Economic Developments in 2008

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THE INTERNATIONAL ECONOMIC ENVIRONMENT IN 2008

The global economy was characterised by two distinct periods in 2008. In the first half year, economies across the world were facing intense inflationary pressures amidst sharp increases in prices of oil, food and other commodities. This, however, gave way to concerns over the intensification and spread of turmoil in the international financial markets and their contractionary impact on economic growth. The global economy sustained its growth in the first half of 2008, largely due to the strong performance of the emerging economies, while the advanced economies, particularly the United States (US), experienced a moderation in growth. The emerging and developing economies continued to sustain the global growth momentum in the first half, led by PR China and India. The deterioration of the financial problems in the advanced economies initially caused investment funds to shift out of mortgage securities and equities to commodities, contributing to record high prices of oil and other commodities by the middle of the year. This subsequently resulted in increased cost-push inflationary pressures globally.

The global economy experienced a reversal from inflationary concerns in the first half of 2008 to the sharp deterioration in growth in the second half following an intensification of the global financial crisis

Global economic conditions, however, experienced a major reversal in the second half of 2008, as the financial crisis developed into a systemic failure of the financial system. Concerns over inflationary pressures that prevailed in the first half shifted rapidly towards the threat of economic contraction as the intensification of the global financial turmoil and the ensuing credit crunch led the advanced economies into a synchronised recession. The spillover effects on the emerging economies were evident towards the end of the year. The more open economies in Asia experienced export-led recessions, while growth in the other economies moderated sharply. The sharp deterioration in global financial and economic conditions precipitated a rapid correction in commodity prices, and together with rapidly contracting demand conditions, resulted in large reduction in inflationary pressures sweeping across the global economy.

Table 1.1
World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2007	2008e	2007	2008e
World Growth	**5.2**	**3.4**	–	–
World Trade	**7.2**	**4.1**	–	–
Major Advanced Economies				
United States	2.0	1.1	2.9	3.8
Japan	2.4	-0.6	0.0	1.4
Euro Area	2.4	0.8	2.1	3.3
United Kingdom	3.0	0.7	2.3	3.6
East Asia	**10.0**	**6.5**	**4.1**	**6.0**
Asian NIEs[1]	**5.6**	**1.7**	**2.2**	**4.5**
Korea	5.0	2.5	2.5	4.7
Chinese Taipei	5.7	0.1	1.8	3.5
Singapore	7.8	1.1	2.1	6.5
Hong Kong SAR[2]	6.4	2.5	2.0	4.3
The People's Republic of China	**13.0**	**9.0**	**4.8**	**5.9**
ASEAN[3]	**6.2**	**4.4**	**3.8**	**7.9**
Malaysia	6.3	4.6	2.0	5.4
Thailand	4.9	2.6	2.3	5.5
Indonesia	6.3	6.1	6.3	10.2
Philippines	7.2	4.6	2.8	9.3
India[4,5]	9.1	7.0	4.6	3.0

[1] Newly Industrialised Asian Economies
[2] Inflation refers to composite price index
[3] Includes Singapore
[4] Real GDP growth refers to fiscal year
[5] Inflation refers to wholesale price index
e Estimate

Source: International Monetary Fund, National Authorities & BNM estimates

The financial problems of US financial institutions arising from deteriorating sub-prime assets as the housing bubble burst in mid-2007, escalated into a major and severe international systemic financial crisis by late 2008. What started as a problem in the US financial system rapidly developed into a global financial crisis as it spread swiftly across all segments of financial markets in the advanced economies and rapidly to the emerging economies. In the early stages of the crisis, the primary focus of the authorities in the large advanced economies was to address liquidity problems in the financial system. However, the failure of a number of systemically large US financial institutions in September 2008 triggered widespread loss of confidence across the global financial markets leading to the breakdown and dysfunctioning of the interbank and credit markets in the advanced economies. Credit spreads increased to abnormal levels and liquidity dried up across most markets in the financial system, resulting in funding difficulties and the rapid collapse in values of financial assets. This threatened the solvency of many large financial institutions. In response, governments in the advanced economies intervened to inject massive quantities of liquidity and capital to strengthen the balance sheets of the large financial institutions. At the same time, major efforts were made to restore the functioning of credit markets through aggressive direct purchase of a range of financial papers and guarantee schemes. At the international level, massive currency swap arrangements between the Federal Reserve and a number of major central banks in the world were undertaken to ease the tightening global US dollar liquidity.

Despite the unprecedented large and aggressive financial measures taken by the authorities to address the financial meltdown, financial markets remained highly volatile and the credit markets dysfunctional. The deepening crisis in the financial markets has subsequently spilled over into the real economy, as the credit crunch and declining asset values contributed to the rapid and sharp contraction in real economic activities. The global stock market capitalisation has declined by 45% to USD29 trillion in 2008 (end-2007: USD53 trillion). The huge wealth destruction, equivalent to 44% of the world's GDP, has severely undermined consumer spending and the ability of the corporate sector to raise capital or refinance their existing borrowings. Consumer and business confidence in the advanced economies deteriorated rapidly following the weakening economic prospects, impaired balance sheets and difficulties in obtaining access to financing. This has exerted further pressure on the balance sheets of financial institutions as non-performing loans increased. To contain the sharp contraction in economic activity and the negative feedback loop between the financial system and the real economy, the authorities in several countries responded with large fiscal stimulus packages and aggressive monetary easing and quantitative injections of liquidity directly into illiquid financial markets.

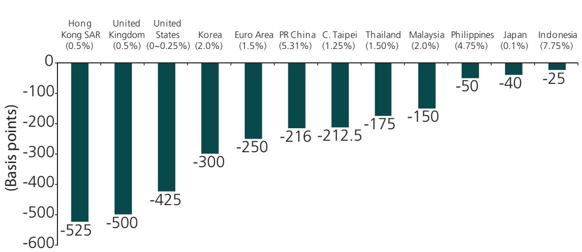
In the **US**, despite the emerging negative impact from the financial sector problems, real GDP recorded a better-than-expected growth of 2.3% in the first half of the year, lifted by the temporary boost from the USD168 billion fiscal stimulus introduced in February 2008. Nevertheless, there were increasing signs of rising stress in the US financial system, leading to a major US investment bank to fail in March. The Federal Reserve (the Fed) moved aggressively to ease the federal funds rate to 2% by April, and at the same time introduced deposit and lending facilities to manage the growing erosion of confidence in the financial system. However, in the second half of the year, as the financial turmoil intensified and spread, the contractionary impact on the real economy accelerated in magnitude, leading growth in real GDP to be flat in the second half of the year, bringing the overall growth to 1.1% for 2008. Consumer sentiment was severely affected by deteriorating housing and equity prices as well as large job losses of 3.1 million. Sharp declines in house prices, together with declining equity markets, led to an estimated wealth loss of about USD11.2 trillion for households, resulting in further cuts in household borrowings and spending. The decline in investment, initially in residential investment, accelerated in the second half of the year as non-residential investment also suffered its first decline due to falling demand and profits, and tight financing conditions. In response, the Fed cut its federal funds rate aggressively by another 175 to 200 basis points to 0 – 0.25% by December. The Fed also resorted to quantitative easing in an attempt to revive the credit markets. In addition, the US Treasury introduced the USD700 billion Troubled Asset Relief Program (TARP) to recapitalise troubled financial institutions and provide liquidity support to revive the markets for a number of important financial instruments.

In the other advanced economies, economic growth moderated in the first half of 2008 after expanding above potential for two years. However, the other advanced economies followed the US into a synchronised recession in the second half as the financial turmoil escalated further. Growth in the **euro area** also moderated in the first half, reflecting the impact of slower exports on the German economy and the negative influence arising from the bursting of the housing bubble in other euro area economies such as Spain and Ireland. Inflation, which averaged 3.5% in the first half, was a major reason underpinning the European Central Bank's (ECB) decision to raise its policy rate by 25 basis points to 4.25% in July as commodity prices continued to rise. However, the euro area experienced its third consecutive quarter-on-quarter decline in the fourth quarter, confirming that the region was in recession despite registering anaemic growth of 0.8% for the year as a whole. The European banking institutions were also adversely affected by their exposure to sub-prime credit and derivative products. With significantly weaker balance sheets, there was a pullback in credit to the real economy, thus impacting domestic demand. In response, the ECB cut its key rate to 2.5% by December and took measures to restore the functioning of the interbank market. The four largest euro area member countries, Germany, France, Italy and Spain, also introduced fiscal stimulus, ranging from 1.3% to 5.2% of GDP, to support the real economy.

Meanwhile, in the **United Kingdom** (UK), real GDP slowed in the first half following weakness in the construction as well as the business and financial services sectors. Despite inflation edging upwards on higher commodity prices, the Bank of England (BOE) eased its base lending rate gradually from February 2008 in response to the emerging weakness in the financial sector as financial institutions were hit by the rising mortgage defaults from the burst of the bubble in the housing market. In the second half, real GDP declined by 0.8% as the housing bust and credit crunch led to the failure of one of the largest mortgage lenders in September 2008 and the freezing of credit channels by the banking system. The credit crisis led to a weaker domestic demand as households and firms had difficulties in securing financing. In response, the BOE reduced its key rate to 2% by end-2008, its lowest level since 1951, while the Government implemented two bank rescue packages to resuscitate the vulnerable financial system. In addition, the Government announced a fiscal stimulus package amounting to 1.6% of GDP to mitigate the impact on the real economy.

In the first half of 2008, positive contribution from net exports and private consumption, supported **Japan's** growth of 1%. The Bank of Japan (BOJ) maintained its overnight call rate at 0.5% even as inflation reached its highest rate of 2.3% in a decade. However, real GDP contracted in the second half, bringing growth for the year to -0.6% as the economy entered into a recession following the sharp deterioration in exports. The BOJ responded by

Chart 1.1
Cumulative Movements of Policy Rates since 2008



Note: Current policy rates in parentheses, as at mid-March 2009

Source: National Authorities

Table 1.2
Fiscal Stimulus in Selected Economies

	Amount (USD bn)	% of GDP
Advanced Economies		
United States	787	5.5
Euro Area[1]	271	2.3
United Kingdom	31	1.6
Japan	116	2.4
Regional Economies		
The People's Republic of China	586	13.3
Singapore	13.7	8.0
Chinese Taipei	24.3	6.2
Philippines	6.3	4.0
Thailand	10.0	3.3
Indonesia	6.1	1.5
Korea	15.0	2.3
Malaysia	18.1	9.5
Hong Kong SAR	1.4	0.7

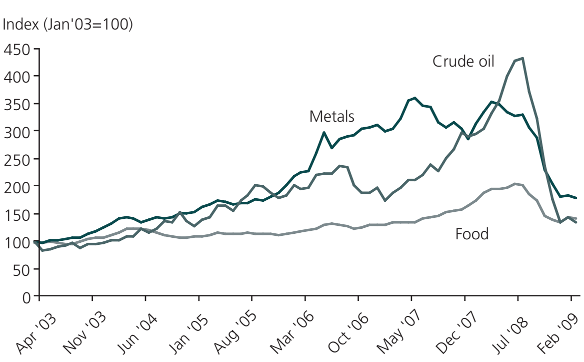
[1] Refers to Germany, France, Italy & Spain

Note: As at mid-March 2009

Source: National Authorities, Bank Negara Malaysia estimates reducing its key rate to 0.1% while the Government unveiled a series of fiscal and financial packages to stabilise the financial sector and mitigate the impact on the real sector.

In the **Asian region**, growth remained strong in the first half, supported by resilient domestic demand and continued favourable export performance, particularly to the non-US markets and growth of intra-regional trade. Notably, **PR China** continued to expand strongly by 10.4% during the first half of the year following robust domestic demand and export performance. Commodity-exporting economies benefited significantly from the substantial improvement in terms-of-trade as a result of higher commodity prices. In response to the rising domestic headline inflation, a number of authorities in the region tightened monetary policy while introducing fiscal measures, including increasing subsidies, tax rebates as well as reducing utility bills and import tariffs, to mitigate the impact of increasing food and fuel prices on the public. As the financial and economic conditions in the advanced economies deteriorated sharply in the second half of 2008, the spillover effects began to be felt by the Asian economies. Exports of the regional economies experienced sharp contractions and industrial production declined towards the end of the year. The commodity-exporting economies were also affected by the sharp declines in commodity prices. While the region's banking system remains healthy, the global deleveraging process and deepening recession in the advanced countries led to declines in the regional equity markets, large outflows of portfolio capital and a weakening of the regional currencies against

Chart 1.2
Key Commodity Prices



Source: International Monetary Fund

the US dollar. Foreign direct investment also slowed considerably. Under these circumstances, the region's overall growth moderated sharply in the second half of the year. The newly-industrialised Asian economies (NIEs) as a group entered into recession, while PR China recorded its lowest quarterly growth since 2001 in the fourth quarter of 2008.

Global inflation was on an uptrend in the first half of 2008, driven by sharp increases in prices of food, oil and a broad spectrum of commodities. Between January and July, the price of crude oil increased by about 50% to a record high of USD147 per barrel. The rise in commodity prices was largely due to the buying by institutional funds, reinforced by the underlying strong robust demand from the large emerging economies. Supply constraints, including the diversion of certain food crops towards bio-fuel production added to the uptrend in prices. However, in the second half, the deepening financial crisis which resulted in a shift of funds out of the commodity markets as well as the adverse economic developments in the advanced economies, led to a rapid and sharp correction of commodity prices. Notably, crude oil price dropped by about 70% from its peak to USD44 at the end of 2008. Similarly, prices of other commodities and food items also declined by varying degrees, in tandem with the decline in oil prices. As demand conditions weakened and commodity prices declined, inflationary pressures eased significantly across countries towards the end of 2008.

In the **foreign exchange markets**, the US dollar started the year on a weaker note, depreciating against most currencies, influenced mainly by prospects of a greater economic slowdown in the US and interest rate cuts by the Fed. The US dollar was relatively stable from April to July on anticipation that the aggressive monetary easing in the US would support the recovery process. However, from July onwards, the US dollar began to appreciate sharply against most currencies with the exception of the yen, amidst broad-based global deleveraging by financial institutions and investors, leading to large liquidations of their exposure in Asian equities and bonds, and from high-yielding markets such as in Australia and New Zealand. Both the pound sterling and the euro weakened against the US dollar as the financial turmoil in the US spread to Europe, leading to expectations of aggressive monetary easing in Europe. Similarly, the regional currencies depreciated against the US dollar from July onwards as the deleveraging activities in the US caused large outflows of portfolio capital from the region.

THE MALAYSIAN ECONOMY IN 2008

The Malaysian economy registered a growth of 4.6% in 2008, amidst the international financial turmoil and sharp deterioration in global economic environment. Robust domestic demand, in particular sustained private consumption and strong public spending, supported growth during the year. While external demand was strong in the first half of 2008, the sharp and rapid deterioration in the global economic conditions as well as major correction in commodity prices in the second half led to a contraction in Malaysia's export performance in the latter part of the second half year. Given the high degree of openness of the Malaysian economy, the contraction in exports adversely affected income and domestic demand. Private investment activities and private consumption moderated significantly in the fourth quarter of 2008.

The Malaysian economy registered a growth of 4.6% in 2008 amidst the international financial turmoil and rapid deterioration in global economic conditions

The economy grew strongly by 7.1% in the first half of 2008 supported by robust domestic and external demand. Domestic demand was led by continued strong expansion in private consumption, supported by a steady increase in disposable income, positive labour market conditions and favourable financing environment. External demand was supported by very high commodity prices and strong export volume. Demand from the regional countries was also strong. When the global downturn intensified in the second half of 2008, with several major advanced economies slipping into recession and growth in a number of regional economies moderating rapidly, net external demand declined significantly. Nevertheless, real GDP growth remained positive in the second half-year, expanding modestly by 2.4%, supported by strong public consumption and continued expansion in private consumption. Bonus for the civil servants, payment of cash rebates for fuel subsidy and continued access to financing supported private consumption amidst weakening employment conditions which had some dampening influence on consumer sentiments. The deteriorating global economic environment also led to a decline in private investment activities in the second half of the year.

On the supply side, growth in the first half-year was driven by robust performance of the services sector as a result of the strong domestic demand conditions, and the expansion in trade and tourism activities. Further support came from the manufacturing sector due to robust external demand from the non-US markets and higher exports of resource-based products which also benefited from the rising commodity prices. The agriculture sector also expanded at a stronger pace due mainly to the strong expansion in crude palm oil production. However, the manufacturing sector, particularly the export-oriented industries, weakened in the second half of the year in line with the deterioration in global demand and the sharp correction in commodity prices. The services sector continued to support the economy in the second half-year, although growth moderated due to the slowdown in the services sub-sectors that were dependent on trade and capital-market related activities.

In line with the strong economic activities in the first half of 2008, labour market conditions strengthened during the period. Nevertheless, labour market conditions began to soften in the second half of the year as businesses, particularly in the manufacturing sector, turned cautious amidst deterioration in external demand. As a result, the unemployment rate increased to 3.7% in 2008, as total employment expanded at a slower pace compared to the increase in the labour force. Despite the rising inflationary pressure in the first half of the year, there was no evidence of excessive wage increases in response to the higher prices. The Malaysian Employers Federation Survey indicated that average salary in the private sector increased by 5.9% in 2008 in line with historical trends. Meanwhile, labour productivity improved further in 2008, thus supporting increases in salary and wage growth.

Headline inflation was already on an uptrend in the first five months of 2008 following the

Table 1.3: Malaysia - Key Economic Indicators

	2006	2007	2008*p*	2009*f*
Population (million persons)	26.6	27.2	27.7	28.3
Labour force (million persons)	11.5	11.8	12.0	12.1
Employment (million persons)	11.2	11.4	11.5	11.5
Unemployment (as % of labour force)	3.3	3.2	3.7	4.5
Per Capita Income (RM)	20,885	23,115	25,796	24,541
(USD)	5,694	6,724	7,738	6,812[7]
NATIONAL PRODUCT (% change)				
Real GDP at 2000 prices[1]	5.8	6.3	4.6	-1.0 ~ 1.0
(RM billion)	475.2	505.4	528.8	528.9
Agriculture, forestry and fishery	5.4	2.2	3.8	-2.0
Mining and quarrying	-2.7	3.3	-0.8	-0.4
Manufacturing	7.1	3.1	1.3	-8.0
Construction	-0.5	4.6	2.1	3.0
Services	7.3	9.7	7.3	4.5
Nominal GNI	11.6	12.9	13.9	-2.9
(RM billion)	556.4	628.1	715.3	694.8
Real GNI	7.1	6.1	2.9	1.8
(RM billion)	454.6	482.2	496.1	504.9
Real aggregate demand[2]	6.6	9.8	6.9	2.9
Private expenditure[2]	6.7	10.6	7.1	-0.3
Consumption	6.5	10.8	8.4	3.5
Investment	7.5	9.8	1.5	-17.7
Public expenditure[2]	6.5	7.9	6.5	11.4
Consumption	4.9	6.6	11.6	7.3
Investment	8.4	9.3	0.7	16.6
Gross national savings (as % of GNI)	38.4	38.4	37.9	32.2
BALANCE OF PAYMENTS (RM billion)				
Goods balance	134.6	127.7	170.1	108.1
Exports (f.o.b.)	589.7	605.9	664.2	495.8
Imports (f.o.b.)	455.2	478.2	494.1	387.6
Services balance	-6.9	2.4	1.7	-0.9
(as % of GNI)	-1.2	0.4	0.2	-0.1
Income, net	-17.3	-13.9	-25.4	-10.6
(as % of GNI)	-3.1	-2.2	-3.6	-1.5
Current transfers, net	-16.9	-15.7	-17.0	-16.6
Current account balance[3]	93.5	100.4	129.4	80.0
(as % of GNI)	16.8	16.0	18.1	11.5
Bank Negara Malaysia international reserves, net[4]	290.4	335.7	317.4	-
(in months of retained imports)	7.8	8.4	7.6	-
PRICES (% change)				
CPI (2005=100)[5]	3.6	2.0	5.4	1.5 ~ 2.0
PPI (2000=100)[6]	5.1	6.7	8.2	-
Real wage per employee in the manufacturing sector	-1.4	2.2	-0.9	-

[1] Beginning 2007, real GDP has been rebased to 2000 prices, from 1987 prices previously
[2] Exclude stocks
[3] Figures for the year 2008 are estimates
[4] 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
[5] Effective from 2006, the Consumer Price Index has been revised to the new base year 2005=100, from 2000=100 previously
[6] Effective from 2006, the Producer Price Index has been revised to the new base year 2000=100, from 1989=100 previously
[7] Based on average USD exchange rate for the period of January-February 2009
p Preliminary
f Forecast

Note: Numbers may not necessarily add up due to rounding

Table 1.4 Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2006	2007	2008*p*
Revenue	123.5	139.9	159.8
Operating expenditure	107.7	123.1	153.5
Net development expenditure	35.0	37.5	41.9
Overall balance	-19.1	-20.7	-35.6
Overall balance (% of GDP)	-3.3	-3.2	-4.8
Public sector net development expenditure	86.5	95.1	106.7
Public sector overall balance (% of GDP)	-0.3	1.7	-3.3
EXTERNAL DEBT[1]			
Total debt (RM billion)	184.5	187.4	235.6
Medium- and long-term debt	141.7	133.0	155.6
Short-term debt[2]	42.8	54.5	80.0
Debt service ratio (% of exports of goods and services)			
Total debt	4.8	3.8	2.7
Medium- and long-term debt	4.5	3.4	2.5

MONEY AND BANKING	Change in 2006		Change in 2007		Change in 2008	
	RM billion	%	RM billion	%	RM billion	%
Money Supply M1	17.0	13.7	27.6	19.6	14.0	8.3
M3	87.5	13.0	72.4	9.5	99.0	11.9
Banking system deposits	119.3	17.2	56.5	7.0	103.6	11.9
Banking system loans[3]	34.9	6.3	57.2	8.6	82.3	12.8
Loan-deposit ratio (end of year)	70.5		72.2		73.5	
Financing-deposit ratio[4]	79.0		80.7		81.1	

INTEREST RATES (AVERAGE RATES AS AT END-YEAR)	2006 %	2007 %	2008 %
Overnight Policy Rate (OPR)	3.50	3.50	3.25
Interbank rates			
1-month	3.58	3.56	3.30
Commercial banks			
Fixed Deposit 3-month	3.19	3.15	3.04
12-month	3.73	3.70	3.50
Savings deposit	1.48	1.44	1.40
Base lending rate (BLR)	6.72	6.72	6.48
Treasury bill (3-month)	3.43	3.39	2.94
Government securities (1-year)	3.55	3.53	2.89
Government securities (5-year)	3.70	3.78	3.00

EXCHANGE RATES	2006 %	2007 %	2008 %
Movement of Ringgit (end-period)			
Change against SDR	1.8	1.7	-2.7
Change against USD[5]	7.0	6.8	-4.5

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 Adjusted to include holdings of private debt securities
5 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

steady increase in global food and fuel prices that breached unprecedented new highs at mid-year. The inflation rate, however, rose sharply in the third quarter following the 40.4% adjustment to retail fuel prices in June. The increase in the headline inflation peaked at 8.5% in July. The easing of global food prices and bursting of the commodity bubble led to the sharp and rapid correction in the global commodity prices across the board. This led to the decline in prices of domestic food and fuel prices in the fourth quarter. For the year as a whole, headline inflation averaged at 5.4%.

