Economic Developments in 2009

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Economic Developments in 2009

THE INTERNATIONAL ECONOMIC ENVIRONMENT IN 2009

In the first half of 2009, the global economy experienced the sharpest contraction since the Second World War, with countries accounting for more than 60% of world output mired in a synchronised recession. The full impact of the 2008 international financial crisis on the real economy was felt in the first quarter of 2009, where a large number of economies experienced significant contractions in real GDP. In the advanced economies, the financial crisis and the ensuing credit crunch led to a sharp decline in private sector demand. Household consumption was curtailed, affected by a combination of factors including deteriorating employment prospects, falling house prices and difficulties in obtaining access to credit. Similarly, businesses cut their production sharply while inventories were drawn down to abnormally low levels amid weak demand and tight credit conditions. The international production and trade network unravelled, sending shocks to the emerging economies. The Asian economies, particularly those with a higher degree of trade openness, were affected by the collapse in world trade that resulted from the sudden plunge in demand from the advanced economies, leading to double-digit declines in exports and production. The deterioration in the trade-related sectors subsequently impacted the rest of the economy as household and business confidence were adversely affected.

The global economy experienced the sharpest contraction of the post-war period in the first half of 2009 before entering into a gradual but uneven recovery in the second half of the year

The severe global financial crisis and the sharp global recession that ensued led to unprecedented policy responses by governments and monetary authorities across the world. Governments introduced large fiscal stimuli, ranging between 1 – 12% of GDP, while central banks aggressively eased monetary policy as interest rates were reduced to record lows. In the major advanced economies, quantitative easing and financial support measures were also introduced, primarily to provide liquidity to financial markets and to restore stability in their financial systems.

The extraordinary policy responses contributed to the stabilisation of the financial markets and provided some support to the real economy. Of importance, the large fiscal spending and the restoration of normal functioning of financial markets arrested the sharp deterioration in economic activity. As a result, economic activity in most economies began to stabilise by the middle of the year and countries started to gradually emerge from the recession in the second half of 2009.

Economic recovery, however, remained fragile and uneven. The fragility of the recovery was evident as the growth experienced by most countries in the second half of 2009 continued to rely heavily on the fiscal support. In the advanced economies, high unemployment, ongoing deleveraging by the private sector and weak financial systems, continued to weigh on private sector activity. Economic recovery was, however, more pronounced in the emerging economies, particularly in Asia, where domestic demand was supported by sizeable fiscal stimuli and reinforced by the uninterrupted access to financing to the private sector. The recovery of intra-regional trade also provided support to growth.

The crisis in the international financial markets reached its peak in the first quarter of 2009 following the fallout from the failure of the US investment bank, Lehman Brothers, in the fourth quarter of 2008. Further losses revealed by major global financial institutions and uncertainty over the solvency of these large institutions amid heightened concern over systemic failure in a number of financial markets caused a flight to safer assets, including cash. As a result, the securitised debt markets froze, market liquidity dried up and global equity markets declined sharply to multi-year lows by March 2009. The extraordinary policy measures, including near zero interest rates, quantitative easing, and measures to ease liquidity and credit conditions that were taken in the major advanced economies, were important in alleviating the stress in the international financial markets, hence enabling the cost of financing to decline gradually.

By the second quarter, credit spreads began to narrow and equity prices gradually recovered, as risk appetite improved. Interbank markets started to function again, followed by stabilisation in short-term money markets in response to central banks' aggressive liquidity injection into the financial system. However, the improvement in the interbank markets did not translate into higher lending to the private sector in the advanced economies, largely reflecting the continued weakness of the financial institutions.

Table 1.1
World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2008	2009*e*	2008	2009*e*
World Growth	**3.0**	**-0.8**	-	-
World Trade	**2.8**	**-12.3**	-	-
Major Advanced Economies				
United States	0.4	-2.4	3.8	-0.4
Japan	-1.2	-5.2	1.4	-1.4
Euro area	0.6	-4.1	3.3	0.3
United Kingdom	0.5	-5.0	3.6	2.2
East Asia	**6.9**	**5.1**	**5.9**	**0.3**
Asian NIEs[1]	**1.7**	**-0.9**	**4.5**	**1.2**
Korea	2.2	0.2	4.7	2.8
Chinese Taipei	0.7	-1.9	3.5	-0.9
Singapore	1.4	-2.0	6.6	0.6
Hong Kong SAR[2]	2.1	-2.7	4.3	0.5
The People's Republic of China	9.6	8.7	5.9	-0.7
ASEAN	**4.6**	**1.1**	**7.7**	**2.4**
Malaysia	4.6	-1.7	5.4	0.6
Thailand	2.5	-2.3	5.5	-0.9
Indonesia	6.0	4.5	9.9	4.8
Philippines	3.8	0.9	9.3	3.3
India[3]	7.4	6.5	9.1	2.1

[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

In the **United States (US)**, real GDP contracted sharply by an annualised rate of 6.4% in the first quarter of 2009, its biggest contraction in 29 years. The decline in GDP was largely due to the contraction in fixed investment and large inventory drawdown as businesses responded to the significant drop in overall demand since late 2008 by cutting production aggressively. In response, the US government unveiled a USD787 billion fiscal stimulus in February 2009, consisting mainly of tax rebates to households and businesses and infrastructure spending. On the monetary front, with the federal funds rate reduced to near zero since December 2008, the Federal Reserve (Fed), US Treasury and the FDIC implemented quantitative measures in the form of recapitalisation of banks, guarantees for banks' debt, purchases of illiquid and impaired assets held by the financial institutions, particularly mortgage-backed securities and other securities backed by consumer loans, to thaw the frozen credit markets and restore market functioning.

The Fed introduced programmes to purchase USD1.25 trillion of agency mortgage-backed securities, USD175 billion of agency debt and USD300 billion of US treasury securities with the objective of lowering the interest burden for financially-constrained home mortgage borrowers. The extraordinary measures caused the Fed's balance sheet to expand by 150% to reach USD2.2 trillion, underlining the heavy reliance of the financial system on the central bank's support. The Fed's move to assist the housing market was further supported by the fiscal stimulus in the form of tax credits for home buyers, boosting demand for housing. The policy responses stabilised the housing and financial markets, as well as the overall economic conditions by the second quarter of the year. The containment of systemic risk, restoration of functioning of financial markets and large fiscal stimulus contributed to gradual recovery in the equity market from its lows in March, together with the stabilising of house prices since June helped to bring about positive wealth gain of about USD5.7 trillion for the US households from the second until the fourth quarter. The increase in wealth restored part of the wealth loss of USD17.5 trillion experienced during the period mid-2007 to the first quarter of 2009.

By the third quarter, consumption grew as households also benefited from tax incentives for the purchase of automobiles. After declining at a slower annualised rate of 0.7% in the second quarter, GDP expanded at an annualised rate of 2.4% in the second half of 2009. The recovery in the US in the second half of the year was driven by the growth in private consumption, residential fixed investment and government spending. Nevertheless, the pace of recovery remained slow and highly dependent on policy support. In spite of the weak recovery in the second half, overall private consumption continued to be constrained by rising job losses. The US economy had lost a total of 8.4 million jobs between end-2007 and end-2009 and the unemployment rate reached 10% in December 2009. Furthermore, many households continued to reduce their debt as falling house prices had eroded a large part of their wealth. For the year as a whole, the US economy declined by 2.4%.

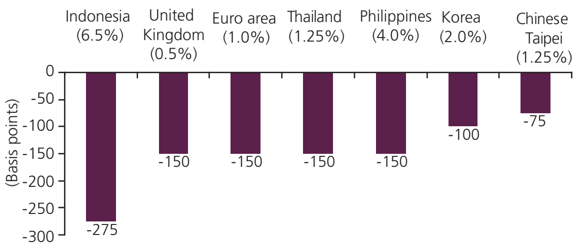
The other advanced economies mirrored the US's growth path closely throughout the year. In the **euro area**, growth contracted sharply by 2.5% quarter-on-quarter in the first quarter, its largest decline since the data was first recorded, due mainly to the large contraction in exports and fixed investment. The deteriorating external environment also spilled into weaker domestic demand following the higher unemployment, tight credit conditions and falling house prices. After reducing the interest rates by 150 basis points to 2.5% in 2008, the European Central Bank (ECB) continued to lower its refinancing rate by a further 150 basis points to 1% by May 2009. The central bank also embarked on a €60 billion covered bond purchase to inject liquidity in the financial system and stimulate lending activity in the euro area.

While the fiscal stimulus in the euro area was relatively smaller than the US, a larger part of euro area's fiscal support came through 'automatic stabilisers', particularly in terms of unemployment and health care benefits. Coupled with tax incentives for employers to retain labour, unemployment in the euro area did not rise as much as the US. Fiscal measures were also directed at boosting consumption through tax rebates, especially on automobiles as well as infrastructure spending. This had enabled a gradual revival in consumer and business confidence, allowing the euro area to turn around to register a small positive GDP growth on a quarter-on-quarter basis in the third and fourth quarters, led by Germany and France. For the year as a whole, the euro area contracted by 4.1%. Nevertheless, the recovery in the euro area was uneven as countries including Spain and Greece remained in recession given the severity of the housing crisis and high unemployment. The euro area was also affected by structural unemployment and the worsening fiscal positions in several euro economies, giving rise to concerns on the sustainability of fiscal stimulus in supporting growth.

Meanwhile, in the **United Kingdom (UK)**, the economy recorded six consecutive quarter-on-quarter declines, its longest decline on record, up to the third quarter of 2009. This was due mainly to the persistent weakness in domestic demand following rising unemployment, tight credit and negative home equity from significantly lower house prices. Meanwhile, fixed investment declined sharply in view of falling demand, difficulty in getting financing and lower capacity utilisation. The bleak outlook of the economy prompted the Bank of England (BOE) to reduce the base lending rate further by 150 basis points in early 2009 to 0.5% by March 2009, its historical low. At the same time, the BOE introduced a £200 billion plan to purchase corporate bonds and government gilts to inject liquidity into the economy and ease the credit crunch. A fiscal stimulus was also implemented to bolster consumption through tax rebates and automobile incentives. These measures began to yield some results, with the UK economy recording a small positive growth in the fourth quarter of 2009. However, for the year as a whole, the UK economy contracted by 5%. The UK economy is confronted with a continued weak labour market and a deteriorating fiscal position.

In **Japan**, real GDP contracted at an annualised rate of 13.7% in the first quarter, its largest post-war decline, due mainly to the double-digit declines in exports and fixed investment. The contraction in trade spilled into domestic demand, resulting in weak private consumption amid persistent deflation. While the Bank of Japan (BOJ) kept its overnight rate at 0.1%, the central bank first implemented quantitative easing through the monthly purchase of government bonds and later, a ¥10 trillion credit program for commercial lenders to inject liquidity into the financial system and to ease the deflationary pressure. Fiscal stimulus was also introduced to support private consumption through tax rebates. Benefiting from the close trade linkages with Asia, particularly

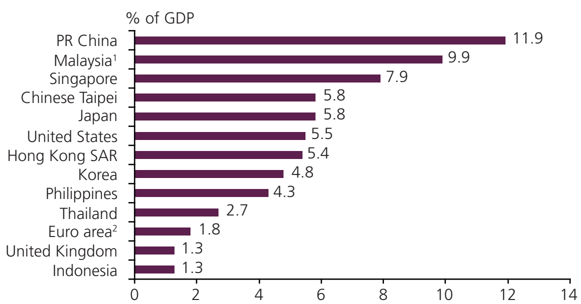
Chart 1.1
Cumulative Movements of Policy Rates since 2009



Note: Current policy rates in parentheses, as at mid-March 2010

Source: National Authorities

Chart 1.2
Fiscal Stimulus in Selected Economies



[1] Of which, direct fiscal injection is USD5.9 billion or 3.3% of GDP
[2] Amount spent under the European Economic Recovery Plan
Note: As at mid-March 2010

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

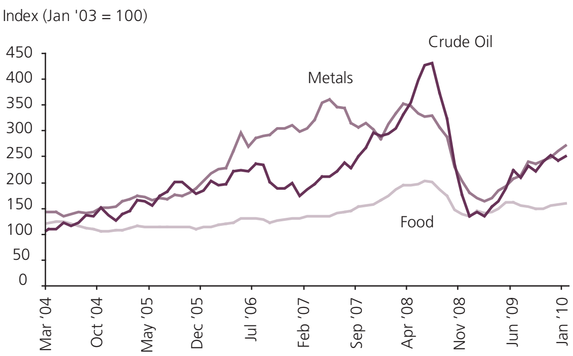
PR China, Japan's real GDP expanded quarter-on-quarter in the second quarter as exports to Asia increased. In 2009, PR China overtook the US to become Japan's largest trading partner. Meanwhile, domestic demand remained weak, lagging the recovery in external demand. For the year as a whole, Japan recorded a contraction of 5.2%.

In the **Asian region**, growth performance was adversely affected by the deterioration in the export sector, especially in the first quarter. The more open economies, particularly the newly industrialised Asian economies, experienced deeper recessions while other regional economies with larger domestic markets such as PR China, Indonesia and the Philippines experienced a moderation in growth. Growth was further affected by large inventory drawdowns as firms sharply reduced production and postponed investment plans, resulting in abnormally low level of inventories. As a result, labour market conditions also weakened, with unemployment rising in most countries, thus affecting consumer confidence and spending.

In response to the large contractionary external demand, regional central banks reduced their interest rates during the year by between 75 and 275 basis points and adopted liquidity and guarantee measures to support the overall growth prospects. Aggressive fiscal spending plans, ranging from 1% to 12% of GDP, were unveiled to bolster domestic demand through a combination of tax rebates, direct cash handouts and infrastructure spending. In some countries, tax incentives were also given to firms to retain their workers. These policy measures had an important role in restoring consumer and business confidence, and stabilising labour market conditions. In addition to the policy support, strong banking institutions and thus the continued financial intermediation, and the relatively healthy financial position of the private sector facilitated a faster recovery in the domestic demand in the region, while stronger intra-regional trade provided an additional impetus to growth. As a result, most regional economies started to experience positive quarter-on-quarter growth in the second quarter, ahead of the advanced economies. The recovery in the Asian economies gathered further momentum in the second half of the year as global economic conditions gradually improved. PR China, in particular, which introduced the largest fiscal stimulus package of 11.9% of GDP, recorded 10.7% growth in the fourth quarter of 2009, its strongest growth since the first quarter of 2008.

On the **global inflation** front, many advanced and regional economies had experienced technical deflation since the early part of the year due to lower commodity prices and the weak demand conditions. While the headline inflation was influenced by the high base in 2008, core inflation remained positive for most economies, suggesting that the threat of actual deflation had been minimal. Following the gradual recovery in the regional economies from the second quarter and by the advanced economies in the third quarter, commodity prices began to rise steadily with oil prices reaching close to USD80 per barrel by year-end. Consumer prices in most economies started to edge higher, reflecting the trend in commodity prices although demand pressure remained subdued. While consumer price inflation

Chart 1.3
Indices of Primary Commodity Prices



Source : International Monetary Fund

was benign throughout the year, rising equity and property prices in several economies raised concerns on asset price inflation. In response, several regional economies undertook measures to curb the formation of asset bubbles, either through imposing administrative measures in the property market or on short-term capital flows.

In the **foreign exchange markets**, the US dollar started the year on a strong note, appreciating against most major currencies in the first two months. The dollar strength was attributed to the portfolio flows into dollar-denominated assets, reflecting investor risk aversion amid deteriorating global growth prospects and ongoing weakness in global financial markets. The dollar also benefited from the waning confidence in the euro following concerns over European banks' exposure to the Eastern European economies. However, as the global equity markets began to recover from their multi-year lows in March, the US dollar started to weaken following the improvement in investor risk appetite that caused a shift out of low-yielding dollar-denominated assets to higher yielding assets denominated in other currencies. As a result, the other major currencies outperformed the dollar throughout most of the year. The performance of the euro and the pound sterling were strongest at about mid-2009, following expectations of a faster pace of recovery in these economies as compared to the US. However, lagging performance of the UK economy in the latter half of the year led to a slight weakening of the pound sterling. Towards the end of the year, both the euro and the pound sterling depreciated considerably due to concerns over the deteriorating fiscal positions in the two economies. Meanwhile, the yen appreciated to its strongest level in 14 years due to the higher repatriation of income from investments abroad. This trend reversed by December when the yen weakened following the decision of the Bank of Japan to expand quantitative easing. In the Asian region, most regional currencies appreciated against the US dollar following improved sentiments driven by the faster pace of recovery in the region vis-à-vis the advanced economies. Among regional currencies, the rupiah recorded the strongest appreciation due to the resilient economic conditions and more favourable political climate.

THE MALAYSIAN ECONOMY IN 2009

The Malaysian economy contracted by 1.7% in 2009, a year when the global economy experienced its deepest downturn in modern history. The domestic economy experienced the full impact of the global recession in the first quarter, declining by 6.2%, marking the first year-on-year contraction in real GDP since the third quarter of 2001. The collapse in global demand and world trade led to double-digit declines in Malaysia's exports and industrial production. Given the high degree of openness of the economy, the deterioration in external demand affected employment, income and overall business and consumer sentiment, causing private consumption and private investment activities to decline in the first quarter of the year. Growth during the quarter was also affected by large drawdowns of inventory, particularly in the manufacturing and commodity sectors.

Despite a sharp contraction in the first quarter, the Malaysian economy contracted moderately by 1.7% in 2009 as recovery strengthened in the second half of the year

However, the accelerated implementation of fiscal stimulus measures, the aggressive easing of monetary policy and the comprehensive measures introduced to ensure continued access to financing contributed to stabilisation in the domestic economy in the second quarter and subsequent recovery in the second half of the year. In addition to higher public spending, the

Table 1.2: Malaysia - Key Economic Indicators

	2007	2008	2009*p*	2010*f*
Population (million persons)	27.2	27.7	28.3	28.9
Labour force (million persons)	11.8	12.0	12.1	12.2
Employment (million persons)	11.4	11.6	11.6	11.8
Unemployment (as % of labour force)	3.2	3.3	3.7	3.6
Per Capita Income (RM)	23,033	25,784	23,381	25,180
(USD)	6,700	7,737	6,634	7,416[6]
NATIONAL PRODUCT (% change)				
Real GDP at 2000 prices[1]	6.2	4.6	-1.7	4.5 ~ 5.5
(RM billion)	504.9	528.3	519.2	543.4
Agriculture, forestry and fishery	1.4	4.0	0.4	3.1
Mining and quarrying	2.0	-0.8	-3.8	2.5
Manufacturing	3.1	1.3	-9.3	6.5
Construction	4.7	2.1	5.7	3.7
Services	9.6	7.2	2.6	4.9
Nominal GNI	12.3	14.2	-7.4	10.0
(RM billion)	625.9	715.0	661.8	727.7
Real GNI	5.9	2.0	1.2	3.6
(RM billion)	481.8	491.5	497.4	515.3
Real aggregate demand[2]	9.6	6.8	-0.4	3.2
Private expenditure[2]	10.7	7.0	-3.4	3.3
Consumption	10.4	8.5	0.8	3.8
Investment	11.8	0.8	-21.8	0.7
Public expenditure[2]	6.8	6.3	7.7	2.7
Consumption	6.5	10.9	3.7	-2.7
Investment	7.1	0.7	12.9	9.3
Gross national savings (as % of GNI)	38.2	37.9	31.3	35.2
BALANCE OF PAYMENTS (RM billion)				
Goods balance	127.7	170.6	141.5	141.6
Exports (f.o.b.)	605.9	664.3	554.2	615.2
Imports (f.o.b.)	478.2	493.8	412.7	473.7
Services balance	2.4	0.2	3.2	-0.7
(as % of GNI)	0.4	...	0.5	-0.1
Income, net	-13.9	-23.7	-12.6	-19.9
(as % of GNI)	-2.2	-3.3	-1.9	-2.7
Current transfers, net	-15.7	-17.5	-19.4	-17.1
Current account balance	100.4	129.5	112.7	103.8
(as % of GNI)	16.0	18.1	17.0	14.3
Bank Negara Malaysia international reserves, net[3]	335.7	317.4	331.3	
(in months of retained imports)	8.4	7.6	9.7	
PRICES (% change)				
CPI (2005=100)[4]	2.0	5.4	0.6	2.0 ~ 2.5
PPI (2005=100)[5]	5.5	10.3	-7.1	
Real wage per employee in the manufacturing sector	2.7	-4.8	1.9	n.a

[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 2006, the Consumer Price Index has been revised to the new base year 2005=100, from 2000=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 2010
p Preliminary
f Forecast

Note: Numbers may not necessarily add up due to rounding

Table 1.3 Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2007	2008	2009*p*
Revenue	139.9	159.8	158.6
Operating expenditure	123.1	153.5	157.1
Net development expenditure	37.5	41.9	49.0
Overall balance	-20.7	-35.6	-47.4
Overall balance (% of GDP)	-3.2	-4.8	-7.0
Public sector net development expenditure	96.3	124.4	118.0
Public sector overall balance (% of GDP)	1.5	-5.6	-3.8
EXTERNAL DEBT[1]			
Total debt (RM billion)	187.4	236.1	233.9
Medium- and long-term debt	133.0	156.5	156.0
Short-term debt[2]	54.5	79.6	78.0
Debt service ratio (% of exports of goods and services)			
Total debt	3.8	2.6	6.5
Medium- and long-term debt	3.4	2.5	6.4

MONEY AND BANKING	Change in 2007		Change in 2008		Change in 2009	
	RM billion	%	RM billion	%	RM billion	%
Money Supply M1	27.6	19.6	14.0	8.3	17.9	9.8
M3	72.4	9.5	99.1	11.9	85.1	9.1
Banking system deposits	56.5	7.0	103.4	11.9	90.7	9.3
Banking system loans[3]	51.2	8.6	82.3	12.8	56.9	7.8
Loan-deposit ratio (end of year)[4]	76.2		77.7		77.9	
Financing-deposit ratio[4, 5]	85.1		85.8		84.6	

INTEREST RATES (AVERAGE RATES AS AT END-YEAR)	2007	2008	2009
	%	%	%
Overnight Policy Rate (OPR)	3.50	3.25	2.00
Interbank rates			
1-month	3.54	3.30	2.06
Commercial banks			
Fixed Deposit 3-month	3.15	3.04	2.03
12-month	3.70	3.50	2.50
Savings deposit	1.44	1.40	0.87
Base lending rate (BLR)	6.72	6.48	5.51
Treasury bill (3-month)	3.43	3.39	2.05
Malaysian Government securities (1-year)*	3.53	2.89	2.12
Malaysian Government securities (5-year)*	3.78	2.99	3.79

EXCHANGE RATES	2007	2008	2009
Movement of Ringgit (end-period)	%	%	%
Change against SDR	1.7	-2.7	0.2
Change against USD[6]	6.8	-4.5	1.2

[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
* Refer to end-year

policy measures also helped to revive private sector sentiment, which, together with improving labour market conditions, led to an expansion in private consumption in the second half of the year. Signs also emerged to indicate that private investment activity had begun to stabilise towards the end of the year. Moreover, external demand provided further impetus to growth as the global economy, particularly the regional economies, gradually recovered. As a result, the Malaysian economy resumed its growth momentum in the fourth quarter, growing by 4.5%, with strengthened domestic and external demand contributing to growth.

