

**Economic Outlook and Prospects
Luncheon Address at the ASLI
Malaysia Strategic Outlook 2006 Conference
by Dato' Ooi Sang Kuang, Deputy Governor,
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Y.Bhg. Dato' Dr. Michael Yeoh, CEO, ASLI

Distinguished Participants,

Ladies and Gentlemen,

1. I would like to thank the Asian Strategy and Leadership Institute for inviting me to address this Strategic Outlook Conference 2006. I would also like to congratulate ASLI for so timely organizing this important conference for decision makers to discuss critical economic and financial issues in order to strategise for the year ahead. Before I give my views on the Economic Outlook and Prospects for Malaysia, it is useful and timely to take stock of recent macro economic trends developing in the global economy and in Malaysia.

2. The year 2005 was an important milestone in many respects. It represented the final year of the Eighth Malaysia Plan and the Second Industrial Master Plan. 2005 also marked the mid-point of the implementation Financial Sector Master Plan as envisaged by Bank Negara. Overall, macro-economic and financial policies taken during the year were targeted at improving the flexibility and responsiveness of the economy to thrive in an intensively competitive global environment.

3. On the external front, the year 2005 was marked by several major developments in the global economy. Global growth was remarkably resilient against the backdrop of record high oil prices, rising interest rates, large payment imbalances and disruptions from natural disasters. Of significance is that despite these challenges global growth was sustained in the second-half of 2005. Growth performance in the two major drivers of the world economy, the United States (US) and China, exceeded expectations and played a vital role in sustaining external demand and global growth. In the United States, expansion in consumer spending was sustained, buoyed by strong asset markets and still accommodative financing conditions despite eight consecutive hikes in interest rates during the year. US growth in the third quarter accelerated to 4.1%,

from 3.3% in the second quarter. Consumer confidence rebounded swiftly after the impact of the hurricanes in the Gulf Coast and spending recovered by the fourth quarter. Meanwhile, strong corporate financial positions together with capacity utilisation exceeding the 80% threshold in the second half of 2005, boosted private investment spending which expanded and gathered momentum towards the later part of the year. Latest indicators point to the US economy's underlying forward momentum for growth into 2006 remaining strong.

4. Robust and sustained growth was even more evident in China, with the Chinese economy estimated to have expanded by more than 9% every quarter in 2005. Improvements to China's statistical survey also led to revisions to the structure and size of the Chinese economy. Revealing, and of important implications to the future of global and regional demand, is that China's services sector of 41% of GNP was much larger than earlier estimates of 32% of GNP. The more broad-based structure implies increased capacity for domestic consumption and more balanced and sustainable growth ahead. China's fast pace of integration with global economy markets as well as the strategy to spread developments to the interior regions would further reinforce the increasing opportunities of broader-based Chinese demand, and yet at the same time reveal more intensified competitive pressures for the ASEAN countries.

5. The year 2005 was also a good year for Japan, which recorded its longest period of sustained expansion since its bubble burst in the early 1990s. On a year-on-year basis, Japanese growth is expected to have expanded more strongly by about 3% in the second half compared with 1.9% in the first half-year. Signs of recovery in domestic demand were clearly evident and expectations are for this trend to remain intact on the back of the significant corporate and financial sector restructuring undertaken in the past decade. For the first time in more than a decade, Japan showed signs of firmly moving out of asset deflation. Core CPI in Japan was in positive territory for Oct and Nov. At the same time, Europe showed signs of recovery, albeit a gradual one, as it continues its process of structural reforms. Growth in the EU-12 is estimated to have risen to about 1.7% in the second half-year from 1.2% in the first half-year.

6. Growth also strengthened in the Asian region as a whole, with several economies, including Malaysia, achieving stronger growth performance in the third and fourth quarter. Current estimates indicate a stronger second half expansion of 7.0% for the Asian region as a whole compared with 6.6% in the first half-year. Across the economies in the Asian region, export performance strengthened in the second half-year, supported by the sustained demand from the United States, an upturn in the global electronics cycle and self-reinforcing growth in intra-Asian regional trade. Intra-regional Asia trade now accounts for 40% of total Asian trade.

