ECONOMIC MANAGEMENT AND OUTLOOK

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ECONOMIC REPORT
2005/2006

Overview

The Government's macroeconomic policies in 2005 focus on sustaining the growth momentum of the economy as well as improving the nation's capacity to generate growth. During the course of the year, the economy continues to face greater external challenges, in particular moderation in global growth, revival in inflationary pressures as well as rising trends in tightening of monetary policy, particularly in the United States (US). There were notable shocks to the world economy when oil prices rose sharply to almost USD70 per barrel on 30 August 2005, the highest recorded in recent years.

Notwithstanding these developments, the Malaysian economy remained resilient, growing by 4.9% during the first half of the year. The prospects for the rest of the year will continue to remain favourable and, therefore, the economy is expected to register a sustained growth of 5% for the whole of this year. The growth reflects a more broad based expansion of the economy, with the impetus to growth originating from stronger domestic demand, primarily private sector activities.

The underlying fundamentals of the economy continue to remain strong. These include:

i. The strong economic recovery in the last six years since the financial crisis of 1997/98 has provided the flexibility to implement policies to further support growth;

ii. The greater diversity in the nation's economic structure as well as trading markets have reduced the vulnerability of the economy to external uncertainties;

iii. The external balance of payments further strengthened, arising from sustained large current account surpluses for the last seven consecutive years, and supplemented by higher inflows of foreign direct investment in recent years;

iv. National income continues to expand and is estimated to increase by 9.1% to reach RM463,546 million this year, contributing to a further improvement in per capita income of 6.8% to reach RM17,741. In terms of purchasing power parity (PPP), it is expected to increase further by 7.2% to USD10,323;

v. The expansion in the nation's national income has also contributed to increased national savings of 36.4% of gross national product (GNP). This high rate of savings has provided ample liquidity to finance private sector investment activities, thus enabling Malaysia to finance her growth primarily from domestic sources; and

vi. With respect to the Government's fiscal position, it has successfully reduced its budgetary deficit from 5.6% of gross domestic product (GDP) in 2002 to a sustainable level of 3.8% in 2005. The reduction has been achieved without sacrificing economic growth. With this reduction, the Government is in a position to provide more resources for development that will contribute to and strengthen further the nation's economic activities, in particular those of the private sector.

Managing the Economy

In managing the economy, the Government has taken advantage from this position of strength, to continuously embark on policies and strategies to ensure the sustainability of the strong growth performance thus far. Budget 2005, which provides the underlying policy directions for this year, focusses on accelerating the shift towards higher value-added activities, ensuring greater dynamism of the private sector in spearheading growth, as well as developing human capital to support growth. Another key thrust is to improve the quality of life of all Malaysians in line with the policy of a more equitable distribution of economic progress.

Moving Towards High Value-Added Growth

Malaysia has been successful in transforming the economy from one that is largely commodity based to an industrialised economy, with the manufacturing sector currently accounting for almost a third of GDP and manufacturing exports, 83% of the nation's total export earnings. The shift to greater industrialisation has also been reinforced by the development of oil and gas, which has contributed in particular to the development of downstream activities especially petrochemical. The nation has also been successful in accelerating and diversifying the services sector, resulting in its share in the economy rising to 57.8% of national output.

Going forward, as part of the ongoing process to promote endogenous growth and enhance competitiveness, the focus has been directed towards developing new sources of growth. In agriculture, the Goverment continues with efforts to leverage on Malaysia's comparative advantage and rich biodiversity to venture into new high value-added areas, such as agro biotechnology. To give impetus to the development of biotechnology, the National Biotechnology Policy (NBP) was launched on 28 April 2005, with the Malaysian Biotechnology Corporation (MBC) set up at the same time to act as the lead agency and one-stop centre to oversee the effective implementation of the NBP. The NBP, to be conducted over three phases spanning 15 years from 2005 to 2020, when fully completed, will attract the setting up of 100 companies, employing 280,000 people contributing about 5% of real GDP by then.

