



**BANK NEGARA MALAYSIA**  
CENTRAL BANK OF MALAYSIA

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**Bank Negara Malaysia Annual Report 2007**

**The Malaysian Economy in 2007**

In 2007, growth in the Malaysian economy strengthened despite a weaker external environment. Robust domestic demand, driven by strong private consumption and investment activities, raised real gross domestic product (GDP) growth to 6.3% (2006: 5.9%). This was reinforced by increased public sector spending. Growth was broad-based, reflecting expansion across all sectors in the economy, and was led by the services sector.

During the year, aggregate domestic demand expanded at a strong pace of 10.5% (2006: 7%), with the private sector continuing as the principal driver of growth. Private consumption expanded at a faster pace of 11.7% (2006: 7.1%), supported by the steady increase in disposable income, stable labour market conditions as well as favourable financing conditions. Higher commodity prices, especially prices of crude palm oil and rubber, led to rising disposable income of households in rural areas. In

addition, the upward salary adjustments for civil servants further strengthened consumption in the second half of the year. Private investment also expanded at a faster rate, recording a strong growth rate of 12.3% (2006: 7%), with acceleration in capital spending in most economic sectors amidst positive business sentiment. Capital expenditure was reinforced by large inflows of foreign direct investment (FDI) and the healthy financial position of businesses due to strong corporate earnings. The Government continued to play a prominent role in supporting and encouraging private sector activities. In Budget 2007, the Government introduced the reduction of corporate tax by two percentage points in two stages, to 27% in 2007 and 26% in 2008. This helped to reduce further the cost of doing business and accorded companies with greater capacity to expand capital spending. Public investment grew at a supportive pace of 8%, while public consumption also increased steadily, by 6.4%.

<b>GDP by Expenditure Components (% change)</b>		
	2006	2007 <sup>p</sup>
Gross Domestic Product	5.9	6.3
Private sector expenditure <sup>1</sup>	7.0	11.8
Consumption	7.1	11.7
Investment	7.0	12.3
Public sector expenditure <sup>1</sup>	6.8	7.2
Consumption	5.0	6.4
Investment	8.9	8.0
Net exports of goods and services	0.1	0.9
Exports	7.4	3.7
Imports	8.6	4.1

<sup>1</sup> Exclude stocks

<sup>p</sup> Preliminary

The strong overall 2007 growth performance reflected positive growth rates in all sectors of the economy. Growth was led by the strong performance of the services sector, and supported by the construction and mining sectors. The strong growth of 9.7% (2006: 7.2%) in the services sector reflected the increasing prominence of the sector as a contributor to growth, having accounted for five percentage points of the

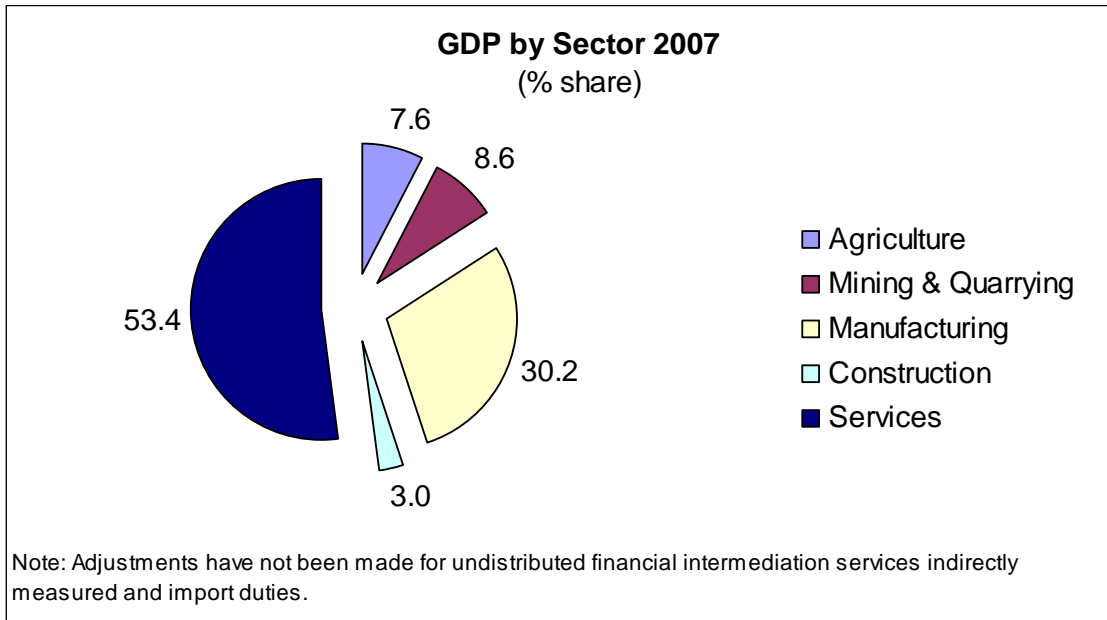
total real GDP growth in 2007. The growth in the services sector was supported by robust domestic demand and tourism activity which benefited from Visit Malaysia Year 2007 promotions. Of importance, the strong performance of the services sector was broad-based, with the key drivers being the real estate and business services; finance and insurance; communication; and wholesale and retail trade sub-sectors.

