Review and Outlook for the Malaysian Economy

Growth moderation seen in 2011 as GDP slows to 5.1%

The Malaysian economy remained resilient in 2011 as growth was supported by robust levels of domestic demand as well as the services sector, not to mention the multiplier effect gained from the government's various initiatives. Easing external demand, however, remained for the most part of the year with exports and manufacturing falling due to the weaknesses in the Eurozone as well as natural disasters occurring in parts of the world.

For 2011 as a whole, growth slowed to 5.1% year-on-year ("YoY") from a strong expansion of 7.2% in 2010. The growth rate was in line with our house estimate of a 5.2% YoY GDP growth for 2011. The main contributors of GDP on the supply side were still the services and manufacturing sectors, while private final consumption drove the economy on the demand side.

Manufacturing slower on external conditions, natural disasters

On the back of the slowdown in trade-related activities, the manufacturing sector expanded at a modest pace of 4.5% in 2011 (2010: 11.4%) as growth in the domestic-oriented industries outweighed weakness in the export-oriented industries. Supply disruptions emanating from the natural disasters in Japan as well as Thailand also contributed to the under-performance of the sector.

Services remain as main contributor to GDP

The services sector (59.4% of total GDP) on the other hand, expanded at a robust rate of 6.8% in 2011 (2010: 6.8%). While the finance and insurance sub-sector expanded firmly following strong performance in bank lending and increased collection of insurance premiums, the wholesale and retail trade sub-sector continued to register steady performance, underpinned by robust private consumption.

Construction moderated, while agriculture expanded

The construction sector expanded at a moderate rate of 3.5% in 2011 (2010: 5.1%) due to slower activity in the civil engineering and non-residential sub-sectors. The civil engineering and special trade sub-sector registered slower growth following the completion of major highway projects and maintenance and upgrading work under the second stimulus package. Growth in the non-residential sub-sector also moderated after strong double digit growth in the previous year.

The agriculture, forestry and fishing sector expanded at a stronger pace of 5.6% in 2011, supported by a recovery in the production of crude palm oil (CPO). Output of other key crops such as rubber and food crops was sustained by strong regional and domestic demand.

Domestic demand expands at a higher rate

In terms of expenditure, domestic demand continued to be the main driver of growth, expanding by 8.2% in 2011 (2010: 6.3%), driven by both household and business spending, and higher public sector consumption.

Private consumption strengthened in 2011, growing by 6.9% (2010: 6.5%), supported by a broad based growth in income following the overall improvement in labour market conditions and higher commodity prices. The year-end festive season as well as the bonus payments to civil servants also supported private consumption.

Public consumption also expanded substantially by 16.8% in 2011 (2010: 0.5%), the outcome of higher public expenditure on emoluments, supplies and services, and the one month bonus payment during the year.

Investments gain on private sector expansion

Private investment expanded by 14.4% in 2011 (2010: 17.7%). Higher capital expenditure was evident across all sectors, especially in the first half of the year, driven mainly by strong domestic demand. However, the strong investment momentum began to moderate slightly towards the second half of the year, especially in the manufacturing sector, following increased uncertainties in the global economic environment.

Public investment, however, contracted by 2.4% in 2011 (2010: 2.8%) following the lapse of the second stimulus package in 2010. Nevertheless, capital spending by the non-financial public enterprises ("NFPEs") remained strong, providing support to overall public investment.

