2011

ECONOMIC DEVELOPMENTS IN 2011

THE INTERNATIONAL ECONOMIC ENVIRONMENT

In 2011, the global economic and financial landscape was characterised by five key trends. First, the global growth momentum moderated after the strong rebound in 2010, weighed down by increasing uncertainties surrounding fiscal issues in the advanced economies, geopolitical tensions and natural disasters. Second, these uncertainties contributed to heightened volatility in the international financial markets, while the rise in global risk aversion exerted upward pressures on safe-haven currencies. Third, commodity prices rose strongly following supply disruptions and adverse weather conditions amid sustained demand. Fourth, inflationary pressures remained elevated throughout most of the year, driven by both supply and demand factors. In particular, rising commodity prices were a key contributor to the inflationary pressures. Fifth, in response to the increasingly challenging economic environment, the stance of monetary policy in several countries shifted from policy normalisation or tightening towards accommodation to support growth.

Global growth moderated in 2011 amid heightened downside risks while inflationary pressures continued to remain elevated

Global growth moderated

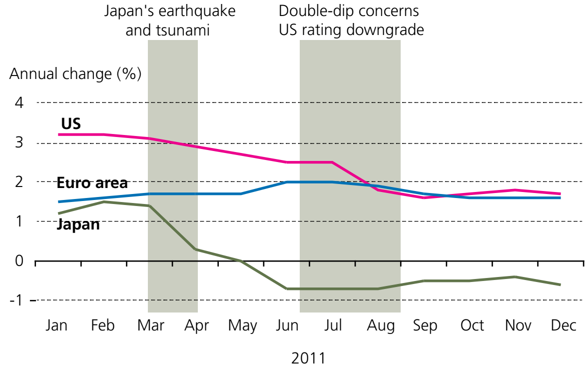
The world economy entered 2011 with expectations for healthy economic growth during the year, supported by optimism over the favourable growth performance in the fourth quarter of 2010. Adverse developments in several major economies, however, led to the continuous downward revision of global growth expectations throughout the year.

In the first quarter of 2011, most economies experienced a positive growth momentum. The Asian economies, in particular, registered better-than-expected growth underpinned by resilient domestic demand and robust intra-regional trade. In March, however, Japan's natural disasters and nuclear crisis not only resulted in power supply disruptions and infrastructure damage in Japan, but also led to significant uncertainties in manufacturing production globally, given that Japan was an essential part of the global supply chain for E&E products and automobile production. The impact of Japan on the world economy became more pronounced in the second quarter, as reflected in the moderation in trade and production activity across Asia and the subsequent slowdown in global growth. For the advanced economies, the impact of the supply chain disruptions emanating from Japan was compounded by slower improvements in labour market conditions, elevated fuel prices and rising concerns over fiscal sustainability.

In the second half of 2011, despite diminishing supply disruptions and the moderation in oil prices, the global environment became increasingly challenging. Escalation of the sovereign debt crisis in the euro area and the downgrade of the US sovereign credit rating in August had intensified the fiscal and financial stress in the advanced economies and dampened consumer and business sentiment. In the US, in particular, fears of a double-dip recession rose, as revisions to growth data indicated a slower recovery from the recession than previously envisaged. Furthermore, consumption

Chart 1.1

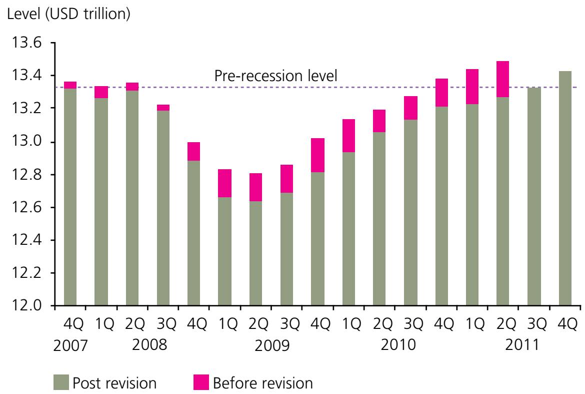
Change in 2011 GDP Forecast for Selected Advanced Economies



Source: Consensus Forecasts

Chart 1.2

Downward Revision to US Real GDP Statistics



Source: US Bureau of Economic Analysis

Table 1.1

World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2010	2011*e*	2010	2011*e*
World Growth	**5.2**	**3.8**	-	-
World Trade	**12.7**	**6.9**	-	-
Advanced Economies				
United States	3.0	1.7	1.6	3.1
Japan	4.4	-0.7	-1.0	-0.3
Euro area	1.9	1.4	1.6	2.7
United Kingdom	2.1	0.8	3.3	4.5
Emerging Asia	**9.5**	**7.9**	-	-
Asian NIEs[1]	**8.4**	**4.0**	**2.3**	**3.5**
Korea	6.2	3.6	2.9	4.0
Chinese Taipei	10.7	4.0	1.0	1.4
Singapore	14.8	4.9	2.8	5.2
Hong Kong SAR[2]	7.0	5.0	2.3	5.3
The People's Republic of China	**10.4**	**9.2**	**3.3**	**5.4**
ASEAN-4	**7.0**	**4.3**	**3.9**	**4.5**
Malaysia	7.2	5.1	1.7	3.2
Thailand	7.8	0.1	3.3	3.8
Indonesia	6.2	6.5	5.1	5.4
Philippines	7.6	3.7	4.1	4.8
India[3]	**10.4**	**7.3**	**9.6**	**9.5**

[1] Newly industrialised economies
[2] Inflation refers to composite price index
[3] Inflation refers to wholesale price index
e Estimate

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

growth remained modest, constrained by the slow recovery in job creation, continued deterioration in the housing market and lower financial wealth. This led to a sharper downward revision of US growth projections. In the euro area, growth also moderated amid weak domestic demand as private sector sentiments in both the core and peripheral economies were significantly affected by the intensification of the sovereign debt crisis. The Asian economies, meanwhile, experienced slower growth in exports and industrial production. Nevertheless, growth remained supported by sustained domestic demand in the region. Consumption, in particular, was underpinned by favourable labour market conditions, continued access to credit, rising incomes and high commodity prices. In China, growth concerns emerged in October following data releases that indicated, for the first time in a year, declining residential property prices on a month-on-month basis. This in turn, increased the risk of a more significant slowdown in China as property investment accounted for 10%-15% of the economy. Towards year-end, US growth recorded some improvements supported by rising consumption and production activity, albeit remaining modest and vulnerable to increasing risks in the global economy. Economic expansion in Asia also softened as export growth continued to moderate following the more widespread global economic slowdown.

International financial markets experienced heightened volatility

In the first half of 2011, the **international financial markets** were buoyed by the more favourable global economic outlook. This was reflected in the positive growth experienced in both major and regional equity markets, with the emerging markets continuing to experience large capital inflows. There were, however, periodic episodes of volatility following heightened geopolitical tensions in the Middle East and North Africa (MENA) region, the disasters in Japan and renewed concerns over the sovereign debt crisis, particularly with respect to the Greek sovereign debt restructuring. The latter event also increased the risk of contagion to other euro area economies with relatively weaker fiscal positions, namely Portugal, Italy and Spain. The persistent market pressure on these economies was reflected in the elevated long-term bond yields, which eventually led to the EU and IMF providing Portugal with a financial package of €78 billion in May.

Financial market conditions worsened in the second half of the year. Intensified fiscal uncertainties in the US due to the debt ceiling debate and the downgrade of the US sovereign credit rating on 5 August triggered heightened risk aversion among investors. The sovereign debt crisis in the euro area continued to spread, amid concerns about contagion to the core economies. Italy and Spain's credit ratings were downgraded in October and subsequently the long-term bond yields of the two countries rose to record highs despite the announcement of further fiscal austerity measures by the authorities. European banks with large exposures to troubled sovereign debt faced renewed funding stress towards the latter part of the year, raising concerns over potential credit disruptions with substantial contagion risk to the global financial markets.

The European leaders responded to the crisis with a second financial package plan for Greece in July, which included further financial assistance and the voluntary participation of the private sector in a restructuring of Greek debt. The plan was revised in October to include an increased role of the private sector and an expansion of the European Financial Stability Facility (EFSF) to €1 trillion from €440 billion, in part through leveraging. However, the impact of these announcements was temporary as sentiments continued to worsen, given the uncertainties surrounding the implementation of the plan. In November, six major central banks announced coordinated measures to provide liquidity support to the global financial system and mitigate strains on the supply of credit, including lowering interest rates on existing US dollar swap agreements. European leaders agreed to an intergovernmental fiscal treaty in December, aimed at improving fiscal discipline in the region. Despite some improvements following these measures, international financial market conditions remained volatile towards year-end, exacerbated by sovereign rating downgrade warnings on fifteen euro area economies, including Germany and France, by a major credit rating agency. In February 2012, following heightened investors' concerns over a Greek bond redemption in March, European leaders reached an agreement on a second financial package for Greece, which included €130 billion financial assistance and greater private sector participation. Nevertheless, financial markets remained cautious over the adequacy of the recent measures in resolving the crisis.

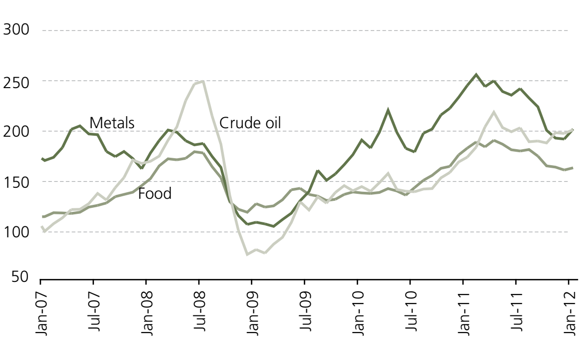
In the **foreign exchange market**, currency movements remained volatile, following heightened risk aversion in the international financial markets amid fiscal concerns in the advanced economies. In the first half of the year, most major currencies appreciated against the US dollar. Both the euro and the sterling strengthened against the dollar, supported by market expectations that the European Central Bank (ECB) and the Bank of England (BOE) would increase policy rates in view of higher headline inflation in the respective economies. The euro also benefited from investor optimism over the growth prospects of the core euro area economies, particularly Germany. However, this trend reversed in May as global risk aversion heightened on renewed concerns over the escalation of the sovereign debt crisis and emerging signs of weaker global growth. The yen continued to strengthen against the US dollar, reaching a peak of ¥76.25 in March, as market participants pushed up the yen on expectations of large repatriations of funds to Japan following Japan's natural and nuclear disasters. The surge in speculative flows subsequently led to coordinated foreign exchange intervention by the G7 economies on 18 March to curb excessive volatility in the foreign exchange markets that could potentially impinge on global financial stability. Most Asian currencies also strengthened against the US dollar in the first half of the year, amid continued capital inflows that were attracted to the region's relatively favourable growth outlook. In the second half of the year, volatility in the foreign exchange market intensified. Weak investor sentiments following prolonged concerns over fiscal sustainability in the advanced economies resulted in upward pressure on safe-haven currencies, triggering interventions by several national authorities. The US dollar appreciated against the euro, pound sterling and several Asian currencies, amid growing concerns over the sustainability of global growth and fears of a worsening debt crisis in Europe. Similarly, the yen strengthened further against the dollar, despite unilateral interventions by the Japanese authorities in August and October. The Swiss franc also appreciated sharply against the US dollar and the euro, prompting the Swiss National Bank to undertake intervention operations and to set a minimum exchange rate for the currency at CHF1.20 per euro in September. In contrast, increased risk aversion led to strong demand for liquid assets by investors, resulting in a reversal of capital flows and the depreciation of Asian currencies. The Indian rupee registered the largest depreciation among the Asian currencies in 2011, weakening by 15.6%.

Commodity prices rose to new peaks
Commodity prices rose further in 2011, reaching new peaks in April, due to supply concerns and strong demand amid continued speculative activity. Of significance, Brent crude oil prices averaged USD111 per barrel (p/b) in 2011, a 38% increase from 2010. Crude oil prices began the year with a continuation of the upward trend from the second half of 2010, supported by robust growth in the emerging economies. The Brent one-month futures price breached USD100 p/b in early February, the highest level since September 2008, as concerns mounted over possible supply disruptions following political unrests in the MENA region. In particular, the disruption in Libyan oil production reduced the supply of high-quality sweet crude oil, used in the production of gasoline, diesel and jet fuel. To alleviate this, the International Energy Agency announced in June the release of 60 million barrels (or 2 million barrels per day) from the emergency stockpiles of its member countries, the third time such a measure has been taken in more than three decades. This uptrend in crude oil prices was, however, reversed in August following the resumption of oil production in Libya. Nevertheless, continued political tension in the MENA region towards the end of the year kept crude oil prices at elevated levels. Non-energy prices surpassed the peaks recorded in 2008, as evidenced by the record-high prices of food and metals. Food price increases were largely triggered by weather-related production shortfalls, with prices peaking in April.

Chart 1.3

Indices of Primary Commodity Prices

Index (Jan '05 = 100)



Source: International Monetary Fund

Global inflationary pressures remained elevated
Inflationary pressures increased during the year in both the advanced and emerging economies, underpinned by higher food and energy prices. This upward trend was reflected in core inflation, with country-specific factors playing a role. In the US, the rise in core inflation reflected mainly the rising cost of rent and apparels. In the UK, headline inflation was sustained above the BOE's target of 2% while the rise in core inflation was due largely to the increase in VAT and to a certain extent, the depreciation of the pound sterling. Nevertheless, underlying inflationary pressures in the advanced economies remained subdued and longer-run inflation expectations were stable, underscoring the low levels of resource utilisation and weak domestic demand. Price increases were more pronounced in the emerging economies, given the larger share of commodity-related products in their consumption baskets. In Asia, the weightage of food in the CPI basket ranges from 14% to 39%. Core inflation also trended up in several regional economies, reflecting rising demand pressures on account of favourable employment conditions and rising wages. Towards the latter part of the year, the upward momentum of price increases slowed, and headline inflation rates started to stabilise in both the advanced and the emerging economies, reflecting in part the slower increases in commodity prices. Core inflation continued to increase in several Asian economies as demand remained strong. In Thailand, core inflation rose through November, reaching the upper limit of the central bank's target range of 0.5%-3.0% as domestic demand continued to expand amid fiscal stimulus by the newly-elected government.

Monetary policy focus shifted from inflation to growth
The **monetary policy** stance in both the advanced economies and Asia was initially focused on inflationary concerns, but subsequently shifted towards supporting growth as the year progressed. In the US, with rising downside risks to the growth outlook, the Federal Reserve (the Fed) indicated in August that it will keep the federal funds rate at exceptionally low levels through mid-2013. This was then extended until late 2014 in January 2012. In September, the Fed announced a maturity extension programme, which consisted of purchasing USD400 billion

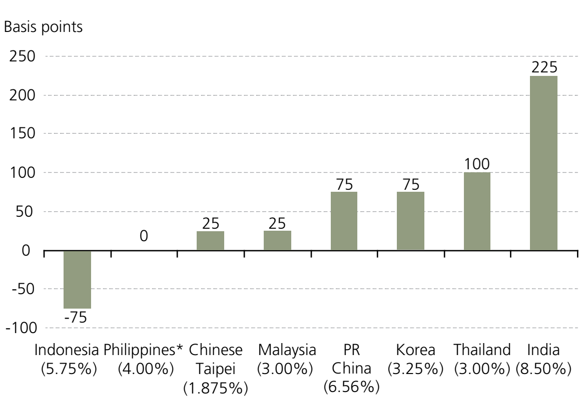
of longer-term Treasury securities, while selling an equivalent amount of short-term securities to keep long-term interest rates low and thereby, support a stronger pace of recovery. In the UK, in view of the weak economic recovery, the BOE maintained its policy rate at 0.5%, but increased its asset purchase programme by £75 billion in October, and a further £50 billion in February 2012 to a total size of £325 billion.

In contrast, rising inflationary pressures in the euro area prompted the ECB to increase its refinancing rate by a cumulative 50 basis points (bps) to 1.5% by July. However, amid heightened strains in the financial market and increasing downside risks to the economic outlook in the second half of the year, the ECB lowered its refinancing rate back to 1% by December. In addition, the ECB embarked on additional credit support measures, which included the introduction of 3-year refinancing operations and a €40 billion covered bond purchasing programme in order to provide liquidity to the banking sector and support lending activity in the region.

The Bank of Japan (BOJ) undertook comprehensive monetary easing measures to support its domestic economy, which included expanding its asset purchase programme by ¥20 trillion in 2011, and a further ¥10 trillion in February 2012. This was conducted mainly through the purchases of Japanese government bonds. In response to the disasters in Fukushima, the BOJ also established a ¥1 trillion loan programme for financial institutions in the areas affected by the earthquake and tsunami.

Chart 1.4

Cumulative Movements of Policy Rates since 2011



Note: Current policy rates in parentheses, as at mid-March 2012

* Bangko Sentral ng Pilipinas raised its key policy rate by 50bps in 2011 and lowered by 50bps in 2012

Source: National authorities

In the Asian region, central banks were largely biased towards monetary policy normalisation or tightening, particularly in the first half of 2011. Rising inflationary pressures prompted most regional central banks (Thailand, Indonesia, India, PR China, Korea, Philippines, and Chinese Taipei) to cumulatively increase benchmark interest rates by 12.5 bps to 125 bps in the first half of 2011. Several monetary authorities also adopted macroprudential measures to mitigate the adverse impact of large portfolio capital inflows on domestic asset prices. However, towards the final quarter of the year, central banks in the region began to shift focus towards supporting growth amid heightened uncertainty in the global economy. Indonesia and the Philippines eased monetary conditions amid increasing signs of a global economic slowdown and moderating domestic inflation. Similarly, Thailand reduced its key policy rate to mitigate the severe impact of flooding. The People's Bank of China reduced its reserve requirement ratio by a total of 100 bps to 20.5% in November 2011 and February 2012. Other central banks in the region were also more cautious in making policy pronouncements. This was reflected by the downgrades of the central bank's assessments on domestic growth prospects, while maintaining current policy rates in view of high inflationary pressure.

THE MALAYSIAN ECONOMY

Despite the challenging international economic environment in 2011, the Malaysian economy recorded a steady pace of growth of 5.1% (2010: 7.2%). Growth was more moderate in the first half of the year, particularly in the second quarter, as the economy was affected by the overall weakness in the advanced economies and the disruptions in the global manufacturing supply chain arising from the disaster in Japan. Although the global economic environment became increasingly more challenging and uncertain in the second half-year, Malaysia's economic growth improved due to stronger domestic demand. Domestic demand registered a higher growth in 2011, driven by both household and business spending, and higher public sector consumption. Private consumption strengthened in 2011, supported by broad-based income growth, following the improvement in the overall labour market conditions. In addition, civil servants benefited from the two half-month bonus payments in the second half of the year, while households in the rural area benefited from the higher rubber and palm oil prices.

Private investment remained firm, although growth moderated slightly in the second half-year, as the external environment became more uncertain. Public consumption also recorded a higher growth in 2011, in tandem with the Government's efforts to improve public delivery services. However, public investment contracted during the year following the lower disbursement of development expenditure by the Federal Government. Investment by the non-financial public enterprises (NFPEs), nevertheless, remained strong during the year. While the external demand for electronics and electrical (E&E) products was affected by the weaker global trade, exports of commodities and non-E&E products remained strong throughout the year, providing additional support to growth.

The Malaysian economy recorded a steady pace of growth of 5.1% in 2011, despite the more challenging external environment

The strong expansion in domestic demand was a key factor in driving the overall growth of the domestic-oriented sectors, while firm regional demand provided support to the commodity-related manufacturing industries and the agricultural sector. The services sector grew strongly in 2011 and remained the largest contributor to growth. The robust expansion in private consumption had provided support to the wholesale and retail trade, and accommodation and restaurant sub-sectors. The manufacturing sector expanded at a much slower pace amid weaker performances in both the export- and domestic-oriented industries. The former was mainly on account of softer external demand and disruptions in the global E&E supply chain, while the latter was due mainly to the contraction in the transport equipment industry following the supply-chain disruptions. Higher production of palm oil had contributed to the stronger growth in the agricultural sector, while the construction sector moderated following the completion of several major projects. The mining sector contracted in 2011, as the output of crude oil and condensates was affected by the shutdown of several production facilities.