7. Strong global demand contributed to rapid expansion in world trade and was a key factor in driving higher global commodity prices. World trade is estimated to have expanded at a stronger pace of 7%. Relatively tight supply conditions and Hurricane Katrina drove oil prices to new peaks in the third quarter, but the global economy maintained its growth performance. Sharp productivity improvements, sustained income growth and wealth creation together with improved energy efficiency and technological improvements in the past decade provided the capacity and resiliency for the global economy to absorb the impact of the latest energy shocks. Hence, while higher oil and commodity prices did have some impact on headline inflation, the effect was relatively modest given the substantial improvements in productivity, the globalisation of production and the addition of very competitive new sources of supply from China, India and eastern Europe. The relatively restrained price conditions allowed monetary authorities across the world to raise interest rates at a gradual and measured pace. Indeed, global financing conditions remained highly favourable, and against conventional economic wisdom, long-term interest rates have stayed very low.

Ladies and Gentlemen,

8. Against this positive backdrop, real economic growths in Malaysia strengthen in the second half of 2005. Real gross domestic product of Malaysia is on track to expand by at least 5% in 2005, with growth gaining momentum in the second half of the year. This growth was driven mainly by private sector activities. Real private consumption expenditure during the year was sustained at high rate, driven by continuing income growth, stable labour market conditions and strong consumer confidence.

9. Similarly, private investment, which had begun to recover since mid 2003, saw a continuation of growth. Growth in gross fixed capital formation accelerated to 9.6% in the third quarter of 2005 compared with 4.5% in the first half of the year. Robust spending, the growth of new industries and services, and the need for new investments to upgrade and add production capacities, contributed to the sustained expansion of the economy. Equally important, a supportive financial environment characterised by low interest rates in the banking sector, and strong corporate cash flows and balance sheets, meant that companies were able to fund these new investments in a balanced and cost-effective manner from the banking sector, the capital markets and from internally generated funds.

10. Malaysia, as an exporter of primary commodities, benefited from higher prices and demand. Firm and favourable price levels for major commodities such as rubber and crude palm oil, especially in the second half of the year, contributed positively to domestic income generation. More importantly, the fact that the higher oil price has not had an adverse impact on global growth ensured that demand for Malaysia's non-commodity exports were sustained. As expected, the up-cycle in the global semiconductor market gathered momentum in the second half of 2005, with Malaysia's electronics sector benefiting significantly. On a year-to-year basis, production in the electronics sector from July to November expanded by 10%, compared with 1.4% in the first half-year. As a result of the supportive demand for all of Malaysia's major exports, growth in exports of goods and services strengthened in the second half to further reinforced the acceleration in domestic demand. Thus, the underlying forward momentum of growth as we enter 2006 remains soundly based and strong for Malaysia.

Ladies and Gentlemen,

11. Against the positive global environment and supportive domestic demand conditions, Malaysia has emerged from 2005 with much stronger macro-economic fundamentals. Over the first nine months of the year, the surplus in current account of the balance of payments remained significant at 16.5% of gross national product, while reserves amounted to US\$ 70.5 billion at end-year. The strong reserves position not only serves as an important buffer against volatile capital flows but accorded the

country macro-economic stability and flexibility. External debt remained low. Reflecting fiscal prudence and consolidation, a lower fiscal deficit is expected. In the financial sector, the banking system strengthened further during the year. Key financial indicators showed that the soundness of the banking sector has been sustained. The capital position of the banking system remained strong with the risk-weighted capital ratio at 13.8% as at end-November 2005. The asset quality of the banking system continued to improve. The net non performing loan (NPL) ratio on the 6-month classification declined to 4.7%, while the 3-month net NPL ratio declined to 6% at end November.

12. Amidst the strengthened macro-economic fundamentals, several important measures were taken during the course of the year. The measures taken were guided by the understanding that current economic circumstances and risks would require a continuous enhancement of economic and financial fundamentals while improving the nation's capacity to adjust. As a result, the core of policy in 2005 was focused on strengthening resilience and improving private and public sector flexibility.