Table 1: Gross Domestic Product at Constant 2000 Prices (% YoY change)

2000 prices (% YoY)	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012f
Agriculture	6.0	4.7	2.6	5.4	1.4	4.0	0.6	2.1	5.6	3.0
Mining	6.1	4.1	-0.4	-2.7	2.0	-0.8	-6.3	0.2	-5.7	-1.0
Manufacturing	9.2	9.6	5.2	7.1	3.1	1.3	-9.3	11.4	4.5	4.3
Construction	1.8	-0.9	-1.5	-0.5	4.7	2.1	5.9	5.1	3.5	7.9
Services	4.2	6.4	7.2	7.3	9.6	7.2	3.1	6.8	6.8	6.0
Real GDP	5.8	6.8	5.3	5.8	6.2	4.6	-1.6	7.2	5.1	5.0
Consumption	8.2	9.4	8.5	6.1	9.9	9.0	1.2	5.2	8.9	6.2
Public	8.6	7.6	6.5	4.9	6.5	10.9	3.9	0.5	16.8	3.4
Private	8.1	9.8	9.1	6.5	10.4	8.5	0.7	6.5	6.9	7.1
Investment	2.8	3.6	5.0	7.9	9.2	0.8	-5.6	9.8	6.0	8.8
Exports	5.1	16.1	8.3	7.0	4.1	1.3	-10.5	9.9	3.7	1.5
Imports	4.5	19.6	8.9	8.5	5.6	1.9	-12.2	15.1	5.4	6.0
Real GDP	5.8	6.8	5.3	5.8	6.2	4.6	-1.6	7.2	5.1	5.0

Prospects for 2012: Domestic demand will be the main growth driver

Domestic demand has been a key driver of Malaysia's GDP growth in the past, especially more so with regard to propelling an economic recovery. We expect this trend to continue in the medium term, especially given the weaknesses seen in the external sector.

While the downside risks of growth emanating from the softening external sector continues to plague mainly the supply-side, domestic demand will likely grow at a stronger rate of 9.9% YoY (2011: 8.2% YoY), on the back of a strong expansion anticipated in private sector activities brought about by increasing income, favourable labour market conditions as well as sustained consumer confidence.

Meanwhile, the public sector will also likely play a crucial role in supporting domestic growth through the implementation of various projects under the Economic Transformation Programme (ETP) and the 10th Malaysia Plan (10MP) as well as higher capital expenditure by the NFPEs.

Higher levels of emoluments as well as supplies and services will also ensure a sustained increase in public sector consumption in 2012.

Private investment growth spurts

We expect private investment to perform relatively well in 2012, on the back of an acceleration in capital spending across most of the major sectors, brought about by the implementation of large infrastructure projects slated to begin this year. In addition, higher FDI into Malaysia will also contribute positively towards private investment growth.

Among the major infrastructure projects that will likely have a significant impact is the MRT, an integrated transport system for the Klang Valley. The objective of the project is to increase the number of people using public transport, alleviate traffic congestion and decrease travel time from one destination to another.

With an encouraging rate of progress, the RM36.6b MRT project will likely spur growth in many of the related sectors such as manufacturing as well as building materials. These major infrastructure projects are also expected to spur property development in surrounding areas.

Apart from construction, among the sectors that will witness significant growth would be investments in manufacturing as well as services, as higher domestic demand will likely result in rising levels of capital spending. The mining sector will also experience a strong increase as supported by the expansion and upgrading of existing production facilities, development expenditure for new discoveries in the past few years, as well as exploration activities in the deepwater and marginal oil fields.

Public investment to garner strength from various ETP, 10MP projects

Following the ETP and 10MP theme, we expect public investment to remain supportive of growth in 2012 on the back of higher government capital spending, driven by new projects planned under the initiatives mentioned earlier. In this regard, development expenditure will also likely increase due to rising investments in providing basic rural infrastructure as well as to improve connectivity in urban public transport.

Another key factor that would drive public investments in 2012 would be the rise in investment by the non-financial public enterprises (NFPEs). Among the key contributors to growth in this sub-sector would be the rise in capital expenditure in the oil and gas sector, largely due to the increase in upstream activities for the development of marginal fields and deepwater explorations. Moreover, capital expenditure in rail and airport expansion will also give rise to an increase in public investments this year. In this regard, we envisage total investment to likely witness a strong growth of 9.4% YoY in 2012 (2011: 6.0% YoY).