Headline inflation averaged at 3.2% in 2011 (2010: 1.7%). The increase in inflation, particularly during the first half of the year, was due mainly to supply factors arising from higher food prices and upward adjustments to administered prices. Inflation peaked in June at 3.5% and trended lower in the second half of 2011, as the impact from the upward adjustments on the prices of petroleum products and sugar in July and December 2010 wore off. Core inflation, an indicator of demand-driven pressures on prices, rose to 2.6% in 2011 (2010: 1.5%).

Malaysia's external position improved in 2011. The overall balance of payments turned around to record a strong surplus as the current account surplus widened and the financial account turned positive. The larger surplus in the trade account, arising mainly from the strong commodity exports which largely benefited from the higher prices, and a lower deficit in the income account, had contributed to the wider surplus in the current account. The positive balance in the financial account was largely attributable to the continued inflows of portfolio funds and foreign direct investment (FDI). Direct investment abroad registered a higher net outflow as the Malaysian companies continued to expand businesses abroad. Other investment outflows, primarily comprising of trade credits and banking flows, moderated sharply during the year. After adjusting for the errors and omissions, the overall balance of payments recorded a large surplus of RM94.7 billion. Consequently, the net international reserves of Bank Negara Malaysia amounted to RM423.3 billion, equivalent to USD133.6 billion, as at 31 December 2011.

DOMESTIC DEMAND CONDITIONS

Domestic demand registered a strong growth of 8.2% in 2011 (2010: 6.3%), driven by both household and business spending, and higher public sector consumption.

Private consumption strengthened in 2011, growing by 6.9% compared to 6.5% in 2010. This was evident in the strong performance of major consumption indicators such as imports of consumption goods, retail sales and credit card spending. Consumer spending was driven by broad-based income growth as overall labour market conditions improved with the unemployment rate declining and job vacancies increasing. A survey conducted by Bank Negara Malaysia indicated that the average salary in the

Table 1.2a

Malaysia - Key Economic Indicators

		2009	2010	2011*p*	2012*f*
Population (million persons)		27.9	28.3	28.6	28.9
Labour force (million persons)		12.1	12.4	12.6	12.9
Employment (million persons)		11.6	12.0	12.2	12.5
Unemployment (as % of labour force)		3.7	3.3	3.1	3.2
Per Capita Income	(RM)	23,850	26,175	29,094	31,097
	(USD)	6,767	8,126	9,508	10,134[6]
NATIONAL PRODUCT (% change)					
Real GDP at 2000 prices[1]		-1.6	7.2	5.1	4.0 ~ 5.0
(RM billion)		522.0	559.6	588.3	614.5
Agriculture, forestry and fishery		0.6	2.1	5.6	3.8
Mining and quarrying		-6.3	0.2	-5.7	0.6
Manufacturing		-9.3	11.4	4.5	3.9
Construction		5.9	5.1	3.5	6.6
Services		3.1	6.8	6.8	5.1
Nominal GNI		-7.5	11.1	12.3	8.0
(RM billion)		665.3	739.5	830.7	897.4
Real GNI		0.6	3.9	4.7	5.7
(RM billion)		497.4	516.8	540.9	571.5
Real aggregate domestic demand[2]		-0.4	6.3	8.2	6.6
Private expenditure[2]		-2.6	8.3	8.2	6.6
Consumption		0.7	6.5	6.9	6.2
Investment		-17.0	17.7	14.4	8.3
Public expenditure[2]		5.4	1.5	8.2	6.7
Consumption		3.9	0.5	16.8	0.2
Investment		7.5	2.8	-2.4	16.2
Gross national savings (as % of GNI)		31.6	34.1	34.6	34.4
BALANCE OF PAYMENTS (RM billion)					
Goods balance		141.7	134.7	149.4	155.6
Exports (f.o.b.)		554.1	640.0	696.1	717.8
Imports (f.o.b.)		412.3	505.3	546.7	562.2
Services balance		4.7	1.7	-8.4	-6.2
(as % of GNI)		0.7	0.2	-1.0	-0.7
Income, net		-14.6	-26.5	-22.0	-19.4
(as % of GNI)		-2.2	-3.6	-2.7	-2.2
Current transfers, net		-19.6	-21.8	-21.1	-20.5
Current account balance		112.1	88.1	97.9	109.5
(as % of GNI)		16.9	11.9	11.8	12.2
Bank Negara Malaysia international reserves, net[3]		331.3	328.6	423.3	-
(in months of retained imports)		9.7	8.6	9.6	-
PRICES (% change)					
CPI (2010=100)[4]		0.6	1.7	3.2	2.5 ~ 3.0
PPI (2005=100)[5]		-7.1	5.6	9.0	-
Real wage per employee in the manufacturing sector		1.9	6.4	0.6	-

[1] Beginning 2007, real GDP has been rebased to 2000 prices, from 1987 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 2012
p Preliminary
f Forecast

Note: Numbers may not necessarily add up due to rounding

Table 1.3a

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2009	2010	2011*p*
Revenue	158.6	159.7	185.4
Operating expenditure	157.1	151.6	182.6
Net development expenditure	49.0	51.3	45.3
Overall balance	-47.4	-43.3	-42.5
Overall balance (% of GDP)	-7.0	-5.6	-5.0
Public sector net development expenditure	112.2	104.4	132.5
Public sector overall balance (% of GDP)	-7.6	2.1	-10.5
EXTERNAL DEBT[1]			
Total debt (RM billion)	232.7	227.1	257.2
Medium- and long-term debt	155.3	147.7	153.4
Short-term debt[2]	77.4	79.4	103.9
Debt service ratio (% of exports of goods and services)			
Total debt	6.5	7.6	10.3
Medium- and long-term debt	6.4	7.6	10.3

	Change in 2009		Change in 2010		Change in 2011	
MONEY AND BANKING	**RM billion**	**%**	**RM billion**	**%**	**RM billion**	**%**
Money Supply M1	17.9	9.8	23.5	11.7	33.8	15.1
M3	85.4	9.2	68.8	6.8	155.8	14.3
Banking system deposits	90.7	9.3	75.0	7.1	161.3	14.2
Banking system loans[3]	57.0	7.8	99.8	12.7	120.2	13.6
Loan-deposit ratio (end of year)[4]	77.9		81.5		80.9	
Financing-deposit ratio[4, 5]	84.6		88.0		86.7	

INTEREST RATES (AS AT END-YEAR)	2009	2010	2011
	%	%	%
Overnight Policy Rate (OPR)	2.00	2.75	3.00
Interbank rates			
1-month*	2.06	2.79	3.06
Commercial banks			
Fixed Deposit 3-month	2.03	2.74	2.99
12-month	2.50	2.97	3.22
Savings deposit*	0.86	1.00	1.15
Base lending rate (BLR)	5.51	6.27	6.53
Treasury bill (3-month)	1.97	2.83	3.00
Malaysian Government securities (1-year)	2.12	2.85	2.82
Malaysian Government securities (5-year)	3.79	3.39	3.23

EXCHANGE RATES	2009	2010	2011
Movement of Ringgit (end-period)	%	%	%
Change against SDR	0.2	13.1	-2.8
Change against USD[6]	1.2	11.1	-2.9

1 Effective from the first quarter of 2008, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (Labuan IBFC) as residents
2 Excludes currency and deposits held by non-residents with resident banking institutions
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 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
* Refers to average rate for the month of December

Dynamics of Household Income and its Linkages with Private Consumption

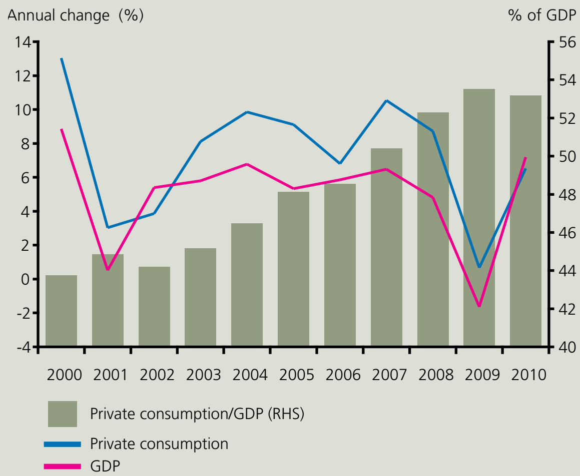
Private consumption is increasingly becoming an important driver of growth in the Malaysian economy. This is reflected in its growing share of GDP, as growth in private consumption has outpaced overall GDP growth over the recent decade (Chart 1). Theoretical and empirical findings across countries consistently highlight the importance of income in determining private consumption[1]. This article explores the dynamics of household income and its linkages with private consumption for Malaysia. The analysis provides two key findings. First, the services sector plays a large role in driving overall income, while income from commodities is also important especially during periods of large commodity price increases. Second, econometric evidence suggests that income has a strong and positive causal relationship with private consumption. Shocks to income are found to have large and persistent effects on private consumption.

Estimating Household Income from a Bottom-Up Approach

The analysis first involves deriving an estimate of household income that encompasses all sectors of the economy. Existing estimates of household income tend to be constrained by data coverage and periodic frequency. For example, income in the construction and some services sub-sectors are not available on at least a quarterly basis. A commonly-used proxy of income is manufacturing sector wages due to its frequent availability. Wages in the manufacturing sector, however, are an imperfect proxy for overall income within the economy since wages in different sectors tend to be influenced by sector-specific factors. For instance, wages in the construction and services sectors are likely to be influenced more by domestic demand considerations, while manufacturing wages are influenced more by external factors.

Chart 1

Private Consumption and GDP



Source: Department of Statistics, Malaysia

To construct a more representative estimate of household income, a quarterly wage series is estimated for each sector where wage statistics are unavailable. This methodology involves estimating the long-run relationship between the wage and labour productivity of the sector, and is premised on the view that wages are primarily a reflection of labour productivity[2]. First, the ratio between wage per worker and value-added per worker of the sector is established using the annual or biannual frequency data from the Department of Statistics Malaysia's survey of companies and the National Accounts. This is done to capture the sectoral variation in the wage-productivity profile. Second, the annual/biannual ratio is interpolated to form a quarterly series. This series is then multiplied by the value-added from the sector to derive quarterly sectoral estimates of gross income. This approach is applied to all sectors except for crude palm oil. This is because wages in the primary commodity sectors are found to be determined more by prices rather than labour productivity due to yield constraints (Chart 2). As such, the price-income relationship that is observed at an annual frequency is utilised to estimate a quarterly series of gross income for the palm oil sector.

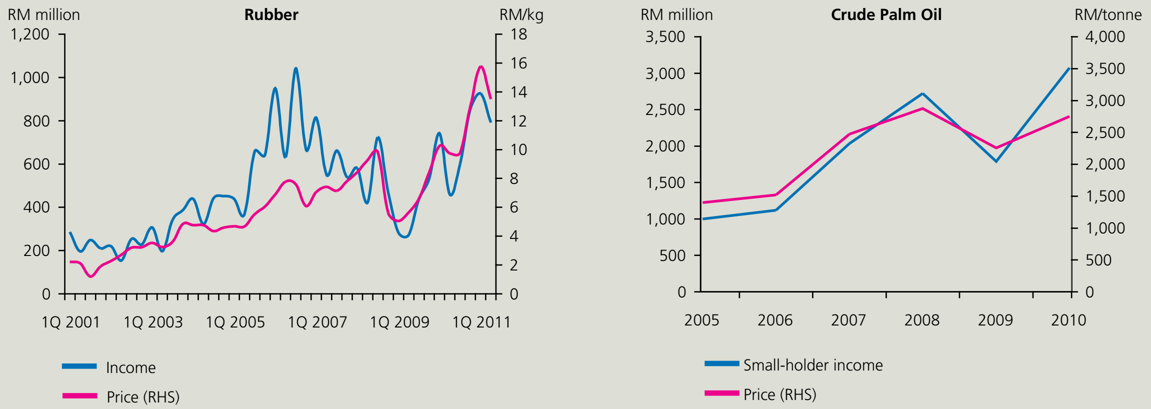
1 Theoretical examples are Carroll (2001) for a partial equilibrium analysis of the aggregate consumption function and Kydland and Prescott (1980) within a general equilibrium framework. Bacchetta and Gerlach (1997) and Case, Quigley and Shiller (2006) are selected recent papers that empirically find income to have the largest impact on consumption across a sample of countries.

2 Wages in certain sectors were found to occasionally deviate from their associated productivity levels, but this deviation was found to be only temporary.

Finally, the observed and estimated income series of all sectors are aggregated to arrive at an estimate of overall household income. An advantage of this approach is that the resulting estimates reflect household income at the overall level from a sectoral perspective.

Chart 2

Price-Income Relationship in the Rubber and Crude Palm Oil Sectors



Source: Department of Statistics, Malaysia and Malaysian Palm Oil Board

The Evolution of Household Income

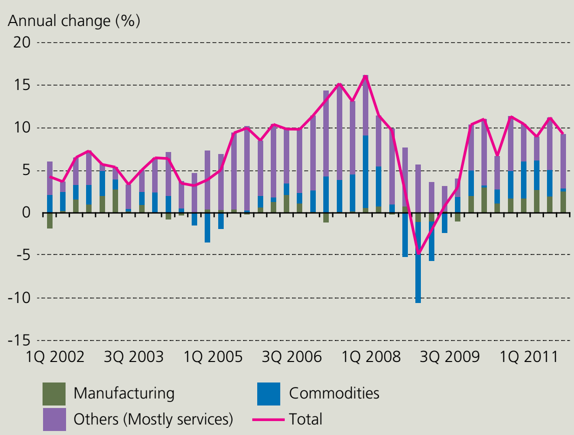
Chart 3 shows nominal income growth and its decomposition across the major sectors from 2002 to 2011. Overall household income grew at an average year-on-year rate of 7.4% per quarter during this period. Household income advanced at a steadily increasing pace from 2005 to 2008, with the highest growth of 16.1% registered in 1Q 2008, the eve of the crisis in the advanced economies.

Two key trends about household income can be observed. First, a large component of overall income growth can be attributed to income from the services sector, with its share of total income growing steadily from 55.7% in 1Q 2001 to 64.6% in 3Q 2011. Chart 3 shows, in particular, that the robust income growth during the 2005-2008 period, as well as its recovery after the crisis in the advanced economies, was attributable to the services sector. This development can be explained by the rise in the share of employment in the services sector to total employment and by higher wage growth in the sector. The share of employment in the services sector rose from 51.1% in 1Q 2001 to 61.5% in 3Q 2011, while wages in major services sub-sectors outpaced overall income growth. For instance, wages in the wholesale and retail, and financial intermediation sub-sectors grew at average rates of 11.1% and 7.7% per quarter respectively, higher than the national average income growth of 7.4%.

The second important finding is that income from the primary commodity sector plays a crucial role in driving the growth of overall income, despite

Chart 3

Nominal Income Growth Across Major Sectors



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

constituting only a relatively small share of total employment. This is because income from commodities is driven significantly by prices, as supply is typically constrained over short- to medium-term horizons. Since commodity prices have been volatile in recent years, income from the sector has also exhibited a similar behaviour. This aspect of income was clearly illustrated during the commodity price cycle from 2008-2009. At the peak of the cycle during the first half of 2008, palm oil prices increased by 64.5% annually, and constituted 48.9% of the 13.8% growth in overall income. Conversely, the subsequent sharp decline in prices, at an average rate of -37%, in the first half of 2009 contributed over 44.1% of the 3.5% decline in overall income.

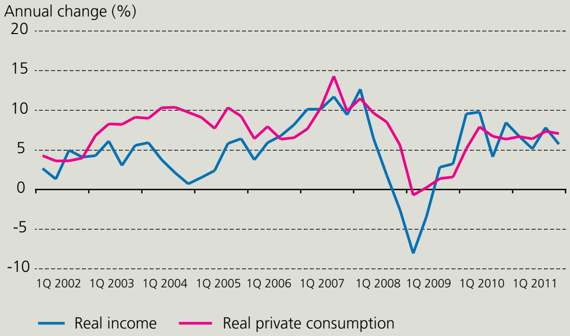
The Linkages between Household Income and Private Consumption

Chart 4 illustrates the relationship between real private consumption and real household income. Nominal income has been deflated using the implicit consumption deflator to facilitate an appropriate comparison with real private consumption. It is evident that income growth is a coincident and highly correlated indicator of the growth of private consumption, with a correlation coefficient between both series of 0.6. Income growth was also more volatile compared to private consumption, with standard deviations of 4.1 and 3.1, respectively.

The co-movement between the growth in private consumption and income growth has been particularly visible since 2006, where private consumption expanded in tandem with robust income growth from 2006 to 2008. When overall income contracted briefly in 2009, as income from commodities and exports declined along with commodity prices and exports, private consumption moderated as well, although by a smaller magnitude. Private consumption subsequently recovered in the second half of 2009, in tandem with the recovery in income.

Chart 4

The Relationship between Real Income and Private Consumption



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

A Vector Auto-regression (VAR) was estimated to further investigate the causal link between income and private consumption[3]. Household credit was also included as a variable to differentiate between the income and credit channels. First, multivariate Granger causality tests were conducted to test if income and credit help to predict future movements in private consumption. The results show that income has a statistically significant positive causal relationship with private consumption. Credit, on the other hand, is not found to have an econometric link with consumption, although the coefficient on the lag of credit shows the expected positive sign. Impulse response analysis was also conducted to estimate the profile of the response of private consumption from shocks to income and household credit (Chart 5). In both cases, their effects on private consumption are positive and statistically significant, especially during the first year after the shock.

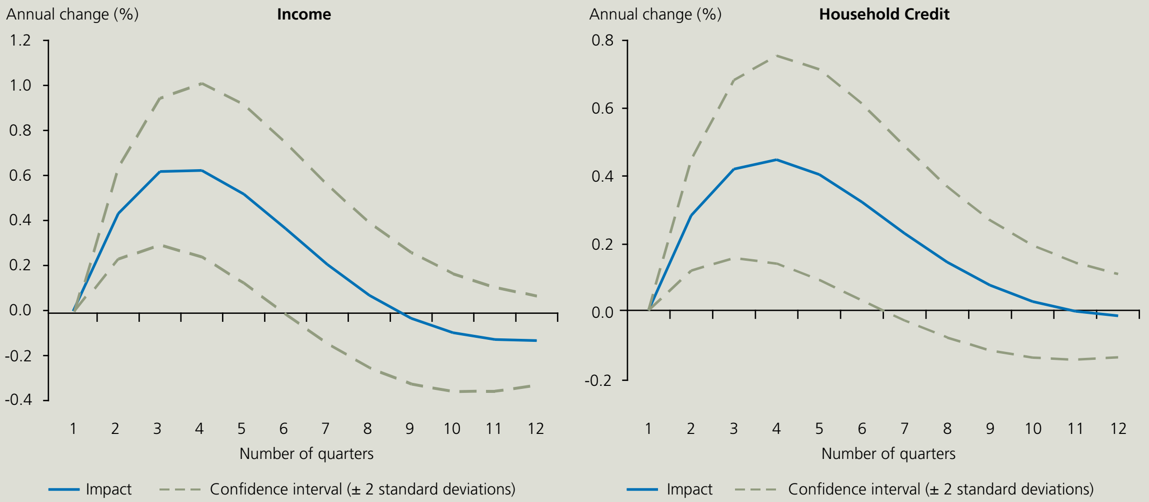
These results illustrate the distinct relationships that income and credit have with private consumption. The Granger causality test results indicate that households tend to rely more on their incomes than on credit for their expenditures on consumption goods. Nonetheless, the impulse response analysis demonstrates that credit also has a positive impact on household expenditure.

[3] A one quarter lag was chosen as selected by the Schwartz criterion. The variables were transformed to year-on-year percentage terms. The estimation period ranges from 2002-2011.

These findings suggest that households access credit markets not only to smooth expenditures on durable items, but also to temporarily support expenditures when they experience adverse income shocks. This was observed in 2009. Private consumption continued to register positive growth of 0.7% despite the estimated -1.3% contraction in income. Household credit grew by 9.3% (2008: 9.1%) as a consequence of households using credit to partially compensate for the loss of income during this period.