In addition, the Government also continues to accelerate efforts at modernising and commercialising as well as improving the supply chain of agricultural activities. Given Malaysia's success in plantation agriculture, greater commercialisation of the sector is being pursued. This includes promoting the participation of government-linked companies (GLCs), which are already in plantations, to assist in commercialising activities such as vegetable, poultry and livestock farming. Towards this end, the Government has provided a sum of RM300 million to GLCs for this purpose, and the progress in terms of the take-up rate thus far, has been encouraging. A total of RM225.9 million worth of projects has been approved and some of these projects are at various stages of implementation.

The Government has also extended attractive tax incentives in 2005 to further spearhead the modernisation and commercialisation of the agricultural sector. These include a 100% deduction on capital expenditure, Pioneer Status or Investment Tax Allowance. To further expand food production, companies have also been provided with investment allowance or group relief, while their subsidiaries undertaking the projects are given 100% tax exemption for a period until 2010. To further encourage mechanisation and automation in the sector with the view to increasing efficiency and reducing dependence on foreign labour, the Government has also reduced the write-off period for capital expenditure to two years.

Malaysia has the potential to become a leading global producer and exporter of *halal* food. To further enhance international recognition of Malaysia's expertise in certification of *halal* products through the issuance of *halal* logo certificates, the Standard *Halal* Malaysia MS 1500:2004 has been launched. As an incentive to ensure high quality Malaysian products and to meet international standards, double tax deduction is provided to producers for expenses incurred in obtaining *halal* certificates. In addition, a special fund for the development and promotion of *halal* products has been established with an allocation of RM10 million to finance business plans and market development of producers.

The policy to further diversify the economy has also focussed on the services sector, particularly in information and communication technology (ICT) and tourism, including health and education tourism. In ICT, the Government continues to leverage on new leading edge technologies. The Government continues to develop the Multimedia Super Corridor (MSC) with its roll-out to cybercities of Bayan Lepas, Pulau Pinang and the Kulim High Technology Park in Kedah. In addition, Government's efforts to promote shared services and outsourcing services in the country have enabled Malaysia to be ranked as the third best location in the world. As at end June 2005, Malaysian Industrial Development Authority (MIDA) had approved the establishment of 98 international and regional operational headquarters (OHQs), 169 international procurement centres (IPCs) and eight regional distribution centres (RDCs). The industry has also contributed to job creation, with some 7,000 jobs created during the first half of 2005, in addition to 8,000 created in 2004.

Tourism has increasingly become an important contributor to economic growth and foreign exchange earnings. Tourist arrivals have increased by 3.5% during the first half of this year to reach 8.16 million tourists compared with 7.89 million during the same period last year, while earnings from tourism and tourism-related activities are expected to increase to RM33.2 billion this year compared with RM29.7 billion last year. Government efforts at promoting health tourism have also resulted in more foreigners seeking treatment, which had increased to 174,200, generating revenue of RM105 million in 2004 compared with 39,000 and RM14.1 million in 1998, respectively. Similarly, the promotion of education tourism has attracted 40,686 foreign students in 2004, from more than 150 countries in both public and private institutions of higher learning.

To further promote tourism products, the Government has in 2005 given full exemption on entertainment duty on arts and cultural performances by local artists performing in the Federal Territories of Kuala Lumpur, Labuan and Putrajaya. In the case of education, to enhance further Malaysia's position as a centre of excellence, the Government had exempted stamp duty and real property gains tax to private colleges undertaking mergers with the view to strengthening these institutions. In promoting health services, the Government further relaxed the issuance of employment visas to foreign medical specialists as well as visas for those seeking treatment in Malaysia.

Efforts continue to be undertaken to further improve tourism infrastructure and develop tourism products. Towards this end, the Government has provided an additional RM500 million to the Tourism Infrastructure Fund, thus increasing the total size of the Fund to RM700 million. Of the additional increase, RM479 million has been approved for integrated tourism projects, theme parks and marinas. In addition, the recently opened Kuala Lumpur Convention Centre will provide another state-of-the-art convention centre that will further entrench

Malaysia as an attractive destination for international meetings, incentives, conventions and exhibitions (MICE). As part of measures to promote greater domestic tourism, the Government announced a five-day workweek for staff of the civil service.