The external position remained strong in the first half of 2008, due mainly to the large current account surplus. The current account was supported by a significantly larger trade surplus following the stronger growth in both commodities and resource-based manufacturing exports amidst high commodity prices. The services account continued to record a surplus, due to higher receipts from tourism. The financial account also recorded a large surplus in the first half of 2008 due to strong inflows of foreign direct investment and other investment. The large surplus in the current account was sustained in the second half of 2008 as the moderation in exports was mitigated by a decline in imports. Nevertheless, the overall balance of payments position in the second half of 2008 recorded a net deficit as the large net outflows in the financial account more than offset the surplus in the current account. The net outflow in the financial account was due mainly to the large reversal of portfolio investment flows due to the deleveraging activities by foreign financial institutions following the intensification of the global financial crisis.

The Malaysian economy faced the global financial crisis from a position of strength. This is largely due to the strengthened financial system after the Asian financial crisis a decade ago and the more balanced and diversified economic structure. The country's external position is also resilient, with low external debt, a sustained current account surplus and high level of foreign reserves. The financial sector is sound, with strong liquidity and capital buffers. Given the continued uncertainty in the external environment, the policy response has focused on supporting domestic demand, by ensuring that there will be continued expansion in private consumption and public spending, and preventing widespread unemployment.

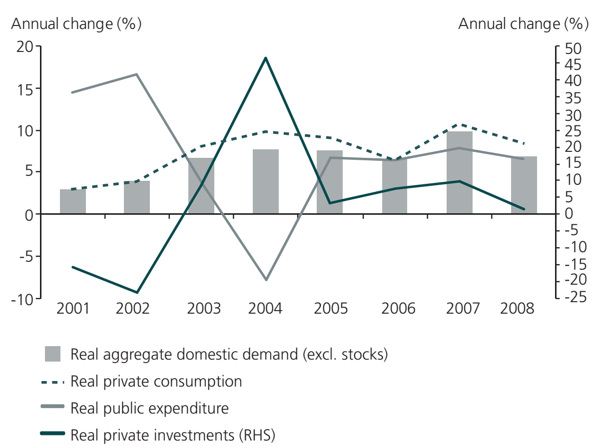
DOMESTIC DEMAND CONDITIONS IN 2008

In the first half of 2008, the economy expanded strongly on the strength of domestic demand, which grew by 9.4% driven mainly by strong growth in private consumption spending. The resilient consumer spending was supported by a steady increase in disposable income, stable labour market conditions and favourable financing environment. However, as the global financial crisis worsened in the second half of 2008, the global downturn intensified further, leading to sharp decline in external demand and correction in commodity prices.

Domestic demand, which grew strongly in the first half, moderated towards end-2008 as the global economic downturn intensified

The impact was felt in economic sectors with high trade exposure, subsequently affecting domestic demand. As a result, growth in domestic demand moderated to 4.7% in the second half-year, bringing the overall growth in aggregate **domestic demand** for the year to 6.9% (2007: 9.8%). Private consumption growth slowed down towards end-2008 following the weaker outlook in the job market. Private investment moderated, particularly in the second half of 2008, as the global economic

Chart 1.3
Real Domestic Demand Aggregates

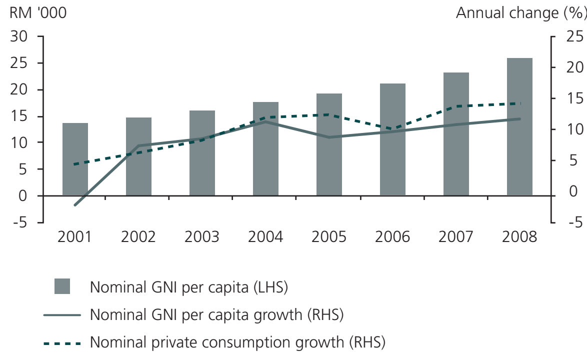


slowdown started to affect capital spending activities, especially within the export-oriented manufacturing sector. The public sector, meanwhile, continued to be supportive of overall economic growth.

Private consumption remained resilient in 2008, increasing by 8.4% (2007: 10.8%) despite concerns over the higher general level of prices following the hike in fuel and electricity prices in June 2008. The performance of major consumption indicators such as imports of consumption goods, credit card spending, loans approved and disbursed to households, as well as passenger car sales remained strong. Household spending was supported by the steady increase in disposable income arising from the high commodity prices and stable labour market conditions, particularly during the first half of the year. Although commodity prices moderated significantly in the second half, prices were on average at favourable levels relative to historical trends. The expansionary impact from the civil servants' salary adjustment in second half of 2007 also carried over into the first half of 2008, providing support for higher consumer spending. Meanwhile, the bonus to the civil servants, which was paid in September and December 2008, offered an additional lift to consumption. Furthermore, labour market conditions remained largely stable throughout the year. Towards the year-end, however, the impact of the deepening and broader global economic slowdown has resulted in weaker job prospects, with companies mainly in the export-oriented industries taking cost-cutting measures through temporary lay-offs and shorter working hours; hence, leading to a moderation in consumption spending, especially in the fourth quarter of 2008.

While consumer spending was still expanding, consumer sentiments were undermined by a number of factors as the year progressed. Reflecting consumers' concerns over rising prices and subsequently worsening global conditions, the Malaysian Institute of Economic Research (MIER)'s Consumer Sentiment Index fell below the 100-point threshold from the second quarter of 2008 onwards. Consumers were initially concerned with the impact of the 78-sen hike in retail fuel prices on their disposable income. However, this was mitigated by the rebates and subsidies provided to selected motorists and car owners. The Government subsequently reduced

Chart 1.4
GNI per Capita



the fuel prices in line with the decline in global crude oil prices. Towards end-2008, consumer sentiments shifted from concerns of higher cost of living to conditions in the job market and income prospects as the global recessionary conditions deepened.

During the year, consumer spending was also supported by favourable financing conditions. Interest rates remained low and accommodative, while consumers continued to enjoy access to credit. Against this backdrop, household credit expanded further with outstanding household loans increasing by 9.7% in 2008 (2007: 7.7%), driven mainly by loans for purchase of residential property, consumer durables and passenger cars. On the whole however, household balance sheets remained sound, with household debt to financial asset ratio remaining low at 41.9% (2007: 36.8%), while the non-performing loan (NPL) ratios for household loans and residential property declined further to 4.1% and 5.6% respectively (2007: 5.3% and 7.0% respectively) at end-2008.

Private investment, however, moderated to 1.5% in 2008 (2007: 9.8%). While private investment was strong in the early part of 2008, capital expansion activities slowed towards the year-end as businesses deferred or cancelled investment decisions following the sharp global economic downturn. Various investment indicators showed weakening investment activities in the later part of 2008. Imports of capital goods, which showed strong positive growth of 9.6% in the first half, declined by 7.9% in the second half. Loans disbursed to businesses, and private debt securities issued for new activities also indicated

Patterns of Investment in Countries at Different Stages of Development

Introduction
Investment plays an important role in the economic development process, as it expands a country's productive capacity of physical and human capital. Total investment comprises capital spending by both the private and public sectors, with the public sector's role being mainly to focus on providing basic and necessary infrastructure to support private sector economic activities. As an economy develops, patterns of investment spending tend to expand to involve more diverse types of economic activities.

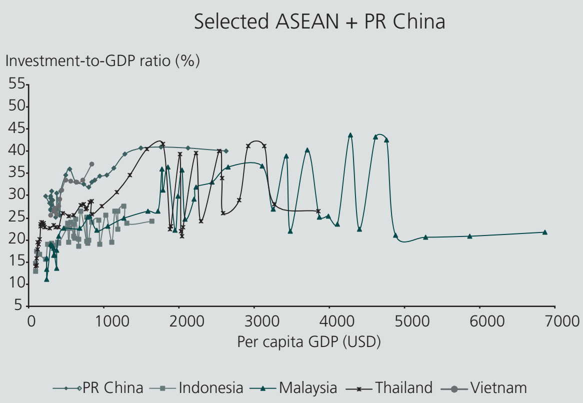
This article analyses the patterns of total investment as a percentage of gross domestic product (GDP) in countries at different stages of economic development. By analysing the investment patterns of different groups of countries, the article assesses whether different stages of economic development, as measured by nominal income per capita, correspond to particular levels of investment relative to GDP. The second part of the article discusses the reasons for the steady decline of the investment-to-GDP ratio as a country becomes more developed. The final part of the article assesses whether there is a distinctive, overall trend in the investment–to-GDP ratio as a country progresses from a low to a high income economy.

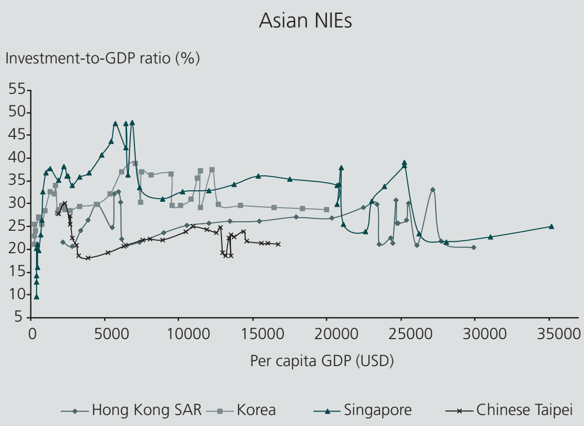
Do stages of development influence investment levels?
Analysing the investment-to-GDP ratios of the 14 economies in Chart 1 in relation to income per capita shows that there is no common investment level associated with any particular stage of development. Countries have different investment expenditure as a percentage of GDP even at similar stages of development. For example, at the same USD1,000 income per capita, Malaysia's share of investment to GDP was nearly 22%, Thailand 28%, while PR China is even higher at 35%. In certain cases, a country's investment-to-GDP ratio is twice the level of another country although both have relatively similar incomes per capita. For instance, Singapore's investment-to-GDP ratio is 40% at a per capita income of USD6,000, roughly double Chinese Taipei's investment-to-GDP ratio which has a similar income per capita.

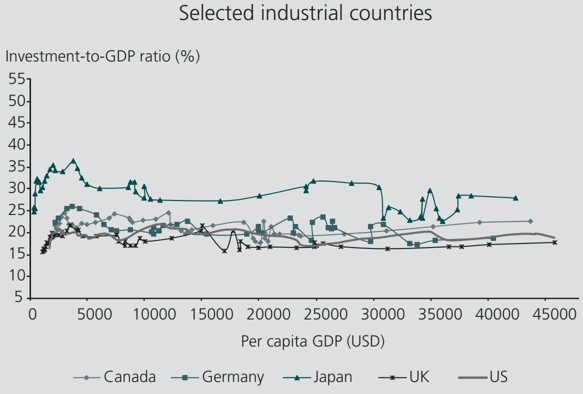
This suggests that there are other factors that influence a country's investment expenditure as a percentage of its GDP. Three factors are particularly important. The first factor is the growth strategies that countries pursue. For example, countries that adopt aggressive export-oriented industrialisation strategies, which often involve promotion of inflows of foreign direct investment (FDI), tend to have higher investment ratios. The industrialisation process is generally driven by rapid expansion of the manufacturing sector, which is more capital-intensive since it requires the private sector to invest heavily on machinery and equipment. In addition, as the industrialisation process intensifies and contributes to a higher level of income per capita, the level of investment also increases as the country moves up to higher value-added manufacturing activities. In the case of countries relying on FDI, the high investment ratios may persist if foreign firms continue to expand the initial investment and reinvest their earnings in the host economies.

The second factor relates to the role of the public sector in the economy at the different stages of economic development. The experience of ASEAN, Asian NIEs and PR China show that investment undertaken by the public sector is high at the early stages of the development, in particular in the areas of transportation infrastructure, utilities and education, which is necessary to create a conducive environment to support private sector activity as well as in attracting FDI.

Chart 1
Selected Economies Pattern of Investment







The third factor that may influence the investment-to-GDP ratio is whether the countries have natural resources. Countries which lack natural resources or land, such as Singapore and Japan, have higher incentives to attract and nurture strong, diverse and capital-intensive industries. Resource-rich countries, on the other hand, may have lower investment ratios as they seek to exploit their natural advantage, which tend to involve lower capital input. This is especially true if countries do not expend much effort to generate higher value added from these natural resources, particularly in developing downstream activities.

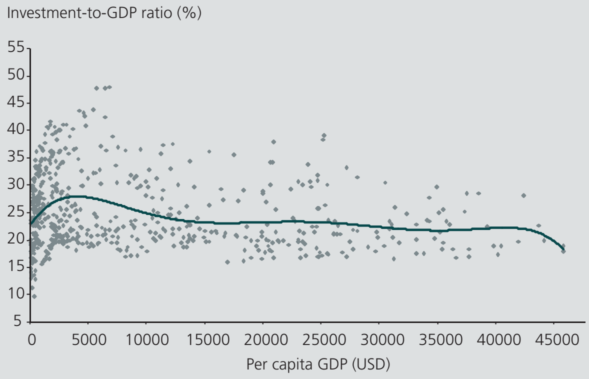
Why does the investment ratio decline steadily as an economy becomes developed?

As shown in Chart 1, industrial countries tend to have lower and more stable investment ratios, with the ratios converging within a smaller band of between 15-25% of GDP, except for Japan (20-35%). This may be the outcome of the rise of the services sector as the largest economic sector as an economy becomes more developed. The services sector, by its nature, is less capital-intensive, but has a higher value-added relative to the manufacturing sector. Unlike the export-oriented manufacturing sector, the services sector is more related to and has higher reliance on private consumption spending. Indeed, private consumption is higher in advanced economies, mainly in line with their high level of income, which is one of the major determinants of private consumption expenditure.

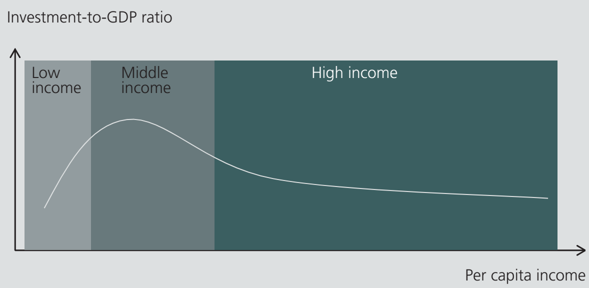
The investment ratios of the Asian developing countries tend to lie within a relatively wider band of 10-45% of GDP. In addition, the investment ratios are also more volatile compared with the industrial countries. This may be due to the diverse characteristics of the countries, in terms of the degree of openness, production structure, investment policies, and the mix of capital and labour in the economy. For instance, a more open economy is often associated with a higher investment ratio at any given income per capita, but may be more susceptible to external demand volatility.

Chart 2
Pattern of Investment as Countries Move Across Stages of Development

Scatter plot



Possible investment path across development stages



Is there a distinctive trend for the investment-to-GDP ratio across the different development stages?
Despite considerable heterogeneity across countries as outlined above, there seems to be a broad common trend in investment-to-GDP ratio as countries move from one stage of economic development to another, as suggested in Chart 2[1].

First, low income countries tend to have a rapid increase in their investment-to-GDP ratios. During the early development stage, nations need to build up basic and necessary infrastructure in order to get the major factor markets connected and functioning properly, for example, through building road and transportation networks. This would require high initial investment. In addition, economic activity is typically concentrated in labour-intensive commodity production and basic assembly operations. Hence, although the amount of investment involved may be smaller, the growth of its share to GDP is more significant. Also, the increase in investment-to-GDP ratio is a reflection of the cost of acquiring the latest technologies from foreign companies in the more advanced countries. The technology acquisition approach represents a quicker way to moving up the development ladder.

[1] Excluding the last few observations in the scatter plot related to those with highest income per capita, the trend line in the scatter plot can almost exactly replicate the path projected in the second chart.

Next, the investment pattern stabilises in the middle-income stage. As economic activity becomes more sophisticated, and as countries move towards higher value-added activities in the supply chain, they need to improve and upgrade their infrastructure. This includes, for example, more advanced ports with higher capacity, telecommunications, and utilities infrastructure. Furthermore, their industrial structures may also entail high investment. Moving from simple assembly operations to wafer production for instance, requires high investment since the new process needs different and almost certainly higher cost machinery and inputs.

Finally, advanced countries tend to have lower investment ratios, generally due to their shift towards services and greater consumption spending, which leads to a larger consumption-to-GDP ratio. They also have bigger and more efficient services sectors that serve their domestic economies. Since the services sector tends to be less capital-intensive, the overall share of investment to GDP is lower. Another contributing factor is the relocation of the major economies' lower value-added production activities abroad as a means to remain viable through lower costs. Firms still retain part of the production supply chain in the developed economies especially the higher value-added activities, as the developed economies tend to be driven more by innovation and knowledge-based activities. Investment expenditure then focuses more on improving learning and fostering innovation, rather than spending on heavy machineries and physical capital inputs.

In the case of Malaysia, during the early stages of development, major economic activities were concentrated on exploiting the rich natural resources. During the early stage of development, Malaysia was heavily dependent on the resource-based sector through production and exports of major commodities such as rubber, tin and later, palm oil and crude oil. Investment expenditure was mainly concentrated in developing and improving higher-yielding agricultural crops as well as the provision of basic infrastructure by the public sector. The global economic crisis in the early 1980s prompted the Government to diversify the sources of growth and pursue an export-oriented industrialisation strategy. The active promotion of a capital-intensive manufacturing sector led to rising private investment particularly through high FDI inflows, which resulted in a higher share of the manufacturing sector in the economy. Public investment was also sustained as the Government, through its privatisation exercise, embarked on improving further and upgrading infrastructure such as roads, ports, airports, telecommunications and utilities. Investment peaked at 43.6% of GDP in 1995. After the Asian Financial Crisis of 1997/98, however, the investment-to-GDP ratio declined and stabilised at lower levels as the less capital-intensive services sector became more prominent, while large-scale public sector infrastructure projects, which were mainly started prior to the crisis, were completed.

Conclusion

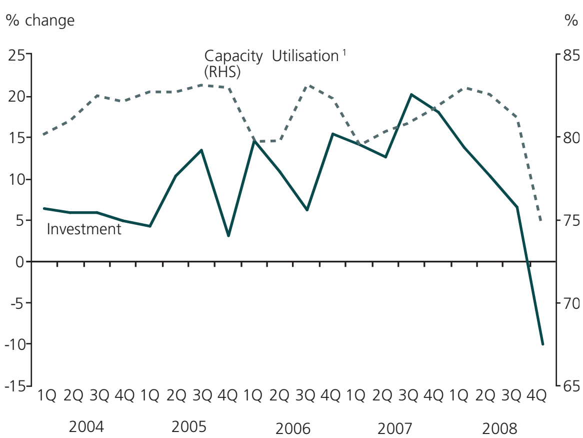
In summary, this article analyses patterns of investment in countries at different stages of economic development rather than across time. A few observations could be drawn from this analysis. First, there is a wide range of investment-to-GDP ratios among countries, even within the same income band. This suggests that there are factors other than the level of income that influence investment ratios. The development and industrialisation strategies, role of the public sector as well as the existence of natural resources are important determinants. Secondly, investment ratios for more advanced economies tend to stabilise at a relatively lower rate. This largely reflects the shift towards higher value-added but less capital-intensive and services-related activities. Finally, there is a broad pattern of investment–to-GDP ratio as countries evolve through the different development stages as measured by level of per capita income – a rapid rise in investment at the initial stage of development, followed by a stable investment ratio as it reaches the middle income stage, before converging to a lower investment ratio as a more advanced stage of development is achieved.

slower investment activities towards the year-end. Although gross FDI inflows remained high at RM51 billion (2007: RM46.2 billion), the worsening global economic environment affected inflows in the second half of 2008. Reflecting the weaker investor sentiments, MIER's third quarter Business Conditions Index (BCI) dipped below the 100-point confidence threshold, and ended the year at a low 53.8 points in the final quarter.

Investment in the manufacturing sector was the most severely affected by the deteriorating global economic conditions. As demand for manufactured exports declined, so did production activities which led to lower capacity utilisation rates. MIER's capacity utilisation rates dropped from 83% in the first quarter of 2008 to 74.4% in the fourth quarter, thereby reducing the need for firms to undertake new capacity expansion exercises. While ongoing projects were continued, the global economic downturn has led to some postponements of new projects. Trends in indicators such as imports of machineries and loans disbursed to the manufacturing sector confirmed the declining investment trend.