Chart 5

Responses of Private Consumption to Income and Household Credit Shocks



Source: Bank Negara Malaysia

References

Kydland, F. and Prescott, E.C. (1980) "Time to Build and the Persistence of Unemployment," Discussion Papers 453, Northwestern University, Center for Mathematical Studies in Economics and Management Science.

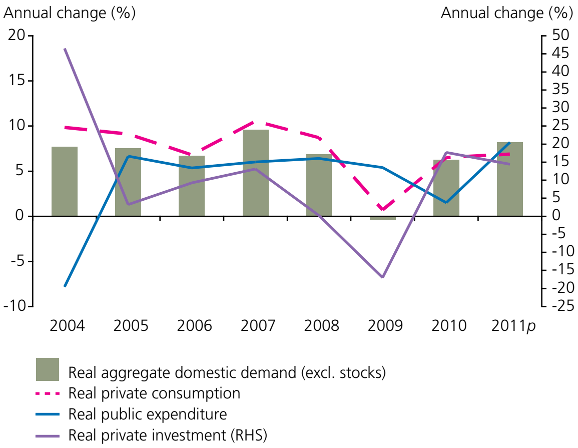
Carroll, C.D. (2001) "A Theory of the Consumption Function, With and Without Liquidity Constraints," Journal of Economic Perspectives, v15 (3, Summer), 23-45.

Case, K.E., Quigley, J.M. and Shiller, R.J. (2006) "Comparing Wealth Effects: The Stock Market Versus the Housing Market," Advances in Macroeconomics. Cowles Foundation Paper No. 1181.

Bacchetta, P. and Gerlach, S. (1997) "Consumption and Credit Constraints: International Evidence," Journal of Monetary Economics, Elsevier, vol. 40(2), pages 207-238, October.

Chart 1.5

Real Domestic Demand Aggregates

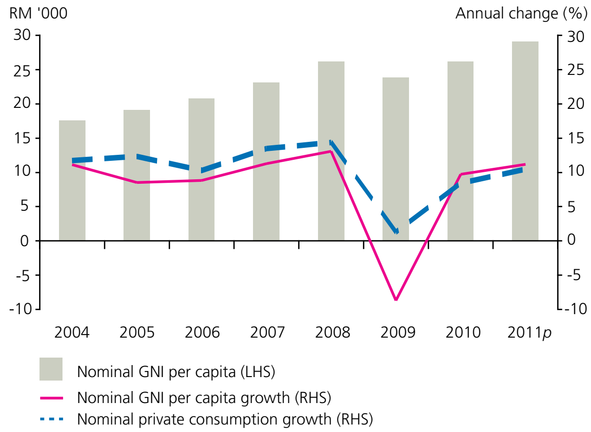


p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.6

GNI per Capita and Private Consumption



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

private sector rose by 4.0% in 2011 (2010: 4.5%). Income in the rural areas also experienced strong growth, with rubber and palm oil prices increasing by 27.8% and 19.1% respectively. Feedback from industry engagements indicated that the higher retail spending in the rural areas had led to increased wages and employment within these sectors as well. Consumer spending, particularly on discretionary items, was also supported by sustained consumer confidence, with the MIER Consumer Sentiments Index remaining above the 100-point threshold. The two half-month bonus payments to civil servants during the third and fourth quarters of the year also supported consumer spending.

Domestic demand strengthened, driven mainly by private sector spending and supported by public sector consumption

Financing conditions for households remained supportive of consumer spending, with lending rates remaining low at an average of 5.1% (2010: 5.0%). Loan disbursements for the purchase of passenger cars and for personal consumption expanded by 9% (2010: 12.6%). Overall household indebtedness edged higher to 76.6% of GDP as at end-2011 (end-2010: 75.8%). Despite the higher level of debt, household balance sheets remained sound with the household debt to financial assets ratio remaining at a prudent level of 43.5% (2010: 42.0%).

Private investment expanded robustly by 14.4% in 2011 (2010: 17.7%). Higher capital expenditure was evident across all sectors, particularly in the manufacturing, mining and services sectors, driven by strong domestic demand, and favourable external conditions in the first half of 2011. The implementation of several projects under the Economic Transformation Programme (ETP) had also augmented the strong performance of private investment. Domestic-oriented firms expanded their capacity further, benefiting particularly from the resilience of private consumption expenditure throughout the year. Investment by export-oriented firms was also strong, although it moderated towards year-end due to increased uncertainties on the global economic environment.

The continued expansion in private investment activity was reflected in key investment indicators. Imports of capital goods recorded a strong growth of 9.7% (2010: 12.2%), sales of construction-related materials advanced by 12.1% (2010: 11.2%), while loans disbursed to businesses were higher by 12.5% (2010: 9.8%). However, the strong investment momentum began to moderate slightly towards the second

The Evolution of Capital Stock in Malaysia

Introduction

The capital stock of a country is the total quantity of capital assets available for the production of goods and services. The size and growth of this capital stock have an important bearing on the production capabilities of an economy. Drawing on the newly-published capital stock statistics by the Department of Statistics, Malaysia (DOSM)[1], this article uses Net Capital Stock (NKS)[2] to analyse the trend in the capital stock in Malaysia as well as the changes in the intensity and productivity of its usage in the recent decades.

Trends in Capital Stock

In this recent four decades, the NKS increased significantly from RM38 billion in 1970 to RM1,008 billion in 2010 based on constant 2000 prices. This trend reflects the large magnitude of capital investment over these four decades. Table 1 provides a snapshot of the NKS in the Malaysian economy by types of economic activity and asset class as at 2010.

Table 1

NKS by Types of Economic Activity and Asset Class in 2010 at Constant 2000 Prices

NKS (RM billion)	Agriculture	Mining	Manufacturing	Construction	Services	**Total**
Structures	7.1	14.3	65.2	4.2	566.8	**657.5**
Transport equipment	0.5	0.0	8.1	1.4	40.7	**50.6**
Machinery and equipment	1.0	27.8	115.9	1.8	49.4	**195.9**
Other assets	8.6	94.3	0.0	0.0	0.9	**103.7**
Total	**17.2**	**136.4**	**189.1**	**7.4**	**657.7**	**1,007.8**

Note: "Other assets" includes livestock, capital planting and mineral exploration activity
Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

By type of economic activity (Chart 1), the manufacturing and services sectors together accounted for 84% of total NKS in 2010. The NKS of the manufacturing sector expanded the most since 1970 with an average annual growth of 12.7%. In part, this reflects the significant expansion of the manufacturing sector over this period, particularly between 1980 and 1990. Over the period from the 1970s to the 2000s, policies such as the Export-Oriented Industrialisation (EOI) and the First Industrial Master Plan (1986-1995), and provision of incentives through legislations such as the Promotion of Investment Act (1986), served to intensify the promotion of investment in the manufacturing sector. The rapid development of the country's manufacturing sector further supported the expansion of capital assets in the form of machinery and equipment (Chart 2). Investment in this type of capital asset was deemed essential to enhance technology adoption and improve the productive capacity of businesses in the manufacturing sector.

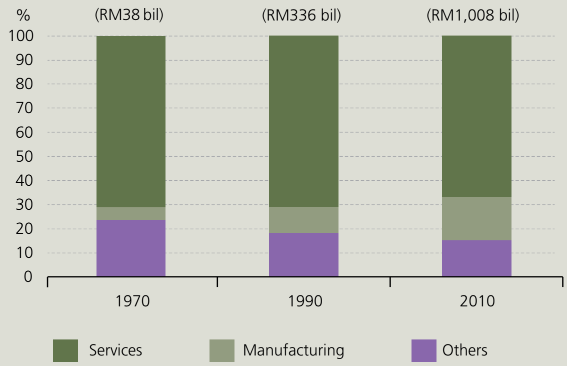
Investment in the services sector also expanded over the years, as reflected in the sector's share of total NKS that was consistently above 60% (Chart 1). This was supported by the strengthening of domestic expenditure, particularly in domestic-oriented services sub-sectors such as the wholesale and retail trade, accommodation and restaurant; and finance, insurance, real estate and business services. Furthermore, the industrialisation of the manufacturing sector naturally spurred the growth of investment in manufacturing-related services such as ICT-network-virtual manufacturing, R&D, quality and standards certification, packaging, transportation and export services.

[1] Technical details of the estimation of Malaysia's capital stock are available in the *National Accounts: Capital Stock Statistics* (1955-2006 and 2000-2010) publication by DOSM.

[2] NKS refers to the current market value of an economy's capital assets that are still in operation, taking into account the depreciation in their value.

Chart 1

Share of NKS by Type of Economic Activity (2000=100)

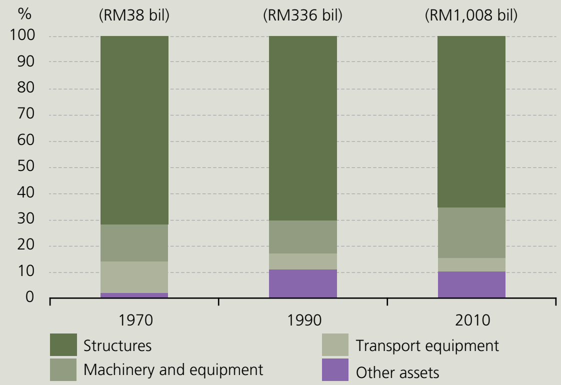


Note: "Others" comprises of the agriculture, mining and construction sectors

Source: Department of Statistics, Malaysia

Chart 2

Share of NKS by Type of Asset Class (2000=100)



Note: "Other assets" includes livestock, capital planting and mineral exploration activity

Source: Department of Statistics, Malaysia

Capital assets in structures (Chart 2), on the other hand, comprised 69% of total NKS on average and have remained as the largest capital asset class, particularly in sectors related to transport, storage, and communications; finance, real estate and businesses; and government services. The increase in structure-related capital stock reflects capital spending on residential and commercial office buildings, industrial plants and factories, and physical infrastructure. The fast pace of urbanisation and the development of new growth centres during the period stretching from the 1970s to the 2000s further augmented investments in this type of capital asset.

Preliminary Analysis on Capital Intensity and Productivity

Between the 1980s and the 2000s, the economy became more capital-intensive across most economic sectors, as reflected by the rising proportion of capital assets to the number of workers employed[3] (Table 2).

The mining and quarrying sector has been the most capital-intensive, followed by the services and the manufacturing sectors. The accumulation of capital assets in the mining sector was mainly for mineral exploration activity, in line with the development of the oil and gas industry in the country. Capital intensity in the services sector almost doubled, as the liberalisation and modernisation policies that were undertaken to promote services as a new area of growth in the 2000s played a supporting role in attracting higher investment activity. Capital intensity in the manufacturing sector also improved considerably, aligned to the process of industrialisation and the initiatives taken to move the economy to higher value-added manufacturing activities.

During the same period, overall productivity of capital, as measured by the incremental capital-output ratio (ICOR)[4], has also improved. Further research, however, is needed to analyse the trends of capital productivity from a more holistic perspective by examining the efficiencies of both the human capital and the physical capital (i.e. total factor productivity).

[3] Capital intensity is estimated as the ratio of the net capital stock to total employment (total number of employed persons) in the country.

[4] ICOR is estimated as a ratio of the annual change in net capital stock to the annual change in Gross Domestic Product (GDP) during the same period.

Table 2

Capital Intensity and Productivity

Period	1981-1990	2001-2010
Capital Intensity (RM/employed person)	RM42,788	RM86,899
Agriculture	*RM8,028*	*RM12,573*
Mining	*RM754,983*	*RM2,273,546*
Manufacturing	*RM25,205*	*RM78,317*
Construction	*RM16,914*	*RM8,900*
Services	*RM64,402*	*RM105,893*
Capital Productivity (ICOR)*	2.6	1.2

* A lower ICOR indicates better productivity as less capital is needed to produce similar amount of output
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Conclusion

The net capital stock of the Malaysian economy has grown significantly in this recent four decades. In terms of sectors, most of the capital assets were accounted for by the manufacturing and services sectors. Building structures and machinery and equipment were the most common type of capital stock. Preliminary analyses on the capital stock data suggest that the economy has also become more capital-intensive and, more importantly, overall capital productivity has improved over the years.

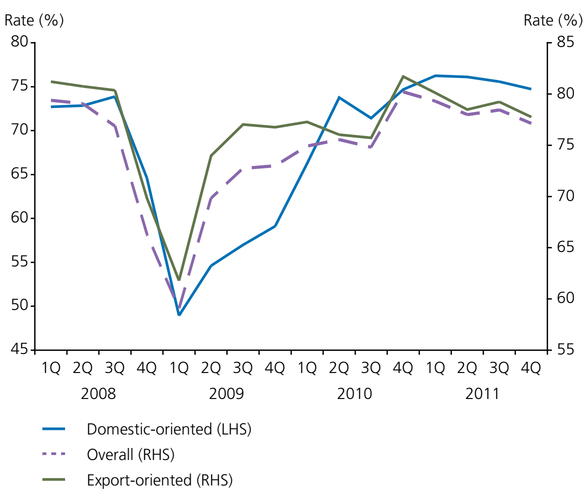
Going forward, as the economy undergoes a transformation towards a high value-added, high income economy, improving the quality of the capital stock and the efficiency of its utilisation would be critical success factors. Indeed, enhancement in capital efficiency and productivity is a critical element in ensuring the new investment projects driven by the Economic Transformation Programme (ETP) boost economic growth and achieve Malaysia's aspiration to become a high value-added, high income economy.

half of the year, especially in the manufacturing sector given the worsening global environment. This was reflected in imports of machinery for manufacturing which recorded a lower growth of 0.7% in the second half of the year compared to a growth of 7.4% in the first half-year. Growth in sales of commercial vehicles also moderated to 2.7% in the second half-year from 8% in the first half-year (2010: 21.8%). This was also reflected in investor sentiments, which deteriorated towards the end of the year. The MIER Business Conditions Index (BCI), which remained above the 100-point confidence threshold in the first three quarters of 2011, dipped to 96.6 points in the fourth quarter, with businesses citing significantly lower sales and new orders.

In the manufacturing sector, higher capital expenditure was incurred for capacity expansion by both the domestic- and export-oriented firms. Nevertheless, investment growth for the manufacturing sector moderated in the second half of the year, especially for export-oriented firms. This was reflected in the lower levels of capacity utilisation observed at end-2011 (77%; end-2010: 80%), leading firms to scale back and delay new capacity expansion. Capital spending in the manufacturing sector, however, was supported by the continued implementation of approved manufacturing projects, investment in new growth areas, namely renewable energy, advanced E&E and medical equipment industries, and product diversification.

Chart 1.7

Capacity Utilisation in the Manufacturing Sector



Source: Bank Negara Malaysia

Investment activity in the services sector registered robust growth, particularly among the domestic-oriented sub-sectors such as communication and wholesale and retail trade, due to continued high consumer spending. Capital spending in the communication sub-sector was focused on the upgrading of mobile broadband infrastructure and the expansion of network coverage. Higher capital expenditure was also observed for the expansion of outlets in the distributive trade and restaurants sub-sectors and for fleet expansion in the air transportation sub-sector.

In the mining sector, capital spending was higher mainly for exploration and development activity in the oil and gas sector, as energy prices remained elevated. Furthermore, tax incentives for deepwater and marginal oil field development provided additional support for higher capital expenditure in these fields.

Progress in the implementation of selected ETP projects especially in the wholesale and retail trade, hotel and accommodation, and oil and gas-related sectors, also augmented the strong growth in overall investment activity.

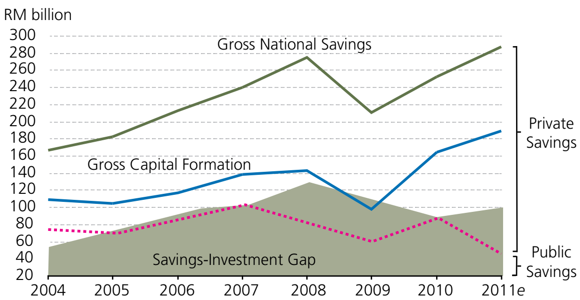
Public consumption expanded by 16.8% in 2011 (2010: 0.5%), following higher public expenditure on emoluments, supplies and services, and the one month bonus payment during the year. The expansion in expenditure on supplies and services reflected the continued efforts by the Government to improve the public delivery services.

Public investment contracted by 2.4% in 2011 (2010: 2.8%) following the lapse of the second stimulus package in 2010 and slower implementation of new projects under the 10th Malaysia Plan. Meanwhile, capital spending by the NFPEs remained strong, providing support to overall public investment.

The Government's development expenditure in the economic sector was focused on improving transportation infrastructure and public amenities in urban and rural areas, and enhancing the competitiveness of small and medium enterprises (SMEs). Capital spending in the social services sector was aimed at improving the infrastructure and facilities for higher education and skills training as well as increasing the provision of healthcare capacity of the nation.

Chart 1.8

Gross National Savings and Savings-Investment Gap



e Estimate

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

Table 1.2

Real GDP by Sector (2000=100)

	2010	2011*p*
	Annual change (%)	
Agriculture	2.1	5.6
Mining & quarrying	0.2	-5.7
Manufacturing	11.4	4.5
Construction	5.1	3.5
Services	6.8	6.8
Real Gross Domestic Product (GDP)	**7.2**	**5.1**

p Preliminary

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

As for the NFPEs, the increase in capital spending was mainly in the mining, transportation, utilities and communication sectors. Investment in the mining sector reflected mainly the exploration and development of oil and gas fields, while the expansion of road, rail and air infrastructure was the main area of investment in the transportation sector. Capital spending in the utilities and communication sectors was focused on expanding Malaysia's power-generation capacity and extending the coverage of High-Speed Broadband (HSBB) services respectively.

Private sector savings increased to RM242.1 billion or 29.1% of gross national income (GNI) in 2011 (2010: 22.2%), broadly reflecting the sound financial position of the household and corporate sector. Banking sector deposits held by individuals and businesses rose to RM943.9 billion in 2011 (2010: RM821.8 billion). However, public sector savings declined to RM45 billion or 5.4% of GNI (2010: 11.9%), due to the lower operating surpluses of the NFPEs during the year. Overall, the **gross national savings (GNS)** increased by 13.9% to RM287.1 billion, which in turn led to a larger savings-investment surplus of RM97.9 billion or 11.8% of GNI in 2011. This surplus of savings enabled Malaysia to finance its long-term investment outlays primarily from domestic sources.

SECTORAL REVIEW

From the supply side, overall growth in 2011 was sustained by firm activity in the domestic-oriented sectors. The services sector remained the key contributor to growth amid robust domestic demand throughout the year. In the manufacturing sector, growth in the domestic-oriented industries outweighed the weaker performance in the export-oriented industries amid the softening of external demand. Manufacturing production was also adversely affected by supply disruptions following the natural disasters in Japan and Thailand. Firm regional demand continued to provide

Table 1.3

Services Sector Performance at Constant 2000 prices

	2010	2011*p*	2010	2011*p*
	Annual change (%)		Share to GDP (%)	
Services	**6.8**	**6.8**	**57.7**	**58.6**
Intermediate services	7.2	6.2	25.2	25.5
Finance and insurance	6.4	5.9	11.7	11.8
Real estate and business services	7.8	6.3	5.5	5.5
Transport and storage	6.9	5.3	3.8	3.8
Communication	8.5	7.6	4.2	4.3
Final services	6.5	7.3	32.4	33.1
Wholesale and retail trade	8.0	7.6	13.6	13.9
Accommodation and restaurant	5.0	5.2	2.4	2.4
Utilities	8.2	3.0	3.0	3.0
Government services	5.8	11.6	7.5	8.0
Other services	4.0	4.1	5.9	5.8

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

support to the resource-based manufacturing industries despite commodity prices remaining elevated. Nevertheless, the mining sector was adversely affected by the shutdown of several production facilities, while growth in the construction sector moderated following the completion of several major projects.

The **services sector** recorded strong growth of 6.8% in 2011 (2010: 6.8%), amid firm domestic demand. The sector remained the largest contributor to growth, accounting for 3.9 percentage points of overall GDP growth.