Promoting Greater Dynamism of the Private Sector in Generating Growth

Policies and strategies continue to be put in place to enable stronger private sector investment initiatives with the view to facilitating the private sector to become the main engine of economic growth. In Budget 2005, the incentives structure continues to be enhanced to promote investment, particularly in new areas in the agriculture, manufacturing and services sectors, while efforts at improving the delivery system are being intensified.

The additional tax incentives are aimed at providing a more conducive business environment, in particular measures at reducing further the cost of doing business. An important initiative taken was the setting up of the Tax Review Panel to ensure the taxation system is more efficient, equitable and business friendly. Improvements will also be made to existing tax provisions to enable greater clarity and transparency of the nation's tax administration.

Specific tax measures have also been provided, including expediting tax refunds with the setting up of a fund to provide refunds, allowing *zakat* as tax deduction for companies with the view to reducing the cost of doing business as well as several measures facilitating taxpayers to ascertain their tax liabilities. For companies that relocate their industries in promoted areas, including the Eastern Corridor of Peninsular Malaysia, Sabah and Sarawak, the Government provides a second round of Pioneer Status or Investment Tax Allowance.

In addition, to promote the manufacture of high quality Malaysian products, double tax deductions have been given on expenses incurred in obtaining international quality standards. Import duties on selected imports continue to be abolished or reduced to further assist the private sector in its efforts to reduce cost of doing business.

Enhancing Effectiveness of Public Sector Expenditure

The Government's commitment to strengthen its budgetary position is evidenced by the marked narrowing of its budgetary deficit from 5.6% of GDP in 2002 to 3.8% in 2005. This significant success in reducing the deficit has been achieved both by enhancing revenue as well as improving efficiency and effectiveness of Government expenditure. As such, the reduction has not sacrificed growth of the economy. In fact, growth has further strengthened during the period.

The reduction in deficit provides the policy flexibility and option for the Government to mitigate any potential adverse effects from uncertainties in the external sector. The Government has focussed its expenditure in 2005 primarily at generating further economic activities. In this regard, development expenditure rose 5.7%, concentrating on smaller projects which have significant multiplier effects in creating economic activities in the immediate term, particularly in agriculture, construction, housing and infrastructure in rural areas. During the course of the year, the Government announced the implementation of small projects, costing RM2.4 billion, to be implemented immediately by small contractors. In addition, a sum of RM2.5 billion has been provided for the construction of quarters for the Royal Malaysian Police on a build-lease-transfer basis.

In managing expenditure, emphasis is placed on maximising the use of existing infrastructure facilities so as to enhance the value of existing assets through productive use and regular maintenance. In this context, the Government provided RM500 million for maintenance works of Government buildings.

The Government continues to give emphasis on the development of human resources, focussing on developing skills so as to increase productivity and value add contribution from the workforce. Thus, the education and training sector continues to be provided with the largest allocation of more than a quarter of the annual budget. Apart from programmes to further strengthen the education system, increasing skills training opportunities for Malaysians have also been emphasised through graduate training schemes and courses offered by skills development centres.

Monetary Policy Supportive of Growth

Monetary policy continues to remain supportive of economic growth. Malaysia's strong macroeconomic fundamentals continue to accord flexibility in the adoption of an accommodative monetary stance. The removal of the ringgit peg in favour of a managed float in July 2005 was conducted from a position of strength, particularly steady economic growth, high external reserves, large current account surplus and a sound banking system. Of significance, the managed float will provide greater flexibility in monetary policy options for the Government.

