2012

ECONOMIC DEVELOPMENTS IN 2012

THE INTERNATIONAL ECONOMIC ENVIRONMENT

In 2012, the international economic landscape became more challenging relative to the preceding year. Global growth experienced a synchronised moderation as weakening economic conditions in several key economies affected international trade and subsequently had adverse spillover effects on domestic activity in the emerging economies. The lower global growth prospects, coupled with the ongoing fiscal uncertainties in the advanced economies, cumulatively contributed to sustained volatility in the financial markets. In the commodity markets, with the exception of crude oil prices that had remained elevated, the prices of other commodities were lower on account of weaker global demand and more favourable supply conditions. This subsequently led to more subdued inflationary pressures. In response to the uncertain external environment, many countries pursued further monetary easing to support growth.

Global growth experienced a synchronised moderation amid heightened downside risks while inflationary pressures remained subdued

Moderation in global growth

In 2012, global economic growth moderated, continuing a downtrend that had begun in early 2011. Most emerging regions expanded at rates significantly lower than their pre-crisis averages, as weakness in key economies spilled over to the rest of the world.

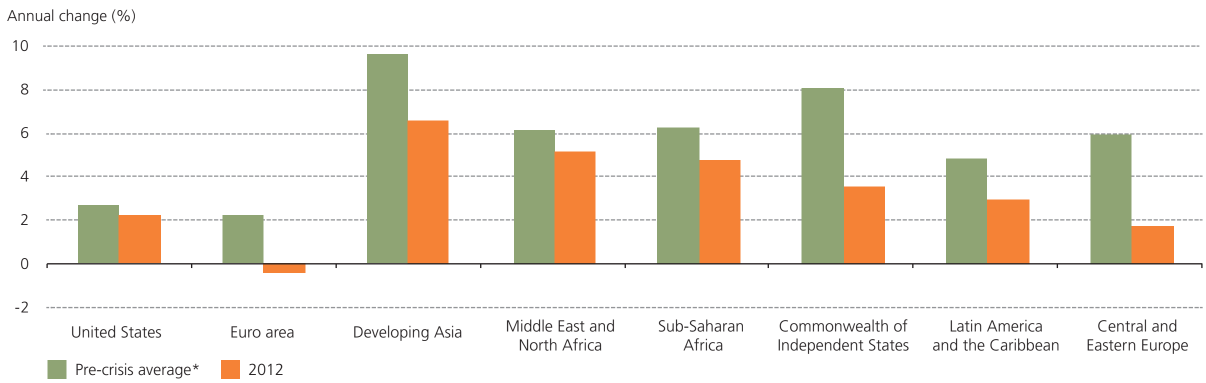
The growth momentum in the advanced economies was uneven. The US continued to experience an ongoing but fragile recovery, while several other major economies registered weak growth. The US economic recovery was modest, dampened by both domestic and external weaknesses. Domestically, this reflected mainly the sluggish conditions in the housing and labour markets, continued deleveraging by banks and households, and increased uncertainty arising from fiscal concerns. Growth in the US was also affected by negative business sentiments and a slowdown in exports attributable largely to the economic weakness in Europe. Towards the latter half of the year, however, the housing and labour markets recorded signs of stabilisation, providing some support to growth.

The euro area, however, experienced a recession amid a widespread decline in economic activity amongst the member economies. The series of measures undertaken by the authorities contributed to stabilising the financial market conditions during the year, but they fell short of providing a comprehensive resolution to the crisis. Growth in the crisis-affected economies continued to be weighed down by fiscal austerity measures, high unemployment and impaired financial intermediation. As the year progressed, growth in the core economies also decelerated, albeit to a lesser extent, with Germany recording a slower expansion on account of weakening investment, and economic activity in France stagnating amid anaemic domestic demand. Similarly, the UK economy recorded protracted weakness in growth, reflecting the negative impact of ongoing fiscal consolidation and declining exports to the euro area. In Japan, while growth initially benefited from the reconstruction-related demand as the economy gradually recovered from the previous year's natural disaster, the effect tapered off towards the second half of the year. This was further exacerbated by continued weakness in the external environment and a slowdown in consumption as the policy support for the purchase of energy-efficient cars diminished.

In Asia, the moderation in growth which had begun in late 2011 continued into the year, reflecting mainly the weakness in external demand. In the Newly Industrialised Economies (NIEs), the moderation intensified towards the middle of the year on account of adverse spillover effects from the external sector on domestic demand. In PR China, the growth slowdown was also attributable to policy tightening measures that had

Chart 1.1

Current Growth vs Pre-Crisis Averages



*Refers to real GDP growth average in 2003-2007

Source: International Monetary Fund (IMF)

been implemented in the property sector over the recent two years. In addition, the government did not announce any major pro-growth policies as efforts were increasingly geared towards growth stabilisation and the rebalancing of the economy. Nevertheless, domestic economic activity improved towards the end of the year, supported by infrastructure investments and some stabilisation in the property market. In contrast to the broad trend of moderation in the region, many ASEAN economies registered relatively robust growth rates. This was underpinned by government-led initiatives and resilient domestic demand, which was supported by favourable labour market conditions, continued access to financing and rising incomes.

Improvement in international financial conditions

In the first quarter of the year, the **international financial markets** were characterised by improved sentiments as the severity of the European sovereign and banking crises subsided following the measures introduced by the European Central Bank (ECB), the Federal Reserve (Fed) and the Bank of Japan (BOJ). In addition, better global growth prospects arising from positive economic developments in the US and the continued resilience of emerging economies had altered investors' risk appetites. As a result, equity prices recovered and emerging market economies recorded an inflow of capital.

These favourable trends reversed in April following renewed concerns on the euro area, particularly in Spain. Spain's borrowing costs increased on concerns over the domestic banking system and a deepening of the recession in the country. In addition, an inconclusive election outcome in May led to heightened fears of a potential exit of Greece from the single currency union. Contagion risks also rose when the credit ratings of sovereigns and banks in several major economies, including the US and core European economies, were downgraded. Incipient signs of weakening growth in the US and PR China contributed to further volatility in the global financial markets. The decline in market sentiments and confidence was reflected in deposit flight from some European countries, a fall in global equity market indices and increased demand for safe haven assets. Following these developments, government bond yields in the US, Germany and Switzerland declined. Similarly, the global uncertainties also culminated in the reversal of capital flows from the Asian region.

In the second half of the year, sentiments improved, benefiting from the announcements of several proposals to address the European sovereign debt crisis. These measures were aimed to break the negative feedback loop between the national banking systems and the sovereign fiscal positions and to restore confidence in the currency union. The proposed measures included direct recapitalisation of banks, the formation of a banking union and a €120 billion growth pact to support economic activity in the euro area. In July, the ECB President's statement to "do whatever it takes" to preserve the euro led to improved market confidence and sentiments. In particular, 10-year government bond yields of crisis-affected countries

Table 1.1

World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2011	2012*e*	2011	2012*e*
World Growth	**3.9**	**3.2**	**-**	**-**
World Trade	**5.9**	**2.8**	**-**	**-**
Advanced Economies				
United States	1.8	2.2	3.2	2.1
Japan	-0.6	2.0	-0.3	-0.1
Euro area	1.4	-0.6	2.7	2.5
United Kingdom	0.9	0.2	4.5	2.8
Developing Asia	**8.0**	**6.6**	**-**	**-**
Asian NIEs[1]	**4.0**	**1.7**	**3.5**	**2.6**
Korea	3.6	2.0	4.0	2.2
Chinese Taipei	4.1	1.3	1.4	1.9
Singapore	5.2	1.3	5.3	4.6
Hong Kong SAR[2]	4.9	1.4	5.3	4.1
The People's Republic of China	**9.3**	**7.8**	**5.4**	**2.6**
ASEAN-4	**4.3**	**6.2**	**4.5**	**3.3**
Malaysia	5.1	5.6	3.2	1.6
Thailand	0.1	6.4	3.8	3.0
Indonesia	6.5	6.2	5.4	4.3
Philippines	3.9	6.6	4.8	3.1
India[3]	**7.8**	**4.0**	**9.5**	**7.5**

[1] Newly Industrialised Economies
[2] Inflation refers to composite price index
[3] Inflation refers to wholesale price index; GDP at market prices for the calendar year
e Estimate

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

such as Spain and Italy retreated moderately from their peak. Investor concerns of a sharp slowdown in global growth also receded as key economies started to show signs of stabilisation and modest improvements. This was also reflected in the resumption of capital flows into emerging economies, particularly in the Asian region. Despite these positive developments, considerable risks remained. In Europe, while there was greater clarity in key policy initiatives to manage the crisis, uncertainty remained over implementation details. In the US, heightened concerns over the expiration of fiscal stimulus weighed on financial markets towards the end of the year.

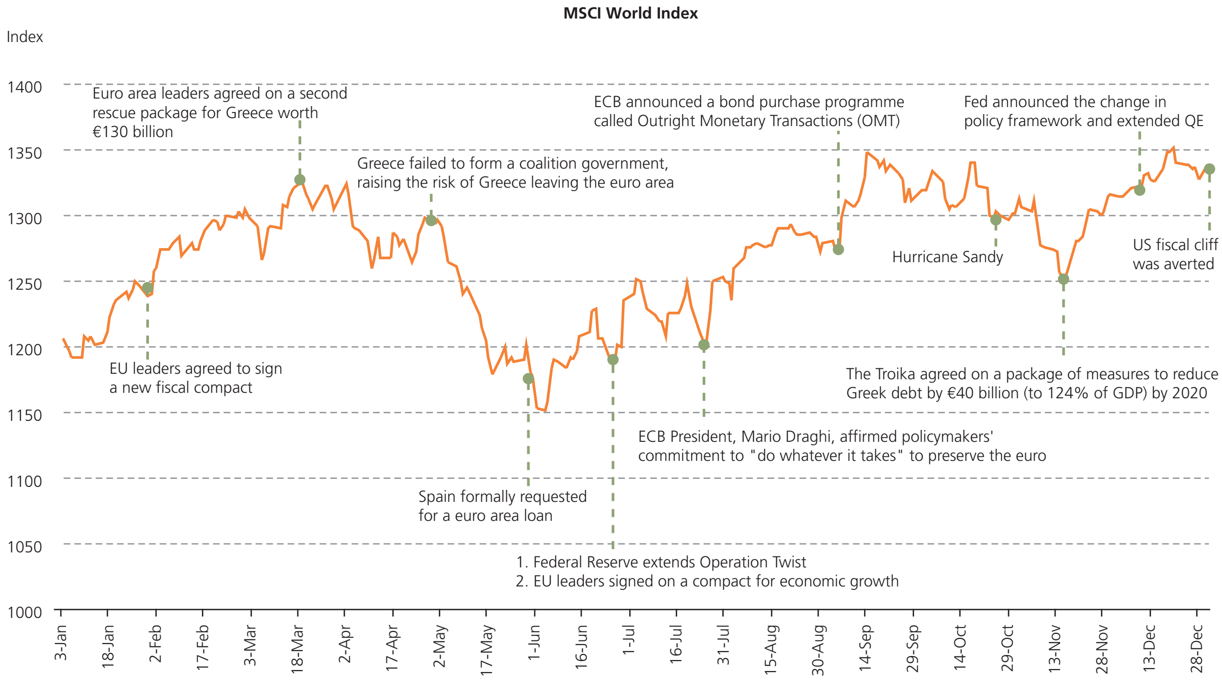
In the **foreign exchange market,** the currencies of most advanced and Asian economies appreciated against the US dollar in 2012. The euro and pound sterling strengthened following a general improvement in sentiments amid some progress towards resolving the European sovereign debt crisis. There were, however, periodic episodes of depreciation of the euro and pound sterling attributable to policy uncertainties in Greece, fiscal and banking issues in Spain, as well as releases of weak economic data. While Asian currencies depreciated in the second quarter following greater concerns over the strength of global growth, the trend reversed in the second half of the year as sentiments were buoyed by the favourable policy actions of several major central banks to support growth. Unprecedented policy easing measures undertaken by the Fed, the BOJ, and the ECB led investors to seek higher yielding assets, contributing to the general appreciation of most Asian currencies against the dollar. Against this trend, the Indonesian rupiah weakened by 7.3% against the US dollar due to concerns on the nation's external position. While safe haven demand drove the appreciation of the Japanese yen in the first half of 2012, the trend reversed in the latter part of the year against the backdrop of weaker economic data and expectations of further monetary easing by the BOJ.

Continued volatility in commodity prices

Global commodity prices remained volatile in 2012, attributable to both demand and supply factors. In the energy market, Brent crude oil price recorded an average of USD112 per barrel (p/b) in 2012, close to the USD111 p/b registered in 2011. However, prices fluctuated throughout the year due to geopolitical developments in the Middle East and growth concerns in key economies. While slower global economic activity exerted downward pressure on crude oil prices, persistent uncertainties in global supply conditions kept prices at elevated levels. In the first quarter, the potential imposition of sanctions on oil exports from Iran, the fourth largest oil producer, caused oil prices to reach an 11-month high of USD126 p/b. The upward trend reversed in April following talks between Iran and key global powers, as well as higher OPEC oil production. Prices rebounded in July as the negotiations failed. Towards the end of the year, political tensions in Egypt and other parts of the region led to heightened uncertainties. On the demand side, weaker economic data in the US, Europe, and PR China raised concerns of a slowing global growth. On the non-energy commodities front, metal prices declined as the slowdown in PR China led to lower demand for iron ore and copper. Food prices were also lower during the

Chart 1.2

Selected Events That Affected the Global Financial Environment in 2012



Source: Bloomberg

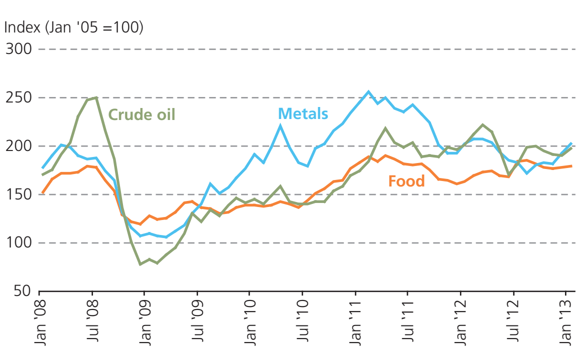
year as the weaker global consumption offset tight supply conditions caused by low inventories and weather-related reductions in crop yields especially during the second half of the year.