However, investment in other sectors remained positive. In the mining sector, capital expenditure in the oil and gas sector remained high. Rising crude oil prices, particularly in the first half of 2008, supported exploration activities especially into deepwater oil fields. Investment

Chart 1.5
Total Nominal Investment and Manufacturing Sector Capacity Utilisation



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

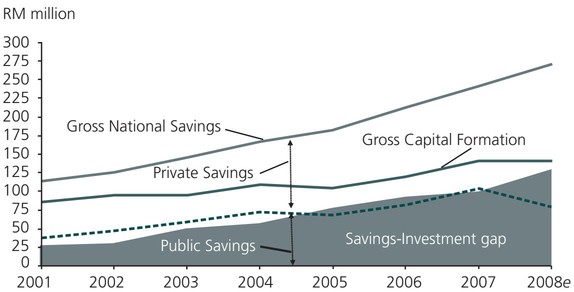
in the services sector expanded mainly in the transportation sub-sector, attributable to expansion in the rail and air transport, as well as in port facilities. Meanwhile, ongoing network upgrading exercises by current and new mobile operators supported investment in the communications sub-sector. In the wholesale and retail trade sub-sector, there were ongoing expansion projects for new outlets.

Public investment grew at a slower pace of 0.7% in 2008 (2007: 9.3%). Large development expenditure continued to be channelled into projects to further improve the economic and social services sectors of the economy, in line with the Government's role to provide support for growth. In the economic sector, expenditure was mainly targeted to improve and upgrade industrial and public utilities infrastructure, enhance transportation system and increase efficiency in agriculture production. Meanwhile, spending in the social services sector continued to focus on essential services including education, healthcare and housing.

Capital spending by the non-financial public enterprises (NFPEs) was sustained. Investment by PETRONAS expanded further, channelled mainly into exploration and development activities in the upstream oil and gas sub-sector, as well as shipping fleet expansion. Further capital spending by the NFPEs was to improve the utilities, transportation and communication systems. Tenaga Nasional Berhad continued to undertake capital spending to upgrade and improve its power generation, transmission and distribution systems. Meanwhile, capacity improvement in the communications sector was mainly to enhance the broadband infrastructure facilities in order to provide for wider and better communication services.

Public consumption expanded strongly by 11.6% in 2008 (2007: 6.6%) due mainly to higher expenditure on emoluments, defence as well as supplies and services. The increase in emoluments expenditure reflected the Government's commitment to enhance human resource development in the public sector. Meanwhile, the higher expenditure for supplies and services during the year was mainly for maintenance of buildings and fixtures as well as to improve administrative machinery and delivery system of the public sector.

Chart 1.6
Gross National Savings and Savings-Investment Gap



e Estimate

Despite the strong growth in private consumption, private sector savings increased significantly to RM190.5 billion or 26.6% of GNI in 2008 (2007: 21.8%), broadly reflecting households' sound financial position. Banking sector deposits held by individuals rose further to RM366 billion during the year (2007: RM330.6 billion). However, public sector savings declined to RM80.4 billion or 11.2% of GNI (2007: 16.6%). In total, **gross national savings (GNS)** increased by 12.3% to RM270.9 billion, which in turn led to a larger savings-investment surplus of RM129.4 billion or 18.1% of GNI in 2008. This high rate of savings enabled Malaysia to finance its growth mainly from domestic sources.

SECTORAL REVIEW

The Malaysian economy entered 2008 with favourable growth across all major sectors, amidst strong domestic demand and supportive external demand conditions from regional economies and rising prices of commodities. Growth in the first half-year was driven by robust performance of the services sector with further support coming from the manufacturing and agriculture sectors. However, the sharp deterioration in the global economic conditions in the second half of 2008 led to a pronounced deceleration in external demand. This led to weakened performance of sectors most directly exposed to global demand, particularly the electronics and electrical industry. In addition, the external sector was also affected by the bursting of the commodity price bubble. The economy, however, continued to be supported by the expansion of the services sector.

Services Sector

In 2008, the **services sector** expanded by 7.3% compared with 9.7% in 2007. The sector contributed 3.9 percentage points to the overall GDP growth whilst its share to GDP increased to 55% (2007: 53.6%). In the first half of the

Table 1.5
Services Sector Performance at Constant 2000 prices

	2007	2008*p*	2007	2008*p*
	Annual change (%)		Share to GDP (%)	
Services	**9.7**	**7.3**	**53.6**	**55.0**
Intermediate services	11.7	6.0	23.4	23.7
Finance and insurance	11.1	7.7	10.7	11.0
Real estate and business services	18.2	1.5	5.3	5.1
Transport and storage	10.0	6.1	3.7	3.8
Communication	7.0	7.3	3.7	3.8
Final services	8.1	8.4	30.2	31.2
Wholesale and retail trade	12.5	9.8	12.2	12.8
Accommodation and restaurant	10.8	7.3	2.4	2.4
Utilities	3.9	2.1	3.0	2.9
Government services	4.5	11.9	6.9	7.4
Other services	5.0	4.9	5.7	5.7

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

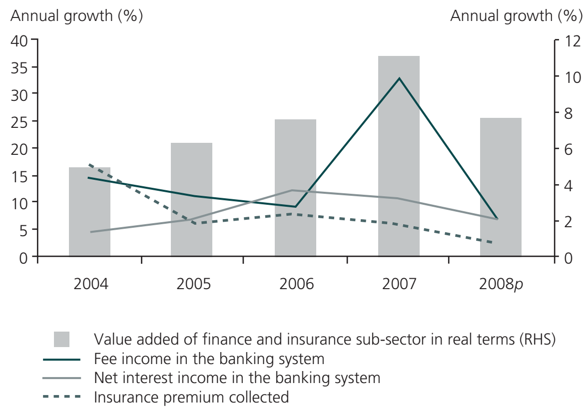
year, the sector posted a strong performance due to the robust domestic demand conditions, and expansion in trade and tourism activities. In contrast with other sectors that were affected by the global economic slowdown, growth in the services sector registered a commendable growth of 6.4% in the second half of the year (1H 2008: 8.4%). Growth in the second half year was affected by the moderation in the services sub-sectors that were dependent on trade and capital market-related activities.

Despite moderating in the second half of the year, growth of the services sector continued to remain strong in 2008

The **wholesale & retail trade** sub-sector expanded by 9.8% compared with 12.5% in 2007. The sub-sector registered a strong growth in the first half year, in line with robust domestic demand. The continued expansion in hypermarkets and retail outlets coupled with the extension of Visit Malaysia Year and Malaysian Mega Sale events helped boost retail spending. In addition, the motor vehicle segment grew significantly during the first nine months, following the launch of new models. However, growth moderated in the second half year, affected by high inflation and weak consumer sentiments. As a result, consumer purchases were mainly confined to food and beverages, and essential household items.

The **finance and insurance** sub-sector recorded a growth of 7.7% (2007:11.1%) to account for 11% of GDP at end-2008. In the finance segment, financial intermediation continued to support economic activity in an environment of ample liquidity and continued access to financing. Total loans outstanding of the banking system increased by 12.8% (2007: 8.6%) with strong loan growth to all sectors of the economy. Nevertheless, the net interest income of the banking system recorded a lower growth of 8% (2007: 10.8%) partly as a result of narrowing interest rate spreads following greater competition. Meanwhile, fee-based income moderated due mainly to the slowdown in the capital market activities in the second half of the year. Islamic finance continued to expand during the year, with six new Islamic

Chart 1.7
Performance of the Finance and Insurance Sub-sector vis-à-vis Related Indicators



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

banks commencing operations, resulting in a total of 17 Islamic banks in operation as at end-2008. Meanwhile, the insurance services industry recorded a moderate growth due mainly to lower activities in the life insurance segment.

In the **communication** sub-sector, increased competition in the telecommunications market and the roll-out of new broadband services, particularly WiMax, provided impetus for strong demand in both the cellular and broadband segments. By August, four WiMax operators were offering high speed broadband services to key urban areas. This development acted as a catalyst in enhancing broadband accessibility throughout the country. Meanwhile, the cellular segment continued to remain vibrant with the entrance of a new player, aggressive promotions of post-paid business and the implementation of mobile number portability. As at end-2008, penetration rate of broadband increased to 21.1% of household (end-2007: 14.4%), while that of cellular segment rose to 96.8% of population, compared to 85.1% as at end-2007. These developments contributed favourably towards a higher growth of 7.3% in the communication sub-sector (2007: 7%).

Meanwhile, the **transport and storage** sub-sector expanded at a moderate pace of 6.1% (2007: 10%). The cargo-related segment performed favourably in the first half of the year,

Table 1.6
Selected Indicators for the Services Sector

	2007	2008*p*
	Annual change (%)	
Utilities		
Electricity production index	3.9	1.2
Wholesale & Retail Trade and Accommodation & Restaurant		
Consumption credit disbursed	9.5	10.8
Tourist arrivals	19.5	5.1
Total sales of motor vehicles	-0.7	12.5
Finance & Insurance and Real Estate & Business Services		
Loans outstanding in the banking system	8.6	12.8
Insurance premiums	6.1	2.7
Bursa Malaysia turnover (volume)	94.1	-59.8
Transport & Storage and Communication		
Total container handled at Port Klang and PTP (TEUs)	13.6	7.7
Airport passenger traffic	6.2	5.9
Air cargo handled	-5.5	-6.7
SMS traffic	70.6	28.7
	%	
Penetration rate:		
- Broadband[1]	14.4	21.1
- Cellular phone[2]	85.1	96.8
- Fixed line	47.8	44.9

[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; PTP; Malaysia Airports Holdings Berhad; Senai Airport Terminal Services Sdn Bhd; Malaysian Communications and Multimedia Commission; and Bank Negara Malaysia.

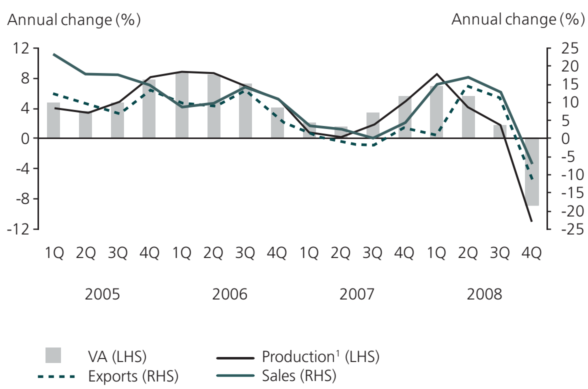
supported by favourable trade and manufacturing activities. However, in the second half of the year, the global economic downturn adversely affected the manufacturing sector, which in turn, translated into lower demand for air cargo, shipping, ports and other related services. Nevertheless, the passenger-related segment continued to be resilient. In particular, air passenger traffic at all airports sustained its momentum from the previous year, primarily on strong domestic and regional travel, as budget airlines continued to prosper in the region. Furthermore, the year also saw a significant milestone in the airline industry following the partial liberalisation of the Kuala Lumpur-Singapore air route to budget airlines in February and full liberalisation in December.

In the **other services** sub-sector, growth was sustained at 4.9% (2007: 5%). The sub-sector benefited from continued demand for private education services, healthcare services and entertainment-related services. However, the **accommodation & restaurant** sub-sector recorded a more moderate growth in 2008, having registered a double-digit growth in 2007, as the sub-sector was affected by the weaker consumer sentiments in the latter part of the year. Similarly, the **real estate & business services** sub-sector registered a lower growth of 1.5% in 2008, following a robust growth of 18.2% in 2007. The moderation in growth was mainly due to weak capital market-related activity and the moderation in property transactions that was particularly evident in the second half of the year.

Manufacturing Sector

Manufacturing sector expanded, albeit at a much slower pace in 2008 (1.3%; 2007: 3.1%), driven mainly by domestic-oriented industries. In the first half of the year, growth was strong and broad based with robust external demand for both electronics and electrical (E&E) products, emanating largely from non-US markets, and primary-related products which benefited from the rising commodity prices.

Chart 1.8
Manufacturing Sector: Value-added, Production, Exports and Sales



[1] Data from 2008 onwards are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia

Table 1.7
Performance of the Manufacturing Sector

	2007	2008
	Annual change %	
Value-added (RM million at 2000 prices)	**3.1**	**1.3**
Overall Production[1]	**2.2**	**0.7**
Export-oriented industries	**1.0**	**-1.2**
Electronics & electrical cluster	**-1.5**	**-3.5**
of which:		
Electronics	3.0	-5.4
Electrical	-10.8	1.1
Primary-related cluster	**2.7**	**0.4**
of which:		
Chemicals and chemical products	3.6	-3.5
Petroleum products	2.5	5.9
Rubber products	8.6	4.7
Off-estate processing	-8.9	9.4
Domestic-oriented industries	**7.6**	**8.0**
Consumer-related cluster	**5.6**	**11.0**
of which:		
Transport equipment	-1.1	23.4
Food, beverage & tobacco products	9.1	7.4
Construction-related cluster	**10.0**	**4.3**
of which:		
Construction-related products	8.5	3.2
Fabricated metal products	12.5	6.1
Exports	**0.3**	**3.6**

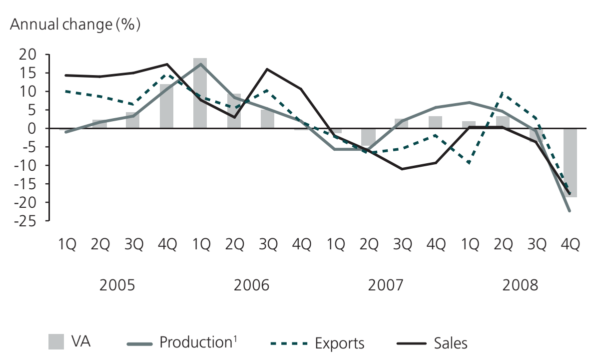
[1] Production data are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia

This was further reinforced by the firm performance in domestic-oriented industries owing to strong domestic demand. In the second half of the year, the manufacturing sector began to weaken in line with the rapid deterioration in global demand and the sharp correction in commodity prices. Export-oriented industries were severely affected, particularly towards the end of the year as global demand decelerated sharply. This weakness also affected the performance of the domestic-oriented industries, but the strong expansion in the consumer-related products partly cushioned the overall decline in the manufacturing sector. Nevertheless, manufacturing sector continued to be the second largest contributor to the economy with its share of GDP of 29.2% (2007: 30.1%).

Manufacturing sector growth was driven by domestic-oriented industries as the performance of export-oriented industries weakened significantly towards year-end

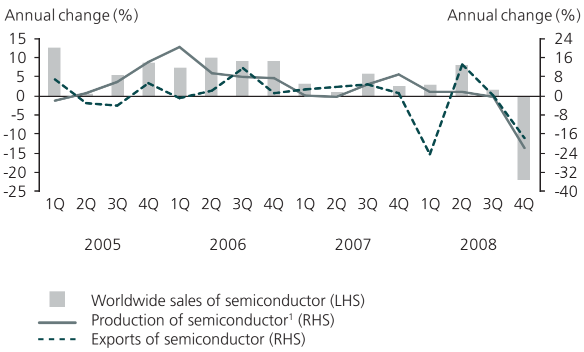
Export-oriented industries contracted by 1.2% (2007: 1.0%) as the declines in the E&E cluster of industries outweighed the growth of the primary-related cluster. **E&E** industry continued to weaken in 2008, affected by the global downturn in the second half of the year, which more than offset the robust external demand from emerging economies in the early part of the year. During the first half of the year, production of computers and parts recorded a strong performance attributable to the surge in external demand from the non-US markets. Meanwhile, output of semiconductors increased as there was strong demand for end-products such

Chart 1.9
E&E Cluster: Value-added, Production, Exports and Sales



[1] Data from 2008 onwards are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia

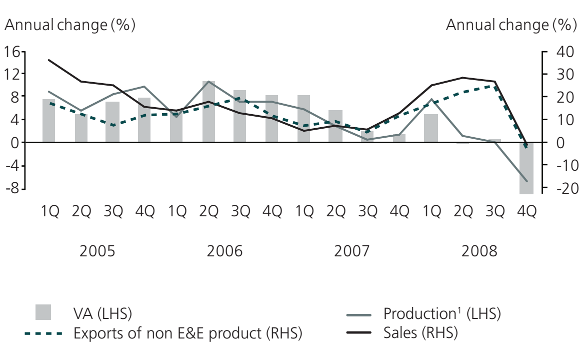
Chart 1.10
Production and Exports of Semiconductors



[1] Data from 2008 onwards are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia
Semiconductor Industry Association (SIA)

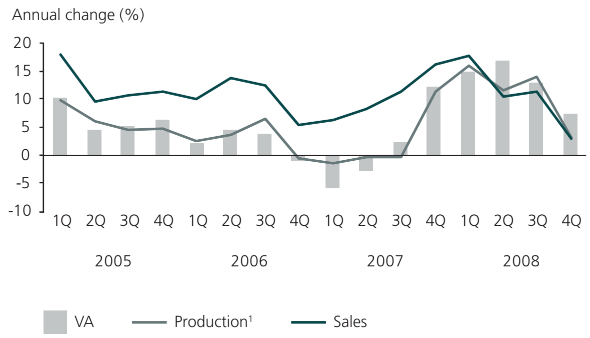
as computers, consumer electronics and telecommunications, mainly from PR China, Hong Kong and India. Similarly, strong demand for new electrical products such as Blu-ray disc players and HD LCD televisions, mainly from Australia and Middle-East, contributed significantly, reversing the decline in production of electrical goods in the previous year. However, these trends reversed sharply in the second half of the year as the downturn in the global economy precipitated declines in E&E production.

Chart 1.11
Primary-related Cluster: Value-added, Production, Exports and Sales



[1] Data from 2008 onwards are based on the new Industrial Production Index (2005= 100)
Source: Department of Statistics, Malaysia

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

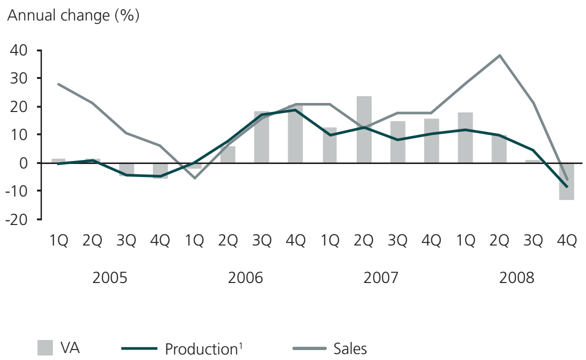


[1] Data from 2008 onwards are based on the new Industrial Production Index (2005=100)
Source: Department of Statistics, Malaysia

Manufacturers in the E&E industry also faced price attrition in their products amidst intense competition not only locally but also among major global players.

Output in the **primary-related** products industry expanded, albeit marginally, supported mainly by the off-estate, chemicals and rubber products. During the first half of the year, the strong growth in the off-estate processing segment was due mainly to the high commodity prices that encouraged more harvesting and processing, while rubber products were mainly sustained by continued growth in the transportation industry and the strong external demand for rubber gloves. In addition, the sustained growth of the E&E and transportation sub-sectors lent support to the plastic industry in the chemicals and chemical products segment. In the second half of the year, primary-related products were affected by both the global economic slowdown and the commodity price correction. Production of the off-estate processing registered a sharp decline. The decline in production of rubber tires due to slower growth in the transportation segment was cushioned by the more resilient demand for rubber gloves which supported the overall rubber products segment. The growth of the chemicals and chemical products was mainly affected by the tapering off in demand for E&E products as well as other consumer and industrial goods.

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



[1] Data from 2008 onwards are based on the new Industrial Production Index (2005=100)

Source: Department of Statistics, Malaysia

Domestic-oriented industries registered a stronger growth of 8% (2007: 7.6%), supported mainly by strong domestic demand. Output of **consumer-related products** such as food, beverages and tobacco increased by double digits, attributable to the robust private consumption during the year. Meanwhile, transport equipment saw a robust performance in the first half year in line with the high car sales. Car sales reached its four-year cyclical peak, owing to the positive consumer sentiment given continuous income growth, availability of competitive financing rates as well as aggressive promotions on new car models. However, in the second half year, the performance of auto industry moderated as consumers turned cautious due to the weakening economic outlook.

Strong growth in production of **construction-related** materials in the first half of the year was supported by both the domestic construction sector and robust external demand from the region. The removal of the price ceiling on steel bars and billets as well as the reduction in import duty on cement provided a further boost. Slower growth in the second half of the year was due mainly to weak local demand and decline in prices, but cushioned somewhat by external demand especially for iron and steel products.

Agriculture Sector

The agriculture, forestry and fishing **(agriculture) sector** expanded at a faster pace of 3.8% in 2008, driven mainly by stronger palm oil production, which accounted for about 30% of value add in the agriculture sector. Growth during the year was also supported by higher output of key food-related activities such as fisheries and livestock.

Table 1.8
Agriculture Sector: Value Added and Production

	2007	2008*p*
	Annual change (%)	
Value added	**2.2**	**3.8**
Industrial crops	**0.1**	**3.2**
Production of which:		
Crude palm oil	-0.4	12.1
Rubber	-6.6	-10.1
Saw logs	0.7	-16.3
Cocoa beans	10.2	-20.5
Food crops	**5.3**	**4.7**
Production of which:		
Fish	0.2	5.2
Livestock [1]	9.9	4.3
Vegetables	8.6	11.9
Fruits	-2.8	3.2

[1] Refers to Peninsular Malaysia only
p Preliminary

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

Crude palm oil production rose strongly by 12.1% to 17.7 million tonnes in 2008, driven by favourable weather conditions and in part by strong increase in crude palm oil prices of 16.3% to an average of RM2,875 per tonne.

The expansion in agriculture sector was driven mainly by stronger palm oil production

Strong outperformance was attributable to the more widespread application of fertilizer that contributed to higher yields in Peninsular Malaysia which recorded total output of 10.1 million tonnes

Impact of Developments in Commodity Prices

Commodity prices were characterised by exceptional volatilities in 2008, with prices moving in large magnitudes on the upswing and downswing within the short period of a year. Commodity prices increased sharply in the first half of the year due in part to the strong underlying demand and the expectations of stronger demand from the large emerging economies and also due to the increase in demand from funds as commodities became a new investment asset class. In addition, food prices were also driven by the increasing use of food crops for the production of alternative fuels and production shortfalls due to adverse weather conditions. Prices of several commodities reached all time highs. However, as the global financial turmoil intensified in the second half of the year, the large unwinding of long positions by funds and the pull back of financing by financial institutions caused commodity prices to correct sharply, with prices of several commodities declining significantly from their peaks in the first half of 2008. As the year progressed, the decline in demand also contributed to the softening in prices of commodities.

