Review and Outlook of the Malaysian Economy

THE MALAYSIAN ECONOMY IN 2009

The Malaysian economy, not immune to the global slump, had already begun to experience greater impact from the deterioration in global economic conditions causing a decline of 1.7% in 2009. The domestic economy experienced the full impact of the global recession in the first quarter, declining by 6.2%, marking the first year-on-year contraction in real GDP, the worst contraction in eight years. This has led to a collapse in exports and manufacturing activity in recent months and has undoubtedly affected the manufacturing sector, which contributes one-third of GDP and is the second largest sector behind the services sector in Malaysia.

The collapse in global demand and world trade also led to double-digit declines in the industrial production index which affected employment, income and overall business and consumer sentiment, causing private consumption and private investment activities to decline in the first quarter of the year. Growth during the quarter was also affected by large drawdowns of inventory, particularly in the manufacturing and commodity sectors.

As its external conditions are deteriorating faster, Malaysia is in urgent need of fiscal and monetary stimuli to spur domestic demand. The Government had unveiled a RM60 billion (or 9.0% of GDP) stimulus package under its Mini Budget. A fiscal injection of RM10 billion in 2009 and RM5 billion in 2010 has been proposed. Under the first stimulus package, RM6.5 billion has been channelled to various ministries and agencies. The proposed Guarantee Funds of RM25 billion comprises the Working Capital Guarantee Scheme (RM5 billion), and the Industry Restructuring Loan Guarantee Scheme (RM5 billion) to address the funding concerns faced by the SMEs. A new Financial Guarantee Institution will be established by the central bank, along the same principles of the Credit Guarantee Corporation ("CGC"), to provide credit enhancement of up to RM15 billion to companies seeking to raise capital via the bond market.

The Malaysian economy resumed its growth momentum in the fourth quarter, growing by 4.4%, with strengthened domestic and external demand contributing to growth along with the recovery of the regional economies.

Supply Side

Only the construction sector posted gains, while all others sectors posted a negative growth in the first quarter. The manufacturing sector, particularly the export-oriented industries, reported the biggest decline of 18.2%, severely affected by the significant deterioration in external demand. Nevertheless, the manufacturing sector gradually improved and recorded positive growth in the fourth quarter, in tandem with the recovery in external demand.

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Meanwhile, the poor performance of the services sector of +1.0% in the first quarter has reflected a slowdown of sub sectors which are related to manufacturing and trade activities. In line with the improvement in domestic demand, the performance of the services sector had gradually improved since the second quarter, with growth coming from the services sub-sectors that are dependent on domestic economic activity as well as finance and capital market-related activities.

Nonetheless, growth of the construction sector had remained positive throughout the period due primarily to the implementation of construction related projects under the Ninth Malaysia Plan ("9MP") and the fiscal stimulus measures.

TABLE 1: Real GDP by Sectors and Demand Aggregate

% Change YoY	2004	2005	2006	2007	2008	2009	2010f
Agriculture	4.7	2.6	5.4	1.3	4.3	0.4	6.1
Mining	4.1	-0.4	-2.7	2.0	-2.4	-3.8	2.5
Manufacturing	9.6	5.2	7.1	2.8	1.3	-9.4	12.3
Construction	-0.9	-1.5	-0.5	7.3	4.2	5.8	7.7
Services	6.4	7.2	7.3	10.2	7.4	2.6	7.1
Consumption	9.4	8.5	6.1	9.9	9.0	1.3	4.2
Public	7.6	6.5	4.9	6.5	10.7	3.1	4.0
Private	9.8	9.1	6.5	10.8	8.5	0.7	4.9
Investment	3.6	5.0	7.9	9.2	0.7	-5.6	4.6
Exports	16.1	8.3	7.0	4.1	1.6	-10.4	16.1
Imports	19.6	8.9	8.5	5.6	2.2	-12.3	18.4
Real GDP	**6.8**	**5.3**	**5.8**	**6.5**	**4.7**	**-1.7**	**8.0**

Demand Conditions

On the domestic demand side, consumption spending contracted by 0.3%, with a lower private consumption (-0.6%) triggered by fears of a serious recession here and elsewhere as well as wide spread unemployment since October 2008. Similarly, gross investment also declined for the second time by 11.1% in 1Q09 after a decrease of 10.2% in the last quarter. The external sector continued its negative momentum with both exports and imports declining. Most major export items experienced declines in export value, while the deceleration in imports was due to the contraction in imports of intermediate and capital goods.

The second half of the year saw an expansion in private consumption due to the policy measures and a higher public spending that helped to revive the private sector sentiment. Growth in private consumption had increased to1.8% in the last quarter. Meanwhile, total investment had unexpectedly rebounded to a remarkable growth of 8.2% in 4Q09 from -10.2% in the previous quarter.