The **wholesale and retail trade sub-sector** benefited from the robust growth in private consumption. The retail segment registered strong performance, buoyed by positive consumer spending throughout the year. However, the motor vehicle distributive trade segment was affected by the supply chain disruptions following the Fukushima disaster, especially during the second quarter of the year. The resilience in private consumption also provided support to the sustained growth in the **accommodation and restaurant sub-sector**. This more than offset the slower tourist-related activity in the sub-sector due to slower tourist arrivals amid global economic uncertainties.

The services sector continued to be a major driver of growth

In the **communication sub-sector**, growth was led mainly by the continued expansion in the broadband segment. The broadband penetration rate rose to 62.3% of households as at end-2011 (end-2010: 55.6%), as a result of wider and improved broadband network coverage by key industry players. Initiatives to boost broadband connectivity, including the provision of broadband facilities in rural areas, had also contributed to the higher broadband penetration rate.

The **finance and insurance sub-sector** grew by 5.9% (2010: 6.4%), following strong performance in bank lending and increased collection of insurance premiums. Total loans outstanding in the banking system were higher by 13.6% in 2011 (2010: 12.7%), reflecting strong demand for financing by both households and businesses.

Table 1.4

Selected Indicators for the Services Sector

	2010	2011*p*
	Annual change (%)	
Utilities		
Electricity production index	8.8	2.0
Wholesale & Retail Trade and Accommodation & Restaurant		
Consumption credit disbursed	13.7	7.1
Tourist arrivals	4.4	0.1
Total sales of motor vehicles	12.8	-0.9
Finance & Insurance and Real Estate & Business Services		
Loans outstanding in the banking system	12.7	13.6
Insurance premiums	11.4	3.2
Bursa Malaysia turnover (volume)	2.1	29.9
Transport & Storage and Communication		
Total container handled at Port Klang and PTP (TEUs)	15.6	11.3
Airport passenger traffic	12.2	10.6
Air cargo handled	14.2	-2.1
SMS traffic	8.3	-3.8
	%	
Penetration rate:		
- Broadband[1]	55.6	62.3
- Cellular phone[2]	119.2	127.7
- Fixed line[1]	42.5	37.3

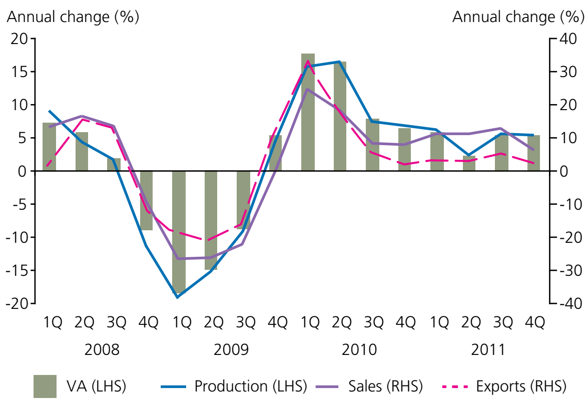
1 of household
2 of population
p Preliminary

Source: Department of Statistics, Malaysia; Malaysia Tourism Promotion Board; Malaysian Automotive Association; Bursa Malaysia Berhad; Port Klang Authority; Pelabuhan Tanjung Pelepas Sdn Bhd; Malaysia Airports Holdings Berhad; Senai Airport Terminal Services Sdn Bhd; Malaysian Communications and Multimedia Commission; and Bank Negara Malaysia.

The **real estate and business services sub-sector** recorded strong growth in the first half of the year, but moderated towards the year-end as increased uncertainties in the global financial markets adversely affected the capital market-related business services segment. In line with the moderation in trade- and manufacturing-related activity, the **transport and storage**, and **utilities sub-sectors** recorded a more modest expansion. Demand for cargo-related transport services and electricity production was lower amid the weakness in external demand.

Chart 1.9

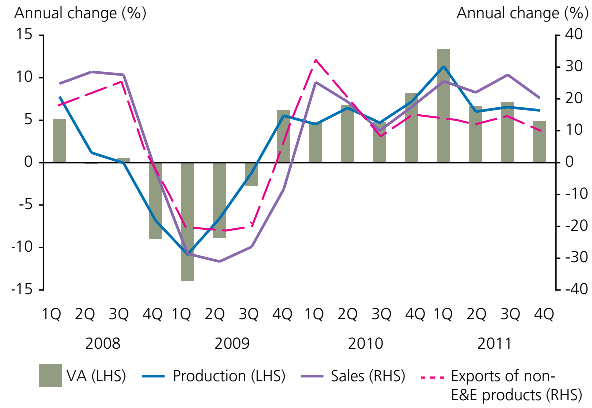
Manufacturing Sector: Value-added, Production, Sales and Exports



Source: Department of Statistics, Malaysia

Chart 1.11

Primary-related Cluster: Value-added, Production, Sales and Exports



Source: Department of Statistics, Malaysia

Overall, the **manufacturing sector** continued to expand, albeit at a more moderate pace (2011: 4.5%; 2010: 11.4%), as growth in the domestic-oriented industries outweighed weakness in the export-oriented industries. Subdued external demand, particularly from the advanced economies, had weighed down the performance of the export-oriented industries. Supply disruptions were also contributing factors to the under-performance of the sector. Nevertheless, domestic-oriented industries remained resilient, supported by favourable domestic demand conditions.

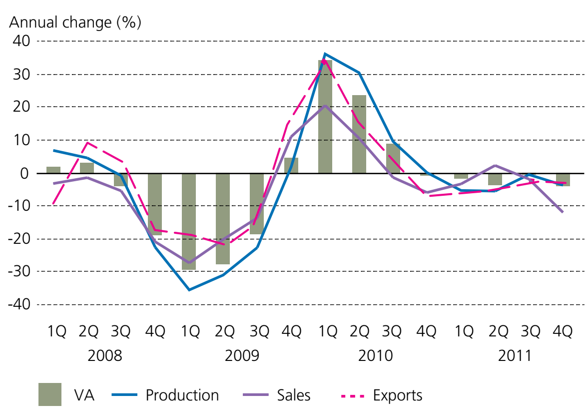
During the course of 2011, the export-oriented industries expanded at a slower pace of 3.4% (2010: 9.7%), as contraction in the **electronics and electrical products (E&E) cluster** offset growth in the primary-related cluster. E&E output growth weakened in 2011, affected by the weakness in external demand and disruptions in the global E&E supply chain.

More moderate growth in the manufacturing sector

Nevertheless, firm regional demand for the output of the **primary-related cluster** continued to support growth of the export-oriented industries, driven mainly by the refined petroleum

Chart 1.10

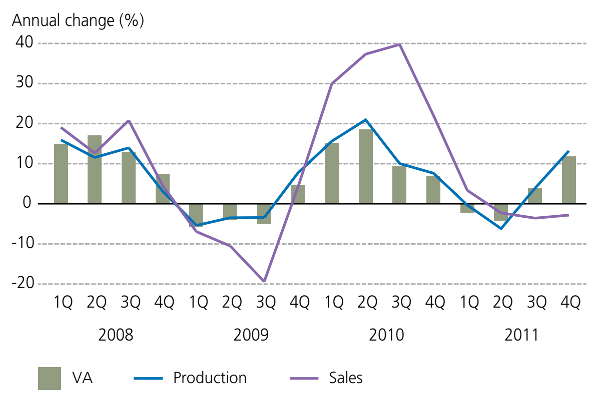
E&E Cluster: Value-added, Production, Sales and Exports



Source: Department of Statistics, Malaysia

Chart 1.12

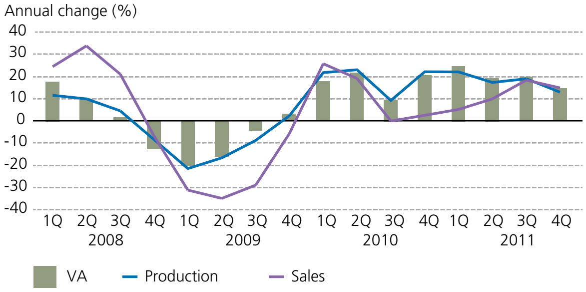
Consumer-related Cluster: Value-added, Production and Sales



Source: Department of Statistics, Malaysia

Chart 1.13

Construction-related Cluster: Value-added, Production and Sales



Source: Department of Statistics, Malaysia

Table 1.5

Performance of the Manufacturing Sector

	2010	2011
	Annual change (%)	
Value-added (RM million at 2000 prices)	**11.4**	**4.5**
Overall Manufacturing Production[1]	**11.1**	**4.7**
Export-oriented industries	**9.7**	**3.4**
Electronics & electrical products cluster	**17.4**	**-3.6**
of which:		
Electronics	3.1	-11.7
Electrical products	47.8	8.4
Primary-related cluster	**5.7**	**7.4**
of which:		
Chemicals and chemical products	11.5	8.8
Petroleum products	-2.4	6.2
Rubber products	20.8	13.9
Off-estate processing	-2.3	8.7
Domestic-oriented industries	**15.6**	**8.9**
Consumer-related cluster	**13.4**	**2.6**
of which:		
Transport equipment	29.7	-1.0
Food, beverage & tobacco products	8.8	5.9
Construction-related cluster	**18.9**	**17.6**
of which:		
Construction-related products	21.9	13.0
Fabricated metal products	15.0	23.8
Exports	**12.6**	**3.4**

[1] Production data are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia

product, and chemicals and chemical-related product industries.

The domestic-oriented industries continued to register firm growth in 2011, supported mainly by the strong performance of the **construction-related cluster**. The robust performance of this cluster was underpinned by firm domestic construction activity, which benefited both the fabricated metal and non-metallic mineral product industries. However, growth in the **consumer-related cluster** moderated sharply as the contraction in the production of transport equipment, which was adversely affected by supply chain disruptions in the second quarter of the year, outweighed the expansion of the food, beverage and tobacco industry during the year.

The agriculture, forestry and fishing **(agriculture) sector** expanded at a stronger pace of 5.6% in 2011, supported by a recovery in the production of crude palm oil. The production of **crude palm oil** (CPO) increased

Table 1.6

Agriculture Sector: Value-Added and Production

	2010	2011*p*
	Annual change (%)	
Value-added	**2.1**	**5.6**
Industrial crops	**-2.3**	**5.3**
Production of which:		
Crude palm oil	-3.3	11.3
Rubber	9.6	6.1
Saw logs	-2.9	-7.7
Cocoa beans	-13.8	-70.6
Food crops	**7.4**	**5.8**
Production of which:		
Fish	2.7	1.3
Livestock[1]	2.4	4.4
Vegetables	-17.6	10.5
Fruits	8.3	2.8

[1] Refers to Peninsular Malaysia only
p Preliminary

Source: Department of Statistics, Malaysia
Malaysian Palm Oil Board
Malaysian Rubber Board
Forestry Departments (Peninsular Malaysia, Sabah and Sarawak)
Malaysian Cocoa Board
Department of Fisheries, Malaysia
Department of Veterinary Services, Malaysia
Department of Agriculture, Malaysia

by 11.3% to 18.9 million tonnes, supported by factors such as favourable weather conditions and firm prices. Output of other key crops such as rubber and food crops remained firm, driven by strong regional and domestic demand. The agriculture sector benefited from favourable demand and supply conditions.

Stronger growth in the agriculture sector due mainly to higher production of crude palm oil

The average price of SMR 20 rubber strengthened to RM13.67 per kg (2010: RM10.70 per kg). Similarly, the CPO price rose to an average of RM3,279 per tonne (2010: RM2,752 per tonne). Apart from the brief period of adverse weather which led to flooding in key production areas, overall weather conditions were conducive for higher yields of industrial crops during the year.

Value-added of the **mining sector** contracted by 5.7% in 2011, reflecting the decline in the production of crude oil and condensates. This decline was caused by shutdowns of several production facilities for maintenance purposes, declining production from mature fields and lower-than-expected production from new fields. Despite higher demand from Japan following the natural disaster in March, output of natural gas rose only marginally by 0.4%, as production was affected by the shutdown of gas processing facilities in Peninsular Malaysia.

Output in the mining sector contracted following a decline in the production of crude oil and condensates

The **construction sector** expanded at a moderate rate of 3.5% in 2011 (2010: 5.1%), following slower activity in the civil engineering and non-residential sub-sectors. The civil engineering and special trade sub-sector registered a slower growth, especially in the second quarter, following the completion of major highway projects, and maintenance and upgrading work under the second stimulus package.

Moderate growth in the construction sector

The residential sub-sector registered an improved performance with a turnaround in growth. Construction of residential properties, particularly in the high-end segment, picked up significantly following a recovery in building approvals in 2010. The combination of robust demand, lower overhang, and higher land and building materials costs resulted in higher house prices in 2011. The average national house price rose at a faster pace of 8.6% in the first

Table 1.7

Mining Sector: Value-Added and Production

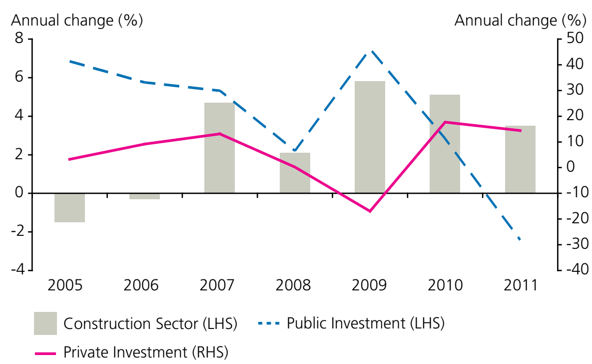
	2011	2011*p*
	Annual change (%)	
Value-added	**0.2**	**-5.7**
Production		
of which:		
Crude oil and condensates	-3.1	-10.2
Natural gas	2.1	0.4

p Preliminary

Source: PETRONAS
Department of Statistics, Malaysia

Chart 1.14

Value-added Growth in Construction Sector versus Growth in Public and Private Investment



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.8

Indicators of the Construction Sector

	2010	2011*p*
	Annual change (%)	
Construction sector value-added	**5.1**	**3.5**
Total property transactions		
Value	32.5	27.9
Volume	11.4	14.1
Loans for purchase of residential property		
Loan approvals	19.5	12.8
Loan outstanding	13.2	13.2
Loans for construction sector		
Loan approvals	53.6	25.7
Loan outstanding	4.7	3.8
Housing approvals	23.6	32.2
New sales & advertising permits	16.0	16.1
Imports of construction-related materials	27.5	14.0
Production of construction-related materials	18.9	18.2
Malaysian House Price Index	6.7	8.6[1]

[1] Jan-Sept 2011
p Preliminary
Source: Bank Negara Malaysia, Department of Statistics of Malaysia, Ministry of Housing and Local Government and National Property Information Centre (NAPIC).

three quarters of the year (2010: 6.7%), significantly above the average growth rate of 3.7% between 2000 and 2010.

In the non-residential sub-sector, growth moderated after posting a strong double-digit growth in the previous year. Concerns over the oversupply of office space, particularly in the Klang Valley, affected the sub-sector's performance in the second half of the year.

EXTERNAL SECTOR

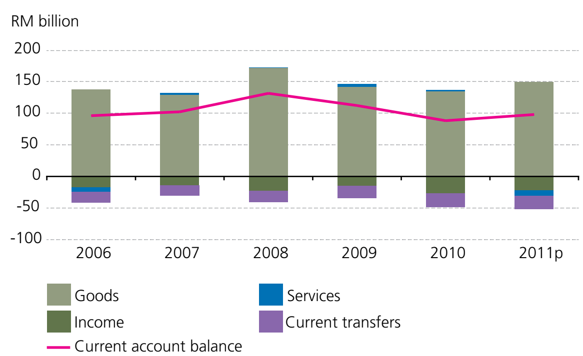
Balance of Payments
Malaysia's external sector strengthened in 2011

Despite the challenging external environment, Malaysia's external position strengthened further in 2011. The overall balance of payments turned around to register a strong surplus position, with the current account recording another large surplus while the financial account reversed to register a net inflow position. The current account surplus was supported by a larger trade surplus, attributed mainly to strong exports of commodities following higher commodity prices, and lower net income outflows. The turnaround in the financial account was largely due to the continued inflows of portfolio funds and foreign direct investment (FDI), amid the firm domestic economic prospects. Higher outflows of direct investment abroad reflected continued efforts by Malaysian companies to further expand businesses abroad. Other investment outflows, which primarily comprise private sector flows, moderated significantly during the year.

During the year, errors and omissions (E&O) excluding the cumulative foreign exchange revaluation gain amounted to an outflow of RM26.1 billion. This represented 2.1% of Malaysia's total trade, well within the internationally-accepted norm of 5% of total trade. Being one of the most open economies with relatively significant amount of cross-border trade and financial flows, statistical errors and unrecorded transactions are inevitable in the course of recording these information. In view of the magnitude of these flows, the authorities have undertaken various measures to improve the recording of such transactions. On 1 December 2011, the Money Services Business Act 2011 was enacted to strengthen the regulation and supervision of the money services business industry, which comprises the money changing, remittance and wholesale currency businesses. In order to improve efforts to gather intelligence and evidence on cross-border transactions, international collaboration and information sharing with foreign law enforcement agencies have also been intensified.

Chart 1.15

Current Account



p Preliminary
Source : Department of Statistics, Malaysia

The Changing Structure of Malaysia's Exports

INTRODUCTION

Malaysia's export sector has evolved significantly over the five recent decades. In line with the nation's economic industrialisation, the composition of exports had gradually shifted from comprising mainly of agricultural and mining products in the 1960s to manufactured goods in the 1980s. The development and growth of the manufacturing sector was so rapid that by the late 1990s, the sector accounted for more than 80% of total exports. Today, manufactured goods remain the largest component of total exports (Chart 1).

Since 2000, two notable trends have emerged in Malaysia's export structure. First, the gradual move away from a heavy concentration in electrical and electronics (E&E) exports, towards non-E&E manufactured products and commodities. The second key trend is the diversification of Malaysia's export markets. This box article examines Malaysia's changing export structure since 2000, identifies the reasons underpinning this trend and broadly outlines key challenges facing the export sector going forward.

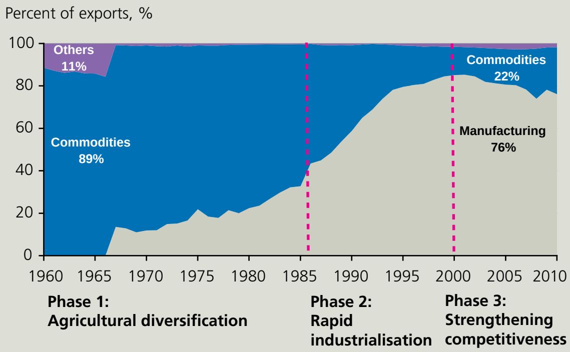
CHANGING STRUCTURE OF MALAYSIA'S EXPORT SECTOR SINCE 2000

Greater diversification in the composition of export products

While E&E products continue to account for a significant proportion of Malaysia's total exports (42.4% in 2010), this most recent decade has seen a steady rise in the share of non-E&E manufactured exports from 23.4% to 33.8%. During the same period, the share of commodities in total exports has also increased, from 13.3% to 22.2% (Chart 2).

