Chapter 1

# The Malaysian Economy

The foundations of the Malaysian economy continue to remain solid in 2008. While some moderation is expected following the strong growth in the early part of the year, private consumption and investment activities would continue to expand, reinforced by public spending activity. All economic sectors would continue to record positive growth.

## 1. The Malaysian Economy in 2007

In 2007, Malaysia's real gross domestic product (GDP) expanded by 6.3%, driven mainly by strong domestic demand despite a weaker external environment. The stronger growth achieved reflected the strengthening of macro -economic fundamentals of the country and benefits of a more diversified economic base. While the contribution of the manufacturing sector remains substantial, the services sector has become the main driver of growth for the year, supported by new growth areas and domestic demand activities.

Aggregate domestic demand recorded a robust growth of 9.8% driven mainly by the private sector activities. Private consumption increased at a faster pace of 10.8% in 2007. The rise in disposable income from stable employment conditions and high commodity prices contributed to the strength of consumer spending. These factors have benefited both the rural and urban households. During the year, the low interest rate environment and access to credit also provided support for households' spending. The household debt to financial assets ratio remained low, while the non-performing loans ratio for household loans declined.

**Real GDP by Expenditure (at 2000 prices)**

| | 2006 | 2007 |
|---|---|---|
| | Annual Change (%) | |
| Domestic demand[1] | 7.0 | 10.5 |
| Private sector expenditure | 7.0 | 11.8 |
| Consumption | 7.1 | 11.7 |
| Investment | 7.0 | 12.3 |
| Public sector expenditure | 6.8 | 7.2 |
| Consumption | 5.0 | 6.4 |
| Investment | 8.9 | 8.0 |
| Net Exports of goods and services | 0.1 | 0.9 |
| Exports | 7.4 | 3.7 |
| Imports | 8.6 | 4.1 |
| **Real Gross Domestic Product** | **5.9** | **6.3** |

[1]Excludes stocks
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Private investment recorded a high growth of 9.8%, spurred by strong capital spending in the following sectors:

- The manufacturing sector saw capital expenditure on new machinery and equipment, and was sustained due to high capacity utilisation levels;
- The services sector saw increased investments in the transportation and communications sub-sector, attributed mainly to the expansion of air transport facilities and the enhancement of the telecommunications network; and

- In the oil and gas sector, capital expenditure was driven by robust upstream activity and intensified exploration and production activities in deepwater oil fields.

Private investment received an additional boost from healthy corporate balance sheets due to favourable corporate earnings. This enabled companies to largely fund capital expenditure using internal sources, while continuing to benefit from competitive financing conditions.

The Government continued to play a strong role in supporting private sector activities. Public consumption grew by 6.6% due mainly to strong growth in emoluments and high expenditure on supplies and services for maintaining and improving the public delivery system. Public investment remained high at 9.3% with large expenditure channeled into projects to improve capabilities in the economic, social services sectors and to reduce rural-urban and regional disparities.

On the sectoral front, growth was broad based in 2007, reflecting expansion in all sectors of the economy. The services, construction and mining sectors showed strong performance during the year.

**Real GDP by Sector (at 2000 prices)**

| | 2006 | 2007 |
|---|---|---|
| | Annual Change (%) | |
| Agriculture | 5.2 | 2.2 |
| Mining & Quarrying | -0.4 | 3.2 |
| Manufacturing | 7.1 | 3.1 |
| Construction | -0.5 | 4.6 |
| Services | 7.2 | 9.7 |
| **Real Gross Domestic Product** | **5.9** | **6.3** |

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The services sector expanded by 9.7%, supported mainly by the real estate and business services; finance and insurance; communication; and wholesale and retail trade sub-sectors. There was also, contribution from new areas of growth in the business services segment, including telecommunications, Islamic finance, shared services and outsourcing and Information Technology (IT) services.

Value added in the manufacturing sector expanded by 3.1%, underpinned by growth in domestic-oriented and selected resource-based industries. The construction sector turned around to record a positive growth of 4.6% driven mainly by the civil engineering sub-sector. The mining sector also recorded positive growth of 3.3% due to higher output of oil and natural gas.

## Prices

The headline annual average inflation rate, as measured by the Consumer Price Index (CPI) increased to 2% in 2007. The main contributor to inflation was the price increase in the food and non-alcoholic beverages category. Domestic food prices were largely influenced by the higher global prices for food commodities which were underpinned by both structural and cyclical factors. Nonetheless, inflation expectations were broadly well-anchored throughout the year. The appreciation of the ringgit exchange rate during the year had also mitigated some inflationary pressures by reducing the cost of imports.