On the supply side, growth in the first quarter was particularly affected by a sharp decline in the manufacturing sector, while other sectors, except construction, also contracted. The manufacturing sector, particularly the export-oriented industries, was severely affected by the significant deterioration in external demand. Nevertheless, the manufacturing sector gradually improved and recorded positive growth in the fourth quarter, in tandem with the recovery in external demand. Meanwhile, the services sector recorded a marginal decline in the first quarter due mainly to contractions in the sub-sectors which are related to manufacturing and trade activities. In line with the improvement in domestic demand, the performance of the services sector had gradually improved since the second quarter, with growth coming from the services sub-sectors that are dependent on domestic economic activity as well as finance and capital market-related activities. Nonetheless, growth of the construction sector had remained positive throughout the period due primarily to the implementation of construction-related projects under the Ninth Malaysia Plan (9MP) and the fiscal stimulus measures.

Labour market conditions weakened considerably in the first quarter as firms in the manufacturing sector reduced their operations, particularly in the first two months of the year. Total retrenchments increased to a seven-year high of 25,064 persons in 2009, with one-half the workers being retrenched in the first quarter. Labour market conditions began to stabilise in the second quarter and improved thereafter as retrenchments declined and firms started to hire new workers. The quicker-than-expected recovery in the labour market following improvements in both global and domestic economic conditions, resulted in a lower unemployment rate of 3.7% of the labour force, compared to the earlier forecast of 4.5%. Despite the challenging economic environment and declining productivity growth in 2009, employers in the private sector had continued to grant salary increments, albeit at a moderate rate of 3.4% (2008: 5.1%).

Headline inflation averaged 0.6% in 2009 (2008: 5.4%) as inflationary pressures in Malaysia moderated substantially, in line with global and domestic developments. Weak global demand conditions, particularly in the first quarter of 2009 led to a significant drop in global commodity prices, especially crude oil prices. As a result, several countries experienced lower inflationary pressures during the year. Inflation in the advanced economies recorded a steep decline, while inflation in emerging market economies also saw a decline in 2009, with the most notable deceleration recorded by China (2009: -0.7%; 2008: +5.9%). The decline in global fuel and commodity prices and the lower inflation in Malaysia's major trading partners in turn contributed to lower domestic inflation. The cumulative reductions in domestic retail petrol prices in the second half of 2008 contributed significantly to the moderating trend of domestic inflation in 2009.

Malaysia's external position remained strong in 2009 despite the extremely weak external environment. The current account continued to record a large surplus during the year, supported by a sizeable trade surplus and improvements in the services account. Although gross exports deteriorated significantly in 2009, particularly in the first half of the year, the trade surplus remained large as lower demand for exports was also accompanied by a decline in imports. The services account registered a significant surplus in 2009 following higher travel receipts from sustained regional travel activity, as well as an improvement in the other services deficit. Meanwhile, the financial account recorded lower net outflows in 2009, reflecting largely the significant moderation in portfolio outflows in the first half of the year and net inflows in the second half of the year. Both net inflows of foreign direct investment and outflows of direct investment abroad also moderated amid the weak economic conditions, whereas other investment outflows, which largely consist of trade credits, increased during the year. As large current account surplus more than offset the net outflows in the financial account, the overall balance of payments recorded a surplus in 2009, contributing to a further increase of RM13.9 billion in net international reserves to RM331.3 billion (or USD$96.7 billion) as at 31 December 2009.

The Malaysian economy, which was significantly affected by the developments in the global economy in the first quarter of 2009, recovered rapidly to register positive growth in the fourth quarter. In addition to the improvement in external demand, the domestic economy was supported by the accelerated implementation of fiscal stimulus measures, the accommodative monetary environment and continued access to financing. The rapid and comprehensive policy responses, which also helped to restore consumer and business sentiments, had an important role in sustaining domestic demand, which was the main factor supporting economic activities throughout the period. In addition, the domestic financial system remained strong despite the challenging international financial environment, effectively performing its financial intermediation function and facilitating the recovery in domestic demand. Overall, the continued strength in both economic and financial fundamentals, as reflected by the resilience in domestic demand, high international reserves position, low external debt, sustained high rate of savings and strong banking sector, has placed the Malaysian economy in a better position to grow further going forward.

DOMESTIC DEMAND CONDITIONS IN 2009

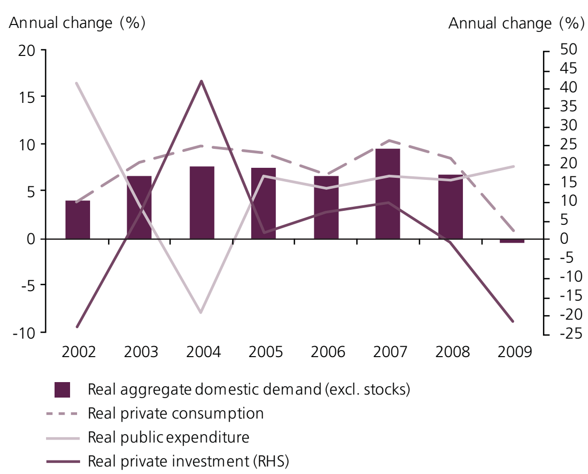
Domestic demand contracted by 2.9% in the first quarter, the first contraction since the third quarter of 2001, as households and businesses turned more cautious amid a significant deterioration in external demand, weaker labour market conditions and an overall decline in private sector sentiment. Despite the persistence of weak external demand, domestic demand conditions began to stabilise in the second quarter due to higher public sector spending following the implementation of fiscal stimulus measures to support the economy and expansion in private consumption.

The public sector had an important role in mitigating the impact of the global recession on the domestic economy through active implementation of two stimulus packages throughout the year. The strong public sector spending, together with an accommodative monetary policy, the continued access to financing, improvements in labour market conditions and a gradual recovery in external demand contributed to an expansion in domestic demand activity in the second half of the year. An increase in private consumption was supported by the rebound in consumer sentiment, stable employment prospects, low inflation and favourable financing conditions. Although private investment activity remained weak throughout 2009, there were signs of stabilisation towards the end of the year as global economic conditions and external demand started to improve. As a result, domestic demand turned around to record a positive growth of 1.7% in the second half of 2009, bringing the overall growth in aggregate domestic demand for the year to a marginal decline of 0.4% (2008: +6.8%).

Domestic demand, which contracted in the first quarter, recovered in the second half of 2009 as conditions in the labour market and external sector improved

Private consumption recorded a marginal growth of 0.8% in 2009, marking its slowest expansion since the Asian Financial Crisis. In the early part of the year, household spending was

Chart 1.4
Real Domestic Demand Aggregates



How Did the Recent Global Recession Affect the Malaysian Economy?

Introduction

The problems in the US financial system arising from the deteriorating quality of sub-prime assets that started in mid-2007, escalated into a major and severe global financial crisis in the second half of 2008. In particular, the failure of a number of large US and global financial institutions in September 2008 generated widespread fear of a systemic disruption across global financial markets which in turn had led to the "freezing" of the interbank and credit markets in many financial centres around the world. Despite the unprecedented large and aggressive financial measures taken by the authorities, the crisis intensified as prices of a large number of classes of financial assets collapsed resulting in a huge negative income and wealth effect. This, together with a widespread loss of confidence, led to a synchronised recession among the advanced economies in the second half of 2008, which deepened further in the first quarter of 2009 (Chart 1). Following the implementation of large fiscal and monetary policy stimulus, the global economy showed signs of stabilisation in the second quarter, and subsequently, gradually recovered towards the end of 2009. Nevertheless, the recovery of the global economy has been uneven, with growth still weak in the advanced economies and stronger in the emerging economies.

Chart 1
Advanced Economies in a Synchronised Recession by End-2008

Source: Haver Analytics

The sharp recession in the advanced economies had a significant spillover effect on Asian regional economies through the finance and trade interlinkages. The global deleveraging process had also, towards the end of 2008, triggered large outflows from the region, of short-term portfolio funds and a sharp decline in bank financing, causing the substantial declines in equity and debt markets, slowing foreign direct investments and weakening of regional currencies against the US dollar. However, the underlying fundamental strength of the regional economies and a sound financial sector in the region enabled the regional economies to cope with these adverse developments relatively well without disruptions in the intermediation process by the domestic financial systems. The collapse in global trade led to severe declines in the region's exports and industrial production, causing the more open economies in the region to experience an economic contraction, while other economies experienced sharp deceleration in growth in the fourth quarter of 2008.

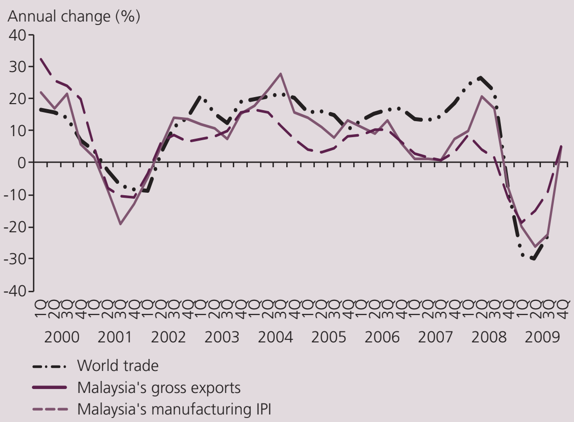
The Effects of the Global Recession on Malaysia

The global financial crisis and the deleveraging activities in the advanced economies led to disposal of assets world wide, including in the region, which caused sharp declines in the regional equity and bond markets. There was a large reversal in short-term capital flows, especially in the second half of 2008 as these funds were remitted back to the US. This sharp reversal of funds flows was, however, well absorbed by the domestic financial markets, given the ample liquidity in the financial system and the sound banking system. The strong reserves position of the country also acted as a buffer for US dollar liquidity and exchange rate movements during this turbulent period. In addition, the broad-based financial sector reforms and capacity building measures that have been undertaken following the Asian financial crisis had increased the financial sector's resilience to withstand the financial turmoil. The exposure of the domestic banking system to the sub-prime assets was also limited.

The Malaysian banking system was on a strong foundations when the global financial crisis erupted. The level of capitalisation of the Malaysian banking system remained high, with a risk-weighted capital ratio of 14.7% at end-December 2009 (end-2008: 12.6%), while the net non-performing loan ratio was low at 1.8% (end-2008: 2.2%). The strong capitalisation and ample liquidity in the banking system had ensured that the intermediation function remained uninterrupted, as reflected in the continued expansion of loans outstanding to businesses and households throughout 2009. Total business loans outstanding expanded by 2.6% in 2009 (end-2008: 13.2%) while household loans outstanding expanded at a sustained high rate of 9.8% as at end-2009 (end-2008: 9.7%).

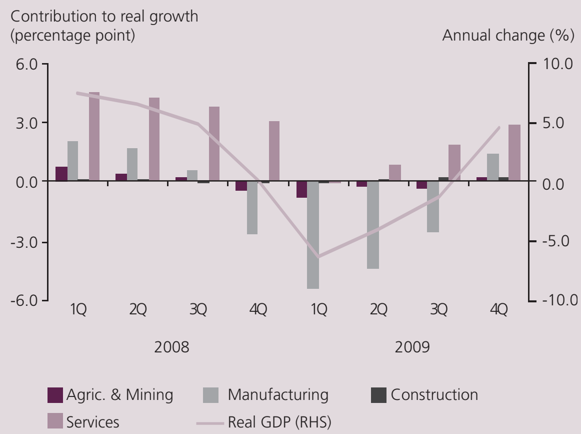
As Malaysia is a highly open economy, the impact of the global recession was felt strongly in the external trade-related sectors. The recession in the advanced economies started to impact the Malaysian economy in the fourth quarter of 2008. Exports and manufacturing production declined by 7.4% and 11.1% respectively (Chart 2), and private investment activity was dampened by the deteriorating business conditions. However, the resilience of domestic demand, particularly private consumption, provided support to the economy, preventing it from contracting in the fourth quarter of 2008 (real GDP growth: 0.1%).

Chart 2
Collapse in World Trade Led to Sharp Contractions in Malaysia's Gross Exports and Manufacturing Production



Source: Haver Analytics; Department of Statistics, Malaysia

Chart 3
Export-oriented Manufacturing Sector was the Worst Affected

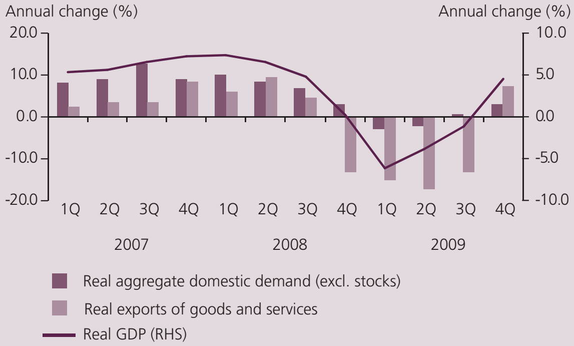


Source: Department of Statistics, Malaysia

Malaysia experienced the full impact of the global crisis in the first quarter of 2009, as the deepening recession in the advanced economies intensified the impact of a rapid decline in global demand on trade, production and investment activities in the domestic economy. As the advanced and some emerging economies slide into a recession in the first quarter of 2009, world trade declined sharply by 28.6% (4Q 08: -7.4%), and in turn, affected exports from the region, including from Malaysia. Malaysia's gross exports declined by 20% during the quarter (4Q 08: -7.4%), resulting in subsequent reductions in production, particularly in the manufacturing sector (Chart 3). In response to the significantly lower exports and production activity, firms undertook measures to reduce the cost of labour by enforcing a freeze on new hiring, initiating pay-cuts, reducing overtime work and laying off some workers. Retrenchments increased to 12,590 persons in the first quarter, compared with a quarterly average of 3,873 persons during the 2005-2008 period, affecting mainly workers from the manufacturing sector. The unemployment rate increased to 4% in the first quarter (4Q 08: 3.1%).

Although the income of households in the other sectors that were not directly exposed to external demand remained relatively unaffected, their spending behaviour was affected by the weak sentiment following the overall weaker economic conditions and uncertainties over their income outlook and job security. This resulted in a marginal decline in private consumption spending by 0.7%. Total investment also weakened significantly (-10.8%), following the sharper contraction in private investment spending, as capacity expansion activity was affected by the considerable decline in external demand, lower-than-normal capacity utilisation and deteriorating business confidence. As a result, aggregate domestic demand declined by 2.9% and the economy contracted sharply by 6.2% in the first quarter of 2009 (Chart 4), the first contraction since the third quarter of 2001. A large inventory drawdown during the quarter, particularly in the manufacturing and commodity sectors, further contributed to the decline in growth.

Chart 4
External Weakness Led To Broad-based Domestic Weakness in the Economy by the First Quarter of 2009



Source: Department of Statistics, Malaysia

Policy Response and the Recovery of the Malaysian Economy

In response to the global crisis, the Government introduced several policy measures to mitigate the adverse impact of the global downturn, and to prevent the economy from slipping into a fundamental economic recession (Table 1). These measures centred around three broad areas, namely, fiscal policy (two stimulus packages amounting to RM67 billion or 9.9% of GDP were unveiled), monetary easing (the Overnight Policy Rate was reduced by a total of 150 basis points to 2.00%) and reinforced by comprehensive measures to ensure continued access to finance. The implementation of these measures not only provided direct support to domestic activity, but equally important, led to a revival in business and consumer sentiments. As a result, domestic demand registered a slower decline of 2.2% in the second quarter of 2009, and subsequently recovered to record a positive growth of 1.7% in the second half of the year. Of significance is the improvement in private consumption, which recovered to post a growth of 0.5% in the second quarter, before strengthening further to 1.7% in the fourth quarter.

On the external front, the stabilisation and subsequent gradual recovery in the global economy since the middle of the year provided further support to the Malaysian economy. In particular, the strong recovery in the regional economies, especially PR China, benefited Malaysia, with exports to the region starting to improve in the second half of the year. In particular, Malaysia's exports to PR China turned around to record positive annual growth rates from as early as August. The recovery in exports became more broad-based towards the end of the year, as exports to several advanced economies also began to recover. External demand contributed positively to growth by the fourth quarter of 2009.

Conclusion

The Malaysian economy, given its high degree of openness, was affected by the global recession which set in during the third quarter of 2008 and continued into the first quarter of 2009. With the stabilisation of the global financial markets and the subsequent recovery in the economies of the advanced countries, the rapid policy responses on both the fiscal and monetary fronts had an important role in sustaining domestic demand throughout this period. Malaysia's sound economic fundamentals, strong financial system and the implementation of comprehensive policy support measures prevented the economy from slipping into a severe and prolonged period of negative growth. The strong economic and financial foundations provided the basis for a rapid recovery. The strength and stability of the domestic financial system throughout this period ensured that financing continued uninterrupted and enabled the private sector to obtain access to credit. Coupled with the healthy private sector financial position, this facilitated a fast recovery in domestic demand once the global financial crisis was contained and the global economic and financial conditions stabilised. These fundamentals enhance the prospects for a stronger recovery going forward.