Easing inflationary pressures

In 2012, global **inflationary pressures moderated,** reversing the upward trend experienced in the previous year. Two underlying trends contributed to this development. Firstly,

Chart 1.3

Indices of Primary Commodity Prices



Source: International Monetary Fund (IMF)

the general slack in economic activity following weaker overall demand contributed to more muted demand-driven pressures. Secondly, the lower increase in energy prices also had a direct impact in slowing the rise in consumer prices, particularly in the advanced economies. While headline inflation movements in the US varied in tandem with fluctuations in energy and commodity prices, core inflation moderated throughout the year, indicating the absence of demand pressures. In the euro area and the UK, consumer prices continued on a downward trend amid receding energy price pressures. Japan's headline consumer prices (less food) remained in deflationary mode, reflecting the persistent negative output gap and broad-based weakness in prices across all components. Similarly, inflation in Asia was relatively modest, attributable mainly to the relatively benign increases in food and commodity prices. Of significance, domestic prices of staple foods in the region, such as rice, stabilised with support from lower global demand and market intervention by several governments. The downward pressures on inflation differed across economies, reflecting country-specific factors such as higher accommodation costs (Singapore and Hong Kong SAR) and transitory increases in food prices following adverse weather conditions in several regional countries (PR China, Chinese Taipei, Korea and the Philippines). Core inflation was however generally contained.

Further monetary easing

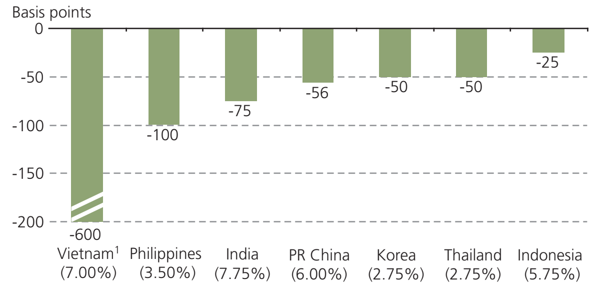
Amid relatively weaker growth prospects and subdued inflationary pressures, **monetary policy** remained accommodative in both the advanced and Asian economies as central banks were concerned about the risks to growth throughout the year.

In the US, the Fed maintained its highly accommodative monetary policy, implemented through its maturity extension programme (Operation Twist) to exert downward pressures on longer-term interest rates and thus make broader financial conditions more accommodative. In October, the Fed announced further quantitative easing measures through the purchase of mortgage-backed securities, and again in December with an outright purchase of long-term Treasuries. Notably, the Fed shifted from a time-based to an indicator-based approach by pledging to maintain the current accommodative stance as long as the unemployment rate remains above 6.5% and inflation between one and two years ahead is no more than 2.5%.

In Europe, the ECB reduced its policy rate by 25 bps to a low of 0.75%. It also expanded the range of assets that could be used as collateral to improve the access to liquidity by the banking sector in the euro area. In the UK, the Bank of England (BOE) increased the size of its asset purchase programme by £50 billion in February and another £50 billion in July to a total of £375 billion during the year. In addition, the BOE and the British government jointly unveiled a lending plan for households and businesses. Concerned with the weakening domestic economy and the continued risk of deflation, the BOJ expanded the amount of its asset purchase programme five times to a total of ¥101 trillion. The BOJ also announced an inflation goal of 1% to manage expectations, while increasing the size of its Growth-Supporting Funding Facility, and providing unlimited amount of affordable loans to financial institutions to stimulate bank lending. In January 2013, the BOJ introduced a price stability target of 2% and an 'open-ended asset purchasing method' under the Asset Purchase Programme to overcome the deflation and to spur growth.

Chart 1.4

Cumulative Movements of Policy Rates Since 2012



[1] Refers to rediscount rate

Note: Current policy rates in parentheses, as at end-January 2013

Source: National Authorities

In the Asian region, central banks in PR China, India, Korea, Thailand, the Philippines, Indonesia and Vietnam reduced their key policy rates between 25 and 600 bps. The decisions were undertaken to support growth given the heightened downside risks from the external environment. Notably, the central banks in the region were vigilant against the risk of negative spillovers from the external sector on domestic economic activity.

THE MALAYSIAN ECONOMY

Overview

The Malaysian economy performed better than expected in 2012, with a higher growth of 5.6% (2011: 5.1%). The strong growth was supported by resilient domestic demand, which cushioned the negative impact of the weak external environment. Domestic demand recorded its highest rate of expansion for the decade, supported by stronger consumption and investment spending. Unlike in 2009 when the weakness in external demand had significantly affected domestic economic activity through its impact on private investment and private consumption, domestic demand had remained resilient in 2012. The continued resilience in domestic demand was underpinned largely by sound macroeconomic fundamentals, the more diversified and balanced economic structure, the stronger and more developed financial system, and greater macroeconomic policy flexibility.

Building on the trends observed since 2011, gross fixed capital formation registered robust growth in 2012. Private investment sustained

Table 1.2

Malaysia - Key Economic Indicators

	2010	2011	2012*p*	2013*f*
Population (million persons)	28.6	29.0	29.3	29.7
Labour force (million persons)	12.3	12.7	13.1	13.5
Employment (million persons)	11.9	12.3	12.7	13.1
Unemployment (as % of labour force)	3.3	3.1	3.0	3.1
Per Capita Income (RM)	26,882	29,661	30,809	33,015
(USD)	8,346	9,693	9,974	10,760[6]
NATIONAL PRODUCT (% change)				
Real GDP at 2005 prices[1]	7.2	5.1	5.6	5.0 ~ 6.0
(RM billion)	674.9	709.3	749.1	789.9
Agriculture, forestry and fishery	2.4	5.9	0.8	4.0
Mining and quarrying	-0.4	-5.7	1.4	5.0
Manufacturing	11.9	4.7	4.8	4.9
Construction	6.0	4.6	18.5	15.9
Services	7.2	7.0	6.4	5.5
Nominal GNI	10.0	11.8	5.2	8.5
(RM billion)	768.5	859.1	903.9	981.0
Real GNI	4.3	4.9	4.3	6.7
(RM billion)	633.8	664.6	693.5	739.7
Real aggregate domestic demand[2]	7.0	8.2	10.6	8.1
Private expenditure	8.3	8.2	10.7	9.1
Consumption	6.6	7.1	7.7	7.1
Investment	15.5	12.2	22.0	15.6
Public expenditure	3.8	8.4	10.3	5.4
Consumption	2.9	16.1	5.0	3.6
Investment	5.0	-0.3	17.1	7.5
Gross national savings (as % of GNI)	35.4	35.5	33.0	32.9
BALANCE OF PAYMENTS (RM billion)				
Goods balance	134.7	148.1	125.2	102.3
Exports (f.o.b.)	640.0	696.6	702.9	713.1
Imports (f.o.b.)	505.3	548.5	577.7	610.8
Services balance	1.7	-8.0	-13.4	-12.7
(as % of GNI)	0.2	-0.9	-1.5	-1.3
Income, net	-26.5	-22.0	-33.7	-27.2
(as % of GNI)	-3.4	-2.6	-3.7	-2.8
Current transfers, net	-21.8	-21.0	-18.2	-19.6
Current account balance	88.1	97.1	60.0	42.7
(as % of GNI)	11.5	11.3	6.6	4.4
Bank Negara Malaysia international reserves, net[3]	328.6	423.3	427.2	-
(in months of retained imports)	8.6	9.6	9.5	-
PRICES (% change)				
CPI (2010=100)[4]	1.7	3.2	1.6	2.0 ~ 3.0
PPI (2005=100)[5]	5.6	9.0	0.1	-
Real wage per employee in the manufacturing sector	6.4	0.6	4.6	-

[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 2013
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)	2010		2011		2012*p*	
Revenue	159.7		185.4		207.9	
Operating expenditure	151.6		182.6		205.5	
Net development expenditure	51.3		45.3		44.3	
Overall balance	-43.3		-42.5		-42.0	
Overall balance (% of GDP)	-5.4		-4.8		-4.5	
Public sector net development expenditure	103.0		101.8		163.9	
Public sector overall balance (% of GDP)	2.5		-3.5		-10.2	
EXTERNAL DEBT						
Total debt (RM billion)	227.1		257.4		252.8	
Medium- and long-term debt	147.6		153.5		159.8	
Short-term debt[1]	79.4		103.9		93.0	
Debt service ratio[2] (% of exports of goods and services)						
Total debt	7.6		10.3		10.2	
Medium- and long-term debt	7.6		10.2		10.1	
MONEY AND BANKING	**Change in 2010**		**Change in 2011**		**Change in 2012**	
	RM billion	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply M1	23.5	11.7	33.8	15.1	28.9	11.2
M3	68.8	6.8	154.8	14.3	109.4	8.8
Banking system deposits	75.0	7.1	161.0	14.1	109.4	8.4
Banking system loans[3]	99.8	12.7	120.2	13.6	104.5	10.4
Loan-deposit ratio (end of year)[4]	81.5		80.9		82.1	
Financing-deposit ratio[4, 5]	88.0		86.6		89.2	
INTEREST RATES (AS AT END-YEAR)	**2010**		**2011**		**2012**	
	%		**%**		**%**	
Overnight Policy Rate (OPR)	2.75		3.00		3.00	
Interbank rates (1-month)	2.83		3.05		3.06	
Commercial banks						
Fixed deposit 3-month	2.74		2.99		2.98	
12-month	2.97		3.22		3.15	
Savings deposit	1.00		1.15		1.03	
Base lending rate (BLR)	6.27		6.53		6.53	
Treasury bill (3-month)[6]	2.82		2.99		3.04	
Malaysian Government Securities (1-year)[6]	2.85		2.82		3.01	
Malaysian Government Securities (5-year)[6]	3.39		3.23		3.24	
EXCHANGE RATES	**2010**		**2011**		**2012**	
Movement of Ringgit (end-period)	**%**		**%**		**%**	
Change against SDR	13.1		-2.8		3.9	
Change against USD[7]	11.1		-2.9		3.9	

[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] Exclude financial institution transaction
[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

impressive growth rates throughout the year, with broad-based investment activity undertaken by firms across most sectors. Investments in the oil and gas sector reflected the concerted efforts by both the public and private sectors to increase oil production through new investments in deepwater and marginal oil fields. The continued strong growth in private consumption had the effect of spurring more investments in the consumer-related services and manufacturing sectors, while firm regional demand provided strong incentives for investments in the tourism-related services sectors, such as the airline industry, medical and education services. The conducive financing environment in the banking sector and the capital market also supported the financing of the capital spending. In addition, the commencement and progress of several infrastructure projects, including those under the Economic Transformation Programme (ETP) such as the MY Rapid Transit, had also provided significant positive spillover effects to activities in the domestic manufacturing and services sectors. Reflecting these developments, value-added in the construction sector registered robust growth in 2012.

The Malaysian economy registered a better-than-expected growth of 5.6% in 2012, supported by stronger domestic demand amid the weak external environment

Despite the uncertainties in the external environment, consumption activity remained strong during the year. This was attributable mainly to favourable income growth, the low inflation environment, and supportive financing conditions. Household spending also received further support from the Government transfers to low and middle-income households. Although income in the rural areas was affected by the decline in the prices of rubber and palm oil, this was in part mitigated by the payment of RM15,000 to the FELDA settlers, which amounted to a total of RM1.7 billion.