Private consumption remains as key contributor to domestic demand

We expect private consumption to be the main contributor to domestic demand growth in 2012, remaining robust on the back of steady consumer confidence and a stable employment outlook as well as a higher

Chart 1: Real GDP Growth (% YoY)

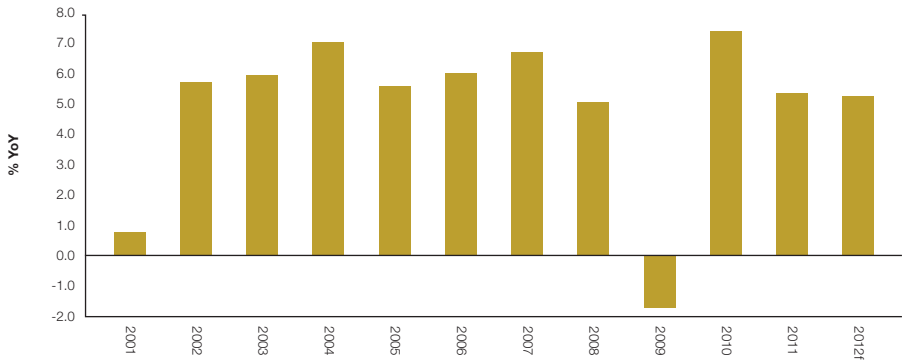

Chart 2: Expenditure on GDP (% YoY)

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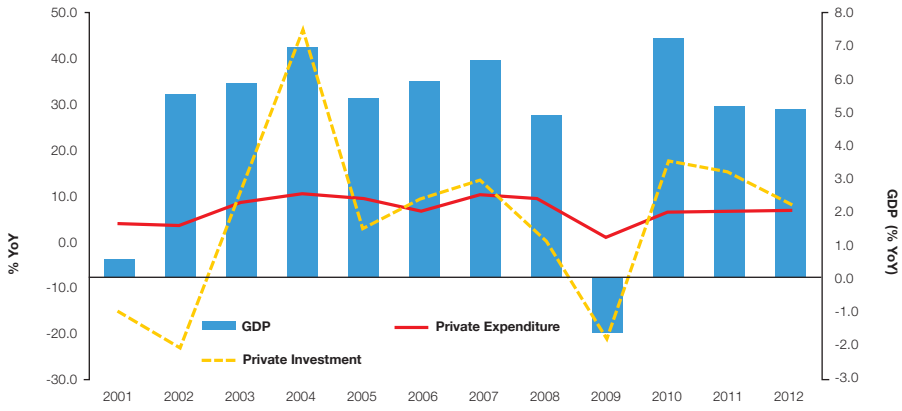
Chart 3: Private Expenditure and Investment Growth (% YoY)



household income. Under Budget 2012, the government had also announced a wide range of policy measures that will ensure a sustained growth of the domestic demand this year.

In this regard, growth in private consumption is expected to be broad-based, expanding by 6.9% in 2012 (2011: 6.9% YoY). While firmer commodity prices are expected to encourage higher rural household spending, the proposed civil service reform programme under Budget 2012 will also encourage higher levels of spending due to an increase in disposable income for civil servants.

Supply-side sectors to grow at a steady pace

Broad-based growth is expected for all sectors of the economy, with services and manufacturing continuing to be the major contributors of GDP.

We expect the services sector to expand by 6.2%, supported by the increasing demand coming from the implementation of many ETP projects this year as well as strong private consumption, steady intra-Asian trade and increased tourist spending. All sectors are expected to register a healthy growth rate led by the wholesale and retail trade, finance and insurance as well as communication sub-sectors.

The manufacturing sector, however, will likely witness a more apparent slowdown, due to the impact of a weaker external demand trickling down to this heavily trade-related sector. While the sector would be supported by the strong growth in domestic-oriented industries, we expect growth in manufacturing to slow from +4.5% in 2011 to +4.3% this year.