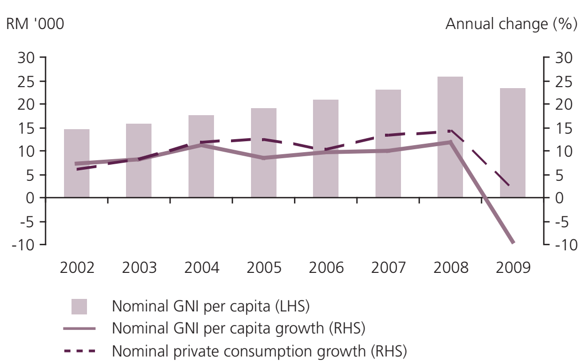
Table 1: Policy Responses to Mitigate Economic Downturn

Policy Responses	**Measures**
Two Economic Stimulus Packages of RM67 billion (direct fiscal injection: RM22 billion), with a primary focus on supporting domestic demand as well as mitigating the impact of the global downturn on the affected segments of the economy	➢ First package (RM7 billion) • Construction, upgrade, repair and maintenance of facilities • Construction of low and medium cost houses • Human capital development programmes • Accelerated improvement to telecommunication services • Assistance to Private Sector ➢ Second package (RM60 billion) • Reducing unemployment and increasing employment opportunities • Easing people's burden, in particular, the vulnerable groups • Assisting the private sector in facing the crisis • Building capacity for the future
Monetary stimulus to reduce the cost of intermediation	➢ Reduced Overnight Policy Rate by 150 basis points between November 2008 and February 2009 to 2.0% ➢ Reduced Statutory Reserve Requirement by 300 basis points to 1.0%
Comprehensive measures to ensure continued access to financing as well as to minimise the impact of the economic downturn on specific affected sectors	➢ Ensure continued access to financing • Financing and guarantee schemes for SMEs and businesses • Establishment of Financial Guarantee Institution (Danajamin Nasional Bhd) ➢ Restructuring and Rescheduling of Credit Facilities • Flexibilities to restructure and reschedule loans to deal pre-emptively with borrowers • Enhanced Corporate Debt Restructuring Committee and expanded Small Debt Resolution Scheme ➢ Pre-emptive measures to sustain confidence in financial sector • Full guarantee of all deposits until end-2010 • BNM's liquidity facility was extended to insurance and takaful operators ➢ Avenues for borrowers to seek assistance & redress • Integrated Contact Centre: BNMLINK, BNMTELELINK, Complaints Management and Advisory Unit • Expanded outreach of Credit Counselling & Debt Management Agency • ABMConnect Toll Free Channel • Complaint units at financial institutions • Financial Mediation Bureau • Small Debt Restructuring Committee
Other Measures	➢ Voluntary reduction of EPF employees' contribution by 3 percentage points from 11% to 8% in 2009 and 2010 ➢ Allow purchase of commercial properties above RM500,000 by foreigners for own use without FIC approval ➢ Increase vehicle loan eligibility for civil servants

affected by high retrenchments and a decline in real wages that had begun towards the end of 2008. Weak consumer spending was reflected in major consumption indicators such as the sales of new passenger cars, loan disbursements to households and imports of consumption goods. The MIER Consumer Sentiments Index (CSI) remained below the 100-point threshold (1Q 09: 78.9 points), indicating a pessimistic outlook on employment prospects and income expectations by households. As a result, private consumption declined by 0.7% in the first quarter.

Private consumption improved gradually from the second quarter onwards, before recording a higher growth of 1.7% in the fourth quarter. Improvements in labour market conditions, higher commodity prices and earlier than expected recovery in the manufacturing sector had lent support to consumer spending. Also, an early monetary policy response and the implementation of two fiscal stimulus packages helped to revive consumer confidence, as reflected by the improvement in the MIER CSI to above the 100-point threshold since the second quarter of 2009. Moreover, favourable financing conditions offered additional support to consumer spending as consumers continued to enjoy access to credit in an environment of low interest rates. Of significance, household credit continued to expand during the year with loan disbursed to households increasing strongly by 17.3% (2008: 8.9%). Despite the economic slowdown, household balance sheets remained sound, with the household debt to financial assets ratio remaining low at 40.6% (2008: 42.6%) and non-performing loan ratio for household loans declining further to 3.1% at the end of 2009 (2008: 4.1%).

Chart 1.5
GNI per Capita

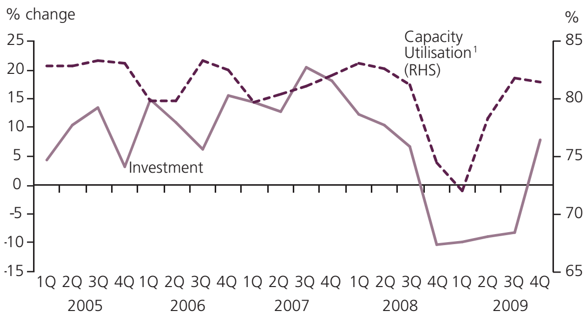


Reflecting the full impact of the global economic downturn in 2009, **private investment** declined significantly by 21.8% during the year (2008: 0.8%). The decline in capital spending activity that began at the end of 2008 had continued to worsen as the year progressed. Businesses deferred or cancelled investment decisions given deteriorating external demand and a more cautious outlook on domestic economic conditions. The sluggish private sector capital spending was also reflected in the marked decline of major investment indicators. Imports of capital goods recorded a decline of 5.9%, while sales of construction-related materials declined significantly by 26.1%. Disbursement of loans to businesses and the issuance of private debt securities for new activity also slowed down during this period, reflecting weaker demand for business financing. Meanwhile, gross inflows of FDI moderated to RM31.6 billion, as foreign investors were affected by the less favourable global economic environment. These indicators, however, gradually improved towards the end of 2009, as global economic conditions began to recover.

Investment in the manufacturing sector was the most affected by the extremely weak global economic conditions. The sharp decline in manufactured exports had led to a significant slowdown in production activity, in turn resulting in lower capacity utilisation. In the first quarter of 2009, the MIER capacity utilisation rate declined to 72%, reducing the need for firms to embark on additional capacity expansion. However, the capacity utilisation rate improved markedly to 81.4% in the fourth quarter, in line with the better performance of the manufacturing sector.

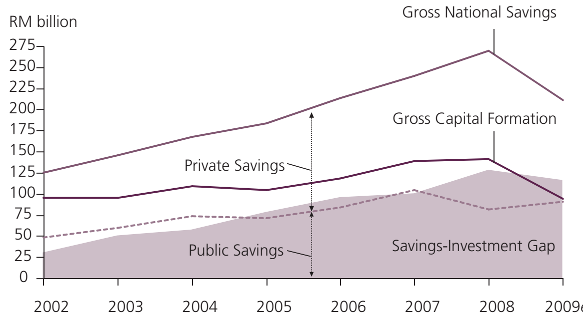
Capital spending programmes in the other sectors of the economy continued in 2009, albeit at a smaller scale compared to the previous year. Capital expenditure in the oil and gas sector, mainly for upstream production facilities and exploration activity, remained sizeable. Investment in the services sector was also sustained, reflecting the ongoing capacity expansion and upgrading exercise in the transportation, utilities and telecommunication sub-sectors, as well as the opening of new retail outlets.

Chart 1.6
Total Nominal Investment and Manufacturing Sector Capacity Utilisation



[1]Source: Malaysian Institute of Economic Research (MIER)

Chart 1.7
Gross National Savings and Savings-Investment Gap



e Estimate

Public investment expanded strongly in 2009, recording a double-digit growth of 12.9% (2008: 0.7%) following the introduction of the two economic stimulus packages to mitigate the impact of the global economic downturn. In the economic sector, expenditure was aimed mainly at developing the rural and agriculture sector, improving the transport system, enhancing public utilities and upgrading industrial infrastructure. Capital spending in the social services sector continued to be targeted at improving the provision of essential services, namely education, healthcare and housing. Of importance, high impact projects outlined in the first stimulus package had been fully implemented, while about 64% of the allocated development expenditure in the second package had been implemented in 2009.

Capital spending activity by the non-financial public enterprises (NFPEs) had also supported the strong expansion in public sector investment in 2009. Investment by the NFPEs was largely concentrated in the mining, transportation, utilities and communication sectors. In the mining sector, capital expenditure in the upstream oil and gas segment remained high, while the increased capital spending in the transportation sector was attributable to capacity expansion undertaken by both the rail and air transport companies. Additional capital spending was also evident in the power utility segment due to continuous upgrading and improvement of the power generation, transmission and distribution systems. Meanwhile, capital spending in the communication sector was mainly focused on the development of the broadband infrastructure facility under the High Speed Broadband initiative.

Public consumption increased by 3.7% in 2009 (2008: 10.9%), largely on the account of higher expenditure on emoluments, partly as a result of the higher emoluments incurred under the Government's initiative to fill up almost 50,000 vacancies in the public sector. Expenditure for supplies and services remained large due to the enhancement of the public sector's administrative machinery and delivery system as well as the maintenance of buildings and fixtures.

Public sector savings increased to RM92.3 billion or 13.9% of gross national income (GNI) in 2009 (2008: RM80.9 billion or 11.3%) following larger operating surpluses of the NFPEs. Private sector savings, however, declined to RM114.9 billion or 17.4% of GNI (2008: RM189.9 billion or 26.6%), reflecting the sustained household consumption spending amid the decline in income growth. In total, **gross national savings (GNS)** declined for the first time since 2001 by 23.5% to RM207.2 billion. Nevertheless, the decline in GNS was largely offset by a contraction in private sector investment, which led to a slightly lower savings-investment surplus of RM112.7 billion or 17% of GNI in 2009 (2008: RM129.5 billion or 18.1%).

SECTORAL REVIEW

Overall, 2009 was a challenging year for most economic sectors in the Malaysian economy. In the first quarter, amid the worsening global and domestic economic environment, all sectors, except construction, registered negative growth. In particular, the external demand-dependent sub-sectors were significantly affected, with an unprecedented rate of contraction in the electronics and electrical products cluster of the manufacturing sector and sharp contractions in trade-related services sub-sectors. In addition, spill-over weaknesses from the external sector to domestic demand, as well as lower commodity prices, also resulted in weak performance across most of the other sub-sectors.

Conditions began to improve in the second quarter, underpinned by the concerted and timely domestic policy support and stabilising external environment. The implementation of the two fiscal stimulus packages and the accommodative monetary policy environment cushioned the weakness in external demand and contributed towards improving consumer and business sentiments in the domestic-oriented sectors. Of significance, the construction sector registered positive growth in all four quarters, benefiting mainly from the projects under the 9MP and the fiscal stimulus packages. The pace of improvements gathered momentum in the third quarter, with smaller rates of decline in the manufacturing, agriculture and mining sectors. By the fourth quarter, growth resumed in all sectors, except mining, as domestic demand strengthened and external conditions improved further.

Services Sector

The **services sector** expanded by 2.6% in 2009 (2008: 7.2%), providing support to the Malaysian economy during the global economic crisis. Consequently, the sector's share to GDP increased further to 57.4% from 55.0% in 2008. The sector benefited from the resilient domestic demand, which was supported by the fiscal stimulus and an accommodative monetary policy. After registering a marginal decline of 0.2% in the first quarter of 2009, the services sector turned around to record an expansion of 1.6% in the second quarter, and continued its positive growth path to expand by 4.3% in the second half of 2009 (1H 2009: 0.8%). While most services sub-sectors followed the same growth trend, those that are largely dependent on trade and manufacturing activities, namely transport and storage; and utilities, recovered at a slower pace.

The services sector provided support to the overall economy in 2009

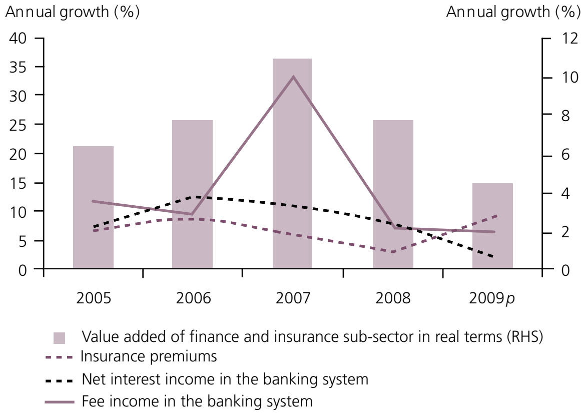
The **finance and insurance** sub-sector recorded a moderate growth of 4.4% (2008: 7.7%), reflecting the subdued performance of domestic demand especially in the first half of the year. In the finance segment, total loans approved and disbursed by the banking industry declined by 12.2% and 3.7% respectively in the first half of the year, as demand for financing moderated in tandem with lower economic activity. As a result, net interest income

Table 1.4
Services Sector Performance at Constant 2000 prices

	2008	2009*p*	2008	2009*p*
	Annual change (%)		Share to GDP (%)	
Services	**7.2**	**2.6**	**55.0**	**57.4**
Intermediate services	6.0	3.0	23.8	25.0
Finance and insurance	7.7	4.4	11.0	11.7
Real estate and business services	1.5	2.1	5.1	5.3
Transport and storage	6.1	-2.8	3.8	3.8
Communication	7.3	6.0	3.9	4.2
Final services	8.3	2.2	31.2	32.4
Wholesale and retail trade	9.8	1.2	12.8	13.2
Accommodation and restaurant	7.3	2.7	2.4	2.5
Utilities	2.1	0.4	2.9	3.0
Government services	11.1	3.0	7.4	7.7
Other services	5.2	4.4	5.7	6.0

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

Chart 1.8
Performance of the Finance and Insurance Sub-sector vis-à-vis Related Indicators



p Preliminary

Source: Department of Statistics, Malaysia; Bank Negara Malaysia

of the banking system recorded a lower growth. Meanwhile, fee-based income declined in the first quarter, due mainly to a drop in fees related to capital market activity. However, conditions in the finance segment improved during the second half-year, as economic recovery gathered momentum. Loan indicators registered marked improvements, while net interest income recorded better growth and fee-based income increased significantly by 18% following higher turnover in the equity market. In the insurance industry, growth was more moderate, as both the life and general business segments were affected by the weak economic activity and the decline in motor vehicle sales in the first half. However, both segments improved in the second half, in tandem with the economic recovery.

The **wholesale and retail trade** sub-sector was affected by weak private consumption, especially in the first half of the year. The sub-sector contracted by 1.7% in the first quarter, due to lower wholesale activity, cautious consumer spending and the contraction in motor vehicle sales. As consumer sentiments subsequently improved amid better domestic economic and labour market conditions, the sub-sector turned around to register a marginal growth in the second quarter before gradually strengthening in the second half of the year. For the year as a whole, the sub-sector grew by 1.2% (2008: 9.8%).

Similarly, the **real estate and business services** sub-sector registered a decline of 6.7% in the first quarter but recovered subsequently to expand by 2.1% for the year as a whole (2008: 1.5%). Affected by weak business sentiments at the beginning of the year, the sub-sector improved in the second half of 2009, benefiting from higher real estate and capital market-related activities as domestic demand strengthened. In 2009, the Kuala Lumpur Composite Index rallied 45.2%, to close the year at 1,272.8 (end-2008: 876.8).

Both the **accommodation and restaurant** and **other services** sub-sectors recorded lower growth

Table 1.5
Selected Indicators for the Services Sector

	2008	2009*p*
	Annual change (%)	
Utilities		
Electricity production index	1.2	0.8
Wholesale & Retail Trade and Accommodation & Restaurant		
Consumption credit disbursed	10.8	14.0
Tourist arrivals	5.1	7.2
Total sales of motor vehicles	12.5	-2.1
Finance & Insurance and Real Estate & Business Services		
Loans outstanding in the banking system	12.8	7.8
Insurance premiums	2.9	9.1
Bursa Malaysia turnover (volume)	-59.8	60.6
Transport & Storage and Communication		
Total container handled at Port Klang and PTP (TEUs)	7.7	-1.8
Airport passenger traffic	5.9	6.9
Air cargo handled	-6.7	-13.7
SMS traffic	28.7	22.1
	%	
Penetration rate:		
- Broadband[1]	21.1	31.7
- Cellular phone[2]	98.9	106.2
- Fixed line[1]	44.9	44.0

[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.

rates of 2.7% and 4.4% respectively in 2009 (2008: 7.3% and 5.2% respectively). Growth in the accommodation and restaurants sub-sector remained weak in the first half of the year, in tandem with sluggish private consumption activity. Growth improved in the second half, supported by better consumer sentiments and a rise in regional travel, following the expansion of new routes by airlines and various tourism promotional activities organised during the year. Meanwhile, growth in the other services sub-sector was affected mainly by softer demand for private education and private healthcare during the year. In addition, the global economic slowdown had affected the number of foreign students and foreign patients seeking education and healthcare services in the country.

The **communication** sub-sector was only marginally affected by the economic slowdown, registering a strong growth of 6% (2008: 7.3%). Growth was supported by continued demand for cellular and broadband services arising from competitive pricing by service providers as well as the aggressive rollout of broadband services. The year also saw extensive promotions by both the fixed and wireless broadband players to attract new subscribers. In addition, the availability of affordable smart phones and Wi-fi-enabled devices in the market also boosted demand for data services. These positive developments were reflected in the increase in both the cellular penetration rate (end-2009: 106.2%; end-2008: 98.9%) and broadband penetration rate (end-2009: 31.7%; end-2008: 21.1%).

In contrast, the **utilities** sub-sector registered a marginal growth of 0.4% compared to a 2.1% growth in 2008 as it was affected by lower demand for electricity during the year. In the first half of the year, growth declined by 4.6%, in line with the sharp drop in manufacturing activity. The sub-sector returned to positive growth in the third quarter before expanding strongly in the fourth quarter. The improvement in the utilities sub-sector was reflective of the gradual recovery in electricity demand from industrial users, and the steady increase in demand from household and commercial users.

Meanwhile, the **transport and storage** sub-sector was the worst performing services sub-sector, with three consecutive quarters of contraction before turning around to record a positive growth in the fourth quarter. Performance was affected by the decline in global trade and local manufacturing activity, which resulted in lower demand for shipping, haulage, ports and other trade-related services. However, the performance of the sub-sector gradually improved in the second half, in line with the improvement in trade and manufacturing activity. This was further supported by the steady increase in passenger travel, benefiting from improvements in consumer sentiments and the aggressive discounts offered by both full-service and low-cost carriers. For the year as a whole, the sub-sector declined by 2.8% (2008: 6.1%).

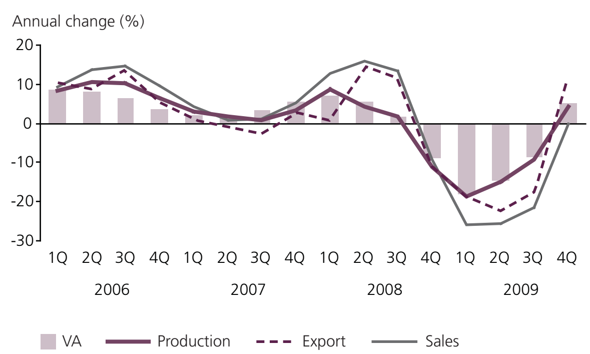
Manufacturing Sector

The **manufacturing sector** faced a challenging start in 2009, as the sharp decline in exports at end-2008 worsened further. The contraction in the sector stabilised in the second quarter of 2009 and conditions became more favourable towards the year-end, with production recording a positive growth in the fourth quarter of 2009, after experiencing four consecutive quarters of declines.

Manufacturing sector contracted significantly in the first quarter, but conditions gradually improved from second quarter onwards

In the export-oriented industry, the **electronics and electrical products (E&E) cluster** was the worst affected by the global downturn,

Chart 1.9
Manufacturing Sector: Value-added, Production, Exports and Sales

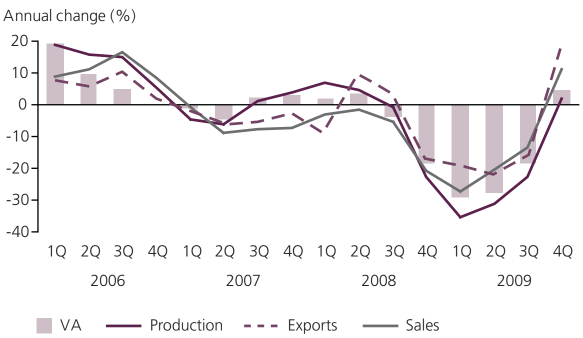


Source: Department of Statistics, Malaysia

declining by 22.8% in 2009. Production fell sharply by 35.4% in the first quarter, following a significant drop in global demand. Manufacturers across the global E&E supply chain reacted by cutting back production and drawing down from inventory, adversely affecting the semiconductor segment. Similarly, broad contraction in global demand also led to substantial declines in the computer and parts and electrical product segments. In particular, lower output of computer and parts was due to corporations delaying investment in equipment and software, while the electrical products segment was influenced by lower consumer spending. However, the decline in output moderated from the second quarter onwards, especially for semiconductors and electrical products, supported by an improvement in regional demand and inventory replenishment activity. In the region, the implementation of economic stimulus measures partially helped to boost demand for final electronic products. The E&E cluster performed better in the fourth quarter to record a marginal expansion, driven by higher consumer spending on electronics such as netbooks, smartphones and flat panel televisions, during the festive season, both in the advanced and regional economies.