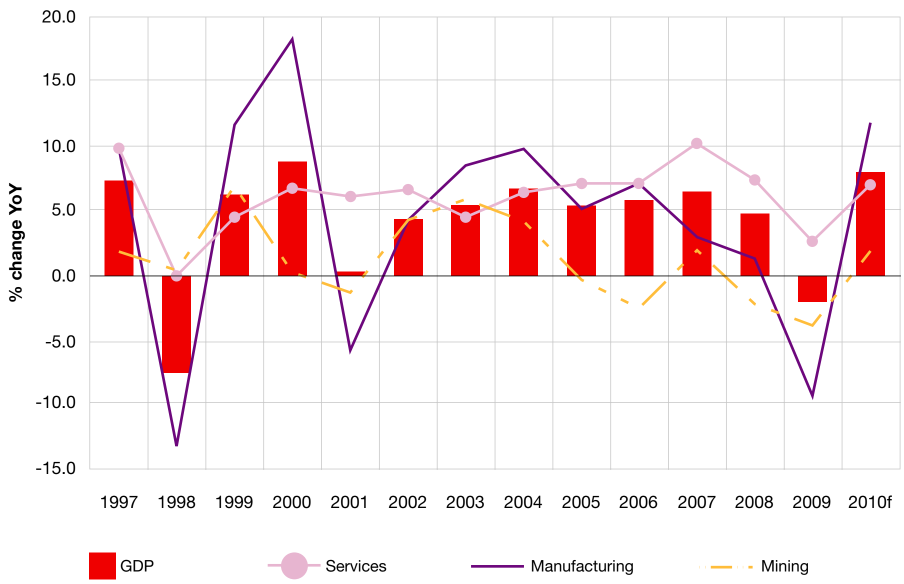
The Malaysian economy, which was significantly affected by the developments in the global economy in the first quarter of 2009, recovered rapidly to register positive growth in the fourth quarter.

Base-effect Surprises the GDP in 2010

Given recent developments in both domestic and external conditions, the full-year target could also surprise from a base effect. We are now projecting a much-higher forecast of 8% for this year, even though fiscal and monetary stimulus will be gradually withdrawn by year-end. Bank Negara Malaysia ("BNM") upgraded its 2010 GDP growth forecast to 4.5%-5.5% March while the World Bank is looking at a more optimistic growth of 5.7% this year. The Prime Minister is even more optimistic with a forecast of not less than 6.0% in 2010, and the foreign houses are similarly optimistic with forecasts as high as 8.0%.

However, with prospects of a disappointing global upswing getting dimmer, we maintain that the economic expansion will be sustained at around 6.0% in 2011. But this will depend very much on the type of reforms in the pipeline as well as the Government's commitment in making it a reality. Since late last year, several liberalisation measures have been introduced to raise direct foreign investment in financial services and in other tertiary sectors. By 3Q this year, Malaysia will also kick-start the second and final part of the New Economic Policy, detailing structural reforms with timeliness, and this should boost the country's potential even more strongly.

CHART 1: Real GDP by Sector (% change YoY)

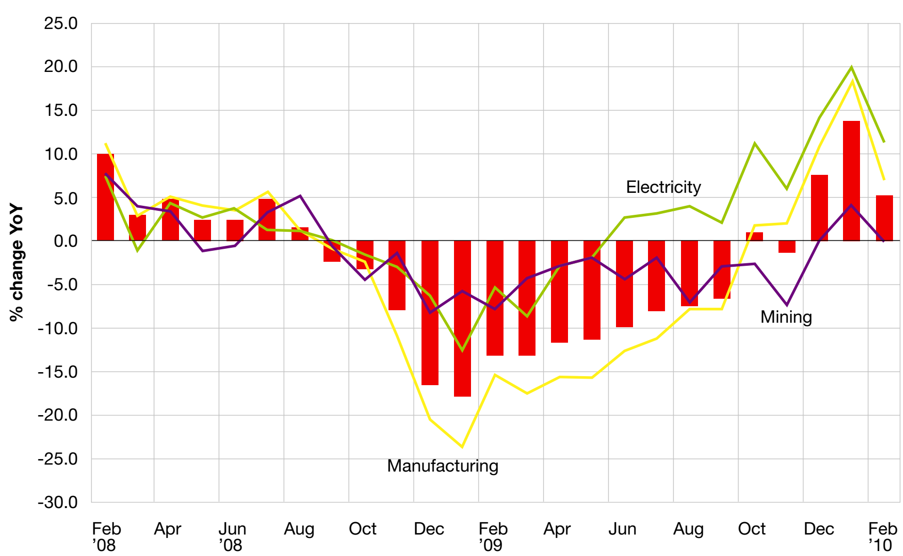


Broad-based Recovery on Supply Side

It will be a broad-based recovery, with all major sectors of the economy registering positive growth amid strengthening domestic demand and a pick-up in external demand. Since activities have normalised after the recent festival season, we believe growth would have rebounded to normal levels for March, after a slowdown in February following a shorter working month.

