2013

ECONOMIC DEVELOPMENTS IN 2013

THE INTERNATIONAL ECONOMIC ENVIRONMENT

The global economy expanded at a modest pace in 2013, with uneven momentum across economies. In the advanced economies, growth remained on a path of gradual improvement, led by a private-sector recovery in the US. The euro area emerged from recession while economic activity improved in Japan following the introduction of stimulative policies. The pace of recovery, however, was modest as policy uncertainties and structural constraints continued to weigh on overall demand. Following the above-trend growth over the last few years, growth in the emerging economies moderated as a prolonged weakness in external demand spilled over to the domestic economy. A number of emerging economies had also introduced policy measures to manage potential domestic vulnerabilities, which led to some moderation in domestic demand. In addition, the shift in market expectations of a normalisation in US monetary policy towards the second half of the year led to large capital flow reversals from the emerging economies. Against this backdrop, global inflation slowed, reflecting the moderate demand conditions in many economies and lower non-energy commodity prices.

The global economy expanded at a modest pace in 2013, with uneven momentum across economies

A modest and uneven global recovery

While the global economic environment experienced gradual improvement throughout the year, growth was weak at the start of 2013. Policy uncertainties weighed on the pace of expansion in the advanced economies. The increase in payroll tax and the automatic government spending cuts in the US dampened consumption activity and resulted in a further decline in government spending. In the euro area, uncertainties emanating from the crisis in Cyprus reignited sovereign debt concerns and exacerbated the existing weakness in private-sector sentiments. In Asia, the prolonged weakness in the external environment, coupled with country-specific factors, affected the strength of domestic economic activity. In PR China, ongoing efforts to re-balance growth to a more sustainable and consumption-driven path also led to more moderate growth. While domestic demand remained as the key contributor to growth in the ASEAN economies, the waning effect of previous stimulus measures amid weak external demand weighed on economic activity.

Overall global growth began to gain momentum in the second quarter of 2013. The improvement in the advanced economies was driven by different underlying factors, underscoring a divergence in growth dynamics. Economic recovery in the US benefitted from gradual improvements in the labour and housing markets. In spite of fiscal risks from the debt ceiling debate and government shutdown in late 2013, private investment began to rise, providing further support to the private sector-led growth. In the euro area, economic activity improved marginally, supported by a slower pace of fiscal consolidation. However, private sector demand remained weak, constrained by post-crisis structural impediments such as high unemployment, tight credit conditions and elevated debt levels. In Japan, the coordinated introduction of fiscal and monetary stimulus under a new leadership (`Abenomics´) led to improved business and consumer sentiments, and subsequently, a reduction in deflationary pressures.

Amid signs of more entrenched improvements in the labour market, the Federal Reserve (Fed) indicated a possible scale-back of quantitative easing (QE) in May 2013. The news caused investors to reassess and rebalance their portfolio positions in the emerging markets in response to expectations of tighter financial conditions and narrowing interest rate differentials. This led to capital outflows from the emerging economies and triggered large movements in the global financial markets, with adverse effects on the foreign exchange, equity and bond markets in the emerging economies.

(More discussion on this can be found in the box article `QE Spillovers on Asia´ in Chapter 2.)

These developments, however, had limited impact on real economic activity in Asia. In tandem with a recovery in the advanced economies, tentative signs of improvement began to emerge in the second half of 2013, particularly for the more open economies. Of significance, in several advanced Asian economies, dissipating external weakness and targeted stimulus measures provided some support to growth. In PR China, the economy benefited from `mini´ stimulus measures implemented by the government in July 2013. These included tax cuts for small-medium enterprises (SMEs), streamlining customs regulations to facilitate exports and reforms in the Value Added Tax (VAT).

Table 1.1

World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2012	2013*e*	2012	2013*e*
World Growth	**3.1**	**3.0**	**-**	**-**
World Trade	**2.7**	**2.7**	**-**	**-**
Advanced Economies				
United States	2.8	1.9	2.1	1.5
Japan	1.4	1.5	0.0	0.4
Euro area[1]	-0.7	-0.5	2.5	1.4
United Kingdom	0.2	1.8	2.8	2.6
Emerging Asia[2]	**6.5**	**6.4**	**2.7**	**2.7**
Other Advanced Asian Economies	**1.8**	**2.7**	**2.6**	**1.6**
Korea	2.0	2.8	2.2	1.3
Chinese Taipei	1.5	2.1	1.9	0.8
Singapore	1.9	4.1	4.6	2.4
Hong Kong SAR[3]	1.5	2.9	4.1	4.3
The People's Republic of China	**7.7**	**7.7**	**2.6**	**2.6**
ASEAN-4	**6.3**	**5.1**	**3.3**	**4.4**
Malaysia	5.6	4.7	1.6	2.1
Thailand	6.5	2.9	3.0	2.2
Indonesia	6.3	5.8	4.3	7.0
Philippines	6.8	7.2	3.2	3.0
India	**4.7**	**4.6**	**9.7**	**10.1**

1 Refers to EU-17
2 Emerging Asia refers to Chinese Taipei, Hong Kong SAR, Indonesia, Korea, Malaysia, Philippines, PR China, Singapore and Thailand
3 Inflation refers to composite price index
e Estimate

Source: International Monetary Fund, National Authorities and Bank Negara Malaysia estimates

Global inflation moderated

Inflation moderated across regions, reflecting subdued demand conditions in many economies. The lower price pressures were also in part attributable to lower commodity prices.

During the year, amid increased supply and lower demand growth from key emerging economies, commodity prices continued to moderate from the peak recorded in early 2011. Record production of grains, primarily corn and rice, along with higher stocks dampened food prices. The increased supply of metals, amid weak demand, led to lower non-energy commodity prices. Oil prices were sustained at 2012 average levels. During the first half of the year, oil prices fell due to growth concerns in major oil importing economies in Asia. However, as these concerns abated, geopolitical developments in the Middle East took precedence. Brent crude oil price rose to a six-month high of USD118 per barrel (p/b) in August, amid escalations in geopolitical tensions in Egypt and Syria. Prices stabilised at the end of the year to average USD109 p/b for the year.

In the advanced economies, core inflation rates, which exclude food and energy prices, remained subdued following weak domestic demand as high unemployment continued to suppress wages and consumption. In the US and euro area, headline inflation rates declined to levels below targets set by the central banks. Downward adjustments to wages in the crisis-affected economies in the euro area, stemming from unit labour cost realignments to improve competitiveness, reinforced the lower inflationary pressures. In contrast, the price level in Japan reached its highest since end-2008 due partly to increases in the cost of energy. Notably, core inflation turned positive towards the end of the year, supported by stronger domestic demand. In Asia, lower commodity prices and the moderation in growth exerted downward pressures on inflation. Nevertheless, India and Indonesia experienced elevated inflation rates, reflecting the adverse impact of currency depreciation and adjustments to administered fuel prices. In India, inflation was also driven by acceleration in food prices, particularly vegetables, rising wages, and supply-chain constraints.

Global policy responses remained supportive of growth

Confronted with a challenging operating environment, policymakers pursued measures to support growth and mitigate concerns driven by domestic factors. Monetary policy remained accommodative across regions. In the advanced economies, monetary authorities placed greater emphasis on forward guidance to minimise market uncertainties on future policy directions. The pace of fiscal consolidation moderated in some advanced economies, while targeted fiscal support was introduced in some Asian economies. Macroprudential measures were also undertaken in Asia to address financial imbalances such as rapid credit growth and rising asset prices.

In the advanced economies, policies were geared towards supporting the economic recovery. Amid low policy rates, monetary authorities used `forward guidance´, a communication tool to manage market expectations of future interest rates. While the Fed maintained its numerical thresholds for unemployment and inflation rates introduced in December 2012, it highlighted at the end of 2013 that interest rates would be kept low, well beyond the threshold where the unemployment rate falls below 6.5%. Following cumulative improvement in labour market conditions, the Fed announced that it would reduce its asset purchases by USD10 billion in December 2013 and subsequently, in January 2014 to USD65 billion per month. Similarly, the Bank of England (BOE) indicated that an unemployment rate threshold of 7% would apply before it considered adjustments to the Bank Rate. In addition, it announced changes to the Funding for Lending Scheme, by refocusing incentives from households to SMEs. The European Central Bank (ECB) lowered its key policy rate in May and November by a total of 50 basis points (bps) to 0.25% on account of low underlying price pressures. Further, the ECB stated that key interest rates would remain at prevailing or lower levels for an extended period of time with no explicit thresholds.

On the fiscal front, consolidation remained in place, albeit at varying speeds across economies. The US averted the fiscal cliff[1] through the American Taxpayer Relief Act which provided for permanent and temporary extensions of fiscal measures including tax relief. However, the government allowed automatic spending cuts to take effect in March under the Budget Control Act 2011. In the euro area, the pace of fiscal consolidation slowed as policymakers initiated pro-growth strategies, including measures to improve lending to SMEs and to increase youth employment. Of significance, countries such as France, Spain and Portugal were given extensions in timelines to reduce budget deficits.

In Japan, `Abenomics´ was introduced, consisting of a three-pronged plan of fiscal stimulus, monetary easing and structural reforms. A fiscal stimulus was announced in January, directed at accelerating post-disaster reconstruction, disaster prevention and stimulating private investment. A supplementary budget, unveiled in December, was aimed at offsetting the potential impact from an increase in consumption tax in April 2014. This underscored the government's efforts in balancing between supporting growth and reducing the high public debt. On the monetary policy front, the Bank of Japan introduced the Quantitative and Qualitative Monetary Easing in April to achieve the inflation target of 2% within two years. By the second half of the year, structural reforms encompassing measures for the labour market, private investment and competitiveness were laid out.

