
RATING PERSPECTIVE

Malaysian economy on a stable growth path

Preface

JCR revised the rating on Malaysia's foreign currency long-term senior debts from "A-" to "A" and its outlook from "positive" to "Stable" as of August 28, 2006. The ratings reflect Malaysia's development brought by its high economic growth since the middle of the 1980s, its political and social stability supported by the economic development and its fairly sound fiscal and external debt position. The Abdullah administration, which has taken over from the former Mahathir administration, attained a bigger-than-expected victory in the general election held in March 2004, taking a step forward toward establishing a stable political power base. The Malaysian economy has been staying on a stable growth path under the new administration. In 2006, it is expected to post a growth rate on the order of 5%, the same level as the previous year, driven by domestic demand centering on private consumption and investment. In July 2005, the Malaysian ringgit was brought back to a managed floating exchange rate regime from the fixed exchange rate system, which had been put in place in September 1998 in the wake of the financial crisis. Meanwhile, the country's fiscal deficit has been steadily decreasing, with the deficit/GDP ratio falling from 5.3% in 2003 to 4.3% in 2004 and 3.8% in 2005. The ratio is projected to drop further to 3.5% in 2006. If the ratio can be maintained at the 3% level over a medium term as envisaged by the government, the ratio of Federal Government debt to GDP is expected to keep falling moderately. Government-led financial reforms have added to the stability of the country's banking system. While the banking sector's net non-performing loan ratio was reduced to 5.5% at the end of June 2006 from 13.6% at the end of 1998 just after the Asian currency crisis, the risk-weighted capital ratio was kept high at 12.9%. Former Prime Minister Mahathir Mohamad has been drawing attention for his harsh criticism of the current government's policies. However, the move is unlikely to erode the country's political stability as it is not expected to shaken the ruling system of the current coalition government. Taking these factors into consideration, JCR has upgraded its rating on Malaysia's foreign currency long-term senior debts by one notch. The stable rating outlook mainly reflects the political stability under the Barisan Nasional (BN), the ruling coalition led by UMNO, and the stability of the country's macro economy.

This report shall review the current situation of Malaysian politics and economy with reference to some of the tasks it may face in the future.

Political situation

Prime Minister Abdullah Ahmad Badawi who succeeded Mr. Mahathir in October 2003 is known as a devout Muslim

and has high prestige among the people. Reputed for his gentle nature and fondly referred to as "Pak Lah," he is in contrast to his predecessor who sometimes took a high-handed approach in leading the nation. For that reason, how Prime Minister Abdullah will forge his political power base had been keenly watched. Malaysia's eleventh general election held in March 2004 under the Abdullah administration resulted in an overwhelming victory for the National Front (Barisan Nasional or BN), the coalition camp consisting of 14 parties centering on the ruling United Malays National Organization (UMNO). BN captured 198 out of 219 parliamentary seats or 90.4%. The ratio was the highest since 1974 when the coalition government came into being. BN also garnered 66.4% of the total number of votes cast, up from 56.5% in the previous election in 1999. Since inaugurating his administration, Prime Minister Abdullah has taken a series of measures to consolidate his power base. He announced a postponement of the major railway construction project launched by Mr. Mahathir and his close business confidant. He also announced a policy to fight corruption as top priority. By taking steps that indicate an important policy shift with regard to the relationship between politics and business, he succeeded in appealing his image as a new prime minister to the voters just before the crucial election. In January 2004, he carried out a cabinet reshuffle. The appointment of Defense Minister Najib who has strong influence among the ruling UMNO concurrently as deputy prime minister cleared uncertainty over who would be the next prime minister and was effective in consolidating the party's power base prior to the election. In addition, he put another strongman, Mr. Muhyiddin Mohd Yassin, in charge of agricultural development in a bid to maintain social stability and counter the opposition Islamic Party of Malaysia (Parti Islam se-Malaysia or PAS) which has obtained broader support in the lower-income class (Mr. Muhyiddin's portfolio was changed from Domestic Trade and Consumer Affairs to Agriculture and Agro-based Industry). Prime Minister Abdullah, who doubles as finance minister, also appointed Mr. Nor Mohamed Yakcop, a capable financial expert, as deputy finance minister. Thus, the new prime minister has made steady headway in establishing his administration's power base. Political pundits said that these initiatives taken by him combined with the strong economic growth in leading the ruling coalition to an overwhelming election victory. Amid the global outcry over the terrorism by Muslim extremists, the new prime minister's policy to uphold moderate and progressive Muslim has strongly appealed to the voters, they added.