Manufacturing: In this regard, we saw a 16.9% growth for the manufacturing sector in the first three months of the year, contributing 4.4 percentage points to 1Q GDP. Growth drivers will certainly

CHART 2: Industrial Production Index Growth (% Change YoY)



come from the Electrical & Electronics ("E&E") sector, which had already posted a 34% growth in the period, as well as non-E&E industries. Moving ahead, several key indicators are turning more positive and this points to a sustainable manufacturing sector through this year. Given this, we forecast a strong growth of 12.3% for the manufacturing sector, which represents nearly 28% share of GDP in 2010 – one-third from E&E industries.

Factors Supporting Stronger Manufacturing Activity

1) Improvement in global confidence:
The Global Total Output Index, produced by JP Morgan with research and supply management organisations, rose to 57 in May, near to its highest reading since July 2007.

2) Sustained expansion in PMI data:
US Institute for Supply Management manufacturing index posted its strongest pace in 5 1/2 years at 59.7 in May. China's Purchasing Managers' Index ("PMI") rose to over 54% in May, according to a survey by the China Federation of Logistics and Purchasing and the National Bureau of Statistics.

3) Surging global chip sales:
According to the Semiconductor Industry Association ("SIA"), worldwide semiconductor sales in April rose 2.2% over a month ago, but grew by 50.4% YoY - reflecting a continued recovery of sales in semiconductors.

4) Activity in E&E sectors:
Manufacturers of semiconductor equipment posted a book-to-bill ratio of 1.13 in April, according to Semiconductor Equipment and Material International. A book-to-bill of 1.13 means that US$113 worth of orders was received for every US$100 of product billed for the month.

5) Leading indicators:
The Index of Leading Indicators, which monitors the economic performance in advance, declined marginally by 0.1%, the six-month smoothed growth rate of the Leading Index ("LI") at 5.2% suggests that economic conditions remain favourable in the short- to medium-term.

Services sector: During the quarter, a base effect coupled with a stronger-than-expected demand and positive wealth effect led the services sector to remain as a key contributor to growth for the quarter and year. The sector has been benefiting from a recovery in trade and manufacturing-related as well as domestic-oriented sub-sectors. In the services sector, growth was higher at 8.5% (4Q09: 5.6%), driven primarily by strong performance in finance and insurance, wholesale and retail trade, and real estate and business services sub-sectors. As a whole, we forecast growth of 7.2%, contributing at least 4.2 percentage points to GDP and representing a share-to-GDP ratio of 57.1% in 2010.

Domestic Demand Strengthening

Meanwhile, domestic demand should strengthen with better employment conditions and uninterrupted credit flows. While the public sector remains supportive, growth is expected to be driven by greater private sector activity and robust external demand from regional countries.

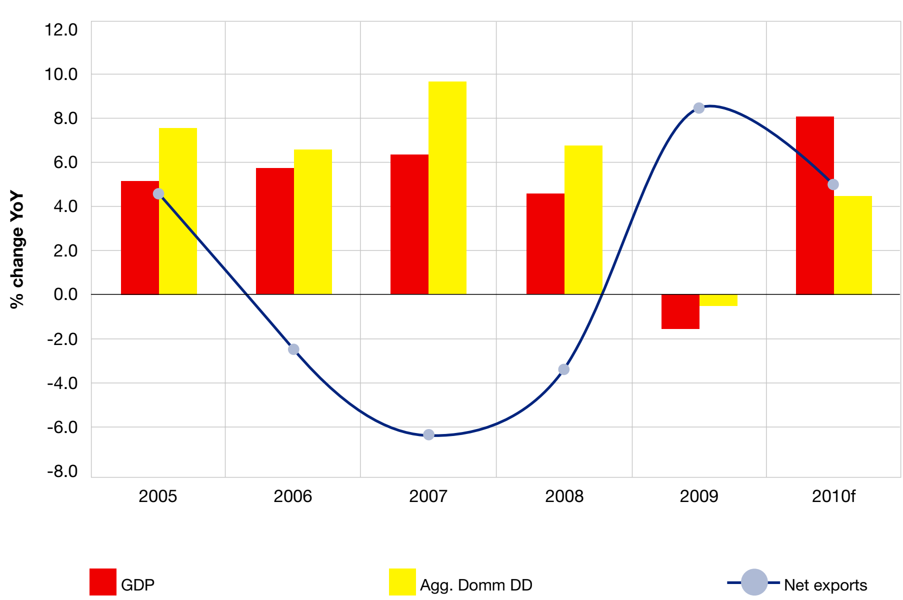
In the private sector, consumption is expected to rise on the back of improvements in the labour market, disposable incomes and consumer confidence. We forecast growth of 4.2% this year, against 1.3% in 2009. Additionally, private investment is expected to recover in line with the strengthening of global trade and increasing domestic demand. Investment is expected to rebound with the planned investment in infrastructure and recovery in external demand. In total, gross investment is forecast to grow by 4.6% in 2010, after a contraction of 5.6% last year.