The improvement in domestic economic activity during the year had resulted in sustained strong growth in the import of goods and services. The strong growth largely reflected the robust imports of capital goods, led by the import of machineries,

Table 1.4

Real GDP by Expenditure (2005=100)

	2011	2012*p*	2011	2012*p*
	Annual change (%)		Contribution to growth (ppt)	
Domestic Demand[1]	**8.2**	**10.6**	**6.9**	**9.2**
Consumption	8.9	7.1	5.4	4.5
Private sector	*7.1*	*7.7*	*3.5*	*3.8*
Public sector	*16.1*	*5.0*	*1.9*	*0.7*
Gross Fixed Capital Formation	6.5	19.9	1.5	4.7
Private sector	*12.2*	*22.0*	*1.5*	*3.0*
Public sector	*-0.3*	*17.1*	*-0.0*	*1.7*
Change in stocks			**-0.7**	**0.3**
Net exports of goods and services	**-7.4**	**-29.4**	**-1.1**	**-3.8**
Exports	*4.2*	*0.1*	*4.3*	*0.1*
Imports	*6.2*	*4.5*	*5.4*	*3.9*
Real Gross Domestic Product (GDP)	**5.1**	**5.6**	**5.1**	**5.6**

[1] Excluding stocks
p Preliminary

Source: Department of Statistics, Malaysia

telecommunications equipment and passenger aircrafts. The import of consumption goods also expanded in line with the stronger growth in consumer spending. The import of services was also driven mainly by higher payments for professional

Table 1.5

Real GDP by Sector (2005=100)

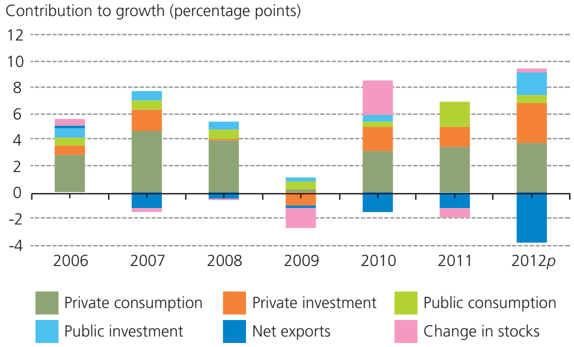
	2011	2012*p*	2011	2012*p*
	Annual change (%)		Contribution to growth (ppt)[1]	
Agriculture	5.9	0.8	0.4	0.1
Mining & quarrying	-5.7	1.4	-0.6	0.1
Manufacturing	4.7	4.8	1.2	1.2
Construction	4.6	18.5	0.1	0.6
Services	7.0	6.4	3.7	3.5
Real Gross Domestic Product (GDP)	**5.1**	**5.6**	**5.1**	**5.6**

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

Source: Department of Statistics, Malaysia

Chart 1.5

Real GDP by Expenditure



p Preliminary

Source: Department of Statistics, Malaysia

and construction services, given the strong investment and construction activities during the year. Travel payments were also higher, reflecting the higher number of Malaysians travelling abroad for leisure.

The export of goods and services moderated significantly amidst weaker external demand from both the advanced and regional economies. The lower growth in gross exports was due mainly to the weaker demand for crude commodities and non-electrical and electronics (E&E) products. In the first half of the year, growth in non-E&E exports was supported by regional demand. In the second half of 2012, however, demand from the region for both manufactured and commodity exports declined, following slower growth in the major regional economies. Of significance, the lower demand for crude palm oil and natural rubber coincided with the slowdown in growth in PR China and the recession in the euro area. The contraction in the export of commodities was also compounded by the lower production of crude palm oil and disruptions in the production of natural gas. The export of E&E, while registering a marginal improvement, nevertheless, remained fragile due to the weak investment and consumption trends in the advanced economies. The export of services improved slightly, mainly on account of higher receipts from the provision of computer and information and communications technology (ICT) services, and business and professional services by Malaysian companies. Receipts from transportation services declined sharply, following the moderation in the export of goods and lower tourist arrivals. The slower growth in tourist arrivals also weighed down on receipts from tourism activities for the year.

The higher growth of imports of goods and services relative to exports led net exports of goods and services to register a higher contraction in 2012, resulting in a larger negative contribution to overall GDP growth. This was nevertheless more than offset by the higher contribution from the stronger domestic demand.

Stronger domestic demand

Domestic demand registered a strong expansion of 10.6% in 2012 (2011: 8.2%), and contributed significantly to overall GDP growth. This was attributable to the robust expansion in total gross fixed capital formation and stronger growth in private consumption.

Gross fixed capital formation (GFCF) registered a marked expansion of 19.9% in 2012, underpinned by higher capital spending in both

Table 1.6

External Trade & Services Account

	2011	2012*p*
	Annual change (%)	
Gross exports	**9.2**	**0.6**
Manufactures	3.5	3.1
Electronics and electrical (E&E)	*-3.7*	*-1.8*
Non-E&E	*12.7*	*8.4*
Commodities	28.2	-6.7
Agriculture	*33.0*	*-15.3*
Minerals	*23.8*	*1.9*
Gross imports	**8.5**	**5.9**
Capital goods	8.7	20.5
Intermediate goods	5.5	-3.4
Consumption goods	19.0	11.6
Services exports	**4.6**	**6.4**
Transportation	-1.8	-10.5
Travel	1.9	1.5
Other services	12.8	22.1
Government services n.i.e.	6.2	-17.8
Services imports	**14.0**	**10.5**
Transportation	6.2	1.3
Travel	29.0	12.4
Other services	12.2	18.0
Government services n.i.e.	2.6	-13.8

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Continued Expansion across All Economic Sectors

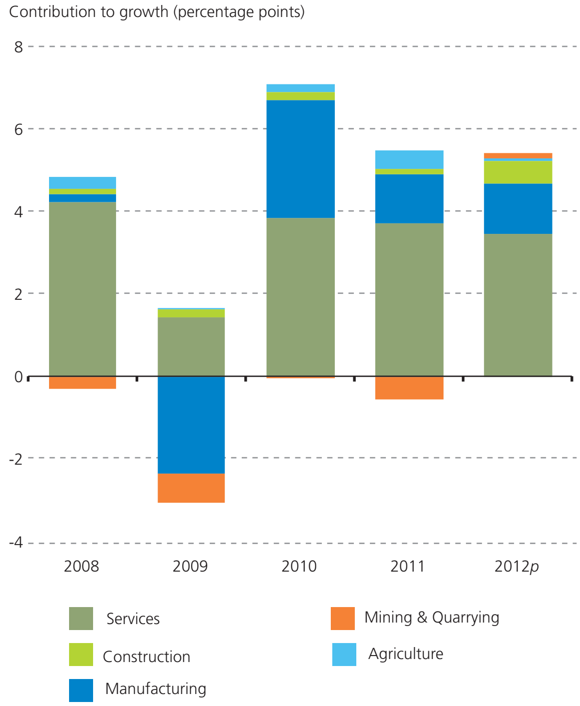
On the supply side, all economic sectors continued to expand in 2012, with significant improvement registered in the construction sector. The robust growth of the construction sector (see Information Box: Strong Performance of the Construction Sector) reflected mainly the significant progress in civil engineering projects. The continued growth in domestic demand, particularly in private sector spending, contributed to growth in domestic-related activities in the services and manufacturing sectors, while the slowdown in external demand affected the performance of trade-related services.

The services sector remained the largest growth contributor (3.5 percentage points of overall GDP growth), as sub-sectors catering to the domestic market, namely retail and telecommunications, benefited from strong consumer spending. The finance and insurance sub-sector recorded higher growth, reflecting continued financing, particularly to businesses, coupled with higher fee-based income and stronger growth of earnings from insurance premiums. Trade-related services, particularly the wholesale and transportation sub-sectors, moderated in tandem with slower external trade activities.

The manufacturing sector expanded by 4.8%, with both the export-and domestic-oriented industries registering better growth. In the export-oriented industry, production in the E&E cluster, particularly in semiconductors, normalised, following the major disruptions arising from the natural disasters in Japan and Thailand in 2011. The continued demand for chemicals and petroleum products, mainly from the region, contributed to the expansion of output of the primary-related cluster. The improvement in the domestic-oriented industries was due to the better performance of the construction- and consumer-related clusters, driven by higher domestic construction activity and robust private consumption.

Chart 1

Real GDP by Economic Activity



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Source: Department of Statistics, Malaysia

The agriculture sector recorded a more moderate growth of 0.8% in 2012. CPO output was affected by deteriorating weather conditions in the first half of the year, leading to a sharp decline in yields. This, however, was offset by strong growth in key food commodities, such as livestock, vegetables and paddy, amid strong domestic demand.

The value-added of the mining sector turned around to record a growth of 1.4%, reflecting the recovery in the production of crude oil and condensates. This was driven mainly by higher output from oil fields located offshore from Peninsular Malaysia and Sabah. The higher oil output was also contributed by the commencement of production from marginal and new oil fields. Output of natural gas declined marginally, affected by a prolonged shutdown of several facilities in Sarawak for maintenance purposes during the middle of the year.

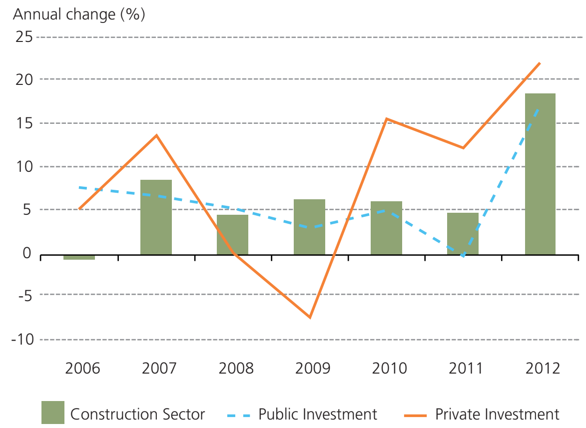
the private and public sectors. Higher capital spending was widespread across the economic sectors, particularly in the services, manufacturing and mining sectors, driven by strong domestic consumption activity, resilient regional demand and firm crude oil prices. Contributing further to the strong investment performance was the commencement and continued progress of several infrastructure projects, including those under the ETP and the regional growth corridors. The investment performance during the year also reflected the steady improvement in the investment climate, following the introduction of measures to further enhance the conditions for doing business in Malaysia.

Investment activity accelerated, supported by strong capital spending by both the private and public sectors

Private investment recorded a double-digit growth of 22%, attributable to capital spending in the consumer-oriented services sectors, domestic-oriented manufacturing sectors, and the implementation of major infrastructure projects, particularly in the mining sector. In the services sector, capital spending was driven by investments in the consumer-related sub-sectors, such as communications and wholesale and retail trade, and benefited from continued high consumer spending and efforts by firms to upgrade existing infrastructure and services. Real estate investment registered rapid expansion with higher residential and non-residential construction, following the strong growth in property launches between 2010 and 2011. Higher capital expenditure was also evident in the transportation services sub-sector, particularly in the airline industry, in response to sustained demand for air travel. Underpinned by firm energy prices and further supported by tax incentives to encourage the development of deepwater and marginal oil fields, mining investment increased significantly, with capital spending channelled mainly into oil field development and enhanced output recovery from existing fields. In the manufacturing sector, investment was attributable mainly to capacity expansion by the domestic-oriented firms, particularly in the consumer-related clusters. Investment by the export-oriented manufacturing firms reflected the implementation of approved

Chart 1.6

Growth in Public and Private Investments versus Construction Sector



Source: Department of Statistics, Malaysia

manufacturing projects in the primary-related clusters, and investments in new technology for product diversification and in new growth areas, namely medical and telecommunications equipment. Investment was also supplemented by investments in automation to enhance productivity and upgrade technology to mitigate the impact of high energy prices and labour costs.

Public investment recorded a strong growth of 17.1%, driven by higher capital spending by public enterprises in the oil and gas sector, and the transportation, utilities, and telecommunications services sub-sectors. Major projects in the oil and gas sector included the exploration and development of new oil and gas fields, the rejuvenation of existing oil fields, and the construction of the regasification terminal in Melaka. Construction of the new terminal for low-cost carriers (KLIA2), aircraft fleet modernisation, the extension of the Light Rail Transit and purchases of equipment to improve urban rail services were the main areas of investment in the transportation sub-sector. Investment in the utilities and telecommunications sub-sectors included the building of power plants and infrastructure to broaden the coverage of the High-Speed Broadband (HSBB) network. The Federal Government's development expenditure in the economic sector was directed mainly to transportation, public utilities and trade and industry (particularly to upgrade infrastructure facilities in industrial areas). In the social services sector, investment was focused mainly on education and health.

Strong Performance of the Construction Sector

In 2012, the construction sector recorded a robust growth of 18.5%, the highest since 1995 (21.1%), driven mainly by the civil engineering sub-sector. This reflected the efforts to improve road and rail accessibility, enhance electricity generation capacity, and increase oil and gas output in Malaysia. Compared to the rapid growth in 1995, existing major projects are more broad-based in terms of sector and geographical location, covering areas beyond the Klang Valley (see Table 1). The strong growth was reflected in higher construction-related financing, manufacturing sales and production activity in 2012 (see Table 2).

Growth in the sector was also contributed by the residential and non-residential sub-sectors. The performance of the residential sub-sector was underpinned by the construction of high-end properties in the Klang Valley, Penang and Johor, following robust launches in 2010 and 2011 (see Table 2). Industrial projects in the Samalaju Industrial Park, tourism projects in Iskandar, and commercial projects in the Klang Valley supported growth in the non-residential sub-sector. Construction of learning and health institutions, such as the University Teknologi Mara campuses and National Cancer Institute, also provided further impetus to this sub-sector.

