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KEY HIGHLIGHTS: BNM ANNUAL REPORT 2025

OUR GDP FORECAST ALIGNS WITH UPPER END OF BNM'S RANGE

Table 1: Real GDP by expenditure components

Growth, y-o-y%	2024	2025	2026F	
			Bank Islam	BNM
Real GDP (by expenditure)	5.1	5.2	4.7	4.0 – 5.0
Private Consumption	5.1	5.2	5.4	5.0
Public Consumption	4.7	6.6	4.3	4.9
Private Investment	12.3	9.4	7.5	7.5
Public Investment	11.1	10.3	8.0	7.3
Exports of goods and services	8.3	3.1	3.9	2.8
Imports of goods and services	8.2	4.6	5.3	4.3

Sources: BNM, Bank Islam

- **Our 2026 economic growth projection for Malaysia lies at the upper end of BNM's forecasts range.** We expect the Malaysian economy to moderate from 5.2% in 2025 to 4.7% in 2026, which is at the higher end of BNM's forecast range of 4.0% to 5.0%. The central bank's projection range is broader compared to the MOF's estimate of 4.0% to 4.5%, announced during Budget 2026 last October. Downside risks to growth persist, primarily due to ongoing geopolitical tensions between U.S.-Israel and Iran, which have recently involved other nations. These developments may indirectly impact Malaysia's economic activity, especially if the global economy slows as a result of energy shocks and supply chain disruption caused by the closure of the Strait of Hormuz. Additional downside risks include U.S. tariff, however a recent reduction from 19% to 15.0%, following a Supreme Court ruling on the legality of charges against President Trump, may provide temporary relief for Malaysian exporters by enhancing the competitiveness of Malaysian products in the U.S. market. We anticipate stronger growth in both exports and imports of goods and services, projecting increases of 3.9% (2025: 3.1%) and 5.3% (2025: 4.6%) respectively, compared to BNM's estimates of 2.8% and 4.3%. However, higher costs arising from U.S. tariff measures could continue to weigh on global investment and consumption, partially dampening Malaysia's export performance.

- Nonetheless, **domestic demand, which accounts for more than 90% of overall GDP, is expected to continue cushioning the impact of global economic uncertainties**. Private consumption is projected to be the key growth driver, with an estimated expansion of 5.4%, above BNM's forecast of 5.0%. This will be supported by stable labour market conditions, the salary adjustments under Phase 2 of the Public Services Remuneration System (SSPA) effective January 2026, and continued government financial assistance programs such as the Sumbangan Tunai

Rahmah (STR) and SARA. The continuation of the BUDI95 program will also support households, as the subsidized RON95 fuel price is maintained at RM1.99/litre despite significant hikes in global oil prices following the U.S.-Israel-Iran tension. **In contrast, BNM's projection for public consumption is higher than our forecast, at 4.9% versus 4.3%.** Public consumption growth is expected to be driven primarily by continued government spending on emoluments due to civil servant salary adjustment, while expenditure on supplies and services is expected to grow more moderately.

- **Private investment is set to expand modestly, supported by sustained capital spending on high-value and innovation-driven investment.** We expect private investment to remain resilient this year, albeit growing at a slower rate of 7.5% (2025:9.4%), in line with BNM's forecast, due in part to the high base effect from strong investment in past years. The expansion is expected to be supported by the implementation of previously approved projects, especially in high-technology sectors such as information and communications technology (ICT) and electrical and electronics (E&E). Notably, about 84.9% of manufacturing projects approved between 2021 and 2025 are currently in various stages of implementation. Global technology expansion and advance in automation and digitalization are supporting investment in high-value, innovation-driven activities. Early-stage construction also remains robust, signaling continued positive investment prospects (2025: RM40.5 billion; 2024: 33.9 billion). Additionally, the rollout of the New Investment Incentive Framework (NIIF), along with national strategies including NIMP 2030, the National Semiconductor Strategy, and the National Energy Transition Roadmap, will further reinforce investment momentum, particularly in semiconductors, AI, and digital economy. Malaysia's ambition to attain "AI Nation" status by 2030 underscores 2026 as a pivotal year in advancing the National AI Action Plan, with a strong focus on accelerating technology adoption, strengthening talent pipelines, expanding digital infrastructure, and promoting sustainable investment. However, downside risk remains from elevated global tariffs, which could affect investor sentiment and delay new project commitments.

- Meanwhile, **we expect the public investment to grow moderately, slowing from 10.3% in 2025 to 8.0% in 2026, which remains above BNM's prediction of 7.3%.** The slower growth anticipation is mainly due to the near completion of several large infrastructure projects, and the investment will remain focused on catalytic investments in strategic sectors like utilities, energy, and transportation, including electricity generation enhancement, railway upgrades, and public transit improvements. On top of this, the implementation of national master plans, including Budget 2026 and the Thirteenth Malaysia Plan (13MP), alongside ongoing projects, will continue to support public investment growth.

