ECONOMIC REVIEW

• Review and Outlook of the Malaysian Economy

DEVELOPMENT IN 2007

Overview

The Malaysian economy continued to show resilience and strength in 2007, particularly during the fourth quarter. To a significant extent, it reflects the well-diversified base and structure of the economy on both the supply and demand side.

The economy has a large services sector as well as sizeable agriculture and mining sectors that had helped insulate the economy against the impact of a sharp slowdown in manufacturing activities. The firmer activity in construction had also contributed to the better performance of the economy in 2007.

Exports of manufacturing generally had eased on account of lower international demand for the electrical and electronic goods, especially by the United States (US). However, there were bigger earnings from primary commodities, especially oil and gas and palm oil following higher demand and prices.

The relatively large and robust domestic demand also provided the economy with greater flexibility and strength to counter the effect of external demand slowdown in 2007. Both the consumption and investment spending had accelerated last year, also to reflect the positive effects of the Government expansionary fiscal and monetary policies.

Overall, real gross domestic product (GDP) rose by an impressive 6.3% in 2007, accelerating from 5.9% in 2006. It was also the fastest rate of expansion achieved by the economy in three years. The fourth quarter also saw growth recording a high of 7.3%, the best since the second quarter of 2004.

The stronger growth performance in 2007 was achieved in an environment of greater price stability as reflected by the sharply lower inflation rate of 2.0% against 3.6% in the preceding year. This mirrors to a large extent the effectiveness of various policy measures implemented by the Government to manage price, and also supported by a stronger Ringgit. The slower inflation in turn helped facilitate the conduct of accommodative monetary policy, amidst flush liquidity condition, thus ensuring stable and low interest rate.

The fundamental of the Malaysian economy in 2007 was further strengthened by a steadier external position. There was a larger overall surplus in the balance of payments, thus a bigger accumulated external reserves, chiefly derived from a sustained large current account surplus. The external reserves as at end of 2007 amounted to RM335.7 billion or US$101.3 billion, higher by RM45.3 billion or US$18.9 billion compared with the level recorded at the end of 2006. The external sector therefore had contributed more to the liquidity built-up in the last year.

Demand Condition

Domestic demand condition generally was buoyant in 2007. Both the consumption and investment spending registered stronger growth of 10.6 % and 10.2% respectively against 6.6% and 7.9% in 2006. Private consumption rose by a faster 11.7% last year generally supported by a steadier increase in disposable income, firm labour market condition and easy access to credit. During the year, higher commodity prices, particularly crude palm oil and rubber, the upward salary adjustments for civil servants and strong performance of the equity market as well as rising job opportunities had contributed to income expansion. Subsequently, the contribution by private consumption to the overall real GDP growth last year had increased to 5.2 percentage points (pps) from 3.4 pps in 2006. At the same time, the share of private consumption to GDP had increased to 51% from 48.4% in 2006.

TABLE 1 : REAL GDP BY DEMAND AGGREGATE

% Change	2003	2004	2005	2006	2007	2008f
Consumption	**8.2**	**9.4**	**8.2**	**6.6**	**10.6**	**6.9**
Public	8.6	7.6	6.4	5.0	6.4	5.2
Private	8.1	9.8	8.7	7.1	11.7	7.4
Investment (ex-stock)	**2.8**	**3.6**	**5.0**	**7.9**	**10.2**	**5.8**
Public	-0.3	-21.5	6.8	8.9	7.5	1.0
Private	8.8	46.5	3.3	7.0	12.3	6.2
Agg. Domestic Demand	**6.6**	**7.7**	**7.3**	**7.0**	**10.5**	**6.6**
Public	3.7	-7.8	6.6	6.8	6.9	3.7
Private	8.2	15.6	7.6	7.0	11.8	7.2
Exports	**5.1**	**16.1**	**7.9**	**7.4**	**3.7**	**4.3**
Imports	**4.5**	**19.6**	**8.9**	**8.6**	**4.1**	**6.2**
Real GDP	**5.8**	**6.8**	**5.0**	**5.9**	**6.3**	**5.2**

Private investment also charted a firmer growth of 12.3% last year from 7.0% in 2006, spreading across all sectors particularly manufacturing, services and mining. The economy also witnessed larger inflow of foreign direct investment (FDI) in the manufacturing and mining sectors, reflecting the country's sustained competitive position in attracting foreign capital.