After three years of decline, the construction sector turned around to register a positive growth of 4.6% (2006: -0.5%), driven mainly by the civil engineering sub-sector, the oil and gas sector, and the expansion in the non-residential and residential sub-sectors. The civil engineering sub-sector benefited from the implementation of the projects under the Ninth Malaysia Plan (9MP). The mining sector also rebounded to record a positive growth of 3.2% (2006: -0.4%), led by higher production of crude oil following the coming on-stream of the Kikeh oil field. The manufacturing and agriculture sectors recorded more moderate expansion in 2007. The manufacturing sector expanded by 3.1% (2006: 7.1%). Weaker external demand led to a slowdown in the production and exports of electronics and electrical products, especially in the first half of the year. Nevertheless, reflecting the relatively broad-based structure of the manufacturing sector, the impact on overall manufacturing activity was cushioned by the sustained growth in the domestic-oriented and resource-based industries. The agriculture sector expanded by 2.2% in 2007 (2006: 5.2%), supported by food-related activity, particularly livestock, paddy, and vegetables. The strong performance in food-related activity more than offset the weaker performance in key industrial crops, namely crude palm oil and rubber, which were affected by the biological yield down-cycle and adverse weather conditions.

**GDP by Economic Sector (% change)**

	2006	2007 <sup>p</sup>
Real GDP	5.9	6.3
Agriculture	5.2	2.2
Mining & Quarrying	-0.4	3.2
Manufacturing	7.1	3.1
Construction	-0.5	4.6
Services	7.2	9.7

<sup>p</sup> Preliminary



The average headline inflation rate, as measured by the annual change in the Consumer Price Index (CPI), was lower at 2% in 2007 (2006: 3.6%). The level of inflation was within the Bank's forecast range of 2.0 – 2.5%. Of the CPI components, price increases in the food and non-alcoholic beverages category were the main contributors, accounting for 47.1% of the headline inflation rate. While supply factors remained important, their contribution to overall inflation moderated, as the impact of earlier adjustments to administered prices waned in the first quarter of 2007. The absence of major adjustments to price-administered items during the year also mitigated the impact of supply factors on domestic prices.

#### Inflation and Unemployment

	2006	2007
Average Inflation (% change)		
CPI (2005=100)	3.6	2.0
Core CPI <sup>1</sup>	2.1	1.8
Unemployment (% of labour force)	3.3	3.3

<sup>1</sup> Excludes price-controlled items and price-volatile items as well as items that are subject to one-off price adjustments

Malaysia's external position strengthened in 2007. The current account recorded a larger surplus of RM99.3 billion or 15.8% of GNI (2006: RM93.4 billion or 16.8% of GNI), while net outflows in the financial account moderated. The large trade surplus was sustained, underpinned by strong growth in commodity exports which partially mitigated the weaker demand for manufactured exports, while improvements were registered in the services and income accounts. The services account recorded its first surplus of RM1 billion or 0.2% of GNI due mainly to higher tourism and transportation receipts. Higher profits and dividends accruing to Malaysian companies investing abroad as well as higher returns from external reserves led to a lower income account deficit. In the financial account, improved economic prospects and investor sentiment contributed to higher net inflows of both FDI and portfolio investment. However, these inflows were offset by higher direct investment abroad by Malaysian companies, and net outflows of other investment.