Policies in Asia were shaped primarily by domestic concerns amid a challenging external environment. Throughout most of the first half of 2013, growth concerns arising from protracted weakness in the external environment led most national authorities to adopt accommodative monetary policies to support growth against the backdrop of benign inflationary pressures. Central banks in India, Thailand and Korea lowered their policy rates by between 25 bps and 75 bps. However, in May 2013, following the Fed's indication of a possible QE scale-back, investors began to reassess their investment strategies. Asia's fundamentals came under greater scrutiny and countries with both current account and fiscal deficits experienced large capital reversals. Bank Indonesia increased its benchmark rate to reinforce its policy mix, which was aimed at anchoring inflation expectations, while stabilising the rupiah and ensuring the sustainability of the current account position. The Reserve Bank of India also raised interest rates on inflationary concerns and instituted measures to narrow the current account deficit. Most Asian economies have demonstrated resilience in managing the volatility arising from capital flows, due in part to the enhanced buffers built post-Asian Financial Crisis

1 'Fiscal cliff' refers to a set of tax increases and spending cuts that were estimated to reduce the US fiscal deficit by USD502bn in FY2013. The Congressional Budget Office (CBO) projected that if these policies had taken effect, the US economy would have returned to recession in FY2013. The American Taxpayer Relief Act in January 2013 eliminated part of the fiscal cliff.

Table 1.2

Malaysia - Key Economic Indicators

	2011	2012	2013*p*	2014*f*
Population (million persons)	29.1	29.5	29.9	30.4
Labour force (million persons)	12.7	13.1	13.8	14.3
Employment (million persons)	12.3	12.7	13.3	13.8
Unemployment (as % of labour force)	3.1	3.0	3.1	3.1
Per Capita Income (RM)	29,683	30,667	31,698	34,175
(USD)	9,700	9,928	10,060	10,337[6]
NATIONAL PRODUCT (% change)				
Real GDP at 2005 prices[1]	5.1	5.6	4.7	4.5 ~ 5.5
(RM billion)	711.4	751.5	786.7	828.1
Agriculture, forestry and fishery	5.8	1.0	2.1	3.8
Mining and quarrying	-5.5	1.4	0.5	1.6
Manufacturing	4.7	4.8	3.4	3.5
Construction	4.7	18.1	10.9	10.0
Services	7.0	6.4	5.9	6.2
Nominal GNI	11.9	4.9	4.9	9.4
(RM billion)	862.7	905.2	949.3	1,038.8
Real GNI	4.9	3.9	5.1	5.8
(RM billion)	666.9	693.1	728.3	770.2
Real aggregate domestic demand[2]	7.9	10.6	7.6	6.9
Private expenditure	7.6	10.7	9.0	8.3
Consumption	6.8	7.7	7.6	6.9
Investment	10.5	21.9	13.6	12.6
Public expenditure	8.9	10.3	3.7	2.9
Consumption	15.8	5.1	6.3	3.0
Investment	1.0	17.1	0.7	2.9
Gross national savings (as % of GNI)	35.7	33.1	31.2	31.4
BALANCE OF PAYMENTS (RM billion)				
Goods balance	151.6	125.6	102.7	93.7
Exports	699.6	703.2	690.9	714.6
Imports	548.0	577.5	588.2	620.9
Services balance	-6.3	-14.0	-15.0	-11.9
Primary income, net	-21.8	-36.0	-35.2	-34.9
Secondary income, net	-21.1	-18.2	-15.2	-16.0
Current account balance	102.4	57.3	37.3	30.8
(as % of GNI)	11.9	6.3	3.9	3.0
Bank Negara Malaysia international reserves, net[3]	423.3	427.2	441.9	-
(in months of retained imports)	9.6	9.5	9.5	-
PRICES (% change)				
CPI (2010=100)[4]	3.2	1.6	2.1	3.0 ~ 4.0
PPI (2005=100)[5]	9.0	0.1	-1.9	-
Real wage per employee in the manufacturing sector	0.6	4.7	5.6	-

[1] Beginning 2012, real GDP has been rebased to 2005 prices, from 2000 prices previously
[2] Exclude stocks
[3] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account
[4] Effective from 2011, the Consumer Price Index has been revised to the new base year 2010=100, from 2005=100 previously
[5] Effective from 2010, the Producer Price Index has been revised to the new base year 2005=100, from 2000=100 previously
[6] Based on average USD exchange rate for the period of January-February 2014
p Preliminary
f Forecast

Note: Numbers may not necessarily add up due to rounding

Table 1.3

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2011		2012		2013*p*	
Revenue	185.4		207.9		213.4	
Operating expenditure	182.6		205.5		211.3	
Net development expenditure	45.3		44.3		40.7	
Overall balance	-42.5		-42.0		-38.6	
Overall balance (% of GDP)	-4.8		-4.5		-3.9	
Public sector net development expenditure	101.3		135.2		180.2	
Public sector overall balance (% of GDP)	-3.4		-4.5		-13.6	
EXTERNAL DEBT						
Total debt (RM billion)	257.4		252.8		318.1	
Medium- and long-term debt	153.6		159.8		190.0	
Short-term debt[1]	103.8		93.0		128.1	
Debt service ratio[2] (% of exports of goods and services)						
Total debt	10.4		10.1		10.3	
Medium- and long-term debt	10.3		10.1		10.3	
MONEY AND BANKING	**Change in 2011**		**Change in 2012**		**Change in 2013**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply M1	34.6	15.4	30.8	11.9	37.8	13.0
M3	155.6	14.3	111.2	9.0	109.5	8.1
Banking system deposits	160.9	14.1	109.4	8.4	119.1	8.5
Banking system loans[3]	120.2	13.6	104.5	10.4	117.7	10.6
Loan-deposit ratio (end of year)[4]	80.9		82.1		84.6	
Financing-deposit ratio[4, 5]	86.2		88.7		91.2	
INTEREST RATES (AS AT END-YEAR)	**2011**		**2012**		**2013**	
	%		%		%	
Overnight Policy Rate (OPR)	3.00		3.00		3.00	
Interbank rates (1-month)	3.05		3.06		3.20	
Commercial banks						
Fixed deposit 3-month	2.99		2.97		2.97	
12-month	3.22		3.15		3.15	
Savings deposit	1.15		1.03		0.99	
Base lending rate (BLR)	6.53		6.53		6.53	
Treasury bill (3-month)	2.99		3.04		3.00	
Malaysian Government Securities (1-year)[6]	2.82		3.01		3.03	
Malaysian Government Securities (5-year)[6]	3.23		3.24		3.66	
EXCHANGE RATES	**2011**		**2012**		**2013**	
Movement of Ringgit (end-period)	%		%		%	
Change against SDR	-2.8		3.9		-7.3	
Change against USD[7]	-2.9		3.9		-6.8	

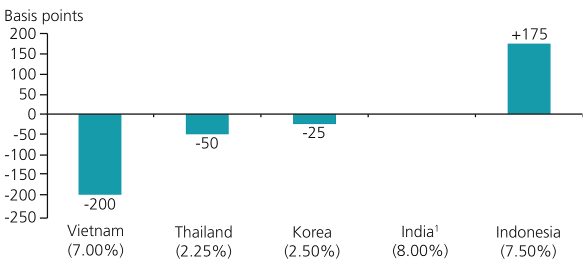
[1] Excludes currency and deposits held by non-residents with resident banking institutions
[2] Includes prepayment of medium- and long-term debt
[3] Includes loans sold to Cagamas
[4] Excludes transactions between financial institutions
[5] Refers to the ratio of loans and holdings of PDS by the banking system to deposits of the banking system
[6] Refers to data from FAST, Bank Negara Malaysia
[7] Ringgit was pegged at RM3.80=USD1 on 2 September 1998 and shifted to a managed float against a basket of currencies on 21 July 2005
p Preliminary

and the pre-emptive measures undertaken to ensure that capital outflows would not be disruptive.

To provide support to domestic economic activity, several Asian countries also announced stimulative fiscal measures. The stimulus packages were designed to aid SMEs, facilitate investment in infrastructure projects, provide tax incentives and support exports. Cognisant of financial imbalances arising from elevated debt levels and rising asset prices, several national authorities introduced further macroprudential policy measures. These measures included increasing minimum loan-to-value (LTV) ratios, hiking stamp duties and reducing loan tenures to address rising property prices.

Chart 1.1

Cumulative Movements of Policy Rates (Jan. 2013 - Feb. 2014)



[1] Reserve Bank of India lowered its policy rate by 75 bps in 1H 2013, raised it by 50 bps in 2H 2013 and subsequently increased it by 25 bps in 2014

Note: Current policy rates in parentheses, as at end-February 2014

Source: National Authorities

Table 1.4

Real GDP by Expenditure (2005=100)

	2012	2013*p*	2012	2013*p*
	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**10.6**	**7.6**	**9.2**	**6.9**
Consumption	7.1	7.3	4.5	4.7
Private sector	*7.7*	*7.6*	*3.8*	*3.8*
Public sector	*5.1*	*6.3*	*0.7*	*0.8*
Gross Fixed Capital Formation	19.9	8.2	4.7	2.2
Private sector	*21.9*	*13.6*	*3.0*	*2.1*
Public sector	*17.1*	*0.7*	*1.7*	*0.1*
Change in Stocks			**0.6**	**-0.2**
Net Exports of Goods and Services	**-31.7**	**-22.9**	**-4.2**	**-2.0**
Exports	*-0.1*	*-0.3*		
Imports	*4.7*	*1.9*		
Real Gross Domestic Product (GDP)	**5.6**	**4.7**	**5.6**	**4.7**

[1] Excluding stocks
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Source: Department of Statistics, Malaysia

THE MALAYSIAN ECONOMY

Overview

The Malaysian economy expanded by 4.7% in 2013 (2012: 5.6%), driven by the continued strong growth in domestic demand. Despite the weaker external environment in the first half of the year, domestic demand remained resilient throughout the year, led by robust private sector activity. Private consumption was strong, supported mainly by favourable employment conditions and wage growth. Private investment registered a strong growth in 2013, continuing the momentum from the previous year. Growth was underpinned by capital spending in the mining, services and manufacturing sectors. Although the Federal Government's development expenditure declined during the year, growth in public investment remained positive as a result of the continued high capital spending by the public enterprises.