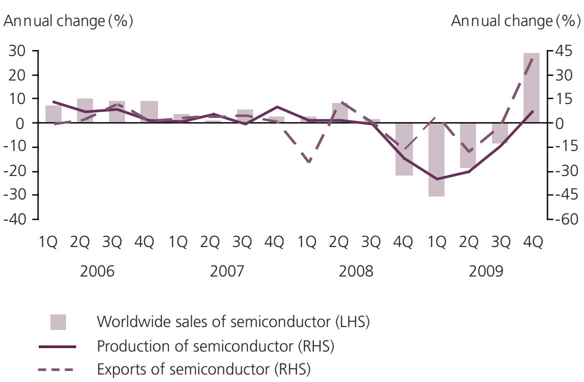
The **primary-related cluster** recorded similar trends to the E&E cluster, but fared better due to support emanating from the domestic consumer market and regional demand. Of significance, the sharp fall in the chemical products industry in the first quarter was due to lower demand for plastic parts and components used in the E&E and automotive industries. Meanwhile, production of the off-estate processing industry was affected by unfavourable commodity prices, providing less incentive to process off-estate products. The cluster performed better from the second quarter onwards, led by the chemical products industry as demand for plastic parts and components picked up with the improving E&E and household goods segments. The rubber products industry turned positive in the third quarter, driven by increasing demand for hygiene and medical products due to the Influenza A (H1N1) pandemic, while movements in commodity prices in the second half of the year contributed positively to the production in the petroleum and off-estate processing industries. By the fourth quarter of 2009, the cluster turned around to grow by 6.7%, led by

Chart 1.10
E&E Cluster : Value-added, Production, Exports and Sales



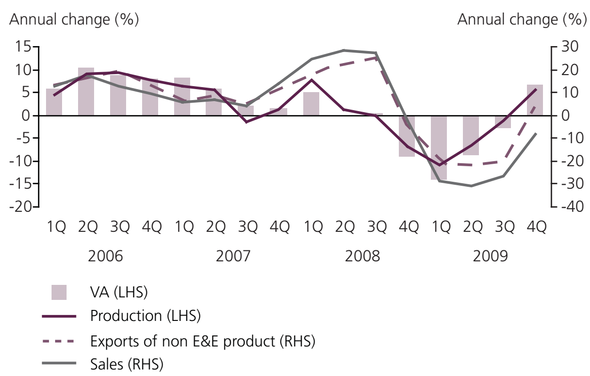
Source: Department of Statistics, Malaysia

Chart 1.11
Production and Exports of Semiconductors



Source: Department of Statistics, Malaysia
Semiconductor Industry Association (SIA)

Chart 1.12
Primary-related Cluster: Value-added, Production, Exports and Sales



Source: Department of Statistics, Malaysia

Remaining Competitive: Issues in Enhancing Productivity, Energy Efficiency and Innovation in the Manufacturing Sector

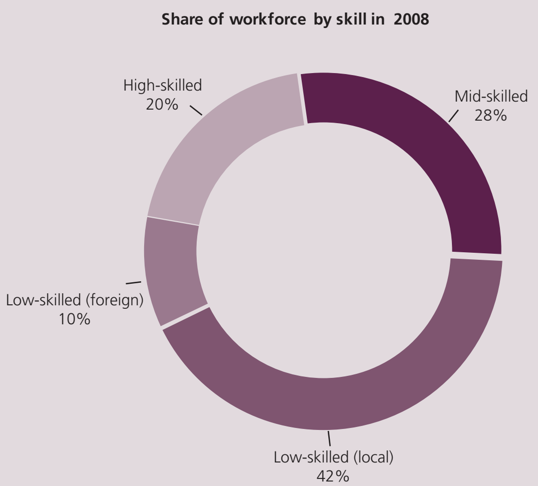
Introduction

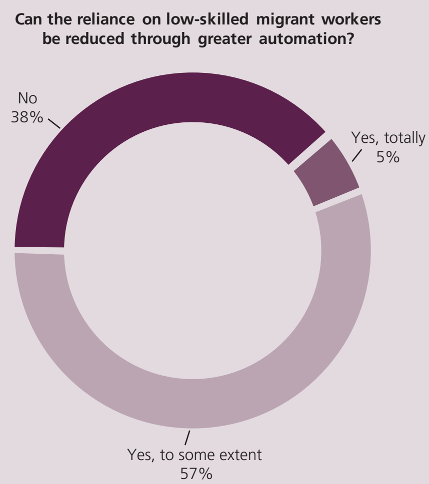
As Malaysia advances towards becoming a high value-added economy, productivity, energy efficiency and innovation will increasingly gain importance for the economy to remain competitive and to move up the value-added chain. The manufacturing sector is no exception, where the reliance on cost competitiveness will not be sustainable in the longer term. This article discusses the various efforts undertaken and constraints faced by Malaysian manufacturers in enhancing productivity, energy efficiency and innovation amidst an increasingly challenging global environment. The analysis draws on the BNM Biennial Manufacturing Survey 2008[1].

Productivity

Improving the skills of the workforce and increasing automation in the existing production lines are the most common strategies adopted by manufacturers in enhancing productivity. **Upskilling** is vital as about 80% of the manufacturing workforce is low to mid-skilled, and less than half of the workers have received formal training. Training and retraining opportunities focus mainly on improving technical skills, with about half of the training budget allocated for this. To enhance **automation**, manufacturers continue to face several impediments, particularly in terms of the high cost of machinery and equipment as well as an insufficient scale of production to justify extensive automation. In addition, the presence of easily available and relatively cheap low-skilled workers potentially further hinders the adoption of greater automation, as the survey result indicates that about 60% of the jobs currently undertaken by low-skilled foreign workers can to some extent, be replaced by automation (Chart 1). Manufacturers also highlight the importance of Government incentives in supporting automation, identifying the Human Resource Development Fund (HRDF) training fund, exemption on import duty and tax for machinery, and Reinvestment Allowance as the three most effective measures (Chart 2).

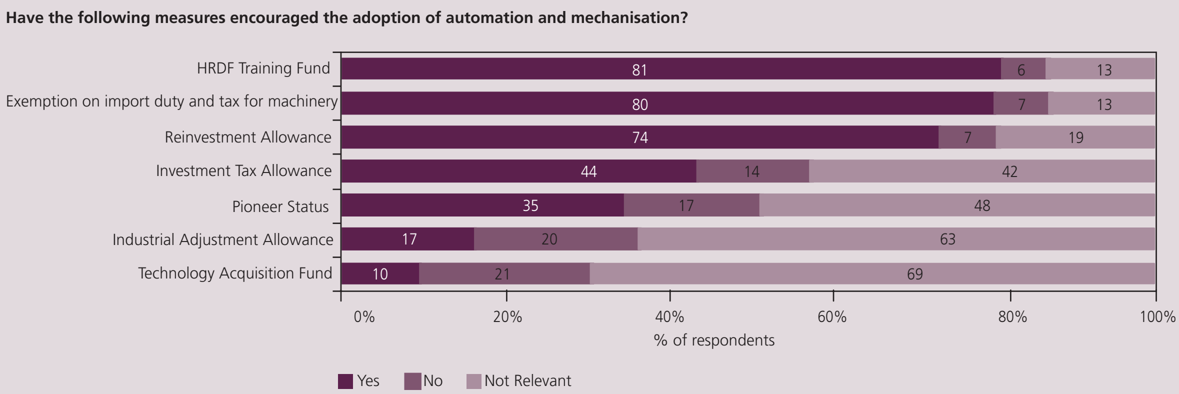
Chart 1
Large presence of low cost, low-skilled workers potentially hinders greater adoption of automation





[1] The BNM Biennial Manufacturing Survey 2008 was conducted in December 2008, covering 301 manufacturing companies in 17 industries, categorised into four clusters: electronics and electrical products (E&E): 90 companies; primary-related: 119 companies; consumer-related: 47 companies and construction-related: 45 companies. The response rate was at 56% at the close of the survey on 30 April 2009.

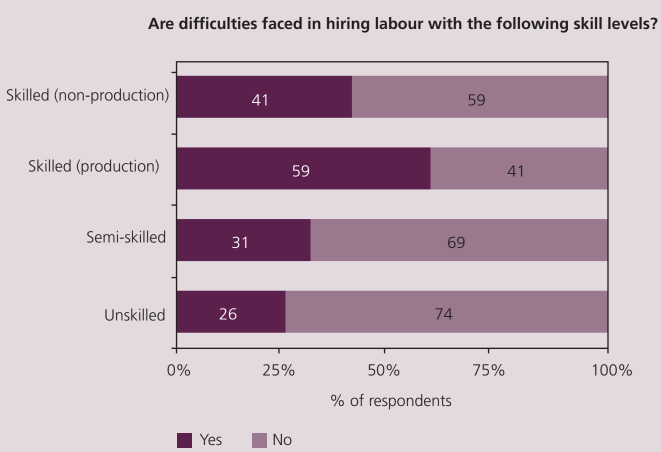
Chart 2
Exemption on import duty and tax on machinery and Reinvestment Allowance are effective in encouraging automation



Innovation

Innovation, proxied by the extent of **research and development (R&D**) **activity**, is fundamental for manufacturers to move up the value chain. About 57% of the manufacturing firms surveyed undertook R&D activity in 2008. A major constraint to greater R&D activity that has been identified by manufacturers is the quality of the workforce. At present, only about 20% of the manufacturing workforce consists of **high-skilled labour**, while manufacturers face difficulties in the hiring of high and semi-skilled workers, to the extent that there is currently a critical shortage of engineers, technicians, supervisors and quality control experts. This situation is expected to remain for at least the next three years (Chart 3). Meanwhile, only about 10% of the respondents that undertook R&D activity in 2008 utilised the available Government incentives, citing heavy administrative burdens as discouraging application (Chart 4). Most respondents suggested that easing the application process and the eligibility criteria for the Government incentives would enhance accessibility to these incentives.

Chart 3
Difficulties faced in hiring skilled workers with critical shortages of engineers and technicians



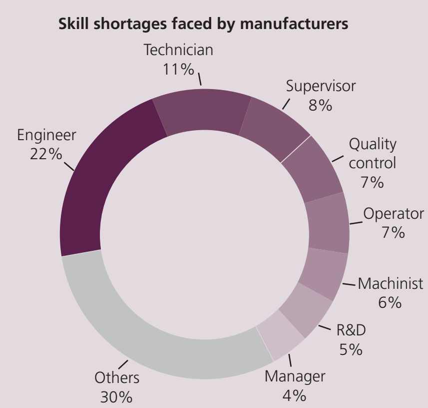
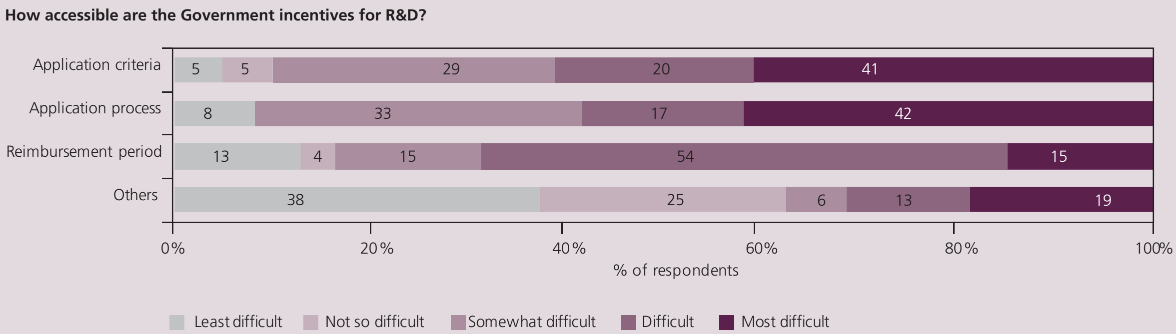


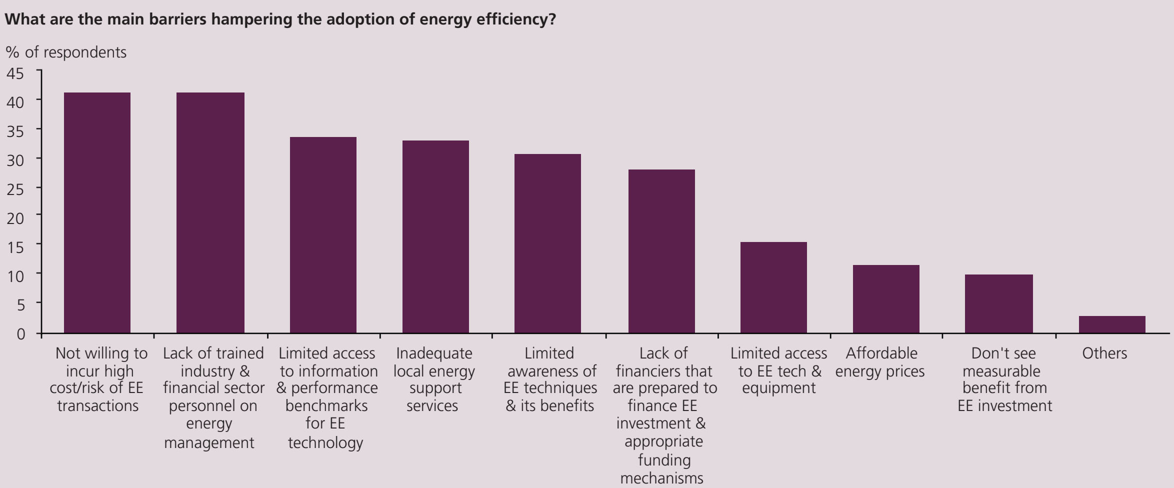
Chart 4
Heavy administrative burdens discourage application for Government incentives on R&D



Energy Efficiency

Given the high energy consumption in the manufacturing sector and the rise in utility costs since 2005, **energy efficiency** (EE) constitutes an important component of enhancing the overall efficiency of the sector. However, despite the importance of energy management and due, in part, to different levels of awareness of the benefits of EE, less than 30% of the firms surveyed have a full-time energy manager, while only about 40% have conducted an energy audit since 2005. Furthermore, less than 20% of the respondents had utilised the various Government incentives available for EE. The key challenges reported to be faced in the adoption of EE include the unwillingness to incur additional costs from the significant capital outlays to adopt EE, especially given uncertain potential returns, and the lack of trained human capital and information specific to EE (Chart 5).

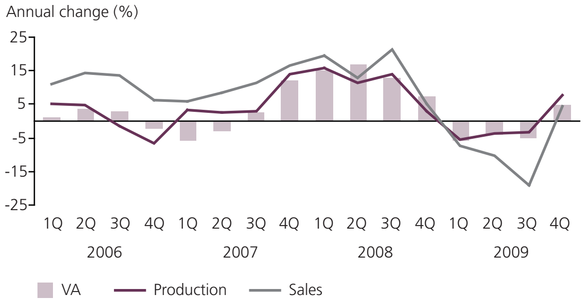
Chart 5
Significant barriers exist against the adoption of energy efficiency



Conclusion

The Malaysian manufacturing sector has, in varying degrees, employed strategies, such as upskilling, increasing automation, undertaking R&D activities and conducting energy audits, to enhance productivity, improve energy efficiency and strengthen innovation, so as to remain competitive in an increasingly challenging global environment. However, there remain challenges and constraints in these endeavours that need to be promptly addressed for the successful movement up the value chain. Of significance are the issues of human capital, high initial investment costs and administrative burden in gaining access to the incentives and funding programmes.

Chart 1.13
Consumer-related Cluster: Value-added, Production and Sales

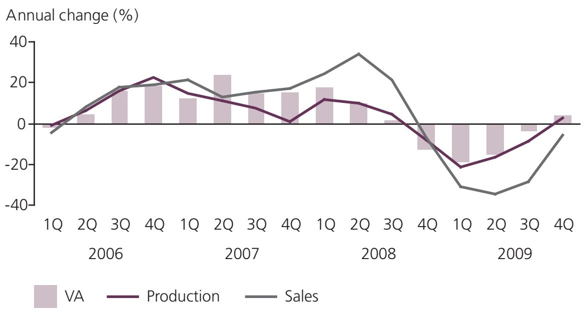


Source: Department of Statistics, Malaysia

higher demand for chemical, rubber and off-estate processing products.

In the domestic-oriented industry, performance in the first quarter was affected by the weak labour market conditions and dampened consumer spending. As domestic conditions improved from the second quarter onwards, production also recovered gradually to register a positive growth in the fourth quarter. The **consumer-related cluster** was negatively affected by the large decline in the transport equipment industry, in line with the sharp decline in new motor vehicle sales. Nonetheless, the food, beverages and tobacco industry provided some support to the cluster, due to sustained demand for food products. Output dipped slightly in the first quarter, before recovering from the second quarter onwards to grow by 7.7% in the fourth quarter, reflecting the improvement in domestic private consumption.

Chart 1.14
Construction-related Cluster: Value-added, Production and Sales



Source: Department of Statistics, Malaysia

Performance of the **construction-related manufacturing cluster** mirrored both external and domestic demand, registering a sharp contraction in the first quarter, particularly in production of iron and steel due to slower domestic civil engineering activity and lower regional demand. The cluster, however, gradually improved from the second quarter onwards to record a positive growth in the fourth quarter. The improvement in the cluster reflected the strong pick up in the domestic construction activity, as the implementation of stimulus measures gathered momentum.

Table 1.6
Performance of the Manufacturing Sector

	2008	2009
	Annual change (%)	
Value-added (RM million at 2000 prices)	**1.3**	**-9.3**
Manufacturing Production[1]	**0.7**	**-10.0**
Export-oriented industries	**-1.2**	**-11.1**
Electronics & electrical products cluster	**-3.6**	**-22.8**
of which:		
Electronics	-5.4	-24.6
Electrical products	0.9	-18.8
Primary-related cluster	**0.4**	**-3.5**
of which:		
Chemicals and chemical products	-3.5	-1.7
Petroleum products	5.9	-0.8
Rubber products	4.7	-3.0
Off-estate processing	9.4	-2.1
Domestic-oriented industries	**8.0**	**-5.7**
Consumer-related cluster	**11.0**	**-1.2**
of which:		
Transport equipment	23.4	-12.4
Food, beverage & tobacco products	7.4	1.5
Construction-related cluster	**4.3**	**-11.4**
of which:		
Construction-related products	3.2	-18.1
Fabricated metal products	6.1	-1.1
Exports	**3.8**	**-12.5**

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

Agriculture Sector

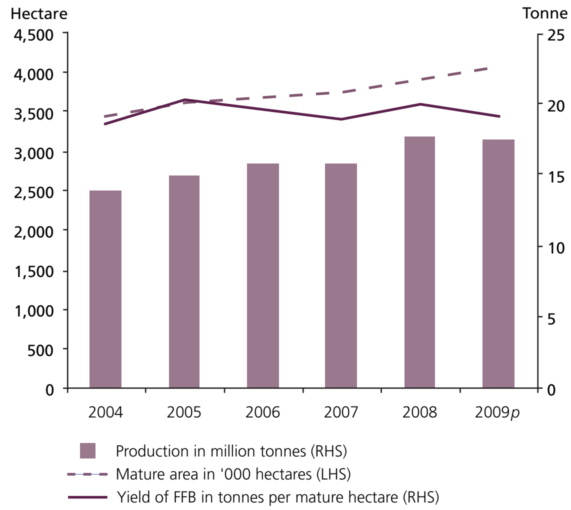
The agriculture, forestry and fishing **(agriculture) sector** grew at a slower pace of 0.4% in 2009 due to lower production of industrial crops. However, higher output of key food-related industries such as fisheries and livestock provided support to the sector.