After adjusting for errors and omissions, which include the foreign exchange revaluation loss arising from the strengthening of the ringgit against major currencies, net international reserves increased by RM45.3 billion to RM335.7 billion (equivalent to USD101.3 billion) as at 31 December 2007. As at 14 March 2008, the international reserves level rose further to RM393.2 billion (USD119.1 billion), adequate to finance 9.8 months of retained imports and is 7.2 times the short-term external debt.

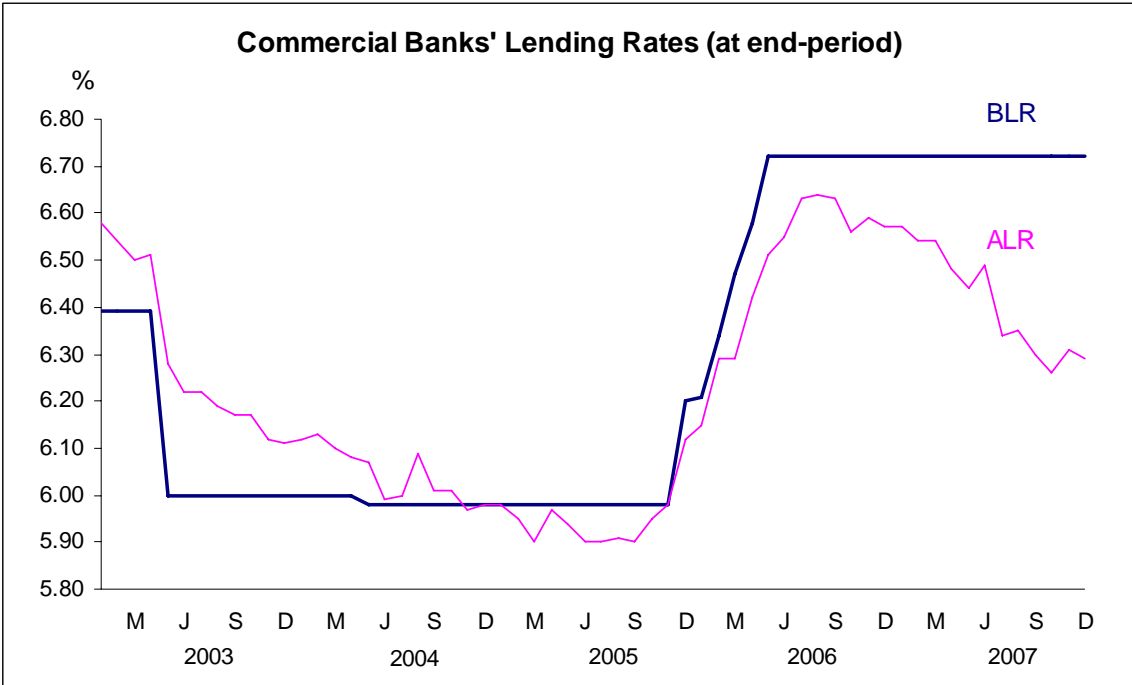
### **Monetary and Financial Conditions in 2007**

Domestic monetary and financial conditions remained favourable in 2007. Despite being subject to bouts of volatility in capital flows coinciding with swings in sentiments in response to developments in the global financial markets, domestic financial markets demonstrated resilience, supported by robust domestic macroeconomic fundamentals.

In fulfilling the objective of maintaining price stability and promoting sustainable economic growth, monetary policy in 2007 was faced with the dual challenge of inflationary pressures emanating from escalating global commodity and food prices, and

heightened downside risks to growth arising from unstable global financial markets. Although domestic demand had accorded considerable resilience to the economy, as a small and highly open economy, Malaysia is not insulated from external developments. The heightened uncertainties in the major financial markets, particularly the US financial system, in 2007 gave rise to a wide range of possible outcomes surrounding growth and inflation prospects. The overall assessment was that the risks to growth and inflation in Malaysia were about balanced. The prevailing monetary conditions were thus assessed as being consistent with the medium term growth and inflation outlook. The Overnight Policy Rate (OPR) was, therefore, left unchanged at all of the eight policy meetings during the year.