On the other hand, public investment moderated last year with a growth of 7.5% against 8.9% in 2006, but continued to support strongly the expansion of private investment. Overall, investment contributed a larger 2.2 pps to the overall GDP growth in 2007 as apposed to 1.8 pps in 2006.

TABLE 2 : CONTRIBUTION TO GROWTH – DEMAND

% Points	2003	2004	2005	2006	2007	2008f
Consumption	**4.7**	**5.4**	**4.9**	**4.0**	**6.1**	**4.4**
Public	1.1	1.0	0.8	0.7	0.9	0.7
Private	3.6	4.4	4.0	3.4	5.2	3.7
Investment (ex-stock)	**0.7**	**0.8**	**1.1**	**1.8**	**2.2**	**1.3**
Public	-0.1	-3.1	0.7	1.0	0.8	0.1
Private	0.7	3.9	0.4	0.8	1.4	1.2
Stocks	-1.0	0.8	-1.3	0.1	-1.3	0.9
Agg. Dom Demand	**5.3**	**6.2**	**6.0**	**5.8**	**8.3**	**5.7**
Public	1.0	-2.1	1.5	1.6	1.7	0.8
Private	4.3	8.4	4.4	4.2	6.6	4.9
Exports	**5.7**	**17.7**	**9.5**	**9.1**	**5.2**	**5.2**
Imports	**4.2**	**18.0**	**9.1**	**9.1**	**5.8**	**6.7**
Net Exports	**1.5**	**-0.2**	**0.4**	**0.0**	**0.6**	**-1.4**
Real GDP	**5.8**	**6.8**	**5.0**	**5.9**	**6.3**	**5.2**

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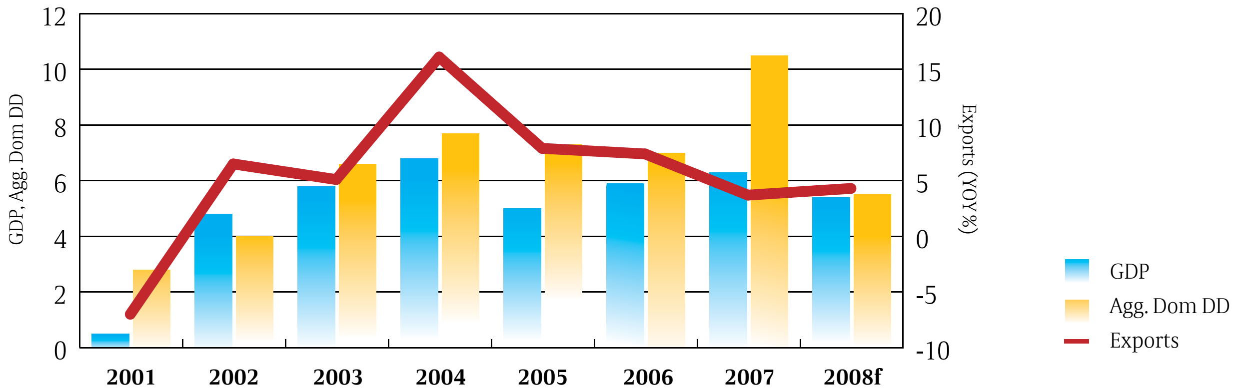
On the external front, export of goods and services decelerated last year and growth slowed sharply to 3.7% from 7.4% in 2006 mainly on account of falling external demand for the electrical and electronics (E&E) products. However, exports of primary commodities expanded sharply to help offset the lackluster export performance of manufactures. Exports of primary commodities such as oil and gas and palm oil saw sharp rises in earnings last year, contributed to a large extent by price increases. While the price of crude oil rose to an average of US$76.46 a barrel in 2007 from US$68 in the preceding year, the price of palm oil jumped to an average of RM2,368 per tonne last year compared with RM1,544 per tonne in 2006.