After the election, the country's political situation stayed generally calm throughout much of 2005. In October that

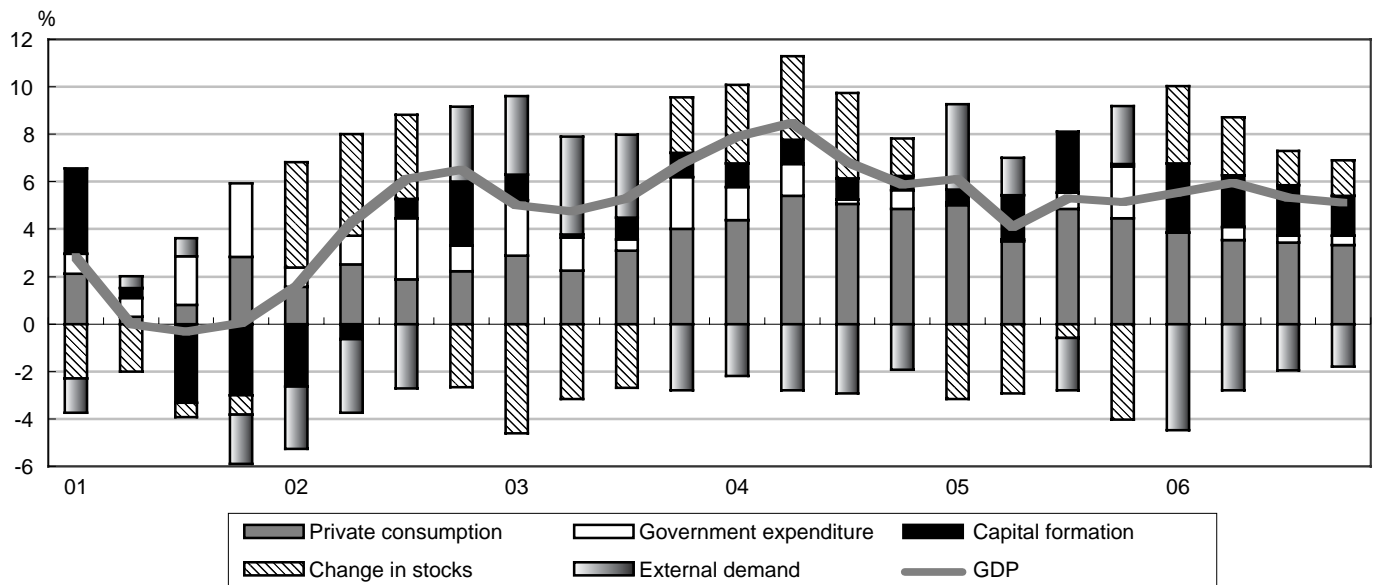
year, the prime minister's wife passed away, touching off speculation that the loss of his beloved moral support might quicken his retirement. In reality, however, there was no critical change in the stable political situation and the year was over rather quietly. A change did occur in 2006. In June, Prime Minister Abdullah, who had reviewed the large-sized infrastructure projects initiated under the former administration, decided to suspend the construction of a bridge linking Malaysia with Singapore, the pet project pushed by former Prime Minister Mahathir. The decision drew a scathing criticism from Dr. Mahathir. Since then, he has stepped up his personal attack on Prime Minister Abdullah. In October, a private meeting was arranged between the two men, which failed to lead to their reconciliation. After the meeting, Dr. Mahathir pronounced that he would continue his criticism of the current administration whenever necessary. Faced with this situation, the ruling UMNO which Prime Minister Abdullah heads has announced its renewed support for him. Malaysia's political situation may not turn unstable at once due to this personal confrontation. However, should it get intensified and prolonged, it could stir up grievances among the voters, allowing the opposition parties to gain popular support. For Malaysia which is pressing ahead with a medium- to long-term plan with an aim of becoming an industrialized economy by 2020, political leadership remains imperative. How the issue will affect Prime Minister Abdullah's leadership needs a close watch.