Chart 1

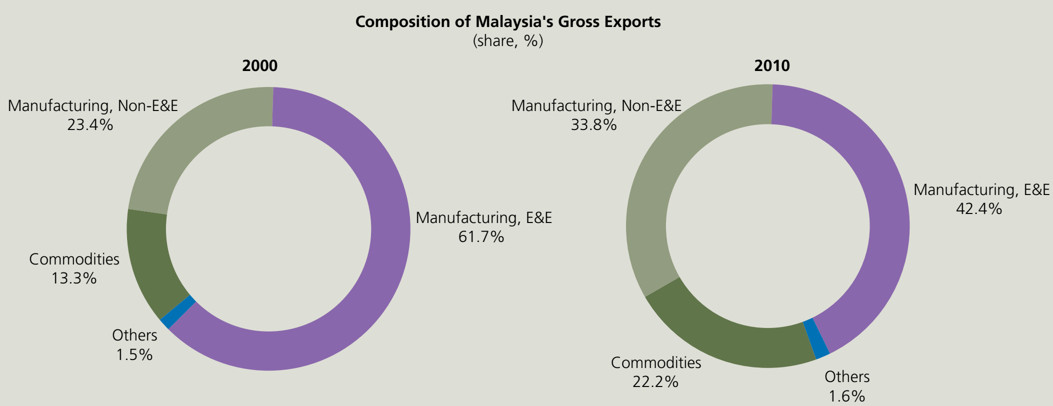
Malaysia has evolved from being a major commodities exporter to being primarily an exporter of manufactured goods



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 2

The share of non-E&E manufactures and commodities have been increasing over this recent decade



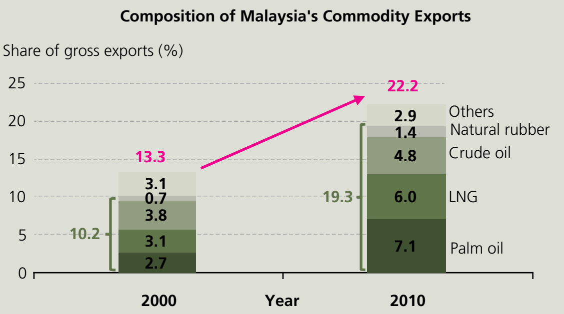
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

This compositional shift in exports reflects several factors. First is the **rising world demand for raw materials**. Given the country's wealth of natural resources in areas such as agriculture and mining, Malaysia is well positioned to benefit from the growing global demand for raw materials, particularly from the fast growing economies of Asia. This has contributed to the rising share of Malaysia's commodity exports over this recent decade, with four major commodities – palm oil, liquefied natural gas (LNG), crude oil and natural rubber – accounting for most of the increase in the share of commodities in gross exports during the period (Chart 3).

Chart 3

Increased share of commodities in Malaysia's gross exports driven mainly by four major commodities



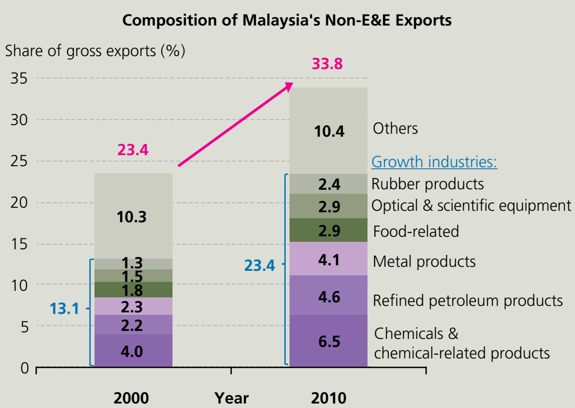
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The second factor contributing to the compositional shift in exports is the greater focus on **higher value-added downstream manufacturing activities**. This is reflected in the increasingly capital-intensive investment pattern in the manufacturing sector, with capital investment per employee in approved manufacturing projects rising from RM381,450 in 2000 to RM557,894 in 2011. Supported by the domestic availability of raw materials and continued efforts to move the non-E&E sector up the value chain, Malaysia has, during this recent decade, emerged as a major exporter in key non-E&E industries such as chemicals and chemical-related products, refined petroleum products and rubber products. Growth experienced in these industries has been so rapid that it has contributed to most of the increase in the share of non-E&E manufactured products in Malaysia's gross exports (Chart 4). The increasing importance of the non-E&E sector is also reflected in the changing investment patterns within Malaysia's manufacturing sector. Relative to the E&E sector, foreign direct investment in the non-E&E sector has also become more important over the years (Chart 5).

Chart 4

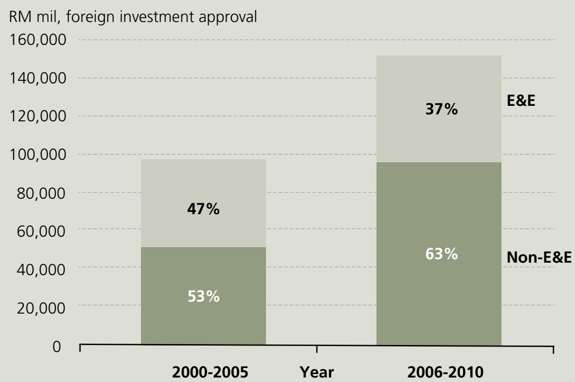
Increased share of non-E&E in Malaysia's gross exports driven mainly by six growth industries



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 5

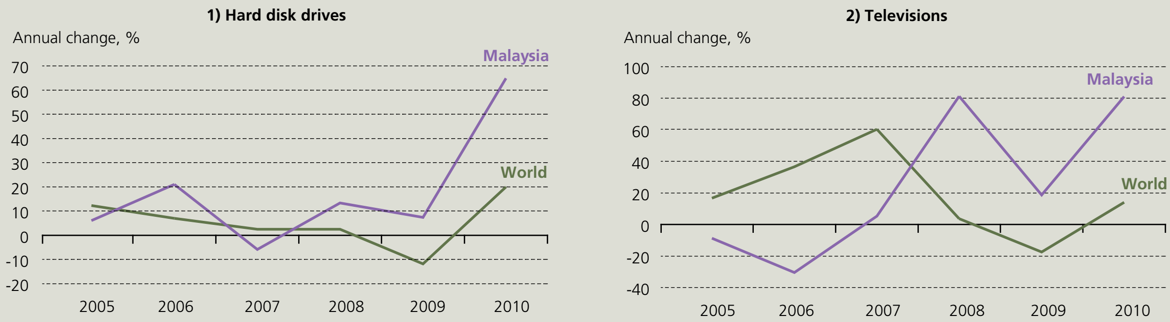
The share of non-E&E in total foreign investment approved has been increasing over this recent decade



Source: Malaysian Investment Development Authority

Chart 6

Fast growing E&E segments providing support to Malaysia's E&E export performance



Source: World Trade Atlas, UN Comtrade, Bank Negara Malaysia calculations

The compositional shift in exports also reflects the **reduced reliance on E&E products** due to the changing trend away from personal computers to newer mobile electronic devices such as tablets and smart phones – new growth segments in which Malaysia is not heavily involved in. The E&E sector, however, continues to be an important contributor to Malaysia's export growth, with strong performance in segments such as hard disk drives and consumer electrical products such as televisions (Chart 6). The E&E sector's performance is also further supported by its ability to continually evolve into new areas of comparative advantage such as the solar and light-emitting diode (LED) industries.

Greater diversification in the destination of Malaysia's export markets

Another key emerging trend is the **greater diversification in the destination of Malaysia's exports**. While the share of Malaysia's exports to traditional markets such as the US, Japan and the European Union (EU) remains high, demand from the regional economies, particularly East Asia, has risen substantially since 2000 (Chart 7). ASEAN[1] remains a key export market, accounting for about 25% of Malaysia's total exports. Of significance is also the deepening of trade linkages with other Asian economies, particularly the PR China and India. The share of Malaysia's exports to PR China has quadrupled from 3.1% in 2000 to 12.5% in 2010. There has also been an accompanying rise in Malaysia's imports from PR China, thus resulting in PR China as Malaysia's largest trading partner. The rise in bilateral trade relations with PR China has made Malaysia the largest trading partner in South East Asia of PR China. Beyond Asia, Malaysia has also experienced growth in trade with Australia and New Zealand, as well as new markets such as those in the Middle East and Latin America.

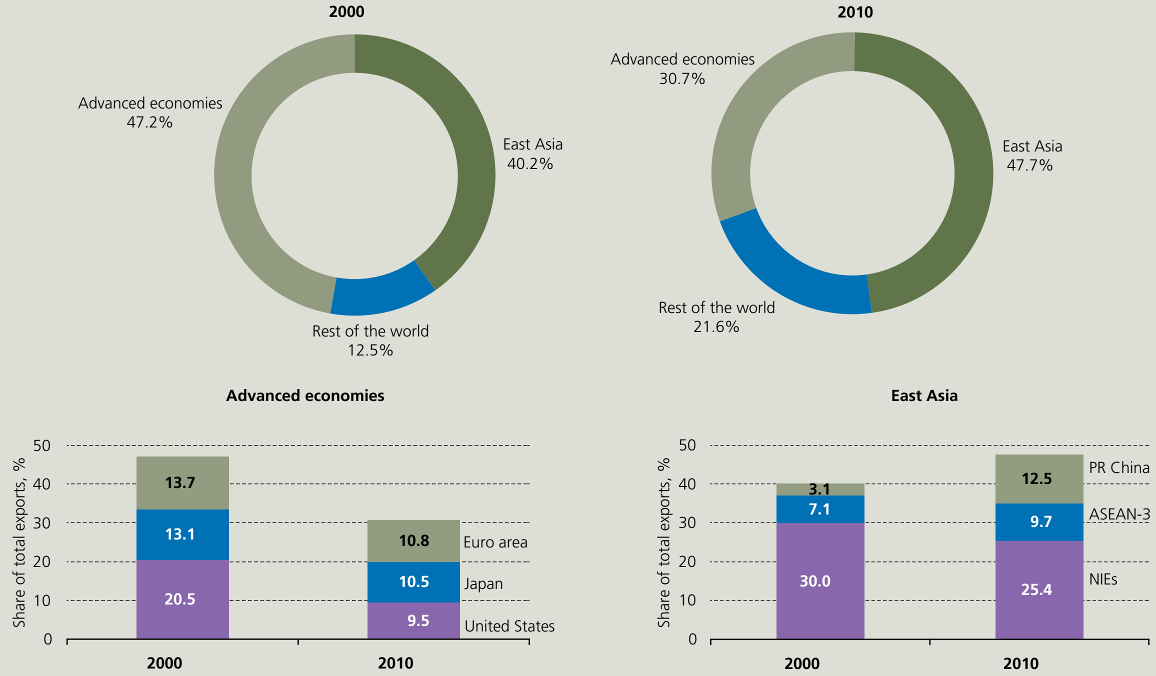
The changing structure of Malaysia's exports over the past decade can also be seen in the context of the **concurrent rise of the emerging economies**. It is projected that the emerging economies will grow twice as fast as the advanced economies and account for more than half of all global growth by 2025[2]. In parallel with this development, a new global middle class is emerging in these countries, resulting in changes in the pattern of global consumption with the growing significance of consumption expenditure in emerging economies. This shift in global consumers is also transforming

[1] ASEAN refers to Singapore, Thailand, Indonesia, Vietnam, Philippines, Brunei Darussalam, Myanmar, Cambodia and Laos.

[2] World Bank 2011, *Global Development Horizons 2011: Multipolarity: The new global economy,* Washington DC.

Chart 7

East Asia has become an increasingly important export destination for Malaysia



* ASEAN-3 refers to Thailand, Indonesia and Philippines
* NIEs refer to Singapore, Hong Kong SAR, Chinese Taipei and Korea

Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

the patterns of global trade, with trade not only flowing from the advanced economies into emerging economies, but also increasingly among emerging economies. In response to these developments, the product composition and destination of Malaysia's exports has also been shifting, with a greater focus on the emerging economies. These changes reduce the nation's vulnerability as exports become less dependent on any specific product or economy.

KEY CHALLENGES AHEAD

While Malaysia has made notable progress in diversifying its export composition and markets over this recent decade, two key challenges remain in the continuing efforts to ensure sustained export performance going forward. Firstly, in the immediate future, with increased uncertainty on the global growth outlook, export demand, particularly from the advanced economies, is expected to be less buoyant. The risk of slower external demand could affect the overall performance of the Malaysian export sector, particularly in industries that are more dependent on the advanced economies, for example, the E&E sector. Secondly, the rise of several large emerging economies, particularly in Asia, will intensify competition in global markets for manufactures, particularly in the export of low-cost, labour-intensive manufactured products. This trend is expected to challenge the competitiveness of the Malaysian export sector, thus intensifying the need for firms in Malaysia to move up to higher value-added activities.

Table 1.9

Balance of Payments

Item	2010			2011*p*		
	+	-	Net	+	-	Net
	RM billion					
Goods	640.0	505.3	134.7	696.1	546.7	149.4
Trade account	*638.8*	*528.8*	*110.0*	*694.5*	*574.2*	*120.3*
Services	105.3	103.6	1.7	107.1	115.5	-8.4
Balance on goods and services	**745.3**	**608.9**	**136.4**	**803.2**	**662.2**	**141.0**
Income	38.3	64.8	-26.5	52.0	74.1	-22.0
Current transfers	1.9	23.7	-21.8	4.7	25.8	-21.1
Balance on current account	**785.5**	**697.4**	**88.1**	**859.9**	**762.0**	**97.9**
% of GNI			**11.9**			**11.8**
Capital account			-0.2			-0.2
Financial account			-19.8			15.5
Direct investment			-13.6			-12.4
Portfolio investment			48.5			30.3
Financial derivatives			-0.7			-0.1
Other investment			-54.0			-2.4
Balance on capital and financial accounts			**-20.0**			**15.3**
Errors and omissions			-70.7			-18.5
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*-32.6*			*7.6*
Overall balance			**-2.6**			**94.7**
Bank Negara Malaysia international reserves, net			**328.6**			**423.3**
USD billion equivalent			**106.5**			**133.6**

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

After adjusting for the E&O, the overall balance of payments recorded a large surplus position of RM94.7 billion. Consequently, the net international reserves of Bank Negara Malaysia amounted to RM423.3 billion, equivalent to USD133.6 billion, as at 31 December 2011. As at 29 February 2012, the reserves remained high at RM426.7 billion (equivalent to USD134.7 billion). This level of reserves is adequate to finance 9.4 months of retained imports and is 4.1 times of the short-term external debt. Malaysia's external reserves remain usable and unencumbered.

CURRENT ACCOUNT

The current account surplus widened to RM97.9 billion or 11.8% of GNI in 2011 (2010: RM88.1 billion or 11.9% of GNI), reflecting a higher trade surplus from the sustained expansion in exports of commodities and non-electronic and electrical (E&E) manufactured products. The larger surplus in the

Table 1.10

External Trade Performance

	2010	2011*p*
	Annual change (%)	
Gross exports	**15.6**	**8.7**
Manufactures	**12.6**	**3.4**
Electronics and electrical (E&E)	8.9	-4.1
Non-E&E	17.7	12.8
Commodities	**28.8**	**26.4**
Agriculture	28.8	32.9
Minerals	28.9	20.3
Gross imports	**21.7**	**8.6**
Capital goods	12.2	9.7
Intermediate goods	23.0	5.4
Consumption goods	9.7	19.0

p Preliminary
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

goods account was more than sufficient to finance the deficits in the services, income and current transfer accounts.

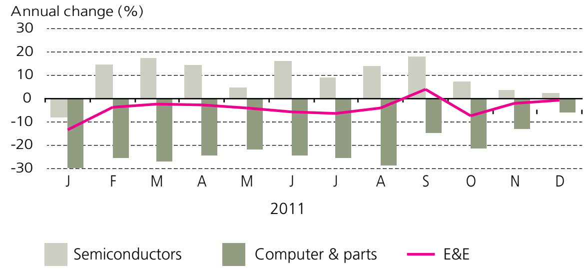
Current account surplus widened, mainly supported by a larger trade surplus

In line with the moderate growth in the advanced economies and heightened uncertainties in the global financial markets, **gross exports** grew at a more modest pace of 8.7% (2010: 15.6%) in 2011. The moderation in gross exports was due mainly to the contraction in exports of E&E products amid sustained growth in exports of commodities and non-E&E products. The lower growth in manufactured exports mainly reflected weaker external demand. Nonetheless, robust regional demand and favourable commodity prices provided crucial support for exports of commodity and resource-based non-E&E products.

External demand for manufactured products was dampened by moderation in global growth
Growth in **manufactured exports** moderated to 3.4%, from a strong growth of 12.6% in 2010. The decline in E&E exports was due mainly to

Chart 1.16

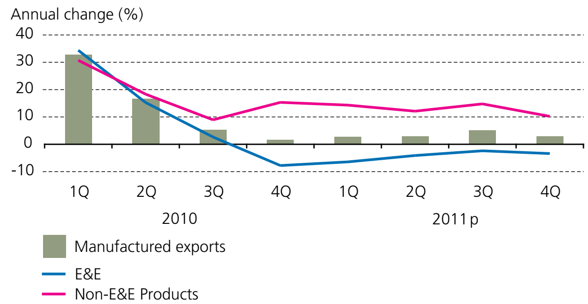
Exports of Semiconductors and Computer and Parts



Source: Department of Statistics, Malaysia

Chart 1.17

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



p Preliminary
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.11

Direction of External Trade

	2011*p*				
	Exports		Imports		Trade balance
	RM billion	Annual change (%)	RM billion	Annual change (%)	RM billion
Total	**694.5**	**8.7**	**574.2**	**8.6**	**120.3**
of which:					
United States	**57.6**	**-5.5**	**55.4**	**-1.5**	**2.2**
European Union (EU)	**71.9**	**4.7**	**60.0**	**10.8**	**12.0**
Selected ASEAN countries[1]	**169.0**	**5.4**	**158.4**	**11.2**	**10.6**
Selected North East Asia countries	**171.0**	**8.9**	**139.4**	**5.9**	**31.6**
The People's Republic of China	*91.2*	*13.9*	*75.6*	*13.8*	*15.6*
Hong Kong SAR	*31.2*	*-3.6*	*13.6*	*7.2*	*17.7*
Chinese Taipei	*22.7*	*12.4*	*27.1*	*13.6*	*-4.4*
Korea	*25.8*	*6.1*	*23.2*	*-19.2*	*2.6*
West Asia	**25.0**	**12.1**	**27.3**	**44.7**	**-2.4**
Japan	**80.0**	**19.8**	**65.3**	**-1.8**	**14.6**
India	**28.2**	**34.6**	**10.2**	**27.6**	**18.0**

[1] Singapore, Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam
p Preliminary
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia

the contraction in exports of computers and parts, while exports of semiconductors expanded further. Exports of computers and parts remained subdued throughout the year. In the first half of 2011, E&E exports registered negative growth as the weak demand from advanced economies was compounded by global supply disruptions following the disaster in Japan. However, the contraction in exports of E&E moderated in the second half of the year as demand for electronics improved while the impact from the global supply-chain disruption receded. Notwithstanding the sluggish performance in E&E exports, non-E&E exports continued to record robust growth in 2011, driven mainly by regional demand for construction-related products such as iron and steel, manufactures of metal and non-metallic mineral products.

Firm regional demand and strong commodity prices boosted export growth

Growth in commodity exports was sustained at 26.4% (2010: 28.8%), amid strong regional demand and high commodity prices. Agriculture exports expanded at a strong pace throughout 2011, mainly on account of resilient domestic demand in the region, and the firm prices of crude palm oil and natural rubber. Mineral exports grew at a more moderate pace of 20.3% (2010: 28.9%), supported by the high prices of crude oil and natural gas. In addition, the export volume of natural gas increased significantly, following higher demand for gas-powered electricity generation in Japan.

Resource-based non-E&E exports also benefited from the elevated commodity prices and firm regional demand, particularly exports of chemicals, petroleum-related products and rubber products. In addition, rebuilding and reconstruction efforts in Japan have further increased demand for exports of wood products and non-metallic mineral products.

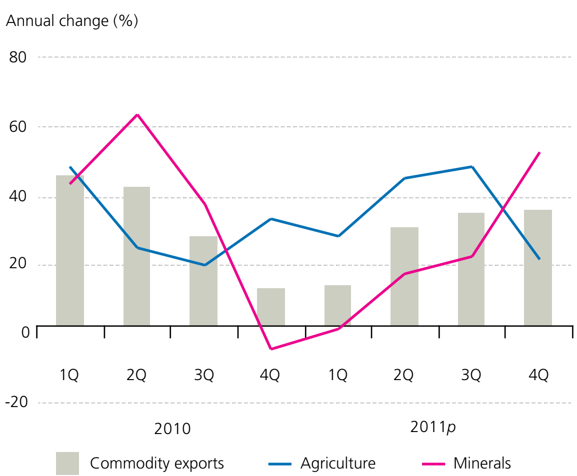
Robust domestic demand spurred higher import growth of consumption goods

Gross imports grew at a more moderate pace of 8.6% (2010: 21.7%) reflecting the slower growth in gross exports and were mainly supported by the continued resilience of domestic demand. Growth in intermediate imports was significantly lower (5.4%; 2010: 23%), in tandem with the moderation in manufacturing activity. Of significance, imports of intermediate goods such as parts and components of machineries were adversely affected by the disaster in Japan in the first half of 2011. The global supply chain was once again disrupted in the fourth quarter of the year as a result of the massive flooding in Thailand, which affected Malaysia's imports of parts and components for computer products.