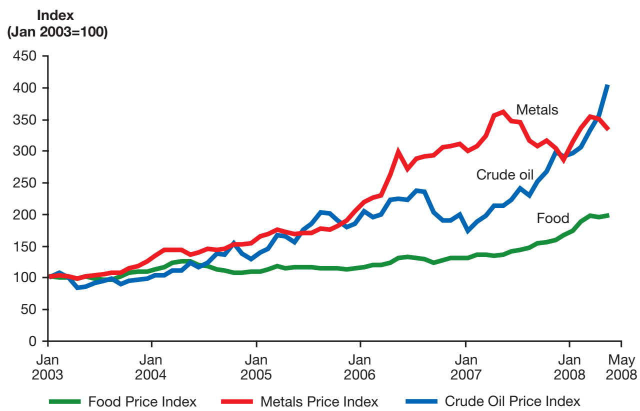
The impact of higher global commodity prices was more evident in the Producer Price Index (PPI), which increased by 6.7% in 2007. The commodities components of the PPI contributed significantly to the increase following higher world prices for commodities such as crude oil, rubber and crude palm oil.

**Inflation and Unemployment (%)**

| | 2006 | 2007 |
|---|---|---|
| | Annual Change (%) | |
| Inflation | | |
| Consumer Price Index (2005=100) | 3.6 | 2.0 |
| Core Consumer Price Index[1] | 2.1 | 1.8 |
| Producer Price Index (2000=100) | 5.1 | 6.7 |
| **Unemployment** | **3.3** | **3.3** |

[1]Excludes price-controlled items and price-volatile items as well as items are subject to one-off price adjustments
Source: Bank Negara Malaysia

**World Price Indices for Selected Commodities**




Source: International Monetary Fund (IMF)

## Employment

In 2007, the domestic labour market continued to strengthen as demand for workers rose during the year amidst faster economic growth.

- The unemployment rate remained low at 3.3% of labour force;
- Total employment expanded by 2.1%, outpacing the growth of the labour force;
- Total retrenchments continued on a downward trend which began in 2001, declining to 14,035 persons; and
- Vacancy trends also pointed to positive employment conditions, as reflected in the high number of active vacancies reported and active jobseekers registered via the Electronic Labour Exchange (ELX).

There were positive job creations for all key sectors, with the highest rates of employment growth in the services sector. Of significance, the construction sector expanded its workforce in tandem with the recovery in the sector. Nevertheless, the moderation in manufacturing activities led to slower hiring and smaller job gains.

The stronger expansion of economic activities and labour demand resulted in some wage pressures, with executives in the private sector receiving a higher salary increase (5.9%) compared to the non-executives (5.6%). The higher average salary increase reflected in part companies' policy in rewarding performance, and use of salary to attract and retain talent. The supply of talent, however, has not matched the pace of demand, resulting in skill shortages, which were felt more acutely in the area of experienced and professional workers. Demand for skilled workers has increased and is expected to remain high in the medium term.

Labour productivity, as measured by the real value added per worker, recorded a higher growth of 4.1%. Labour productivity growth was positive in all key sectors, the highest in the services sector, followed by the mining and construction sectors. In the manufacturing sector, labour productivity growth moderated due to weaker sales and output performance.

**Balance of Payments**

Malaysia's external position strengthened in 2007 due to a larger current account surplus, while net outflows in the financial accounts moderated.

- The current account recorded a larger surplus of RM100.4 billion, equivalent to 16% of Gross National Income (GNI), attributable to a large trade surplus and improvements in the services and income accounts;
- Gross exports grew at a moderate pace of 2.7% in 2007 as weak demand for manufactured exports was partially mitigated by strong growth in primary commodity exports;
- Exports of primary commodities, which have become an important source of foreign exchange earnings to the country, expanded by a double-digit rate for the fifth consecutive year due to higher global commodity prices;
- The growth in exports of manufactured goods was supported mainly by the favourable performance of selected resource-based industries;
- Gross imports expanded by 5%, reflecting mainly imports of inputs for manufactured goods and higher demand for consumer and capital spending;
- The services account recorded a surplus for the first time due mainly to higher tourism and transport receipts;
- The improvement in the income account deficit reflected higher profits and dividends accruing to Malaysian companies with overseas investments and higher returns from external reserves; and
- The financial account recorded a smaller net outflow of RM37.7 billion as net outflows of other investment moderated, while the large net direct investment abroad by Malaysian companies was partially offset by higher net inflows of foreign direct investment (FDI) and portfolio investment.

Gross FDI increased further to RM46.2 billion, supported mainly by higher inflows of equity capital to acquire interests in Malaysian companies. This development reflected the confidence of foreign investors in the Malaysian economy, and that the country remained as an attractive investment destination.

## 2. The Malaysian Economy in 2008

The Malaysian economy enters this more challenging period following several consecutive years of solid growth averaging 6% per annum. The economy continued to register a strong growth of 7.1% in the first quarter of 2008, led by expansion in both private and public consumption spending, while investment activities remained firm. Growth was further supported by a strong contribution from external demand, following stronger growth arising from commodities exports and demand from non-US markets.