Table 1

List of Selected Key Civil Engineering Projects

Sector	Projects	Location
Transport	MRT (Sungai Buloh–Kajang)	Klang Valley
	LRT extension	Klang Valley
	KLIA2	Klang Valley
	Second Penang Bridge	Penang
	Seremban-Gemas Double Track	Negeri Sembilan
	Rural Road Programme	Various states
Utilities	Janamanjung Power Plant	Perak
	Tanjung Bin Power Plant	Johor
	Pahang-Selangor Raw Water Transfer[1]	Pahang & Selangor
Oil & Gas	Melaka LNG Regasification Terminal	Melaka
	Sabah-Sarawak Gas Pipeline	Sabah & Sarawak
	Sabah Oil and Gas Terminal	Sabah
	Gumusut-Kakap Deepwater Project	Sabah

[1] Excluding Langat 2 Water Treatment Plant

Source: News flows and Budget 2012

Table 2

Value-added and Selected Indicators for the Construction Sector

Annual change (%)	2008	2009	2010	2011	2012
Value-added	4.4	6.2	6.0	4.6	18.5
Loans disbursed for the construction sector	6.8	16.6	5.5	5.4	20.7
Industrial production					
Other articles of concrete, cement and plaster	*9.5*	*-2.7*	*-7.0*	*5.5*	*6.7*
Structural non-refractory clay and ceramic	*-2.1*	*-14.4*	*2.7*	*-4.5*	*5.1*
Manufacturing sales					
Forging, pressing, stamping and roll-forming metal	*10.6*	*-22.7*	*5.6*	*-0.1*	*15.6*
Treatment and coating of metals and machining[1]	*10.2*	*57.6*	*-19.6*	*-18.4*	*6.6*
Launches of new residential units	-3.4	1.3	11.7	7.1	-11.2[2]

[1] Includes cleaning, welding and cutting of metal, sandblasting and boring

[2] 1Q-3Q 2012 (preliminary)

Source: Bank Negara Malaysia, Department of Statistics, Malaysia and National Property Information Centre

Overall, growth of GFCF was broad-based, with higher growth in both investment in structures and machinery and equipment (46.5% and 45% share to GFCF respectively). Investment in structures registered rapid expansion of 27.2% in 2012 (2011: 4.9%), and was evident in all construction segments, namely civil engineering, residential and non-residential.

In addition, capital spending in machinery and equipment grew by 15.5% in 2012 (2011: 4.2%), as reflected in the increase in the import of capital goods. The import of capital goods expanded by 20.5% in 2012 (2011: 8.7%), supported by the import of machinery for manufacturing (2012: 22.3%; 2011: 3.3%), telecommunications equipment (2012: 16.4%; 2011: 12.3%), mining

Stable Labour Market Conditions

Employment growth was higher at 3.6% (2011: 3.2%), with a net addition of 438,800 jobs. Gains in employment were registered mostly in the services and agriculture sectors. The unemployment rate declined marginally to 3% (2011: 3.1%).

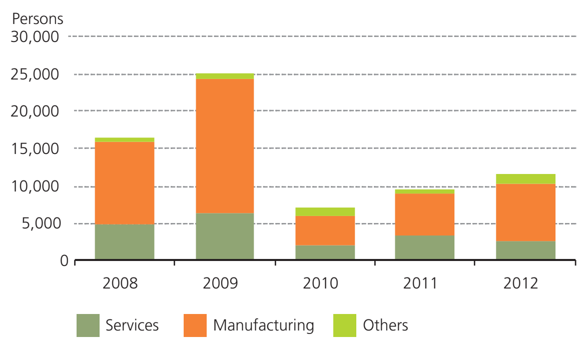
Total retrenchments increased to 11,494 persons from 9,450 in the previous year, due mainly to higher layoffs in the manufacturing sector (7,616 persons; 2011: 5,635 persons). The agriculture and services sectors, however, recorded lower retrenchments during the year.

Based on a survey conducted by Bank Negara Malaysia, average nominal salary in the private sector increased by 5% in 2012 (2011: 4%), with average increments of 3.4% and 5.4% in the manufacturing and non-manufacturing sectors respectively (2011: 2.2% and 4.5% respectively). Increments for executives grew at a higher rate of 5.2% (2011: 3.7%). Non-executives also received a higher increment of 4.7% (2011: 3.9%).

As at end-2012, the number of registered foreign workers[1] in Malaysia decreased marginally to 1,571,589 workers (end-2011: 1,573,061 workers). Foreign workers accounted for 12.4% of employment in Malaysia, and were mostly employed in the manufacturing (39%), agriculture (29%) and construction (14%) sectors.

Chart 1

Retrenchment by Sector



Note: Others refer to the agriculture, mining and construction sectors

Source: Ministry of Human Resources

Table 1

Selected Labour Market Indicators

	2008	2009	2010	2011	2012
Employment ('000 persons)	10,659.2	10,899.0	11,899.5	12,284.4	12,723.2
Labour force ('000 persons)	11,028.1	11,315.3	12,303.9	12,675.8	13,119.6
Unemployment rate (% of labour force)	3.3	3.7	3.3	3.1	3.0
Retrenchments (persons)	16,469	25,064	7,085	9,450	11,494

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 and Ministry of Human Resources

[1] Excludes expatriates and foreign workers legalised by the 6P Programme.

and construction equipment (2012: 20.5%; 2011: 35.2%) and transport equipment (2012: 43.1%; 2011: 14.9%).

Despite the more adverse external environment, foreign direct investment continued to register a sizeable net inflow, albeit to a lesser extent. The inflows were broad-based, and were channelled into both the domestic- and export-oriented sectors. During the year, there were also fewer mergers and acquisitions of Malaysian companies by the multi-national corporations, due to the uncertainties in global growth prospects. Of importance, there were significant inflows into high-growth areas, such as the oil and gas sector and the communication services sub-sector. Some of the funds were also for projects under the ETP.

Private consumption strengthened, underpinned by income growth, Government transfers and supportive financing conditions

Private consumption registered a healthy growth of 7.7% in 2012 (2011: 7.1%). The strong performance was attributable to three main factors. First is the favourable income growth amid the stable labour market conditions during the year. The low unemployment rate (3%; 2011: 3.1%) and the high demand for labour had led to higher nominal wage growth in the private sector (see information box: Stable Labour Market Conditions). Civil servants and pensioners also received higher incomes under the improved Malaysian Remuneration Scheme (SSM). Nevertheless, income in the rural areas faced downward pressures as rubber and palm oil prices declined by 29.3% (2011: +30.9%) and 13% (2011: +21.1%) respectively. However, for the FELDA settlers, this was mitigated in part by the payment of RM15,000, which had been disbursed in three phases to each FELDA settler, in conjunction with the listing of FELDA Global Ventures Holdings. This amounted to a total of RM1.7 billion.

Second, private consumption benefited from the Government transfers to low- and middle-income households during the year. These included the Bantuan Rakyat 1Malaysia (BR1M), Baucar Buku 1Malaysia (BB1M) and the schooling assistance for primary and secondary students. These targeted income transfers had sizeable effects on aggregate private consumption, as the benefiting households generally have relatively high marginal propensity to consume (see box article: Variations in Household Propensity to Consume across Income Segments).

Finally, financing conditions remained supportive of consumer spending in 2012, with the average lending rate (ALR) on new loans to households declining to 4.6% (2011: 4.8%). Although households were subjected to stricter criteria for loan applications following the introduction of the Guidelines on Responsible Financing that had come into effect on 1 January 2012, creditworthy households continued to have access to financing. Total bank financing to households grew by 11.6% in 2012 (2011: 12.9%).

Public consumption recorded a more moderate increase of 5% in 2012, due mainly to the significant moderation in expenditure on supplies and services as the Government continued with its fiscal consolidation efforts. Expenditure on emoluments remained high due to the higher salary increments and bonus payments to the civil servants, which also contributed to sustaining private consumption during the year.

EXTERNAL SECTOR

Malaysia's external sector remained resilient amid continued uncertainties and challenges in the global economic and financial environment. The overall balance of payments (BOP) remained strong. The current account surplus was more than adequate to meet the net outflows in the financial account. The level of reserves remained at comfortable levels, and was more than sufficient to meet the short-term obligations and provide a buffer against volatile short-term capital flows.

Lower current account surplus amidst weak external demand and strong expansion in domestic activity

Malaysia's current account surplus was lower at RM60 billion in 2012 (2011: RM97.1 billion), reflecting the cyclical and structural adjustments that are taking place in both the global and domestic economy. This development can be assessed from two inter-related perspectives – namely, in terms of Malaysia's international trade performance, and the national saving-investment gap.

Table 1.7

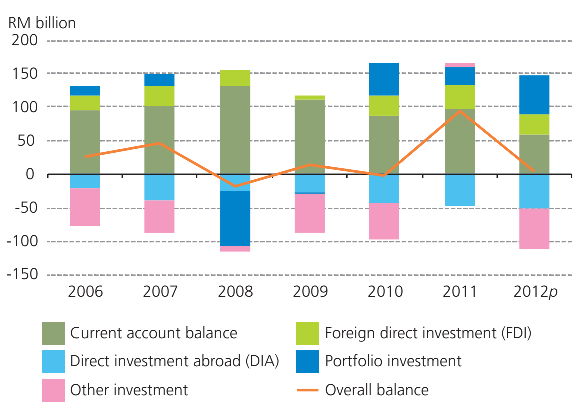
Balance of Payments

Item	2011 +	2011 -	2011 Net	2012*p* +	2012*p* -	2012*p* Net
	RM billion					
Goods	696.6	548.5	148.1	702.9	577.7	125.2
Services	110.1	118.1	-8.0	117.1	130.5	-13.4
Balance on goods and services	**806.7**	**666.6**	**140.1**	**820.0**	**708.2**	**111.9**
Income	52.4	74.4	-22.0	42.3	76.0	-33.7
Current transfers	4.7	25.6	-21.0	6.9	25.1	-18.2
Balance on current account	**863.8**	**766.7**	**97.1**	**869.2**	**809.2**	**60.0**
% of GNI			**11.3**			**6.6**
Capital account			-0.2			0.1
Financial account			22.3			-22.5
Direct investment			-10.1			-21.9
Abroad			*-46.7*			*-51.0*
In Malaysia			*36.6*			*29.1*
Portfolio investment			25.8			59.2
Financial derivatives			-0.1			0.9
Other investment			6.6			-60.7
Balance on capital and financial accounts			**22.1**			**-22.5**
Errors and omissions			-24.5			-33.6
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*7.6*			*-7.7*
Net E&O as % of total trade			*-2.6*			*-2.0*
Overall balance			**94.7**			**3.9**
Bank Negara Malaysia international reserves, net			**423.3**			**427.2**
USD billion equivalent			**133.6**			**139.7**

p Preliminary
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia

Chart 1.7

Balance of Payments (BOP)



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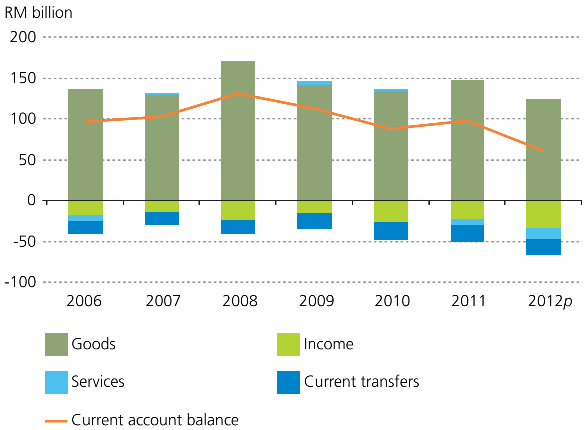
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Malaysia's external sector remained resilient despite continued uncertainties and challenges in the global environment

From the international trade perspective, the lower current account surplus was due mainly to the lower goods surplus amid larger deficits in the services and income accounts. In the goods account, the deceleration in gross exports was due to the weak external demand and lower commodity prices. While demand for manufactured goods from the advanced economies was weak throughout the year, the

Chart 1.8

Current Account



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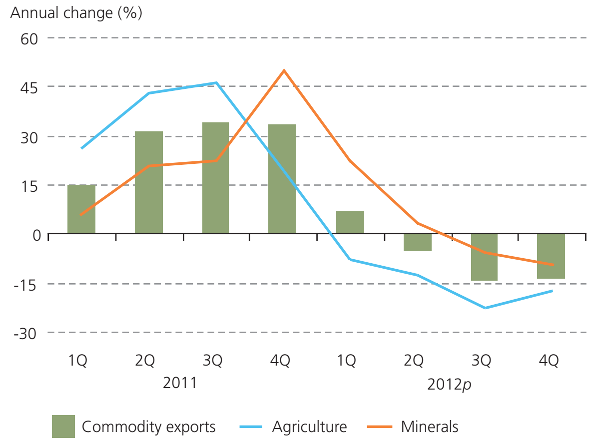
Source : Department of Statistics, Malaysia

Chart 1.9

Commodity Export Performance



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Source: Department of Statistics, Malaysia and Bank Negara Malaysia

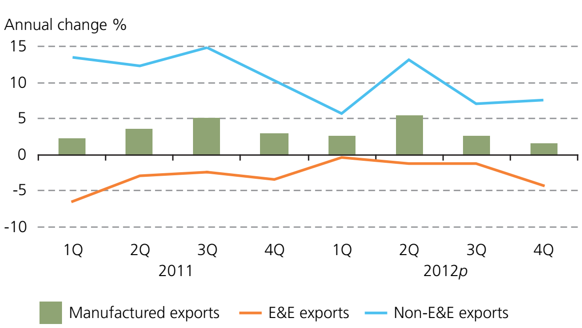
export of non-E&E products were supported by strong regional demand, especially in the first half of the year. However, slower economic growth in the region in the second half of the year led to a moderation in demand for non-E&E products and commodities. The lower demand for non-E&E products and commodities was further compounded by the decline in the prices of major commodities, particularly crude palm oil and natural gas. In contrast, exports of E&E products registered a smaller contraction, arising from the normalisation of E&E production, arising from the supply disruption following the severe floods in Thailand in 2011.

There was strong growth in the import of capital and consumption goods following the improvement in domestic demand. In particular, the robust growth in domestic investment activity led to a marked increase in the import of machinery, telecommunications equipment and passenger aircrafts. The strength in consumer spending activity saw continued strong growth in the import of consumption goods, particularly the import of durable and semi-durable consumer goods. The import of intermediate goods, which are used mostly as inputs for manufactured exports, however, registered a contraction.

