Review and Outlook of the Malaysian Economy

THE MALAYSIAN ECONOMY IN 2010

In 2010, real GDP growth rebounded to 7.2% on improved external demand and low statistical base, compared to a contraction of 1.7% in 2009. Overall growth was supported by the resilient domestic demand and services sector, spurred by the multiplier effect gained from the government's economic stimulus packages.

Easing external demand however took charge in the second half of the year (2H10), as exports and manufacturing fell rapidly, with the debt worries and austerity measures in the Eurozone and deflationary risks in the US. As such, GDP growth slowed to 5.1% in the second half of the year from 9.4% in 1H10.

Supply side

On the supply side, all sectors registered strong performances in 2010, in line with the robust domestic demand and rebound in exports. The services sector, in particular, benefited from the favourable domestic demand conditions, and remained as the largest contributor to growth.

All services sub-sectors recorded higher growth in 1H10 but growth moderated in 2H10, following the slowdown in external demand that affected trade- and manufacturing-related services sub-sectors. Nevertheless, the sustained expansion in domestic consumption continued to benefit the sub-sectors dependent on domestic demand. Overall, the services sector posted a growth of 6.8% in 2010, compared with 2.6% in 2009.

The manufacturing sector recovered firmly, with the electronics and electrical ("E&E") cluster and domestic-oriented industries registering double-digit growth rates in 1H10. Despite the moderation in 2H10, full-year growth of the sector remained robust, registering a double-digit growth of 11.4%.

In terms of expenditure, domestic demand continued to be one of the principal drivers of growth, expanding by 6.3% in 2010. Domestic demand conditions remained strong throughout the year, supported by favourable labour market conditions and positive consumer confidence. Private consumption expanded by 6.6%, particularly driven by consumption of non-essential goods such as communication and transport.

Investment also rebounded strongly in 2010, expanding by 9.4% after recording a 5.6% contraction in the year before. This was reflected in the improvement of major investment indicators. Imports of capital goods recorded a strong growth of 16.2% in 2010, while sales of construction-related materials increased by 11%. Moreover, accommodative financing conditions provided further support to private investment activity. Gross FDI inflows rose to RM89.2 billion (2009: RM70.8 billion), reflecting the more favourable investment climate following improvements in the global economic environment as well as several key initiatives announced by the government.

Table 1: Real GDP by Sector and Demand Aggregate

2000 Prices (% YoY)	2005	2006	2007	2008	2009	2010	1H10	2H10	2011f
Agriculture	2.6	5.2	1.3	4.3	0.4	1.7	4.5	-0.8	0.3
Mining	-0.4	-1.0	2.0	-2.4	-3.8	0.2	1.6	-1.2	-1.0
Manufacturing	5.2	6.7	2.8	1.3	-9.4	11.4	16.5	6.9	4.5
Construction	-1.5	-0.3	7.3	4.2	5.8	5.2	6.3	4.2	9.7
Services	7.2	7.4	10.2	7.4	2.6	6.8	7.9	5.8	6.1
Consumption	8.5	6.4	9.7	9.0	1.2	5.3	6.5	4.1	7.3
Public	6.5	5.0	6.6	10.7	3.1	0.1	6.6	-4.5	5.8
Private	9.1	6.8	10.5	8.5	0.7	6.6	6.5	6.8	7.7
Investment	5.0	7.5	9.4	0.7	-5.6	9.4	9.4	9.5	11.6
Exports	8.3	6.6	4.1	1.6	-10.4	9.8	16.5	4.0	2.7
Imports	8.9	8.1	5.9	2.2	-12.3	14.7	24.5	7.0	5.8
Real GDP	**5.3**	**5.8**	**6.5**	**4.7**	**-1.7**	**7.2**	**9.4**	**5.1**	**5.0**

PROSPECTS AND OUTLOOK IN 2011

Growth remains healthy, though easing slightly

We expect the Malaysian economy to grow further by 5.0% in 2011, supported mainly by continuing expansion in domestic demand. Bank Negara Malaysia (BNM) is projecting a growth between 5.0% and 6.0% this year, while the World Bank forecast stands slightly lower at 5.3%.