The agriculture sector recorded marginal growth due to lower production of industrial crops

The production of **crude palm oil** declined by 1% to 17.6 million tonnes in 2009, due to the biological yield down-cycle, unfavourable weather conditions and replanting activity. Consequently, average national fresh fruit bunches (FFB) yield per hectare declined by 4.9% to 19.2 tonnes. Yields in Sabah and Sarawak, which accounted for 42% of total production, registered sharp drops of 8.1% and 5.7% respectively, due mainly to the heavy rainfall in East Malaysia in early 2009. Despite weaker production, palm oil stocks were higher by 12.2% at 2.24 million tonnes at the end of 2009, due to weaker global demand. As a result, the average CPO price fell by 19.2% to RM2,245 per tonne in 2009 (2008: RM2,778 per tonne).

Natural rubber production contracted by 20.2% to 0.86 million tonnes in 2009 due to weather-related factors, weak prices in the early part of the year, as well as the implementation of a programme to curb exports by the three major rubber producing countries. As prices plunged sharply towards the end of 2008, Malaysia, Thailand and Indonesia agreed to cut

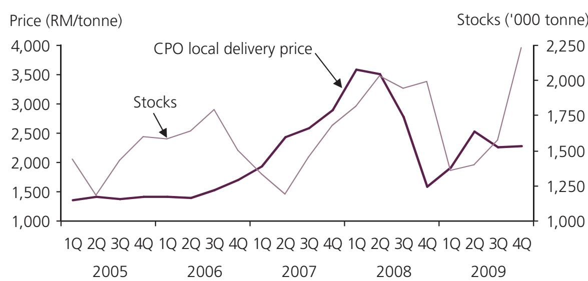
Chart 1.15
Oil Palm: Area, Production and Yield



p Preliminary

Source: Malaysian Palm Oil Board (MPOB)

Chart 1.16
Palm Oil Price and Stocks



Source: Malaysian Palm Oil Board (MPOB)

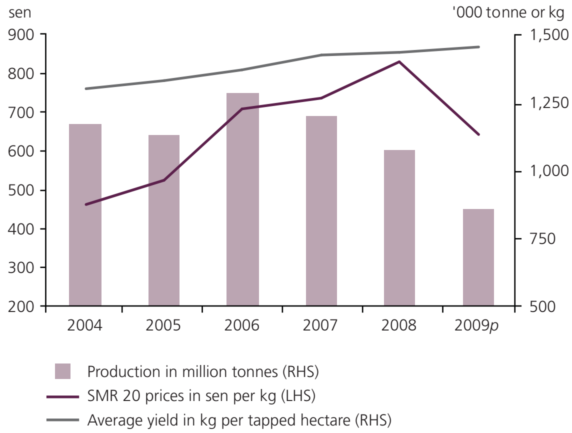
Table 1.7
Agriculture Sector:
Value Added and Production

	2008	2009*p*
	Annual change (%)	
Value added	**4.0**	**0.4**
Industrial crops	**2.9**	**-4.6**
Production of which:		
Crude palm oil	12.1	-1.0
Rubber	-10.6	-20.2
Saw logs	-8.9	-10.9[2]
Cocoa beans	-20.5	-35.1
Food crops	**5.6**	**7.2**
Production of which:		
Fish	5.2	6.7
Livestock [1]	4.3	7.6
Vegetables	11.9	3.1
Fruits	3.2	0.6

[1] Refers to Peninsular Malaysia only
[2] Jan-Nov 2009
p Preliminary

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

Chart 1.17
Natural Rubber: Production, Prices and Yield



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Source: Malaysian Rubber Board (MRB) and Department of Statistics, Malaysia

exports of natural rubber by 700,000 tonnes in 2009. In addition, low prices in early 2009 discouraged tapping activity, especially amongst price-sensitive smallholders. The drop in output was further compounded by the frequent occurences of heavy rainfall at the end of the year, which further disrupted tapping activity. As such, rubber prices more than doubled by the end of 2009 to 958 sen per kg.

Mining Sector

Value-added of the **mining sector** contracted by 3.8% in 2009, largely reflecting the lower output of crude oil and natural gas, following lower external demand and the shutdown of several oil and gas facilities during the year for maintenance purposes.

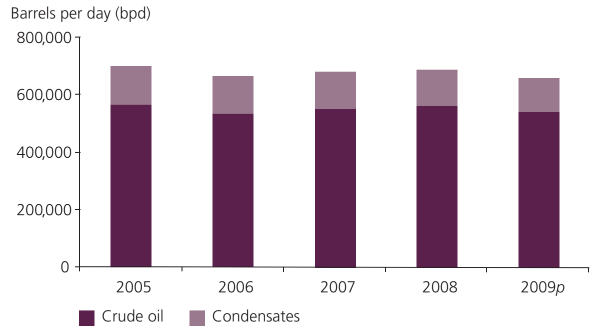
Table 1.8
Mining Sector: Value Added and Production

	2008	2009*p*
	Annual change (%)	
Value added	**-0.8**	**-3.8**
Production		
of which:		
Crude oil and condensates	1.1	-4.4
Natural gas	0.3	-4.0

p Preliminary

Source: PETRONAS
Department of Statistics, Malaysia

Chart 1.18
Production of Crude Oil and Condensates



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Source: PETRONAS

Production of **crude oil (including condensates)** averaged 659,845 barrels per day (bpd) in 2009, lower by 4.4% compared to 2008. In abiding to the production limits set by the National Depletion Policy, production in Peninsular Malaysia declined by 11.7% and accounted for 45% of total output of crude oil of the country. However, production in Sabah increased by 20%, supported by output from the deepwater oil field in Kikeh.

The mining sector contracted further due to lower output of both crude oil and natural gas

Output of **natural gas** contracted by 4% to 5,667 million standard cubic feet per day due to lower

Table 1.9
Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at 1 January	
	2008	2009*p*
Crude oil (including condensates)		
Reserves (billion barrels)	5.46	5.52
Reserve/Production (year)	22	22
Natural gas		
Reserves (billion barrels of oil equivalent)	14.67	14.66
Reserve/Production (year)	36	36

[1] The National Depletion Policy was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).

p Preliminary

Source: PETRONAS

demand for liquefied natural gas (LNG) from major importers. Nonetheless, support for LNG demand emerged in the fourth quarter with the commencement of the long-term contract for Petronas exports to China from October 2009. The output from Sarawak, which accounted for the bulk of the country's LNG production, declined by 4.7%.

Oil reserves in the country increased to 5.52 billion barrels or a lifespan of 22 years at current production levels. Meanwhile, natural gas reserves were at 14.66 billion barrels of oil equivalent, which are sufficient to cover 36 years of gas output at current production levels.

Construction Sector

The **construction sector** recorded a stronger growth of 5.7% in 2009 with improved performance across all sub-sectors. Growth picked up progressively throughout the year due primarily to the implementation of the construction-related activities under the 9MP and the fiscal stimulus packages. The performance of the sector improved significantly in the second half of the year, growing by 8.5% compared to 2.9% in the first half of the year. Meanwhile, stable costs of construction materials provided a further boost to activities in the sector.

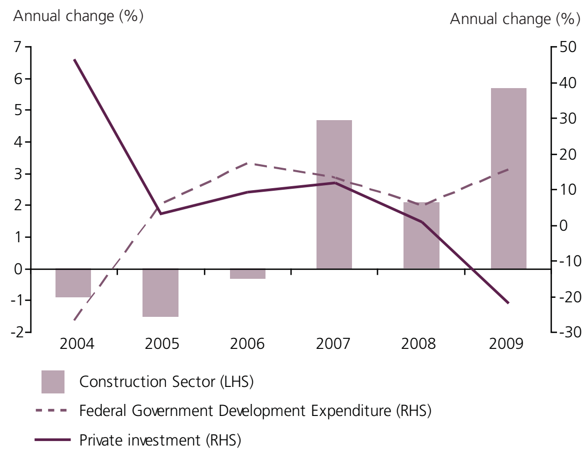
The construction sector recorded stronger growth in 2009

In the **civil engineering** sub-sector, growth was bolstered by the continued implementation of projects associated with the 9MP as well as those under the stimulus packages. This was evident from the 15.6% increase in the Federal Government development expenditure to RM49.5 billion, partly to upgrade existing infrastructure.

Growth in the **non-residential** sub-sector was robust, driven mainly by stimulus spending on the upgrading, repairing and maintenance of public buildings, as well as the on-going construction of commercial buildings. Incoming supply of office space in the Klang Valley was 6.4 million square feet at end-2009 (end-2008: 7.6 million square feet). Demand for office space in the Klang Valley was driven mainly by the relocation of existing tenants into new office buildings while new take-up was modest. As such, the occupancy rate in the area eased marginally to 82% in 2009 (2008: 84%). Rental rates generally remained stable during the year as incentives such as longer rent-free periods and free furnishing sustained the demand.

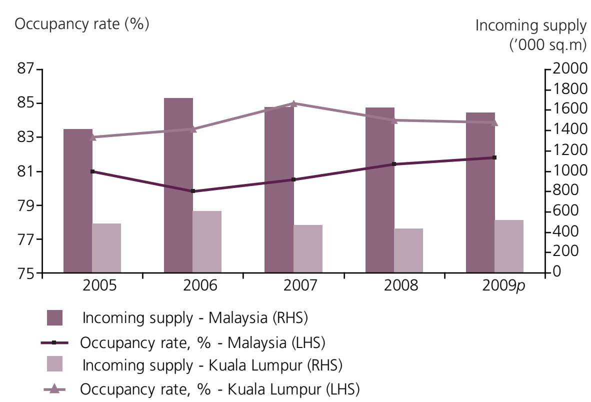
On retail space, fewer shopping complexes were constructed nationwide in 2009 following the considerable supply of large shopping centres that became available during 2007-2008. The 26 newly constructed shopping complexes were mainly neighbourhood malls catering to nearby residential

Chart 1.19
Value-add Growth in Construction Sector versus Growth in Federal Government Development Expenditure and Private Investment



Source: Department of Statistics, Malaysia and Accountant General's Department

Chart 1.20
Incoming Supply and Occupancy Rate of Retail Space in Malaysia and Kuala Lumpur (as at end period)



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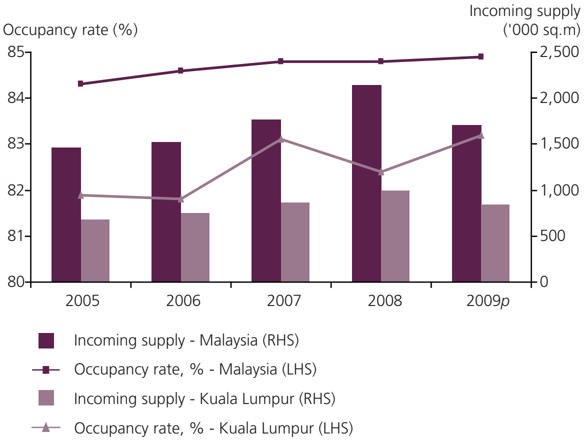
Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

Chart 1.21
Incoming Supply and Occupancy Rate of Purpose-Built Office Space in Malaysia and Kuala Lumpur (as at end period)



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Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

areas. As at the end of 2009, the stock level of retail space rose to 10 million square metres (2008: 9.4 million square metres). Rental rates remained stable in prime centres, but softened slightly in other areas. Similar to the office market, landlords provided various incentives to attract tenants, in turn maintaining the occupancy rate at 81.8% (2008: 81.4%).

Performance in the **residential** segment was relatively mixed during the year. In the first quarter, demand for properties weakened due to uncertainty about the global and domestic economic outlook. Demand, however, started picking up in the second quarter as developers introduced attractive financing packages while borrowing costs were lowered following

Table 1.10
Demand and Supply Indicators of the Residential Property Market

	1H '08	2H '08	1H '09	2H '09*p*
	Annual change (%)			
	Demand indicators			
Residential property transactions				
Value (RM million)	35.5	-3.0	-14.3	17.1
Volume	20.7	-1.2	-10.4	5.7
Finance for purchase of residential property				
Loan applications	43.4	9.1	11.1	50.6
Loan approvals	42.3	3.4	0.3	44.1
	Supply indicators			
New launches	**25.0**	**-23.0**	**-29.6**	**17.7**
New sales and advertising permits	**2.0**	**-38.6**	**-16.8**	**57.8**
Housing approvals	**19.0**	**-52.6**	**-23.7**	**66.7**
Loans for construction				
Loan applications	19.3	-33.2	-31.4	36.5
Loan approvals	20.5	-19.8	-38.2	4.2

p Preliminary

Source: Bank Negara Malaysia, National Property Information Centre (NAPIC), Valuation and Property Services Department and Ministry of Housing and Local Government

Table 1.11
Overhang of Residential Property in Malaysia by Price Range

Residential Price Range	Units	Share (%)	Units	Share (%)
	As at end-2008		As at end-2009*p*	
RM50,000 or less	3,602	13.8	2,946	13.0
RM50,001 - RM100,000	7,491	28.8	6,920	30.6
RM100,001 - RM150,000	4,045	15.5	3,550	15.7
RM150,001 - RM200,000	3,786	14.6	3,419	15.1
RM200,001 - RM250,000	2,119	8.1	1,947	8.6
RM250,001 - RM500,000	3,888	14.9	3,225	14.3
RM500,001 - RM1,000,000	993	3.8	481	2.1
More than RM1,000,000	105	0.4	104	0.5
Total	**26,029**	**100**	**22,592**	**100**

p Preliminary

Source: National Property Information Centre (NAPIC), Valuation and Property Services Department reductions in the OPR by a total of 150 basis points between November 2008 and February 2009. Between the second and fourth quarter of 2009, loan applications and approvals increased at an annual rate of 39.8% and 32.6% respectively, with relatively stronger growth in loans for the purchase of properties priced above RM250,000. With respect to the public sector, there was also an increase in the construction of low- and medium-cost houses as allocated under the stimulus packages.

For the whole year, the volume of residential property transactions contracted by 2.3%, while the value of property transactions rose by 1.3% to RM41.8 billion. Reflecting the overall cautious sentiments of property developers, the number of new launches declined by 15.8%. Given the lower incoming supply and the gradual improvement in demand, the property overhang declined by 13.2% to 22,592 units.

EXTERNAL SECTOR

Balance of Payments

Malaysia's external position remained strong in 2009. The **overall balance of payments** turned around to record a surplus as the continued large surplus in the current account more than offset the lower net outflows in the financial account. Despite the sharp contraction in external demand, the surplus in the current account was supported by a sizeable trade surplus, as lower demand for exports induced a corresponding decline in imports. Meanwhile, sustained regional travel activity resulted in improvements in the services account. The lower net outflows in the financial account largely reflected the significant moderation in portfolio outflows in the first half and the net inflows in the second half of the year. Both net inflows of foreign direct investment and outflows of direct investment abroad also moderated with the weak economic conditions. Other investment

Table 1.12
Balance of Payments

Item	2008			2009*p*		
	+	-	Net	+	-	Net
	RM billion					
Goods	664.3	493.8	170.6	554.2	412.7	141.5
Trade account	*663.5*	*521.6*	*141.9*	*553.3*	*434.9*	*118.4*
Services	101.0	100.9	0.2	99.1	95.9	3.2
Balance on goods and services	**765.4**	**594.7**	**170.7**	**653.3**	**508.6**	**144.7**
Income	39.9	63.6	-23.7	40.5	53.1	-12.6
Current transfers	1.4	18.9	-17.5	3.7	23.1	-19.4
Balance on current account	**806.7**	**677.2**	**129.5**	**697.5**	**584.8**	**112.7**
% of GNI			**18.1**			**17.0**
Capital account			0.6			-0.2
Financial account			-118.5			-82.9
Direct investment			-26.1			-24.9
Portfolio investment			-84.4			0.8
Other investment			-8.1			-58.9
Balance on capital and financial accounts			**-117.9**			**-83.1**
Errors and omissions			-29.9			-15.8
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*-5.8*			*10.7*
Overall balance			**18.3**			**13.8**
Bank Negara Malaysia international reserves, net			**317.4**			**331.3**
USD billion equivalent			**91.5**			**96.7**

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

outflows, which largely reflected trade credits, increased during the year. After taking into account the foreign exchange revaluation gains arising from the strengthening of major currencies against the ringgit, the net international reserves increased by RM13.8 billion to RM331.3 billion (or US$96.7 billion) as at 31 December 2009. As at 25 February 2010, reserves amounted to RM331.8 billion (or USD96.8 billion). This level of reserves is adequate to finance 10 months of retained imports and is 4.3 times the short-term external debt.

Malaysia's external position remained strong despite the weak external environment

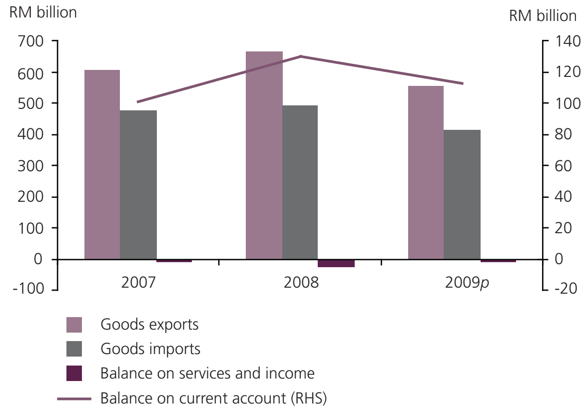
Current Account

The **current account** recorded a marginally smaller surplus of RM112.7 billion or 17.0% of GNI (2008: RM129.5 billion or 18.1% of GNI). Despite the sharp contraction in external trade, the trade surplus remained sizeable as the decline in intermediate imports largely offset the contraction in exports. A larger inflow of tourism receipts, particularly from Asia, contributed to a higher surplus in the services account, while the narrowing of the income account deficit was attributed mainly to lower profits and dividends accruing to the MNCs operating in the manufacturing sector.

Current account surplus remained large, supported by a sizeable trade surplus and an improvement in the services account

For the year as a whole, **gross exports** contracted by 16.6% (2008: +9.8%). Gross exports closely mirrored the developments in the global economy. The export contraction in the first half was exacerbated by the sharp adjustment in inventories by final producers in the importing countries. In addition, the decline in commodity prices also affected exports performance given that commodity and resource-based exports accounted for 39.4% of gross exports. In tandem with the gradual improvement in the global economy, particularly the regional economies, exports started to stabilise in the third quarter, before picking up momentum to register a positive growth of 5.1% in the fourth quarter. Inventory replenishment and a rebound

Chart 1.22
Current Account



p Preliminary

Source: Department of Statistics, Malaysia

Table 1.13
Gross Exports

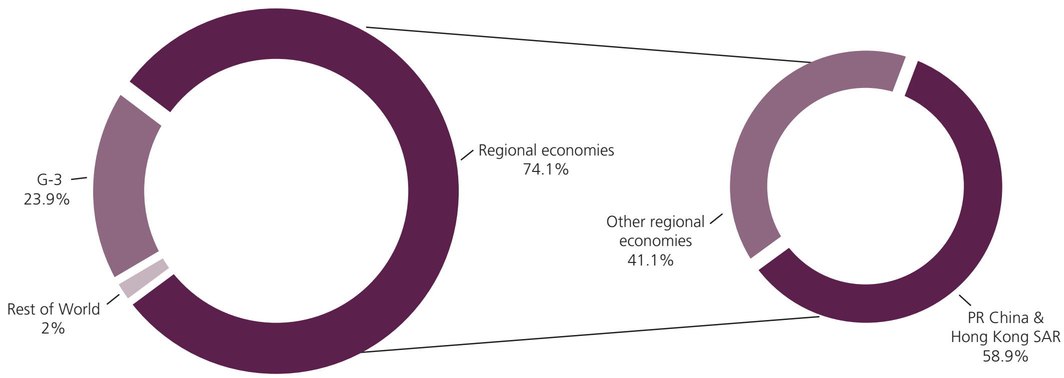
	2008	2009*p*
	Annual change (%)	
Gross exports	**9.8**	**-16.6**
Manufactures	**3.8**	**-12.5**
of which:		
Electronics	*-8.3*	*-8.6*
Semiconductors	*-7.1*	*3.5*
Electronic equipment and parts	*-9.3*	*-18.8*
Electrical products	*9.9*	*-16.6*
Resource-based products[1]	*20.9*	*-17.4*
Commodities	**36.0**	**-27.6**
Agriculture	**29.7**	**-21.6**
of which:		
Palm oil	*43.5*	*-20.9*
Rubber	*10.6*	*-45.0*
Minerals	**41.4**	**-32.2**
of which:		
Crude oil and condensates	*33.0*	*-42.0*
LNG	*51.2*	*-23.4*

[1] Refers to food, beverages and tobacco products, wood products, furniture and parts, rubber products, petroleum products, chemicals and chemical products and non-metallic mineral products

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.23
Direction of Semiconductor Exports in 2009



Note: G-3 refers to the US, Japan and Euro Area

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

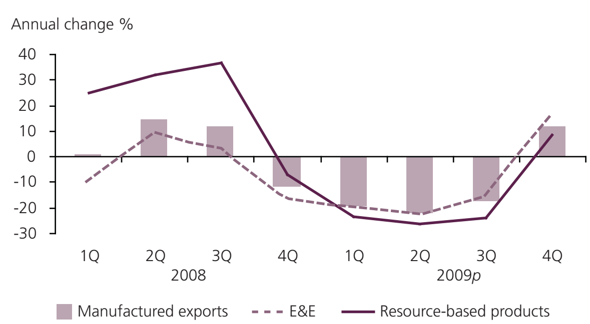
in commodity prices lent further support to export recovery. All segments of exports, except for exports of minerals, registered positive growth in the fourth quarter.