The services account registered a larger deficit due mainly to the higher deficit in the transportation account and lower net receipts from the travel account. The larger drag from the transportation account reflected the higher payments for imported freight services, in line with the strong import growth. Tourism receipts were lower in 2012

Chart 1.10

Export Performance of Electronics & Electrical (E&E) and Non-E&E Products



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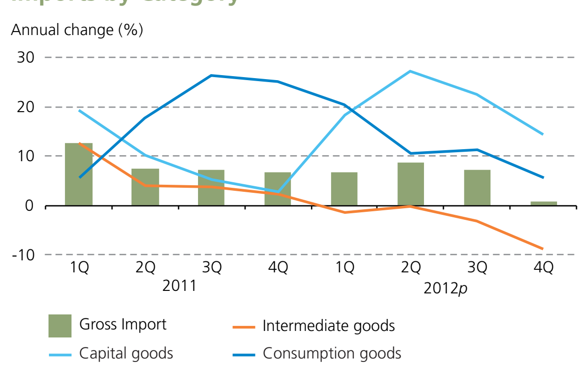
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.11

Imports by Category



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Source: Department of Statistics, Malaysia and Bank Negara Malaysia as tourist arrivals into Malaysia grew at a more moderate pace, reflecting the slower growth in the regional economies.

The larger deficit in the income account reflected the higher income accrued to foreign companies in Malaysia, mainly in the manufacturing and mining sectors, and financial services sub-sector. On the other hand, income accrued to Malaysian companies investing abroad was lower in 2012, following the increased global uncertainty and lower commodity prices.

The lower current account surplus also reflected the lower surplus of national savings over domestic investment spending. Public sector savings increased by 10.1% to RM71.2 billion or 7.9% of gross national income (7.5% of gross national income (GNI) in 2011). Meanwhile, private sector savings declined by 5.3% to RM227.5 billion or 25.2% of GNI in 2012 (2011: RM240.2 billion or 28%). Overall, gross national savings (GNS) declined by 2% to RM298.7 billion in 2012. Nevertheless, the ratio of GNS to GNI remained high at 33% (2011: 35.5%). Given the decline in GNS and the faster pace of growth in gross domestic investment, the savings-investment surplus declined to RM60 billion or 6.6% of GNI in 2012 (2011: RM97.1 billion or 11.3%).

Continued two-way flows of capital

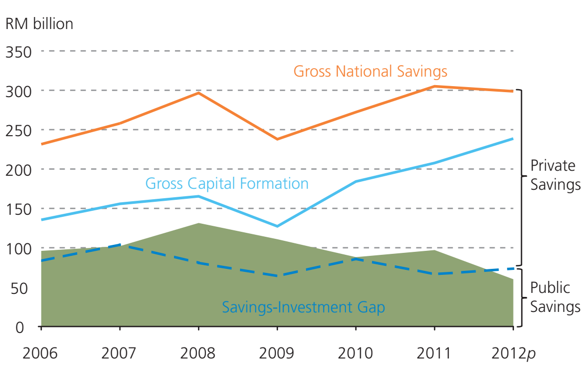
Given the excess global liquidity, Malaysia continued to experience two-way financial flows in 2012, with inflows of foreign funds attracted mainly to the country's resilient growth prospects. These inflows were almost entirely offset by resident outflows, reflecting the increasing interest and ability on the part of domestic financial institutions and companies to expand their global and regional presence by acquiring foreign assets and diversifying their investments abroad.

Continued inflows of FDI and portfolio funds amidst higher outflows of DIA

Foreign direct investment (FDI) continued to register a sizeable net inflow of RM29.1 billion or 3.1% of GDP (2011: RM36.6 billion) in 2012. FDI inflows were mainly in the form of equity capital investment and higher corporate profitability during the year. Sizeable earnings were retained by the multi-national corporations for re-investment within the domestic economy. The export-oriented sector and other sectors directly linked to external demand, however, experienced a slight moderation in FDI inflows, given the increased uncertainties surrounding global growth prospects. The manufacturing sector, in particular, had been affected by the slowdown in global trade, given its close integration with the regional supply chain network. FDI into the finance and insurance sub-sector moderated as well, reflecting the volatility experienced in the global financial markets. Nevertheless, inflows into the oil and gas sector and the communications sub-sector registered increases, following the steady implementation of

Chart 1.12

Gross National Savings & Savings-Investment Gap



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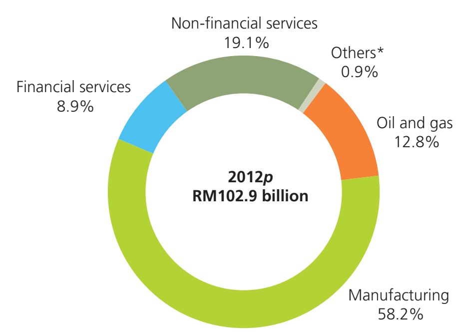
Source: Department of Statistics, Malaysia
Ministry of Finance, Malaysia

Chart 1.13

Gross FDI Inflows by Sectors



* Refers to agriculture and construction sectors
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Source: Department of Statistics, Malaysia

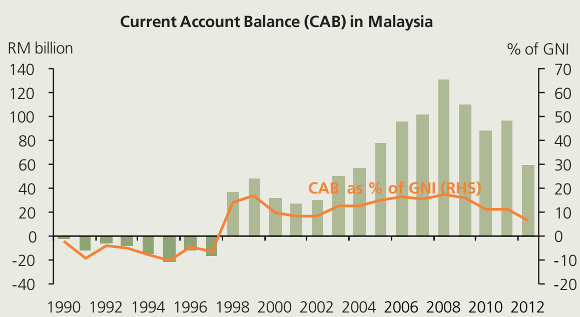
Current Account Balance in Malaysia: Recent Developments and Outlook

Introduction

Since the Asian financial crisis, Malaysia's current account balance has consistently recorded a surplus. Exports of goods have outpaced imports, and have more than offset the deficit in the services and income accounts. The strong performance of Malaysia's exports was due, in large part, to the broad diversification of products and the expansion of trade in new markets. In particular, commodity exports, which have low import content, played an important role in contributing to the increase in the current account surplus. In line with rising commodity prices in 2008, the current account surplus peaked at 17.6% of GNI in 2008. The Global Financial Crisis (GFC), however, marked the beginning of a moderating trend in the current account surplus (Chart 1). Weaker global demand and lower commodity prices have resulted in lower exports for Malaysia in recent years. Imports, on the other hand, increased significantly, driven by stronger domestic demand. The outcome of these trends has been the narrowing of the savings-investment surplus.

Chart 1

Current Account Balance Narrowing After More Than a Decade of Surplus



Source: Department of Statistics, Malaysia

Although the current account balance reflects the excess of exports over imports, it also mirrors the savings-investment surplus in an economy. In other words, the current account balance can be assessed in terms of both the international trade perspective and the savings-investment behaviour in an economy. In a closed economy, investment activity is funded solely from domestic savings. However, in an open economy such as Malaysia, investment activity may be funded by domestic or foreign savings. If an economy is saving more than it is investing, the economy would register a current account surplus. These excess savings can be used to accumulate reserves to provide a buffer against external vulnerabilities or channelled abroad to finance the consumption and investment activities of other economies, either in the form of extension of loans or investments abroad. In contrast, a current account deficit would indicate that an economy is investing more than it is saving. In this case, the economy would either borrow funds from abroad or receive inflows of foreign investment to finance its domestic consumption and investment requirements.

This box article explores the recent narrowing trend of the current account surplus from the two interrelated perspectives, namely the international trade and the savings-investment position.

I. International trade perspective

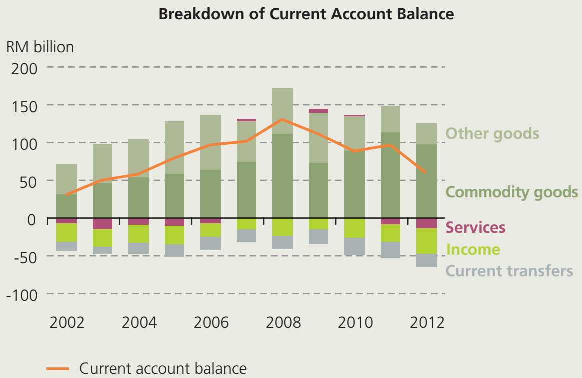
In the international trade perspective, developments in the current account balance can be viewed in terms of the changes in the exports and imports of goods and services, and the net balances of income and current transfers. In Malaysia, the current account surplus has been driven mainly by the surplus in the goods account, while the other components have remained in deficit[1] (Chart 2).

The goods surplus widened significantly after the Asian financial crisis as the growth of imports weakened following a substantial decline in domestic investment activity. At the same time, gross exports continued to expand[2], underpinned by the diversification in export products and markets. However, following the GFC, Malaysia's exports have expanded at a more modest pace. The weak

[1] In 2007-2010, the services account registered small surpluses.
[2] Gross exports expanded by an annual average rate of 8.7% in 2000-2008.

Chart 2

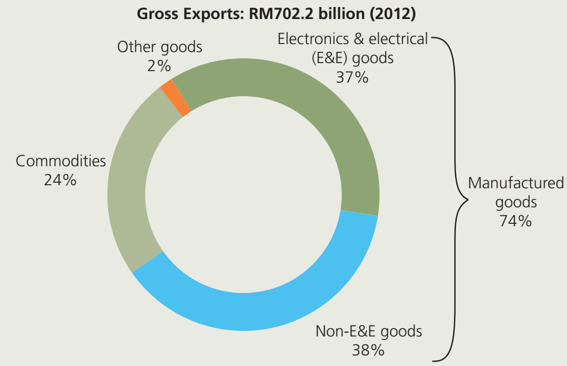
Current Account Surplus Narrowed Due Mainly to Lower Goods Surplus



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 3

Exports of Manufactured Goods Account for the Bulk of Gross Exports



Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

global economy has reduced the demand for Malaysia's manufactured and commodity exports (74% and 24% share of gross exports respectively, Chart 3) and this has been further compounded by lower commodity prices.

Conversely, amid stronger domestic demand, imports have risen steadily since 2009 (Chart 4), due mainly to import of capital and consumption goods (16% and 8% share of gross imports respectively). Reflecting the increase in investment activity by both the public and private sectors, capital imports rose at an average annual rate of 13.8% during 2010-2012. Similarly, import of consumption goods increased by an average of 13.4% over the same period, supported by stronger domestic consumption, and to a smaller extent, the appreciation of the ringgit. Import of intermediate goods (61% of gross imports, Chart 5), on the other hand, recorded a moderation in growth, given that the bulk of these imports are used as inputs for the production of manufactured exports. This close relationship between manufactured exports and intermediate imports acts as an automatic stabiliser for the current account balance.

Chart 4

Growth of Imports Has Outpaced Exports in Recent Years

Source: Department of Statistics, Malaysia

Chart 5

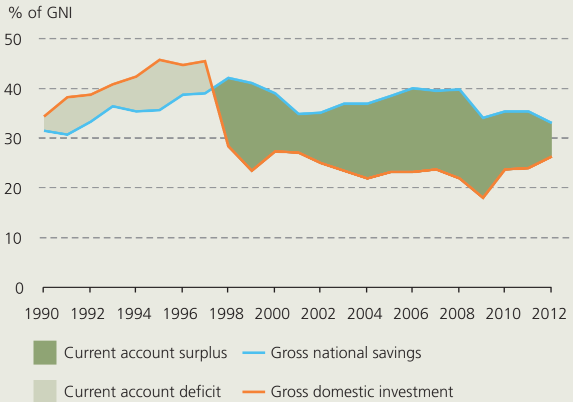
Intermediate Imports Account for 61% of Gross Imports

Source: Department of Statistics, Malaysia

Chart 6

Current Account Surplus Narrowed as Investment Increased Amid Lower Savings

Savings-Investment Gap in Malaysia

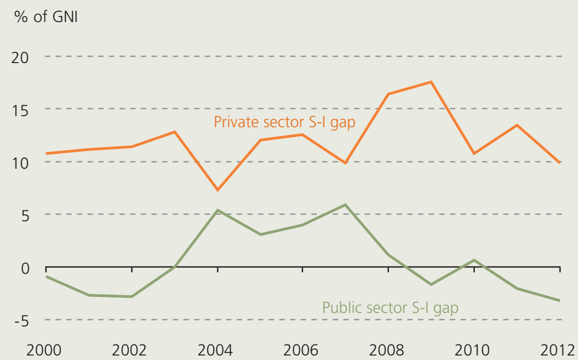


Source: Department of Statistics, Malaysia

Chart 7

Private Sector Remains a Net Saver while the Public Sector Has Turned into a Net Investor in Recent Years

Savings-Investment (S-I) Gap by Public and Private Sectors



Source: Department of Statistics, Malaysia

II. Savings-investment gap perspective

The current account balance is also an outcome of the inter-temporal investment and consumption decisions of both the public and private sectors in an economy. In the case of Malaysia, the sustained current account surplus since the Asian financial crisis reflected the sharp decline in investment amid a sustained high level of savings. In contrast, beginning 2010, gross fixed capital formation has been on the rise. This upturn in investment activity has resulted in a narrowing of the savings-investment gap (Chart 6).