Capital imports remained strong, albeit registering a more modest growth of 9.7% (2010: 12.2%), driven mainly by the implementation of capital-intensive ETP projects in the manufacturing and mining sectors. Growth in imports of consumption goods more than

Chart 1.18

Commodity Export Performance

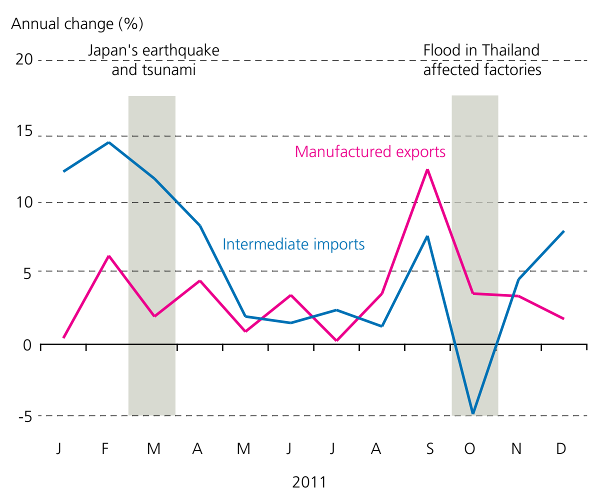


p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.19

Impact of Global Supply Chain Disruptions on Manufactured Exports and Intermediate Imports



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

doubled to 19% (2010: 9.7%) due mainly to higher prices of food and beverages, which rose in tandem with global commodity prices. The improvement in domestic labour market conditions and consumer spending also boosted imports of motor vehicles and durable consumer goods.

In 2011, the **services account** reversed to record a deficit of RM8.4 billion. The deficit stemmed mainly from lower net receipts from the travel account and higher net payments for transportation services.

The net surplus in the **travel** account moderated to RM24.3 billion (2010: RM33.3 billion) due to lower tourism receipts and higher travel outflows. The moderation in tourism receipts reflected mainly the marginal improvement in tourist arrivals of 24.7 million visitors (2010: 24.6 million) and lower receipts from excursionists, mainly on account of the uncertain external environment. Nevertheless, travel remained the single largest contributor to gross services receipts. The larger travel outflows were attributable to the higher expenditures incurred by Malaysians travelling abroad, particularly for business, leisure travel and to seek medical treatment. The higher number of Malaysian Muslims performing the pilgrimage during the year was also a contributing factor.

Table 1.12

Services and Income Accounts

	2010	2011*p*		
	RM billion			
	Net	+	-	Net
Services Account	**1.7**	**107.1**	**115.5**	**-8.4**
Transportation	-23.2	14.8	40.0	-25.2
Travel	33.3	55.9	31.6	24.3
Other services	-8.0	36.1	43.2	-7.0
Government transactions n.i.e.	-0.5	0.3	0.7	-0.5
Income Account	**-26.5**	**52.0**	**74.1**	**-22.0**
Compensation of employees	-2.1	3.6	6.0	-2.4
Investment income	-24.4	48.4	68.1	-19.7
Direct investment	-30.8	28.7	55.7	-27.0
Portfolio investment	-6.9	2.4	11.0	-8.6
Other investment	13.2	17.4	1.4	16.0

n.i.e. Not included elsewhere
p Preliminary
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia

The deficit in the **transportation** account widened to RM25.2 billion (2010: -RM23.2 billion), reflecting largely the increase in freight charges by international shipping lines amid higher fuel costs. Gross receipts were lower due to lower earnings from passenger fares and cargo services provided by domestic shipping companies.

The **other services** account continued to record a large net outflow of RM7 billion (2010: -RM8 billion), as higher receipts from the provision of services was offset largely by larger payments for imported services, particularly for royalties and licence fees, communication, construction as well as insurance and financial services. Computer and information services continued to record a net surplus.

The **income account** deficit narrowed to RM22 billion as the increase in investment income accruing to Malaysian companies investing abroad outpaced the increase in investment income accruing to foreign investors. The higher profits and dividends accruing to Malaysian companies from their investments abroad were mainly accounted for by the mining, financial and insurance as well as agriculture sectors. Investment income accruing to foreign investors also increased following the higher inflows of FDI and portfolio funds into Malaysia during the year.

FINANCIAL ACCOUNT

In 2011, the financial account reversed from a net outflow position to record a net inflow of RM15.5 billion (2010: -RM19.8 billion), largely due to the continued inflows of portfolio funds and foreign direct investments (FDI). Despite heightened uncertainty in the global financial markets, portfolio inflows continued to be buoyed by prospects for strong growth in the region, including Malaysia, and expectations of stronger regional currencies. Of significance, FDI inflows were also higher, amid robust domestic economic conditions and higher corporate profitability. Similarly, direct investment abroad (DIA) by Malaysian companies was higher mainly arising from the expansion of existing businesses abroad. Other investment outflows which largely reflected private sector flows, moderated sharply during the year.

For the year as a whole, **portfolio investment** continued to record a strong, albeit smaller, net inflow, amounting to RM30.3 billion (2010: +RM48.5 billion). The inflows of foreign portfolio

Table 1.13

Balance of Payments: Financial Account

	2010	2011*p*
	RM billion	
Financial Account	**-19.8**	**15.5**
Direct Investment	**-13.6**	**-12.4**
Abroad	-42.9	-45.3
In Malaysia	29.3	32.9
Portfolio Investment	**48.5**	**30.3**
Financial Derivatives	**-0.7**	**-0.1**
Other Investment	**-54.0**	**-2.4**
Official sector[1]	0.2	-1.3
Federal Government	*-0.4*	*-0.2*
NFPEs	*0.6*	*-1.1*
Private sector	-54.2	-1.1

[1] Excludes bonds and notes raised abroad by the Federal Government and NFPEs

p Preliminary

Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

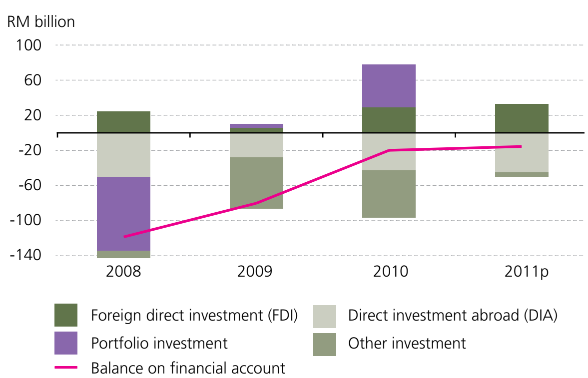
funds were channeled into both the equity and debt securities markets, with the bulk of the funds flowing mainly into long-term debt securities, particularly Government papers. In the first half of 2011, net portfolio investments recorded a strong inflow of RM56.4 billion, exceeding the total amount recorded in 2010. These inflows reflected the favourable economic outlook for the region, notably the strong growth prospects and sound economic fundamentals amid low interest rates and more subdued growth in the advanced economies. However, the intensification of fiscal uncertainties in the US and the escalation of the sovereign debt crisis in Europe led to a substantial deterioration in the global financial markets. The second half of the year saw significant outflows amounting to RM26.1 billion. The reversals reflected deleveraging of assets by international investors following heightened risk aversion in the financial markets, and a tightening of global credit conditions.

The financial account recorded a net inflow on account of continued inflows of portfolio investment and higher FDI

Malaysia has ample policy space and was in a strong position to manage volatile capital flows without causing distortions in the domestic financial system. The country's well-developed financial markets, particularly the deep and diversified bond markets, facilitated efficient intermediation of capital flows. The impact of outflows of foreign funds was cushioned by the greater prominence of domestic institutional players in the capital markets, while the high international reserves of Bank Negara Malaysia instilled market confidence in Malaysia's ability to manage reversals of foreign capital. Importantly, the wide range of monetary instruments at the disposal of the Bank facilitated the efficient management of domestic liquidity while the managed float exchange rate regime provided the necessary flexibility for the exchange rate to adjust to external conditions.

Chart 1.20

Financial Account

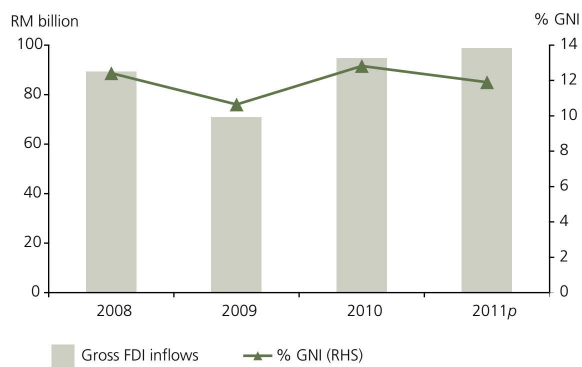


p Preliminary

Source: Department of Statistics, Malaysia

Chart 1.21

Foreign Direct Investment (FDI)



p Preliminary

Source: Department of Statistics, Malaysia

Thus, it was observed that the significant gross flows of foreign funds did not cause undue pressure on the domestic financial system.

Gross inflows of **FDI** remained significant at RM98.9 billion, accounting for 11.9% of GNI in 2011, in tandem with the strong overall domestic investment outlook and a revival of corporate earnings. This was evident in the larger inflows of equity capital and the extension of inter-company loans, amid sizeable earnings retained by existing multinational corporations (MNCs) for reinvestment purposes. Malaysia's growth prospects were a key factor underpinning this trend. The domestic investment climate was further boosted by various Government-facilitated economic initiatives.

Throughout the year, several Entry Point Projects (EPPs) under the Economic Transformation Programme (ETP) had attracted substantial investments from foreign investors. Moreover, Malaysia's improved position in various cross-country economic rankings enhanced investment prospects in the country. Notably, Malaysia made progress in the rankings for global competitiveness, ease of doing business, and FDI confidence, according to reports released by the World Economic Forum, World Bank and global management consultants, AT Kearney. After taking into account adjustments for outflows due largely to loan repayments to parent companies, the net inflow of FDI was higher at RM32.9 billion or 4.0% of GNI.

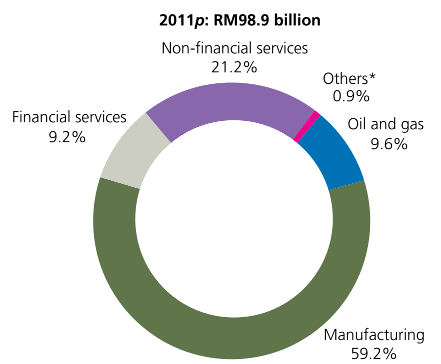
FDI in Malaysia continued to be broad-based, with inflows into the manufacturing sector accounting for most of the FDI (59.2% share), followed by the services (30.3%) and oil and gas (9.6%) sectors. In the manufacturing sector, FDI was mainly channelled into the E&E industry, largely by existing MNCs for the upgrading of equipment and production technology. Other investments in the manufacturing sector were in petroleum refining and petroleum-related products industry, which continued to account for a sizeable portion of FDI in Malaysia. At the same time, there have also been increasingly substantial investments by firms in the solar-energy industry during the year. These investments will boost the expansion of the solar-energy value chain in Malaysia.

In the services sector, FDI inflows were channelled primarily into the wholesale and retail sub-sector, followed by the finance and insurance sub-sector. Of significance, the bulk of investments in the finance and insurance sub-sector were undertaken by foreign financial institutions, mainly in the form of corporate earnings retained for reinvestment. In the wholesale and retail sub-sector, FDI inflows were mainly attributed to foreign general retailers, motor vehicle distributors, and distributive companies related to telecommunications and electronic products.

Investments in the oil and gas sector were largely for extraction operations and production

Chart 1.22

Gross FDI Inflows by Sector



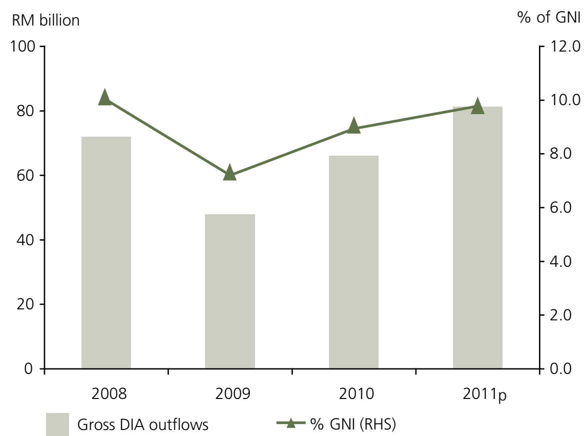
Note: *Refers to agriculture and construction sectors

p: Preliminary

Source: Department of Statistics, Malaysia

Chart 1.23

Direct Investment Abroad (DIA)

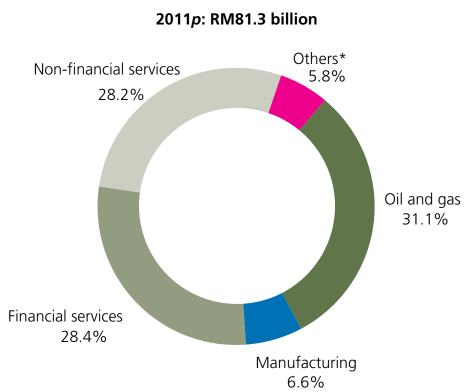


p Preliminary

Source: Department of Statistics, Malaysia

Chart 1.24

Gross DIA Outflows by Sector



Note : *Refers to agriculture and construction sectors

p Preliminary

Source : Department of Statistics, Malaysia

activities. In terms of the country of origin of FDI, major contributors of FDI inflows in 2011 were the advanced economies, particularly the US, Japan and Germany. It is important to note that FDI from regional countries has increased in recent years, accounting for 32.3% of total FDI to Malaysia in 2011, relative to 10.1% in 2003.

In 2011, Malaysian companies continued to explore business opportunities abroad, particularly in Asia and emerging economies as indicated by increased **DIA** outflows during the year. Gross outflows of DIA by Malaysian companies were higher at RM81.3 billion, accounting for 9.8% of GNI. This development reflected the increased capability and rising interest of Malaysian companies to diversify their operations abroad through expansion of existing operations. After taking into account the gross inflows due to repayments of loans by overseas subsidiaries and consolidation of business abroad, net DIA outflows amounted to RM45.3 billion or 5.5% of GNI.

DIA by Malaysian companies were largely channelled into the services (56.5% share) and oil and gas (31.1%) sectors, while investments in the manufacturing sector remained sizeable (6.6%). Of significance, investments in the services sector were led by domestic financial institutions, utilities and telecommunications companies which expanded operations abroad in an effort to further capitalise on business opportunities in the region and to remain competitive on a regional scale.

In the oil and gas sector, the DIA continued to be driven by the Malaysian oil companies, primarily in the exploration and production (E&P) business and downstream processing activities. Investment abroad in the manufacturing sector mainly reflected the continued expansion of operations abroad by companies in the resource-based industries. Of importance, the bulk of DIA during the year were undertaken within the region, particularly in ASEAN, the Newly Industrialised Economies (NIEs) and West Asian economies. There were also sizeable investments abroad by Malaysian companies in the advanced economies, notably in Australia and the United Kingdom.

Other investment recorded a significantly smaller net outflow of RM2.4 billion in 2011 on account of a sharp moderation in private sector outflows. Of significance, the banking sector turned around from a net outflow position to record a net inflow, partly reflecting the deleveraging of assets abroad by domestic financial institutions, in an environment of heightened risk aversion and global economic uncertainties. Net outflows of trade credits were also smaller during the year, in tandem with the slower pace of international trade. The official sector also recorded a net outflow position, mainly reflecting external loan repayments by both the Federal Government and the Non-Financial Public Enterprises.

INTERNATIONAL RESERVES

The **international reserves** held by Bank Negara Malaysia comprise its holdings of gold and foreign exchange, its reserve position with the International Monetary Fund (IMF) and holdings of Special Drawing Rights (SDRs). During the year, net international reserves increased by RM94.7 billion to RM423.3 billion (equivalent to USD133.6 billion) as at 31 December 2011.

The increase in international reserves during the year was mainly supported by the continued surplus in the current account. This was attributed to a larger surplus in the trade account, underpinned by robust exports of commodities and non-E&E exports. Higher international reserves also reflected the inflow of portfolio investment and FDI. The international reserves recorded a significant increase in the second quarter, owing largely to the sizeable inflow of portfolio investment. Nonetheless, the accumulation of international reserves eased in the second half of the year following

Table 1.14

Net International Reserves

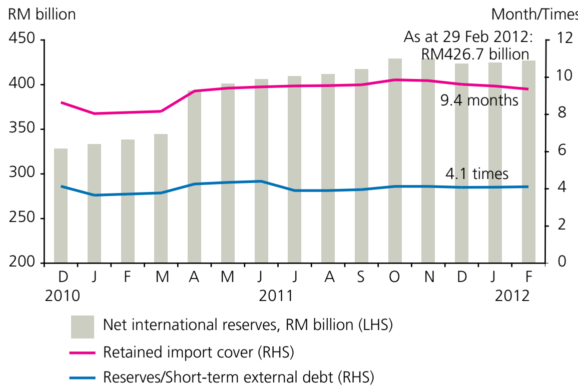
	As at end		Change
	2010	2011	2011
	RM million		
SDR holdings	6,442.5	6,253.0	-189.5
IMF reserve position	1,453.5	2,672.2	1,218.7
Gold and foreign exchange	320,774.5	414,432.5	93,658.0
Gross International Reserves	**328,670.5**	**423,357.7**	**94,687.2**
Less Bank Negara Malaysia external liabilities	21.4	26.7	5.3
Net International Reserves	**328,649.1**	**423,331.0**	**94,681.9**
USD million equivalent	106,518.2	133,609.8	27,091.6
Months of retained imports	8.6	9.6	
Reserves/Short-term external debt (times)	4.1	4.1	

Note: Numbers may not necessarily add up due to rounding

Source: Bank Negara Malaysia

Chart 1.25

Net International Reserves (end-month)



Source: Bank Negara Malaysia

reversals of portfolio investment as the global financial markets turned more volatile. The rise in international reserves was also partly offset by higher direct investment abroad during the year. The cumulative unrealised foreign exchange revaluation gain amounted to RM7.6 billion following the strengthening of some of the major currencies against the ringgit in 2011.

Malaysia remains a participating member in the Financial Transactions Plan of the IMF. Under this plan, a member will provide resources to member countries facing short-term balance of payments difficulties. The increase in Malaysia's **reserve position with the IMF** in 2011 reflected mainly net purchases of currencies by various IMF member countries under the Financial Transactions Plan. The decrease in international reserves held in the form of **SDRs** was attributed mainly to the payment for Malaysia's quota increase under the 2008 IMF Ad Hoc Quota Increase exercise.

The international reserves held by Bank Negara Malaysia continued to be invested in well-diversified markets and asset classes with strong credit quality. In managing the rising financial market volatility from the prolonged European sovereign debt crisis and lower global growth, investment adjustments were undertaken to manage euro area exposures accordingly and to further diversify investments into Asian markets. Thus, despite widespread credit rating downgrades in the euro area, the credit quality of the investments of Malaysia's international reserves remained high. The scope and granularity of surveillance and risk management in the investment of the international reserves were also enhanced during the year. The strong governance process in place ensures that all key events and risks are appropriately disclosed, and in a timely manner, to the Bank's Reserve Management Committee and Board of Directors.

International reserves increased by RM94.7 billion to RM423.3 billion in 2011, supported mainly by the continued surplus in the current account as well as inflows of FDI and portfolio investment

As at 29 February 2012, the reserves level amounted to RM426.7 billion (equivalent to USD134.7 billion), which is adequate to finance 9.4 months of retained imports and is 4.1 times the short-term external debt. The international reserves held by the Bank are usable and unencumbered. There are no foreign currency loans with embedded options and no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks and other financial institutions. Bank Negara Malaysia also does not engage in ringgit-related options activity in the foreign currency markets.