Exports Growth Upgraded Too

In the external sector, the trade surplus should likely remain remain large at RM37 billion in 1Q10, as both gross exports and imports recovered to post positive growth rates of 26% and 30% respectively. Gross exports performance was supported by higher external demand, especially from the region, and stronger commodity prices, while stronger growth in imports reflected higher manufacturing production and an improvement in domestic demand activity.

As a whole, we forecast exports and imports to pick up strongly to post double-digit growth of 16% and 18% in 2010, which will result a higher current account surplus of RM125 billion or equivalent to more than 20% of GDP.

CHART 3: Real GDP, Aggregate Domestic Demand & Net Exports (% YoY)



Inflation to Rise with Changing Economic Conditions

Headline inflation is expected to pick up for the rest of the year, in tandem with improving economic conditions and possible adjustments to prices following the Government's plan to revise subsidies for petroleum products as well as review existing subsidies on other essential items. In March, the Government abandoned its plans to introduce a two-tier mechanism, streamlining the subsidy mechanism. Overall, inflation will remain modest at around 2.5% in 2010.

OPR Set to Rise Further

On 13 May, Bank Negara Malaysia ("BNM") raised interest rates, as the extraordinary conditions under which interest rates were reduced, no longer prevailed. In its opinion, maintaining an extremely low interest rate environment for an extended period of time could result in disintermediation, financial imbalances and under-pricing of risks. As economic expansion gets into high gear, we believe the move will proceed in the coming months.

Given the assumption of splendid economic performance for a decade and higher inflation rates, we reckon the year-end target for OPR will be at 3% now, compared to our expectation of 2.75% previously. As it stays below the neutral levels, the move to normalise interest rates will not choke economic activities and overall stance of monetary policy will continue to remain accommodative and supportive of recovery process.

Fair Value for the Ringgit at 3.10

In this regard, we see the Ringgit rallying towards RM3.10 per US dollar by year-end, moving towards its new fair-value, since the trade-weighted index is a function of GDP and OPR.

Conclusion

Malaysia is expected to put in place wide ranging strategies in its ongoing transformation process to provide an enabling environment - in which high productivity, competitiveness and innovation are key elements in the New Economic Model ("NEM"). Three key areas of priority are: (a) To have a high quality workforce, (b) To develop competition-driven markets, and (c) To strengthen further our existing institutional and physical infrastructure. By the third quarter of this year, Malaysia will also kick-start the second and final part of the NEM, detailing structural reforms with timelines, and this should boost the country's potential even more strongly.

On the other hand, the prospects of a disappointing global upswing getting dimmer and thus, we maintain that the expansion will be sustained at around 6% in 2011.

CHART 4: Overnight Policy Rate (OPR) (%)

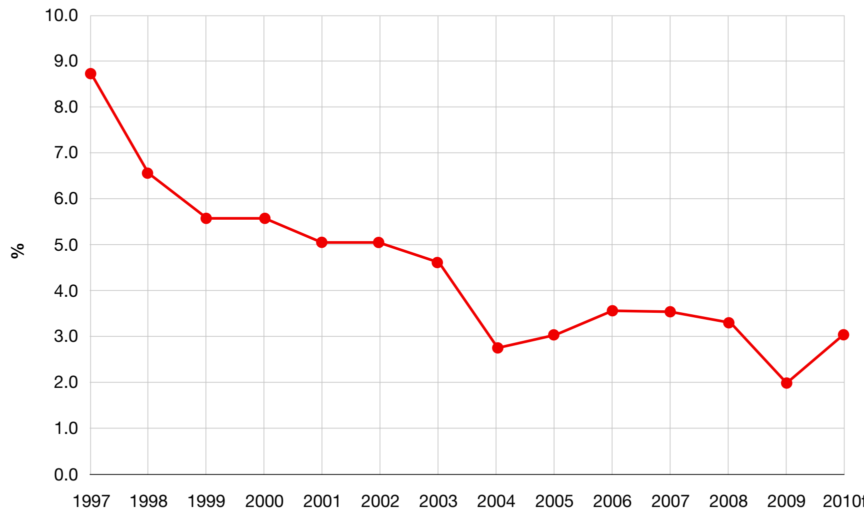


CHART 5: Exchange Rate Vs Major Currencies (Year-to-Date 2009 = 100)