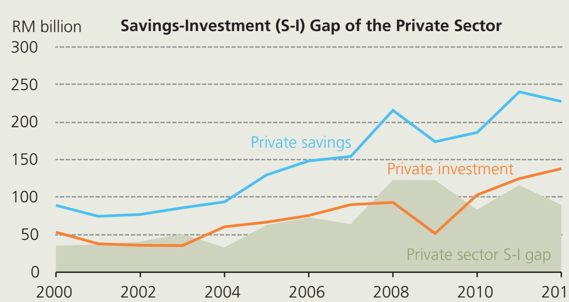
As shown in Chart 7, Malaysia's savings-investment surplus has been driven mainly by the private sector, which has constantly registered an excess of savings over investment in the last decade. Prior to the GFC, the surplus of the private sector was attributable to both the elevated savings rate and low growth of investment (Chart 8). Nevertheless, in 2012, as investment strengthened while savings declined, the savings-investment surplus of the private sector narrowed.

Private investment has emerged as a major contributor to growth in recent years on account of strong corporate profits, high capacity utilisation, continued access to financing and the favourable investment climate[3]. In particular, major investments have been undertaken in the oil and gas, infrastructure, manufacturing and services sectors. Private investment has also been spurred by the implementation of the Economic Transformation Programme, which has catalysed investments in new growth areas, high value-added industries and infrastructure. Of significance, the rise of private investment is expected to enhance Malaysia's productive capacity, improve efficiency, and drive the

Chart 8

Private Savings Moderated while Private Investment Expanded

Savings-Investment (S-I) Gap of the Private Sector



Source: Department of Statistics, Malaysia

[3] For a detailed discussion, please refer to the box article entitled 'Private Investment in Malaysia: Drivers and Sustainability".

growth of high value-added exports in the future. In the near term, it is expected that the expansion in investment activity will contribute to a further narrowing in the current account surplus.

The high level of savings by the corporate sector and households is attributable to two main factors. First, corporate profits have increased following sustained external demand for resource-based products, especially prior to the GFC. Second, mandatory contributions to the Employee Provident Fund, coupled with sustained wage growth, have supported household savings. Going forward, the savings rate is expected to remain elevated amid firm income growth.

As for the public sector[4], the savings-investment gap registered a small surplus, averaging 3.2% of GNI[5], in 2003-2008 (Chart 9). This surplus has turned into a deficit since 2009, when public expenditure increased significantly following the introduction of the two economic stimulus packages by the Federal Government to mitigate the impact of the global economic slowdown. The sustained capital spending by public enterprises have also contributed to the expansion in public investment. The public sector savings-investment gap widened in 2011 and 2012.

Going forward, given the Government's fiscal consolidation efforts through expenditure rationalisation and improvements in revenue collection, savings of the Federal Government are expected to remain firm. The operating surpluses of the public enterprises, however, would depend mainly on the strength of the recovery in the global economy and the resilience of domestic demand.

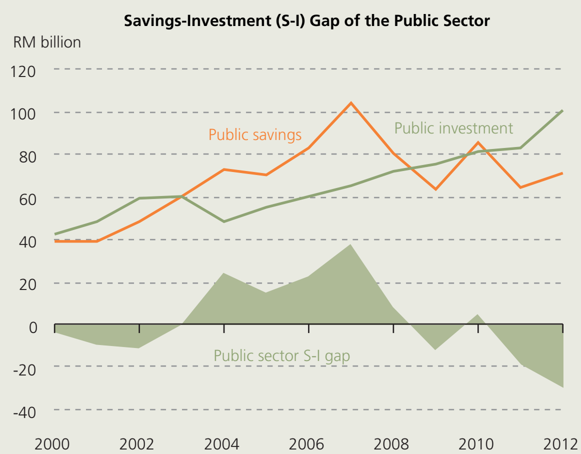
Conclusion

The recent narrowing of the current account surplus in Malaysia and several other Asian countries is consistent with the ongoing global rebalancing, underpinned by shifts in the sources of growth in the regional economies. For Malaysia, resilient domestic demand has supported the strong growth of imports, in turn outpacing exports which has been weighed down by weak external demand and lower commodity prices. Similarly, the stronger growth in investment activity and lower savings have resulted in a narrower current account surplus.

Going forward, amid a modest recovery in global growth and the continued expansion in domestic demand, Malaysia's current account surplus can be expected to narrow in the near term. As a highly open economy, changes in Malaysia's current account, particularly exports, will be highly dependent on factors that are exogenous to the economy. On the domestic front, the ongoing fiscal consolidation by the Government is expected to improve public savings, while private savings will be a function of the strength of private consumption. Over the longer term, the ongoing structural changes in the economy will be a key factor in determining the future path of Malaysia's current account balance. The continued investment in new growth areas and high value-added industries is expected to further diversify Malaysia's exports and enhance its areas of comparative advantage, thereby supporting export growth and the sustainability of the current account balance.

Chart 9

Public Savings Declined Amid Continued Rise in Public Investment



Source: Department of Statistics, Malaysia

[4] Public sector refers to the General Government and public enterprises.
[5] Public sector registered a deficit of 2.2% of GNI in 2000-2002.

the ETP projects and continued inflows into the consumer-related sectors. The diversified profile of the FDI inflows had facilitated to contain Malaysia's exposure to external risks. While the export-oriented manufacturing sector continued to be the largest recipient of FDI (58% of gross FDI inflows), the mining sector increased its share of FDI inflows to 13%. The services sector received 28% of the gross inflows of FDI in 2012.

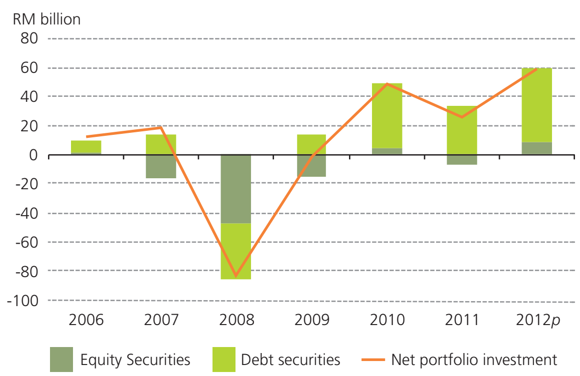
After a period of significant outflows in the second half of 2011, inflows of foreign portfolio funds resumed in 2012, registering significantly higher net inflows during the year (RM59.2 billion; 2011: RM25.8 billion). These inflows reflected mainly higher purchases of debt securities, particularly Bank Negara bills and notes and ringgit-denominated Government bonds. Net foreign inflows into equities remained modest.

Notwithstanding the higher net inflows of portfolio funds, there was a significant degree of volatility in these flows during the year, particularly in relation to events surrounding the European debt crisis. Market sentiments were also partly affected by economic developments in the US and China, amidst uncertainty on the pace of the sluggish US recovery and the fiscal cliff, and concerns over the economic outlook in China. In the first quarter of the year, improved market sentiments brought about a significant resumption of foreign capital inflows, particularly into ringgit-denominated debt securities. However, in the second quarter of the year, portfolio investments registered a small net outflow arising from the liquidation of short-term debt securities by non-residents, which was in response to the deterioration in financial market sentiments following concerns over the health of the Spanish banking system. Nonetheless, portfolio inflows resumed strongly in the second half of the year as investor sentiment recovered. Beyond Malaysia's favourable growth prospects and sound macroeconomic and financial conditions, the higher inflows of portfolio funds were also driven by investors' continued search for higher returns amidst the expansive global liquidity conditions following the additional monetary policy easing by the advanced economies. To a lesser extent, expectations for a further appreciation of the regional currencies were also a contributing factor to these capital inflows.

It is noteworthy that the non-resident inflows were offset by resident outflows through two main channels, namely via higher direct investment abroad (DIA) and outflows from the Other Investment account. DIA outflows amounted to RM51 billion in 2012 (2011: -RM46.7 billion), mainly reflecting higher outflows of equity capital and extensions of loans to subsidiaries abroad. DIA were mainly undertaken by companies in the services sector (60% of gross DIA outflows), particularly in the finance and insurance, and wholesale and retail trade sub-sectors. Companies in the oil and gas and manufacturing sectors also continued to be large contributors of DIA. Compared to its steady trend in the past, the relatively higher DIA was largely due to a one-off strategic acquisition of a Canadian-based energy company by a domestic oil and gas firm. Profitability of these investments abroad was sizeable during the year given that the bulk of investments was undertaken in the Asian emerging economies,

Chart 1.14

Portfolio Investment

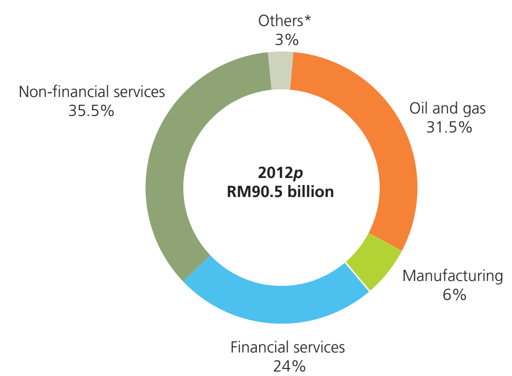


p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.15

Gross DIA Outflows by Sectors



* Refers to agriculture and construction sectors
p Preliminary

Source: Department of Statistics, Malaysia

where economic growth and business activity remains resilient.

Outflows from Other Investment reflected primarily outflows arising from continued net extensions of trade credits. The relatively stronger balance sheet positions continued to enable Malaysian exporters to extend trade credits to counterparts abroad amidst the weak global environment. There were also considerable outflows arising from the domestic banking institutions that placed assets abroad with foreign counterparties. This reflected the banks' liquidity and asset-liability management strategies, amid an environment of ample liquidity within the domestic financial system.

International reserves increased further and provided an adequate buffer against external shocks

The international reserves of Bank Negara Malaysia increased by RM3.9 billion to RM427.2 billion (equivalent to USD139.7 billion) as at 31 December 2012. The increase reflected the continued current account surplus, which more than offset net capital outflows. It has also taken into account the cumulative unrealised foreign exchange revaluation loss of RM7.7 billion, following the strengthening of the ringgit against selected major and regional currencies in 2012.

As at 28 February 2013, the reserves level amounted to RM429 billion (equivalent to USD140.3 billion), which is adequate to finance 9.5 months of retained imports and is 4.6 times the short-term external debt.

External debt declined

Malaysia's external debt declined to RM252.8 billion (USD81.7 billion) as at end-2012 (2011: RM257.4 billion), equivalent to 28% of GNI (2011: 30% of GNI). During the year, the medium- and long-term external debt of the private sector increased. This, however, was largely offset by net repayment of the public sector's medium- and long-term external debt and net repayment of short-term interbank borrowings. The appreciation of the ringgit against some of the major currencies during the year also contributed to the lower external debt in ringgit terms.

Overall, Malaysia's external debt profile continued to be skewed towards a longer maturity structure, with medium- and long-term debt accounting for 63.2% of total external debt. The debt service ratio remained manageable at 10.2% of exports of goods and services. Moreover, about two-thirds of 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, with more flexible terms.

Malaysia has greater latitude to effectively manage external risks

As a small and highly open economy, Malaysia is not insulated from the risks arising from the more challenging global economic landscape. Nevertheless, the resilience of Malaysia's external sector has accorded the country with greater policy flexibility in managing external shocks. The prudent macroeconomic management and policy reforms that have been implemented over the years has strengthened Malaysia's macroeconomic fundamentals and enhanced its growth prospects, while a wider range of money market instruments at the disposal of the Bank has allowed for a more effective conduct of monetary policy. The managed float exchange rate regime has also continued to

Table 1.8

Outstanding External Debt

	2011	2012*p*	2011	2012*p*
	RM billion	RM billion	USD billion	USD billion
Total debt	**257.4**	**252.8**	**80.4**	**81.7**
Medium- and long-term	153.5	159.8	48.0	51.7
Short-term[1]	103.9	93.0	32.4	30.1
As % of total debt	*40.4*	*36.8*		
As % of net international reserves	*24.5*	*21.8*		
As % of GNI				
Total debt	30.0	28.0		
Medium- and long-term debt	17.9	17.7		
As % of exports of goods and services				
Total debt	31.9	30.8		
Medium- and long-term debt	19.0	19.5		
Debt service ratio (%)[2]	**10.3**	**10.2**		

[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

Changing Drivers of Economic Growth in Malaysia

Introduction

Malaysia has witnessed strong sustained growth over the last three decades, growing at an average annual rate of 5.8%. This sustained growth performance has been accompanied by significant structural shifts in the economy, reflecting the transformation of the Malaysian economy amid the changing global and domestic environment. From a primary producer with a gradual industrialisation strategy, the Malaysian economy has undergone transformation into a highly-open economy through greater trade and financial integration since the late 1970s. As a result, Malaysia's trade openness is among the highest in the region, reaching a peak of 192% of GDP in 2000. More recently however, strengthening domestic demand has become a key driver of growth, underpinning the continued resilience of the economy despite the challenging external environment.