With the OPR unchanged at 3.50% throughout the year, monetary conditions were assessed as being supportive of economic activity. Bank Negara Malaysia conducted monetary operations to stabilise the average overnight interbank rate around the OPR. Changes in other domestic money market rates as well as retail interest rates were driven primarily by market factors. While the average base lending rate (BLR) of commercial banks was unchanged at 6.72%, the average lending rate (ALR) on outstanding loans and lending rates on new loans approved trended lower. The declining trend in lending rates reflected the ample supply of loanable funds, coupled with increased competition amongst banks.

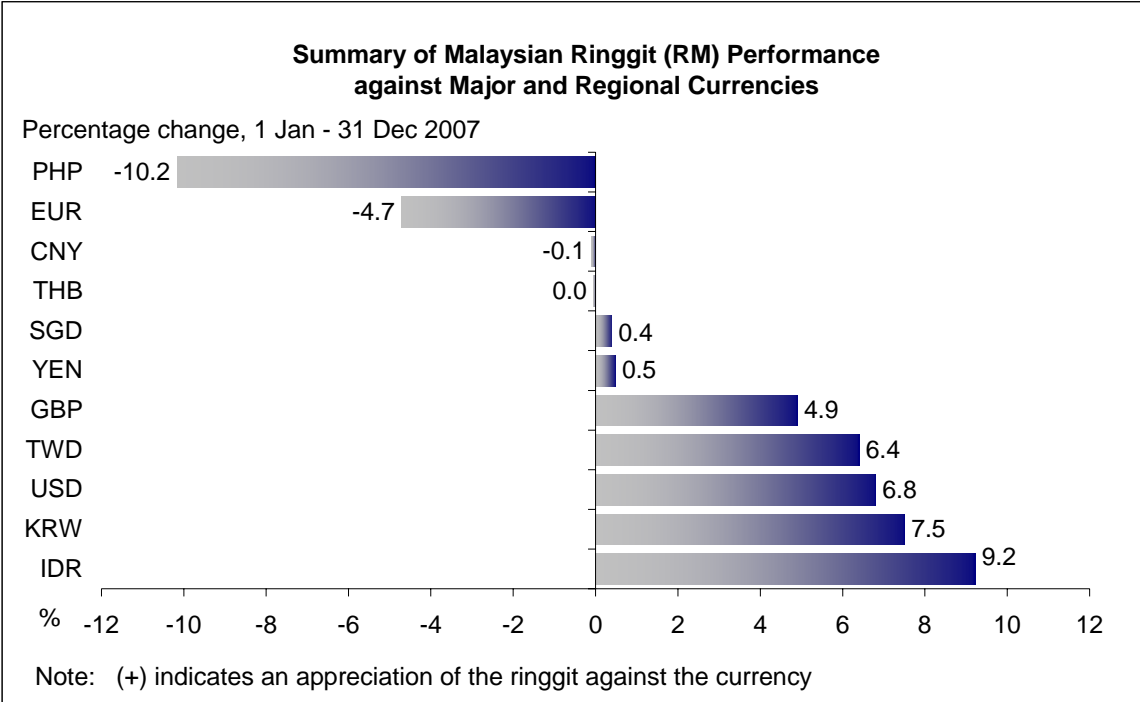


Amid ample liquidity and low borrowing costs, total net financing channelled to the economy, encompassing both the public and private sectors, increased at a higher rate of 9.3% (2006: 6.1%). In terms of financing to the private sector, there was higher demand for financing from both the business and household sectors, to support investment and consumption activities. Corporate merger and acquisition, and privatisation activity, along with the progress of projects under the 9MP provided additional impetus to the growth in financing during the year.

The higher financing to businesses was observed in terms of both bank loans and funds raised in the capital markets, with the former mainly for working capital, while the latter was to facilitate capital investments. In terms of financing to the household sector, there was a rebound in bank loans, which was attributable to higher incomes, stable employment prospects and the introduction of various Government initiatives in the residential property sector. Of importance, the turmoil in the global financial markets in the second half of 2007 had negligible impact on domestic financing activity. The banking institutions do not have direct exposure to securities backed by US subprime mortgages, and with the surplus liquidity and strong capital positions, this mitigated the implications on the domestic financial system. The bond market remained vibrant, with several large issuances contributing to the highest annual amount of funds raised to date of RM66.5 billion (2006: RM30.7 billion).