Accordingly, the contribution by exports to overall real GDP growth declined to 5.2 pps last year from 9.1 pps in 2006. Nevertheless, since imports had slowed faster than exports (4.1% from 8.6%), the net export contribution to the overall GDP growth improved to 0.6 pp last year from a nil contribution in 2006.

CHART 1 : GDP, AGG DOM. DEMAND, & EXPORTS (% YOY)



Supply Condition

All sectors of the economy registered positive growth in 2007, led by the services sector. The services sector had expanded at a faster pace of 9.7% against 7.2% in 2006, benefiting from strong domestic demand and a steadier tourist inflow. The sub-sectors showing strong expansion with a double-digit growth included the real estate, finance and insurance, transport and storage, accommodation and restaurant as well as wholesale, retail trade and motor vehicle. The services sector subsequently had contributed a larger 5.0 pps to the overall GDP growth in 2007 as opposed to 3.7 pps in 2006. The sector constituted a large 53.6% of the total GDP in 2007 (2006: 52.0%).

TABLE 3 : REAL GDP BY SECTOR

% Changes	2003	2004	2005	2006	2007	2008f
Agriculture	6.0	4.7	2.6	5.2	2.2	5.5
Mining	6.1	4.1	-1.3	-0.4	3.2	3.3
Manufacturing	9.2	9.6	5.3	7.1	3.1	4.7
Construction	1.8	-0.9	-1.8	-0.5	4.6	4.6
Services	4.2	6.4	6.7	7.2	9.7	5.9
Real GDP	**5.8**	**6.8**	**5.0**	**5.9**	**6.3**	**5.2**

Meanwhile, after three years of negative growth since 2004, the construction sector rebounded and registered a positive growth of 4.6% in 2007. It was driven mainly by the civil engineering sub-sector that benefited from projects implemented under the Ninth Malaysia Plan. Similarly, the mining sector reverted to a positive growth of 3.2% last year largely in response to higher output of crude oil, amidst firmer prices.

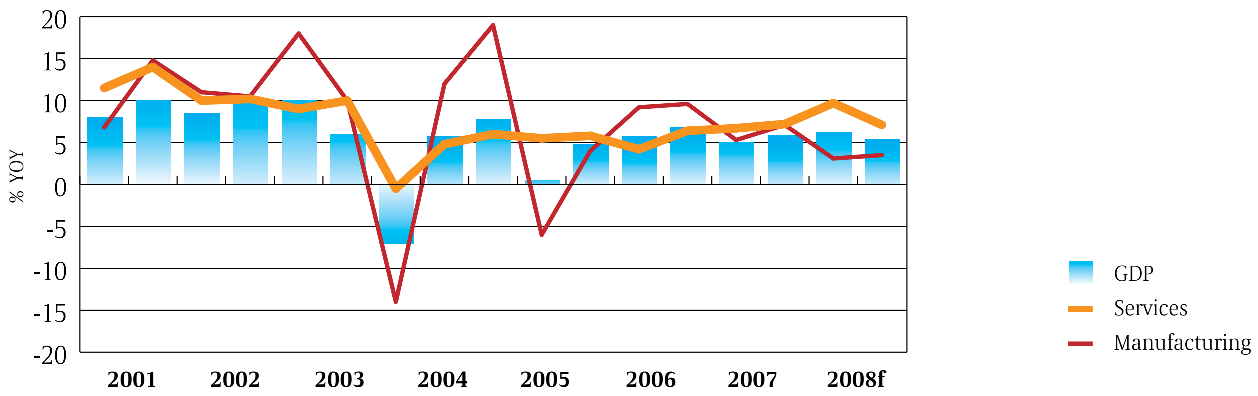
TABLE 4 : CONTRIBUTION TO GROWTH – SECTOR