Chart 1
BNM Commodity Price Index - Level

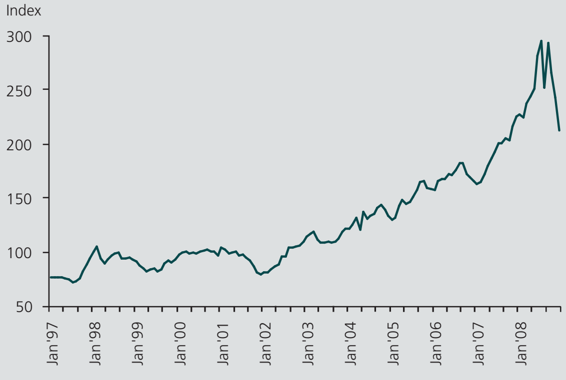
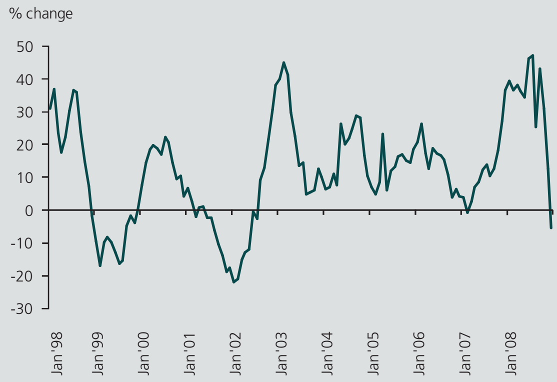


Chart 2
BNM Commodity Price Index: Annual Growth



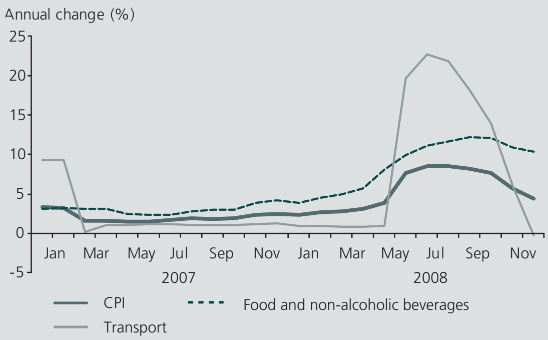
Prior to 2008, commodity prices had already been exhibiting an upward trend as seen in a gradual increase in the BNM Commodity Price Index[1] (Chart 1) since 2003, in tandem with a prolonged period of high global growth accompanied by the rapid industrialisation in several large emerging economies. Nevertheless, commodity prices accelerated sharply in unparalleled magnitudes in the first half of 2008, with the Index increasing sharply by 23.5% (Chart 2). Crude oil prices (NYMEX West Texas Intermediate) reached an all-time high of USD145 per barrel in July, 63.6% higher than in January 2008. Palm oil prices peaked at RM4,180 per tonne in March, doubling in value from a year earlier. Similarly, steel prices also doubled to over RM4,000 per tonne over the same period. However, the second half of 2008 saw a rapid reversal, with prices of most commodities declining sharply. NYMEX crude oil prices ended the year at USD44.60 per barrel, the lowest level since January 2005, while palm oil prices declined to RM1,630, the lowest level since October 2006. Accordingly, the BNM Commodity Price Index declined by 27.9% during this period.

Malaysia, as a major producer and exporter of several commodities such as palm oil, crude oil, natural gas and rubber, has been affected by this sharp increase and subsequent reversal in commodity prices. Changes in commodity prices have a heterogeneous impact on the economy – benefiting some segments while exerting negative impact on others. Key economic variables that have been affected are price levels, external trade, incomes of businesses and individuals involved in the agriculture and mining sectors, and the fiscal position of the Government.

[1] BNM Commodity Price Index is an export-weighted index (2000 = 100) of prices of major Malaysia's export commodities, namely palm oil, palm kernel oil, crude oil, natural gas, saw logs, sawn timber, cocoa, rubber and tin.

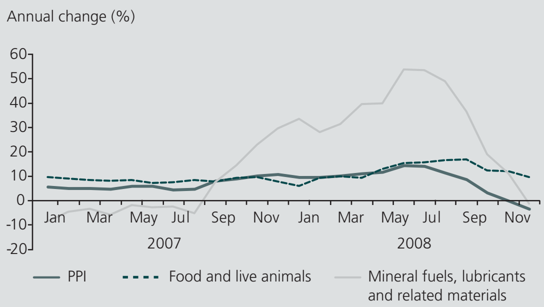
The rapid increase in global commodity and food prices exerted strong pressure on domestic price levels, both the Consumer Price Index (CPI) and Producer Price Index (PPI). While CPI inflation had already been increasing gradually in the first five months of 2008, the fuel subsidy restructuring exercise undertaken by the Government in June caused fuel prices to increase by 40.4%, resulting in a sharp increase in the headline inflation rate, which peaked at 8.5% in July. Subsequently, domestic fuel and food prices declined with the Government's downward fuel price adjustments in line with the global prices, contributing to the moderation in inflation rate to 4.4% by December. Overall, inflation averaged 5.4% in 2008, higher than the country's average long-term inflation rate of 3.0%. Reflecting the effect of commodity prices on domestic inflation, the food and non-alcoholic beverages and transport categories together accounted for 77.1% of the overall rise in domestic prices during the year. The impact of global prices of commodities was more evident in the PPI, which peaked at 14.4% in June, before declining in the second half of the year. In particular, the commodity component of the PPI reached a high of 42.5% in June before declining rapidly to -10.4% by the end of the year. To mitigate the impact of high food and fuel prices on the public, particularly the low income group, the Government introduced several measures, including subsidising prices of domestically-produced rice, subsidising fuel prices for fishermen and public transport operators, as well as providing fuel cash rebates for motorists.

Chart 3
Consumer Price Index (CPI)



Source: Department of Statistics, Malaysia

Chart 4
Producer Price Index (PPI)

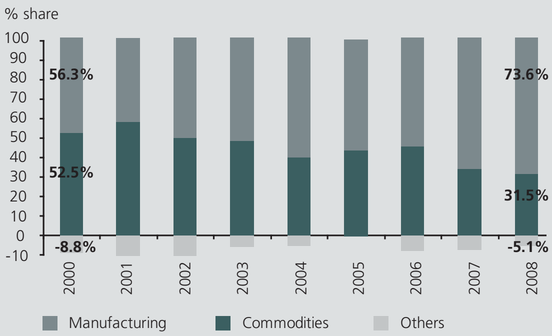


Source: Department of Statistics, Malaysia

Malaysia has over the years undertaken measures to diversify the country's export base, with manufacturing exports becoming the main export earner. Nevertheless, as a major net commodity exporter, the sharp increases in commodity prices have raised the contribution of commodities to Malaysia's exports earnings significantly. Commodity exports' share of total exports doubled to 23.5% in 2008, from 13.3% in 2000. In addition, as commodity exports have relatively low import content compared to the manufactured exports, the contribution of commodity exports to total trade balance has also increased significantly. In 2008, 73.6% of Malaysia's trade surplus of RM142 billion was contributed by exports of commodities, compared with 56.3% in 2000. The large reversal in commodity prices seen in the second half of 2008 has thus led to a significant decline in the value of gross exports of commodities.

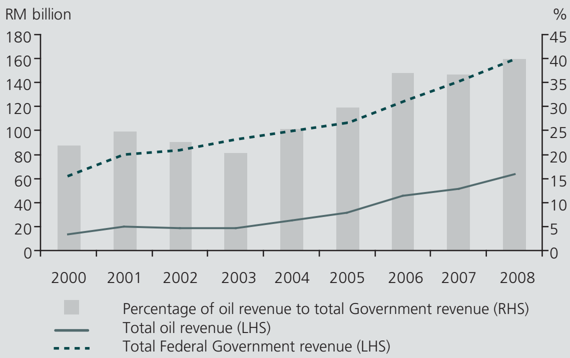
The impact of commodity prices on income levels is also substantial, with participants in both agriculture and mining sectors, including smallholders as well as plantation and oil companies, experiencing strong income growth in line with the rise in prices. Most of the major plantation companies recorded significant growth in profitability, as high as 80% on a year-to-year basis in the second quarter of 2008. Similarly, higher commodity prices, particularly palm oil and rubber, have benefited almost 270,000 smallholders involved in these activities. The average income of the Federal Land Development Authority (FELDA) settlers increased to RM3,014 per month for rubber and RM3,489 per month for palm oil in 2008 compared to the income levels of RM2,353 per month for rubber and RM1,930 per month for palm oil in 2007. However,

Chart 5
Net Contribution to Trade Surplus



Source: MATRADE

Chart 6
Oil revenue contribution to Federal Government revenue



Source: Accountant General Department

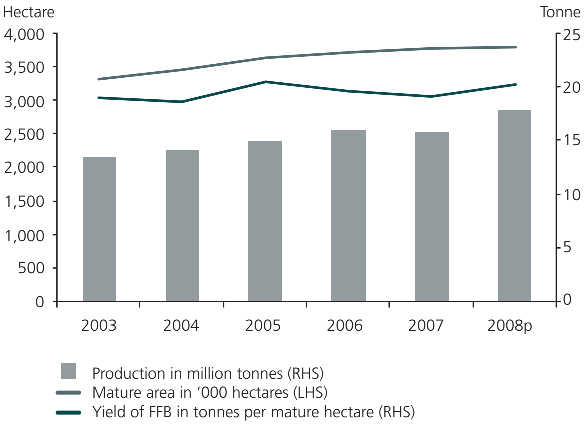
with the decline in commodity prices towards the end of 2008, profits of the plantation and mining companies were adversely affected, while incomes of the smallholders have retreated substantially, to about RM600 per month for rubber and RM750 per month for palm oil as at end-2008.

Another consequence of the sharp increase in commodity prices was the consequential rise in prices of most input materials as well as cost of investment in the mining and agriculture sectors. Oil and gas companies experienced a sharp increase in costs of rigs of about 100% in the first half of the year, as well as steel which rose by 75% during the same period. Meanwhile, the price of fertilizer increased by almost 100% in 2008. While the decline in commodity prices towards the end of 2008 has eased somewhat the cost pressures on these input materials, the concurrent decline in revenue and the reduction in margins served to limit the ability of plantation and oil companies to increase investment expenditure, with several reporting a reduction in capital spending.

The rise in oil prices also contributed significantly to the increase in Government revenue. The revenue to the Government is in the forms of petroleum income taxes, oil and gas royalties, petroleum export duties, sales taxes and dividends paid by PETRONAS. The oil revenue increased from RM13.6 billion in 2000 to RM51.2 billion in 2007. In tandem with the sharp increase in oil prices in 2008, the oil revenue amounted to RM63.7 billion in 2008 to account for 39.9% of the overall Government revenue. These higher oil-based revenue has, over the years, allowed the Government to undertake development spending on infrastructure, education and healthcare, thus contributing further to enhancing the country's long-term productive capacity. However, the large contribution of oil revenues has also increased sensitivity of fiscal revenue to movements in oil prices.

Going forward, commodity prices are expected to remain subdued in 2009, given the significant weakness in global financial and economic conditions. Malaysia, as a major commodity-exporter economy, will be affected. While lower commodity prices will continue to exert downward pressure on inflation, the lower incomes of smallholders, as well as businesses in the agriculture and mining sectors could also affect private consumption and investment expenditure. While a current account surplus is still being projected, the contribution of commodities to Malaysia's trade balance will also be affected.

Chart 1.14
Oil Palm: Area, Production and Yield

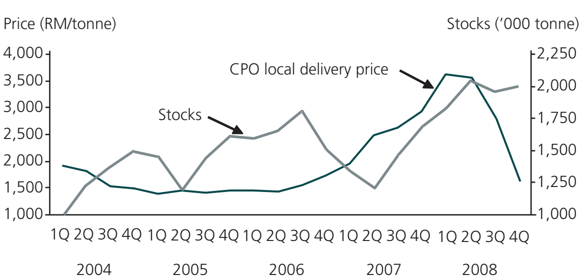


p Preliminary
Source: Malaysian Palm Oil Board (MPOB)

and increased by 17.4%. Production in Sabah increased at a more moderate pace of 3.2% due to a smaller increase in acreage and no growth in FFB yields. Overall, FFB yields increased by 6% to 20.18 tonnes per hectare in 2008. With the increase in production, palm oil stocks rose substantially as well, reaching an all-time high of 2.27 million tonnes in November 2008, before ending the year at 1.99 million tonnes.

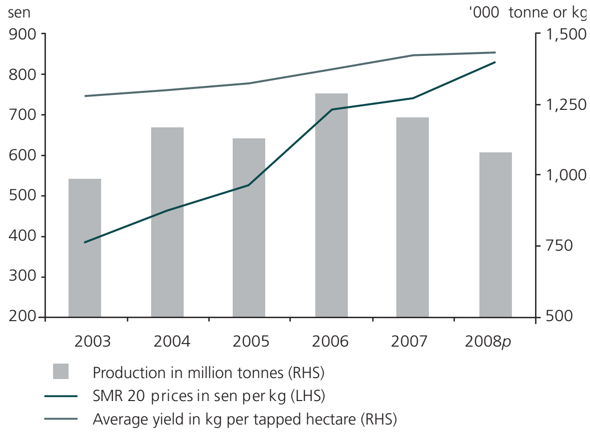
Production of **natural rubber** contracted by 10.1% to 1.08 million tonnes in 2008 due to weather-related factors in the first half of the year, as well as the sharp decline in prices in the second half of the year. In the first half of the year, there were frequent instances of heavy rainfall, particularly in the key producing region of northern Peninsular Malaysia, which disrupted tapping activities. As a result, output

Chart 1.15
Palm Oil Price and Stocks



Source: Malaysian Palm Oil Board (MPOB)

Chart 1.16
Natural Rubber: Production, Prices and Yield



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

during this period declined by 4.7%. Rubber output declined further by 15.4% in the second half, as sharp decline in prices led to smallholders, which produced 95% of total output, to cut their production. Rubber prices declined sharply from a high of 1,053 sen per kilogramme in early July 2008 to a low of 400 sen per kilogramme in December 2008.

The **food crops** sub-sector continued to perform favourably in 2008, with fisheries and livestock sub-sectors growing by 5.2% and 4.3% respectively. Growth in the fisheries sub-sector was driven mainly by growth in aquaculture, while livestock was led by higher output of poultry. In the **forestry** sub-sector, logging activities declined further in 2008, with output of logs contracting by 16.3%, in line with the sustainable forest management policy as set by the International Tropical Timber Organisation. Meanwhile, output of **cocoa** declined by 20.5% due to a significant reduction in cultivation area in Sabah, as well as intensive replanting activities in some areas.

Mining Sector

The value-added of the **mining sector** declined marginally by 0.8% in 2008 due to lower output of natural gas, while crude oil production registered a small increase.

Production of **crude oil (including condensates)** averaged 694,141 barrels per day (bpd) in 2008, representing an increase of 2%. The higher production was driven entirely by the doubling in

Table 1.9
Mining Sector: Value Added and Production

	2007	2008*p*
	Annual change (%)	
Value added	**3.3**	**-0.8**
Production		
of which:		
Crude oil and condensates	2.4	2.0
Natural gas	1.9	-4.9

p Preliminary
Source: PETRONAS
Department of Statistics, Malaysia

Table 1.10
Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at 1 January	
	2007	2008*p*
Crude oil (including condensates)		
Reserves (billion barrels)	5.36	5.46
Reserve/Production (year)	22	22
Natural gas		
Reserves (billions of barrels oil equivalent)	14.82	14.67
Reserve/Production (year)	39	36

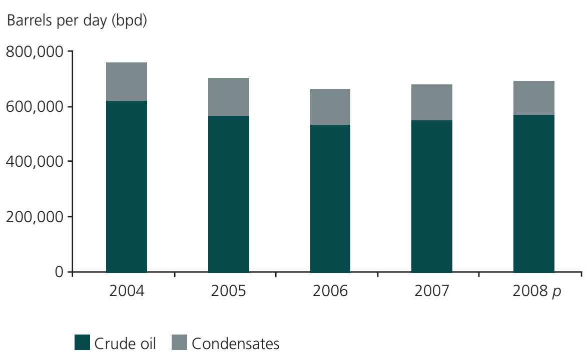
[1] The National Depletion Policy was introduced in 1980 to safeguard the exploitation of the national oil reserves by postponing the development and control the production of major oil fields (with reserves of 400 million barrels or more).
p Preliminary
Source: PETRONAS

crude oil output in Sabah to 150,792 barrels per day (bpd) (2007: 74,800 bpd). Sabah now accounts for 21.7% of total oil output. In keeping with the production limits set by the National Depletion Policy, production in Peninsular Malaysia declined by 8.9% to 337,369 bpd, to account for 49% of total output of crude oil of the country. Meanwhile, condensates continued to contribute significantly, accounting for 17.5% of the total oil production, at 121,511 bpd.

The mining sector declined marginally due to lower natural gas output

Output of **natural gas** contracted by 4.9% to 5,579 million standard cubic feet per day due mainly to lower external demand for liquefied natural gas (LNG). In addition, production was also affected by unplanned maintenance shutdowns at several gas fields in Peninsular Malaysia. Oil reserves in the country increased to 5.46 billion barrels or 22 years of lifespan as at 1 January 2008, suppor ted by the rising reserves from the deepwater discoveries in offshore Sabah. Meanwhile, natural gas reserves is at 14.67 billions of barrels oil equivalent (boe), sufficient to cover 36 years of gas output at current production levels.

Chart 1.17
Production of Crude Oil and Condensates



p Preliminary
Source: PETRONAS

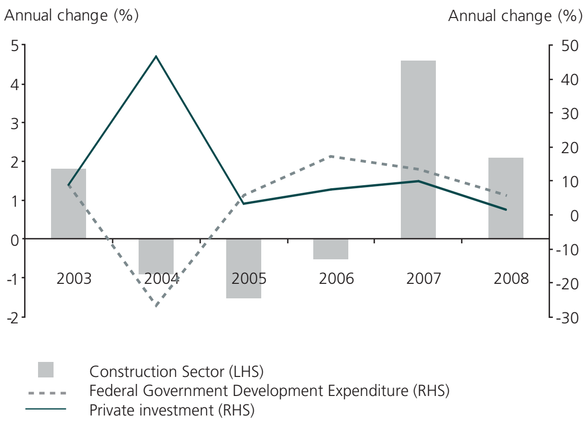
Construction Sector

The **construction sector** recorded a positive growth rate for the second successive year, registering a growth of 2.1%. The growth was supported by higher activities across the three sub-sectors. In the **civil engineering** sub-sector, strong growth was recorded in the first half year following the implementation of projects under the Ninth Malaysia Plan (9MP) as well as those in the oil and gas industry. The Federal Government development expenditure increased by 23.5% in the first half year of 2008, mainly to finance construction of new projects and upgrading of existing infrastructure facilities. The oil and gas industry continued to experience higher activity, especially in building rigs, platforms and storage terminals.

The construction sector growth remained positive in 2008

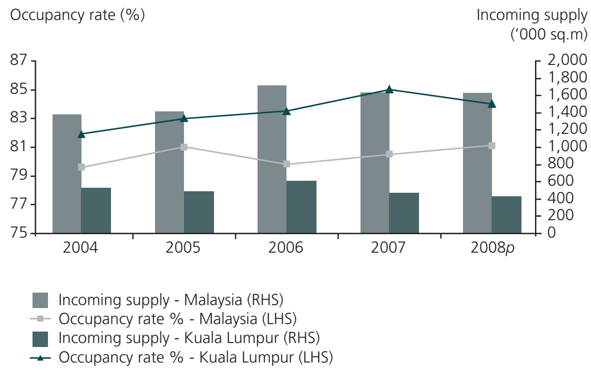
In the second half of the year, the civil engineering sub-sector was affected by the sharp increase in prices of construction materials, particularly steel

Chart 1.18
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 1.19
Incoming Supply and Occupancy Rate of Retail Space in Malaysia and Kuala Lumpur (as at end period)



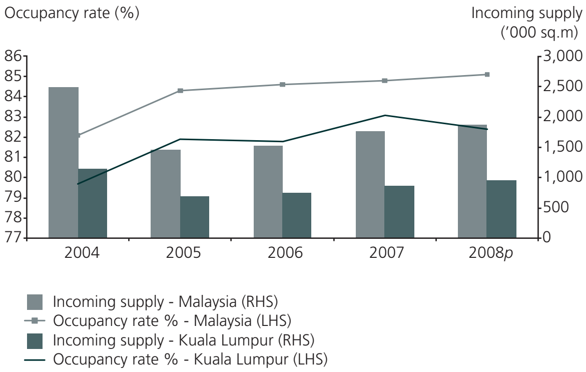
p Preliminary
Source: National Property Information Centre (NAPIC), Valuation and Property Services Department

and cement. Following sharp increases in global prices of building materials, the Government decided to liberalise the pricing structure of both steel and cement in May and June 2008, resulting in a sharp rise in the prices of these materials. As a result, many existing projects experienced a slowdown in construction while companies were reluctant to bid for new projects due to fluctuating costs. To ensure that the implementation of Government projects was completed as planned, the Government issued an update to the Variation of Price (VoP) clause

Table 1.11
Measures Introduced in the Construction Sector in 2008

Announcement Date	Measures
Liberalisation in steel industry 12 May 2008	• Abolishment of ceiling prices on steel bars and billets • Allow import of long steel products without the requirement of an AP (Approval Permit) and abolishment of import duty for steel bars under the HS Code 7214.10 910 and 7214.20 910
Liberalisation in cement industry 5 June 2008	• Abolishment on ceiling price of cement • Import duty reduced to 10% from 50% in non-Asean countries • The liberalisation is effective on the following cement only: - HS 2523 29 900 (ordinary Portland cement); and - HS 2523 90 000 (hydraulic cement). • Cement importers in Sabah and Sarawak are excluded from obtaining license (Approval Permit) to import
Adjustment to the Variation of Price (VOP) Clause Specifications August 2008	• Expanded to include design and build projects on 50:50 cost sharing basis • The materials that come under VOP scheme can be categorised under: 1) Civil Works - 11 items from the previous 5 items 2) Building Works - 15 items 3) Mechanical and Electrical Works - 7 items • The ruling is applicable for Government projects implemented after 1 January 2008, including design and build projects on 50:50 cost sharing basis
First Stimulus Package 4 November 2008	• 10% import duty on cement abolished • Import duty of another 54 HS Codes for long steel products abolished • All imports must comply with Malaysian Standards (MS) or recognised International Standards if MS is not available

Chart 1.20
Incoming Supply and Occupancy Rate of Purpose-Built Office Space in Malaysia and Kuala Lumpur (as at end period)



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

for these projects in August 2008. This initiative, along with the moderation in steel prices towards the end of the year, revived somewhat the confidence in the construction industry.