Manufactured exports contracted by 12.5% in 2009, with all major segments recording negative growth. Exports of **E&E** declined by 11%, largely reflecting the sharp contraction in exports in the first half year, following the decline in demand from both advanced and regional countries. Exports recovered in the second half, amid improvements in the global economic conditions, led by stronger growth in the regional economies. The impetus for the recovery was driven by exports of electronics, particularly semiconductors. Exports of semiconductors constituted half of electronic exports, with regional markets accounting for 74% of semiconductor exports. Of significance, PR China and Hong Kong SAR emerged as the largest export destinations for semiconductors with a share of 44%, with the demand coming primarily from the production of netbooks and smart phones. This development was underpinned by the pivotal role played by PR China in the regional production network. Consequently, Malaysia benefited from PR China's demand for parts and components, both for re-exports to advanced economies and increasingly, for its domestic demand. Demand for electronic equipment and parts by advanced countries, however, remained subdued due to lower spending on information technology by corporations.

Exports of **non-E&E** declined by 14.4% in 2009, with the decline being more pronounced in the first half of the year. The sharp fall in commodity prices contributed to a substantial drop in resource-based exports, which accounted for 57.4% of non-E&E exports. These included rubber products, chemicals and chemicals products, and petroleum products. However, the improvement in regional demand and the rebound in commodity prices in the second half led to the recovery in non-E&E exports, which recorded a positive growth in the fourth quarter.

Commodity exports contracted by 27.6%, attributed to weaker demand and lower prices. Both agriculture and mineral exports declined

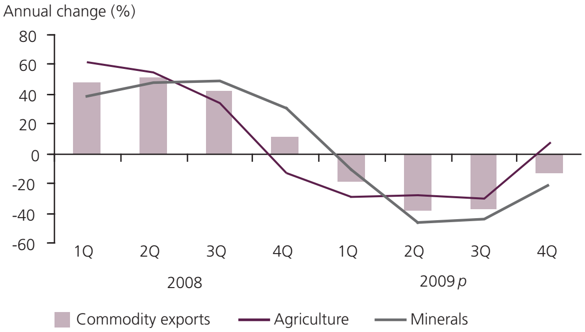
Chart 1.24
Export Performance of Electronics & Electrical (E&E) and Resource-Based Industries



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.25
Commodity Export Performance



p Preliminary

Source: Department of Statistics Malaysia and Bank Negara Malaysia

significantly in the first half, where rubber, crude petroleum and LNG experienced lower prices and export volumes. Meanwhile, the higher export volume of crude palm oil was unable to cushion the fall in prices. The contraction in export receipts eased in the second half on the back of improved commodity prices and some recovery in volume demand, particularly from the region, following the improvement in the economic conditions.

Gross imports declined by 16.6% (2008: +3.8%), with contractions in all major categories of imports. Imports of **intermediate** goods declined by 21.6%. In the first half year, the weak external demand for E&E exports led to the curtailment of intermediate imports, particularly imports of parts and accessories for capital goods. In tandem with the decline in non-E&E exports, imports of fuels and lubricants, as well as industrial supplies such as chemicals and metals were also lower. In the second half, consonant with improvements in exports, imports for intermediate goods recovered and recorded positive growth in the fourth quarter.

Imports of **capital** goods contracted by 5.9%, reflecting lower domestic private investment spending. In the first half year, imports of agricultural, construction, mining and manufacturing equipment contracted significantly, following deterioration in domestic demand conditions and business confidence. Weak external demand and lower capacity utilisation had affected capacity expansion particularly in the manufacturing sector. However, imports of telecommunication equipment remained strong, reflecting investment for wireless networks, following the accelerated migration to mobile services as well as the expansion in the coverage of broadband services. In the second half year, the contraction in capital imports moderated, with imports of office machines recording positive growth in tandem with capacity expansion.

Table 1.14
Imports by End-Use

	2008	2009*p*
	Annual change (%)	
Capital goods	**...**	**-5.9**
Capital goods (except transport equipment)	2.2	-8.2
Transport equipment	-13.6	10.5
Intermediate goods	**5.7**	**-21.6**
Food and beverages, mainly for industry	30.0	-16.8
Industrial supplies, n.e.s.	9.7	-21.8
Fuel and lubricants	32.0	-36.0
Parts and accessories of capital goods (except transport equipment)	-5.0	-19.0
Consumption goods	**11.8**	**-2.7**
Food and beverages, mainly for household consumption	21.4	7.8
Consumer goods, n.e.s.	5.5	-9.1
Re-exports	**-6.5**	**24.0**
Gross Imports	**3.8**	**-16.6**

n.e.s. Not elsewhere specified
p Preliminary
... Negligible

Source: Department of Statistics, Malaysia

Consumption imports also declined, albeit, at a more moderate rate of 2.7% as consumers were more cautious in their spending on imported consumer durables and semi-durables. Nevertheless, imports of food and beverages for household consumption continued to increase. Growth in consumption imports resumed in the fourth quarter in tandem with the strengthening of private consumption.

With the earlier and stronger rebound in economic activity in the Asian economies, exports to the region began to recover as early as the third quarter and strengthened further in the fourth quarter. The greater role by Asia in supporting the recovery in global trade resulted in a shift in Malaysia's trade pattern. The share of exports to the region increased to 49.3% (2008: 45.7%), with the share to PR China increasing to 12.2% (2008: 9.5%). The share of exports to advanced economies including the US, EU and Japan, declined to 31.6% in 2009 (2008: 34.6%).

In 2009, the **services account** recorded the third consecutive year of surplus, the largest recorded surplus of RM3.2 billion (0.5% of GNI). The surplus stemmed from higher travel receipts, as well as an improvement in the other services deficit.

Despite the economic downturn and outbreak of influenza A (H1N1), tourist arrivals expanded strongly by 7.2% to 23.6 million visitors (2008: 5.1%, 22.1 million visitors), where most of the tourists were from Asia. Malaysia benefited from the increase in tourist arrivals spurred by the growing number of middle income travelers from Asia. In addition, the expansion of short and medium-haul leisure travel was further facilitated by the low cost carriers.

The other services account recorded a lower deficit of RM10.7 billion, as a result of mainly lower net outflows for construction services, as well as royalties and licence fees. In addition, net inflows from computer and IT services also improved, attributable to the higher shared services outsourcing (SSO) activities by foreign financial institutions and IT companies in Malaysia. Regional economies emerged as one of the major markets for Malaysia's export of software and IT support services, earnings of which accounted for about 40% of total receipts. Growth was further supported by regional IT centres for the oil and gas industry. Net payments for professional services, however, increased reflecting imported consultancy services by the financial and manufacturing sectors.

Table 1.15
Direction of External Trade

	2009*p*				
	Exports		Imports		Trade balance
	RM billion	Annual change (%)	RM billion	Annual change (%)	RM billion
Total	**553.3**	**-16.6**	**434.9**	**-16.6**	**118.4**
of which:					
United States	**60.6**	**-26.8**	**48.6**	**-13.9**	**11.9**
European Union (EU)	**60.0**	**-19.9**	**50.8**	**-17.7**	**9.2**
Selected ASEAN countries[1]	**141.0**	**-16.8**	**109.0**	**-13.4**	**32.1**
Selected North East Asia countries	**131.6**	**-1.5**	**110.1**	**-15.2**	**21.6**
The People's Republic of China	*67.2*	*6.4*	*60.7*	*-9.3*	*6.6*
Hong Kong SAR	*28.8*	*1.9*	*10.8*	*-20.8*	*18.0*
Chinese Taipei	*14.4*	*-11.1*	*18.5*	*-26.4*	*-4.0*
Korea	*21.1*	*-18.5*	*20.1*	*-16.9*	*1.0*
West Asia	**21.4**	**-18.0**	**14.8**	**-41.0**	**6.6**
Japan	**54.4**	**-24.2**	**54.3**	**-16.6**	**0.1**
India	**17.0**	**-31.3**	**7.9**	**-23.6**	**9.1**

[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

Table 1.16
Services and Income Accounts

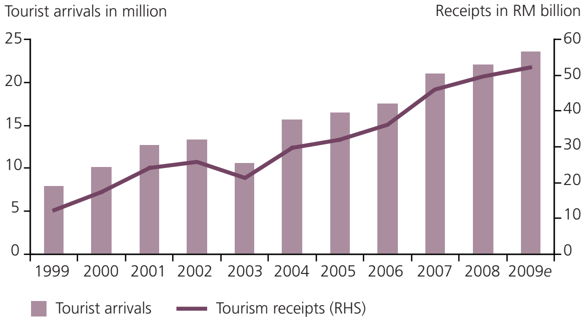
	2008	2009p		
	RM billion			
	Net	+	-	Net
Services Account	**0.2**	**99.1**	**95.9**	**3.2**
% of GNI	...			*0.5*
Transportation	-15.4	14.9	32.0	-17.1
Travel	28.5	54.2	22.6	31.6
Other services	-12.4	29.8	40.5	-10.7
Government transactions n.i.e.	-0.6	0.1	0.7	-0.6
Income Account	**-23.7**	**40.5**	**53.1**	**-12.6**
% of GNI	*-3.3*			*-1.9*
Compensation of employees	-0.7	4.0	5.4	-1.4
Investment income	-23.0	36.5	47.7	-11.2

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

For the year, the transportation account recorded a larger deficit of RM 17.1 billion as lower earnings from passenger fares and cargo offset the lower freight payments due to the declining volume of trade. The global economic downturn inevitably led to lower passenger traffic against the backdrop of excess capacity and greater competition within the travel industry. The decline in earnings from passenger fares moderated in the second half year following the upturn in regional travel demand amidst reductions in capacity.

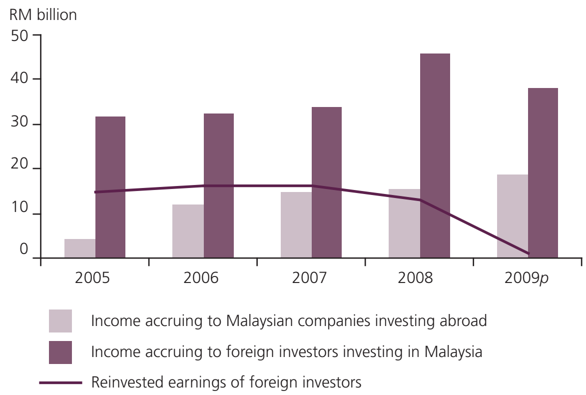
The **income account** deficit narrowed to RM12.6 billion or 1.9% of GNI, reflecting mainly lower

Chart 1.26
Tourist Arrivals and Tourism Receipts



e Estimate
Source: Malaysia Tourism Promotion Board and Department of Statistics, Malaysia

Chart 1.27
Direct Investment Income



p Preliminary
Source: Department of Statistics, Malaysia

profits and dividends accruing to foreign direct investors in Malaysia, particularly in the E&E sector. This was due to the weak performance of manufacturing sector in the first half of the year. Meanwhile, profits and dividends accruing to Malaysian companies investing abroad were higher, reflecting the improvement in earnings from commodities.

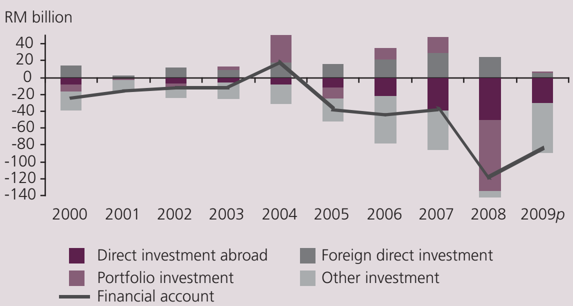
Financial Account
In 2009, the **financial account** recorded a lower net outflow of RM82.9 billion (2008: -RM118.5 billion). Of significance, net portfolio outflows moderated sharply in 2009 as the large reversal of short-term capital flows experienced since the second half of 2008 turned to net inflows in the second half of 2009, following improved global and domestic economic conditions. Meanwhile, both foreign direct investment and direct investment abroad by Malaysian companies moderated, particularly in the first half of 2009, due to the sharp deterioration in global economic conditions. Outflows in the other investment category were higher as a result of the continued extension of trade credits by Malaysian exporters and the placement of deposits abroad by residents.

For the year as a whole, **portfolio investment** recorded a small net inflow of RM0.8 billion. In the first half, portfolio outflows moderated to RM22.1 billion (2H 2008: -RM88.5 billion) as deleveraging by international investors subsided. Subsequently, this outflow turned around to register a net inflow of RM22.9 billion in the second half of the year,

Nature and Trends of Capital Flows in Malaysia

Malaysia is one of the most open economies in the world. Throughout its development, Malaysia has been highly integrated with the global economy and international financial system, resulting in not only significant trade expansion, but also large investment flows. For more than a century, Malaysia has received foreign direct investment, which has been an important contributor to the country's economic development. As the Malaysian economy evolves to become more developed, the nature of the capital flows has changed responding to the changing conditions prevailing in the country. Two distinct developments have emerged in the recent years. First, short-term capital flows have become more prominent in the Malaysian financial system, in tandem with the global surge in this form of capital flows. Short-term flows, in particular, portfolio flows, have risen in volume and their volatility has been increasing, with potentially destabilising effects on exchange rates, the financial markets and the real economy. Second, a more recent development has been the large increase in investment abroad by Malaysian companies in search of new growth opportunities and markets.

Chart 1
Trends of Net Capital Flows in Malaysia



p Preliminary

Source: Department of Statistics, Malaysia

Chart 2
Net FDI Flows

p Preliminary

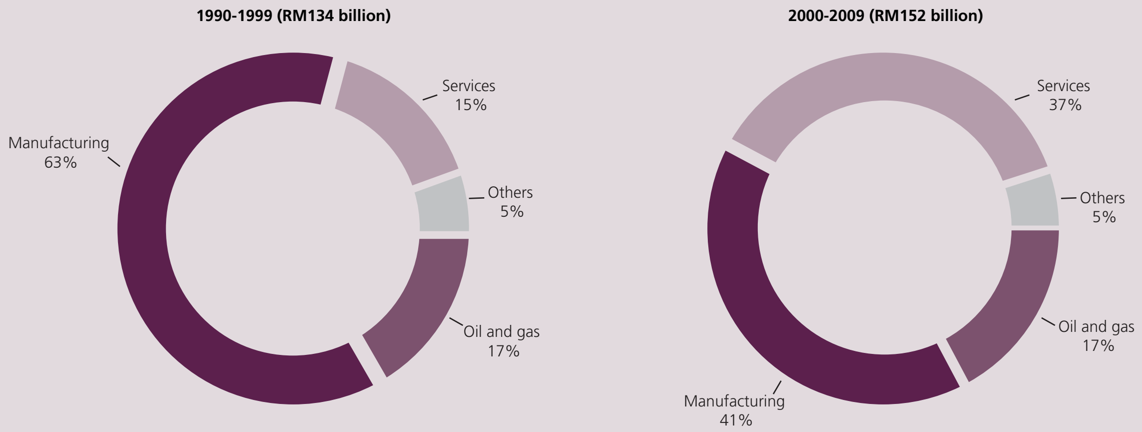
Source: Department of Statistics Malaysia

Foreign Direct Investment

Foreign direct investment (FDI) is an important contributor to the growth and the transformation of the Malaysian economy, particularly in establishing new industries, enhancing production capacity, employment, trade and technological capability. Malaysia has attracted a steady inflow of net FDI in the recent decade, averaging 3% of GDP per annum with a peak of 4.5% of GDP in 2007. However, relatively lower FDI inflows were recorded in 2001 and 2009, similar to the global trend, following the collapse of the technology bubble and the global financial crisis respectively.

In absolute volume, Malaysia recorded RM152 billion in net FDI inflows during the period of 2000-2009, higher than the RM134 billion received during the period of 1990-1999. However, as a share of GDP, the net inflows of FDI were lower during the period of 2000-2009 (3% of GDP) compared to the period of 1990-1999 (6.3% of GDP). This moderation was mainly attributed to two reasons. Firstly, the FDI inflows into Malaysia in this recent decade have increasingly been channelled into the higher value-added services sector, namely the financial services and shared services operations. The scale of the investments in these sub-sectors are less and are also less capital-intensive compared to the manufacturing sector, thus involving lower amounts. More importantly, however, is the value-add and contribution to growth of this lower amount of FDI is higher as these sub-sectors are more skill-intensive and have higher labour productivity. Secondly, the rising competition for FDI in the region from new emerging market economies such as PR China, India and Vietnam as well as established investment centres, namely Singapore and Hong Kong SAR. While global net FDI flows into the region have more than doubled during the period

Chart 3
Cumulative Net FDI Flows by Sector



Note: Others mainly consist of the agriculture and construction sectors

Source: Department of Statistics, Malaysia

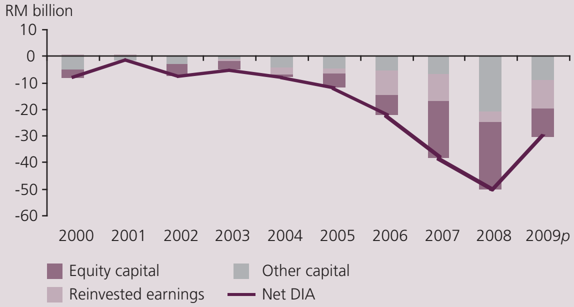
of 2000-2009 (USD1.4 trillion; 1990-1999: USD0.6 trillion), Malaysia's share of the regional FDI flows has declined as a major part of these flows went to PR China.

In terms of the sectoral distribution, inflows of FDI into Malaysia are relatively broad-based. While FDI inflows continue to be underpinned by the large and long-standing presence of MNCs in the manufacturing sector and investments in the oil and gas sector, the period 2000-2009 saw the rising importance of FDI into the services sector, with the share of FDI in this sector more than doubling to 37% of the total FDI flows (1990-1999: 15%). FDI in the services sector is well diversified, with investment being channelled to the financial services, shared services and outsourcing, communications, transportation, hotels and wholesale and retail trade sub-sectors. A significant development is the sizable increase in FDI in the financial sector, including Islamic finance. It is estimated that net FDI inflows into this sector amounted to RM41.6 billion over the recent 10-year period following the liberalisation that has been undertaken in this sector. In the oil and gas sector, investment in upstream activity continued to be significant as PETRONAS and its foreign partners continued to be actively engaged in exploration, production and the development of oil and natural gas resources in the country. Additionally, the manufacturing sector in Malaysia continues to be successful in attracting FDI in new growth areas such as renewable energy and medical equipment.