EXTERNAL DEBT

To further enhance efficiency in the management of corporate finance and access to more competitive financing, flexibility was accorded for resident corporations to freely borrow in ringgit or foreign currency within a corporate group in Malaysia and from abroad. In tandem with the flexibility accorded for accessing offshore borrowing, resident corporations were also able to undertake effective asset and liability management through the well-developed domestic financial markets. An early detection mechanism of possible risks to monetary and financial stability has been put in place. In line with this, continuous emphasis is placed on having a well-functioning and robust debt monitoring system that covers the overall debt level, structure, maturity and debt-servicing obligations.

As at end-2011, Malaysia's total external debt amounted to RM257.2 billion (or USD80.4 billion), equivalent to 31% of GNI (2010: RM227.1 billion). This reflected the increase in both medium- and long-term and short-term debt. The appreciation of some of the major currencies against the ringgit during the year also contributed to the rise in the overall external debt level. As at end-year, Malaysia's external debt profile continued to be skewed towards a longer maturity structure with medium- and long-term debt accounting for 59.6% of total external debt.

Table 1.15

Outstanding External Debt

	2010	2011*p*	2010	2011*p*
	RM billion	RM billion	USD billion	USD billion
Total debt	**227.1**	**257.2**	**72.8**	**80.4**
Medium- and long-term	147.7	153.4	47.4	47.9
Short-term[1]	79.4	103.9	25.5	32.5
As % of total debt	*35.0*	*40.4*		
As % of net international reserves	*24.2*	*24.5*		
As % of GNI				
Total debt	30.7	31.0		
Medium- and long-term debt	20.0	18.5		
As % of exports of goods and services				
Total debt	30.5	32.0		
Medium- and long-term debt	19.8	19.1		
Debt service ratio (%)[2]	**7.6**	**10.3**		

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

Malaysia's external debt remained low at 31% of GNI

The increase in the **medium- and long-term external debt** partly reflected the net drawdown of external borrowings by the Federal Government and private sector. In July 2011, the **Federal Government** successfully issued a dual tranche (5-year and 10-year) Wakala Global Sukuk of USD2 billion. The issuance was Malaysia's third US dollar-denominated sovereign sukuk issuance, after the previous Global Sukuk issuance in 2010. As at end-year, the outstanding external debt of the Federal Government rose to RM18.1 billion (2010: RM16.7 billion), as higher gross borrowings and exchange rate revaluation losses more than offset repayments during the year. The external debt of the **NFPEs** however declined to RM65 billion in 2011 (2010: RM66.6 billion). The improvement came mainly from large repayments of external loans following the maturity of several bonds, as well as continued loan repayments throughout the year.

The medium- and long-term debt of the **private sector** increased to RM70.3 billion (2010: RM64.3 billion), following net drawdown of external borrowings by the banking sector, which outweighed the net repayment by the non-bank sector.

During the year, outstanding **short-term external debt** rose to RM103.9 billion (2010: RM79.4 billion), attributed primarily to increased interbank borrowings. The bulk of the short-term debt continued to be held by the banking sector (88.9% share). The short-term external debt of the non-bank private sector, comprising mainly of term loans, remained low. As at end-2011, the short-term external debt remained low, accounting for only 12.5% of GNI, 24.5% of international reserves and 12.9% of exports of goods and services.

LABOUR MARKET DEVELOPMENTS

Overall labour market conditions improved in 2011, as reflected by the gains in employment and higher number of vacancies. The unemployment rate declined to 3.1% of the labour force in 2011 from 3.3% in the previous year, the lowest annual rate recorded since year 2000.

Labour market conditions improved in 2011

During the year, **employment** expanded by 2.4%, equivalent to a net addition of 291,500 jobs. Gains in employment were registered across all major sectors. Services and manufacturing sectors remained the major sources of employment creation, with net additions of 174,300 and 117,500 jobs respectively. Employment gains in the services sector were mainly recorded in the wholesale and retail trade (107,100 jobs); and transport, storage and communications (23,600 jobs) sub-sectors.

Retrenchments increased to 9,450 persons, compared to 7,085 persons in 2010. This was caused mainly by higher layoffs in the manufacturing (5,635 persons; 2010: 3,854 persons) and services sectors (3,329 persons; 2010: 2,073 persons). Nevertheless, this level of retrenchments was still low compared to the 2002-2007 average annual retrenchments of 18,853 persons. More than a third of retrenchments in the manufacturing sector occurred in the month of August, when 2,056 workers were retrenched as a result of the closure of several low-end E&E and furniture companies. The agriculture and mining sectors recorded improvements in total retrenchments, with the agriculture sector registering 80% lower retrenchments compared to 2010. **Vacancies** posted on JobsMalaysia Portal increased to 2.3 million positions (2010: 1.8 million positions), attributable to higher number of job openings in the services (34% of total positions) and manufacturing (31% of total positions) sectors. Hiring activity in the construction sector was particularly strong in the second half of the year, supported by the expansion in construction activity during this period.

Chart 1.26

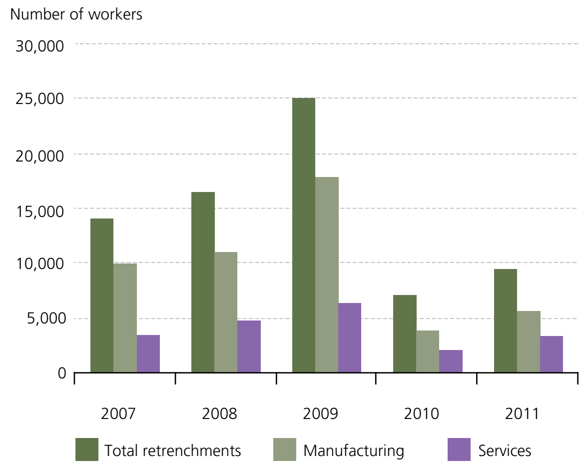
Output and Employment

e Estimate

Source: Economic Planning Unit and Department of Statistics, Malaysia

Chart 1.27

Retrenchments in Selected Sectors



Source: Ministry of Human Resources

In July 2011, the Government initiated the Illegal Immigration Comprehensive Settlement Programme (6P) to register and legalise illegal immigrants in order to enhance the management and monitoring of **foreign workers**. Under the programme, a total of 2.3 million immigrants, comprising 1 million legal and 1.3 million illegal workers were registered as at end-August 2011. As at 13 February 2012, 379,020 illegal workers had been legalised while a total of 94,856 illegal workers had been granted amnesty and had left the country. Excluding the legalised workers from the 6P programme, as at end-2011, total registered foreign workers (including expatriates) in Malaysia increased by 3.6% to 1.9 million workers (2010: 1.8 million). Of significance, high-skilled expatriates which constituted 2.4% of foreign workforce, increased by 40% to 45,619

Table 1.16

Selected Labour Market Indicators

	2007	2008	2009	2010	2011e
Employment[1] ('000 persons)	11,398.0	11,576.5	11,632.1	11,956.0	12,247.5
Annual change (%)	2.1	1.6	0.5	2.8	2.4
Labour force[1] ('000 persons)	11,775.1	11,967.5	12,083.0	12,361.3	12,645.7
Annual change (%)	2.0	1.6	1.0	2.3	2.3
Retrenchments (persons)	14,035.0	16,469.0	25,064.0	7,085.0	9,450.0
Unemployment rate[1] (% of labour force)	3.2	3.3	3.7	3.3	3.1
Real labour productivity growth[2] (%)	4.2	3.1	-2.2	4.5	2.6

[1] Based on estimates by Economic Planning Unit
[2] Based on estimates by Bank Negara Malaysia
e Estimates

Source: Bank Negara Malaysia
Economic Planning Unit
Ministry of Human Resources

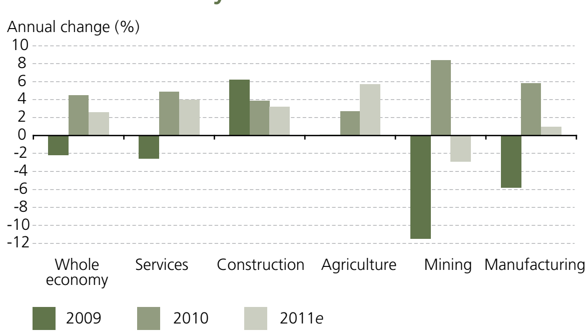
persons. In total, foreign workers accounted for 15.4% of employment in Malaysia and were mainly engaged in the manufacturing (38%), agriculture (27.4%) and domestic help (12%) sectors.

Labour productivity, as measured by real value-added per worker, recorded a positive but slower growth of 2.6% in 2011, compared to 4.5% in the previous year. The slower growth reflected a moderation in productivity gains in the services, manufacturing and construction sectors, and a decline in productivity in the mining sector, attributable mostly to the lower value-added growth of these sectors during the year.

According to a survey conducted by Bank Negara Malaysia, the average **salary** in the private sector increased by 4.0% in 2011 (2010: 4.5%), with an average increment of 2.2% and 4.5% in the manufacturing and non-manufacturing sectors respectively (2010: 3.8% and 5.5% respectively). Increments for executives grew at a slower rate of 3.7% (2010: 4.3%), while non-executives received a salary increment of 3.9% during the year (2010: 4.4%).

Chart 1.28

Labour Productivity Trends



e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

PRICE DEVELOPMENTS

Consumer prices

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 3.2% in 2011 (2010: 1.7%). Inflation in 2011 was within the Bank's forecast range of 2.5-3.5%. The increase in inflation, particularly during the first half of the year, was due mainly to supply factors, arising from higher food prices and upward adjustments to administered prices. Inflation peaked in June at 3.5% and subsequently stabilised in the second half of 2011, as the impact from the upward adjustments on the prices of petroleum products and sugar in July and December 2010 wore off. Core inflation, an indicator of demand-driven pressures on prices, rose to 2.7% in 2011 (2010: 1.5%).

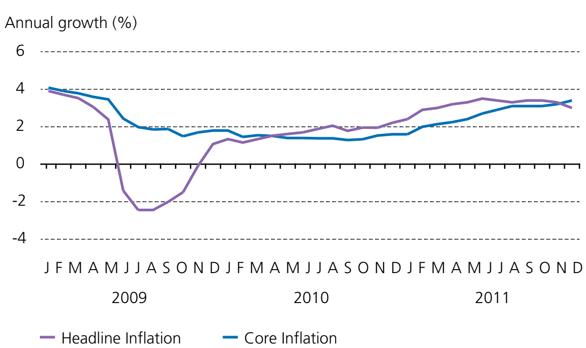
The main contributors to inflation in 2011 were the *food and non-alcoholic beverages* and *transport* categories, which together accounted for 67.1% of the overall increase in domestic prices during the year. Inflation in the *food and non-alcoholic beverages* category averaged at 4.8% (2010: 2.4%) mainly on account of higher price increases in the *meat, fish and seafood, vegetables* and *fruits* sub-categories. Inflation in the *transport* category registered a significant increase from 1.6% in 2010 to 4.4% in 2011 following adjustments to the price of RON97 petrol and higher maintenance costs for personal transport. However, the increase in inflation during the year was partly mitigated by the decline in prices for *clothing and footwear* and *communication* categories, which averaged -0.2% and -0.3% respectively (2010: -1.4% and -0.2% respectively).

Supply factors, both external and domestic, were the key drivers of inflation during the year. Externally, rising inflationary trends were evident in the emerging economies, underpinned by higher global commodity prices and stronger domestic demand, particularly in the first half of the year. These factors, however, subsided in the second half of the year, following concerns over the strength of global growth. Global food prices, which had been on an uptrend since the second half of 2010, rose further in 2011. Global cereal prices, in particular wheat, corn and rice, increased following adverse weather conditions and low stockpiles in key producing countries. The excessive heat experienced in Russia and the United States had led to reduced supplies of wheat and corn, driving their prices higher, while the floods in Thailand and Vietnam raised global prices for rice. This resulted in the reduction of stockpile for both corn and rice. For rice, global prices were already rising following the new measure announced by the Thai Government to buy rice directly from the farmers at 50% above the market rates.

Global energy prices were also higher. Global crude oil prices rose sharply during the first four months of

Chart 1.29

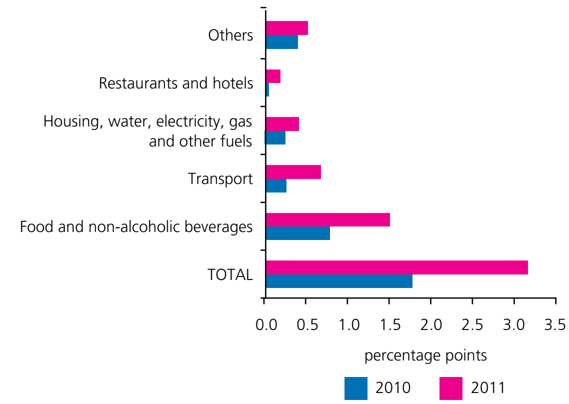
Consumer Price Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.30

Contribution to Inflation



Note: Others refer 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 year due to supply concerns following political tensions in Middle East and North Africa (MENA) region. The increase in prices was further amplified by the increase in investors' yield-seeking activities due to the high global liquidity and low interest rate environment. However, the spike in global crude oil prices subsided in May 2011 and into the second half of the year, following the easing of concerns about supply conditions. Supply was expected to improve following a commitment made by the Organisation of the Petroleum Exporting Countries (OPEC) to increase oil production and the announcement of the release of 60 million barrels of crude oil from the emergency stockpile by the International Energy Agency (IEA) member countries.

The high global commodity prices, especially crude oil and food, had also led to higher inflation in Malaysia's key import partners. In addition to pressures from supply factors, some import partners also experienced higher inflation following stronger-than-expected growth in domestic demand. This had led to higher imported prices and subsequently higher domestic retail prices in Malaysia. The upward price pressures from higher global commodity prices and inflation in key import partners were slightly mitigated by the appreciation of the ringgit during the first half of 2011. The role of the ringgit appreciation in mitigating the impact of higher imported inflation on domestic inflation, however, was relatively small *(See white box on Impact of Ringgit Appreciation on Import Prices and Inflation).*

Compared to 2010, the impact from external supply factors on domestic prices was more dominant in 2011. For example, the higher prices of corn and wheat had led to higher prices of poultry feed, which in turn increased poultry prices in Malaysia. The increase in global rice price, however, had a minimal impact on domestic rice prices as the bulk of the rice consumption is sourced domestically and contracts for imports of rice have been secured up to 2012. Following the increase in global energy prices in 2011, there were several upward adjustments on administered prices during the year. The price of RON97 petrol, which was determined under a managed float mechanism, was raised by a total of 50 sen/litre between January and July 2011, and contributed 0.25 percentage points to headline inflation in 2011. Electricity tariffs were also revised upward on average by 7.1% from 31.31 sen/kWh to 33.54 sen/kWh due to the higher price of natural gas. In addition, the Government adjusted the price for kerosene upward by 10 sen/litre, from RM2.40/litre to RM2.50/litre in January 2011, and raised the retail price of sugar by 20 sen/kilogram, in line with the Government subsidy rationalisation plan.

Besides the impact from external prices, disruptions in domestic supply due to irregular weather patterns and labour shortages had also led to increases in food inflation during the year. Heavy rains due to the monsoon season had kept prices of fish and seafood high throughout the year. This was amplified by the withdrawal of additional subsidies for diesel for fishing trawlers in May. For vegetables and fruits, shortages of foreign labour had compounded the supply disruptions arising from adverse weather, adding further upward pressure on prices.

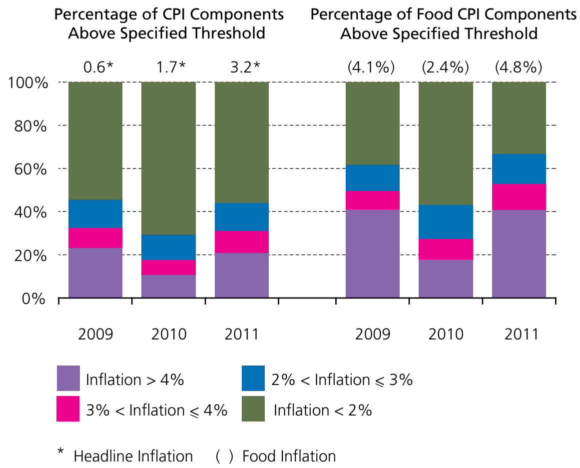
As inflation during the year was driven mainly by supply factors, the Government introduced various initiatives, comprising both short- and long-term measures, to address the rising cost of living and contain the increases in domestic prices. In the short run, to prevent any sudden hikes in prices, the Government employed a more gradual subsidy rationalisation programme and focused on the strict enforcement of the festive season price control scheme. In addition, the Government also calibrated the supply and demand of essential food items to ensure sufficient supply by issuing more approved permits (APs) for higher food import. This helped contain food price increases in the domestic market.

As for long-term measures, the Government strives to preserve the standard of living and provide more alternatives to consumers. Towards this goal, the Government initiated campaigns to encourage fair pricing, for example, through the launch of *Kedai Rakyat 1Malaysia (KR1M)* and *Menu Rakyat 1Malaysia*. The *1Malaysia Pengguna Bijak Portal* was also created to safeguard the interest of consumers and promote consumer awareness. Furthermore, two new legislations were enacted, namely the Anti-Profiteering Act (2011) and The Competition Act (2010). In ensuring sustainable food supply and to reduce reliance on food imports, the Government introduced the 4th National Agri-food Policy (NAP) 2011-2020 that aimed at improving food security. The Government also implemented measures to improve the public transportation system in Malaysia, including the extension of current Light Rail Transit (LRT) route and the launch of a new Mass Rapid Transit (MRT) project.

Demand pressures were stronger in 2011. There were indications that strong domestic demand reinforced the cost-push inflation. Private consumption increased in 2011 as household spending during the year was supported by favourable labour market conditions and a continued rise in wages. The income boost from high commodity prices also provided further impetus to consumption in the rural areas. In addition, there was limited slack in the economy as output was near its potential. During the year, firms registered higher capacity utilisation of close to 80% (2010: 76%). Given the strong demand conditions, firms were able to pass on the increase in costs arising from high commodity prices by adjusting retail prices upward. Consequently, core inflation rose during the year, with more pervasive increases in inflation across the CPI components. Of significance, the proportion of the CPI sub-categories registering inflation rates of more than 2% rose from 35% in January to 49.6% in September. The pervasive price increases were confined mainly in the *food and non-alcoholic beverages* category, with 65% of food components recording inflation of more than 2% in the first nine months of 2011 (2010: 43%). Towards the end of the year, there was indication

Chart 1.31

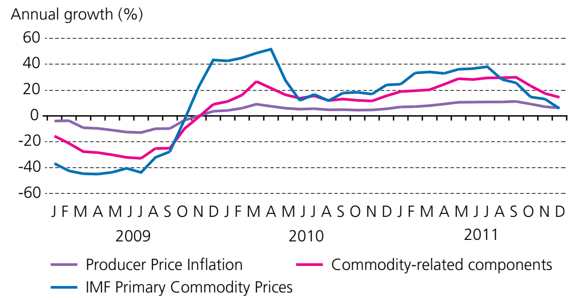
Percentage of CPI Components and Food CPI Components Above Specified Threshold



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.32

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, IMF and Bank Negara Malaysia

that the widespread increase in inflation had been contained. The percentage of CPI sub-categories registering inflation rate of more than 2% have stabilised since October 2011. The subsiding supply pressures and increased uncertainties over growth prospects in the fourth quarter of the year helped to restrain pressures on inflation.

Producer prices

Producer price inflation, as measured by the annual percentage change in the Producer Price Index (PPI), rose to 9.0% in 2011 (2010: 5.6%) driven by higher global commodity prices. The annual growth of the PPI trended upwards from the beginning of the year and subsequently moderated since October, as global commodity prices declined.

In terms of composition, the commodity-related components of the PPI saw a significant increase of 23.6% (2010: 15.4%). The increase in global commodity prices during the year led to higher inflation of 24.2% and 23.2% in the *mineral fuels, lubricants, etc*. and *crude materials, inedible* sub-categories respectively during the year (2010: 12.8% and 22.4%). The non-commodity related PPI components, however, increased at a more moderate pace of 2.1% in 2011 (2010: 1.6%). Both local and imported components of the PPI registered higher inflation during the year. The annual growth of the PPI for local components increased to 12.0% (2010: 7.7%) while that for the imported components rose by 2.3% on an annual basis (2010: 1.4%).