While external demand remains weak as a result of slackening growth in the OECD countries, we expect domestic demand to remain the driver of the economy. We expect domestic demand to be driven mainly by a robust expansion in private sector activity, especially private consumption, which is supported by favourable labour market conditions, higher disposable income and sustained consumer confidence. In the investment front, growth will be led by planned investments in infrastructure through the Economic Transformation Programme ("ETP") and other government programmes. In addition, widening interest rate differentials will also encourage more short-term inflows into the country.

Chart 1: Real GDP by Sector (% YoY)

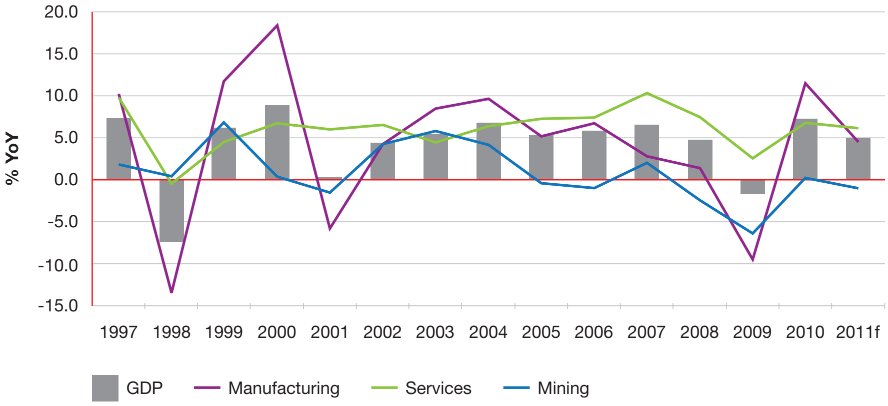
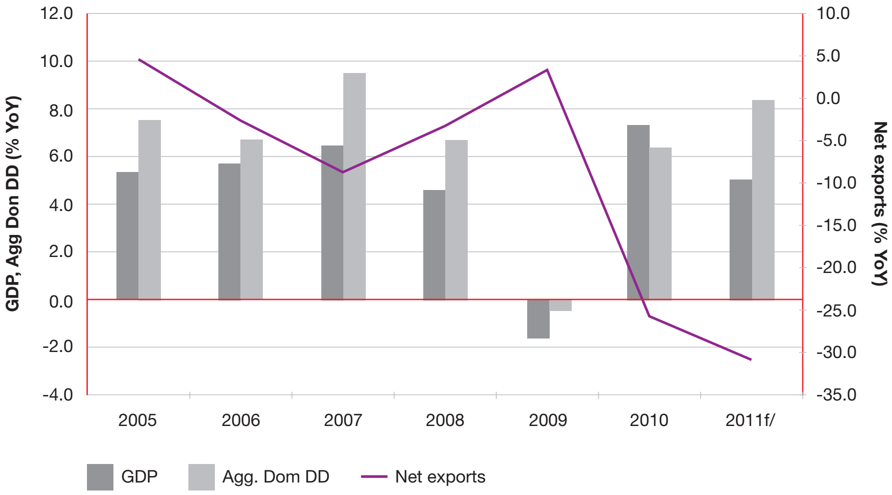


Chart 2: Real GDP, Aggregate Domestic Demand & Net Exports (% YoY)



Manufacturing to moderate in 2011

On the back of continuing easing external demand, we expect manufacturing activity to remain moderate in the coming months. While encouraging PMI figures globally and in developed countries point to a faster-than-expected global economic recovery, high levels of inflation in emerging countries however threaten to put a drag on growth in these economies due to monetary tightening. For Malaysia, we forecast a 4.5% growth in manufacturing output.