Percentage Points	2003	2004	2005	2006	2007	2008f
Agriculture	0.5	0.4	0.2	0.5	0.2	0.4
Mining	0.6	0.4	-0.1	0.0	0.3	0.3
Manufacturing	2.7	2.9	1.6	2.2	1.0	1.4
Construction	0.1	0.0	-0.1	0.0	0.1	0.1
Services	2.1	3.2	3.4	3.7	5.0	3.2
Other items	-0.2	-0.1	0.0	-0.3	-0.2	-0.2
Real GDP	**5.8**	**6.8**	**5.0**	**5.9**	**6.3**	**5.2**

The manufacturing sector recorded a sharp slowdown in 2007 with a moderate growth of 3.1% against 7.1% in 2006. This was also the slowest pace recorded since 2001. The weakness was largely in the export-oriented industries, particularly electrical and electronics. The production of electrical and electronic goods had contracted by 2.2% from a growth of 4.6% in 2006. On the other hand, output of domestic-oriented industries charted strong growth, including food and beverages, iron and steel and fabricated metal products. The contribution by manufacturing to the overall GDP growth therefore eased to 1.0 pps last year, the smallest since 2001. At the same time, the share of manufacturing to GDP declined to 30.1% in 2007, the lowest since 2003.

Similarly, the agriculture sector saw a slower rate of expansion of 2.2% compared with 5.2% in 2006 on account of lower output of rubber and palm oil. However, this was more than offset by the stronger production in the food related sectors.

CHART 2 : GDP, MANUFACTURING, SERVICES (% YOY)



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PROSPECT IN 2008

The global economy is bracing a slowdown as the US economy decelerates in response to the sub-prime mortgage and credit crisis. The risk of the US economy entering a recession has increased following the surge in crude oil prices and the continuing decline in the US dollar. While the US Federal Reserves has placed high priority on growth, the rising inflationary pressures complicate the conduct of monetary policy and interest rate management to support growth.

In the face of a more challenging external environment, Malaysia may see a sharp deceleration in its export performance during the second half of this year after a steady first half. In tandem, the manufacturing sector is also expected to slow during the third and fourth quarter. Nonetheless, the Malaysian economy has entered 2008 from a point of strength and its diversified and broad economic base could again help sustain the overall growth momentum this year.

On the supply side, the services, construction, mining and agriculture can be expected to retain favourable expansion this year. Despite a weaker second half, the manufacturing sector may register a slightly faster growth this year, thanks to a steadier first half and the continuing strong domestic demand.

The domestic demand will continue to expand, amidst expansionary fiscal and monetary policies. The continuing flush liquidity condition would only ensure adequate supply of funding for both the public and private sector.

Furthermore, overall exports can chart further growth as Malaysia continues to benefit from rising prices of primary commodities, especially crude oil and gas, palm oil and rubber.

Against the above backdrop, real GDP is projected to register a moderately slower growth of 5.2% in 2008 compared with 6.3% in 2007. While the US economy may undergo a more severe downturn thus to exert greater downward pressures on global demand, the Government can be expected to embark on more aggressive fiscal and monetary responses to stimulate domestic demand and overall economic growth.

Demand Condition

Consumer and investor sentiments are affected by the external uncertainties as well as rising domestic inflationary pressures this year. Nevertheless, the strong underlying factors, which include steady growth in income following higher commodity prices, firm labour market condition and continuing easy access to credit as well as low interest rates would help sustain private consumption. In this regard, private consumption spending could continue to register a strong growth of 7.4% this year, but slower compared with 11.7% in 2007.

The positive effect of higher salaries of civil servants following adjustments in 2007 would also continue to be felt in the first half of this year. The flexibility for the contributors to utilize their savings in the Employees Provident Fund (EPF) for mortgage repayments could also help spur further private consumption spending this year.