The Malaysian economy expanded by 4.7% in 2013, driven by continued strong growth in domestic demand amid a weak external environment in the first half of the year

The more moderate growth performance in 2013 was to a large extent attributable to developments in the external sector. Real GDP registered a more moderate growth of 4.3% in the first half of the year (1H 2012: 5.4%), weighed down by prolonged weak external demand. Demand for Malaysia's exports, particularly for electronics and electrical (E&E) products, was affected by the slow growth in the US

Table 1.5

Real GDP by Sector (2005=100)

	2012	2013*p*	2012	2013*p*
	Annual change (%)		Contribution to growth (ppt)[1]	
Agriculture	1.0	2.1	0.1	0.2
Mining & quarrying	1.4	0.5	0.1	0.0
Manufacturing	4.8	3.4	1.2	0.8
Construction	18.1	10.9	0.6	0.4
Services	6.4	5.9	3.5	3.2
Real Gross Domestic Product (GDP)	**5.6**	**4.7**	**5.6**	**4.7**

[1] Numbers do not add up due to rounding and exclusion of import duties component

p Preliminary

Source: Department of Statistics, Malaysia

and weak economic activity in most of the European economies. The prolonged weak demand from the advanced economies had also affected several regional economies, which in turn led to slower demand for Malaysia's non-E&E products. As a result, real exports of goods and services declined by 2.9% in the first half of 2013. Real imports of goods and services, on the other hand, expanded further in the first half-year following sustained growth in domestic investment and consumption. This contributed to a bigger contraction in net exports. As a result of the weak export performance, Malaysia's growth forecast for 2013 was revised downward to 4.5%-5% in August, from the earlier projection of 5%-6%. Growth forecasts were also revised downwards in some other regional economies. As the overall global growth gained momentum at the onset of the second quarter of the year, Malaysia's real exports improved to register a positive growth of 2.3% in the second half of the year. Consequently, despite the stronger expansion in real imports, net exports recorded a smaller contraction in the second half of 2013.

From the supply perspective, the continued firm growth in domestic demand contributed to the expansion in domestic-related activities in the services and manufacturing sectors during the year, while the export-oriented industries in the manufacturing sector benefitted from the improvement in external conditions in the second half-year. Meanwhile, the robust activity in the residential and civil engineering sub-sectors contributed to the continued strong growth in the construction sector.

Domestic demand remained the key driver of growth

Domestic demand remained the key driver of Malaysia's economy, expanding by 7.6% in 2013 (2012: 10.6%). This was attributable to the robust growth in private consumption and investment. Public expenditure growth moderated but remained supportive of overall growth.

> Private consumption remained strong, supported mainly by favourable employment conditions and wage growth

Private consumption continued to register a strong growth of 7.6% in 2013. Spending was underpinned mainly by favourable employment conditions and wage growth. During the year, wages in the domestic-oriented industries in the manufacturing sector recorded a stronger growth (10.3%; 2012: 6.6%), whilst those in the export-oriented industries registered sustained growth (5%; 2012: 5.2%). The implementation of the minimum wage policy on 1 January 2013 also contributed to the higher wage levels. The new policy had minimal adverse effects on employment, and was confined mostly to the fourth quarter of 2012, during which, retrenchments were temporarily higher as companies started to implement the policy. Government transfers to low- and middle-income households continued to support private consumption, albeit to a lesser extent compared to 2012. These included Bantuan Rakyat 1Malaysia (BR1M), Baucar Buku 1Malaysia (BB1M), and schooling assistance to primary and secondary school students, which in total amounted to RM3.8 billion. Private consumption was also supported by continued access to financing for creditworthy households. Outstanding consumption credit to households continued to grow, albeit at a slower pace of 8.5% (2012: 13.3%), which was in part attributable to the pre-emptive macroprudential measures introduced by the Bank in July 2013.

Public consumption recorded a higher growth of 6.3% in 2013 (2012: 5.1%) due mainly to higher expenditure on supplies and services. Expenditure on emoluments was sustained.

Favourable Labour Market Conditions

In 2013, the labour market remained favourable, as continued expansion in economic activity across all sectors supported the demand for labour. During the year, employment recorded a strong growth of 4.8% (2012: 3.6%), representing a net addition of 613,000 jobs from the previous year. The unemployment rate remained low at 3.1% (2012: 3.0%).

The favourable labour market was also reflected in lower retrenchments reported to the Ministry of Human Resources. Total retrenchments decreased to 11,195 persons from 11,494 in the previous year, as the higher retrenchments in the manufacturing sector (7,940 persons; 2012: 7,616 persons) were offset by lower retrenchments in the services (2,605 persons; 2012: 2,639 persons) and construction (353 persons; 2012: 1,002 persons) sectors. In terms of sentiments, employees were more optimistic in finding employment, as evidenced by the higher JobStreet Employee Confidence Index (JECI) of 50.3 (2012: 48.8). Employers also reported an optimistic view of the job market as reflected in higher Jobstreet's Job Outlook Index of 54.4 (2012: 52.5).

The services sector added the most jobs during the year, contributing to 65% of the net job addition, followed by the agriculture (18%) and construction (16%) sectors. Mid-skill workers accounted for almost three quarters of the net job additions, followed by low-skill (19%) and high-skill (10%).

In terms of employment structure, the services sector remained the largest employer with 60% of employment, followed by the manufacturing (17%), agriculture (13%), construction (9%) and mining sector (0.7%). Employment by skill levels also remained unchanged, with mid-skill workers accounting for 63% of employment, followed by high-skill (25%) and low-skill (13%).

In 2013, the number of registered foreign workers increased markedly to 2.47 million workers (2012: 1.57 million workers). The significant increase can be attributed to the legalisation of foreign workers through the 6P programme. Most foreign workers were employed in the manufacturing (35% of total foreign workers), agriculture (26%) and construction (20%) sectors.

The national minimum wage policy was put into effect on 1 January 2013. The higher employment growth and lower retrenchments suggest that most firms were able to adjust to the minimum wage policy.

Based on a survey by the Malaysian Employers Federation, average salary in the private sector increased by 6.6% in 2013 (2012: 6.0%). On average, executives recorded a salary growth of 6.3% (2012: 6.3%) while non-executives registered a salary growth of 6.7% (2012: 5.8%), reflective of the minimum wage policy.

Table 1

Selected Labour Market Indicators

	2009	2010	2011	2012	2013*p*
Employment ('000 persons)	10,899	11,900	12,284	12,723	13,336
Labour force ('000 persons)	11,315	12,304	12,676	13,120	13,763
Unemployment rate (% of labour force)	3.7	3.3	3.1	3.0	3.1
Retrenchments (persons)	25,064	7,085	9,450	11,494	11,195
Foreign workers ('000 persons)	1,918	1,818	1,573	1,572	2,470

p Preliminary

Note: Beginning 2010, employment and labour force data was based on new population estimates and cannot be directly compared to previous years' data

Source: Department of Statistics, Malaysia, Ministry of Human Resources, Ministry of Home Affairs and Bank Negara Malaysia

Gross fixed capital formation (GFCF) registered a lower growth of 8.2% in 2013, following a robust growth of 19.9% in 2012. The share of private investment to GFCF rose to 61% (2012: 58%), reflecting continued strong growth in private investment amid more modest growth in public investment.

The pace of investment activity moderated from the exceptionally strong growth in 2012, supported mainly by private sector capital expenditure

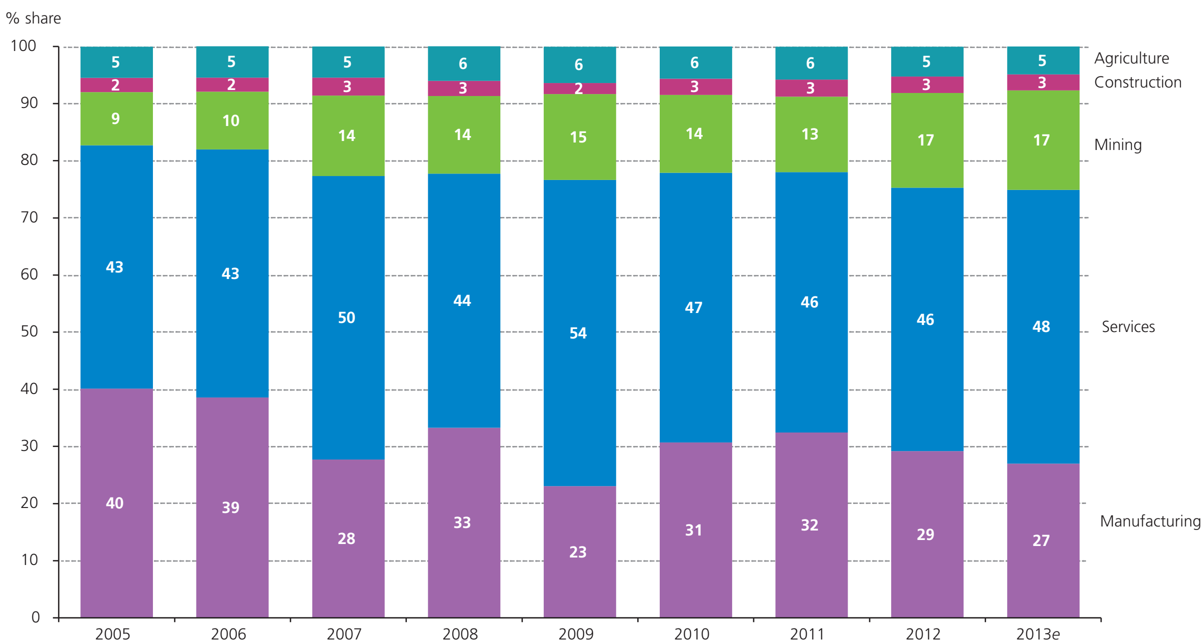
GFCF was supported by investment in both structures, and machinery and equipment. Investment in structures grew by 11.1% (2012: 25.1%), and was evident in all construction sub-sectors. Investments in machinery and equipment increased by 5.1% (2012: 16.9%). The moderation in machinery and equipment investment growth was reflected in the decline in imports of machinery for manufacturing (2013: -2.9%; 2012: 21%), imports of office equipment (2013: -8.7%; 2012: 3.5%) and imports of locomotives (2013: -96.9%; 2012: 186.6%).