Direct Investment Abroad

An important development in recent years has been the sharp increase in direct investment abroad (DIA) by Malaysian companies, averaging 3.5% of GDP per annum between 2000 and 2009, and peaking at 6.8% of GDP in 2008. Cumulatively, net DIA amounted to RM182 billion over this period, with 78% occurring between 2006 and 2009. The increasing trend of DIA reflects the growing presence of Malaysian companies abroad, especially in the Asian region. Similar to other global companies, the factors driving Malaysian companies to invest abroad include expanding markets for their products, gaining access to more competitive supply of land and labour, expanding into rapidly growing industries, acquiring brands and technology, and taking advantage of the comparative advantage of host countries. In particular, given the relatively small domestic market, regional and global expansions allow Malaysian companies to achieve greater economies of scale by tapping into new and larger markets. Generally, Malaysian companies which invested abroad have also enhanced their domestic operations by expanding capacity and moving up

Chart 4
Net DIA Flows



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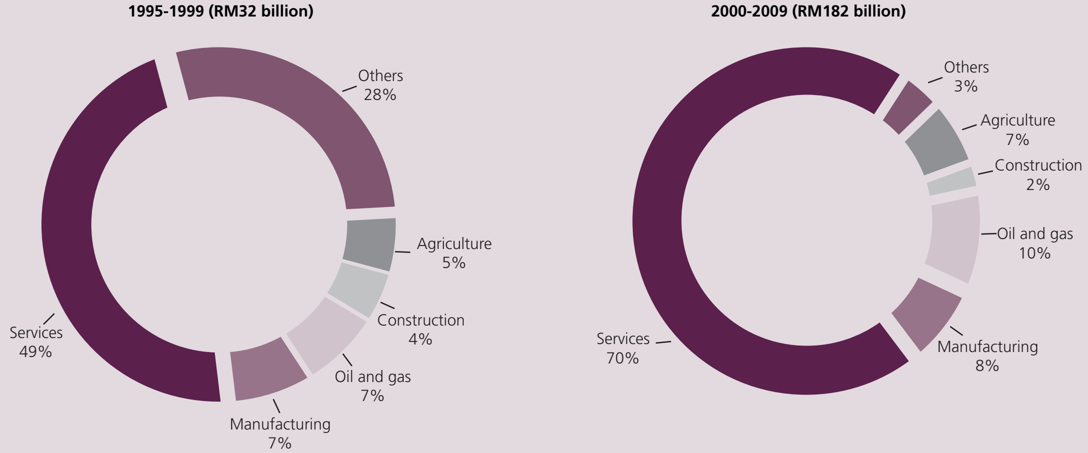
Source: Department of Statistics, Malaysia

the production value chain in order to establish an integrated supply chain management with their overseas subsidiaries. This has increased their overall efficiency and enabled them to better compete in the global market. Therefore, the rising investment abroad by Malaysian companies, over a medium term, will benefit the country through having more competitive and globalised Malaysian companies, through greater job opportunities for Malaysians, higher dividends for shareholders, and higher inflows from profit repatriation.

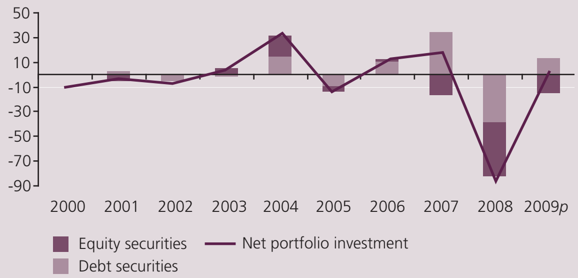
The scope of DIA by Malaysian companies has also broadened over the years. In the earlier years, investments were undertaken mainly by PETRONAS and Government-linked plantation companies, to explore the potential for further natural resources such as oil and gas as well as to increase the available land for plantation activity. This has, however, changed in recent years, with investments, mainly in the services sector, being undertaken by both the Government-linked companies and private companies, particularly in the financial services, telecommunication, utilities and business services sub-sectors. Most of the investments were undertaken in the region, particularly in ASEAN, the Asian Newly Industrialised Economies (NIEs), PR China and West Asian economies.

Chart 5
Cumulative Net DIA Flows by Sector



Source: Department of Statistics, Malaysia

Chart 6
Net Portfolio Flows



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Source: Department of Statistics Malaysia

Portfolio Investment Flows

A key development since the early nineties has been the surge in portfolio flows to Malaysia. At its peak in 2008, total gross portfolio inflows and outflows in absolute terms were 23 times higher than in 2000. In addition, a distinct characteristic of the portfolio flows in recent years has been the increased volatility of the flows. Since 2004, there have been several episodes of large inflows and outflows of portfolio funds in response to the developments in global financial markets as well as changes in domestic economic conditions. Of significance, between 2004 and the first half of 2008, Malaysia experienced net portfolio inflows of RM54 billion. These inflows were mainly driven by Malaysia's strong economic fundamentals as well as the prospects of better corporate outlook as the economy recovered strongly following the aftermath of the Asian financial crisis. In addition, the rapid development of the domestic bond market has also attracted sizeable inflows of foreign portfolio investment into the debt securities market. The emergence of debt securities as an asset class for foreign investors alongside the equities has resulted in an increasingly diversified composition of portfolio investment flows in Malaysia.

The build-up of inflows of speculative funds in 2005 was due to the expectations for the appreciation of the ringgit which was floated on 21 July 2005. The surge of portfolio inflows since 2005 was interrupted by several external market developments which led to episodes of reversals in flows by foreign investors. Among others, the deteriorating global inflation outlook in 2006, the Shanghai stock market correction in February 2007 and the heightened global market uncertainty following the US sub-prime mortgage problem in July-August 2007 had subsequently led to outflows of foreign funds. Of significance was the massive deleveraging activities by foreign financial institutions following the global financial crisis in the second half of 2008 that triggered large-scale liquidation of portfolio funds by international investors, which affected emerging markets across the board including Malaysia. These reversals culminated in a net portfolio outflow of RM111 billion between the second half of 2008 and the first half of 2009. Nevertheless, inflows of foreign portfolio funds resumed in the second half of 2009 amid stronger growth prospects in the region as well as further normalisation of conditions in the international financial markets. This subsequently led to an improvement in investors' risk appetite for financial assets in the emerging markets, including Malaysia.

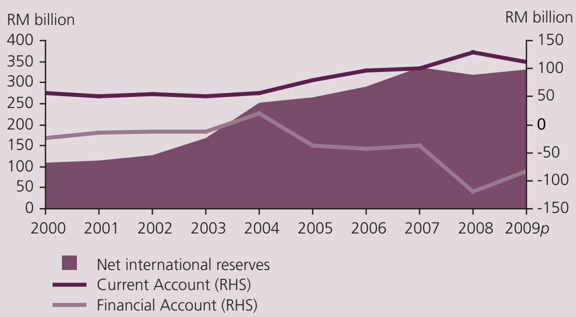
While the magnitude of the recent reversals were larger than the net outflows recorded during the height of the Asian financial crisis, the impact on the domestic economy was limited given Malaysia's well-developed financial system. In particular, the development of the debt market allowed for the diversification of the composition of portfolio flows into Malaysia. As such, the reversals of the flows did not cause a significant disruption in any particular asset market. In addition, the depth of the domestic financial market also provided greater liquidity and price sensitivity to changes in financial conditions, facilitating more effective monetary operations to sterilise the impact of large capital flows. The strong international reserves position has been able to accommodate these outflows of funds without affecting overall domestic liquidity or interrupting the normal functioning of the foreign exchange and domestic money markets. Given these conditions, Malaysia has not only been able to withstand large shifts in funds but has also managed to ride out the recent period of turbulence in international financial markets without serious disruptions to the domestic economy.

Meanwhile, portfolio outflows due to residents investing abroad have been steadily growing over the years, averaging about 3.9% of GDP during the period of 2000-2009 and were mainly in the form of equity securities. The liberalisation of the foreign exchange administration rules since 2005 has also allowed for greater flexibility for residents to invest abroad. The increase in external portfolio assets resemblance similar trends in other parts of the region, especially among the Asian NIEs in which the build-up in external portfolio assets at the international level has become increasingly significant.

Other Investment

In addition to portfolio investment, other investment comprising mainly net external loans undertaken by the official and private sectors, net placements of deposits by the banking institutions as well as trade credit extension, have consistently recorded net outflows, averaging 5.6% of GDP over the recent ten years. The net external loan repayments by both the official and private sectors have contributed to these outflows. Another component of other investment includes activities by the banking institutions in managing their liquidity. This reflected mainly placement of deposits abroad and inter-bank borrowings. These flows in the banking sector have in part been responsive to interest rate and liquidity movements. The non-bank private sector experienced an outflow during this period, due mainly to extension of trade credits by Malaysian exporters and repayments of trade credits by Malaysian importers. These flows have been fairly volatile and large, and they were mainly driven by financing requirements and business decisions of the non-bank private sector.

Chart 7
Movement of International Reserves



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Source: Department of Statistics Malaysia

International Reserves

The changes in net international reserves over this recent decade have been shaped by developments in both the current and financial accounts of the balance of payments, particularly movements in portfolio investments. With current account surplus exceeding financial account deficits, there was a build-up of external reserves from 2001-2003. The large inflows of portfolio funds from 2004 up to the first half of 2005 coupled with the continued surplus in the current account resulted in a significant increase of international reserves from RM168 billion (USD44.2 billion) as at end-2003 to RM297.1 billion (USD78.2 billion) as at end-July 2005. While a significant amount of these inflows were attracted to the investment opportunities provided by the deepening Malaysian capital market, there were also significant speculative portfolio inflows over this period in anticipation of the ringgit exchange rate realignment. These speculative inflows reversed in the second half of 2005 after the ringgit was floated in July 2005 and reserves stabilised at RM265.2 billion (USD70.2 billion) as at end-2005.

In 2007 and the first half of 2008, Malaysia again received substantial capital inflows, particularly portfolio funds. These large capital inflows coupled with the current account surplus, resulted in a significant appreciation of the exchange rate and an increase in the international reserves which peaked in June 2008 at RM410.9 billion (USD125.8 billion). The significant deleveraging activities following the intensification of the global financial crisis led to a large reversal of portfolio flows of RM111 billion between the second half of 2008 to the first half of 2009, resulting in a substantial decline in the international reserves to RM322.9 billion (USD91.5 billion) as at end-June 2009. The decline in reserves during this period is less than the net portfolio outflow as Malaysia continued to record a current account surplus during this period. The portfolio inflows resumed since the second half of 2009. The external reserves as at end-2009 amounted to RM331.3 billion (USD96.7 billion). This reserves position was sufficient to finance 9.7 months of retained imports and is 4.3 times of the short-term external debt. As at 25 February 2010, the net international reserves was amounted at RM331.8 billion (USD96.8 billion).

Conclusion

This review of developments in capital flows in Malaysia over the recent ten years has brought to the forefront several important policy considerations for Malaysia moving forward. First, investments abroad by Malaysian companies can be expected to continue to remain sizeable in the future and this development is in response to the changing structure and competition in the region and in the global economy. The changing composition of capital flows would contribute to Malaysia's long-term competitiveness, economic transformation and growth. Second, competition for FDI will continue to intensify, going forward. Malaysia has shifted gear to attract FDIs in the high value-added activities and those that will bring in new technology, required to support Malaysia's transition into a high income economy.

The third, is the challenge with respect to managing the increasingly volatile nature of short-term capital flows. The strategy adopted is to further deepen and broaden the domestic financial system to cope with and manage the volatile capital flows without resulting in disruptions and instability in the domestic financial markets. Malaysia has also consistently maintained vigilance over developments in capital flows through close surveillance and assessments of the risks associated with these flows. Maintaining Malaysia's strong macroeconomic fundamentals and a sound and strong banking system will provide the flexibility for the country to intermediate volatile capital flows while maintaining financial stability and promoting growth in the domestic economy.

Table 1.17
Balance of Payments: Financial Account

	2008	2009*p*
	RM billion	
Financial Account	**-118.5**	**-82.9**
Direct Investment	**-26.1**	**-24.9**
Abroad	-50.2	-30.5
In Malaysia	24.1	5.7
Portfolio Investment	**-84.4**	**0.8**
Other Investment	**-8.1**	**-58.9**
Official sector[1]	0.8	4.1
Federal Government	*-0.5*	*-0.6*
NFPEs	*1.3*	*-1.9*
Bank Negara Malaysia	*0.0*	*6.6*
Private sector	-8.9	-63.0

[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 and Bank Negara Malaysia

going mainly into long-term debt securities. The inflows took place following further normalisation in the international financial markets and stronger growth prospects in Asia, which led to the improvement in investors' risk appetite.

The financial account recorded a lower net outflow following the return of portfolio funds in the second half of the year

Gross inflows of **foreign direct investment** (FDI) moderated to RM31.6 billion (or 4.8% of GNI) in 2009. This largely reflected the significantly lower amount of earnings retained for investments by existing multinational corporations (MNCs) due to lower profits during the year. In addition, a significant share of the profits was also repatriated to home countries. Rising excess capacity amid the falling export demand and uncertainty in the global economic outlook further discouraged inflows of FDI during the year. After taking into account the adjustments for outflows due largely to loan repayments to parent companies, net inflows of FDI amounted to RM5.7 billion or 0.9% of GNI.

The FDI continued to be broad-based, with inflows mainly into the manufacturing (47% share), services (28%) and oil and gas (25%) sectors. In the manufacturing sector, the bulk of FDI was in the E&E sub-sector, largely undertaken by MNCs for the upgrading of equipment and technology. There were also sizeable investments in the petroleum refining and petroleum-related industry, as well as in the solar energy industry. FDI in the services sector was channelled primarily into the finance and insurance, as well as wholesale and retail trade sub-sectors. Investment in the oil and gas sector reflected on-going extraction operations and production activities undertaken by MNCs jointly with PETRONAS.

Direct investment abroad (DIA) by Malaysian companies was also affected by global developments. However, DIA continued to remain sizeable. For the year as a whole, net DIA amounted to RM30.5 billion and was mainly channelled into the services (46%), oil and gas (38%), and manufacturing sectors (6%). Although investments in terms of equity and inter-company loans were lower, reinvested earnings more than doubled in 2009. This largely reflected the continued investment by Malaysian companies in their existing operations.

In the services sector, DIA was mainly undertaken through increased participation in existing operations abroad, particularly in the Asian region. Of significance, the domestic banking and telecommunication players have strategised to realign their operations on a regional scale to remain competitive. The investment in the oil and gas sector mainly reflected the continued expansion into global markets by PETRONAS to improve returns and to diversify geographical risks. During the year, PETRONAS invested in a gas processing plant in Turkmenistan, an LNG project in Australia and other existing projects in Asia, Africa and Central Asia. Meanwhile, investments in the manufacturing sector were primarily in the form of reinvestments into upstream and downstream activities related to palm oil.

The **other investment** account recorded a higher net outflow as outflows in the private sector more than offset inflows in the official sector. The private sector outflows reflected the net placement of deposits abroad by residents and the extension of trade credits by Malaysian exporters. During the year, trade credits extended by Malaysian exporters were higher than the trade credits received by Malaysian importers, as foreign exporters experienced constraints in trade financing as a result of the global financial crisis. Meanwhile, the net inflows of the official sector were due mainly to the special allocation of IMF's Special Drawing Rights (SDR) to Bank Negara Malaysia, which was partially offset by external loan repayments by the Federal Government and the Non-Financial Public Enterprises (NFPEs).

International Reserves

The international reserves held by Bank Negara Malaysia comprise the holdings of gold and foreign exchange holdings, the reserve position with the IMF and the holdings of Special Drawing Rights (SDR). In 2009, net international reserves increased by RM13.8 billion to RM331.3 billion (equivalent to USD96.7 billion) as at 31 December 2009.

International reserves increased by RM13.8 billion to RM331.3 billion in 2009, supported mainly by the continued surplus in the current account

For the year as whole, the increase in international reserves was largely supported by the continued surplus in the current account. Foreign exchange inflows arising from export proceeds and FDI were more than able to cover the external obligations arising from external loans and imports as well as net outflows arising from both DIA and portfolio investments. The movements of the international reserves during the year were to a large extent influenced by developments in portfolio flows. In the first half of the year, the moderation of deleveraging activities by international investors led to small gains in the net international reserves as portfolio outflows subsided. Net international reserves position subsequently increased moderately in the second half with the revival of investor sentiments and the return of net foreign portfolio inflows. Meanwhile, the cumulative foreign exchange revaluation gain amounted to RM10.7 billion, reflecting the strengthening of major currencies against the ringgit, particularly in the first three quarters of 2009.

Malaysia is a participating member in the Financial Transactions Plan of the IMF which makes resources available to member countries facing short-term balance of payments difficulties. The increase in **reserve position with the IMF** in 2009 reflected mainly net purchases of currencies by various member countries under the Financial Transactions Plan. Meanwhile, the significant increase in international reserves held in the form of SDRs was attributed mainly to an additional allocation of **SDRs** to Malaysia by the IMF in a move to strengthen the financial safety net available to member countries during the financial crisis in 2009.

Table 1.18
Net International Reserves

	As at end		Change
	2008	2009	2009
	RM million		
SDR holdings	786.4	7,279.2	6,492.8
IMF reserve position	1,127.1	1,515.8	388.7
Gold and foreign exchange[1]	315,554.2	322,505.6	6,951.4
Gross International Reserves	**317,467.7**	**331,300.6**	**13,832.9**
Less Bank Negara Malaysia external liabilities	22.5	23.9	1.4
Net International Reserves	**317,445.3**	**331,276.7**	**13,831.4**
USD million equivalent	**91,529.5**	**96,688.1**	**5,158.6**
Months of retained imports	7.6	9.7	
Reserves/Short-term external debt[2] (times)	4.0	4.3	

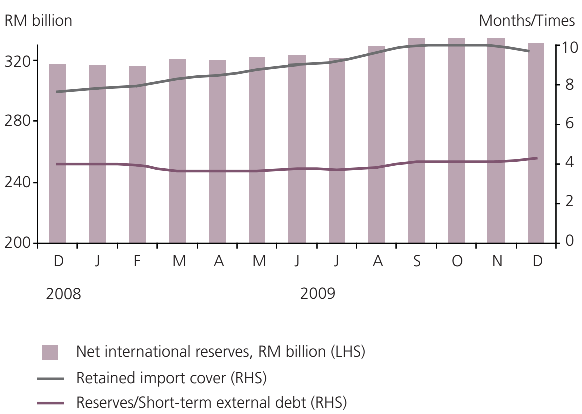
[1] 'Other Foreign Currency Claims on Residents' is reclassified from 'Gold and Foreign Exchange' to 'Other Assets' of Bank Negara Malaysia
[2] With effect from end-March 2008, the short-term external debt refers to the external debt under the new definition, with offshore entities in Labuan IBFC being treated as residents
Note : Numbers may not necessarily add up due to rounding

Source: Bank Negara Malaysia

For the first few months of 2009, the global financial markets remained in turmoil. Central banks and governments implemented large scale and unprecedented measures to arrest the crisis. The functioning of global financial system was impaired by the failure of some financial markets. Market volatility was large, and at times were extreme. Credit markets were frozen while large financial institutions in distress were rescued by governments. At the end of the first quarter, governments in major advanced economies had announced a wide range of unprecedented fiscal and monetary measures to stabilise the financial system. Aggressive monetary accommodation brought down policy rates to historical lows and unconventional quantitative measures were introduced to ease liquidity and restart financial intermediation. Subsequently, the volatility subsided and financial conditions stabilised. This was then followed by a strong recovery of the equity market. For the remaining part of the year, major equity and commodity markets rebounded, benefiting from the abundance of liquidity while credit spreads tightened considerably. Investment flows returned to riskier assets and emerging markets were the best performing asset class for the year.

During the course of the year, the reserves management strategy shifted towards anticipating the financial and economic recovery. Investment duration and asset allocation were managed in anticipation of an expected rise in bond yields due to the record debt supply as well as rising long-term inflationary risk from the unprecedented fiscal and monetary expansions. Diversification into other currencies and asset markets resumed, capitalizing on improving financial market conditions, which led to a strengthening of non-US dollar currencies and credit markets in general. Throughout the crisis and the ensuing recovery, risk management practices remained robust and were continually reviewed, particularly in managing elevated operational and credit risks.

Chart 1.28
Net International Reserves (end-month)



Note : With effect from end-March 2008, the short-term external debt refers to the external debt under the new definition, with offshore entities in Labuan IBFC being treated as residents

Source: Bank Negara Malaysia

As at 25 February 2010, the reserves level amounted to RM331.8 billion (equivalent to USD 96.8 billion), which is adequate to finance 10 months of retained imports and is 4.3 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

Malaysia continues to undertake a prudent yet pragmatic external debt management strategy which facilitates diversification of external borrowings by the private and public sectors while instituting prudential measures to minimise risks associated with large external obligations and debt servicing ability. In promoting monetary and financial stability as well as in safeguarding the balance of payments position, the country's external debt management is supported by a comprehensive surveillance and debt monitoring system which enables early detection of emerging risks and vulnerabilities arising from the country's overall external debt exposure.

Malaysia's external debt remained low at 35.3% of GNI

As at the end of 2009, Malaysia's total external debt moderated to RM233.9 billion (or USD67.7 billion), or equivalent to 35.3% of GNI. During the year, **the medium- and long-term external debt** declined due to net repayments by both the Federal Government and the private sector, which more than offset the larger net drawdown by the NFPEs. The appreciation of the ringgit against the US dollar also contributed to the decline in the overall external debt.