13. From the Central Bank's perspective, a number of significant changes were made during the year in all areas under Bank Negara's purview. Most significantly, **BNM ended the pegged exchange rate arrangement in July**, which would further enhance the economy's capacity to cope with potentially rapid changes in the volume and structure of trade, real investment and financial flows. The move to change Malaysia's exchange rate regime was the culmination of a gradual process that encompassed improving macroeconomic fundamentals and instituting the necessary systems to manage this variability. Measures were introduced to give flexibilities for companies to manage their exchange risks with hedging instruments. Similarly, adequate risk management systems and processes among banking institutions were introduced to ensure proper monitoring of capital movements. Consequently, the adjustment to the new system was assimilated rapidly and more importantly, in an orderly manner by investors, financial institutions and the financial markets.

14. In one other respect, the market's orderly reaction to the change in the exchange rate regime proved the timing was appropriate. Together with normal trade payments

and sizeable inflows and outflows of capital, the smooth functioning of the foreign exchange market and the price discovery process resulted in relative stability of the exchange rate. Speculative inflows that had taken place in anticipation of substantial gains have largely flowed out and were within our expectations. The country's reserves remain strong and, together with the more flexible currency arrangement, provide the country with greater capacity and flexibility to manage economic and financial shocks.

15. Bank Negara also raised interest rates in November to contain inflationary pressures when stronger economic activity was evident.

16. For the banking sector, policy measures continue to focus on enhancing the capacity and capability of the domestic banking institutions. This includes completion of the mergers of commercial bank and finance company entities within a domestic banking group. At the same time, efforts were intensified to work towards improving consumer education and activism. Initiatives to enhance the consumer protection framework in 2005 included the establishment of the Financial Mediation Bureau and the establishment of a deposit insurance scheme. The Bank is now finalising the details for the establishment of a Credit Counselling and Debt Management agency, with the aim of providing individuals with credit counselling and assistance in restructuring their debts.

17. Of significance, several segments of the **financial sector were liberalized**, bringing greater competition into the financial system. Bank Negara and the Securities Commission moved ahead in formulating the regulatory framework for investment banks. Bank Negara also allowed a greater foreign presence in this segment by providing the scope for foreign investors to acquire up to 49% of these new institutions. These new institutions are expected to provide the impetus to further enhance and broaden the range of financial products and services to all capital market participants. More recently, Bank Negara also announced a more **liberal branching policy for foreign-owned banks**. The move to allow foreign-owned banks to open up to four more branches would further enhance the participation of these institutions in the development process while spurring competition in the banking industry. The formula under the new policy takes due notice of the important developmental role of banks by

ensuring that foreign banks participate in this role in the same manner as the Malaysian banks.

18. In the area of **Islamic banking and takaful**, Malaysia has moved ahead of its announced liberalisation timetable. In 2004, three licenses were issued to reputable foreign Islamic banks and financial conglomerates to set-up fully foreign-owned Islamic banks in Malaysia. In addition, as in the case of investment banks, Islamic subsidiaries of Malaysian-incorporated banks could also have foreign shareholdings of up to 49% of their total equity. In the case of takaful, BNM invited applications for four new takaful licenses, which drew the interest of several parties. Eventually, the new participants will add greater dynamism to the industry.

Ladies and Gentlemen,

19. **Turning to the outlook for 2006, the world economy enters the year on a strong and positive note. World growth** is seen to be **broadening** across the major economies. While the US and China would continue to drive growth, it is expected that the recoveries in Japan and Europe would provide additional support to global demand. Another notable feature would be the stronger investment uptrend in several major economies. While oil prices have remained at high levels, it is not expected to destabilise global growth unless a renewed and prolonged rise occurs. However, the risks of renewed spike in oil prices remain a source of concern with uncertainties in Nigeria and geo-political issues in the Middle East. Outside of oil, the spread of avian flu could alter the global and region prospects significantly. Baring these two major threats, strong prices for a broad range of commodities are expected to add impetus to the growth in many resource-based industries.