Economic situation

In 2006, as domestic demand centering on personal consumption and private investment kept growing against the background of a steady expansion of exports, Malaysia

registered a real GDP growth rate of 5.9% (year-on-year) in the second quarter (5.5% in the first quarter). Domestic demand growth was kept high at 6.9% in the second quarter (7.6% in the first quarter). Especially, private consumption, which was supported by favorable conditions of the labor market as well as an increase of disposable income against the backdrop of the rise of commodity prices such as palm oil and rubber, grew a strong 7.3% (7.5% in the first quarter). In addition, capital investment, while decelerating from an 11.4% expansion in the previous quarter, grew 7.6%, supported by investment activities in both the private and public sectors. The country's economy is susceptible to the fluctuations of the world economy as its total external goods and services trade/GDP ratio, a gauge of the openness of a country's economy, is very high at 198% (in 2005). While the U.S. economy, the locomotive of the global economy, has begun slowing down, a relatively steady economic expansion has been continuing in China and India as well as in Japan and Europe. Thus, the world economy is expected to stay generally steady for a while. The Malaysian economy is expected to continue growing on expansion of domestic demand against the backdrop of steady exports. A growth rate of 5.5%-6.0% will be within reach in 2006. As for 2007, with the world economy expected to slow down moderately due to the deceleration of the U.S. economy, the Malaysian economy is also expected to slightly decelerate as compared with the previous year. However, barring unexpected factors such as a sharp slowdown of the U.S. economy, the Malaysian economy will continue growing, led by domestic demand and exports. Given the effect of the government's expansionary fiscal measures, a growth rate on the order of 5% will be within reach in 2007 (Graph 1).

Graph 1. Contribution to Change in Real GDP growth



Source: BNM

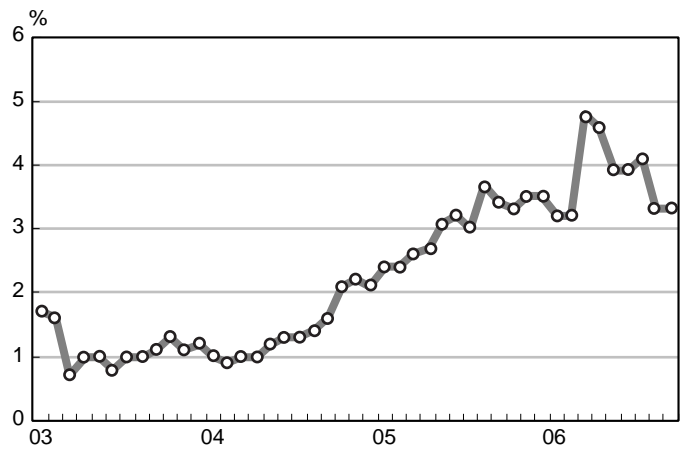
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Inflation rate had stayed below 2.0% between 2000 and 2004. However, CPI accelerated to 3.0% in 2005 due mainly to the rise of crude prices. In 2006, it turned moderate due in part to the effect of the government's economic policy. CPI for the first nine months to September was up 3.3% year-on-year. As an anti-inflation measure, the government implemented oil subsidy and tax cut totaling RM19.0 billion in 2006, up from RM16.0 in 2005. The Ministry of Finance envisages an equal amount for 2007 on the assumption that crude prices will average US\$70.00 per barrel (Graph 2). In July 2005, following China's devaluation of the yuan, the Malaysian central bank announced shifted the ringgit from a fixed exchange rate regime to a managed floating regime based on a basket of currencies. Malaysia thus graduated from a fixed exchange rate system, which it introduced along with restrictions on capital movement to avert a liquidity crisis in the wake of the Asian currency crisis (Graph 3).