Several relaxations have also been made to Malaysia's foreign exchange administration rules during the course of 2005, with the objective of reducing the cost of doing business, facilitating transactions involving foreign exchange as well as encouraging better risk management. Among others, the liberalisation measures, effected on 1 April 2005, allow resident individuals and companies to invest abroad, limited to RM100,000 and RM10 million, respectively, for investments funded with domestic credit facilities. The maximum amount allowed to be invested abroad by unit trust management companies has also been raised to 30% from 10% of net asset value of resident funds.

The rationalisation of banking and financial institutions saw further efficiency improvements in the banking industry. The recent entry of foreign players in Islamic banking and increased foreign equity up to 49% in Islamic subsidiaries from 30% previously, is expected to spur competition and enhance global financial linkages.

Improving Further the Delivery System

The Government continues to improve on its delivery system to ensure greater efficiency and better quality services, conducive to further expand private sector investment initiatives. Taking cognizance of the importance of a quality delivery system, government agencies have established customer service offices (CSOs) and one-stop centres to provide more efficient and effective services. In addition, the Government has also established a comprehensive public service portal, leveraging on ICT, to expand the reach to the general populace and improve response time.

Counter services have also been enhanced with the greater use of ICT. Time taken for the Immigration Department to process and issue new chip-embedded passports has been shortened from three to two days. Jabatan Pengangkutan Jalan (JPJ) is in the process of implementing a new electronic system, e-Khidmat, to make it more convenient for the public to access services provided by JPJ. *Perbadanan Tabung Pendidikan Tinggi Nasional (PTPTN)* is also in the process of upgrading its computerised education loan system which, when completed, will facilitate student loan applications and approvals.

Measures to improve and modernise land administration transactions have been undertaken through e-Tanah. A pilot project in Pulau Pinang has been implemented. At the same time, to reduce backlogs in land approvals, the Government has set up a flying squad in each district office. As of 1 April 2005, almost 890,000 backlog cases for 2003 and 2004 have been cleared.

Strengthening Small and Medium Enterprises

Special focus has been given to improve competitiveness of, and promote investment by small and medium enterprises (SMEs) given that they represent an important segment of the economy, providing the linkages in the nation's industrial development to both large corporations and the multinational corporations (MNCs). The large SME base, currently accounting for more than 90% of companies in the manufacturing sector, provides vast opportunities for SMEs to become the growth catalyst for the expansion of private sector investment.

The Government's strategic move in the development of SMEs is the establishment of the SME Bank, to be operational on 3 October 2005. An outcome of the merger between Bank Industri & Teknologi Malaysia Berhad (BITMB) and Bank Pembangunan dan Infrastruktur Malaysia Berhad (BPIMB), the SME Bank will specialise in providing both financial and non-financial assistance to SMEs. The new Bank will also function as a one-stop centre to integrate and meet the business advisory needs of SMEs and continuing education and training programmes, especially for start-ups. The Bank will also promote the creation of entrepreneurs in new areas, including commercialisation of research and development.

To further promote SMEs to venture abroad and expand their exports of goods and services, the Export-Import Bank of Malaysia (EXIM Bank) will be strengthened and also absorb the functions of Malaysia Export Credit Insurance Berhad (MECIB). This will enhance the availability of trade finance and export insurance to further increase Malaysian exporters' competitiveness in the global market.

To further enhance the marketing and promotional activities of SMEs, the maximum grant limit under the Market Development Grant has been increased from RM60,000 to RM100,000 and its scope expanded to include marketing and promotion in domestic markets and the establishment of representative offices abroad. In addition, a RM100 million fund for enhancing product design, packaging and labelling has also been established to finance design facilities.

Developing the Capital Market

The nation has achieved significant progress in strengthening the foundations of the capital market. Malaysia possesses a sound corporate governance framework, strong network of capital market intermediaries, as well as diversified and thriving bond market, including an internationally recognised Islamic capital market.