20. In the **US**, investment is expected to emerge as a stronger driver of growth in 2006. Already, indicators point to a need to expand capacity, including high capacity utilisation, strong corporate profits and balance sheets, and lean inventories. This need to expand capacity has positive implications on demand for **electronics** from the rest of the world as surveys suggest that a significant portion of this capital expenditure would be ICT-related, especially for upgrading and replacement. Meanwhile, despite signs of a cooler housing market, American consumer spending while expected to

show a slight moderation, would continue to provide support as job creation and income growth are expected to strengthen further this year. On the fiscal front, spending on post-hurricane reconstruction is also expected to provide further stimulus to the US economy. Monetary tightening is expected to be at a significantly slower pace than in 2006. Market expectation is that monetary tightening is close to the peak. The large US current account deficit is however expected to widen further. While the risk of disorderly adjustment remains, international financial system and markets have shown improved capacity of orderly recycling of capital flows.

21. Meanwhile the recovery in **Japan**, still the largest economy in Asia, and the second largest in the world, would be more firmly entrenched this year. Capital expenditure is expected to expand strongly this year, not only to meet external demand but more significantly to cater to the recovery in domestic demand in Japan. Job creation and income conditions have improved noticeably and Japanese consumption is seen to be on a gradual recovery trend. Japan is also seen to be taking further steps in increasing its integration with the region and gradually liberalising its domestic market, which would further support intra Asian regional trade.

22. Rapid and sustained growth in two other regional giants, namely **China** and **India**, would further lift the growth momentum in the Asian region. In addition to rapid growth in trade of manufactured goods and commodities, China's emergence has already spurred strong growth in intra-regional Asian trade and increases in travel and tourism. While India is less integrated with the Asian region, the rise in imports from the region seen in the recent years shows strong potential for demand in the years ahead. Fast-rising income levels, broadening affluence and a growing middle class, both in China and India, augur well for demand across a wide range of goods and services from the Asian region. However, competitive forces emerging from China and India can be expected to intensify as well.

23. Current indicators point to the **global electronics uptrend** to be firmly intact. Growth in world semiconductor sales as measured by the Semiconductor Industry Association had strengthened to 7.2% in November 2005 from virtually zero growth in July 2005, and expectations are for further strength in 2006. In addition to stronger

investment spending in the industrial economies, accelerating demand in the Asia is expected to drive growth moving forward.

Ladies and Gentlemen,

24. Against these positive and favourable trends, Malaysia's growth prospects are expected to strengthen in 2006. The strong global and regional growth would benefit Malaysia, in particular the demand for our exports. The stronger export performance, reinforced by sustained domestic demand, is expected to be positive for real income and employment generation. Real private consumption is therefore set to grow further, while real private investment is forecast to expand, supported by the need to undertake capacity expansion, particularly in the manufacturing and oil and gas sectors. As a result of both supportive external and domestic demand, the economy is expected to register improved performance in 2006.

25. The focus of policy thrusts in 2006 would be to build on the gains of 2005, ensuring fundamentals are strengthened and the flexibility of the economy is further enhanced. Macroeconomic policy would continue to stress growth with stability.

26. The year 2006 would see some new initiatives following the announcement of several important medium and long-term documents. The key policy documents to be released this year, namely the Ninth Malaysia Plan and the Third Industrial Master Plan, would chart growth prospects and highlight areas of policy focus and new sources of growth. In particular, both these Plans would stress the importance of making progress in new growth areas in order to achieve the successful transformation of Malaysia into a more resilient knowledge-based economy. Areas for emphasis would include agriculture and biotechnology, Islamic banking and finance, business process and outsourcing services and higher value-added manufacturing activities. More crucially, the emphasis on encouraging private sector-led growth would see more efforts undertaken to ensure that the economic and financial environment are conducive for the building of a dynamic, resilient and flexible economy.

27. In conclusion, the outlook for 2006 remains very positive and the underlying support for growth well grounded. On the part of the private sector, it will be an

opportunity to prepare and upgrade to capture the broader global and domestic opportunities ahead. While the Government will continue to provide an enabling environment for businesses to thrive, the shift to new industries, new activities and new growth areas must ultimately be driven by private entrepreneurs seizing the opportunities to expand and innovate. On this note I would like to thank ASLI once again for giving me this opportunity to address this very important gathering. Thank you.

Jabatan Ekonomi
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