Propagation of Global Commodity Prices to Inflation in Malaysia

Introduction

Global commodity prices have surged since early 2007 and have continued to remain high with the exception of the brief and sharp decline in 2009 following a contraction in global growth. Within this period, there were also sharp and large swings in prices of the key commodities, especially crude oil prices. The high and more volatile global commodity prices in the recent years are the result of rising global demand, global supply disruptions and the increased financialisation of commodities amid excess global liquidity. This situation is expected to remain for a sustained period, as these factors are expected to continue.

The increase in global commodity prices has a varying impact on inflation across different countries. The magnitude of the pass-through from global prices to domestic inflation is structurally determined, amongst others, by the contribution of these commodities, either directly or indirectly, to items in the Consumer Price Index (CPI) basket, the extent to which the domestic prices of these commodities are subsidised by the Government, whether a country is a net exporter or importer of commodities, as well as exchange rate movements. This article looks at the channels through which global commodity prices are propagated to domestic inflation in Malaysia based on recent episodes of higher commodity prices in 2008 and 2011.

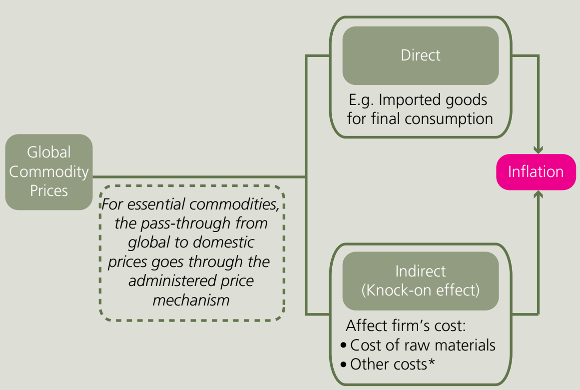
Propagation of Global Commodity Price Shocks in Malaysia

For Malaysia, global commodity prices are one of the key drivers of domestic inflation. The transmission of global commodity prices to inflation is, however, influenced by the Government's administered price mechanism. Domestic prices of essential commodities, such as rice, sugar and fuel, are administered or subsidised by the Government[1]. Hence, the degree of adjustments to administered prices in response to changes in global commodity prices would be a key determinant of the ultimate impact on inflation.

Changes in global commodity prices can be transmitted directly and indirectly to domestic inflation. The **direct effect** happens when changes in global commodity prices are transmitted directly into changes in the prices of final goods and services that are purchased by consumers. The **indirect effect** or the **knock-on effect** of higher global commodity prices on domestic inflation occurs when the prices of other non-commodity related consumer goods and services are raised by businesses in response to the increase in their cost of operations arising from the higher commodity prices. These costs include the cost of raw materials, transportation, logistics and utilities. The magnitude of knock-on effect is conditional on several factors. First, the extent to which the increase in cost affects profit margins. If higher commodity prices lead to a significant increase in costs, businesses may be more inclined to pass on the costs to protect their margins. Second, the structure of the market for the products. In a competitive market, concerns about losing market share may constrain the extent to which firms can raise prices. Conversely, in a monopolistic market,

Chart 1

Direct and Indirect Effects of Changes in Global Commodity Prices to Inflation



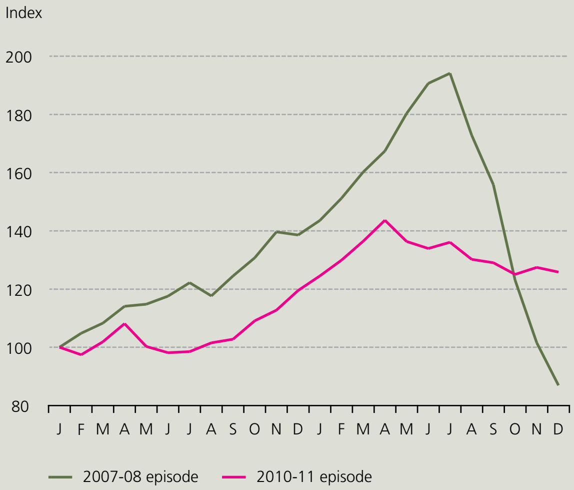
* Other costs include transportation, utilities, packaging, logistics and distribution

Source: Bank Negara Malaysia

[1] Details of the Government's Administered Price Mechanism are available in the White Box on Determinants of Inflation in Malaysia, published in the Bank Negara Malaysia 2010 Annual Report.

Chart 2

Global Commodity Prices in 2008 and 2011



Note: The IMF Primary Commodity Index has been rebased to January 2007=100 for the 2007-08 episode and January 2010=100 for the 2010-11 episode.

Source: IMF

or a market with a dominant player, there may be a greater propensity to raise prices. Third, the underlying demand conditions also matter. If demand is weak, or is highly responsive to price changes, businesses may maintain prices to retain sales.

The strength of the knock-on effect on inflation is reflected in the degree of pervasiveness of price increases. If there is a strong knock-on effect, there will be a widespread increase in prices across the CPI components. The more widespread increase in prices would also be reflected in the rise in core inflation. A more generalised and persistent increase in prices will consequently raise the cost of living.

The two most recent episodes of higher global commodity prices occurred in 2008 and 2011. In 2008, the increase in global commodity prices was sharp and persistent. Between January 2007 and July 2008, global crude oil prices more than doubled, while global food prices rose by more than 50% within the 19-month period. In particular, there was a sharp increase in global rice prices in March 2008 as poor harvests in the major rice-exporting countries caused supply shortages and prompted large-scale stockpiling by some countries to ensure food security, further contributing to the shortages and intensifying the pressure on prices.

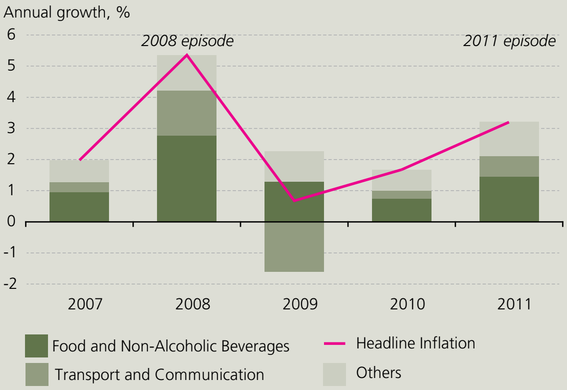
The impact of the sharp increases in global commodity prices on domestic inflation was, nevertheless, delayed due to the Government controls over some of the domestic food and energy prices. The average inflation rate in the first five months of 2008 remained subdued at 2.9%. The regional economies[2], meanwhile, registered a higher inflation rate of 8.7% during the same period (2007: 4.7%). However, as the increases in global commodity prices intensified, the Government revised the prices of several administered items, including retail petroleum products, electricity tariffs and rice to reduce the drain on Government resources in providing the subsidies. Apart from the substantial financial burden to the Government, subsidies were also becoming a source of inefficiencies in the economy and created market distortions. Prices were, therefore, adjusted over three consecutive months. These adjustments were large, with domestic rice prices being raised by 15-40% in May, fuel prices[3] increased by an average of 40.4% in June and electricity tariffs adjusted upwards by 5% in July. As a result, the headline inflation rose sharply to 7.7% and 8.5% in June and July respectively. In terms of the direct effects, inflation in the *rice, bread and other cereals* category of the CPI basket rose sharply to 18.8% in May, while inflation in the *transport* category increased by 19.6% in June. Inflation in the *electricity, gas and other fuels* sub-category was higher at 4.4% in July. Together, the direct effects of the adjustments to administered prices contributed to 40% of the average inflation between May and July 2008.

The increase in global energy and food prices, and the subsequent adjustments to administered prices also led to increases in the cost of raw materials, transportation and electricity, which in turn increased

[2] Comprised of the PR China, Indonesia, India, Philippines, Singapore, Thailand and Vietnam.
[3] Refers to prices for RON92 and RON97 petrol and diesel.

Chart 3

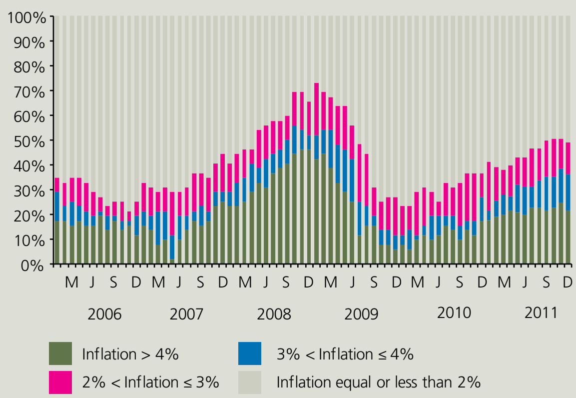
Headline Inflation, 2007 - 2011



Source: Bank Negara Malaysia and Department of Statistics, Malaysia

Chart 4

Percentage of CPI Components Experiencing Specific Levels of Inflation



Source: Bank Negara Malaysia

the cost of operations for businesses. The robust domestic demand conditions in the first half of 2008 enabled many businesses to pass on the higher costs to consumers by raising retail prices within three months of the adjustments on administered prices. There were large knock-on effects to other CPI categories, such as *restaurants and hotels* and *furnishing, household equipment and routine household maintenance*. The strong knock-on effects were reflected in a more pervasive increase in prices. Close to two thirds of the CPI components registered an inflation rate of more than 2% in the second half of 2008. Core inflation was also higher at 4% (an average of 1.8% between 1999 and 2008).

In contrast, global commodity prices rose at a more gradual pace in 2010 and 2011. Between January 2010 and September 2011, both global crude oil and food prices increased by 35% and 26%, respectively. A notable increase was in the global price of corn, which rose by 94% between June 2010 and September 2011 due to disruptions in supply and low stockpiles.

Accordingly, prices of fuel and some of the controlled food items in Malaysia were adjusted upwards in a gradual manner over a span of two years. The adjustments were undertaken as part of the subsidy rationalisation programme and the quantum of each adjustment was also smaller compared to that in 2008. The retail prices of petroleum products[4] were raised by an average of 1.3% in July 2010 and 3.1% in December 2010. While the retail price of RON97 petrol was adjusted several times in 2010 and 2011, the impact on inflation was contained as the consumption of RON97 petrol is relatively small. There was also an upward adjustment to electricity tariffs in June 2011 by an average of 7.1%. These adjustments had a direct effect in increasing inflation in the *transport* and *housing, water, electricity, gas and other fuels* categories. Given the smaller and more gradualised price increases this time, the direct impact through the petroleum products and electricity tariffs in the CPI accounted for only 19% of inflation in 2011. In terms of the food categories, the higher global corn prices led to higher prices for poultry feed. As a result, prices for chicken increased sharply by 11.4% in 2011 (average 2007- 2011: 6.7%), and contributed 5.2% to headline inflation in 2011.

Given that adjustments to administered prices over this period were paced, businesses were better able to cope with the rise in costs. These adjustments were also well-anticipated by businesses as the Government

[4] Refers to RON95 and RON97 petrol, diesel and liquefied petroleum gas (LPG).

had earlier communicated its subsidy rationalisation roadmap. While domestic demand was relatively strong, rising by 8.2% in 2011, the knock-on effects were relatively modest and took a longer period of six months to occur. The knock-on effects were observed in the same categories as in 2008, namely the *restaurants and hotels* and *furnishing, household equipment and routine household maintenance* categories. Compared to the 2008 episode, inflation was less pervasive, with a smaller proportion of the CPI categories recording an inflation of more than 2%. Meanwhile, core inflation was also relatively lower at 2.7% in 2011.

The direct and indirect effects of changes in global commodity prices discussed above are also known as the ***first-round effects***. Strong first-round effects may result in more broad-based price increases and consequently, lead to higher costs of living, which could raise inflation expectations and increase the pressure on households to demand for higher wages. If businesses accommodate the demand for higher wages and passed on the higher labour costs to consumers by increasing the prices of goods and services, this would create ***second-round effects*** on inflation. Unless policy action is taken to manage these second-round effects, they can lead to further increases in the prices of goods and services, triggering another round of wage increases and leading to even higher inflation. The repetition of this cycle is called the wage-price spiral. Should this spiral occur, inflation would become both difficult and costly to control.

The likelihood of second-round effects occurring depends on inflation expectations, labour market conditions and the strength of underlying demand in the economy. If inflation expectations are well-anchored, that is, consumers perceive that the increases in prices to be temporary, they will adjust consumption and spending, for instance by temporarily reducing expenditure on non-essential items to compensate for the rising cost of essential goods or, borrow or reduce savings to smooth consumption. In these scenarios, second-round effects on inflation are less likely to occur. However, if inflation expectations are not well-anchored, consumers would believe that the higher level of inflation is persistent, and thus will demand for higher wages to cope with the higher cost of living. In an environment of strong demand and tight labour supply, businesses would accommodate the wage demands and will in turn raise the retail prices of goods and services, leading to the occurrence of the second-round effects on inflation.

Despite the higher inflation in 2008 and 2011, and some signs of inflation pervasiveness particularly in 2008, there was limited evidence that supply pressures had led to second-round effects on inflation. First, wage growth in general was stable. With this, the high food inflation led to cutbacks in discretionary spending as the purchasing power of consumers was eroded, especially in 2008. Second, higher inflation was expected to be transitory. The weak global growth at the end of 2008 and the prospect of slower global growth in the second half of 2011 were expected to restrain further increases in global commodity prices. The expectation that domestic economic growth would also moderate helped to further curb domestic inflation.

Conclusion

Based on the experiences of 2008 and 2011, it can be concluded that the different magnitude of global commodity price increases had a differing impact on the propagation of these shocks to domestic inflation. With the administered price mechanism in place, the propagation of these global price increases to domestic inflation were, in most cases, delayed and incomplete. The pace of adjustments in administered prices in response to global commodity price increases were a key determinant of the strength of inflationary pressures that were transmitted through the first-round effects. The first-round effects would be better contained if adjustments to administered prices were undertaken in a gradual manner, as businesses would be better able to manage the impact on their costs. This, in turn, would result in a more gradual increase in inflation and the cost of living and reduce the risk of second-round effects occurring.

Liberalisation of Foreign Exchange Administration (FEA) Rules to Enhance the Competitiveness of the Malaysian Economy

Malaysia remains committed to further liberalising FEA rules to support and enhance the competitiveness of the economy through the creation of a more supportive environment for trade, business and investment activities.

In 2011, the Bank continued with the efforts to create a more favourable environment to promote the expansion of the private sector's productive capacity abroad in tandem with the liberal regulatory environment on international trade. The liberalisation recognises the growing trend for Malaysian companies to venture abroad given the strong economic growth in the emerging economies, particularly in Asia, and the deepening regional integration. Between 2001 and 2010, direct investments abroad by resident companies averaged 4.3% of GDP and peaked at 9.4% of GDP in 2008. Cumulatively, net direct investments abroad amounted to RM215 billion over this period, where a significant share of the investments was channelled into new areas of comparative advantage particularly in the oil and gas, manufacturing, telecommunication, finance and insurance sectors.

The increasing trend of Malaysian corporations venturing abroad underscores the importance of robust and sound domestic financial markets to meet the demand for more diverse and sophisticated financial solutions and services. Various measures, including the liberalisation of FEA rules, have been implemented by the Bank to promote the liquidity, depth and number of players in the domestic financial markets.

Productive direct investment abroad

As one of the fundamental measures to support the presence of domestic businesses globally, resident companies that meet the Bank's prudential requirements have been granted the flexibility to undertake any amount of direct investment abroad. The implementation of this liberalisation measure is sequenced to take into account the capacity of the resident companies. This is one of the Bank's strategic thrusts towards full cross-border capital mobility for productive purposes that will benefit the Malaysian economy. With this liberalisation measure, direct investment abroad by qualified resident companies will no longer be subject to the annual threshold of RM50 million equivalent in aggregate per corporate group for investment in foreign currency assets.

Access to competitive financing

To facilitate the expansion of the private sector's productive capacity abroad and to enhance the efficiency of financial management, greater freedom has been accorded to resident companies in managing financial resources within their corporate group. This liberalisation measure to allow a company to obtain any amount of inter-company loans from its related resident and non-resident companies will further enhance business efficiency.

Additionally, the limit of RM5 million imposed on foreign currency-denominated trade financing from non-residents has been abolished. Accordingly, foreign currency trade financing will now be computed as part of the prevailing limit on foreign currency borrowing by resident companies and individuals, of RM100 million and RM10 million equivalent, respectively.

Effective risk management

Given the importance of having appropriate risk management practices to the financial health of residents, greater flexibility has also been granted for them to undertake asset and liability management through the swapping of their ringgit or foreign currency debt obligations into debt obligations in another foreign currency. This liberalisation measure will help residents with exposure to international transactions to manage their financial risk exposures related to these transactions.

Greater product innovation

As domestic firms grow in size and strength and become increasingly integrated with the global markets, having a sound, robust and dynamic domestic financial market is critical to support the expansion of the Malaysian economy. In line with this, the FEA rules were liberalised to support domestic financial market players in innovating and offering new financial products to meet the diverse needs of a more developed and internationally-integrated Malaysian economy. In this regard, the scope of product offerings by licensed onshore banks has been expanded to allow greater flexibility in the trading of foreign currency against other foreign currencies with residents. Similarly, flexibility was also granted to licensed onshore banks to offer interest rate derivative contracts to non-bank non-residents for any purpose. These liberalisation measures are in line with the broad thrust of the Bank's Financial Sector Blueprint to widen the investor base and further enhance the development of the domestic financial markets.

Promote Treasury Management Operations

Efforts to create a dynamic and more internationally-integrated economy were further supported by the Budget 2012 announcement on new incentives to promote and facilitate the establishment of Treasury Management Centres (TMCs) in Malaysia by foreign and domestic-owned multinational companies. In addition to the fiscal incentives, FEA flexibilities have also been accorded to TMCs to facilitate effective management of their financial resources. These flexibilities include the ability to undertake investments and foreign currency financing to support the needs of companies with international presence.

Strengthening Malaysia's competitive position

The continuous efforts undertaken by the Bank and the Government to enhance efficiency and reduce the cost of doing business have contributed towards the improvement in Malaysia's ranking in the Global Competitiveness Report published by the World Economic Forum. Malaysia's competitiveness improved from 26th position in 2010/2011 to 21st position in 2011/2012. This was attributed, among others, to the openness of the Malaysian economy to international trade and foreign direct investment, as reflected in its liberal environment, notably on capital mobility. Similarly, the liberal environment for investment in Malaysia has also resulted in Malaysia being ranked as one of the top ten most preferred investment destinations in the world in the A.T. Kearney FDI Confidence Index for 2012.

The strengthening of the Bank's surveillance mechanisms, including enhanced regional cooperation, has enabled the Bank to intensify its liberalisation initiatives while ensuring that the benefits of the liberalisation outweigh the risks. The liberalisation measures are complemented by robust safeguards to ensure monetary and financial stability.

Conclusion

Consistent with the need for greater flexibility on cross-border current account and financial account transactions to support the growing global integration of the Malaysian economy, the implementation of FEA measures will shift towards a more principle-based regulatory framework to enhance clarity of the desired regulatory outcomes. This shift is part of the regulatory reform embarked on by the Bank to create a more facilitative and transparent regulatory environment that will support Malaysia becoming an investment destination of choice.

The policy thrust of FEA to enhance competitiveness of the economy will continue to be pursued in support of the transformation of the Malaysian economy into a high-income, high value-added economy by 2020. Important consideration would be given towards creating an enabling environment to support areas where Malaysia has a comparative advantage and to further enhance the competitiveness of Malaysian corporations. Focus will also be given to areas that will enhance the development of Malaysia's financial markets and also promote regional economic and financial integration. In this regard, continuous engagement and consultation with all stakeholders, including the industry players, will be undertaken to promote the role of the private sector in realising these desired outcomes. The progressive liberalisation of the FEA measures will continue to be reinforced by adequate prudential safeguards to ensure monetary and financial stability, both of which are integral for achieving sustainable growth of the Malaysian economy.