Strong two-way trade and investment flows continued to influence ringgit performance against major and regional currencies during the year. Underlying demand for the ringgit was derived from the positive net trade balance, sustained inward direct investment and repatriation of profits and dividends by Malaysian companies with investments abroad. Ringgit demand was augmented by significant portfolio inflows, especially into the equity market, as expectations of strong earnings growth and further currency appreciation contributed to the rerating of Malaysian equities. These factors were somewhat counterbalanced by demand for foreign currencies to fund larger outward direct and portfolio investments, repayment and prepayment of external loans

by both the public and private sectors and the repatriation of profits and dividends by non-residents. The broadly positive ringgit trend was also punctuated by several global financial events during the year, such as the global equity correction in the first quarter and the US subprime mortgage related turmoil in the third quarter.



The disorderly conditions in the global financial markets also contributed to some volatility in the ringgit bond market yields. Bond yield movements were also influenced by expectations of a stronger ringgit and changes in inflation expectations during the year. Notwithstanding bouts of volatility, the Kuala Lumpur Composite Index (KLCI) remained resilient in 2007. The KLCI continued its upward momentum and achieved several new highs to reach 1,445.03 at year-end, recording a gain of 31.8% in 2007. The KLCI was buoyed by strong macroeconomic fundamentals, robust corporate earnings and higher commodity prices.

During the periods of temporary reversals in capital flows, the unwinding of existing outstanding sterilisation operations facilitated orderly adjustment in the money and financial markets. The prompt and flexible monetary response in dealing with strong

outflows, particularly in the August-September period, was possible due to the use of various monetary instruments with short average maturities.

### **Outlook and Prospects for the Malaysian Economy in 2008**

After robust growth in 2007, global growth is expected to moderate to 3.7% in 2008 (4.7% in 2007). While economic activity in the developed economies is expected to soften, the growth momentum is expected to remain strong in Asia and in the other emerging economies. The global growth outlook would depend critically on the length and depth of the US slowdown and its impact on the global economy, as well as the extent of the impact from large scale financial market disintermediation on the rest of the world. Inflation is expected to remain elevated following sustained high commodity and food prices. While these developments will have a dampening impact on the Asian regional economies, the growth in the Asian region will continue to be supported by strong domestic demand and the strong growth momentum in the large emerging economies in the region, in particular China and India. The high commodity prices will provide additional impetus for growth in several of the commodity-producing economies.

Considerable uncertainty, however, surrounds the global and regional outlook. In the event of a protracted period of significantly below-trend growth of the US economy, accompanied by a sharper slowdown in other industrialised economies, there would be a larger impact on growth across the region as trade linkages to the developed economies remain strong. A further risk is the impact from the disruptions in the functioning of the financial markets and the ability to allocate capital effectively. Further adverse credit-constraining developments in the affected economies could precipitate more widespread financial market volatility, affecting business and consumer sentiment, and potentially prolonging the downturn in economic activity.

On the domestic front, the resilience of the Malaysian economy to weather a slowdown in the global economy has strengthened over the years, due to a number of

factors. First, domestic demand has emerged as a key driver of growth. Second, Malaysia's export markets are increasingly diversified, with almost 54% of total exports to the Asian (exclude Japan) economies (2001: 46.2%). The share of Malaysia's exports to US has declined to 15.6% in 2007 from 20.2% in 2001. Thus, while global growth is expected to moderate in 2008 due mainly to slower growth in the US, and to a lesser extent, in Europe and Japan, the baseline outlook for strong economic growth in the Asian region and other emerging economies would support the export sector. Third, as a commodity producer, Malaysia will continue to benefit from high prices of crude oil, palm oil and rubber. In addition, the strong base in the commodity sector also helps to further strengthen the linkages with down-stream activities, including the resource-based industries which will continue to benefit from robust domestic demand as well as demand from the regional economies.

Against this backdrop, the outlook for the Malaysian economy in 2008 remains favourable with GDP projected to expand by 5 – 6% in 2008. Domestic demand is expected to remain resilient, providing strong support to the economy. The major underlying factors supporting domestic private sector activities are expected to remain broadly intact in 2008. Private consumption will be supported by the steady growth in income, firm labour market conditions, high commodity prices as well as a conducive financing environment. The diversified and high levels of approved domestic and foreign direct investments for a number of years now, particularly in the manufacturing, services, and oil and gas sectors, indicate that private investment activity will remain robust in 2008. In addition, private investment will also benefit from measures implemented to further improve business environment, including the reduction in corporate tax rate, as well as intensification of implementation of projects under the 9MP and the economic corridors. The public sector will continue to remain supportive of growth in facilitating the efficient implementation of these projects.