The current low interest rates and ample liquidity position in the financial system will also help boost private consumption. At the end of May this year, the excess liquidity in the financial system was estimated at RM351.5 billion compared with RM280 billion as at end of 2007. Credit has also shown a strong uptrend, rising by 11% in May, the strongest pace seen since May 1998. To a certain extent, the higher loans had helped improve the performance of domestic automotive market. It was reported that new vehicle sales in the first five months of this year stood at 228,984 units or 52,028 units more than the number recorded in the corresponding period last year.

Private investment spending is also envisaged to increase in 2008 on account of strong economic activity particularly stimulated by the accelerated pace of implementation of projects approved under the Ninth Malaysia Plan (9MP-2006-2010). The effects of tax adjustments and others to enhance the country's competitiveness such as corporate tax reduction to 26% and a single-tier tax system could also help boost private investment this year. It is expected real private investment can increase by 6.2% in 2008. Including public investment, which is projected to grow by 1.0% against 7.5% in 2007, capital formation for 2008 would rise by 5.8% compared with 10.2% in 2007.

As a ratio of GNP, total investment including stock changes is projected to decrease to 20.8% of GNP in 2008 from 22.2% in 2007. In comparison to savings ratio of 35.3% of GNP (2007: 38.9%) the resource surplus may narrow to 14.5% of GNP (2007: 16.7%) as reflected by the surplus in the current account of the balance of payments. While the current level of investment is only adequate to generate growth of slightly more than 5% this year, there is potential for the economy to chart a faster rate of expansion following higher saving utilisation. In 2008, the contribution by investment to overall GDP growth could ease to 1.3pps from 2.2pps in 2007.

Overall, private spending contribution to overall real GDP growth this year would remain significant at 4.9 pps from 6.6pps in 2007. Public spending contribution is projected to moderate to 0.8 pp from 1.7 pps last year.

On the external front, real exports of goods and services are projected to weaken during the second half of this year following deteriorating export performance of E&E. However, on account of a firmer first half and stronger exports of primary commodities the value of real exports for the whole of 2008 could chart a faster increase of 4.3% compared with 3.7% in 2007. In the first five months of this year, total exports of goods had expanded by 14.6% despite the sharp fall in the E&E exports of 4.8%, thanks to the sharply bigger earnings of primary commodities.

Overall, exports are projected to show a contribution of 5.2 pps to the overall GDP growth similar to that in 2007. However, as imports could rise faster than exports, the contribution by net exports to the overall GDP growth in 2008 may revert to a negative 1.4 pps as opposed to a positive 0.6 pp last year.

Supply Condition

The services sector is expected to continue charting a strong performance this year. It is projected to rise by 5.9%, on the back of a steady private consumption and overall business activities, especially tourism. Expansion in domestic tourism and strong foreign tourist arrivals would contribute to further growth of the wholesales and retail trade, hotels and restaurants sub-sectors. Nevertheless, concerns about rising prices could affect business activity in the remaining months of this year as consumer may slow or delay spending as real disposable income declines.

In the agriculture sector, growth is projected to strengthen to 5.5%, largely supported by increases in output of palm oil and rubber. Initiatives by the Government to further intensify food sub-sector through various measures under the Ninth Malaysia Plan would further boost the sector.

The construction sector is envisaged to register a growth of 4.6% this year, led by civil engineering sub-sector and supported by residential and non-residential sub-sector. However, concerns about rising costs of construction, higher inflation and global economic uncertainties may dampen growth in the real estate sector particularly over the short and medium term. Meanwhile, the mining sector will continue to show growth, estimated at 3.3% on account of continuing strong demand and capacity expansion in new oil and gas fields.

Growth in the manufacturing sector is projected to increase slightly to 4.7% this year from 3.1% last year on account of sustained strong performance in the domestic-oriented industries. On the other hand, the export-oriented industries are likely to show a further weakness this year especially during the second half.