The **Federal Government** debt registered a larger net repayment of RM6.3 billion in 2009, due primarily to the maturity of the Global Bond (1999). For the sixth consecutive year, no market loan was raised from the international

Table 1.19
Outstanding External Debt

	2008	2009p	2008	2009p
	RM billion	RM billion	USD billion	USD billion
Total debt	**236.1**	**233.9**	**67.4**	**67.7**
Medium- and long-term	156.5	156.0	44.6	45.1
Short-term[1]	79.6	78.0	22.7	22.6
As % of total debt	*33.7*	*33.3*	*33.7*	*33.3*
As % of net international reserves	*25.1*	*23.5*	*25.1*	*23.5*
As % of GNI				
Total debt	33.0	35.3		
Medium- and long-term debt	21.9	23.6		
As % of exports of goods and services				
Total debt	30.9	35.8		
Medium- and long-term debt	20.5	23.9		
Debt service ratio (%)	**2.6**	**6.5**		

[1] Excludes currency and deposits held by non-residents with resident banking institutions
p Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

capital market as the Federal Government maintained its practice of sourcing its funding requirements from non-inflationary domestic sources. Meanwhile, the higher external debt of the **NFPEs** (end-2009: RM71.6 billion; end-2008: RM63.1 billion) was due mainly to the issuance of a USD4.5 billion two-tranche bond by PETRONAS in August 2009, to finance its future capital expenditures. Excluding this transaction, the NFPEs registered a net repayment of their external debt following the maturity of several large bonds as well as reduced borrowings for capital expenditure and expansion abroad.

Similarly, the **private sector** registered a net repayment of RM3.3 billion in 2009, due mainly to larger repayments of debt by companies in the manufacturing and oil and gas sectors. Meanwhile, loan drawdowns also declined as investment expansion plans slowed down.

During the year, the **short-term external debt** outstanding declined to RM78 billion as inter-bank borrowings arising from treasury operations moderated. The short-term external debt accounted for only 11.8% of GNI, 23.5% of international reserves and 11.9% of exports of goods and services. The bulk of the short-term debt continued to be held by the banking sector (88.5%). Short-term external debt of the non-bank private sector, comprising mainly of revolving credits and overdraft facilities, remained low.

LABOUR MARKET DEVELOPMENTS

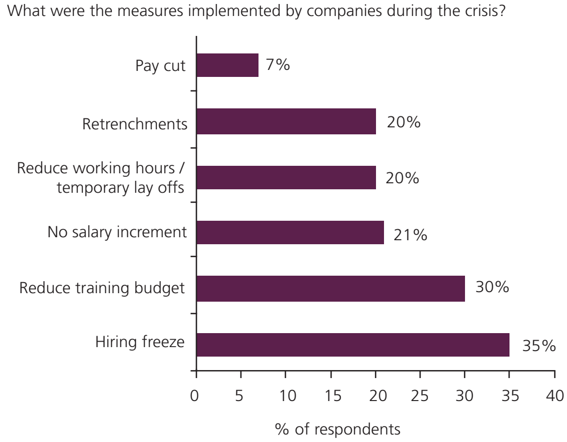
The labour market was adversely affected by the significant deterioration in the global economy in the early part of the year. In response to the sharp decline in export orders and weakening domestic demand, firms particularly in the trade-related sectors reduced operations, particularly in the first two months of the year.

Weak labour market conditions in the early part of 2009 but conditions had steadily improved

According to a survey conducted by Bank Negara Malaysia, various measures were undertaken by companies to reduce costs, of which imposing a hiring freeze and reducing the training budget were the most common. Firms also stated that retrenchment was generally implemented as a last resort, only after all other cost-cutting measures had been exhausted. For the year as a whole, total retrenchments increased to a seven-year high of 25,064 persons, with one-half of these retrenchments occurring in the first quarter.

Chart 1.29
Various Measures to Reduce Labour Costs by Companies

What were the measures implemented by companies during the crisis?



Source: Annual Survey, Bank Negara Malaysia

Table 1.20
Selected Labour Market Indicators

	2005	2006	2007	2008	2009e
Employment[1] ('000 persons)	10,892.8	11,159.0	11,398.0	11,576.5	11,609.1
Annual change (%)	4.1	2.4	2.1	1.6	0.3
Labour force[1] ('000 persons)	11,290.5	11,544.5	11,775.1	11,967.5	12,061.1
Annual change (%)	4.1	2.2	2.0	1.6	0.8
Retrenchments (persons)	16,109	15,360	14,035	16,469	25,064
Annual change (%)	-19.3	-4.6	-8.6	17.3	52.2
Unemployment rate[1] (% of labour force)	3.5	3.3	3.2	3.3	3.7
Real labour productivity growth[2] (%)	1.2	3.3	4.0	3.0	-2.0

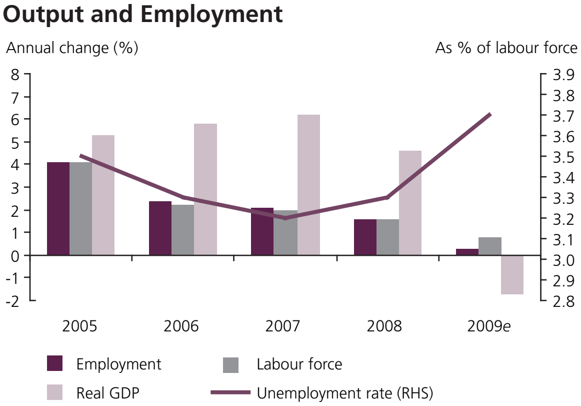
[1] Based on estimates by Economic Planning Unit
[2] Based on estimates by Bank Negara Malaysia
e Estimate

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

Labour market conditions began to stabilise in the second quarter and improved thereafter, in tandem with the overall improvement in global and domestic economic conditions. The implementation of expansionary fiscal policy and accommodative monetary policy domestically had contributed to a rebound in business and consumer sentiments, and together with a gradual improvement in the global economic conditions, led to a significant decline in retrenchments and a revival in hiring activity by firms from the second quarter onwards. The quicker-than-expected improvements in labour market conditions in turn resulted in a lower unemployment rate of 3.7% of the labour force, compared to the earlier forecast of 4.5%. Despite the challenging economic environment and declining productivity growth, employers in the private sector continued to grant salary increments, although the quantum moderated to 3.4% (2008: 5.1%).

Total **retrenchments** in 2009 were significantly higher than in the previous year, with the highest number of retrenched workers being recorded in the first quarter of the year (12,590 persons). Workers in the manufacturing sector were the worst affected (78% of total retrenchments in the first quarter), particularly in the E&E cluster (45% of total retrenchments) following the sharp drop in export orders. The number of retrenched workers,

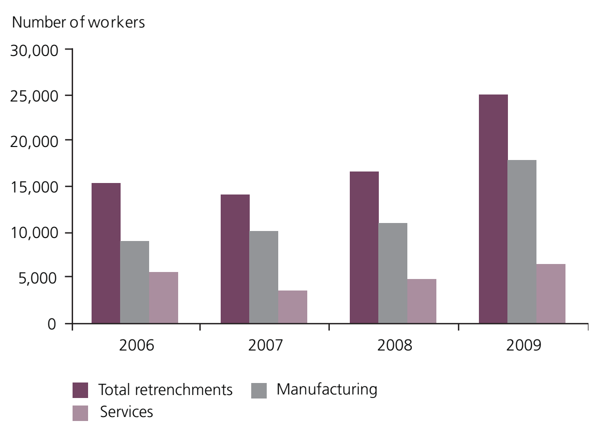
Chart 1.30
Output and Employment



e Estimate

Source: Economic Planning Unit
Department of Statistics, Malaysia

Chart 1.31
Retrenchment in Selected Sectors



Source: Ministry of Human Resources

however, declined significantly from the second quarter onwards (7,470 persons) and by the third quarter, normalised to pre-crisis level. Overall, total retrenchments increased by 52% to 25,064 persons in 2009 (2008: 16,469 persons), of which 71% were from the manufacturing sector and 25% were from the services sector.

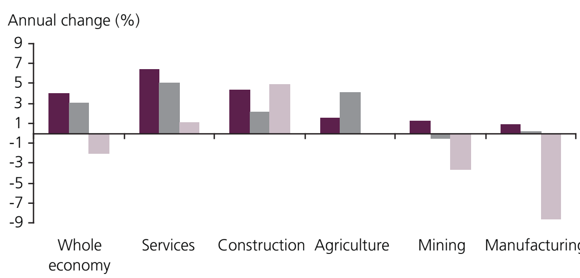
Recruitment activity also ceased in the first quarter amidst heightened uncertainty about the business outlook. Total **vacancies** posted during the first quarter amounted to about 222,000 positions, a decline of 16% from the preceding period. However, business sentiments began to improve subsequently, which translated into higher job offerings in the second half of the year, particularly in the services, manufacturing and construction sectors. For the year as a whole, the cumulative number of vacancies rose to 1.5 million positions (2008: 1.1 million positions), with most positions being offered in the manufacturing and services sectors, particularly in the distributive trade, financial intermediation, and community, social and personal services sub-sectors.

The improving economic conditions in the second half of the year and the various measures undertaken by the Government helped to support overall **employment** conditions, which recorded a marginal increase of 0.3% (2008: 1.6%). The increase in employment was mainly in the services sector, as well as in the construction and agriculture sectors. In contrast, the manufacturing sector recorded a net decline in employment, reflecting largely the freeze in new hiring and the higher number of retrenchments. In order to mitigate the impact of the global recession on employment, the Government introduced several measures, including filling about 50,000 vacant positions in the professional and support group levels in the public sector, while another 100,000 individuals were provided with on-the-job training and were put in temporary job placements with various Government agencies, government-linked companies (GLCs) and private companies. These included more training places provided under the Special Training and Re-Training Programmes, industrial and technical skills training courses managed by various states' skills training centres as well as on-the-job training and job placements in the financial sector and GLCs. In addition, the Government also assisted firms to lower labour costs by reducing the Human Resource Development Fund levy and providing a double-tax deduction to companies that hired retrenched workers. A total of 22 new JobsMalaysia Centres were set up and 109 existing centres were upgraded to provide job-placement assistance, career counseling and information on training opportunities to unemployed workers.

In 2009, the total number of registered **foreign workers** (migrant workers and expatriates) declined by 23% to 1.62 million workers, of which 98% were the low-skilled migrant workers. Total migrant workers declined by 23% to 1.59 million (2008: 2.06 million) due to retrenchment and early termination of work contracts by employers. In addition, the Government also imposed stricter rules on the hiring of migrant workers, including a freeze on the hiring of new migrant workers in the manufacturing and services sectors, a prohibition of the practice of deducting levy payments from the wages of new migrant workers thereby increasing the cost of hiring, and a freeze on the issuance of new licenses for labour outsourcing companies. Foreign expatriates employed in the country declined by 13% to 32,138 persons.

Labour productivity, as measured by real value-added per worker, was also affected by the weak economic performance during the year. Labour productivity growth contracted by 2.0% in 2009 (2008: +3.0%) due mainly to a sharp decline in labour productivity in the manufacturing sector, as production fell in response to the significant deterioration in external demand in the early part of the year. Despite the challenging economic environment and lower productivity, employers in the private sector continued to grant salary

Chart 1.32
Labour Productivity Trends



e Estimate

Source: Bank Negara Malaysia
Department of Statistics, Malaysia

increments, albeit at a moderate rate. According to the survey conducted by Bank Negara Malaysia, average **salary** increments in the private sector moderated to 3.4% (2008: 5.1%), with both the executives and non-executives receiving a lower salary increment of 3.2% and 3.7% respectively (2008: 4.9% and 5.1%).

PRICE DEVELOPMENTS

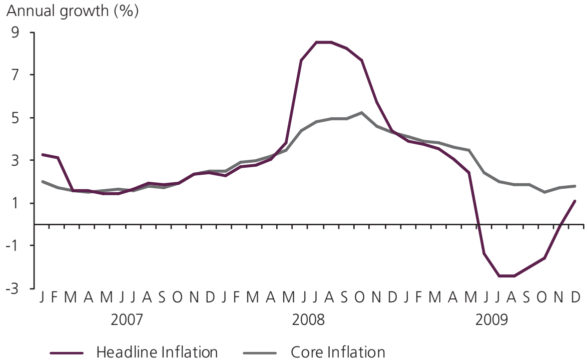
Consumer Prices

In line with global and domestic developments, inflationary pressures in Malaysia moderated substantially during the year. Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 0.6% in 2009 (2008: 5.4%). The marked decline in headline inflation during the year was driven by supply-related factors and subdued demand conditions. Meanwhile, core inflation, an indicator of the demand-driven pressure on prices, moderated to 2.7% in 2009 (2008: 4%).

Inflation in 2009 was influenced by both external and domestic factors. Externally, the economic weakness that emerged in the second half of 2008 had led to disinflationary pressures in both the major and emerging market economies. This impact was particularly evident in the first quarter of 2009. Two major forces responsible for these disinflationary pressures were the significant drop in global commodity prices, especially for crude oil, and the increasing slack in the economy as the global recession deepened.

After reaching its historical peak at USD147.27 per barrel in July 2008, oil prices plummeted by more than 60% in January 2009 (USD41.68 per barrel). The sharp reversal had a direct impact

Chart 1.33
Consumer Price Inflation

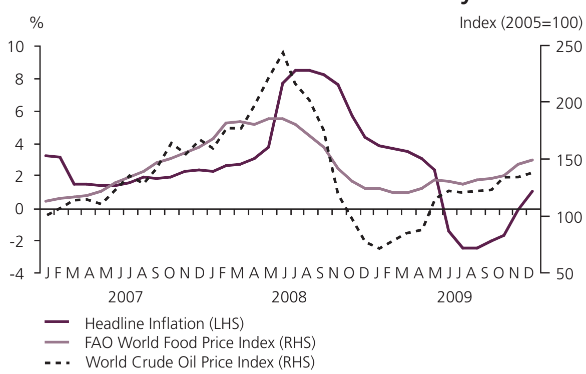


on inflation through lower retail fuel prices across the globe. Lower energy costs and lower prices for a wide-range of oil-related inputs also allowed producers to decrease their prices.

In an environment of tighter credit conditions, rising unemployment and deteriorating consumer and business confidence, households and businesses restrained their spending activities and contributed to the weak global demand conditions, particularly during the early part of the year. As a result, many countries experienced lower inflationary pressures during the year. Inflation in the advanced economies recorded a steep decline. The annual inflation rate in the US dropped to levels that were not seen since the late 1940s, while annual inflation in the euro area declined to its lowest levels since the inception of the European Union. Similarly, inflation in emerging market economies also saw a decline in 2009 with considerable deceleration evident in PR China, where the inflation rate decreased from 5.9% in 2008 to -0.7% in 2009.

On the domestic front, Malaysia's position as a highly trade-oriented economy meant that external developments had a sizeable impact on the domestic economy. The decline in global fuel and commodity prices, and the deflationary conditions experienced by Malaysia's top trading partners, contributed to lower domestic inflation. Most significantly, the cumulative reductions in the retail petrol prices in the second half of 2008 contributed significantly to the moderating trend of domestic inflation. The effect was particularly

Chart 1.34
Headline Inflation and World Commodity Prices



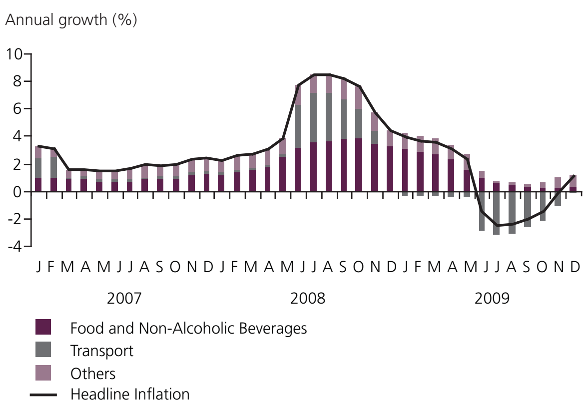
Note: 1. FAO stands for Food and Agricultural Organisation of the United Nations.
2. The FAO Food Price Index consists of a weighted average of 55 food commodities considered by FAO specialists as representing the international prices of food.
3. FAO Food Price Index and World Crude Oil Price Index were re-based using 2005 average as the base year.

significant in July 2009, as the high base effect accounted for a 19.9% drop in the *transport* category, which contributed to a 3.2 percentage point fall in inflation.

The impact on headline inflation was sizeable, with the annual rate of price level falling by -2.4% in July, its lowest rate since August 1986. The CPI for *food and non-alcoholic beverages* also moderated to an average of 4.1% during the year (2008: 8.8%). This mainly reflected the receding effect of global supply constraints. In particular, the CPI sub-category for *rice, bread and other cereals* moved into negative territory in June 2009 following the significant fall in global grain prices from the second half of 2008. As most of these base effects began to dissipate towards the end of the year, the headline inflation gradually recovered and started to turn positive again. Meanwhile, prices for other CPI categories remained relatively stable, with an average increase of 1.5% in 2009 (2008: 2.3%). Another important factor affecting headline inflation during the year was the imposition of an additional excise duty of 1 sen per cigarette in October, which resulted in higher CPI for the *alcoholic beverages and tobacco* category.

A key concern during the year was the risk of deflation. Given the base effect of high inflation in 2008 and the rapid disinflation, many countries registered negative inflation rates in 2009. As a result of the extensive scale of the global financial crisis that triggered a global recession, and the large uncertainties surrounding the prospects for resolution of the financial crisis and its impact on the real economy, some countries in the region faced the risk of a more prolonged and deeper deflation. By definition, deflation is a situation of a persistent and broad-based decline in the general price level. When such conditions prevail and result in entrenched deflationary expectations, the reinforcing postponement of consumption, falling asset prices and rising real debt burdens could drive the real economy into a more severe and protracted recession. The IMF World Economic Outlook in October 2009 reported that the deflation vulnerability indicator, which combines a range of macroeconomic indicators such as core inflation, output gap, house and equity prices as well as credit and broad money growth, pointed to an increased risk of deflation in a number of major and emerging market countries. However, the very strong policy responses both on the fiscal and monetary fronts succeeded in mitigating such an outcome. Concerns over deflation abated in the second half of 2009 as the financial crisis stabilised and global economic conditions began to show signs of improvement on the back of large and aggressive fiscal stimulus.

Chart 1.35
Contribution to Inflation



Note: Others refer to communication, clothing and footwear, health, education, recreation services and culture, furnishings, household equipment and routine maintainence, alcoholic beverages and tobacco, restaurant and hotels, miscellaneous goods and services and housing, water, electricity, gas and other fuels

For Malaysia, although headline inflation was negative between June and November 2009, deflation was mostly a statistical development and there was no evidence of deflationary pressures being embedded in the economy. Although core inflation moderated, it continued to remain positive throughout the year. Consumer and business confidence also remained resilient, underpinned by the significant policy measures undertaken by the Government and the Bank. More importantly, while demand conditions were relatively subdued during the year, they remained sufficiently strong to mitigate the risk of a protracted deflation.

Producer Prices

Producer price inflation, as measured by the Producer Price Index[1] (PPI), declined in 2009 amidst the broad decline in commodity prices. The annual change in the PPI averaged -7.1%

[1] Effective from 2010, the Producer Price Index (PPI) has been revised to the new base year 2005=100, from 2000=100 previously.

in 2009 compared with an increase of 10.3% in 2008. The annual change in the PPI followed a moderating trend in the first half of the year and reached its lowest rate for the year at -13% in July. This was largely consistent with the sharp decline of 32.5% in the commodity components of the PPI over the same period. Since then, PPI inflation has been increasing moderately, reflecting a mild rebound in global commodity prices. Overall, the PPI for commodity-related components recorded a decline of 19.8% in 2009 (2008: 26.6%). Meanwhile, non-commodity related producer prices declined at a relatively slower average annual rate of 2.5% in 2009 (2008: 5.8%).

In terms of composition, both the local and imported components of the PPI declined during the year. The annual growth of the PPI for local components fell to -10.4% in 2009 (2008: 13.3%), reflecting a broad-based decline across its sub-groups. Meanwhile, the weak global demand conditions and lower commodity prices were also reflected in the lower PPI for imported products, which declined by an average of 0.5% in 2009 (2008: 4%).