Growth in the **non-residential** sub-sector was robust, driven primarily by the office segment. Strong business activities at the beginning of the year provided businesses with the room to expand, resulting in higher demand for prime grade office buildings in the Klang Valley. Occupancy rate was higher at 85.1% in 2008 (2007: 84.8%) while rental rates increased to a high of RM10 to RM12 per square feet. A total of 24 new office buildings were completed, while incoming supply was at 1.9 million square metres as at end- 2008. Resilient private consumption contributed to a sustainable retail market. In total, 29 new shopping complexes

Table 1.12
Demand and Supply Indicators of the Residential Property Market

	1H '07	2H '07	1H '08	2H '08
Annual change (%)				
Demand indicators				
Residential property transactions				
Value (RM million)	10.5	35.9	35.5	-3.0
Volume	1.7	16.3	20.7	-1.2
Finance for purchase of residential property				
Loan applications	38.4	57.2	43.9	12.2
Loan approvals	27.8	65.3	43.1	7.3
Supply indicators				
New launches	**8.2**	**62.6**	**25.0**	**-33.7**
New sales and advertising permits	**0.4**	**3.6**	**2.0**	**-38.6**
Housing approvals	**-17.5**	**-5.3**	**19.0**	**-52.6**
Loans for construction				
Loan applications	67.5	35.7	22.2	-30.0
Loan approvals	94.8	32.6	20.5	-19.8

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

Table 1.13
Overhang of Residential Property in Malaysia by Price Range

Residential Price Range	Units	Share (%)	Units	Share (%)
	As at end-2007		As at end-2008*p*	
RM50,000 or less	3,356	14.0	3,602	13.8
RM50,001 - RM100,000	7,151	29.8	7,491	28.8
RM100,001 - RM150,000	4,284	17.9	4,045	15.5
RM150,001 - RM200,000	3,639	15.2	3,786	14.6
RM200,001 - RM250,000	1,778	7.4	2,119	8.1
RM250,001 - RM500,000	2,920	12.2	3,888	14.9
RM500,001 - RM1,000,000	776	3.2	993	3.8
More than RM1,000,000	93	0.4	105	0.4
Total	**23,997**	**100**	**26,029**	**100**

p Preliminary

Source: National Property Information Centre (NAPIC), Valuation and Property Services Department were completed increasing the stock level to 9.2 million square metres as at end- 2008 (2007: 8.6 million square metres). Rentals were relatively stable, while tenants had several options in terms of location and type of properties. Occupancy rate increased slightly to 81.1% in 2008 (2007: 80.5%).

Performance in the **residential** segment was relatively mixed during the year. In the first half of 2008, demand for properties was strong, with property transactions increasing by 35.5%. Nevertheless, demand for properties began to soften in the second half year as consumer sentiment started to decline, first as a result of rising inflationary pressures and later, the deteriorating global economic conditions. Demand for properties in the high-end segment of the market was especially affected. As a result, property transactions reversed and registered a decline of 3% in value terms in the second half. The moderation in demand was also observed in terms of property overhang. Overall overhang level increased by 8.5% in 2008, with property overhang of prices above RM200,000 experiencing a sharp increase of 27.6% to 7,105 units (2007:5,567 units). Property developers reacted cautiously to the softening demand by reducing the number of launches of new developments which led to lower housing approvals and demand for bridging loans. In addition, property developers were affected by increases in construction cost following the liberalisation in prices of cement and steel, which led to some delays in the implementation of existing and new projects.

EXTERNAL SECTOR

Balance of Payments

Malaysia's external position remained resilient in 2008, despite a weak external environment in the second half of the year. The current account recorded another large surplus, while the reversal

Table 1.14
Balance of Payments

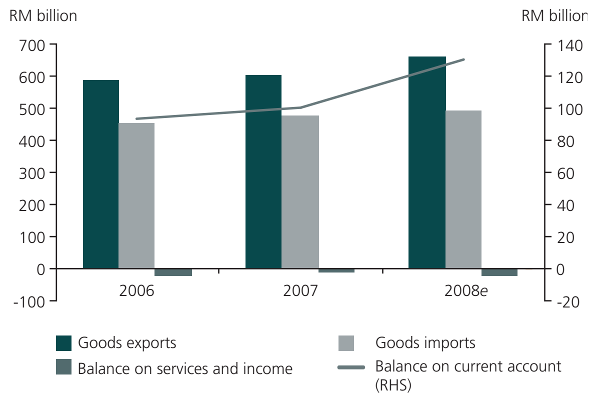
Item	2007			2008e		
	+	-	Net	+	-	Net
	RM billion					
Goods	605.9	478.2	127.7	664.2	494.1	170.1
Trade account	*605.2*	*504.8*	*100.3*	*663.5*	*521.6*	*141.9*
Services	101.2	98.9	2.4	102.2	100.5	1.7
Balance on goods and services	**707.2**	**577.1**	**130.0**	**766.4**	**594.5**	**171.8**
Income	38.8	52.7	-13.9	39.1	64.5	-25.4
Current transfers	1.4	17.2	-15.7	1.4	18.5	-17.0
Balance on current account	**747.4**	**647.0**	**100.4**	**806.9**	**677.5**	**129.4**
% of GNI			**16.0**			**18.1**
Capital account			-0.1			0.6
Financial account			-37.7			-123.9
Direct investment			-9.1			-20.5
Portfolio investment			18.4			-92.4
Other investment			-46.9			-11.0
Balance on capital and financial accounts			**-37.8**			**-123.3**
Errors and omissions			-17.3			-24.3
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*-5.6*			*-5.8*
Overall balance			**45.3**			**-18.2**
Bank Negara Malaysia international reserves, net			**335.7**			**317.4**
USD billion equivalent			**101.3**			**91.5**

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

of short-term capital flows in the second half of the year resulted in a net outflow in the financial account. The **overall balance of payments** recorded a deficit as the higher net outflow in the financial account more than offset the larger surplus in the current account.

The larger current account surplus of RM129.4 billion or 18.1% of GNI was due to a higher trade surplus and sustained surplus in the services account. The income account, however, recorded a larger deficit following higher profits and dividends accruing to the MNCs operating in Malaysia.

Chart 1.21
Current Account



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

Malaysia's external position remained resilient in 2008, despite a weak external environment in the second half of the year

The financial account recorded a larger net outflow due to the significant liquidation of portfolio investment by foreign investors, particularly in the second half of 2008, following deleveraging activities as the global financial turmoil intensified. During the year, net direct investment abroad by Malaysian companies increased, mainly through acquisition of interests and expansion of existing operations abroad. Meanwhile, the net inflows of foreign direct investment (FDI) moderated, particularly in the second half-year, in tandem with the deterioration in the global economic and financial conditions. After adjusting for errors and omissions, which include the foreign exchange revaluation loss arising from the revaluation of the international reserves due to the strengthening of the ringgit against some major currencies, the net international reserves declined by RM18.2 billion to RM317.4 billion or equivalent to USD91.5 billion as at 31 December 2008. As at 27 February 2009, the reserves remained at a comfortably high level of RM315.9 billion (equivalent to USD91.1 billion), adequate to finance 7.6 months of retained imports and cover 3.9 times of the short-term external debt. Malaysia's reserves remain usable and unencumbered.

Current Account

The **current account** recorded a larger surplus of RM129.4 billion or 18.1% of GNI (2007: RM100.4 billion or 16% of GNI), supported by a significantly higher trade surplus and sustained surplus in the services account. Stronger growth in both commodities and resource-based manufacturing exports, particularly in the first half of 2008 due to high commodity prices, contributed to a larger trade surplus. The services account surplus was due mainly to higher tourism receipts from 22.1 million visitors. The larger deficit in the income account reflected mainly higher profits and dividends accruing to the MNCs operating in Malaysia, particularly in the manufacturing, oil and gas, and services sectors.

The larger current account surplus was underpinned by strong exports of commodities and resource-based manufacturing products as well as higher tourism receipts

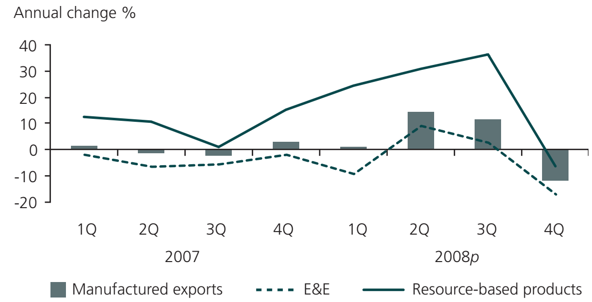
Gross exports increased by 9.6% in 2008 (2007: 2.7%), led by the expansion in both commodities and resource-based manufacturing exports. In the first half of 2008, **manufactured exports** grew by 7.8%, supported mainly by regional demand for resource-based manufacturing exports. However, in the second half-year, the ensuing weakness in global demand and easing of commodity prices led to a marginal decline in manufactured exports

Table 1.15
Gross Exports

	2007	2008*p*
	Annual change (%)	
Gross exports	**2.7**	**9.6**
Manufactures	**0.3**	**3.6**
of which:		
Electronics	*-3.5*	*-8.2*
Semiconductors	*3.2*	*-6.9*
Electronic equipment and parts	*-8.4*	*-9.3*
Electrical products	*-5.9*	*8.6*
Resource-based products[1]	*9.7*	*20.2*
Commodities	**14.7**	**37.1**
Agriculture	**24.4**	**30.0**
of which:		
Palm oil	*47.8*	*43.7*
Rubber	*-10.9*	*10.6*
Minerals	**7.5**	**43.2**
of which:		
Crude oil and condensates	*3.5*	*35.0*
LNG	*12.3*	*55.7*

[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 1.22
Export Performance of Electronics & Electrical (E&E) and Resource-Based Industries



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

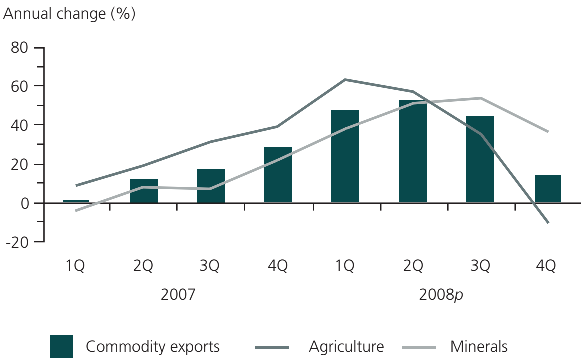
of 0.2%. For the year as a whole, exports of **electronics and electrical (E&E)** products contracted by 3.8%, as the decline in exports of electronics more than offset the strong recovery in exports of electrical products. The exports of semiconductors were affected by weak demand for electronic equipment and parts from the advanced economies, particularly in the second half of the year, as well as lower prices. Electrical exports, however, expanded strongly by 8.6%, driven by consumer electrical goods as well as industrial and commercial electrical products. Product innovation which led to a shift to higher value-added products, as well as penetration to new export markets, notably the United Arab Emirates, Saudi Arabia, India and Australia, contributed towards the expansion in electrical exports.

Exports of **non-E&E** products strengthened by 15.2%, in line with higher input prices of commodities and sustained demand from regional countries. In the first half-year, exports of non-E&E products, particularly resource-based products such as rubber, petroleum, and chemicals and chemical products, increased by 20%. Growth was also supported by exports of construction-related products, such as manufactures of metal amidst booming construction activity in PR China, Vietnam and Singapore. In the second half-year, growth in exports of non-E&E products moderated to 10.8%, following the decline in commodity prices.

Exports of **primary commodities** expanded strongly by 37.1% and accounted for a higher share of gross exports of 23.5% (2007: 18.8%). In the first half of the year, commodity exports expanded strongly by 50.2%, driven mainly by significantly higher prices of palm oil, rubber, crude oil and LNG. Despite a marked softening of commodity prices in the second half of 2008, the growth in commodity exports remained strong at 26.9%, supported mainly by LNG exports.

Agriculture exports strengthened by 30%, led mainly by strong exports of palm oil and rubber. In the first half of 2008, export earnings from palm oil surged by 90.9%, underpinned by sharply higher prices (+53% to an average of RM3,140 per tonne) and exports volume (+24.8%). Exports of rubber expanded by 26.2%, attributable mainly to higher prices (+20.9% to an average of 846 sen per kilogramme), amidst low global stocks in major producing regions and rising demand. In the second half of 2008, the growth of agriculture exports moderated to 10%, as prices of major agricultural commodities eased significantly.

Chart 1.23
Commodity Export Performance



p Preliminary
Source: Department of Statistics, Malaysia

Mineral exports recorded a robust growth of 43.2% in 2008, reflecting mainly higher prices and export volume of crude oil, particularly in the first half-year. Higher price of LNG as well as the continued demand by Korea and Japan mitigated the moderate growth of crude oil exports in the second half-year.

Gross imports increased by 3.3% (2007: 5%) due mainly to higher imports of inputs for manufactured exports and consumption goods. Imports of **intermediate goods**, which account for 72.7% of gross imports, expanded by 5.7%. Strong demand by resource-based industries led to an increase in imports of fuel and lubricants as well as chemicals. Consistent with strong domestic consumption, imports of food and beverages for industry expanded. Increased activity in the construction sector, underpinned the imports of industrial supplies, particularly metals. In tandem with the lower global demand for E&E products, imports of parts and accessories of capital goods declined.

Imports of **capital goods** were broadly unchanged (2007: 7.2%), with imports of transportation equipment contracting. Excluding lumpy items, capital imports expanded by 4.3% in 2008. In the first half-year, capital imports expanded strongly by 9.6%, mainly for the oil and gas, manufacturing, and telecommunication sectors. Increased exploration and development activities in the oil and gas industry amidst high crude oil prices resulted in higher imports of construction and mining equipment. In the manufacturing sector, higher imports of machinery were in tandem with continued expansion in capacity. Investments for upgrading in new technologies led to growth in imports of telecommunication equipment. Capital imports, however, declined in the second half of the year as the deterioration in the global economic conditions led to the postponement of capacity

Table 1.16
Imports by End-Use

	2007	2008*p*
	Annual change (%)	
Capital goods	**7.2**	**…**
Capital goods (except transport equipment)	5.6	2.2
Transport equipment	17.8	-13.6
Intermediate goods	**6.9**	**5.7**
Food and beverages, mainly for industry	21.0	30.0
Industrial supplies, n.e.s.	17.0	9.7
Fuel and lubricants	2.0	32.0
Parts and accessories of capital goods (except transport equipment)	0.4	-5.0
Consumption goods	**3.6**	**11.8**
Food and beverages, mainly for household consumption	6.8	21.4
Consumer goods, n.e.s.	1.8	5.5
Re-exports	**-22.4**	**-14.6**
Gross Imports	**5.0**	**3.3**

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

Source: Department of Statistics, Malaysia

Table 1.17
Direction of External Trade

	2008*p*				
	Exports		Imports		Trade balance
	RM billion	Annual change (%)	RM billion	Annual change (%)	RM billion
Total	**663.5**	**9.6**	**521.6**	**3.3**	**141.9**
of which:					
United States	**82.5**	**-12.7**	**56.5**	**3.2**	**26.1**
European Union (EU)	**74.9**	**-3.8**	**61.7**	**2.9**	**13.2**
Selected ASEAN countries[1]	**169.6**	**9.9**	**125.8**	**2.5**	**43.8**
Selected North East Asia countries	**133.6**	**10.9**	**129.9**	**-2.5**	**3.8**
The People's Republic of China	*63.2*	*19.2*	*66.9*	*3.0*	*-3.7*
Hong Kong SAR	*28.3*	*1.2*	*13.7*	*-6.9*	*14.7*
Chinese Taipei	*16.2*	*-1.4*	*25.1*	*-12.6*	*-8.9*
Korea	*25.9*	*12.4*	*24.2*	*-2.8*	*1.7*
West Asia	**26.1**	**38.0**	**25.1**	**44.4**	**1.0**
Japan	**71.8**	**30.0**	**65.1**	**-0.6**	**6.7**
India	**24.7**	**22.4**	**10.3**	**45.8**	**14.4**

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

expansion in the manufacturing, transportation, and oil and gas sectors.

Imports for **consumption goods** expanded by 11.8% in tandem with continued growth in private consumption. The growth in consumption imports reflected largely demand for imports of food and beverages. Imports of consumer goods, particularly clothing and footwear, household furnishing and medicines, were also higher.

In 2008, trade with major trading partners, namely the US, EU and Japan accounted for a lower share of Malaysia's total trade (34.8%; 2007: 36.7%). In contrast, trade links with North East Asia (excluding Japan), West Asia, India, Australia and New Zealand had strengthened substantially. Trade with North East Asia (excluding Japan) was underpinned by growth in exports of E&E components and commodities, particularly to PR China and Korea. Of significance, exports to West Asia, comprising mainly consumer electrical products, palm oil, jewellery and processed food, recorded a robust growth of 38%. Exports to India also registered a strong growth, supported largely by demand for crude petroleum, chemicals and chemical products, as well as palm oil. Exports to Australia and New Zealand consisted largely of crude oil and electrical products.

Trade with ASEAN countries remained robust, with total trade expanding by 6.6% in 2008, driven mainly by demand for energy, food and inputs for the manufacturing industry. Exports to the ASEAN countries increased by 9.9% and accounted for 25.6% of Malaysia's total exports. Exports to Indonesia and Philippines expanded strongly by 16.8% and 11.7% respectively, supported by exports of crude petroleum, chemicals and chemical products, as well as palm oil.

In 2008, the **services account** registered its second consecutive year of surplus of RM1.7 billion or 0.2% of GNI. This reflected a sustained large surplus from travel account and an improvement in other services deficit, which more than offset a higher deficit in the transportation account.

Despite greater competition in the tourism industry in the region and higher costs of travel, particularly in the first half of 2008, tourist arrivals increased to a record level of 22.1 million

Table 1.18
Services and Income Accounts

	2007	2008e		
	RM billion			
	Net	+	-	Net
Services Account	**2.4**	**102.2**	**100.5**	**1.7**
% of GNI	*0.4*			*0.2*
Transportation	-13.2	23.0	37.6	-14.6
Travel	29.1	50.7	22.5	28.2
Other services	-13.2	28.3	39.6	-11.3
Government transactions n.i.e.	-0.4	0.1	0.7	-0.6
Income Account	**-13.9**	**39.1**	**64.5**	**-25.4**
% of GNI	*-2.2*			*-3.6*
Compensation of employees	-0.6	4.4	5.2	-0.7
Investment income	-13.3	34.7	59.4	-24.7

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

visitors in 2008. While tourist arrivals continued to be largely from the region, particularly ASEAN, PR China, Japan and India, long-haul tourists from the Western and Northern Europe have also increased. Extension of the Visit Malaysia Year 2007 campaign until August 2008 and concerted promotional efforts to diversify from traditional markets led to higher tourist arrivals. Promotion was aimed at new and emerging niche segments such as homestay, student travel, wellness tourism and eco-tourism. Increased air service connectivity, particularly by low cost carriers, facilitated travel in the region.

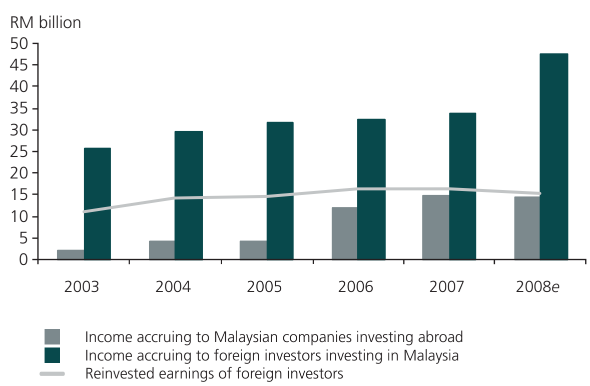
The other services account recorded a lower deficit of RM11.3 billion, stemming mainly from lower net outflows for royalties and licence fees, construction and communication services, as well as improvement in net inflows from IT services. During the year, the lower net outflows for royalties and licence fees reflected sustained payments for acquisition and usage of intellectual property rights which was offset partially by higher receipts due to royalties from oil exploration projects. Meanwhile, net outflows for construction services declined, following lower demand for imported construction services, and in line with the downsizing of deep sea oil and gas exploration projects amidst higher cost of building materials. The improvement in receipts from IT services was attributed mainly to shared services and outsourcing activities in Malaysia. Lower reliance on services and facilities provided by foreign telecommunication operators, following continuous capacity expansion in domestic broadband networks, led to a smaller deficit in communication services. Payments for professional services were larger due mainly to imports of project consultancy services by the oil and gas sector, and construction sub-sector.

The sustained surplus in the travel account and improvement in the other services account were partially offset by a higher deficit in the transportation account of RM14.6 billion. The larger deficit in transportation account was due to lower earnings from passenger fares while payments for freight charges increased following higher fuel prices.