Private investment continued to register a double-digit growth rate of 13.6% (2012: 21.9%), well above the average growth rate of 8.8% over 2000 to 2012. Private investment was driven by capital spending by both the domestic and foreign investors in the mining, services and manufacturing sectors.

Services investments (48% share of private investment in 2013) were underpinned by capital spending in both the domestic- and export-oriented services sub-sectors. In the domestic-oriented services sector, investments were undertaken mainly in the distributive trade, telecommunication and private healthcare sub-sectors. Investments in the export-oriented sub-sectors were mainly for the expansion and upgrading of ports and petroleum storage terminals. Dwellings investment, as proxied by residential construction work done, continued to record strong growth (19.6%). Despite the robust pace, the share of dwellings investment to private investment was broadly unchanged at

Chart 1.2

Real Private Investment by Sector



e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Continued Growth across All Economic Sectors

On the supply side, all economic sectors continued to grow in 2013, driven mainly by continued expansion in domestic demand and improving external conditions in the second half of the year.

The services sector expanded by 5.9% in 2013 and remained the largest contributor to growth (3.2 percentage points of overall GDP growth). Growth in the sector was underpinned largely by sub-sectors catering to domestic demand. In particular, the wholesale and retail trade sub-sector recorded higher growth benefitting from continued strength in households' retail spending. In the communication sub-sector, growth remained robust, mainly on account of continued demand for data communication services. Performance of the transport and storage sub-sector was sustained amid strong growth in passenger travel. On the other hand, growth in the finance and insurance sub-sector moderated following lower interest rate margins and insurance premiums.

The manufacturing sector expanded by 3.4%, attributable to the continued strength in the domestic-oriented industries and better performance of the export-oriented industries in the second half of 2013. Production in the export-oriented industries was supported by stronger exports in both the E&E and primary-clusters, amid a gradual recovery in the global economy. Domestic-oriented industries recorded sustained growth, mainly driven by robust private consumption and resilient construction activity.

Growth remained strong in the construction sector (10.9%), owing to robust activity in the residential and civil engineering sub-sectors. Growth in the residential sub-sector was underpinned by the construction of high-end and high-rise properties in the Klang Valley, Penang and Johor. In the civil-engineering sub-sector, activities in infrastructure, and oil and gas-related projects supported growth. Notable projects included Tanjung Bin and Janamanjung power plants, MRT, Sabah Oil and Gas Terminal, Sabah-Sarawak Gas Pipeline and the Kebabangan Oil and Gas project.

In the agriculture sector, growth was stronger at 2.1% mostly on account of the higher CPO output, reflecting better yields amid favourable weather conditions. Production of food commodities, such as livestock, vegetables and fisheries, was also higher in 2013 following efforts to increase food security as well as ongoing efforts to further improve the agro-food and aquaculture industries.

The mining sector registered a slower growth of 0.5% in 2013, reflecting the reduction in crude oil production amid maintenance works that occurred in the latter half of the year. Output of natural gas, however, recorded stronger growth during the year, driven by higher demand from East Asia for electricity generation as well as commencement of higher production from marginal and new fields.

Chart 1

Real GDP by Economic Activity

p Preliminary

Source: Department of Statistics, Malaysia

17% as investments in other sectors also recorded strong growth rates.

Mining investment (17% share of private investment) remained strong in 2013, reflecting continued capital spending in major upstream projects, such as the Gumusut-Kakap deepwater field, Enhanced Oil Recovery of the Tapis oil field and the Berantai and Balai marginal fields. In the manufacturing sector (27% of private investment), investments were undertaken in both the export-oriented industries such as the E&E and medical devices, and the domestic-oriented industries, particularly in food manufacturing. This expansion reflected improving business sentiment following the gradual improvement in external demand and sustained strong domestic consumption.

Public investment recorded a small positive growth of 0.7% (2012: 17.1%), following the decline in the Federal Government's development expenditure. Nevertheless, this was offset by higher capital spending by the public enterprises, which were channelled mainly into the oil and gas, transportation and energy sectors. The major projects in the oil and gas sector were Sabah Ammonia-Urea Plant, Sabah-Sarawak Gas Pipeline and Kinabalu Non-Associated Gas (NAG) upstream development. Investment in the transportation sub-sector was supported by the construction of the MY Rapid Transit (MRT) and further work on the Light Rapid Transit (LRT) extension. Investment in the utilities sub-sector included the building of power plants, such as in Tanjung Bin and Janamanjung. The Federal Government's development expenditure in the economic sector was directed mainly to transportation, and trade and industry, particularly to upgrade infrastructure facilities in industrial areas.

EXTERNAL SECTOR

In 2013, Malaysia's external sector remained resilient amid a challenging global economic and financial environment. The current account surplus narrowed, but more than offset the net outflows in the financial account. The level of international reserves of Bank Negara Malaysia remained high and was more than sufficient to meet short-term external obligations and to provide a buffer against external shocks.

Developments in the external sector in 2013 were broadly characterised by two distinct periods. In the first half of the year, the current account recorded a smaller surplus of RM11.2 billion (1H 2012: RM24.8 billion), on account of a smaller trade surplus amid lower services and income deficits. The continued economic weakness in the advanced countries resulted in a marked decline in Malaysia's exports (1H 2013: -4%). Demand for E&E products remained weak (1H 2013: -3.9%), as exports of personal computers (PC) and electrical products were weighed down by a delay in the global IT replacement cycle. Lower-than-expected growth in regional economies also affected demand for non-E&E manufactured products (1H 2013: 3.4%) such as iron and steel, optical and scientific equipment, wood and rubber products. In addition, the lower prices of Malaysia's key commodities in the first half of the year also dampened the export performance. On the other hand, robust domestic investment and consumption activities continued to drive the growth of imports (1H 2013: 4.4%). The services and income deficits narrowed due mainly to higher net travel receipts and lower net primary income payments. The increase in net travel receipts was attributed to stronger intra-regional tourism, while higher profits of Malaysian companies investing abroad, particularly in the financial services sub-sector, contributed to the decrease in net primary income payments.

The external sector remained resilient amid a challenging global economic environment

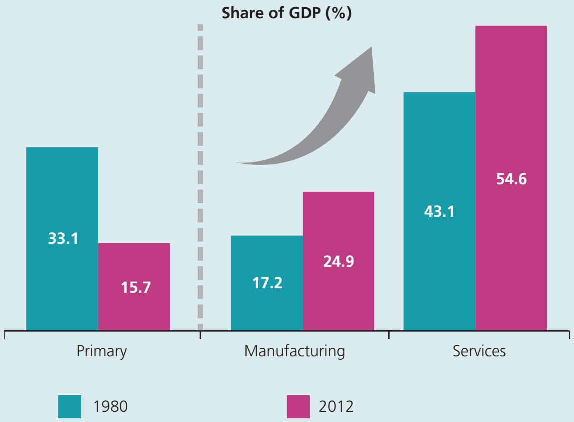
In the second half of the year, the current account surplus widened to RM26.1 billion as export growth returned to positive territory. The improvement in Malaysia's exports (2H 2013: 8.9%) was due to an increase in demand across both manufactured products and commodities. This was further reinforced by more favourable prices of CPO and LNG relative to the first half of 2013. Exports to the EU and the region were higher, in tandem with the improvement in economic activity in these economies. Imports grew at a stronger pace (2H 2013: 9.5%) as firm domestic demand contributed to imports of capital and consumption goods. In particular, sustained investment activity in the domestic-oriented sectors led to higher imports of telecommunication and construction services. The expansion in trade activity also resulted in higher payments for freight services. Net payments for other services components were sustained as the improvement in receipts offset the higher payments.

Further Diversification of Malaysia's Resource-based Industries

The heavy reliance on primary commodities in the earlier years posed considerable challenges to the Malaysian economy, particularly in terms of its vulnerability to swings in commodity prices. In 1980, primary commodities accounted for 33% of GDP and 77% of exports. Beginning in the early 1980s, Malaysia embarked on an economic diversification strategy with the objective of advancing into higher value-added activities, as well as reducing the over-concentration in upstream commodities, namely tin ore and rubber. With the inception of the National Industrial Policy and Industrial Master Plan in the mid-1980s, the Government implemented a series of policy measures to aggressively promote the manufacturing sector, and subsequently the services sector in the 1990s. This resulted in a rapid pace of horizontal diversification of the economy, with robust growth in the manufacturing and services sectors, and a significant reduction in the reliance on the primary sector (Chart 1). Of equal importance, the Malaysian economy also diversified vertically by moving up the commodities value chain from upstream to downstream activities (Chart 2).

Chart 1

Horizontal Diversification Towards Other Sources of Growth



Source: Economic Planning Unit and Department of Statistics, Malaysia

Chart 2

Vertical Diversification Towards Higher Value-added Products

Source: Department of Statistics, Malaysia

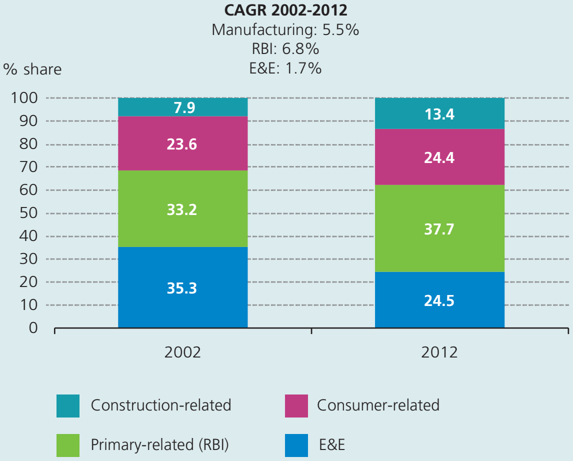
Resource-based industries have been the biggest growth driver of manufacturing sector over the past decade (2002-2012), encompassing mainly the manufacture of petrochemicals, oleochemicals, refined petroleum, palm oil, rubber gloves, tyres and prophylactics products. Rising commodity prices during this period subsequently led to higher prices of most products in the resource-based industries, providing further impetus to the growth of the sector. During this period, value-added of the resource-based industries increased by 6.8% on compounded annual growth rate (CAGR) basis, outpacing the growth of the electronics and electrical (E&E) subsector of 1.7%, thus becoming the largest manufacturing subsector from 2005 onwards (Chart 3). Resource-based industries contributed substantially to Malaysia's exports, growing by 12.4% on CAGR basis during the same period, resulting in the exports of resource-based products accounting for 32% of total manufactured exports in 2012 as compared with 17% in 2002[1] (Chart 4). Diversification into resource-based industries ensured that the share of manufactured exports to total exports remained high at 70-75%, even as primary exports rose in value during the period.