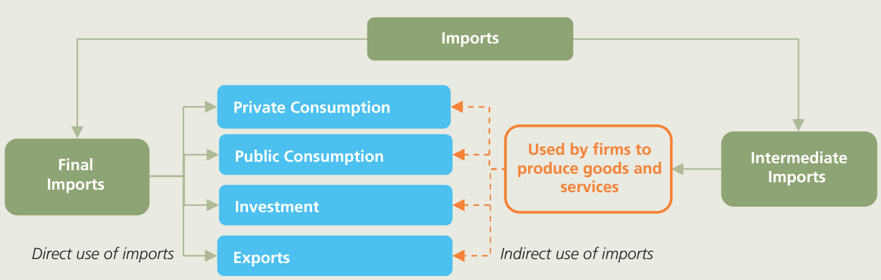
This article aims to shed light on the structural changes in the Malaysian economy in terms of the drivers of its growth. The analysis finds quantitative evidence that while Malaysia remains a highly-open economy, domestic demand has increasingly become an important driver of growth in recent years. This has in turn induced structural changes within the economy, with stronger growth and job creation in the domestic-oriented industries.

Methodology: An Alternative Approach in Estimating the Contribution to Growth

Demand in the economy takes two forms: Domestic demand (private consumption, public consumption and total investment) and external demand (exports). Imports, on the other hand, represent a leakage from the economy. For example, a good that is consumed domestically could be directly imported or produced domestically but contain imported content used in its production (Chart 1). These imports help satisfy domestic demand but do not themselves represent value-added by domestic industries. Domestic demand and exports contain varying degrees of import content which must therefore be subtracted from each of the demand components to better understand their net contribution to the economy.

Chart 1

Final Use of Imports



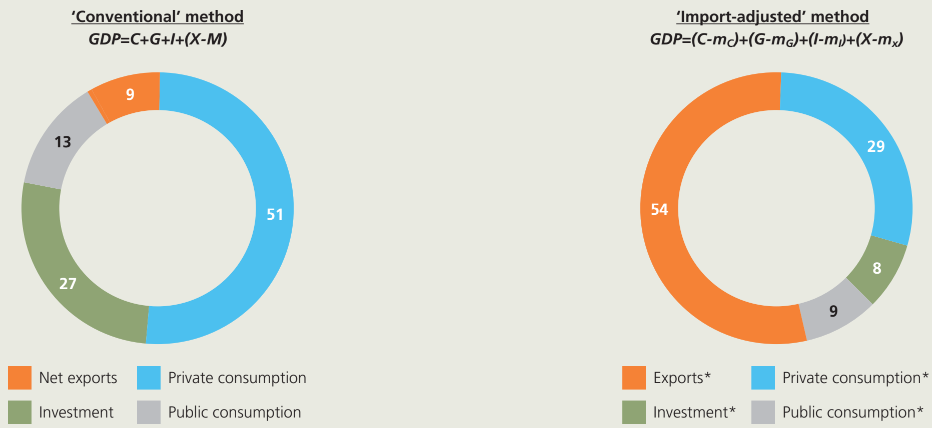
In determining the sources of growth, the quick conventional method is to use private consumption, investment, public consumption and net exports as a share to GDP. The advantages of this approach lie in its simplicity and the fact that net exports immediately highlight the net contribution of foreign trade to economic growth. However, a limitation of this method is that it is not representative of the true relative contribution of domestic and external demand in driving growth. Imports that help satisfy domestic demand are not netted out from domestic demand, overstating the true impact of domestic demand on domestic value-added.

For a more accurate estimation of the net effect of each demand component on value-added, it is necessary to remove, from each component of demand, its import content. In essence, this can be done by decomposing total imports according to the expenditure component that they were eventually intended for. The input-output cumulative production structure[1] (CPS) technique estimates the import content of the goods and services associated with each component of final demand for the economy. The difference between a particular final demand component and its import content is used to derive the net contribution of each demand component to overall GDP. For example, the net contribution of private consumption to GDP is private consumption minus both final imports for consumption and intermediate imports used by domestic firms to produce goods and services that are consumed. Chart 2 compares the conventional method and the import-adjusted method, highlighting the differences in interpretations of the role of domestic demand when each method is used.

Chart 2

Comparison between Import-Adjusted GDP by Expenditure Component with Conventional Practice

(%, share of GDP in 2012)



*Net of imports

Where C= private consumption, G= public consumption, I= investment, X= exports, M= total imports, M_C= imports for C, m_G= imports for G, m_I= imports for I, and m_X= imports for X

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Results: Transformation of the Malaysian Economy

1970s to early 2000s: Towards a more export-oriented economy

Applying the import-adjusted method to the various components of demand in the economy[2], there is a clear indication that within three decades, the Malaysian economy had become increasingly open. Chart 3 shows the evolution of the net contribution of each demand component to GDP since 1978. The net contribution of exports to GDP almost doubled from 36% in 1978 to 61% in 2005. In other words, by 2005, external demand accounted for 61% of domestic value-added created in the economy. This increasing openness meant that the Malaysian economy was more dependent on international demand in 2005 than it was in the 1970s.

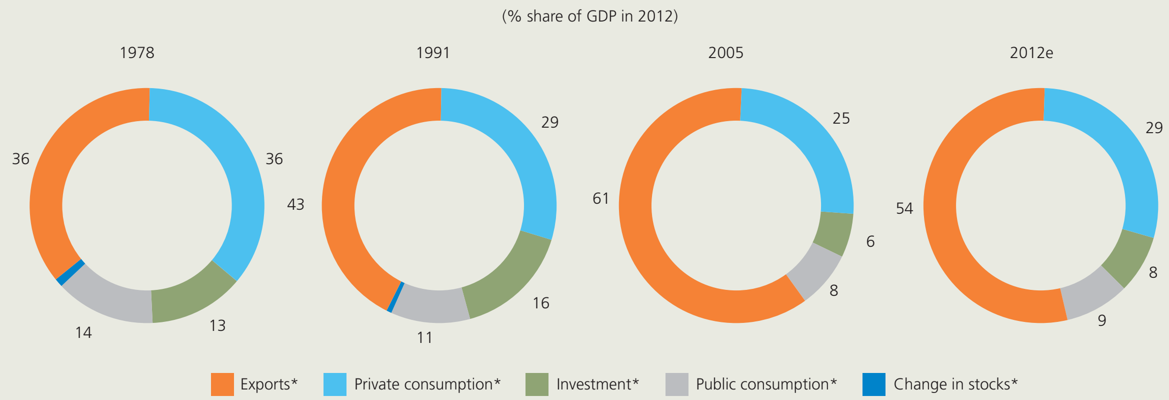
Mid-2000s to present: Emerging strength of domestic demand

Since 2005, domestic demand has emerged as an increasingly important driver of growth. Estimates for 2012 in Chart 3 suggest that the net contribution of exports to GDP has fallen to 54% while domestic demand has increased to 46%. To further analyse this trend, the import-adjusted method is extended[3] to estimate the net contributions of domestic and external demand to GDP from 2005

[1] Klein, 1983.
[2] Using input-output tables published by the Department of Statistics, Malaysia for the years 1978, 1991 and 2005.
[3] Based on Kranendonk and Verbruggen, 2005, 2008.

Chart 3

Evolution of Malaysia's GDP by Import-adjusted Components



* Net of imports

e Estimates based on 2005 Input-Output table

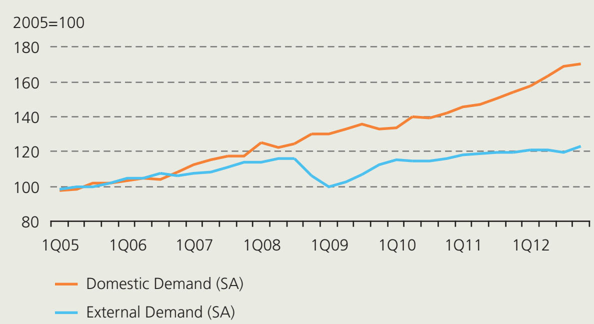
Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

onwards (Chart 4). Chart 4 depicts the strength of domestic demand which began to gain momentum in 2007, even before the external sector was affected by the financial crisis in the advanced economies. Since the crisis, it is evident that the growth of domestic demand has strengthened significantly while the performance of external demand has remained sluggish. From an overall growth perspective, the relative resilience of domestic demand has partly cushioned the economy from the adverse effects of the slowdown in exports.

The net contribution of each demand component to the growth of domestic value-added is estimated in Chart 5 using the import-adjusted method. Private consumption has played an increasingly important role in driving growth, particularly since late 2006 while investment has recorded markedly higher contributions to growth since 2011.

Chart 4

Net Contribution of Domestic and External Demand to GDP



CAGR,%	2005-06	2007-08	2009-10	2011-12
Domestic demand	4.8	9.2	5.2	9.1
External demand	5.6	3.2	1.0	2.5

Source: Bank Negara Malaysia estimates

Real GDP has continued to record an annual growth of over 5% since 2011, with domestic demand growing at a compounded annual growth rate of 9.1%, contributing a significant 74% of GDP growth. These trends all point to domestic demand emerging as a key source of growth in recent years.

Chart 5

Net Contributions to Growth by Expenditure

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Implications: Structural Changes in Industries

The changing drivers of demand can lead to structural shifts in the economy as industries respond to the changing sources of demand. Given that a key source of demand is from the domestic market, industries that are domestic-oriented are likely to grow faster than export-oriented industries. Profitability of domestic-oriented firms will increase, attracting new firms and encouraging existing firms to expand capacity. Resources will shift towards these industries, leading to structural changes in the economy as firms respond to meet this new source of demand.

To verify this hypothesis, the domestic orientation of an industry is estimated. Input-output coefficients allow the estimation of the proportion of output of an industry that is consumed domestically (final goods and services) or indirectly used as an intermediate good for goods and services consumed domestically.

Table 1

Domestic Orientation of Industries

Sector	Domestic share (%)
Agriculture	**33.7**
Mining	**19.2**
Manufacturing	**19.3**
E&E-related industries	*6.7*
Primary-related industries	*21.6*
Consumer-related industries	*36.7*
Construction-related industries	*31.6*
Construction	**87.1**
Services	**52.9**
Wholesale and retail trade	*34.5*
Hotels and restaurants	*92.5*
Transportation	*41.0*
Communication	*59.4*
Finance and Insurance	*37.7*
Other services	*70.7*

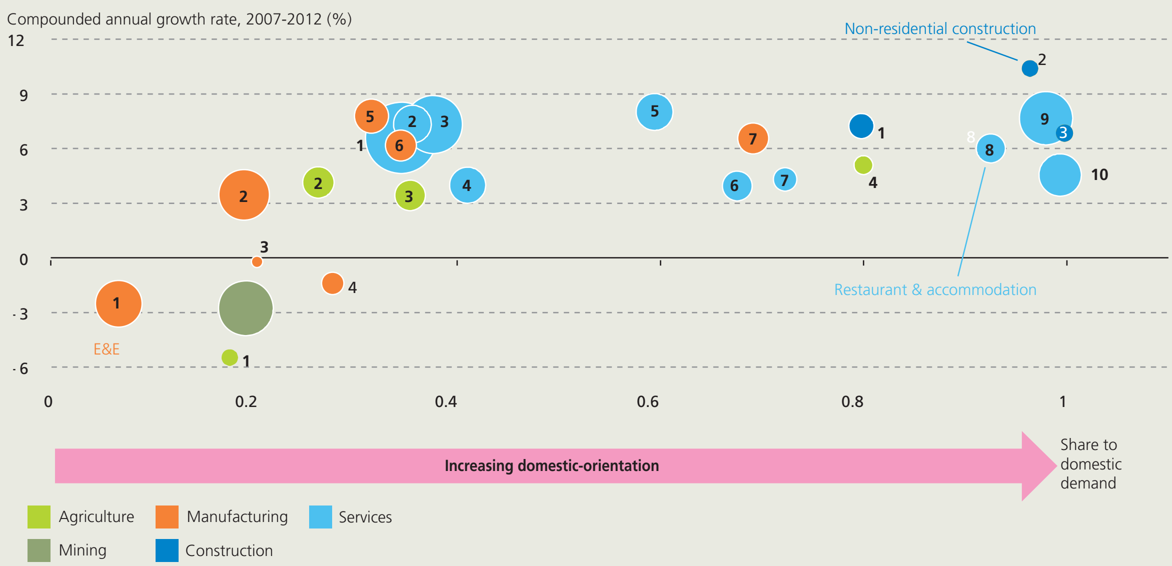
Source: 2005 Input-Output tables and Bank Negara Malaysia estimates

These estimates reveal the proportion of an industry's value-added that relies on domestic final demand. From Table 1, it can be seen that manufacturing and mining are more export-oriented while construction and services are more domestic-oriented.

Chart 6 plots the domestic orientation of sub-sectors in the economy against the average growth rate of each industry sub-sector between 2007 and 2012. As predicted, industry sub-sectors that are more domestic-oriented performed relatively better than those that are more export-oriented. There appears to be a positive correlation between the domestic orientation of an industry and its growth in 2007-2012. Of significance, the electrical and electronics manufacturing sector (export-oriented) experienced an average contraction of 2.5%, although industries catering to regional demand (construction-related and food and beverage manufacturing) had continued to record strong growth[4]. Meanwhile, the non-residential construction and accommodation and restaurant sectors (domestic-oriented) experienced strong growth of 10.4% and 6.0% respectively.

Chart 6

Faster Growth in Domestic-Oriented Industries



*The bubble size represents the relative size of value-added of the industry[5] in 2012

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

The performance of the domestic-oriented sectors has in turn supported favourable employment conditions, with the unemployment rate remaining stable at about 3%. The strength of domestic-oriented sectors has more than offset the weakness in the export-oriented sectors. This has allowed for sustained job creation, especially in the domestic-oriented sectors, and supported income growth over the last few years.