- **We share BNM's view that Malaysia's outlook remains balanced, with risks largely stemming from ongoing geopolitical tensions and global energy price volatility.** The recent escalation of conflict between U.S.-Israel and Iran has disrupted oil and gas production as well as maritime traffic through the Strait of Hormuz, driving up global energy costs and contributing to financial market uncertainty. These external shocks could raise domestic production costs, dampen household consumption, and weigh on exports, particularly if the conflict is prolonged. However, on the upside, Malaysia's macroeconomic fundamentals remain supportive with resilient domestic demand and net energy exporter status provide buffers that could help cushion the economy against external pressures and sustain growth over the medium term.

Table 2: Real GDP by industry components

Growth, y-o-y%	2024	2025	2026F	
			Bank Islam	BNM
Real GDP (by industry)	5.1	5.2	4.7	4.0-5.0
Agriculture	3.1	2.2	2.2	-1.0
Mining & Quarrying	0.9	0.7	1.1	-1.2
Manufacturing	4.2	4.5	3.2	4.3
Construction	17.5	12.2	9.3	9.1
Services	5.3	5.5	5.5	5.2

Sources: BNM, Bank Islam

- **BNM expects overall growth in 2026 to be supported by services and manufacturing sector, while agriculture and mining is expected to contract.** Consistent with BNM's view, we expect the **services** sector to remain the primary engine of growth in 2026, despite a slightly higher growth expectation of 5.5% compared to BNM's 5.2%. The services sector is foreseen to be mainly supported by resilient household spending, stronger tourism activities amid the Visit Malaysia Year 2026 and continued expansion in data centre and ICT-related activities. Furthermore, additional support will also come from improved real estate and business services, in line with continued growth in construction activities. Nevertheless, on the downside, the escalation of the U.S.-Iran conflict may dampen tourism activity as heightened geopolitical uncertainty has disrupted key aviation routes and transit hubs in the Middle East, leading to flight cancellations, longer travel times, and higher airfares, which could reduce tourist arrivals. Weaker travel sentiment and precautionary behaviour among international tourists may further soften demand for travel-related services. Meanwhile, BNM predicts the **manufacturing** sector to grow at 4.3%, higher than our 3.2% projection, as the growth in the E&E industry will be supported by sustained demand linked to AI-related industries, while consumer-oriented industries will continue to benefit from resilient household spending. Our lower forecast lies on the reasoning of policy uncertainty surrounding U.S. tariffs, delayed business planning, as well as easing in front loading activities. Manufacturers are likely to maintain cautious stance in facing persistent global uncertainties including the new threat from U.S.-Iran conflicts that may cause supply chain disruptions.

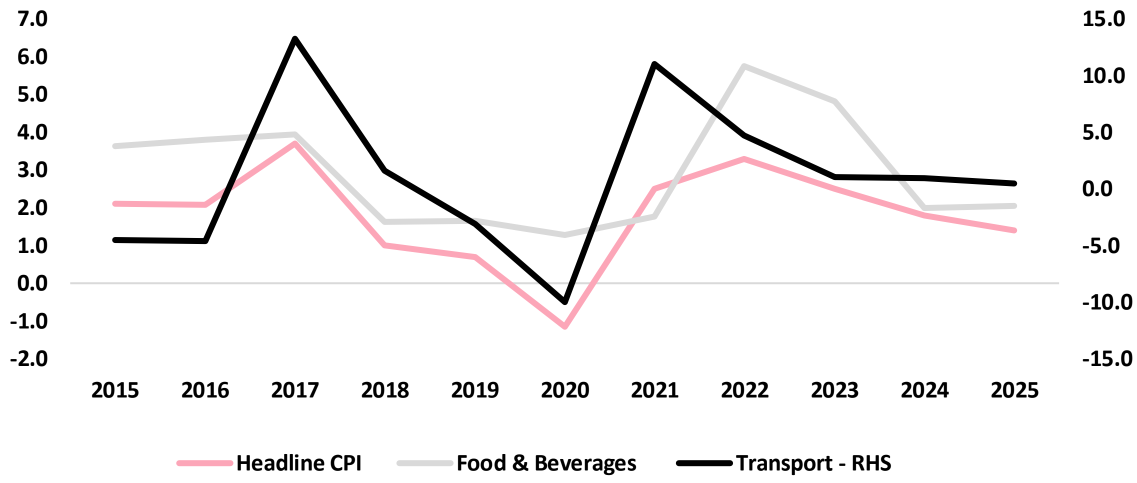
- For the **construction** sector, BNM expects moderate growth of 9.1% (2025: 12.2%), slightly lower than our forecast of 9.3%, driven by continued expansion across all subsectors, despite the nearing completion of several large infrastructure projects. Civil engineering will remain underpinned by sustained public development spending, while non-residential construction will benefit from strong demand for industrial space, including data centre projects. Residential activity will be supported by ongoing launches of affordable housing, with spillovers to early-stage and finishing works sustaining growth in the special trade subsector.