Of significance, the recovery in exports of E&E products was evident in December 2010, expanding by 10% after a 12.8% contraction in November.

However, the recovery will still be gradual and weak, especially in 1H11. On consensus, a downward trend is expected to continue for a few months more, in line with the ongoing effects of the global economic weakness.

ETP will be the catalyst of growth

With external demand expected to dampen further, gains from the ETP in higher domestic demand and investments will be the major driving force in averting any potential pitfalls from the debt crisis in the Eurozone as well as the contractionary impact from the Japanese earthquake, tsunami and radioactive threats.

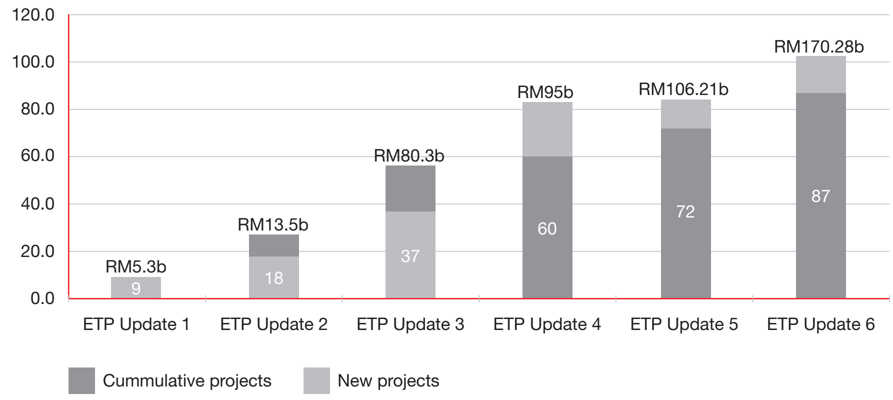
Overall, we are encouraged by the speedier announcement of ETP projects and newsflow on details of implementation. The government is also taking proactive and bold steps towards transformation, which is a positive move in order to set the trend-wise growth momentum needed in this decade. The programme has laid down the necessary policies and foundational measures that are critical to the successful implementation of the NKEAs.

There are good reasons to be optimistic about the ETP, more than the previous plans, whereby a knee-jerk reaction of scepticism was seen with every new plan announced. Providing a strong focus on a few key growth engines, coupled with a detailed approach and a course of action, the ETP is expected to be more successful than previous economic strategies. Though it may be challenging and critical in winning back FDI into the country and in propelling Malaysia to fully-developed status by 2020, we are confident the reforms introduced under the New Economic Model (NEM) would help the government achieve Vision 2020.

In the external sector, we expect to see a sustained surplus in the current account this year, albeit smaller at RM85 billion, on the back of a moderate export growth 2.7% compared to imports 5.8%. The current account surplus could edge higher to around RM100 billion, if oil prices were sustained at above US$100/barrel for a considerable period of time. Being a net exporter of oil, higher levels of oil prices will benefit the country, thus increasing the current account surplus.

High levels of inflation in emerging countries threaten to put a drag on growth with further monetary tightening resulting in a continuing slowdown in external demand, especially from the major trading partners like Singapore, Korea and Thailand. The expected ringgit appreciation will also affect trade performances, as a higher value ringgit would result in an increase in export prices, further reducing Malaysia's competitiveness.

Chart 3: Total ETP Projects that Have Been Announced



The services sector is expected to expand, albeit at a more moderate pace, given the high statistical base of 2010. The services sector will remain the largest contributor to growth, driven by the domestic demand-oriented sub-sectors.

Further progress in ongoing and new infrastructure projects due for implementation under the ETP will provide the impetus to the construction sector.

Inflation to rise, but still at tolerable levels

Moving ahead, we expect inflation to be between 3% and 3.5% this year, accelerating faster in 2H11 as global economic growth picks up. Inflation will likely accelerate further in the near term due to the recent rise in global crude and food prices as well as the government's plan to the implement the subsidy rationalisation programme.