Fiscal situation

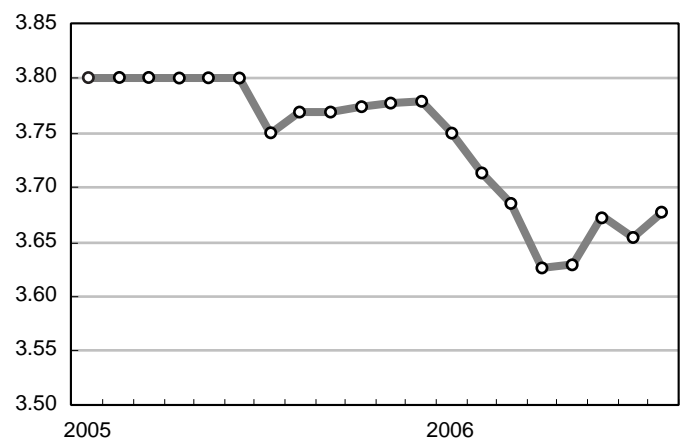
The fiscal balance of the federal government turned adverse in 1998 when the country fell into an economic crisis following the Asian currency turmoil. Since then, the government had kept incurring an annual fiscal deficit in excess of 5.0% of GDP until 2003 as it had to maintain a fiscal stimulus policy. However, the government made a policy shift in a bid to correct its fiscal position. After managing to reduce the deficit/GDP ratio to 4.3% in 2004 and 3.8% in 2005, it aimed to slash the ratio further to 3.5% in 2006. The government's draft budget for 2007 put revenues at RM134.8 billion, up 11.8% from the previous year's RM120.6 billion. Oil-related revenues (dividend from Petronas and oil income tax) will account for 40%. Expenditures on a net basis after deduction of loan recoveries were put at RM157.5 billion, up 11.6% from the previous year's RM141.2 billion, an increase roughly the same as that of the revenues. This would leave RM20.2 billion in fiscal deficit for the year or 3.4% of GDP, a slight decrease as compared with the previous year. The federal debt/GDP ratio had kept increasing till 2004 due to the chronic annual fiscal deficit. The ratio dropped from 48.1% in 2004 to 46.2% in 2005 as the fiscal deficit shrank amid a high nominal GDP growth rate. The ratio is expected to decline to 44.3% at the end of 2006. Meanwhile, under its ninth Malaysia plan (from 2006 to 2010) unveiled on March 31, 2006, the government announced a policy to keep the annual fiscal deficit/GDP ratio at the 3.0% level through 2010. It cited the necessity to continue the development of regional economies and the improvement of the road and other infrastructure in urban areas. If the ratio can be maintained at the 3% level, a primary balance deficit will be kept lower with the likelihood of a nominal GDP growth rate far higher than a nominal interest rate continuing as at present. In that case, the federal debt/GDP ratio is expected to continue falling moderately till the final year of the plan (Graph 4).

Graph 2. CPI (year-on-year)



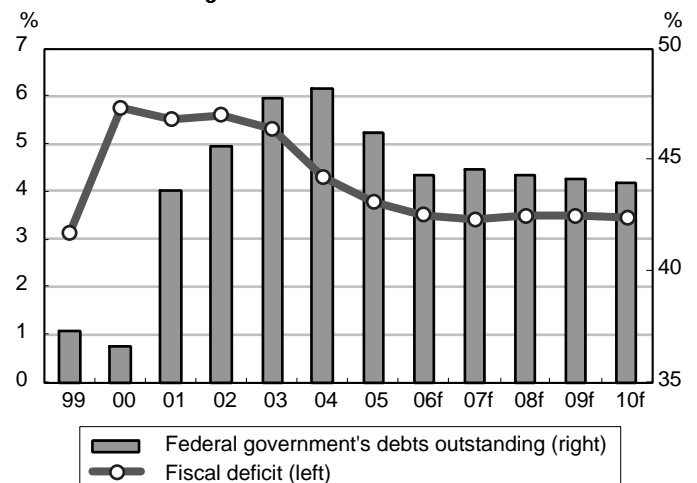
Source: BNM. 2005=100 beginning in January 2006

Graph 3. Trend of FX rate (RM/US\$)



Source: BNM

Graph 4. Federal government's fiscal deficit and public debts outstanding to GDP



Sources: BNM and Ministry of Finance

External balance

Malaysia's current account balance has been constantly in surplus since it turned favorable soon after the 1997 Asian currency crisis. The current account surplus/GDP ratio stood high at 12.6% in 2004 and 15.3% in 2005. Although the ratio fell slightly to an estimated 13.8% in 2006, it was still high. Meanwhile, the external debt/GDP ratio dropped to 39.7% in 2005 from 44.6% in 2004 and was believed to have declined moderately in 2006. The ratio of external debt to goods and services exports also fell to 32.1% in 2005 from 36.8% in 2004 due mainly to a relatively strong growth of exports. The ratio is believed to have remained flat in 2006. The debt service ratio was kept remarkably low at 5.3% in 2005. With these indicators generally improving in recent years amid the export-led economic growth, there is no serious concern over the country's external balance (Graph 5).