Construction to benefit from ETP projects

Meanwhile, a sector that will surely grow significantly in 2012 will be the construction sector, driven by the commencement of large infrastructure projects under the ETP. Construction activities are projected to grow strongly by 7.9% in 2012 (2011:3.5%), supported by the acceleration of ongoing projects such as the construction of the Mass Rapid Transit (MRT) projects as well as the ongoing construction of KLIA2 and development programmes in rural areas.

Despite external headwinds, domestic growth will propel the economy

In summary, while we continue to expect GDP growth to somewhat moderate in 2012, with the external weakness being the main drag, we hold our view that domestic demand, especially in private consumption and investment, would support GDP growth in the quarters ahead.

We may see Malaysia's growth potentially slipping below the trend average of 5% in 1H12, in line with the slowdown in major economies. However, we anticipate a stronger US economy in the coming quarters, as well as further roll-out of major ETP projects in the coming months. In addition, the moderating inflationary pressures would also be positive for the domestic economy in 2012.

Thus, coupled with the support of strong domestic demand, we expect growth to rebound sharply in 2H12, which would average the annual growth to around 5% this year.

Inflation will likely moderate

For Malaysia, we remain confident that inflation has peaked for the next two years at 3.5% YoY in June last year, and will continue to fall in the coming months. In this regard, we envisage inflation to likely slow to around 2% for 2012 on the back of high base effects as well as the slowdown expected in regards to the global economy.

Monetary Policy will remain accommodative

In terms of monetary policy, while uncertainties in the global economy will likely remain as the main downside risk in 2012, robust levels of domestic demand as well as adequate levels of financing suggest that at 3%, the OPR continues to be at an accommodative level in promoting growth, while ensuring adequate levels of price stability.

As such, we do not see the need for any rate cut in the quarters ahead. We expect the OPR to remain at the current level of 3% throughout 2012.

Ringgit to end 2012 at RM3.15 per US dollar

On the back of concerns about the Eurozone debt crisis as well as the increasing risk of a global economic downturn, currencies across the globe had depreciated against the US Dollar in 2012. After appreciating strongly at the beginning of last year to record a low of RM2.93 per US dollar in July, the Ringgit has depreciated significantly ever since on the back of the reduced risk appetite particularly among foreign investors.

While currencies in the region continue to be deemed as undervalued, given the relatively strong growth potential, as well as widening interest rate differentials, the heightened levels of global uncertainties have resulted in large capital outflows from emerging markets as investors seek the safety of the US Dollar as well as the Japanese Yen.

