services to encourage the greater use of these electronic payment channels. To promote the use of formal payment channels, banking institutions will be allowed to appoint third party 'collecting agents' to improve accessibility of their remittance services. Similarly, qualified non-banking institutions will also be allowed to offer remittance services. In leading the industry to adopt more cost effective payment methods, a coordinating body will be established to engage the various stakeholders in promoting the migration to electronic means of payments on a nationwide basis. In addition, efforts will continue to be pursued in enhancing industry security standards and establishing mechanisms to effectively mitigate payment risks. With the growth of e-banking transactions, the Internet banking guidelines will be revised to ensure that the industry adopts best practices and devotes sufficient resources in combating cyber crime and digital attacks. Further, a 'payment versus payment' settlement mechanism will be introduced to mitigate the risks associated with inter-bank foreign exchange transactions, particularly for USD and RM trades.

In 2006, the major policy thrust for the Islamic banking sector will concentrate on further strengthening the resilience of the Islamic banking system and expanding the capacity and capability of the Islamic financial institutions. This is in line with the objective of enhancing the integration of the domestic Islamic banking sector with the international Islamic financial landscape, and strengthening Malaysia's position as a leading Islamic financial centre. The regulatory framework for the Islamic financial institutions (IFIs) will be strengthened following the issuance of the Islamic Financial Services Board's (IFSB) standards on capital adequacy and risk management. Islamic financial institutions are required to conform to the new requirements with effect from 1 January 2007. In addition, a framework on the governance of the investment account holders and a revised guideline on corporate governance for the IFIs will be introduced by Bank Negara Malaysia to further reinforce the institutional framework. Other areas that will be enhanced include the legal and Shariah framework, product and market development, and human capital development and consumer education.

The legal and regulatory framework is expected to be strengthened with the tabling of the revised Islamic Banking Act 1983 in Parliament in 2006. Efforts will also be directed at meeting the manpower requirements through the establishment of the International Centre for Education in Islamic Finance (INCEIF) in April 2006. Talent building is one of the key factors identified for the development of innovation in Islamic banking products and services and INCEIF is expected to increase the pool of required talent in the global Islamic financial market. New policies and initiatives will also focus on making the Islamic financial services environment in Malaysia to be more conducive and investment-friendly to the international Islamic financial community. Promotion and marketing efforts will target at attracting funds from individuals and multinational corporations, particularly from the Muslim countries, to use Malaysia as the platform for their investment as well as financing needs.

The thrust of policy for the development financial institutions (DFIs) in 2006 is to further strengthen the capacity and capability of the DFIs towards nurturing and developing efficient, effective and robust DFIs in providing financial and non-financial support to the targeted sectors of the economy. With the completion of the rationalisation exercise involving four DFIs in 2005, initiatives going forward will focus on enhancing the functions and scope of activities of the DFIs in meeting their mandates and the financial and developmental needs of their respective targeted sectors. These, among others, include strengthening their financial capacity as well as broadening the range of products and services offered by the DFIs. Towards this end, further efforts will be undertaken to enhance the outreach and effectiveness of the advisory services provided by the DFIs to the SMEs, especially through collaboration with relevant Government agencies.

Another important focus will be the enhancement of the regulatory environment to facilitate the operations of the DFIs through customised prudential requirements and regulatory standards, as well as improving their financial soundness and risk management practices. Emphasis will also be accorded towards enhancing the efficiency of the DFIs. In this regard, initiative will be undertaken to establish a comprehensive performance measurement framework for the DFIs, comprising both financial and non-financial performance indicators.