Chart 1.24
Tourist Arrivals and Tourism Receipts

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

Chart 1.25
Direct Investment Income



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

The **income account** deficit widened to RM25.4 billion or 3.6% of GNI, reflecting mainly higher profits and dividends accruing to foreign direct investors in Malaysia. This was contributed by the strong performance of the manufacturing, oil and gas, and services sectors, particularly in the first half of 2008. Profits and dividends accruing to Malaysian companies investing abroad were sustained while returns on holdings of international reserves improved moderately, despite deterioration in the global economic and financial conditions in the second half-year. The bulk of the profits and dividends accruing to Malaysian companies were from investments in the oil and gas sector, and financial services sub-sector.

Financial Account

In 2008, the **financial account** recorded a larger net outflow of RM123.9 billion, due mainly to the reversal of portfolio funds which were received in 2007 and the early part of 2008. The large capital reversal, particularly in the second half of 2008, was due to the deleveraging activities by foreign financial institutions as the global financial crisis worsened. There was also higher direct investment abroad by Malaysian companies, in particular in the finance and insurance sub-sector following expansion of operations in the Asian region, as well as in the utilities sub-sector and oil and gas sector. Meanwhile, net inflows of foreign direct investment (FDI) moderated, particularly in the second half-year, following the deterioration in the global economic and financial conditions.

The larger net outflow in the financial account was due mainly to the reversal of portfolio funds which were received in 2007 and the early part of 2008

For the year as a whole, **portfolio investment** registered a large net outflow of RM92.4 billion, attributed mainly to the liquidation of portfolio investment due to deleveraging activities by foreign financial institutions following the deepening global financial crisis. In the first quarter, there was a net inflow of foreign portfolio funds amounting to RM21.1 billion, mainly for investment in the debt securities market which more than offset the net outflows from the equity market. The

Table 1.19
Balance of Payments: Financial Account

	2007	2008e
	RM billion	
Financial Account	**-37.7**	**-123.9**
Direct Investment	**-9.1**	**-20.5**
Abroad	-38.2	-47.1
In Malaysia	29.1	26.7
Portfolio Investment	**18.4**	**-92.4**
Other Investment	**-46.9**	**-11.0**
Official sector[1]	-5.8	-2.7
Federal Government	*-2.3*	*-0.5*
NFPEs	*-3.5*	*-2.2*
Private sector	-41.1	-8.3

[1] Excludes bonds and notes raised abroad by the Federal Government and NFPEs
e Estimate
Note: Numbers may not necessarily add up due to rounding
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

subsequent intensification of the global financial crisis in the second and third quarters triggered wide scale global deleveraging activity. This resulted in a significant liquidation of portfolio investment from the Asia-Pacific markets, including Malaysia. The reversal of short-term capital flows, particularly in the third quarter was well absorbed with limited disruption to the domestic financial markets and the real sector of the economy. In the fourth quarter, net outflow of portfolio investment moderated as the global deleveraging activities, which peaked in October, subsided towards the end of the year.

Gross inflows of **FDI** increased to RM51 billion (or 7.1% of GNI) during the year. While strong inflows of FDI were recorded in the first half of 2008, the deterioration in the global economic and financial conditions moderated FDI inflows in the second half of the year. FDI continued to be broad-based, and channeled largely into the manufacturing (45% share), services (27%) and oil and gas (26%) sectors. After taking into account the adjustments for outflows due largely to loan repayments to parent companies, net inflows of FDI moderated to RM26.7 billion or 3.7% of GNI (2007: RM29.1 billion).

In the *manufacturing sector*, inflows of FDI in the first half-year increased and were funded mainly by retained earnings as well as new inflows of equity capital. The bulk of FDI was channeled into the E&E industry, undertaken largely by existing companies for the purpose of upgrading of equipment and

External Resilience: An International Balance Sheet Perspective

Introduction

One of the key strengths of Malaysia's economy lies in its strong external position. Despite the on-going global financial turmoil and the consequent deleveraging activities which had caused an outflow of capital from emerging economies, the external position of Malaysia remains resilient. This is reflected in a sustained sizeable current account surplus, a relatively low level of external debt and a high level of international reserves.

Assessment from the international balance sheet perspective

In addition to the traditional flow-based analysis of the balance of payments, the strength of the external sector could be analysed from the international balance sheet perspective. The international balance sheet is generally represented by the international investment position (IIP), which measures the stocks of the external financial assets and liabilities of a country. Analysis of the size and composition of the IIP facilitates identification of possible sources of vulnerability in the country's external financial position in the event of a shock.

During the period 2001-2008, Malaysia's external position has improved substantially (Chart 1). The net IIP of Malaysia strengthened from a large net liabilities position of RM137.6 billion as at end-2001 to a small net liabilities position of RM18.2 billion as at end-2007. This position improved further to a net assets position of RM138.3 billion as at end-2008. The improvement in the external position was due to faster accumulation of external financial assets relative to the build up in the external financial liabilities.

Since 2001, the **total external financial assets** of Malaysia more than tripled to RM778.4 billion as at end-2008 (Chart 2). The large increase was due mainly to:

i. the higher direct investment abroad by Malaysians, at RM240.3 billion (or 32.4% of GDP) and accounted for 30.9% of the total external financial assets as at end-2008, reflecting the diversification and expansion of Malaysian companies abroad. These investments have yielded positive results as shown by the rising profits and dividends accruing to the Malaysian companies from their operations abroad (2008: +RM14.4 billion; 2001: -RM0.2 billion); and

ii. the large build up in international reserves to RM317.4 billion as at end-2008, which accounted for 40.8% of the total external financial assets. The accumulation of reserves since 2001 was attributed largely to the favourable current account surplus and steady inflows of foreign direct investment (FDI). The increase in reserves was also contributed by large inflows of portfolio funds, particularly in 2007 and early part of 2008. Nevertheless, these inflows were subsequently reversed in the second half of 2008 due to the deleveraging activities following the intensification of the global financial turmoil.

Chart 1
Net International Investment Position (IIP)

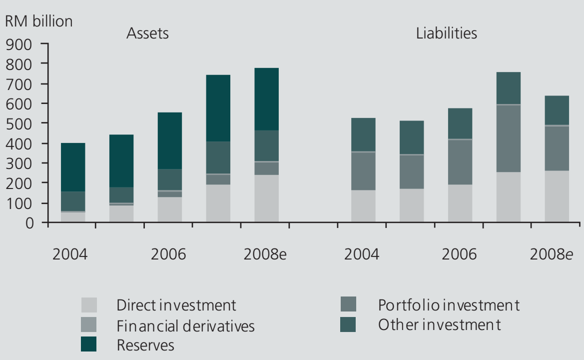
e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Meanwhile, the **total external financial liabilities** almost doubled during the period 2001-2008, to RM640.1 billion as at end-2008. The increase reflected mainly inflow of long-term capital as well as foreign investment in the domestic capital market. During this period, Malaysia received a net inflow of FDI at an average of 3.1% of GDP, and the stock of FDI increased from RM129.1 billion to RM262 billion (or 35.4% of GDP) as at end-2008, reflecting Malaysia as an attractive destination for FDI. The external debt of the economy continues to be low, at 31.8% of GDP as at end-2008, with the debt profile remaining skewed towards a longer maturity structure. Following the recent large reversal of capital flows, a significant proportion of the remaining foreign investment in the domestic capital markets reflect the strategic long-term holdings by foreign investors.

The assessment of the external position indicates limited risks arising from maturity, currency and capital structure mismatches.

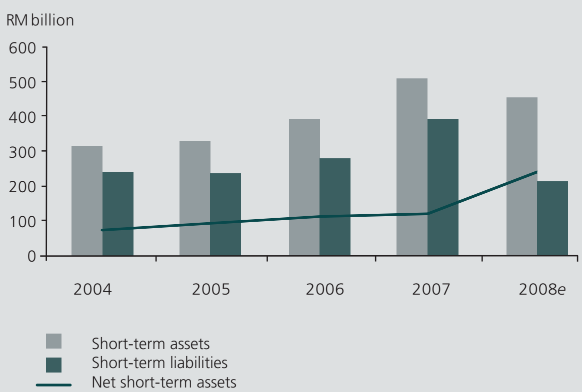
- The sustained net short-term assets position indicates minimum risks of maturity mismatch (Chart 3). The larger short-term assets relative to liabilities demonstrates the strong ability of the economy to service its maturing short-term external obligations, and thus, is unlikely to face liquidity constraints.
- The total foreign currency assets of the economy far outweigh the total foreign currency liabilities (Chart 4). This indicates a low risk of currency mismatch, and therefore, reduced vulnerability to exchange rate shocks.
- From the capital structure perspective, external financing in the form of debt is smaller than that of equity (Chart 5). The increase in the debt-to-equity ratio in 2008 was due mainly to large liquidation of non-strategic equity holdings by foreign investors following the global deleveraging activities in the second half of 2008. The relatively higher external financing through equity reduces solvency risk as equity obligations, in the form of profits and dividends, are not mandatory. In contrast, debt obligations, in terms of the debt servicing and repayment schedule, remain generally unchanged even under adverse economic conditions.

Chart 2
International Investment Position by Broad Components



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

Chart 3
Short-term Assets and Liabilities



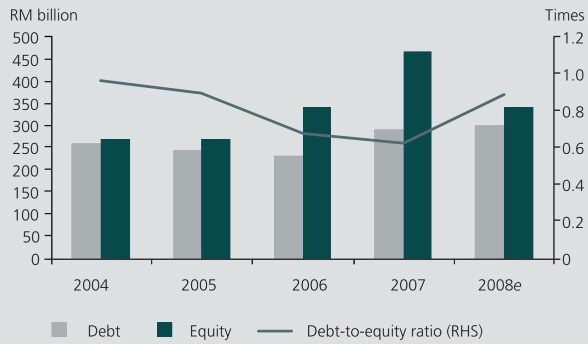
e Estimate
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 4
Foreign-currency Assets and Liabilities

e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 5
Capital Structure of External Liabilities



e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Role of policy in strengthening the external position

The increasing resilience of Malaysia's external sector could be attributed to the policies and strategies adopted, in particular, the further liberalisation of the capital account. The liberalisation has been undertaken on a gradual and sequential basis, taking into consideration the state of the domestic economy, the level of development of the domestic financial system, the strength of the balance of payments position and global developments. Prudential rules are in place to ensure sound external debt management, particularly to reduce risks associated with large external obligations, servicing ability and uncovered positions. While the business and investment climate is continuously being improved to attract FDIs, local companies are also encouraged to invest abroad to expand business opportunities available in the regional and international markets, establish market presence globally and provide greater synergy to domestic businesses. With the increase in international reserves and complexity of asset classes and instruments amidst the challenging operating environment, the reserves management strategy and practices have progressively been enhanced to improve risk adjusted returns while maintaining the traditional objectives of capital and liquidity preservation.

Conclusion

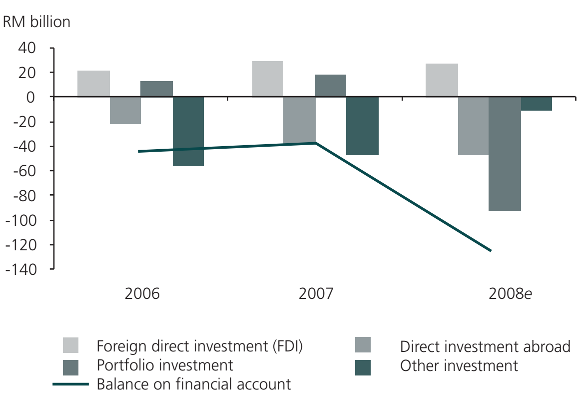
The strong external position is one of the key strengths of Malaysia's economy, particularly during this period of heightened uncertainty in global financial and economic conditions. It is recognised that the openness of the Malaysian economy renders the country more susceptible to vulnerabilities arising from external developments. Thus, it is important to ensure that appropriate policy measures are taken continuously to further enhance the resilience of the external position. In addition, close surveillance and monitoring of global economic and financial conditions as well as strong co-operation and regular engagement with the regional economies are critical for early detection of risks and vulnerabilities in the external position.

technology as well as establishing new product lines. There were also sizeable inflows of FDI into the niche and higher value-added activities, particularly in the production of solar cells, modules and panels as well as testing and measurement instruments. However, as the global economic downturn intensified in the later part of 2008, the amount of earnings retained for reinvestment declined significantly, as a greater focus was accorded on capital preservation due to liquidity constraints faced by their parent companies.

During the year, FDI in the *services sector* was channeled mainly into the finance and insurance sub-sector, followed by the communication, and real estate and business services sub-sectors. FDI inflows into the finance and insurance sub-sector was reflected in the sizeable acquistion of interests in two domestic banking institutions by foreign banks as well as the commencement of operations by a new foreign takaful company. In the communication sub-sector, the FDI inflows reflected mainly the participation of two foreign companies in a newly established mobile operator. Meanwhile, there was continued investment in the real estate and business services sub-sectors, as evidenced by the establishment of 36 new wholly foreign-owned shared services and outsourcing (SSO) companies with Multimedia Super Corridor (MSC) status during the year.

Investment in the *oil and gas sector* was supported by strong crude oil prices and firm global demand in the first half of the year. The investments, ranging from exploration and extraction operations to production and development

Chart 1.26
Financial Account



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

activities, were mostly undertaken by MNCs in joint venture with PETRONAS through production sharing contracts.

Net **direct investment abroad** by Malaysian companies increased to RM47.1 billion in 2008. Overseas investments were led by companies in the *services sector*, mainly in the finance and insurance, communication, and electricity, gas and water sub-sectors. These investments were effected largely through the acquisition of interests or expanding participation in existing operations abroad, particularly in the finance and insurance sub-sector following expansion in activities in the Asian region. In the communication sub-sector, the national telecommunication company has strengthened its presence in India by merging two of its strategically-owned mobile operators. The investment in the electricity, gas and water sub-sector reflected mainly the expansion of activities by a domestic utility company abroad.

Investment abroad in *oil and gas sector* remained significant as PETRONAS continued to conduct exploration, extraction and downstream processing activities in Africa, Central Asia and Vietnam. Meanwhile, investment in the *manufacturing sector* reflected mainly the acquisition of two process equipment manufacturers in Germany and Belgium to acquire new technology and gain a foothold in the European market. There were also some investments in the E&E and cement industries overseas.

The **other investment** account recorded a lower net outflow of RM11 billion, attributed to both lower net external debt repayment by the official sector and net outflows by the private sector. The lower external debt repayment by the **official sector** reflected normal scheduled repayment of term loans by both the Federal Government and NFPEs. Meanwhile, the other investment by the **private sector**, which comprises mainly of banking sector's borrowing and lending as well as placement and withdrawal of deposits, and transactions between the non-bank private sector and unrelated counterparties, recorded a significantly lower net outflow. The improvement was due largely to liquidation of short-term assets placed abroad, resulting in a reversal of the banking sector position to register a net inflow during the year. These inflows were more than offset by higher outflow by the non-bank private sector, due mainly to higher extension of trade credits by Malaysian exporters as well as larger repayment of trade credits by Malaysian importers.

External Debt

The global credit crisis and the deterioration of the global financial landscape in 2008 demonstrate the importance of prudent and pragmatic external debt management. During the year, Malaysia continued to adopt a prudent external debt management strategy, while ensuring that the ability of the private sector to borrow from foreign sources to meet their financing requirements is not impinged. In this regard, the rules on foreign currency borrowing were further liberalised to allow resident corporations to source foreign currency borrowing within the same corporate group, onshore and offshore, without restrictions. This is in line with the overall objective of the Bank of creating a facilitative business environment that enhances the competitiveness of the economy. In addition, the external debt management strategies are also important in safeguarding monetary and financial stability. A comprehensive and robust surveillance and debt monitoring system enabled early detection of possible risks arising from the country's overall external debt exposure of both the public and private sectors.

Table 1.20
Outstanding External Debt

	2007[2]	2008*p*	2007[2]	2008*p*
	RM billion	RM billion	USD billion	USD billion
Total debt	**211.2**	**235.6**	**63.1**	**67.2**
Medium- and long-term	134.0	155.6	40.0	44.4
Short-term[1]	77.2	80.0	23.1	22.8
As % of total debt	*36.6*	*34.0*	*36.6*	*34.0*
As % of net international reserves	*23.0*	*25.2*	*23.0*	*25.2*
As % of GNI				
Total debt	33.6	32.9		
Medium- and long-term debt	21.3	21.8		
As % of exports of goods and services				
Total debt	29.9	30.7		
Medium- and long-term debt	18.9	20.3		
Debt service ratio (%)	**3.8**	**2.7**		

1 Excludes currency and deposits held by non-residents with resident banking institutions
2 End-2007 data has been adjusted to be in line with the redefined external debt data of Malaysia, except for the debt service ratio
p Preliminary

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Malaysia's external debt remained low at RM235.6 billion or 32.9% of GNI

To facilitate a strengthened risk assessment for the economy as well as to be consistent with the international standards and best practices on the treatment of offshore entities in external data compilation, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (IBFC) as residents with effect from the beginning of 2008. Under this new definition, debt exposure of these offshore entities vis-à-vis the rest of the world is included in Malaysia's external debt while debt exposure of residents with offshore entities in Labuan IBFC is excluded. The shift to the new definition in the compilation of external debt has resulted in a higher level of external debt (end-2007: RM211.2 billion; old definition: RM187.4 billion). This was attributed mainly to the debt exposure of offshore financial entities in Labuan IBFC, arising from their inter-bank borrowings.

As at end-2008, Malaysia's total external debt remained low at RM235.6 billion (or USD67.2 billion), or equivalent to 32.9% of GNI. During the year, the **medium- and long-term external debt** increased, reflecting mainly higher external debt by both the non-financial public enterprises (NFPEs) and non-bank private sector. The depreciation of the ringgit against the US dollar and Japanese yen also contributed to the increase in the external debt. The higher external debt by the **NFPEs** was due mainly to loan drawdown by companies in the finance and insurance sub-sector, particularly to finance capital expenditure, as well as the electricity, gas and water sub-sector for capacity expansion. Meanwhile, repayment of external debt, comprising mainly repayment and prepayment of term loans, was lower. During the year, the **Federal Government** sourced its funding requirements mainly from the noninflationary domestic sources. For the fifth consecutive year, no market loan was raised from the international capital market. The drawdown of external loan was entirely from project loans committed earlier from official bilateral sources and multilateral development banks.

In 2008, the **private sector** registered another net drawdown of external debt, amounting to RM9.8 billion. The loan drawdown was effected mainly by companies in the services sector, particularly the finance and insurance and communication sub-sectors, as well as agriculture and manufacturing sectors, largely to finance capital expenditure. Meanwhile, the repayment was attributed largely to companies in the manufacturing and oil and gas sectors as well as communication sub-sector. The private sector debt accounted for about half of the total medium- and long-term debt, and about two third of these debt are inter-company loans that have flexible terms and concessionary interest rate.

During the year, the **short-term external debt** outstanding increased marginally to RM80 billion, attributed primarily to the inter-bank borrowings arising from treasury operations. The short-term external debt accounted for only 11.2% of GNI, 25.2% of international reserves and 10.4% of exports of goods and services. The bulk of the short-term debt was held by the banking sector (90.2%). Meanwhile, short-term external debt of the non-bank private sector, comprising mainly of revolving credits and overdraft facilities, remained low.

Table 1.21
Net International Reserves

	As at end			Change
	2006	2007	2008	2008
	RM million			
SDR holdings	756.9	760.9	786.4	25.5
IMF reserve position	793.4	617.5	1,127.1	509.6
Gold and foreign exchange[1]	288,871.2	334,338.6	315,554.3	-18,784.3
Gross International Reserves	**290,421.5**	**335,717.0**	**317,467.7**	**-18,249.3**
Less Bank Negara Malaysia external liabilities	22.9	22.2	22.5	0.3
Net International Reserves	**290,398.6**	**335,694.8**	**317,445.3**	**-18,249.5**
USD million equivalent	**82,450.8**	**101,338.1**	**91,529.5**	**-9,808.6**
Months of retained imports	7.8	8.4	7.6	
Reserves/Short-term external debt[2] (times)	6.9	6.2	4.0	

[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

International Reserves

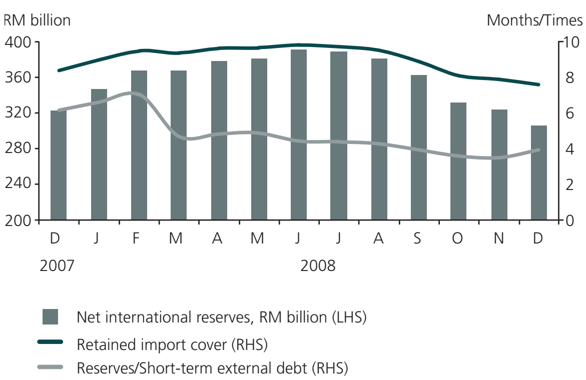
The international reserves held by Bank Negara Malaysia consist of gold and foreign exchange holdings, the reserve position with the IMF and holdings of Special Drawing Rights (SDR). In 2008, the net international reserves moderated by RM18.2 billion to RM317.4 billion (equivalent to USD91.5 billion) as at 31 December 2008.

During the year, the movement in the international reserves was characterised by two distinct periods. In the first six months of the year, the reserves increased by RM75.2 billion to RM410.9 billion (equivalent to USD125.8 billion) as at end-June, due mainly to higher repatriation of export earnings supported by strong commodity exports, and significantly larger inflows of portfolio capital as well as foreign direct investment. However, the reversal of the portfolio capital flows due to the deleveraging activities by international foreign financial institutions following the deepening of the global financial crisis led to a decline in reserves in the second half of the year to RM317.4 billion (equivalent to USD91.5 billion) as at end-December 2008. The high level of reserves has acted as a sound buffer during such periods of large reversals in short-term flows, without undermining the functioning of domestic financial markets and the financing of real sector of the economy. The increased payments for imports of goods and services, larger repatriation of profits and dividends accruing to foreign companies operating in Malaysia as well as higher overseas investment by Malaysian companies also contributed to the outflows. Meanwhile, the cumulative foreign exchange revaluation loss amounting to RM5.8 billion reflected the strengthening of the ringgit against a number of the major currencies, particularly in the first and fourth quarters of 2008.