EXTERNAL BALANCE AND MONETARY POLICY

The external position continued to strengthen in 2007 and the current account surplus is likely to remain large in 2008. This reflects a sustained large resource surplus in the economy, despite rising investment spending. Consequently, the economy continues to grow at sub-optimal level.

In 2007, the surplus in the current account amounted to RM99.3 billion or 15.8% of GNP compared to RM93.4 billion or 16.8% of GNP in 2006. This was largely accounted for by a bigger excess in the merchandise balance and a positive services balance, largely derived from enlarged earnings on the travel account.

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TABLE 5 : BALANCE OF PAYMENTS

RM billion	2004	2005	2006	2007	2008f
Current Acc. Balance	56.5	75.7	93.4	99.3	100.5
% of GNP	12.6	15.3	16.8	15.8	14.5
Merchandise Balance	104.5	125.6	134.6	128.1	128.0
Services Balance	-9.0	-10.3	-6.9	1.0	1.7
Income Balance	-24.5	-23.9	-17.4	-13.7	-11.0
Net Transfer	-14.6	-17.0	-16.9	-16.1	-18.2
Real GDP (% YoY)	**6.8**	**5.0**	**5.9**	**6.3**	**5.2**

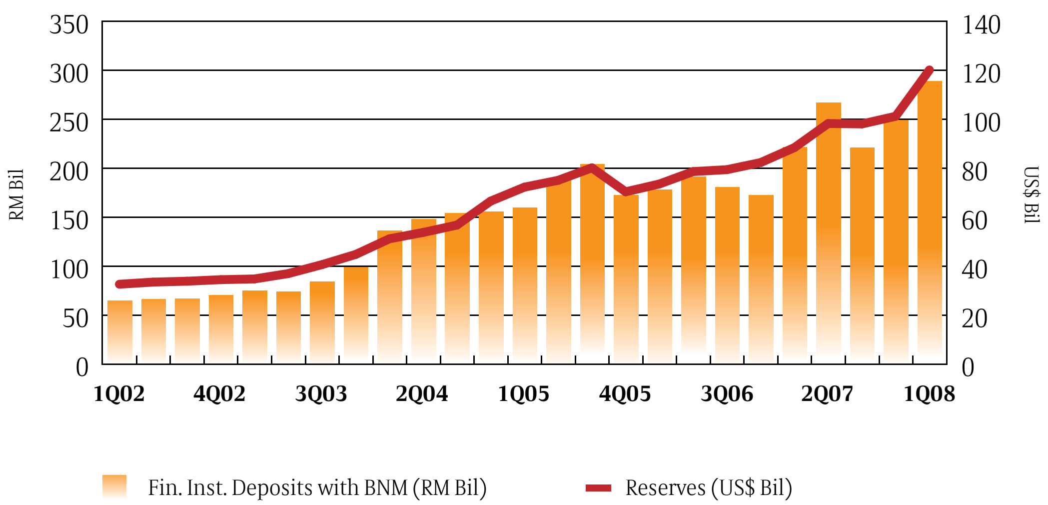
In 2008, the surplus on the current account is projected at RM100.5 billion or 14.5% of GNP on the back of a sustained large trade surplus. The services account is also likely to record another surplus this year.

Against a bigger current account surplus, Malaysia's overall balance of payments had charted a higher surplus of RM45.3billion last year from RM24.0 billion in 2006. This was despite the larger shortfall in the financial account following increased payments and repayments of external loans as well as larger outflow of direct investment by the private sector. Consequently, the external reserves rose to a record RM335.7 billion or US$101.3 billion at end of 2007 from RM290.4 billion or US$82.5 billion in 2006. The reserves were adequate to finance about 8.8 months of retained imports and was 6.1 times of the country's short-term loans.