- As for **mining & quarrying**, BNM foresees the sector contracting 1.2%, in contrast to our projection of 1.1% gain. While BNM expects the sector to contract due to declining output from maturing oil fields, which continue to reduce production capacity, as well as maintenance activities in oil and gas fields that will further constrain output, we foresee that a significant spike in oil prices could partly support the sector. We also expect the **agriculture** sector to register positive growth of 2.2%, in contrast to BNM's forecast of -1.0%, reflecting a normalization from elevated yields in late 2025 and the impact of continued replanting activities in East Malaysia.

RISING INFLATION EXPECTATION AMID RISING OIL PRICES AND POLICY SHIFTS

- **We anticipate headline inflation to average 2.0% in 2026**, which falls within BNM's forecast range of 1.5% and 2.5%. We expect higher inflation this year to be driven mainly by rising global oil prices amid the U.S.-Iran conflict and a reduced fuel subsidies quota for RON95, lowered from 300 litres to 200 litres per month. This reduction may increase consumers' exposure to market prices, leading to higher transportation costs and spillovers on food and consumer good prices. The full-year impact of the expanded Sales and Services Tax (SST) introduced in mid-2025 will also continue to raise operational costs for businesses, with cost pass-through to consumers becoming more apparent this year following strategy adjustment. Additionally, higher U.S. tariffs on imported inputs will add to inflationary pressures. Nonetheless, potential upside risks remain largely shaped by external factors, particularly ongoing tensions in the Middles East that are pushing energy prices significantly higher. Upward pressures could also arise from prolonged supply disruptions, trade policy uncertainty, and higher input costs associated with elevated global commodity prices. Sectors sensitive to import prices, particularly food, could face stronger cost pressures, while some producers and retailers may opportunistically raise prices.

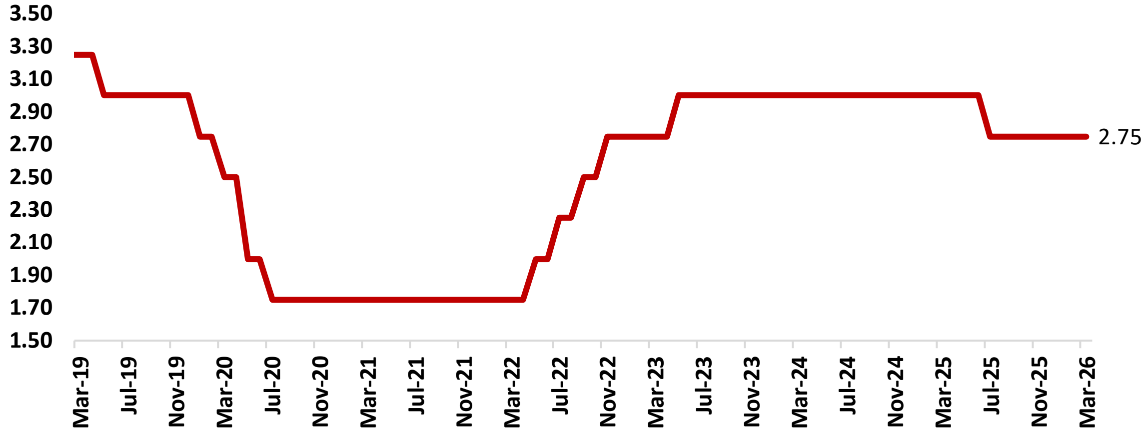
Chart 1: Consumer Price Index (CPI) with key components



Sources: BNM, Bank Islam

OPR EXPECTED TO REMAIN STABLE THROUGHOUT THIS YEAR

Chart 2: Overnight Policy Rate (OPR)



Sources: BNM, Bank Islam

- **BNM is likely to maintain OPR at 2.75% through year-end.** Despite expectations of a modest rise in inflation in 2026, we anticipate that the central bank will maintain the OPR at 2.75% throughout the year. Price pressures are expected to remain within BNM's comfort range, combined with the recent announcement by the government on fuel subsidy development amid rising oil prices, which saw the government maintaining the subsidized RON95 unchanged at RM1.99, and keeping diesel prices in Sabah, Sarawak and Labuan at RM2.15 per litre. Keeping rates steady will enable the central bank to support domestic growth and financial stability amid heightened global uncertainties. While future policy will be data-dependent, a rate hike cannot be ruled out if global oil prices continue to rise further, impacting domestic fuel prices and overall inflation. The significant jump in global oil prices may likely prompt the government to partially rationalize or fully remove fuel subsidies, resulting in higher fuel costs being gradually passed on to businesses and consumers, particularly affecting transportation and food prices.