The tumultuous period for international financial markets in the second half of 2008 heightened the challenge in the management of the reserves. As the global financial turmoil gathered momentum, volatility rose sharply while liquidity evaporated in many of the non-sovereign bond markets. Many large global financial institutions were also under severe stress from sharply rising costs of borrowings in the interbank market, credit ratings downgrades and a general loss of confidence in counter-party risks and in the financial markets of a broad range of instruments. Furthermore, the turmoil also led to significant outflows from the regional markets, including Malaysia. In dealing with these events, the Bank's reserve management strategy was adapted accordingly. During the second half of 2008, increasing emphasis was placed on sovereign or sovereign risk related investments and maintaining sufficient liquidity to meet the outflows as well as ensuring orderly market conditions. Reserve diversification was also reviewed as the correlations between markets increased sharply during the crisis. Oversight and risk management practices were also enhanced, particularly during the heightened volatility period of October.

Malaysia remains 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 2008 reflected mainly net purchases of currencies by various member countries under the Financial Transactions Plan. Meanwhile, the increase in international reserves held in the form of **SDRs** was attributed mainly to the exchange revaluation gains on holding of SDR and receipt of remuneration arising from Malaysia's net creditor position with the IMF.

Chart 1.27
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

The international reserves remained high at RM315.9 billion as at 27 February 2009, adequate to finance 7.6 months of retained imports and cover 3.9 times of the short-term external debt

As at 27 February 2009, the reserves remained at a comfortably high level of RM315.9 billion (equivalent to USD91.1 billion), adequate to finance 7.6 months of retained imports and is 3.9 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 options-related activity in the foreign currency markets with regard to the ringgit.

LABOUR MARKET DEVELOPMENTS

The strong labour market conditions in 2007 continued into the first half of 2008 as reflected in the higher vacancies, lower retrenchments and continued gains in employment. Nevertheless, labour market conditions began to soften in the second half of the year as businesses turned cautious amidst rising cost pressures and declining external demand as a result of the deepening global financial and economic crisis.

Labour market conditions weakened towards the end of the year

Accordingly, for the year as a whole, the unemployment rate increased to 3.7% in 2008 (2007: 3.2%), as total employment expanded at a slower pace of 1.1% compared to the labour

Table 1.22
Selected Labour Market Indicators

	2004	2005	2006	2007	2008*e*
Employment[1] ('000 persons)	10,463.7	10,892.8	11,159.0	11,398.0	11,524.7
Annual change (%)	4.1	4.1	2.4	2.1	1.1
Labour force[1] ('000 persons)	10,846.0	11,290.5	11,544.5	11,775.1	11,967.5
Annual change (%)	4.0	4.1	2.2	2.0	1.6
Retrenchments	19,956	16,109	15,360	14,035	16,469*
Annual change (%)	-5.9	-19.3	-4.6	-8.6	17.3
Unemployment rate[1] (% of labour force)	3.5	3.5	3.3	3.2	3.7
Real labour productivity growth[2] (%)	2.5	1.2	3.3	4.1	3.5

1 Based on estimates by Economic Planning Unit
2 Based on estimates by Bank Negara Malaysia
* Excludes 7,564 retrenched workers from a company that was taken over, and rehired immediately by the new owner
e Estimate

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

force (1.6%). Meanwhile, labour cost increased at a slightly slower pace of 5.9% (2007: 6%), as employers' ability to increase wages was affected by the rising cost and softening economic activity towards the end of the year.

The slower economic activity, particularly in the manufacturing sector, was reflected in the rising number of **retrenchments**. In the first half of 2008, when domestic and external demand was strong, total retrenchments was only 5,218 persons (1H 2007: 8,382 persons). Nevertheless, the sharp deceleration in global demand towards the end-year affected businesses, especially in the export-oriented industries, and prompted companies to adopt various cost-cutting measures, including retrenchment. A total of 11,251[1] persons were retrenched in the second half-year, resulting in the total retrenchments in 2008 rising to 16,469 workers. Most of the retrenchments were in the manufacturing sector (67% share), in particular those involving the electronic and electrical (E&E) industries (29% share of total retrenchments), while the distributive trade, hotels and restaurants sub-sector accounted for another 12%.

Similarly, the demand for workers was also strong in the first half-year. Total **vacancies** increased by 35% during the January-June period, with higher number of vacancies across most sectors. Vacancies in the second half-year continued to increase, but at a slower pace (23%). To some extent, vacancies in the fourth quarter were supported by the active promotion of the employment portal of the Ministry of Human Resources. For the year as a whole, total vacancies increased by 28% to about 1.06 million positions (2007: 0.8 million positions), with the services and manufacturing sectors accounting for 33% and 31% share of total vacancies respectively.

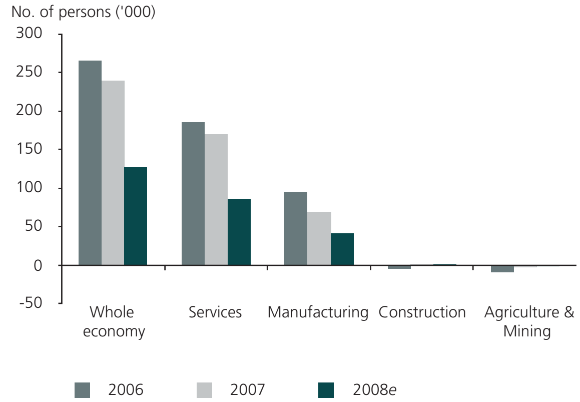
Despite the higher vacancies, many jobseekers found it difficult to secure jobs, as reflected by the decline in MIER Employment Index and Jobstreet Employee Confidence Index to 55.8 points and 47.3 points respectively (2007: 113.1 and 49.6 points, respectively). Apart from cost-cutting measures such as retrenchments, companies were increasingly more selective in their hiring activities. As a result, total **employment** grew at a slower rate in 2008 (1.1%; 2007: 2.1%), reflecting mainly the slower employment growth in the manufacturing and services sectors. The manufacturing sector, which is the second largest employer, had begun to reduce the number of workers since mid-year as a result of the deterioration in global demand which had affected both the E&E and domestic-oriented industries. Employment in the

1 Excludes 7,564 retrenched workers from a company that was taken over in the second half-year, and rehired immediately by the new owner

Chart 1.28
Output and Employment

e Estimate
Source: Economic Planning Unit
Department of Statistics, Malaysia

Chart 1.30
Additions to Employment by Sector

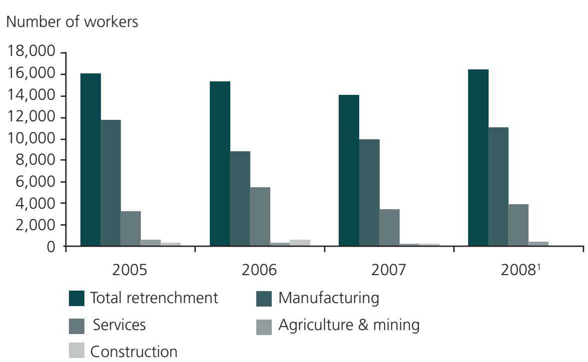


e Estimate
Source: Economic Planning Unit

services sector also grew at a slower pace, as some companies became more selective while others postponed their recruitment plans and trimmed headcounts as business conditions became progressively weaker during the course of the year. Meanwhile, employment in the construction sector was supported by higher activity in the sector. Employment growth in the agriculture sector continued on its long-term downward trend reflecting primarily workers' preference to be engaged in other sectors, while hiring in the mining sector was affected by the slower activity in the sector.

In 2008, total registered **foreign workers** (including foreign expatriates) in Malaysia increased by 0.9% to 2.10 million workers. Foreign workers accounted for 18% of total employment in Malaysia. The increase in migrant workers was at a slower pace of 0.9% to 2.06 million workers (2007: 9.4%) as companies reduced intake of new workers given the weakening economic conditions towards the end of the year. Foreign expatriates employed in the country increased marginally by 0.7% to 36,794.

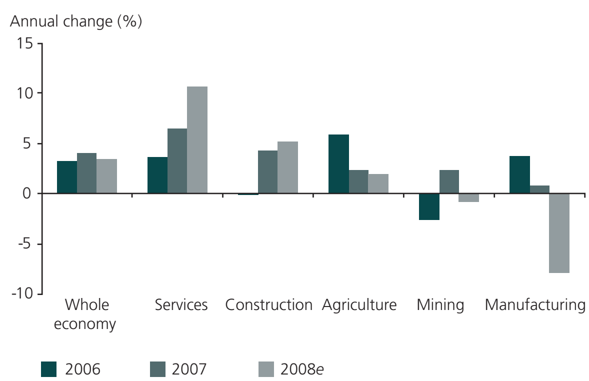
Chart 1.29
Retrenchment by Sectors



[1] Excludes 7,564 retrenched workers from a company that was taken over, and rehired immediately by the new owner

Source: Ministry of Human Resources

Chart 1.31
Labour Productivity Trends



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

Labour productivity, as measured by real value added per worker, grew at a slower pace of 3.5% (2007: 4.1%), due mainly to the deterioration in manufacturing productivity growth (-7.8%). Nevertheless, this was offset to some extent by improvements in the services productivity growth (10.7%). Gains in productivity were supported by the continued growth in capital investment, increased training and the participation of more educated workforce in the labour market. The increase in labour productivity continued to support increases in salary and wage growth. An issue of concern in the earlier part of the year was that rising inflationary pressure would lead to higher wage increases. Bank Negara Malaysia paid close attention to assess if second-round effects emerged, which would result in inflation being persistent. Nevertheless, evidence indicated no signs of excessive wage increases in response to the higher prices. In addition, competitive pressures also reduced the possibility of a wage-price spiral. The second-round effects became less of a concern as inflationary pressures diminished in the latter part of the year amidst weaker global economic conditions and a significant decline in commodity prices. According to the survey conducted by the Malaysian Employers Federations (MEF), average **salary** in the private sector increased by 5.9% in 2008 (2007: 6%), with executives receiving an average increment of 6.1%, while non-executives, a 5.7% increase (2007: 6.3% and 5.8% respectively).

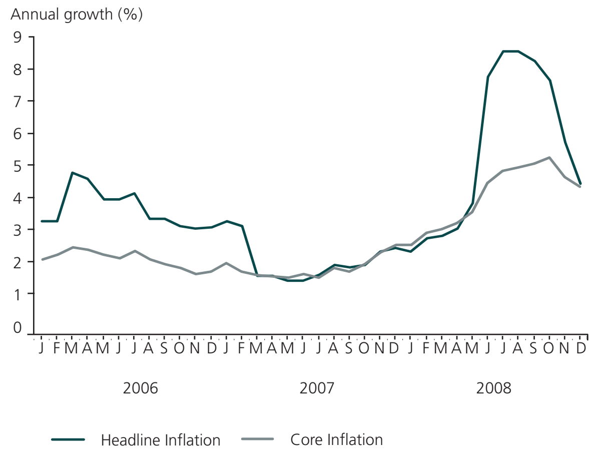
PRICE DEVELOPMENTS

Consumer Prices

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 5.4% in 2008 (2007: 2.0%). This is significantly higher than the country's long-term inflation average of 3.0%. Core inflation, which is a measure of demand-driven pressure on prices, also rose and averaged 4.0% in 2008 (2007: 1.8%).

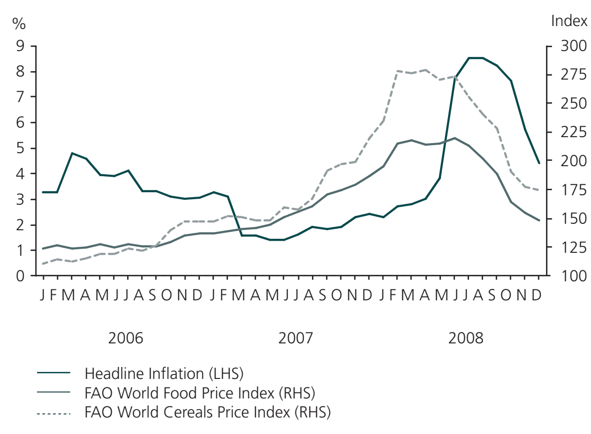
In the first five months of the year, headline inflation had continued its modest uptrend from 2007 as global food and fuel prices rose steadily due to supply-related factors. Most of the rise in inflation during the year, however, occurred in the third quarter when the inflation rate rose sharply following the 40.4% adjustment to retail fuel prices in June – which was the largest adjustment since 1990, as global fuel prices

Chart 1.32
Consumer Price Inflation



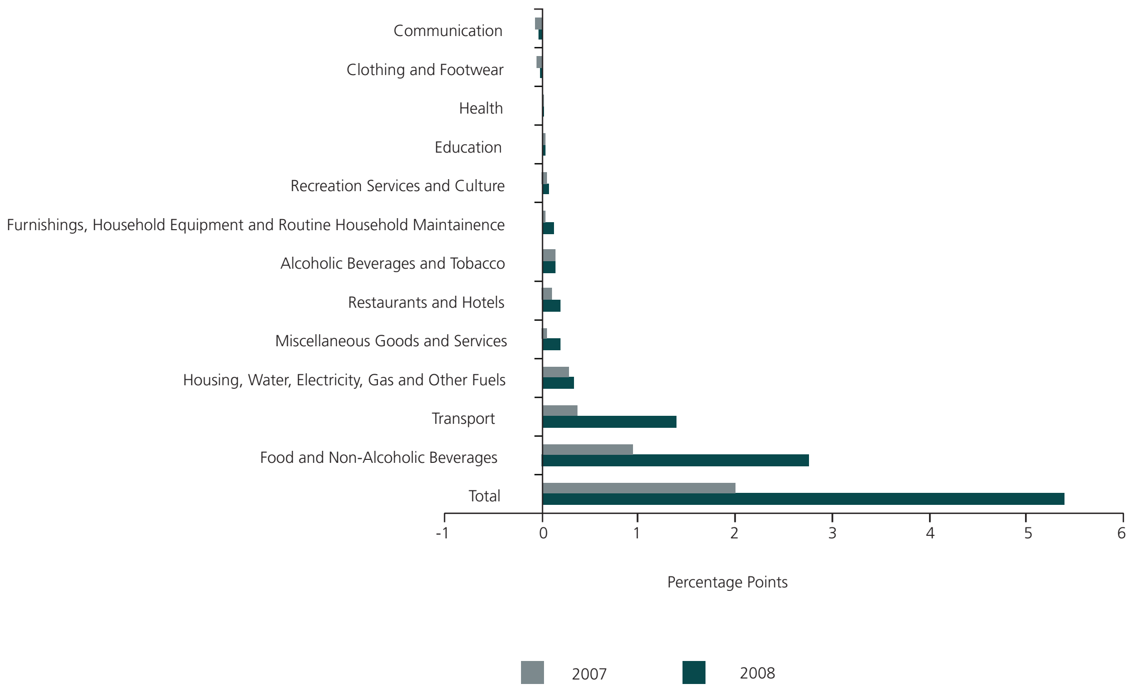
reached historical levels. The benchmark price of West Texas Intermediate (WTI) crude oil trading on the NYMEX rose to a new record level of USD147.27 per barrel on July 11, 2008. As a result, inflation peaked at 8.5% in July. However, the global financial turmoil and higher inflation had a negative impact on the real economy by dampening consumption and investment activities. The contraction in global demand combined with the unwinding of positions taken

Chart 1.33
Headline Inflation and World Food 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. The FAO Cereals Price Index consists of a weighted average of the International Grains Council (ICG) wheat price index and the average price of 16 different rice price quotations.

Chart 1.34
Contribution to Inflation



in the commodity markets led to a rapid decline of commodity prices and allowed domestic fuel and food prices to decline, with domestic inflation moderating to 4.4% by December.

By category, the main contributors to inflation in 2008 were the *food and non-alcoholic beverages* and *transport* categories which together comprised 79.7% of the overall rise in domestic prices during the year. Inflation in the *food and non-alcoholic beverages* category averaged 8.8% in 2008 (2007: 3.0%), and contributed 52.2% to overall inflation in 2008. The increase in food prices was universal, with all food sub-components recording a faster rate of price increase compared to the year before. As in the previous year, the increase in domestic food inflation was mainly due to higher global food prices, especially grain prices. On average, the domestic price of rice rose by 25.3% in 2008 as poor harvests caused supply shortages in major rice-exporting countries, and prompted major stockpiling activities to ensure food security. Overall, the extent of the pass-through from global prices to domestic food prices was moderated by the existence of Government price controls. For food items not subject to price controls, the increase in prices reflected the direct pass-through from higher production costs and global prices to consumers. The uptrend in domestic food prices began in August 2007 and rose to a peak of 12.3% in September 2008. Since then, food-price inflation has been on a moderating trend.

Inflation in the *transport* category averaged 8.8% in 2008 (2007: 2.3%), and contributed 25.9% to domestic inflation. Despite the surge in global fuel prices, inflation in the *transport* category remained relatively modest in the first half of the year as domestic retail fuel prices remained unchanged due to Government subsidies. However, the adjustment to domestic retail fuel prices in June by an average of 40.4% led to inflation in the *transport* category accelerating sharply to 19.6% (May 08: 0.9%). The impact on headline inflation was immediate, with headline inflation rising to 7.7% in June (May 08: 3.8%). Nevertheless, in line with the fall in global fuel prices, the Government revised retail fuel prices down seven times between August and December to end the year at fuel prices that were lower than their pre-June adjustment levels.

Other notable factors affecting headline inflation during the year were the rise in electricity tariffs by 19.4% in July 2008 and the imposition of a

Chart 1.35
Headline Inflation and Retail Petrol Price

Note: Retail petrol price refers to the price of RON 97

20% rise in excise duties on cigarettes in August. Consequently, prices in the *housing, water, electricity, gas and other fuels* category increased at a faster rate of 1.6% in 2008 (2007: 1.3%). Despite the increase in excise taxes on cigarettes, the *alcoholic beverages and tobacco* category still registered a lower inflation rate of 7.3% in 2008 (2007: 7.8%), due to the fact that the increase in excise duties in 2008 were lower than the increase in 2007. As with the previous years, the increase in overall prices was partly mitigated by the decline in prices in the *communication* and *clothing and footwear* categories. Prices in the communication category have been on a declining trend since 2005, while prices in the *clothing and footwear* category have been falling since 1999.

In view of the burden faced by the general public as a result of the sharp increase in food and energy prices in 2008, the Government introduced a number of measures focusing on ensuring an adequate supply of essential goods at affordable prices and on limiting the burden of higher costs on businesses, as well as on consumers, in particular, those in the lower-income groups. To mitigate the impact of high food prices, price controls were expanded to include other types of domestically-produced rice (previously only the Super Tempatan 15% rice was controlled), freeing the movement of paddy between states and initiating a price reduction campaign amongst major hypermarkets and retailers. To mitigate the effect of high fuel prices, the Government provided a targeted cash rebate for owners of vehicles below a certain engine capacity and raised the eligibility criteria for welfare assistance, from a monthly household income of RM400 to RM720 for Peninsula Malaysia, RM830 for Sarawak and RM960 for Sabah.

In addition, the Government also introduced a number of measures aimed at ensuring long-term food security. This included the stockpiling of essential food items such as palm-based cooking oil, allocating more land for agricultural purposes and allocating funds under Budget 2009 for improving the food distribution system. An investment of RM35 billion over 5 years was allocated under Budget 2009 for improving the existing public transportation system in the country.

Producer Prices

The effect of global commodity prices was most evident in the Producer Price Index (PPI). Producer price inflation, as measured by the PPI rose to 8.2% in 2008 (2007: 6.6%). In the first half of the year, PPI inflation escalated and peaked at 14.4% in June. Since then, PPI inflation has been on a rapid decline, mirroring the turnaround in global commodity prices. This development was especially evident in the commodities component of the PPI. For the first eight months of 2008, the commodities component of the PPI recorded high double-digit inflation rates, peaking at 42.5% in June before declining rapidly to -10.4% by the end of the year. For the year as a whole, inflation in the commodities component of the PPI averaged 25.8% (2007: 12.5%). Excluding commodities, PPI inflation declined to 1.9% in 2008 (2007: 4.6%).

In terms of composition, inflation in the local component of the PPI increased to 10.3% in 2008 (2007: 7.6%). This was primarily due to price increases in the *mineral, fuels, lubricants and related materials, chemicals and related products not elsewhere specified* and *manufactured goods classified chiefly by materials* categories. These price increases were attributable mainly to the high prices of petroleum, which then led to higher input costs for petroleum-derived products such as plastics, polymers, fertilizers and soap. Meanwhile, inflation in the imported component of the PPI moderated to 4.2% (2007: 4.8%). This was due to the smaller share of commodities in the imported component of the PPI – commodities made up only 7.2% in the imported component of the PPI compared with 26.8% in the local component of the PPI.

Development of Small and Medium Enterprises

A dynamic small and medium enterprise (SME) sector will contribute to development objectives, including towards more efficient allocation of resources, employment, the development of indigenous entrepreneurship, equitable growth and poverty eradication. The economic potential of the SME sector thus makes SME development an important Government agenda. During the year, further measures were taken to develop a strong and dynamic SME sector by strengthening the enabling infrastructure for SME development, building capacity and capabilities, and improving access to financing by SMEs.

Profile of SMEs

The Baseline Census of Establishments and Enterprises conducted in 2005 (Census 2005) provided important data on the profile and performance of SMEs to facilitate the formulation of effective policies and strategies to support SME development. Based on a large sample response of 552,804 business enterprises, SMEs formed 99.2% or 548,267 of the business establishments in Malaysia, of which almost 80% or about 435,300 were micro enterprises. The findings also revealed that 87% of SMEs were in the services sector, followed by 7.2% in the manufacturing sector and 6.2% in the agriculture sector.