Despite high inflation recorded in many of the emerging markets recently due to the rise in global commodity and food prices, price increases in Malaysia still remain driven mostly by the subsidy cuts implemented by the government. The appreciation of the ringgit has been instrumental in keeping imported inflation at bay; the usage of price controls has also ensured that prices of necessity goods in Malaysia are relatively much lower compared to most countries in the region.

Monetary policy will remain accommodative

With external demand expected to dampen further, gains received from the ETP in domestic demand and investments will be the major thrust in future economic growth. Therefore, an accommodative monetary policy is necessary to ensure easier access to bank credit to fund the ETP. Despite the recent hike in May, we believe the current monetary policy is still pro-growth while aiming to control inflationary pressures.

Higher interest rates might be appropriate when rising inflation is demand-driven, but not when it is mainly due to temporary supply shocks. So, we do not expect any more hikes for the rest of the year. However, this depends on the future impact of global crude oil prices rally on the domestic inflationary environment. If the inflation rate hits 4% and hovers around there for a couple of months, we would not be surprised by an additional 25bps hike in 2H11.

Ringgit will strengthen further

On the ringgit front, we expect the local currency to rally further towards 2.93 per US dollar in the short term, depending on QE II and further accumulation of current account surplus in the system. The rally will not be sustainable in the long term, as "hot money" could potentially leave the country if and when the US dollar reverses. Thus, we see a lower RM/USD rate of 2.97 by end-2011.

Downside risk: Impact of Japanese calamity

It remains premature to quantify the impact of the March 2011 disaster in Japan on its financial markets and economy, and on the global economy as a whole. While the short-term effects have definitely been negative, the long-term implications are more encouraging for an export-oriented nation like Malaysia. We do not expect any recovery in the Japan economy at least until the tail-end of the year, with the negative impact being felt over the next two quarters.

Malaysia's trade activities with Japan may slow in the near term

Japan remained as Malaysia's fourth largest export destination in 2010, accounting for 10.4% of total exports. While the direct impact on trade in the near term would be negative, Malaysia's exports to Japan will improve in the later part of 2H11, as economic activities in Japan resume and the rebuilding process picks up momentum. In the near term, the E&E sector in Malaysia would likely be the most severely affected, as output for several key components that are imported from Japan such as system integration chips for electronics products and components for flat-screen panels would be greatly reduced.

On the other hand, higher exports of energy products such as LNG to Japan could partially offset the reduction in E&E as Japan temporarily maximises its power generation from thermal plants due to the nuclear catastrophe.

Supply chain disruptions will also be detrimental

As a large number of industrial and civil facilities in Japan were destroyed, or their output halted on the back of the rolling blackouts implemented to conserve energy, the resulting supply chain disruption also has a potentially huge negative impact on Malaysia, especially in terms of shortages for intermediate inputs. This has been more profound in the auto sector as even a small shortage of auto parts would immediately affect overall production due to the industry's

Chart 4: Overnight Policy Rate (%)