On the other hand, as to the outlook of the country's foreign capital-supported, export-driven economic growth, continued attention needs to be paid to the impact of an intensifying competition from China for foreign direct investment (FDI). However, as many foreign businesses apparently do not see it appropriate to concentrate their investment on China from the viewpoint of risk diversification, they may spread their investment between China and Southeast Asian countries. JCR considers that the possibility of Malaysia being selected in that case is not necessarily low given the country's past investment records, well-developed infrastructure, and political and social stability. In fact, the volume of FDI inflows into the country's manufacturing sector increased 36.1% to RM17.9 billion in 2005. For 2006, it came to RM10.7 billion in the first eight months, equal to 60% of the total amount for the previous year. By sector, electronics & electrical products claimed the largest share of 42.7%,

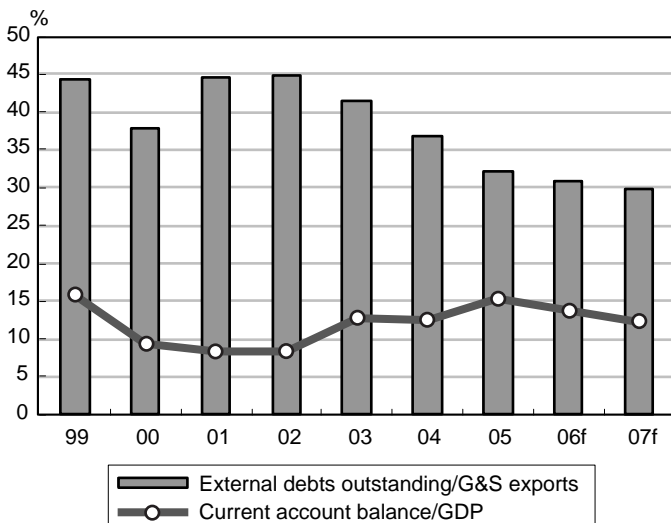
followed by chemical products with 18.9%, plastic products with 8.9%, food manufacturing with 7.6% and scientific & measuring equipment with 6.6%.

Financial system reform in Malaysia

The development of the financial system in Malaysia dates back to the years before its independence in 1957. In those days, banks from the United Kingdom, Malaysia's colonial master, and Chinese banks had set up operations in the country, which laid the foundation of the subsequent development of the financial system in Malaysia. The ratio of bank credit balance to nominal GDP was 119.2% in 2005, significantly high as compared with the corresponding ratios in other Southeast Asian countries. This indicates the measure of importance the banking system's indirect finance assumes in the country's economic development (Graph 6).

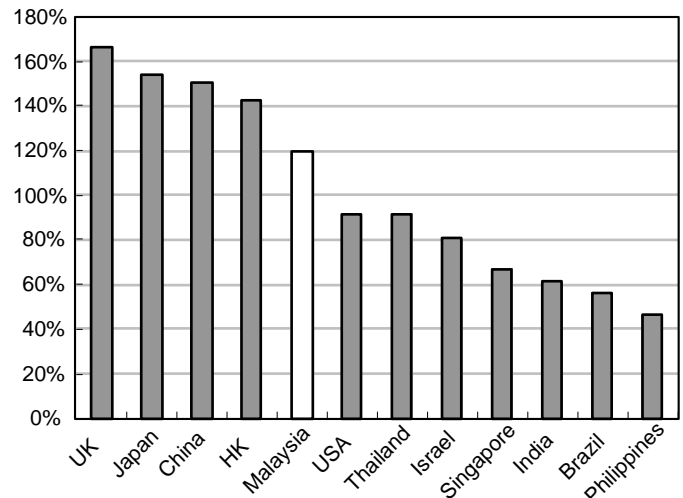
The 1997 Asian currency turmoil also triggered a financial crisis in Malaysia. However, as is well known, the country overcame the crisis on its own without resorting to the international institutions such as the IMF. While stabilizing a volatile FX rate by introducing a fixed rate system and restrictions on capital transactions, Malaysia carried out reforms of its damaged financial system. The government established Danaharta, an entirely state-owned organization for the purchase of non-performing loans (NPLs), which bought NPLs from banks. Besides, the government established Danamodal, an organization wholly owned by the central bank, for public fund injection. It injected public funds into banks (all the amounts were fully repaid by 2004). In addition, the government implemented a major realignment of the financial system including the integration of 58 local banks into 10 groups and the integration and reorganization of local insurance and securities companies. Danaharta

Graph 5. Trend of External Balance



Source: BNM

Graph 6. Domestic credit outstanding/GDP



Source: EIU Country Data (Bureau van Diik)

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was liquidated in December 2005 after completing its role. Thanks to these measures, the NPL ratio (on a net basis) of the banking system was reduced to 5.3% at the end of August 2006 from 13.6% at the end of 1998. The risk-weighted capital ratio was maintained high at 13.2% in August 2006 (Graph 7).