The First Industrial Master Plan launched in 1986 was particularly instrumental in driving the 'multi-sector agglomeration' development strategy for the manufacturing sector. It accelerated the diversification of

[1] The substantially high growth in the exports of resource-based industries during this period was also attributable to the higher commodity prices post 2002.

Chart 3

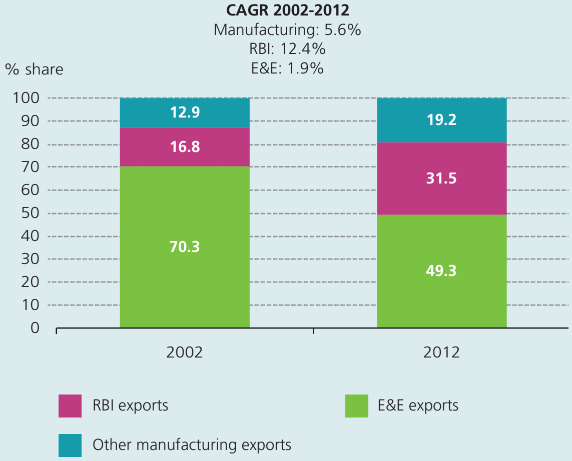
Manufacturing GDP Growth and Share of Key Components



Source: Department of Statistics, Malaysia

Chart 4

Manufactured Exports and Share of Key Components



Source: Department of Statistics, Malaysia

the domestic economy via the creation of wider range of manufacturing activities in the country, thereby reducing the over-concentration on primary commodities. The benefits of economic diversification can be seen from the increasing degree of intensity of economic activity across various interconnected industries over the years. Based on the Input-Output Tables[2] of the Malaysian economy, in 1960, the intensity level of economic activity was very low and mainly concentrated in few major industries. The intensity level increased through time and, by 2005, had risen significantly and became more diverse across most industries in the economy, underlining the extent of diversification.

The positive impact of vertical diversification in the resource-based industries has been very evident. First, it has facilitated the deepening of the forward and backward linkages in the economy, ensuring close interdependence and interconnectedness between upstream and downstream production[3]. Of significance, as the downstream production activities had intensified, higher value-added output was generated within the domestic economy. Second, the increased diversification has led to higher profits for firms, sustained increases in wages, and higher tax revenue for the Government. Third, the growth of the resource-based industries has led to an increase in productivity from the diversion of the underemployed or surplus labour force in the upstream agriculture sector to the manufacturing sector. This is seen in the share of employment in the agriculture sector, which fell from 31% in the 1980-1990 period to 15% in the 2000-2010 period. This was accompanied by the rising share of employment in the manufacturing sector from 16% to 20%. Finally, the diversification has been crucial in moderating the influence of commodity price volatility on the economy. Empirically, firm-level evidence indicates that commodity-based companies that have a larger share of downstream production generally have more positive and stable profits as compared to companies with a larger share of upstream activities.

The degree of vertical diversification, however, varies across the subsectors of resource-based industries. In the oil and gas industry, the strong institutional support provided by PETRONAS in championing investment in the downstream activities was a major enabling factor in the diversification process. Profit

[2] The Input-Output Tables provide a comprehensive aggregation of all production in the economy, tracking everything from sources of inputs to intermediate and final uses of products. The Malaysian Input-Output Tables are published by the Department of Statistics, Malaysia on a five-year basis, with the latest data available at base year 2005.

[3] This is in line with the `path dependency´ theory where it is almost impossible for a country to shift entirely from a traditional sector into the high-technology manufacturing and services sectors without a gradual transformation period (Felipe et al., 2013).

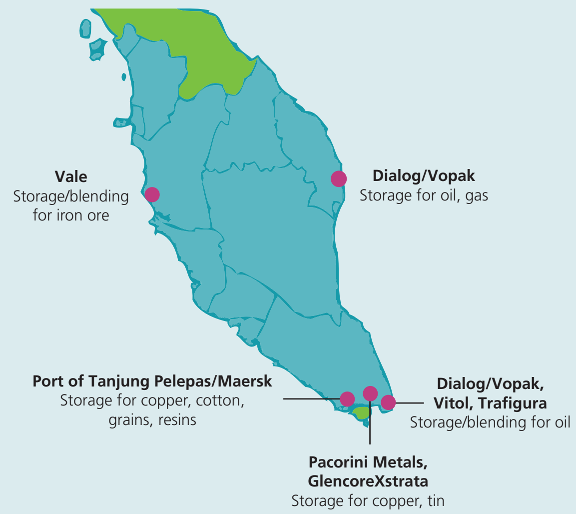
margins and fiscal factors were also crucial in encouraging PETRONAS to diversify. The low crude oil and natural gas prices in the 1980s and 1990s, coupled with the higher petroleum income tax rate of 38% imposed on upstream oil and gas production, enabled higher post-tax profits from various downstream manufacturing activities. The types of oil products produced in Malaysia have evolved from basic upstream output such as petrol, diesel and basic petrochemicals into lubricants, specialty jet fuel and advanced petrochemicals. At present, almost half of PETRONAS's revenue is derived from downstream activities.

The downstream diversification in the rubber industry is also noteworthy. Driven initially by small and medium enterprises (SMEs), the companies have evolved into public-listed entities valued at billions of ringgit, while becoming world leaders in the production of rubber gloves and prophylactics. Lower input costs from declining prices of natural rubber and the availability of low cost foreign labour spurred the development of the industry in the 1980s and 1990s. In contrast, there remains ample scope for greater downstream diversification in the palm oil industry. Among the factors that contributed to this are the higher margins at the upstream level, even when palm oil prices were at low levels. In addition, until March 2013, duty-free exemptions for exports of crude palm oil provided little incentive to move into higher value-added activities. In comparison, many of Malaysia's competitors in the industry have started venturing into various downstream activities, particularly in the production of oleochemicals and palm-based biodiesel.

The diversification strategy seen in the resource-based industries is now being pursued by the resource-based services (RBS) industry. Resource-based services are activities that provide support services to the commodities sector, such as enhancements to the oil and gas-related exploration and production activities, as well as the transshipment and warehousing of commodities. Resource-based services will enable Malaysia to complete the value chain in the commodities sector by moving further into higher value-added activities in the services sector. In relation to the oil and gas-related activities, Malaysia has experienced substantial growth of its homegrown oil service firms, most of which were developed under the Vendor Development Programme initiated by PETRONAS. For transhipment and warehousing activities, Malaysia's inherent advantages in terms of proximity to the Asia Pacific countries, high degree of competitiveness and compelling logistic solutions were key factors attracting

Chart 5

Malaysia is Becoming a Transhipment Hub for Commodities



Source: Various companies

many firms to set up their operations in Malaysia (Chart 5). Replicating the success of resource-based industries, the Government has taken the lead in promoting resource-based services. As an example, the Global Incentive for Trading (GIFT) programme was recently introduced to accelerate commodities trading in the country. The programme is targeted at attracting international trading companies to locate their regional operations, with the aim of establishing Malaysia as the key offshore trading hub in the region.

Going forward, resource-based industries and resource-based services are important sectors that can advance Malaysia's goal of becoming a high income nation by 2020. Even now, there is substantial evidence that Malaysia is already progressing in the right direction. Several manufacturers in the resource-based industries have already moved into producing higher value-added products, such as nitrile-based gloves for the healthcare industry. In terms of resource-based services, the rise in transshipment activities has been reflected in the sharp 44% year-on-year rise in re-exports in 2012 and a further 40% in 2013. This development will contribute towards further improving the country's fundamentals by creating higher value-added activities and by diversifying the sources of growth in the economy.

Reference

Felipe J., R. Briones, D.H. Brooks, A. Mehta and H. Verspagen (2013), `Asia's Economic Transformation: Where to, How, and How Fast?´. Special chapter in Key Indicators for Asia and the Pacific 2013, Asian Development Bank (ADB).

Table 1.6

Balance of Payments[1]

Item	2012			2013*p*		
	+	-	Net	+	-	Net
	RM billion					
Goods	703.2	577.5	125.6	690.9	588.2	102.7
Services	117.0	131.0	-14.0	125.5	140.5	-15.0
Balance on goods and services	**820.2**	**708.5**	**111.6**	**816.3**	**728.7**	**87.6**
Primary Income	42.3	78.3	-36.0	47.5	82.6	-35.2
Secondary Income	6.8	25.1	-18.2	7.3	22.5	-15.2
Balance on current account	**869.3**	**812.0**	**57.3**	**871.1**	**833.9**	**37.3**
% of GNI			**6.3**			**3.9**
Capital account			0.2			-0.0
Financial account			-23.0			-15.0
Direct investment[2]			-21.7			-4.1
Assets			*-51.9*			*-40.6*
Liabilities			*30.2*			*36.5*
Portfolio investment			58.4			-2.8
Assets			*-21.5*			*-31.9*
Liabilities			*79.8*			*29.1*
Financial derivatives			1.0			-0.1
Other investment			-60.6			-8.1
Balance on capital and financial accounts			**-22.9**			**-15.1**
Errors and omissions (E&O)[3]			-30.6			-7.5
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*-7.7*			*18.6*
Net E&O as % of total trade			*-1.7*			*-1.9*
Overall balance			**3.9**			**14.6**
Bank Negara Malaysia international reserves, net			**427.2**			**441.9**
USD billion equivalent			**139.7**			**134.9**

[1] The balance of payments is compiled in accordance with the Sixth Edition of Balance of Payments and International Investment Position Manual (BPM6) by the International Monetary Fund (IMF)
[2] Asset flows also referred to as `Outward direct investment´; while liability flows are also referred to as `Inward direct investment´
[3] Includes unrealised foreign exchange revaluation gains/losses on international reserves
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