4 Mining recorded a contraction due to depleting oil reserves that have affected production.

5 Agriculture: 1=Forestry & logging, 2=Others, 3=Oil palm estate, 4=Fishing ; Manufacturing: 1=Electrical & Electronics, 2=Petroleum, chemical, rubber and plastic products, 3=Textiles products, 4=Wood products 5=Construction-related products, 6=Food, beverage and tobacco, 7=Transport equipment ; Services: 1=Wholesale and retail trade, 2=Business services, 3=Finance and insurance, 4=Transport and storage, 5=Communication, 6=Utilities, 7=Real estate, 8=Restaurants and accommodation, 9=Government services, 10= Others; Construction: 1=Civil Engineering, 2=Non-residential, 3=Residential.

Conclusion

Over the last few years, domestic demand has emerged as a key driver of growth. Private consumption and total investment have been resilient, enabling the economy to expand despite the sluggish performance of exports. Growth and employment have been supported by the domestic-oriented sectors, offsetting the weakness in export-oriented industries. In part, this has been achieved following years of structural reforms and sound economic policies.

Nevertheless, Malaysia remains a highly-open economy for which exports are a key source of demand. Therefore, investing strategically in the right growth industries is crucial to ensure that Malaysia is well-positioned to leverage on new opportunities in the changing global landscape. Encouragingly, export products and markets have become increasingly diversified, orientated towards new growth industries and fast-growing regional economies. This has enabled Malaysia to move up the value chain while capitalising on global growth centres.

Going forward, creating strong, sustainable and balanced growth would entail further reforms. Sustainable growth must be underpinned by productivity improvements and innovation, enabling the transition into a higher value-added and higher-income economy. Recent measures such as the introduction of the minimum wage policy and further liberalisation in selected industries will incentivise this transition, contributing to higher incomes, which would in turn support sustained growth in consumption. Developing a comprehensive social safety net, which includes improvements to the pension and healthcare systems, together with continued efforts to promote financial inclusion, will alleviate the need for precautionary savings and raise consumption. Success in sustaining the magnitude and quality of investments will depend on the progress of structural reforms, continuous financial sector development, favourable business conditions and the availability of skilled labour. These reforms, coupled with diversification in export markets and products, will have to continue to ensure sustained growth going forward.

Reference

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provide the necessary flexibility for the exchange rate to adjust to changes in the external conditions over the medium term. Furthermore, continued current account surpluses, sufficiently high level of reserves, coupled with sizeable liquid foreign assets in the banking sector, also provide additional buffer against any external shocks to the economy.

PRICE DEVELOPMENTS

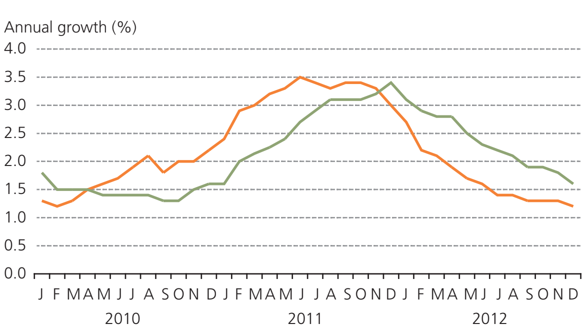
Consumer prices

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 1.6% in 2012 (2011: 3.2%). Headline inflation moderated substantially in the first half of the year, from 2.7% in January to 1.6% in June, and subsequently stabilised at 1.3% in the second half of 2012. For the year as a whole, headline inflation was below the expected range of 2.5-3.0%, due mainly to better-than-expected domestic food supply conditions and lower-than-expected inflation in the *transport* category. Subdued global price pressures arising from slower global growth and base effect from higher inflation in the previous year also contributed to lower inflation during the year. Core inflation, an indicator of demand-driven price pressures, moderated to 2.4% in 2012 (2011: 2.7%).

The moderation in inflation was broad-based and was observed across most CPI categories. Only two CPI categories registered slightly higher inflation in 2012, namely *furnishings, household equipment and routine household maintenance* and *education* (2012: 2.0% and 2.4% respectively; 2011: 1.9% and 2.2% respectively). The main contributors to lower inflation in 2012 in terms of the CPI categories were the *food and non-alcoholic beverages* and *transport*, which together accounted for 78.5% of the overall decline in inflation during the year. Inflation in the *food and non-alcoholic beverages* category moderated to 2.7% (2011: 4.8%), mainly on account of a decline in the prices of meat and vegetables. The moderation in inflation in the *transport* category to 0.7% (2011: 4.4%) was due to the absence of adjustments to most fuel prices and the lower price of RON97 petrol. As a result of the lower inflationary pressures during the year, a more significant share of the CPI components recorded an inflation rate of less than 2% in 2012 (2012: 66.3% of the CPI components; 2011: 55.9%).

Chart 1.16

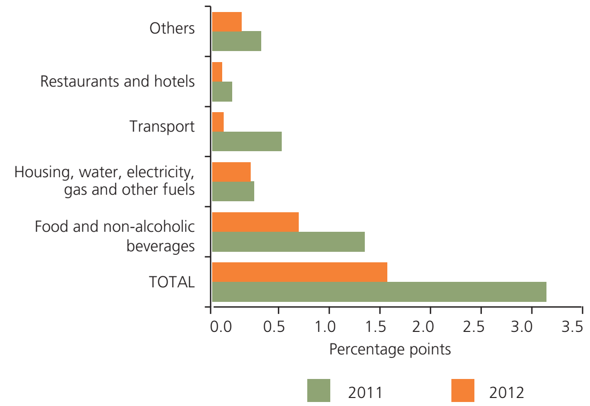
Consumer Price Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.17

Contribution to Inflation



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

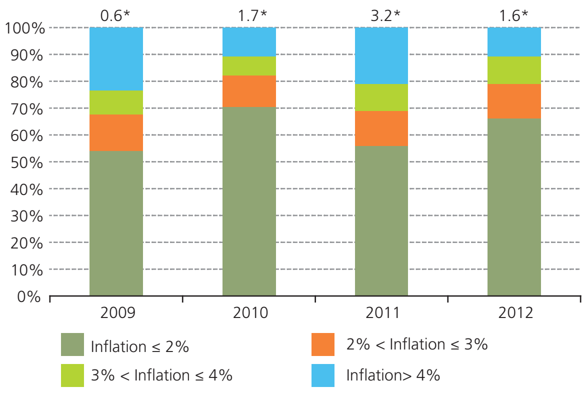
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The moderation in inflation during the year was driven mainly by supply factors. First, external price pressures were more modest in 2012 due to more moderate increases in global energy prices and lower global food prices. While global crude oil prices were affected by bouts of volatility due to geo-political tensions in the Middle East and North Africa, average oil prices for the year as a whole remained stable, increasing only slightly from the previous year[1]. The modest increase in global crude oil prices reflected excess supply of oil due to higher

[1] The price of Brent crude oil averaged at USD112 per barrel in 2012 (average 2011: USD111 per barrel).

Chart 1.18

Percentage of CPI Components Above Specified Threshold

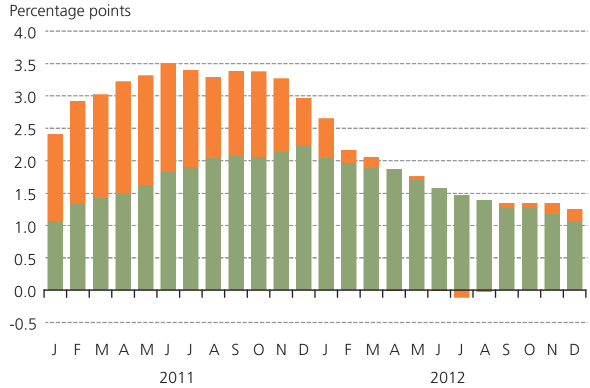


* Headline inflation

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.19

Demand-related and Supply-related Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

production and lower global demand. Global food prices were lower in 2012 compared to the previous year, despite the increases in prices of selected food commodities, such as corn and wheat, in the second half of the year. This was partly due to high stockpiles of most food commodities, especially in the first half of the year, amid weak global demand.

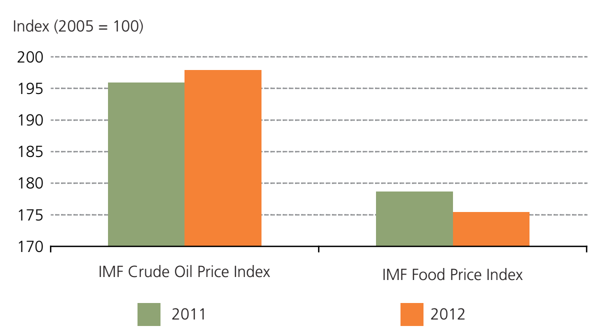
Malaysia's key import partners also experienced lower inflation during the year due to the more moderate global energy and food prices and slower growth in domestic demand in some of these economies. Overall, the softer global commodity prices and subdued inflationary pressures from Malaysia's key import partners coupled with continued ringgit appreciation reduced the direct and indirect external cost-related pressures on consumer prices.

Second, there were significant improvements in domestic food supplies during the year, resulting in lower food prices. In the poultry industry, amid stable feed prices, producers increased production of chicken due to expectations of higher demand for chicken. The actual outcome was an oversupply of chicken and eggs. The domestic supply of vegetables was also higher-than-expected, due to the opening of new farms and better weather conditions. The lower prices of meat and vegetables in turn helped to ease price pressures in the other food-related categories. Inflation in the *food away from home* sub-category, for example, moderated to 3.7% in 2012 (2011: 4.6%).

Third, the lower inflation was also due to the base effect following the sharp increase in the CPI during the previous year. In 2011, food prices rose sharply due to the increase in the price of chicken arising from higher feed prices, and higher vegetable prices due to poor domestic harvests and labour shortages. These factors, however, dissipated in 2012. There were also various one-off price adjustments in 2011 which were absent in

Chart 1.20

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)

Table 1.9

Adjustments to Administered Prices

Month	2011 Item	2011 Magnitude of adjustment	2011 Net change	2012 Item	2012 Magnitude of adjustment	2012 Net change
January	RON97 petrol	+10 sen/litre	RON97 petrol: +50 sen/litre Sugar: +20 sen/kg			RON97 petrol: -5 sen/litre Sugar: +20 sen/kg
February	RON97 petrol	+10 sen/litre				
March						
April	RON97 petrol	+20 sen/litre		RON97 petrol	+10 sen/litre	
May	RON97 petrol Sugar	+20 sen/litre +20 sen/kg				
June	RON97 petrol	-10 sen/litre		RON97 petrol	-10 sen/litre	
July				RON97 petrol	-20 sen/litre	
August				RON97 petrol	+10 sen/litre	
September				RON97 petrol Sugar	+30 sen/litre +20 sen/kg	
October				RON97 petrol	-10 sen/litre	
November				RON97 petrol	-5 sen/litre	
December				RON97 petrol	-10 sen/litre	

2012, namely the upward revisions in electricity tariffs and an increase in charges for satellite television services in mid-July 2011. While there continued to be upward adjustments to prices of RON97 petrol and sugar in 2012, the magnitude of the adjustments in 2011, in their totality, were larger, and occurred earlier in the year compared to those in 2012.

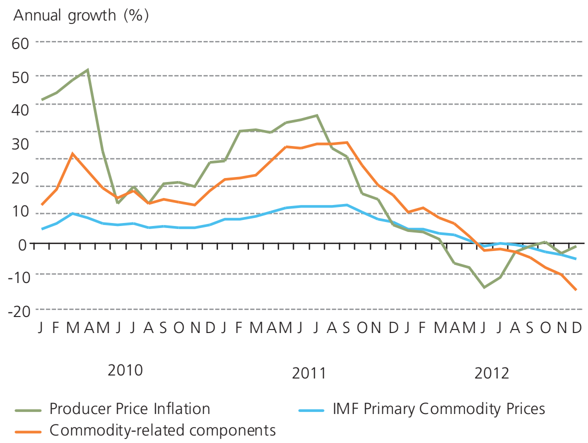
Despite strong domestic demand, demand-driven price pressures remained muted during the year for a number of reasons. While overall income continued to increase at a stable rate, efficiency gains from a stronger increase in productivity helped to attenuate demand pressures. Additionally, firms did not raise prices of goods and services by significant amounts despite strong consumption demand, as cost pressures were more subdued. To some extent, pressures on domestic prices were also alleviated through imports as reflected in the higher imports of consumption goods. Hence, core inflation, which is an indicator of demand-driven inflation, moderated in 2012.

Producer prices

Reflecting subdued cost pressures, producer price inflation, as measured by the annual percentage change in the Producer Price Index (PPI), slowed down to 0.1% in 2012 (2011: 9.0%), driven mainly by lower global commodity prices. In particular, the annual growth of commodity-related components of

Chart 1.21

Producer Price Inflation and IMF Primary Commodity Prices



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 the PPI declined significantly to -0.5% during the year (2011: 23.6%), due mainly to lower inflation in the *mineral fuels, lubricants, etc.* and *crude materials, inedible* sub-categories (2012: 7.0% and -10.3% respectively; 2011: 24.2% and 23.2% respectively). The annual growth of non-commodity related PPI components was also lower at 0.5% (2011: 2.1%). The lower producer price inflation had reduced the pressure on the operating costs of firms and, consequently, eased the pressure on consumer prices.

In terms of composition, both the local and imported components of the PPI moderated during the year. PPI for local components declined by 0.2% (2011: 12.0%), while that for the imported components increased at a slower rate of 0.7% during the year (2011: 2.3%).