Building a world-class capital market is a prerequisite to further support growth, in particular that of the private sector. In addition, enhancing the level of international participation will attract foreign investment into the capital market. Towards this end, the Government has allowed five major foreign stockbrokers and five global fund managers to operate in Malaysia. To date, two stockbroking companies have been given licences and have commenced operations in September, while two are expected to be in operation by October and one, at the end of this year. With respect to fund managers, one is already in operation. The presence of international participation will create growth opportunities, product innovation and enhance liquidity through higher global order flows. At the same time, it will also contribute to the promotion of capital market products and services, utilising distribution channels with international and regional investors and issuers.

To further widen and deepen the domestic bond market, supranational agencies such as the International Finance Corporation (IFC), Asian Development Bank (ADB) and Islamic Development Bank (IDB) were allowed to raise ringgit denominated bonds in the domestic capital market, including *syariah*-compliant issues. A total of RM1.7 billion has so far been raised by these agencies. The successful issuances reflect the confidence of international institutions in the Malaysian capital market.

Meanwhile, to further promote product diversification in the bond market, the Government undertook an asset-backed securitisation of its staff housing loans, in two issuances, amounting to RM3.6 billion ringgit, which attracted overwhelming response, including from foreign investors. One of the issuances is the RM2.1 billion *syariah*-compliant securities, which is the world's first rated Islamic residential mortgage-backed securities.

To encourage foreign investments in ringgit bonds, tax exemption has been given on interest income derived by non-resident companies from ringgit securities and debentures as well as papers issued by the Malaysian Government. In addition, to benefit pensioners, additional issues of RM1.16 billion of Merdeka Savings Bonds were made till end-August this year.

Malaysia hosted the 30th Annual Meeting of the Board of Governors of the IDB in June this year, enabling Malaysia to showcase and share the progress and developments achieved in Islamic finance with the rest of the Islamic world. An important initiative taken during the IDB Meeting is the development of a 10-year Master Plan for Islamic Financial Services Industry. The Plan will provide strategic directions for the development of Islamic financial services for members of the Organisation of Islamic Conference (OIC).

Reducing Financial Burden of Malaysians

The Government is concerned with the potential impact of rising petroleum prices on consumers. To keep retail prices of petroleum affordable, the Government has provided price subsidies as well as tax exemptions on petrol and diesel. In the current situation of sharp increases in world prices, the subsequent level of subsidy and the loss in Government revenue will escalate to an estimated RM15.7 billion this year compared with RM11.9 billion in 2004 and RM6.6 billion in 2003.

The Government has gradually increased pump prices, as this level of subsidy is untenable. However, to help reduce the burden on consumers, the Government has announced recently a moratorium on pump prices of petrol until the end of the year. Similarly, a moratorium on toll charges has also been announced for 2005 and 2006. To further assist consumers, the Government reduced road tax on private and commercial vehicles.

Conclusion

Moving forward, current trends in the global environment point to a more challenging external sector in 2006. While the global economy is expected to expand, there are still downside risks on the horizon. In particular, uncertainties still remain with respect to adjustments in the imbalances brought about by the sharp increases in oil prices. Given the likely pressure on general price levels, interest rate policy is likely to continue to tighten with rates expected to gradually continue its upward trend, especially in the US.

Cognizant of the immediate impact of a potential slowing down of the global economy, Budget 2006 will put in place pro-active measures to further strengthen domestic economic activities in the immediate and short terms. The strategy will be to focus on providing a more conducive and enabling environment for a more dynamic private sector; developing soft infrastructure, particularly human capital to ensure optimal utilisation of existing infrastructure; as well as measures to ensure Malaysians continue to benefit from economic progress and improved quality of life.

In this context, the prospects for the Malaysian economy remains favourable, supported by both domestic and external demand. The Government is confident that with the strength of the economy and its strong fundamentals, Malaysia will achieve a GDP growth of 5.5% in 2006.

For the medium term, the Government is formulating the policy directions and strategic thrusts of the Ninth Malaysia Plan (9MP), 2006–2010, as well as the second phase of Vision 2020. The 9MP will lay the foundation for strengthening of the medium and long-term development as well as prospects of the Malaysian economy.