The current account surplus as reflected by the savings-investment (S-I) surplus has been narrowing in recent years due mainly to the stronger expansion in investment activity. This trend is expected to continue in the near-term as investment is expected to remain strong following the on-going transformation programme into a high-income economy. Total gross capital formation registered a stronger growth of 12.3% in nominal terms over the period 2012-2013 (2007-2011: 11%). At the same time, gross national savings was sustained following the strong growth in total consumption (9.4%; 2007-2011: 10.1%). In 2013, the current account registered a smaller surplus of RM37.3 billion, or 3.9% of gross national income (2012: RM57.3 billion, 6.3% of GNI), reflecting the moderation in gross national savings to 31.2% of GNI (2012: 33.1% of GNI) amid a continued expansion in gross capital formation. The continued widening of the public sector S-I deficit contributed to the smaller savings-investment (S-I) surplus in 2013. Public sector savings declined by 48.7% to RM49.2 billion due to lower operating surplus of public enterprises amid continued positive growth in

Table 1.7

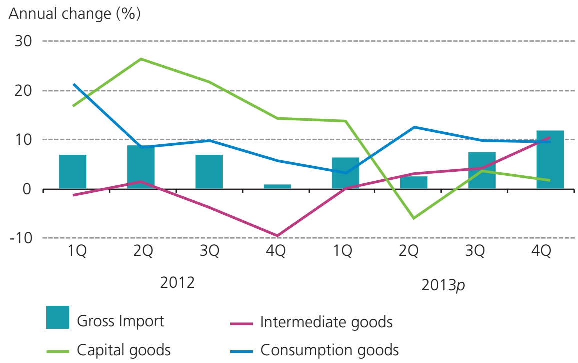
External Trade

	2012	2013*p*
	Annual change (%)	
Gross exports	**0.7**	**2.4**
Manufactures	3.1	5.7
Electronics and electrical (E&E)[1]	*-1.7*	*2.9*
Non-E&E	*8.4*	*8.4*
Commodities	-6.4	-5.6
Agriculture	*-15.4*	*-17.0*
Minerals	*2.6*	*3.8*
Gross imports	**5.8**	**7.0**
Capital goods	19.6	2.8
Intermediate goods	-3.4	4.3
Consumption goods	10.7	8.7

[1] Including machinery and equipment
p Preliminary
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.4

Import Performance



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

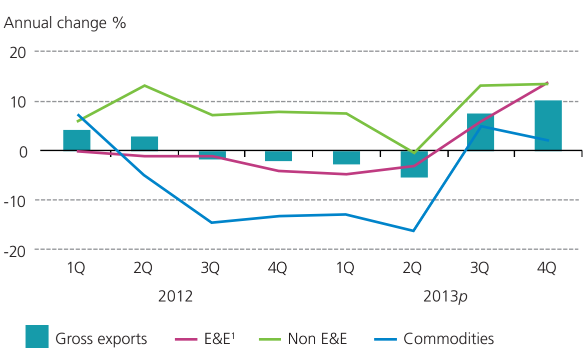
public gross capital formation (1.9%; 2012: 20.3%). On the other hand, private sector S-I surplus increased in 2013 as savings increased at a faster rate of 21.1% to RM247.1 billion (2012: -7.4%), while private gross capital formation expanded moderately by 10.3% (2012: 16.1%).

The financial account continued to experience sustained two-way flows involving cross-border financial transactions by both residents and non-residents. In the direct investment account, from an assets perspective, Malaysian companies continued to expand their international presence by undertaking direct investments abroad. From a liabilities perspective, Malaysia continued to attract direct investment from multinational companies (MNCs). The country's deep capital markets and relatively favourable growth prospects remained attractive to foreign portfolio investors as well. These flows, however, exhibited considerable volatility during the year. Thus, the financial account registered a net outflow of RM15 billion in 2013 (2012: net outflow of RM23 billion).

The economy's performance and growth prospects continued to support international investors' confidence, leading to significantly higher inward direct investment flows, amounting to RM36.5 billion, or 3.8% of GNI (2012: inflows of RM30.2 billion, or 3.3% of GNI). A major part of these flows were in the form of

Chart 1.3

Export Performance

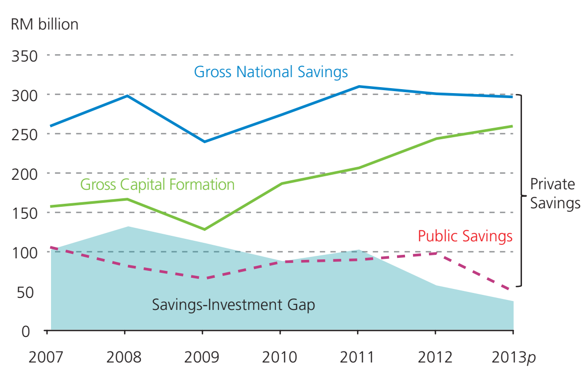


[1] including machinery and equipment
p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.5

Gross National Savings & Savings-Investment Gap



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Source: Department of Statistics, Malaysia
Ministry of Finance

Classification of Direct Investment in BPM6

Beginning from the first quarter of 2013, Malaysia started to compile and disseminate the balance of payments (BOP) statistics based on the guidelines set forth in the Sixth Edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).

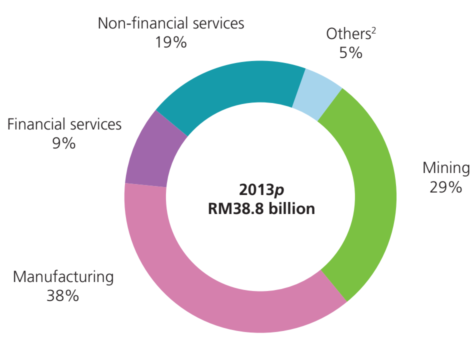
In the financial account, changes mainly affect the reporting format for direct investment, following the shift in reclassifying direct investment flows from directional basis to an asset-liability basis.

Accordingly, the term `direct investment in Malaysia´ (or foreign direct investment, FDI) is reclassified as direct investment liability flows or `inward direct investment´. While the bulk of inward direct investment comprises FDI, it also includes intercompany loans to Malaysian companies extended by their subsidiaries abroad. This is a departure from the previous convention under BPM5, where these flows were registered under direct investment abroad (DIA). As a result of the change, inward direct investment now reflects the total incurrence of foreign liabilities by residents.

Likewise, `direct investment abroad´ is reclassified as direct investment asset flows, or `outward direct investment´. While outward direct investments comprise mainly DIA flows, it also includes extensions of intercompany loans by FDI companies in Malaysia to their parent companies and affiliates abroad. Under BPM5, the extensions of intercompany loans by FDI companies would be recorded as FDI. As a result of the change, outward direct investment will now reflect the total acquisition of foreign assets by residents.

Chart 1.6

Net Foreign Direct Investment by Sectors[1]



[1] Direct investment as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)
[2] Refers to agriculture and construction sectors
p Preliminary

Source: Department of Statistics, Malaysia

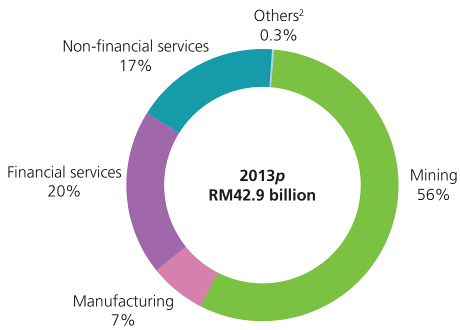
foreign direct investment (FDI), through greater injections of equity capital and intercompany loans, amid sustained levels of earnings retained for reinvestment during the year. FDI inflows were fairly broad-based across sectors. FDI into export-oriented sectors like manufacturing and selected services sub-sectors remained significant, despite the slowdown in export performance in the first half of the year. Foreign investment in the mining sector increased, following steady implementation of ETP initiatives in the oil and gas sector. FDI in the financial services sub-sector was also sustained.

Outward direct investment moderated to RM40.6 billion or 4.3% of GNI in 2013, in tandem with the moderation in the growth outlook of regional economies (2012: outflow of RM51.9 billion or 5.7% of GNI). Outflows mainly reflected DIA flows, comprising larger outflows of equity capital and retained earnings, amid smaller extensions of intercompany loans. The share of DIA into the mining sector increased following the acquisition of a Norwegian firm by a domestic oil and gas company. DIA into the services sector also recorded strong performance, particularly in the financial services sub-sector, reflecting the increased regionalisation of Malaysia's domestic banks. Despite the moderation in outflows during the year, investments in these sectors were profitable, contributing to a larger accrual of direct investment income for domestic firms, and hence a smaller net income deficit in the current account.

Portfolio investment flows in 2013 were largely characterised by two distinct periods. In the first half of the year, broadly positive investor sentiments were supported by ample global liquidity and continued monetary accommodation

Chart 1.7

Net Direct Investment Abroad by Sectors[1]



[1] Direct investment abroad as defined according to the 5th Edition of the Balance of Payments Manual (BPM5) by the International Monetary Fund (IMF)
[2] Refers to agriculture and construction sectors
p Preliminary

Source: Department of Statistics, Malaysia

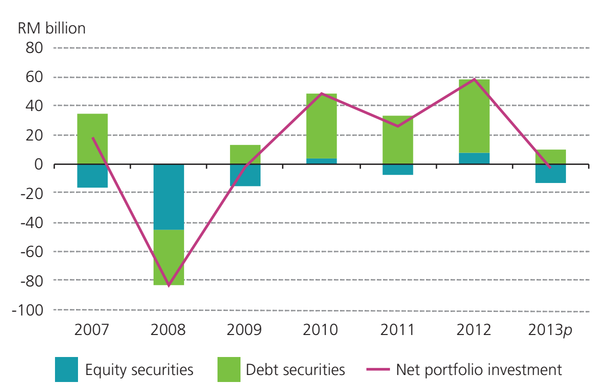
in the advanced economies. As a result, in the first six months of the year, portfolio investment by non-residents registered a strong net inflow of RM23.9 billion, particularly into the equity market in the run-up and following the conclusion of the 13th General Election in early May, while foreign flows into the debt market remained significant. Foreign participation in the equity market trended up steadily while in the debt securities market, non-resident holdings of ringgit-denominated debt securities rose to 23.8% of total outstanding debt securities as at end-May (end-2012: 22.3%). Of these, non-resident holdings of Government securities were 32.4% of total outstanding Government securities (end-2012: 29.8%).