### Real GDP by Expenditure

2008f		
	Annual change (%)	Contribution to real GDP growth (percentage point)
<b>Domestic Demand <sup>1/</sup></b>	<b>5.6</b>	<b>4.9</b>
Private sector expenditure	6.5	4.1
<i>Consumption</i>	6.5	3.3
<i>Investment</i>	6.3	0.8
Public sector expenditure	3.5	0.8
<i>Consumption</i>	6.0	0.8
<i>Investment</i>	0.5	0.1
<b>Change in stocks</b>		<b>1.8</b>
<b>Net exports of goods and services</b>	<b>-8.4</b>	<b>-1.3</b>
Exports	0.9	1.1
Imports	2.3	2.4
<b>Real Gross Domestic Product</b>	<b>5.0 ~ 6.0</b>	

Note: Figures may not necessarily add up due to rounding

<sup>1</sup> Excluding stocks

*f* Forecast

Source: Bank Negara Malaysia

On the supply side, the services sector will remain the key driver of growth, and will be reinforced by higher growth in the construction and commodities sectors. The services sector will be supported by the resilient private consumption and a robust tourism sector, while the implementation of the 9MP projects as well as investment in the oil and gas sector would underpin the growth momentum in the construction sector. The agriculture and mining sectors will register stronger growth following expected higher production of crude palm oil and rubber, as well as crude oil respectively. The manufacturing sector, however, is expected to record a moderate expansion in an environment of weak external demand, particularly from the US. The robust domestic demand and growth of regional economies will, however, support growth in the

domestic-oriented and selected resource-based industries and thus, partly mitigate the downside risks from the projected slowdown in the E&E industry.

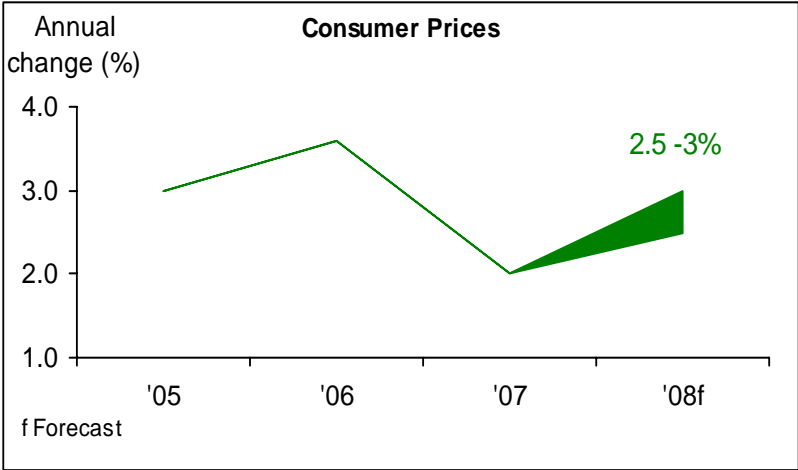
<b>Real GDP by Sector</b>	
	2008 <sup>f</sup>
Agriculture	3.4
Mining & quarrying	6.0
Manufacturing	1.8
Construction	5.5
Services	7.7
<b>Real GDP</b>	<b>5.0 ~ 6.0</b>
<sup>f</sup> Forecast	
Source: Bank Negara Malaysia	

On the external front, reflecting the slowdown in the global economy, both exports and imports are expected to record slower growth of 1.8% and 1.4% respectively in 2008. Nevertheless, the current account surplus is expected to remain high, at 14.4% of GNI. The large surplus in the current account will be supported mainly by a sustained high trade balance underpinned by strong exports of commodities and non-E&E products, and further reinforced by a continued surplus in the services account due to higher tourism receipts. Similarly, the financial account is expected to remain favourable, supported mainly by continued inflows of FDI.

Growth in 2008 will continue to be supported by robust domestic demand in an environment of weaker external demand. All economic sectors are projected to record positive growth. In the event of a severe deterioration in the external environment, Malaysia has at its disposal, policies to contain the implications on the domestic economy.