Chart 4: Total ETP Projects That Have Been Announced

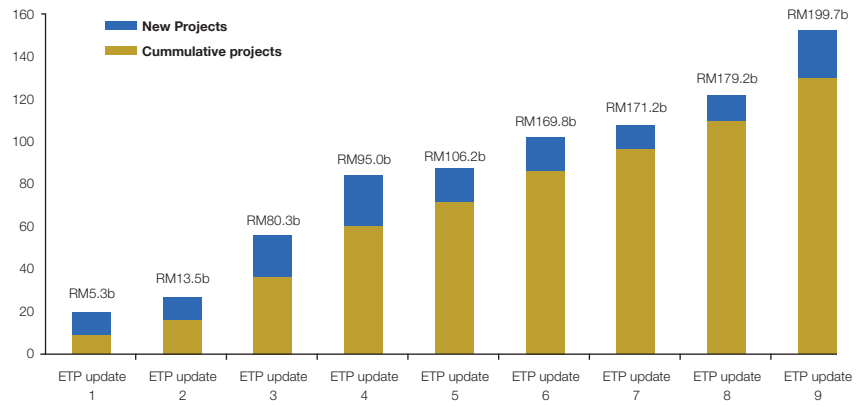


Chart 5: Real GDP Growth (%YoY) and Overnight Policy Rate

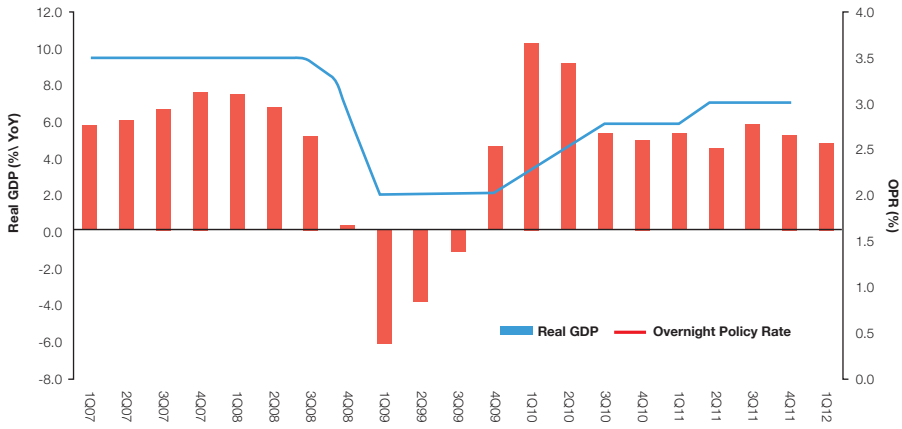
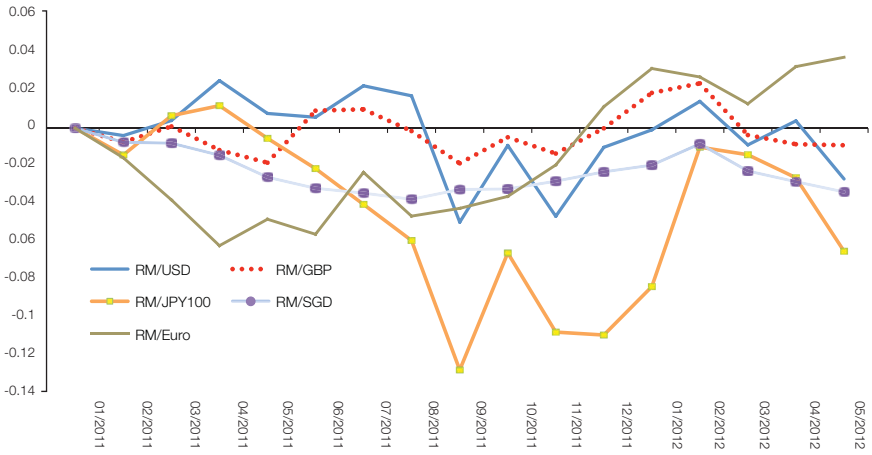


Chart 6: Ringgit Perfomance against other selected currencies (% ytd change)



In this regard, we expect the local currency to end 2012 at around 3.15 per dollar, depending on the performance of global trades and thus its impact on current account surpluses.

Conclusion

While heightened uncertainties in the global economy may continue to cloud the prospects of external demand in the quarters ahead, we continue to believe that strong expansion in domestic demand will prevail to support and remain the main driver of Malaysia's GDP growth this year.

The domestic economy will be able to sustain its momentum, with growth led by the further roll-down of major projects under key government initiatives such as the ETP as well as the 10MP.

In this regard, the commencements of large infrastructure projects, among them the Mass Rapid Transit (MRT) as well as investments in exploration and production activities in the oil and gas sector will likely ensure sustained growth in private investment and consumption. This will also be complemented by the corresponding rise in employment opportunities via domestic-oriented manufacturing and services sectors.

Similarly, lower inflation levels as well favourable labour market conditions would also be positive in providing necessary impetus to expansion, despite the potential weaknesses in external demand from major industrial economies.

Overall, we hold onto our view that domestic demand would support GDP growth in the quarters ahead, and we remain optimistic that for 2012, a decent growth of around 5% YoY would still be achievable.