In the second half, non-resident portfolio inflows moderated to RM5.2 billion, following the Fed's indication of a possible scaling back of its asset purchase programme (or QE) in late May. The increased uncertainty in the financial markets surrounding the timing and magnitude of the QE scale-back led to heightened financial market volatility and resulted in a period of strong reversals of portfolio flows between May and August. These volatility and reversal of flows were broadly experienced by emerging market economies. Inflows resumed in September and October as expectations for the QE scale-back abated briefly following more clarification on policy direction by the Federal Open Market Committee (FOMC) in September. International investor sentiments, however, remained cautious towards the end of the year on renewed expectations of the eventual reduction of the Fed's asset purchases. The QE scale-back was eventually announced to begin in January 2014 during the December FOMC meeting. Thus, for the year as a whole, non-resident portfolio investment recorded a smaller net inflow of RM29.1 billion (2012: net inflow of RM79.8 billion). During the year, domestic institutional investors undertook offshore investments amounting to net outflows of RM31.9 billion (2012: net outflow of RM21.5 billion). These outflows reflected resident investors' continued strategy of diversifying their portfolio investments abroad. For the year as a whole, total portfolio investments registered a small net outflow of RM2.8 billion (2012: net inflow of RM58.4 billion).

Although the gross volumes and volatility of portfolio flows were sizeable, the impact on financial markets and the economy was attenuated by several factors, namely the adjustments in the exchange rate, the depth of the financial markets and the role of domestic institutional investors. The role of domestic institutional investors in the capital markets was noteworthy as they provided a steady demand for domestic assets. Moreover, domestic institutional investors have exhibited their capacity for portfolio rebalancing while absorbing selling by non-residents. This was particularly evident in the bond market. As non-resident investors switched to debt papers of shorter tenures during the May-August period, domestic institutional investors simultaneously increased their purchases of Government securities and reduced their holdings of BNM bills, therefore limiting the volatility of the yields of these securities.

Chart 1.8

Portfolio Investment



p Preliminary

Source: Department of Statistics, Malaysia

Other investment recorded a smaller net outflow of RM8.1 billion for the year (2012: net outflow of RM60.6 billion), reflecting mainly continued extensions of trade credits amid banking inflows. During the year, Malaysian exporters facilitated trade activity in the challenging external environment by extending trade credits to their importing counterparts. These trade credit outflows were partially offset by inflows in the banking sector. In the first quarter, in times of foreign portfolio inflows and ample liquidity, the banking sector actively built an external asset position. This was subsequently unwound in the second and third quarter, in times of heightened financial market volatility. Additionally, the domestic banking sector also received larger placements of deposits by foreign financial institutions to manage their foreign exchange liquidity exposures.

The international reserves of Bank Negara Malaysia increased by RM14.6 billion to RM441.9 billion at end-2013 (end-2012: RM427.2 billion). The higher reserves reflected the continued current account surplus, which offset the net capital outflows from the financial account. It has also taken into account the cumulative unrealised foreign exchange revaluation gains following the depreciation of the ringgit against some major and regional currencies. As at 28 February 2014, the reserves level amounted to RM427.6 billion (equivalent to USD130.6 billion), which is sufficient to finance 9 months of retained imports and is 3.3 times the short-term external debt.

Manageable external debt levels

Malaysia's external debt amounted to RM318.1 billion (USD95.8 billion) as at end-2013 (2012: RM252.8 billion), equivalent to 33.5% of GNI (2012: 27.9% of GNI). Higher medium- and long-term external debt during the year mainly reflected the net drawdown of external borrowing by the public enterprises and the non-bank private sector. The Federal Government, on the other hand, continued to register net repayment of external debt. The higher short-term external debt was largely the outcome of the net drawdown of interbank borrowing mainly for the management of foreign exchange liquidity position. The appreciation of some major and regional currencies against the ringgit during the year also contributed to the higher external debt in ringgit terms.

Table 1.8

Outstanding External Debt

	2012	2013*p*	2012	2013*p*
	RM billion	RM billion	USD billion	USD billion
Total debt	**252.8**	**318.1**	**81.7**	**95.8**
Medium- and long-term	159.8	190.0	51.7	57.2
Short-term[1]	93.0	128.1	30.1	38.6
As % of total debt	*36.8*	*40.3*		
As % of net international reserves	*21.8*	*29.0*		
As % of GNI				
Total debt	27.9	33.5		
Medium- and long-term debt	17.7	20.0		
As % of exports of goods and services				
Total debt	30.8	39.0		
Medium- and long-term debt	19.5	23.3		
Debt service ratio (%)[2]	**10.1**	**10.3**		

[1] Excludes currency and deposits held by non-residents with resident banking institutions
[2] Includes prepayment of medium- and long-term debt
[p] Preliminary
Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Overall, Malaysia's external debt remained manageable. The external debt profile continued to be skewed towards a longer maturity structure, with medium- and long-term debt accounting for 59.7% of total external debt. The debt service ratio remained low at 10.3% of exports of goods and services. Moreover, about two-thirds of non-bank private sector borrowings were sourced from offshore shareholders, parents and associated companies in the form of inter-company loans. These loans were generally of longer maturities, and with more flexible terms. The external debt of the banking system was outweighed by their external assets and represents only a small proportion of the overall liabilities of the banking system.

Resilience against external shocks

As a highly open economy and in view of increasing integration with the global economy and financial markets, the experience of 2013 again showed that Malaysia is not insulated from the risks emanating from the external environment. The country, however, is well positioned to weather such external shocks. Domestic fundamentals remain sound, enabling

Broadening Economic Surveillance through Bank Negara Malaysia's Regional Offices

Economic surveillance by the Bank has in the recent years been strengthened by broadening the surveillance to the regional level through the Bank's Regional Offices. Regional economic surveillance entails the gathering and synthesising of quantitative and qualitative information on current economic and financial conditions at the regional level. The approach involves direct engagement with various economic agents in the different regions of the country. The regional surveillance complements the macro-level assessment of the economy by providing a perspective on the extent to which the regional conditions differ from, or reflect, the national outlook. It also provides information about how economic and financial conditions vary across regions and industries.

Strengthening economic analysis through regional economic surveillance

The geographic concentration of economic activity in Malaysia has become wider and more dispersed over the years. This trend has been further accentuated by the acceleration of growth in the regional economic corridors. Thus, surveillance undertaken at the regional level allows for a closer and deeper monitoring of the pulse of economic activity and emerging trends (refer to fact box on `Re-export Activity Providing Growing Support to Malaysia's Trade´ in Chapter 4). Direct and frequent engagements with businesses, industry associations, consumer groups and lead agencies provide a rich source of information for timely analysis of economic and financial conditions. Often, key insights are obtained well ahead of the release of macro-level statistics, giving a greater lead time for analysis and policy response. Direct engagements with the relevant stakeholders also provide an opportunity for the Bank to communicate and obtain their feedback on policy issues.

Experience of policymakers in other economies

Central banks around the world have expanded their surveillance framework to include regional economic surveillance, through a network of regional offices (Chart 1). The Bank of England's twelve regional offices (known as Agencies) are tasked to assess and provide lead assessments on economic conditions to the Monetary Policy Committee. Similarly, the Reserve Bank of Australia, through its four state offices, extensively monitors and analyses regional economic developments throughout Australia. In the ASEAN region, central banks such as the Bank of Thailand periodically report on domestic economic and monetary conditions from a regional perspective. The importance of expanding surveillance has also been recognised by multilateral agencies such as the International Monetary Fund, particularly when such surveillance incorporates a more active engagement with stakeholders to help promote an effective and timely policy response to emerging policy challenges and risks[1].

Chart 1

Selected Central Banks with Regional Economic Surveillance

Source: Central Bank websites
Note: The branches and regional offices excludes overseas representative offices

[1] Source: International Monetary Fund (2012), `The IMF's Financial Surveillance Strategy´.

Expanding the role of BNM's Regional Offices

Prior to 2009, direct engagements with companies were conducted on a periodic basis, and supplemented by quarterly and annual surveys of businesses. Since 2009, the Bank has adopted a more systematic approach with wider coverage of companies in terms of economic activity and size. The engagements were designed to gauge real-time business conditions and projections on key variables such as revenue, production, sales, prices, investments and labour market conditions. In 2011, the Bank undertook a major initiative in expanding the role of the Bank's branches in Pulau Pinang and Johor towards becoming Regional Offices (ROs) with the objective of strengthening the Bank's outreach and presence at the regional level[2]. The two ROs monitor the developments in the northern and southern regions of Peninsular Malaysia, which together account for about 28% of Malaysia's GDP in 2012[3]. This wide outreach is reflected in the increase in the total number of engagements conducted in the northern, central and southern region over the last three years (Chart 2).

Chart 2

Total Number of Engagements from 2011 to 2013

Source: Bank Negara Malaysia

The value of economic surveillance at the regional level can be assessed through its important role in complementing the Bank's overall surveillance. For example, when Thailand was struck by heavy floods in July 2011, surveillance by the ROs revealed a temporary relocation of production from Thailand to Malaysia, which subsequently resulted in a higher production of electronic and electrical (E&E) products, and food and beverages in Malaysia. This information provided an early assessment on the growth in the manufacturing sector in the second half of 2011, much earlier than the release of the official statistics. In 2013, engagements by the ROs deepened the Bank's understanding on the impact of the minimum wage implementation on inflation and growth. Furthermore, the role also enhanced the assessment on financing conditions across the various industries in the region. In recent months, the engagements have enabled better inferences on businesses' behaviour in reaction to policy measures such as the subsidy rationalisation and macroprudential measures targeting the property sector.