After almost completely clearing the negative legacy left by the financial crisis in 2001, Bank Negara, the central bank, announced a "Financial-Sector Master Plan" for the next 10 years aimed at honing the competitive edge of the country's financial institutions. It called for strengthening the constitution of financial institutions (in Phase I from 2001 to 2003), promotion of domestic competition (in Phase II from 2004 to 2007) and promotion of competition through introduction of foreign capital (in Phase III from 2008 to 2010). According to the Ministry of Finance's 2006/2007 economic report, this plan is progressing smoothly, with 49 proposals completed and 29 other proposals under way as of June 2006. In the coming years, measures to enhance the capability of the domestic financial sector will be stepped up in the remaining period of Phase II to lay the ground for Phase III. Also in 2001, the Securities Commission announced a proposal on the direction of capital market reforms to be carried out in the next 10 years. It consisted of 24 strategies centering on deregulation and 152 policy measures. In March 2002, based on this proposal, the Kuala Lumpur Securities Exchange (KLSE) and Malaysian Exchange of Securities Dealing & Automated Quotation (MESDAQ) were merged and government bond futures trading was introduced.

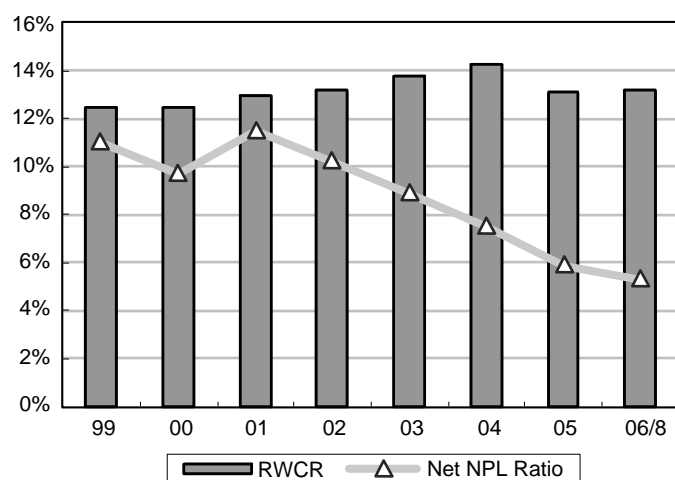
The 9th Malaysia Plan

Malaysia's development strategy consists of a five-year plan and a long-term vision. The former began with the "1st

Malaysia Plan" (from 1966 to 1970) in 1966, and the latter started with the "Outline Perspective Plan 1 (OPP1)" (from 1971 to 1990) in 1971. OPP1 was developed for the main purpose of narrowing the economic disparity among people in the wake of a racial riot in 1969 in which the outburst of the Malayan people's grudges against ethnic Chinese resulted in 196 deaths. As for the five-year plan, eight plans had been implemented and the ninth plan covering the period from 2006 to 2010 was submitted to parliament on March 31, 2006. As for the long-term vision, OPP2 (1991-2000) was carried out and OPP3 (2001-2010) is currently in progress. A long-term economic policy has been set forth for each OPP. OPP1 had the "New Economic Policy (NEP)" aimed at poverty eradication and correction of disparities among races. The "National Development Policy (NDP)" for OPP2 hammered out a new direction by calling for introduction of private-sector dynamism. OPP3 is guided by the "National Vision Policy (NVP)" aimed at interethnic collaboration and evolution into a knowledge-intensive economy. In 1991, then Prime Minister Mahathir announced "Wawasan (Vision) 2020" along with the NDP. This national vision called for developing Malaysia into an industrialized economy by 2020. Since then, OPPs and five-year plans have been used as a tool to realize the vision. The 9th Malaysia plan covers the period from 2006 to 2010, which corresponds to the latter half of the period covered by OPP3. The fourth to eighth five-year plans were drawn up under the long-term administration of Prime Minister Mahathir. The ninth plan was the first one to be worked out by the government of Mr. Abdullah who came to power in 2003. The previous plans put importance on large-scale development projects in the urban area such as the construction of an international airport and a new administrative city. In contrast, the ninth plan places emphasis on education, regional infrastructure development and agricultural promotion, embodying the originality of Prime Minister Abdullah.