The overall balance is likely to witness a further growth in 2008, although its surplus could be smaller as a result of a larger shortfall in the financial account. Consequently, the external reserves would continue to rise this year. The first six months of this year already saw an addition to the external reserves of RM75.1 billion or US$24.4 billion to RM410.9 billion or US$125.8 billion that surpassed the US$18.9 billion accumulated during the whole of 2007.

The external sector has remained as a main source of liquidity to the economy. In the first five months of this year, private sector liquidity as measured by the broad money (M3) had expanded by RM65.9 billion or 8.7% after recording a growth of RM72.5 billion or 9.5% for the whole of 2007. Subsequently, the domestic financial system saw a larger accumulation of excess in liquidity, thus greater intervention by the Central Bank to stabilise interest rates.

CHART 3 : EXT. RESERVES & FIN. INST. DEPOSIT WITH BNM



On the other hand, the prevalence of flush liquidity has facilitated the conduct of accommodative monetary policy to support growth. Consequently, the Overnight Policy Rate (OPR) was retained at 3.5% through the whole of 2007, amidst slowing inflation. Against 3.6% in 2006, the rate of inflation as measured by the consumer price index (CPI) rose significantly slower at 2.0% last year.

In the first six months of this year, inflation rate jumped to 3.7%, above the 2.0% pace registered in the corresponding period of 2007. Inflation in June accelerated to 7.7%, the fastest rise since January 1982 (7.8%) mainly caused by higher fuel and food prices.

Fuel prices have surged in response to the revamp of the subsidy scheme on petroleum products. While the pump price for petrol rose by 41% to RM2.70 per litre, diesel price increased by 63% to RM2.58 per litre with effect from June 5. As part of the subsidy reform, industry and power producers are also charged higher prices for gas. Consequently, electricity tariffs are higher by 18% for householders and 26% for commercial and industrial users with effect from July 1.

Arising from higher fuel and energy as well as food prices, inflation rate in 2008 is projected to rise to 5.8%, the highest in 26 years. In tandem with higher inflation, Bank Negara Malaysia will likely raise the OPR by 50 basis points before the year-end.

To a certain extent, the ringgit appreciation helps moderate the rise in inflationary pressure in 2007 and this year. The local currency had strengthened by 6.8% against the US dollar to an average of 3.31 last year. It had appreciated further by 1.2% in the first six months of this year and touched a high of 3.13 against the US dollar on April 23. The ringgit appreciation to a large extent mirrors the effect of a weakening US dollar, following interest rate cuts by the US Federal Reserves. It also mirrors the strong fundamentals of the domestic economy. Although the ringgit has chartered a downtrend since May arising from a relatively firmer US dollar and some outflow of short-term capital, it is expected to end the year at a healthy level of 3.10-3.20 against the US dollar.

CONCLUSION

The Malaysian economy had performed well in 2007 and this has provided a firmer platform for its expansion in 2008. In this regard, despite the more challenging external environment, the Malaysian economy is expected to continue charting an encouraging growth this year, amidst a steady domestic demand.

As the domestic demand is expected to continue leading the growth process, the Government in turn is expected to implement counter cyclical measures, particularly if the weakening of global demand results in a significant softening of domestic consumer and business confidence. The Government would have to embark on a more expansionary fiscal operation, while continuing with an accommodative monetary policy. This may exert greater pressure on the Government budgetary position, but it is unavoidable as to help the economy to stay on course.

Another major policy concern is the rising inflationary pressure. Amidst the higher fuel and food prices and more expensive import cost, inflation rate can pass the 5.0% mark this year. Consequently, Bank Negara Malaysia is likely to raise the OPR.

As a final remark, the Malaysian economy would continue to show resilience and grow at above 5.0% in 2008, for the 7th year since 2002. The growth momentum could be sustained through 2009-2010 the final two years of the Ninth Malaysia Plan (2006-2010). The accommodative stance of monetary and fiscal policy would support the further expansion in domestic spending. In this regard, real GDP can continue to grow in the range of 5.0-6.0% in 2009 and 2010.

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