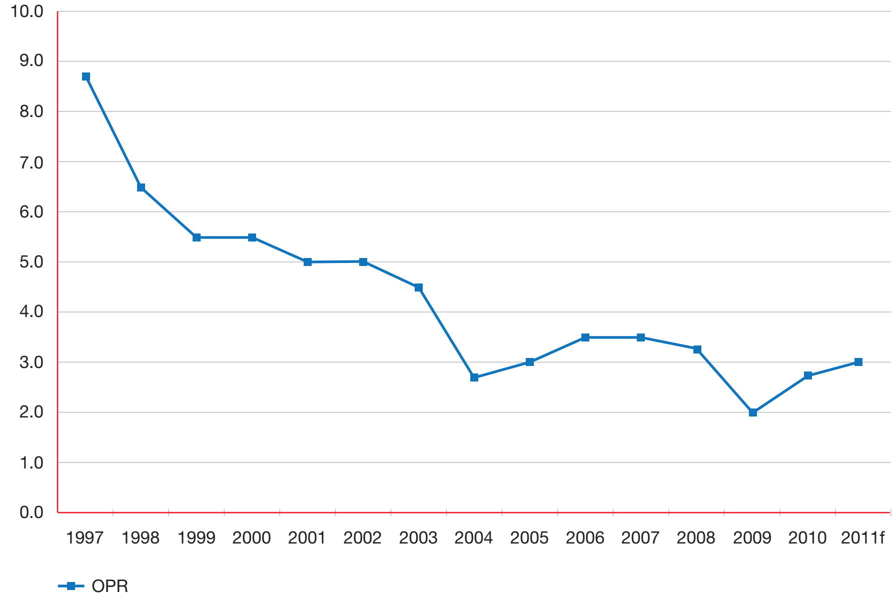


Chart 5: Ringgit Performance Against Major Currencies (Year to Date 2010=100)

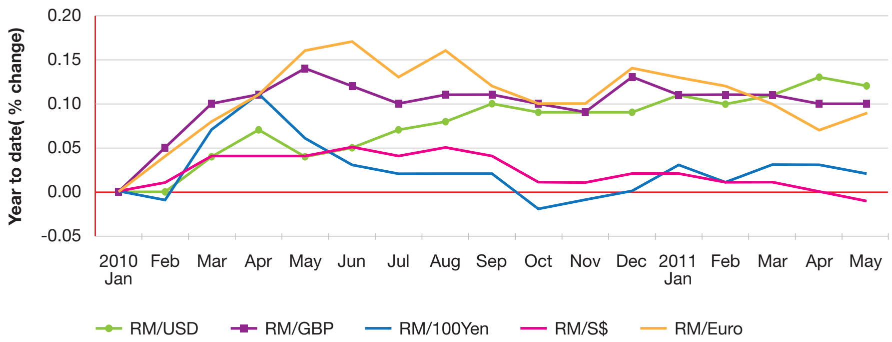
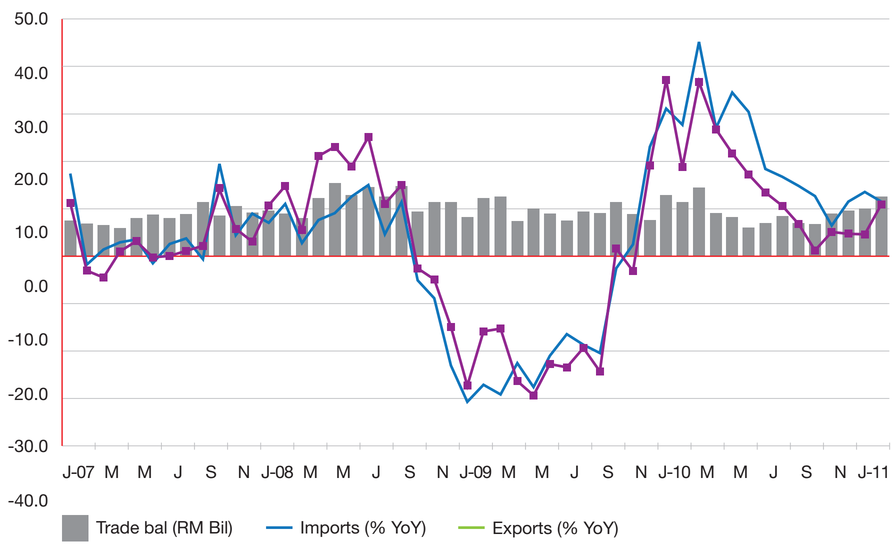


Chart 6: Malaysia External Trade



reliance on just-in-time inventory management. The difficulty in obtaining substitute products will further increase the negative impact on these sectors.

Long-term impact however remains positive

Although the expected slowdown in growth across all sectors in Japan would certainly be felt, heavy spending in the long term on reconstruction projects would eventually help restore Japan's economy, which in turn could result in a surge of demand for some Asian products such as energy, timber and other commodities.