The total budget for the 9th development plan was set at RM200.0 billion, up 18.0% from that for the previous one. Education and training-related expenditures accounted for the largest portion, RM41.1 billion or 20.6% of the total. This reflects the administration's policy to prepare for the intensifying competition from India, China and other Asian countries for foreign investment. The plan also aims to promote agricultural development with a view to narrowing the income gap between the urban and rural areas and further boosting the export of agricultural products. The plan calls for stepping up the Bumiputera policy against the background of the still existing income disparity between the Malays and earlier settlers, that is, Bumiputera and ethnic Chinese people. The Bumiputera policy is thought to have both merits and demerits, such as the effect in stabilizing the society and drawbacks to advancing the economy. Neither can be understated. How to strike a subtle balance between them is one of the challenges Malaysia is faced with.

Graph 7. RWCR and Net NPL ratio



Source: BNM. RWCR (Risk-weighted capital ratio)

The current situation of the Multimedia Super Corridor (MSC) project

As stated above, the Malaysian government announced in 1991 its "Vision 2020" aimed at turning the country into an industrialized economy by 2020. The "Multimedia Super Corridor" project was launched in 1996 as a centerpiece of the state plan. Through this project, the government is seeking to transform the economy into a high value-added industrial structure led by information technology.

While major infrastructure projects were postponed in all the ASEAN countries including Malaysia after the Asian currency crisis in 1997, the MSC was given an exceptional treatment and its core city "Cyberjaya" was completed in 1999. In addition, the construction of the new administrative city "Putrajaya" was started in 1995. In 1999, the prime minister's office was moved to the city, located 25 kilometers southeast of Kuala Lumpur. The Ministry of Transport, Ministry of Science, Technology and Innovation and Ministry of Foreign Affairs were moved there in 2000, with all other government organizations transferred there by 2005. The entire development project involving residences and parks is set to be completed by 2010. The area covered by the MSC is located southeast of Kuala Lumpur. Containing the new administrative city Putrajaya and the new Kuala Lumpur international airport, it stretches 50 kilometers from north to south and 15 kilometers from east to west. The gargantuan scheme consists of three phases. Under Phase I from 1996 to 2003, seven major projects were launched. These included the development of 50 world-class companies, an e-government, an R&D park and a support network for manufacturers as well as the construction of the information industry city Cyberjaya. Under Phase II from 2004 to 2010, the plan aims to foster 250 world-class companies and develop five intelligent cities. Under final Phase III from 2011 to 2020, the number of world-class companies and intelligent cities will be increased to 500 and 12, respectively.

The government has been promoting the scheme by implementing a string of hardware and software infrastructure development projects. It has structured an advanced communications network, enacted the Cyber Law applicable only in the area and striven to attract high-tech industries by introducing various preferential measures, such as an income tax exemption for up to 10 years, authorization of a 100% shareholding by foreign capital and tax breaks for capital investment in multimedia facilities. As of July 18, 2006, the number of companies with MSC status increased to 1,546 (including 1,475 Malay-affiliated technology-related companies) from 1,163 at the end of 2004. World-class companies numbered 67 as of May 2005. The number of newly employed persons in the MSC area increased 43% from 19,061 in 2003 to 27,288 in 2004. It further increased to 30,933 by May 2005. About 89% of the newly employed persons in 2004 were classified as knowledge workers, 88% of them being Malays. Furthermore, 7% of persons employed by MSC-status companies had a master's degree with 1% hav-

ing a doctor's degree. Foreigners have been employed preferentially to make good the shortage of knowledge workers in key areas. The number of foreign knowledge workers increased to 3,094 in May 2005 from 2,872 in May 2004. India, the biggest single supply source, provided 1,430 persons or 46% of the total (1,470 persons as of May 2004). Total sales of the companies which set up operations in the area increased to RM7.22 billion in 2004 (78% in domestic sales and 22% in overseas sales) from RM 5.86 billion in 2003 (79% in domestic sales and 21% in overseas sales).

Phase I of the MSC has been completed with a measure of success and Phase II is proceeding generally well. However, competition from China and India for FDI is expected to become increasingly intensified in the future. Success or failure of the MSC project could have a decisive impact on the fate of Malaysia which is striving for sophistication of its industry. The scheme's future developments need a close watch. 