A key challenge in broadening the surveillance is in building trust and maintaining credible relationships with the private sector and relevant agencies. The Bank practises a strict confidentiality policy to preserve the sensitivity of the information disclosed by stakeholders. Discerning the value of information received from businesses is also a challenge. This requires striking a balance between synthesising information that merely represents firm-specific experience with other information, which best reflects the overall industry conditions.

The way forward

The expanded role of the ROs reflects the importance of broadening and deepening the surveillance process to complement the macroeconomic surveillance of the Bank. Moving forward, the planned expansion of the Bank's branches in Kuching and Kota Kinabalu to become ROs in 2014, is expected to further strengthen the Bank's overall macroeconomic and financial surveillance.

[2] In addition to the previous role of the branches in ensuring efficient cash management, the role of the ROs were expanded to include consumer financial redress and advisory services, undertaking economic and financial surveillance and driving greater financial inclusion agenda.

[3] Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates.

strong defence against potential vulnerabilities arising from the external front. Well-developed capital markets, strong financial intermediaries, and the presence of large domestic institutional investors provide the financial system with greater resilience. The wide range of monetary instruments, high level of international reserves and manageable level of external debt accorded policy flexibility to absorb external shocks.

INFLATION DEVELOPMENTS

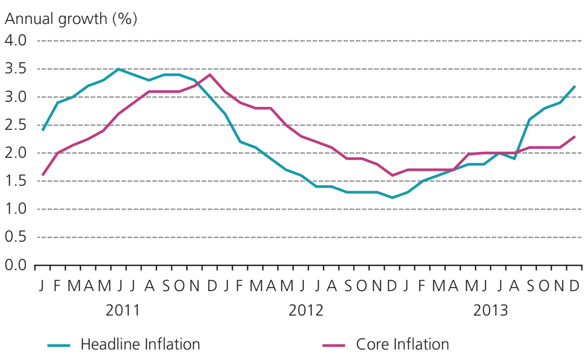
Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), remained modest at 2.1% in 2013 (2012: 1.6%). The annual inflation rate averaged at the lower end of the Bank's earlier forecast of 2%-3%. During the first eight months of the year, the average inflation rate was low at 1.7%, rising from 1.3% in January to 1.9% in August. The average inflation rate for the remaining four months of 2013, however, increased to 2.9%, following the upward adjustments made to administered prices. Core inflation[2], an indicator of demand-driven price pressures, moderated to 1.8% in 2013 (2012: 2.1%).

In terms of components, the main contributors to inflation were *food and non-alcoholic beverages; transport*; and *housing, water, electricity, gas and other fuel*. These three categories together accounted for 87% of the overall increase in consumer prices during the year. Inflation in the *food and non-alcoholic beverages* category rose to 3.6% (2012: 2.7%), due to higher prices in the *fish and seafood*, *meat*, and *vegetables* sub-categories. Inflation in the *housing, water, electricity, gas and other fuels* category averaged 1.7% (2012: 1.6%), reflecting higher rental for housing, particularly for apartments and condominiums, and properties in urban areas. Inflation in the *transport* category more than doubled to 2.0% (2012: 0.7%), stemming from higher prices of fuel. Higher inflation during the year was, however, partially mitigated by continued price declines in the *communication* and *clothing and footwear* categories (-0.7% and -0.6% respectively). On the whole, only four categories of consumer goods and services registered higher inflation rates. Six categories recorded lower inflation, while two remained stable.

In terms of determinants, inflation during the year was driven mainly by domestic cost and supply factors. Higher cost of poultry feed in the early part of 2013 and disruptions in domestic food supply due to adverse weather conditions, such as floods in the east coast of Peninsular Malaysia, were the main factors that led to higher food inflation. Towards the end of the year, the upward adjustments made to prices of several administered items also

Chart 1.9

Consumer Price Inflation

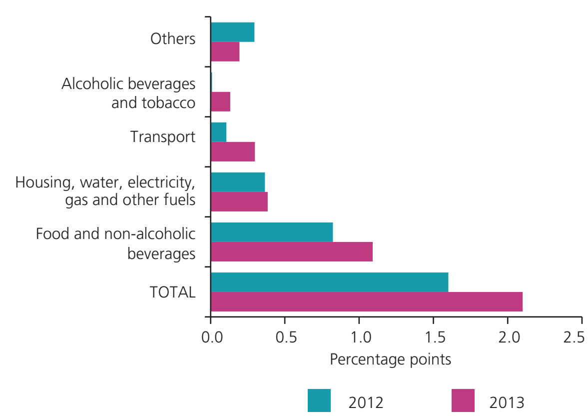


Source: Department of Statistics, Malaysia and Bank Negara Malaysia

[2] Core inflation is a measure of the underlying inflation rate, after excluding volatile and price-administered items, whose price movements are not likely to be related to changes in demand conditions. However, as it is not possible to distinctively separate demand-related and supply-related inflation, prices of goods and services in the core CPI basket are likely to also reflect transitory changes in cost and supply factors, such as improvements in supply conditions, supply disruptions and price adjustments.

Chart 1.10

Contribution to Inflation



Note: Others refers to *communication; clothing and footwear; health; recreation services and culture; furnishings, household equipment and routine household maintenance; restaurants and hotels; education;* and *miscellaneous goods and services*

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.9

Adjustments to Administered Prices in 2013

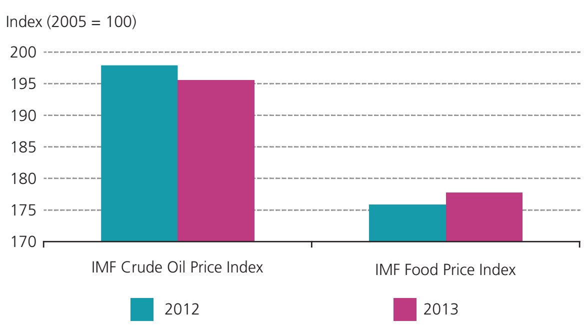
Date	Items	Quantum of adjustment	
		RM	%
15 January	Kesas toll	-20 sen	-9.1
3 June	Cigarettes	+30 sen/pack of 20s	2.9
3 September	RON 95 petrol Diesel	+20 sen/litre +20 sen/litre	10.5 11.1
30 September	Cigarettes	+RM1.50/pack of 20s	14.3
26 October	Sugar	+34 sen/kg	13.6

contributed to higher inflation in the *transport*; *food and non-alcoholic beverages*; and *alcoholic beverages and tobacco* categories.

On the external front, global commodity prices for the year moderated as the supply of commodities improved amid a modest increase in global demand. Global oil prices were lower during the year due to higher supply of crude oil from the United States and stable production from OPEC member countries. Although annual global food prices averaged slightly higher compared to 2012, prices declined sharply during the second half of 2013 due to better harvest, particularly from a higher acreage of crops and improved weather conditions in the United States

Chart 1.11

Global Crude Oil and Food Prices

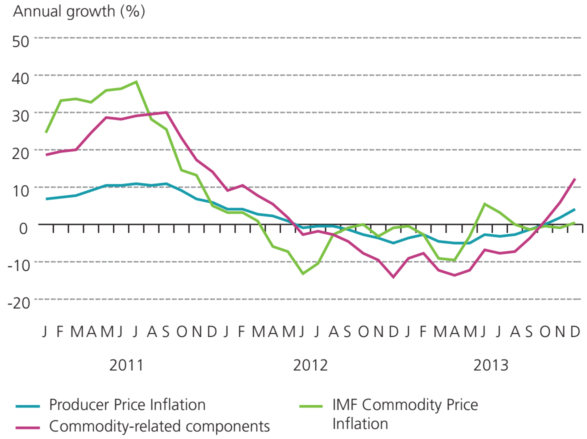


Note:
1. IMF Crude Oil Price Index includes the simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh
2. IMF Food Price Index includes cereal, vegetable oils, meat, seafood, sugar, bananas, and oranges price indices

Source: International Monetary Fund (IMF)

Chart 1.12

Producer Price Inflation and IMF Commodity Price Inflation



Note: 1. Commodity-related components in Producer Price Index (PPI) include *crude materials, inedible; mineral fuels, lubricants, etc.*; and *animal and vegetable oils and fats*
2. Non-commodity related components in PPI include *food; beverages and tobacco; chemicals; manufactured goods; machinery and transport equipment; miscellaneous manufactured articles*; and *miscellaneous transactions and commodities*

Source: Department of Statistics, Malaysia, International Monetary Fund (IMF) and Bank Negara Malaysia

and Europe. In addition, inflation in Malaysia's main import partners' economies was also lower, reflecting the decline in global commodity prices and their modest domestic demand conditions.

Amid the moderate external price pressures, producer prices, as measured by the Producer Price Index (PPI), declined by 1.9% in 2013 (2012: 0.1%). The decline in producer price inflation helped to ease cost pressures for firms and restrained the extent of knock-on effects from adjustments in administered prices to prices of other goods and services. The impact of the fuel price adjustments on the cost of production was also contained. Based on the survey by the Bank, transportation cost constitutes a relatively small share of the total operating cost of firms[3]. In addition, findings from the survey suggested that most firms were more inclined to adopt productivity enhancing measures and absorb the increase in costs rather than raising retail prices of goods and services. Evidently, the knock-on effect was limited. After the fuel price adjustments in September, non-administered prices[4] increased

[3] Based on the Bank's quarterly survey, transportation cost only accounts for 1.6 – 4.8% of total operating cost for firms producing consumer products and services.
[4] Refers to CPI excluding items in which prices are administered by the Government such as RON95 petrol, diesel, electricity and cigarettes.

by only an average of 0.2% during the last four months of 2013, with close to 78% of the CPI items registering an inflation rate of 3% and below.

Despite the strong growth in private consumption and sustained wage growth during the year, demand-driven price pressures remained moderate with core inflation rising gradually from 1.6% in January to 2.3% in December 2013. During the year, there was adequate productive capacity in the economy to help contain demand pressures. This was reflected in real GDP remaining at close to its potential in 2013, and the capacity utilisation rate in the manufacturing sector tapering to 79% (2012: 81%). In addition, the benign cost pressures have also helped to mitigate price pressures.