Key Initiatives and Achievements for SME Development in 2008

Several key initiatives were implemented in 2008, reflecting the strong commitment towards SME development:

(i) SME Central Coordinating Agency - Assuming the Secretariat Function of National SME Development Council

In August 2004, the National SME Development Council[1] (Council) was set up as the highest policy-making body for SME development. The Council is chaired by the Prime Minister and BNM was the Secretariat. Its functions included coordinating and formulating SME policies across all sectors, as well as monitoring and evaluating the implementation and effectiveness of SME programmes by the Ministries and Agencies. The Secretariat also acts as a single point of reference for the Government and SMEs on information relating to the development of SMEs.

During its time as Secretariat to the Council, the following initiatives were implemented to support SME development:

(a) Improved policy formulation, monitoring and assessment

- Preparation of the SME Development Blueprint, an annual action plan and assessment of public sector programmes for the development of SMEs; and
- Establishment of macro targets for SME development 2006 – 2010.

(b) Strengthened capacity and capability building for SMEs

- Appointment of Pembangunan Sumber Manusia Berhad (PSMB) and establishment of the SME Marketing Committee to coordinate training and marketing efforts for SMEs; and
- Strengthened financial advisory services through the establishment of BNM's Laman Informasi Nasihat Khidmat, SME Bank Advisory Centre and financial advisory services provided by the commercial banks.

(c) Enhanced access to financing for SMEs

Strengthened financial service providers through:

- Establishment of SME Bank;
- Transformation of Credit Guarantee Corporation to expand credit guarantee facilities to assist SMEs in obtaining financing;

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[1] Consists of 15 Ministers, the Chief Secretary to the Government and three Heads of Agencies

- Transformation of Bank Pertanian Malaysia to enhance its capacity to lend to agriculture and agro-based industries;

Developed new financial products for SMEs:
- Rolled out microfinance for micro enterprises;
- Introduced new trade finance products;
- Launched RM300 million venture capital funds for agriculture businesses; and
- Introduced RM1 billion Overseas Project Financing facilities.

(d) Improved statistical information
- Developed standard SME definitions;
- Initiated the Census of Establishments and Enterprises 2005; and
- Established the National SME Database.

(e) Disseminated comprehensive information
- Published the SME Annual Reports on the status and performance of SMEs as well as key programmes on SME development;
- Establishment of SMEinfo portal to provide a one-stop information centre for SMEs; and
- Establishment of Human Resource Development (HRD) training portal to provide training information for SMEs.

In July 2008, the secretariat function held by Bank Negara Malaysia was successfully transferred to the Small and Medium Industries Development Corporation (SMIDEC), which will be transformed to become the new SME Corporation Malaysia, a dedicated Government agency to spearhead SME development in Malaysia. This dedicated Agency will coordinate SME policy formulation and programme implementation across all sectors and Government Agencies. The Agency will also serve as the central point of information, reference and advisory services for SMEs across all sectors and acts as the Secretariat to the National SME Development Council. SME Corporation Malaysia is targeted to be fully operationalised in 2009. This marks a turning point for the development of a more dynamic, competitive and resilient SME sector.

(ii) National SME Development Blueprint 2008

The National SME Development Blueprint 2008 which was endorsed by the Council on 2 June 2008, provided an assessment of the SME programmes implemented in 2007 and identified programmes that will be implemented in 2008.

In 2007, more than 286,000 SMEs were assisted through the implementation of 189 key programmes, involving a total expenditure of RM4.9 billion. SMEs assisted in 2007 include a total of 135,000 women entrepreneurs and students who benefited from entrepreneurship and technical training programmes, while more than 4,750 SMEs were provided with business premises and factories.

In 2008, 198 key programmes were targeted to be implemented with a financial commitment of RM3.2 billion to assist SMEs across all sectors, in the areas of infrastructure support, capacity building and in improving access to financing. The main focus of programmes in 2008 was towards promoting SMEs in the services and agriculture and agro-based sectors, in line with the strategies formulated in the Ninth Malaysia Plan (9MP) and Industrial Master Plan 3 (IMP3).

As part of the initiatives to address gaps in SME development programmes, focus group discussions were conducted with the trade associations and business chambers representing SMEs. Arising from the sessions conducted, feedback from SMEs were evaluated and SMEs' views and suggestions were highlighted to the relevant Ministries/Agencies to facilitate future planning and implementation.

The adoption of the SME Blueprint Management Framework by the Council in 2005 has shown benefits after only three years of implementation. The structured approach of the Blueprint has resulted in the strong commitment of Ministries and Agencies to implement focused SME development programmes as well as in meeting the targets set. Inter-Ministry/Agency collaboration and coordination remain the priority of the Blueprint to ensure effectiveness of programmes and greater outreach to SMEs.

(iii) SME Annual Report 2007

On 24 July 2008, the Council released the SME Annual Report 2007. The Report is an important initiative to disseminate information on the strategies and programmes that have been implemented by the Government to support the growth of the SME sector. The report also showcased success stories of several SMEs who have benefited from Government programmes.

Enhancing Access to Financing for SMEs

Comprehensive and Diversified Financing Landscape for SMEs

SMEs have 651,563 accounts[1] with financing value of RM138.9b as at end-2008

Banking Institutions
- **54** banks with **4,149** branches
- **RM124.8 billion** financing outstanding to **550, 716** SME accounts at end-2008
- 2008: **RM54.4 billion** financing approved to **117,524** SME accounts

Development Financial Institutions (DFIs)
- **6** DFIs with **682** branches
- **RM14.1 billion** financing outstanding to **100,847** SME accounts at end-2008
- 2008: **RM4.8 billion** financing approved to **31,220** SME accounts

Financing by Banking Institutions and Development Financial Institutions include:

5 Bank Negara Malaysia Special Funds
- Approved **RM18.1 billion** financing to **37,438** SME accounts
- **RM7.6 billion** outstanding at end-2008
- 2008: **RM2.1 billion** approved to **3,758** SME accounts

2 Financing Schemes with Guarantee Facilities
- August-December 2008: **RM1.1 billion** approved to **4,923** SME accounts

114 Goverment Funds and Schemes[2]
- Approved **RM100.3 billion** to **1.5 million** SME accounts at end-2008
- **RM9.7 billion** financing outstanding at end-2008
- 2008: **RM14.7 billion** approved to **267,929** SME accounts

Small Debt Resolution Scheme
- Since establishment, restructured NPLs of **627** SMEs amounting to **RM373 million**
- 2008: Restructured NPLs of **62** SMEs amounting to **RM49 million**

Credit Guarantee Corporation Malaysia Berhad
- Guaranteed **RM42.1 billion** financing to **384,033** SME accounts since 1972
- Outstanding guaranteed financing of **RM15.6 billion** to **94,354** SME accounts at end-2008
- 2008: Guaranteed **RM3.0 billion** financing to **10,368** SME accounts

Venture Capital (VC)[3]
- **56** VC companies
- Outstanding **RM1.9 billion** investment in **450** companies at end-2008
- 2008: **RM477 million** invested

Leasing and Factoring
- **RM1.8 billion** financing outstanding at end-2008
- 2008: **RM556 million** approved

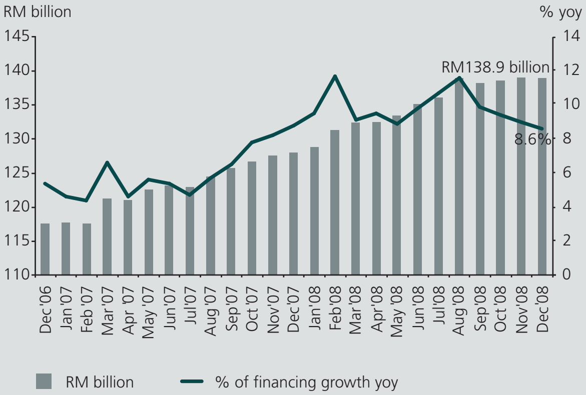
Note 1: Consist of accounts maintained with banking institutions and development financial institutions

Note 2: Only part of the Goverment's funds and schemes are disbursed through development financial institutions. Source from SMIDEC

Note 3: Source from Securities Commission

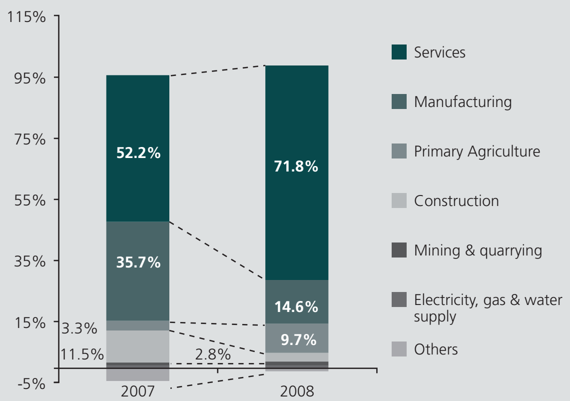
There are various sources of financing available for SMEs. These include financing from banking institutions, development financial institutions, leasing and factoring companies, as well as venture capital companies. In addition, many SME financing schemes have been set up by the Government. Banking institutions remain the largest source of financing for SMEs, accounting for 90% of the SME financing outstanding of the financial institutions[2] at end-2008.

SME Financing Outstanding of Financial Institutions

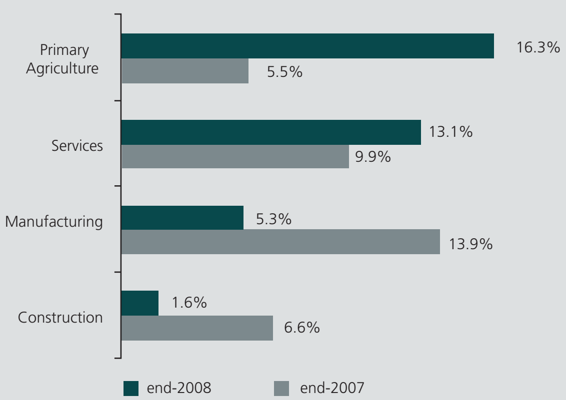


Financial institutions continued to support the financing needs of SMEs in 2008. Despite the challenging economic environment, SME financing outstanding of the financial institutions expanded by 8.6% to RM138.9 billion at end-2008 (end-2007: 8.8%; RM128 billion). Financing to SMEs accounted for 42.3% of total business financing of the financial institutions at end-2008 (end-2007: 44%).

Sector Contribution to the Increase in SME Financing Outstanding



Financing Outstanding by Major Sectors (%yoy change)



On a sectoral basis, the services sector continues to drive financing growth in 2008, contributing 72% to the total increase in the SME financing outstanding in 2008. The strength in the services and agriculture sectors offset the lower contribution from the manufacturing and construction sectors. Financing to the primary agriculture sector grew strongly in 2008, expanding by 16.3% (2007: 5.5%). Financing to the

2 Refers to banking institutions and development financial institutions (DFIs).

manufacturing and construction sectors moderated, reflecting the reduced demand for financing from these sectors.

Progress of Major Initiatives to Improve Access to Financing for SMEs
Efforts to enhance access to financing for SMEs continued to focus on four broad areas: (i) strengthening the financial infrastructure for SMEs; (ii) enhancing and developing financing incentives and schemes for SMEs; (iii) strengthening financial service providers; and (iv) strengthening the provision of advisory services for SMEs. The objective is to ensure that SMEs at various stages of growth are able to have adequate access to financing.

(i) Strengthening the Financial Infrastructure

(a) Development of a Vibrant and Sustainable Microfinance Industry
The findings of the Census 2005 indicated that about 80% of SMEs in Malaysia are micro enterprises, and that most relied on internal sources for financing. Recognising this, the Council in 2006 approved a comprehensive microfinance institutional framework, comprising banking institutions, development financial institutions and credit cooperatives, to develop a sustainable microfinance industry.

To create greater public awareness on the availability and benefits of microfinance, the national Pembiayaan Mikro (microfinance) logo was launched in September 2007. Participating financial institutions have displayed the logo and a microfinance client charter to signify commitment in providing easy, fast and convenient microfinance services. At end-2008, more than 1,500 microfinance access points are displaying the logo. Microfinance clients who obtained microfinance were also encouraged to display the logo at their business premises. Bank Negara Malaysia had also embarked on a microfinance television commercial initiative in November 2008. In addition, microfinance information flyers were distributed at various strategic locations.

As a result of the efforts to promote the growth of the microfinance industry, nine financial institutions are now offering microfinance products under the Pembiayaan Mikro (microfinance) scheme. These provide micro enterprises with access to micro financing for business activities. At end-2008, the amount of outstanding micro financing by the nine Pembiayaan Mikro financial institutions amounted to RM478 million (annual growth rate of 113%), benefiting 45,179 microfinance customers (annual growth rate of 98%).

(b) The SME Credit Bureau
The Census 2005 highlighted that among the main problems faced by SMEs to obtain financing was the lack of financial track records. To address these issues, an SME Credit Bureau was established through a strategic partnership between CGC and Dun and Bradstreet, a premier global provider of credit information on SMEs.

The Bureau, which commenced operations in July 2008, serves as a credit databank by providing financial institutions and trade creditors data on SMEs. This comprise data acquired from Suruhanjaya Syarikat Malaysia (SSM), the Central Credit Reference Information System (CCRIS), Dishonoured Cheque Information System (DCHEQS) and SME trade data. Through its operations, the Bureau will assist SMEs to build good credit track records and hence, credibility. This increases SMEs' prospects of obtaining financing from financial institutions. The Bureau also provides credit ratings for SMEs which will inculcate prudent and sound financial management practices amongst SMEs. The ratings will identify and highlight areas of weaknesses for SMEs to improve their operations. Financial institutions will also be able to have timely and efficient access to credit information on SMEs, leading to faster and accurate decisions on loan applications.

Within five months of operations, the Bureau has managed to secure membership from 37 financial institutions and nearly 18,000 SMEs with more than 3,400 reports generated during the period. The Bureau is currently operated by SME Credit Bureau (M) Sdn. Bhd and SMEs can register as members of the Bureau at www.smecreditbureau.com.my.

(c) The Small Debt Resolution Scheme (SDRS)

Bank Negara Malaysia had established the Small Debt Resolution Scheme in 2003 to facilitate the restructuring and rescheduling of non-performing loans (NPLs) and non-performing financing (NPFs) of SMEs with on-going businesses. As at end 2008, 808 applications with total NPLs/NPFs of RM563 million had been facilitated. Of these, 627 applications involving NPLs/NPFs of RM373 million were approved for either restructuring or rescheduling, while RM18 million in new financing were approved to 37 SMEs. Restructuring and rescheduling of NPLs/NPFs will continue to be an important aspect in supporting the viability and sustainability of financially distressed SMEs. To provide a wider coverage for debt resolution, Bank Negara Malaysia in January 2008 had expanded the range of participating financial institutions to include Bank Kerjasama Rakyat Malaysia Berhad, Bank Pertanian Malaysia Berhad and Export-Import Bank of Malaysia Berhad.

(ii) Enhancing and developing financing incentives and schemes for SMEs

Given that 99.2% of business establishments in Malaysia are SMEs, adequate access to financing is critical to enable SMEs to contribute to the economic development of the nation. Bank Negara Malaysia has developed several initiatives in the past year to address financing gaps and ensure that viable SMEs continue to have adequate access to financing. Among the initiatives taken are:

(a) The SME Assistance Facility and the SME Modernisation Facility

In August 2008, Bank Negara Malaysia introduced two financing facilities amounting to RM1.2 billion: the SME Assistance Facility and the SME Modernisation Facility. The SME Assistance Facility was established to assist viable SMEs that were facing temporary cashflow problems due to rising costs in the third quarter of 2008. Eligible SMEs would be able to enjoy interest rates as low as 4% per annum, thus providing SMEs with more flexibility in managing their finances during the challenging period. Likewise, the SME Modernisation Facility was established to incentivise SMEs to modernise their operations, in particular to purchase or upgrade machinery and equipment, including energy saving equipment, which would reduce operational costs in the long run. The performance and demand for the facilities have been encouraging. As at end 2008, 4,923 applications amounting to RM1.1 billion have been approved by the participating financial institutions.

(b) Micro Enterprise Fund (MEF)

In November 2008, Bank Negara Malaysia established a RM200 million Micro Enterprise Fund (MEF) to ensure viable micro enterprises have continuous access to financing during the current challenging business environment. The fund is accessible through the nine financial institutions participating in the Pembiayaan Mikro scheme. Participating financial institutions will determine the lending or financing rate to be charged and applications are subject to the normal credit approval process of the participating financial institutions. This fund is available for micro enterprises with viable businesses from 5 November 2008 to 31 December 2009. At end-2008, RM4.2 million were approved to 241 micro enterprises under the MEF. It is expected that many more micro enterprises will benefit from creation of this fund.

(c) SME Assistance Guarantee Scheme (SME AGS)
Bank Negara Malaysia established a RM2 billion SME Assistance Guarantee Scheme in January 2009, to ensure that viable SMEs adversely impacted by the current economic slowdown, continue to have adequate access to financing. With the guarantee cover, access to financing can be given at a lower cost to viable SMEs.

Eligible SMEs can obtain financing of up to RM500,000, and with tenures of up to five years. CGC will provide an 80% guarantee cover for financing approved under this Scheme. The guarantee cover will be provided free of charge and the cost of the guarantee will be fully borne by Bank Negara Malaysia. This Scheme is accessible at all commercial and Islamic banks, SME Bank, Agrobank, Bank Rakyat, EXIM Bank and Bank Simpanan Nasional. Participating financial institutions will determine the lending or financing rates and applications are subject to the normal credit approval process of the participating financial institutions. This Scheme is available from 3rd February 2009 till 31st December 2009, or when the financing limit of RM2 billion has been fully utilised.

(d) Rationalisation of Government SME Funds
To enhance the effectiveness of the 111 Government funds for SME, the National SME Development Council has agreed that the Economic Planning Unit (EPU) to conduct a study to analyse the effectiveness of the funds. Among the specific objectives of the study are to provide recommendations to rationalise the funds where appropriate; and to propose a new methodology and mechanism to channel Government funds for SMEs. The guiding principles of this process is to enhance the efficiency of the mechanism to channel financing to SMEs, while ensuring that SMEs eligible to obtain funding under the current mechanisms are not worse-off. In addition, lending to the SMEs by the Government should not be at the expense of good credit practice.

A special committee headed by the Director General of EPU and comprising representatives from the relevant Ministries and Agencies was established to oversee the study and present the recommendations to the Government.

(iii) Strengthening Financial Service Providers

(a) Transformation of Credit Guarantee Corporation (CGC)
To better serve the growth and development of competitive SMEs, CGC embarked on a transformation exercise in 2005. A three year plan was put in place to transform CGC from a traditional credit guarantee provider into a more effective and financially sustainable institution that can better serve the current and evolving needs of SMEs through the provision of a wider range of products and services.

In 2008, CGC focused on putting in place the necessary infrastructure to reduce its dependency on financial assistance from the Government and thus achieve financial sustainability. CGC has turned to the capital market to raise funds, introduced more dynamic investment strategies and enhanced loan quality management. CGC has also established a new business model that would be implemented in the second half of 2009.

Since its establishment in 1972, CGC has guaranteed more than RM40 billion worth of financing to more than 385,000 SMEs with insufficient collateral.

(b) Transformation of Bank Pertanian Malaysia
In 2008, Bank Pertanian Malaysia has been re-branded and renamed as Agrobank to widen its appeal to its core customer base. The corporatised Agrobank, now with a strengthened

capital position, has been operational since April 2008. With strengthened institutional and financial capabilities, Agrobank is positioned to be effective and instrumental in supporting and promoting the development of the agriculture and agro-based sector, by providing a broader range and more innovative financial and non-financial products and services to meet the financing and developmental needs of the sector. Agrobank is currently embarking on a series of enhancement measures to strengthen its capacity and capability, particularly in the areas of product development, risk management and information technology systems enhancement.

(iv) Strengthening the Provision of Financial Advisory Services

Initiatives have also been taken to ensure that a comprehensive financial advisory services infrastructure is in place to help SMEs. SMEs can utilise the various avenues made available to channel queries, complaints and seek assistance to rehabilitate problematic businesses. Bank Negara Malaysia provides these services through the following:

(a) BNMLINK

Bank Negara Malaysia's Laman Informasi Nasihat dan Khidmat (BNMLINK) continues to provide financial advisory services to the SMEs in the following areas:
- Information on various sources of financing available to SMEs;
- Assistance in facilitation of the loan application process; and
- Advice on SME financial requirements and problems.

As at end-2008, the number of enquiries and assistance sought by SMEs totaled 12,880 reflecting continued awareness among SMEs of the availability of such services in Bank Negara Malaysia. Of these, 83% were mainly enquiries on special funds provided by the Government and advice on loan matters, while the remaining were requests for assistance, mainly on loan restructuring and loan rejections.

(b) BNMTELELINK

To complement the walk-in counter services offered by BNMLINK, the BNMTELELINK, Bank Negara Malaysia's dedicated Contact Centre was launched in 2007. BNMTELELINK facilitates members of public including SMEs, to bring their queries and complaints to the Bank via telephone, or in writing via the fax, email or post. BNMTELELINK can be contacted at:

Tel.: 1300 88 5465
Fax: 03 – 2174 1515 / 03 – 2174 1616
Email: bnmtelelink@bnm.gov.my

In addition to the above services by Bank Negara Malaysia, financial advisory services are also being provided to SMEs by all commercial banks through the respective SME Units; the SME Bank through its Advisory Centre (SAC); and the Credit Guarantee Corporation Malaysia Berhad (CGC) through its Business Advisory Services Entity (BASE) panel consultants. The Association of Banks Malaysia (ABM) has also taken steps to enhance communications with business associations, chambers of commerce and members of the public to increase awareness on access to and management of financial products and services. ABM launched a toll-free service at 1300-88-9980 to receive queries and complaints on issues relating to the banking industry and general concerns about credit.