In terms of the domestic inflation outlook, the average headline inflation rate for 2008 is expected to be in the range of 2.5 – 3.0%, with risks remaining on the upside and emanating from external price pressures. There remains considerable uncertainty concerning global commodity and food prices. Global crude oil prices have remained

elevated. Although domestic fuel prices are partly subsidised by the Government, the extent of high global crude oil prices feeding through the supply chain of other imported inputs and ultimately into consumer prices needs to be closely monitored. Meanwhile, world food prices are also subject to both cyclical and structural developments. For food items that are not under any type of controls, the ability of producers to pass on cost increases into consumer prices would depend greatly on the strength of consumption demand and the extent to which consumers substitute more expensive goods for cheaper ones. Government policies to ensure the availability of essential goods would contribute to reducing speculative price pressures on these goods. With the economy expected to operate below its potential, the presence of excess capacity should also have a dampening effect on prices. An additional factor counterbalancing the upside risks to price pressures is the weaker global growth which could contain the rise in global commodity prices.



**Economic and Monetary Management in 2008**

Malaysia’s strong underlying fundamentals places the economy in a position of strength to weather unexpected global developments. The authorities also have a range of policy options to respond in a timely manner as required to counter the downside risks should they emerge and thereby promote domestic growth.

The 2008 Budget outlined wide-ranging tax and non-tax measures to enhance the nation's competitiveness, strengthen human capital development and ensure the well-being of all Malaysians. The bulk of development expenditure will be channelled towards the agriculture sector and for infrastructure as well as education, health and housing. Fiscal policy in 2008 has focussed on expediting the implementation of projects and programmes that had been identified under the 9MP. The Federal Government's overall financial position is expected to strengthen further in 2008. The expected increase in the overall revenue, resulting from increased efficiency in revenue collection and the higher oil-related income, will accommodate the increased Federal Government expenditure, while reducing the budget deficit to 3.1% of GDP in 2008 (3.2% in 2007).

The focus of monetary policy in 2008 will be on sustaining the economic growth momentum while maintaining price stability in the medium-term. In the formulation of monetary policy, the Bank will continue to be forward looking and will weigh the impact of new developments on inflation and growth. The risks to inflation and growth are currently about balanced. The slower global growth could, however, ease pressures on global food and commodity prices. Monetary policy is currently accommodative. However, it should be noted that monetary policy is foremost a demand management tool. As such, it has limited influence in mitigating cost-push price pressures emanating from rising global prices of food and commodities. Moreover, other policies would be more appropriate in addressing structural or supply-driven factors affecting inflation.

There may be a further challenge in the form of more frequent, large and volatile capital flows which would impact on the exchange rate, domestic liquidity and asset prices. Rapidly changing market sentiments, the search for higher yields, and sudden shifts in risk premiums are factors driving such volatile flows. Recognising this, Bank Negara Malaysia has increasingly broadened its range of instruments to manage the flows and enhanced its surveillance mechanisms to ensure that such flows do not disrupt the smooth functioning of the financial system and the economy. In terms of monetary instruments, although uncollateralised direct borrowing and acceptances of

Shariah-compliant deposit placements under the Al-Wadiah concept continue to account for the biggest share of outstanding monetary instruments, the use of direct borrowings has been de-emphasised in favour of greater issuance of Bank Negara Monetary Notes (BNMN) to further develop the short-term ringgit debt securities market. In 2007, adding to diversity and flexibility, a floating rate version of BNMN was introduced which allows the Bank to issue, and for investors to purchase, debt securities at longer maturity terms without undertaking correspondingly longer-term interest rate risks. In the Islamic money market, a key development towards enhancing the efficiency of liquidity management was the introduction of the Commodity Murabahah Programme (CMP).

### **Bank Negara Malaysia's Audited Financial Statements for 2007**

Bank Negara Malaysia's financial position in 2007 has been examined and certified by the Auditor General. Total assets of the Central Bank rose to RM424.9 billion as at end-2007 (end-2006: RM323 billion). The major increase in assets was attributed to an increase in international reserves. Bank Negara Malaysia's international reserves increased to RM335.7 billion (USD101.3 billion) as at end-2007. The Central Bank registered a net profit of RM6.6 billion for the financial year ended 31 December 2007 and declared a dividend of RM1.5 billion to the Government for the year 2007.

**Bank Negara Malaysia**  
**26 March 2008**