*Going forward, economic expansion would continue despite a potentially more difficult environment with slower global economic growth and uncertainties in the international financial markets*

Going forward, economic expansion would continue despite a potentially more difficult environment with slower global economic growth and uncertainties in the international financial markets. A number of factors are expected to provide support for growth and enable the Malaysian economy to weather this environment. These include:

- The more diversified economic structure, with increased contribution to growth from the services, agriculture and commodities sectors and the resource-based and knowledge-driven industries;
- Malaysia's export markets and products are increasingly diversified;
- Malaysia, as a commodity producer, will continue to benefit from high prices of crude oil, palm oil and rubber;
- The strong base in the commodity sector further strengthened the linkages with downstream activities and resource-based industries which continue to benefit from demand from the regional economies; and
- The sound macroeconomic fundamentals.

While the strong growth momentum in 2007 was largely sustained in the early part of 2008, some moderation in growth is expected in the second half year following slower economic expansion in the global economy. While the restructuring of subsidies in June this year may result in some moderation in private consumption growth with a decline in discretionary spending, the stronger than expected performance of the commodities sector and increased government spending may partially offset this moderation. In addition, while private investment may also moderate in 2008 due to the rising costs of production, it is expected to remain strong. Key will be public sector expenditure, particularly public investment and the implementation of the projects announced for the year.

On the sectoral front, all sectors are expected to experience positive growth. The manufacturing sector would continue to benefit from strong demand for resource-based products from the regional countries. However, a number of sectors including the construction sector may be affected by the rising costs of production and weaker external demand particularly for electrical and electronics (E&E) products. Meanwhile, the agriculture and mining sectors are expected to register stronger growth in 2008, supported by higher output of palm oil, rubber and natural gas.

### Balance of Payments

The balance of payments position will remain strong in 2008. The current account surplus is projected to remain high reflecting the continued high trade balance in the goods account and surplus in the services account. Gross exports would be supported by the strong growth in commodity exports and resource-based manufactured goods due to higher international commodity prices, partly mitigating the weaker growth in electrical and electronic (E&E) exports. The services account is expected to record another year of surplus, attributed mainly to higher tourism receipts from the extension of the Visit Malaysia Year campaign which will run until end-August 2008. Inflows of foreign direct investment are expected to remain high, largely from retained earnings by existing Multinational Corporations (MNCs) operating in Malaysia and new inflows of equity capital. Investment abroad is expected to rise further, reflecting the sustained interest of Malaysian companies have in expanding and diversifying business operations abroad and position themselves as regional and global players.

### Prices

The recent increase in inflationary pressures is a global phenomenon, resulting from rising prices of energy and commodity prices. In Malaysia, domestic inflation increased to 3.8% in May 2008, due mainly to higher food prices. Based on Bank Negara Malaysia's preliminary assessment of the impact of the rationalisation of the domestic fuel and energy prices, inflation is expected to rise further in 2008 to average in the range of 4.0-5.0%. Of concern is the potential second-round impact of these prices increases and the extent to which they lead to more generalised price increases.

Since the current inflationary pressures are a global phenomenon, many of Malaysian trading partners and neighbours are having similar or higher inflation rates. Given this fact, the increase in inflation is unlikely to erode Malaysia's comparative advantages in global trade.

### Monetary Policy in 2008

In this uncertain environment, the focus of monetary policy in 2008 will be to sustain economic growth while keeping inflation under control. In formulating monetary policy, Bank Negara Malaysia will continue to be forward looking and will weigh the impact of new developments on growth and inflation. The Bank stands ready to adjust monetary policy in the event the outlook for growth or inflation changes and the nature of the problem warrants a change in monetary policy. Monetary policy is foremost a demand management tool. As such, other policy measures may be appropriate to mitigate cost-push price pressures emanating from rising global prices of food and commodities, in particular, if the problem is structural or caused by supply driven factors.

**Fiscal Policy in 2008**

The 2008 Budget outlined wide-ranging tax and non-tax measures to enhance the nation's competitiveness, strengthen human capital development and ensure the well-being of all Malaysians.

In enhancing the nation's competitiveness, a progressive tax regime and initiatives to strengthen the efficiency of the public service delivery systems were introduced. These include:

- The reduction in corporate income tax in two stages, to 26% for the 2008 assessment year and then to 25% in 2009;
- The introduction of a single-tier tax system, under which profits are only taxed at the company level and dividends received are exempted from tax;
- Tax incentives, income tax exemptions and tax deductions are provided to selected Islamic financial players to promote the Islamic financial sector and Malaysia as an international Islamic financial centre; and
- The establishment of a Special Taskforce to Facilitate Business (PEMUDAH) was established to formulate measures to improve public service delivery system.

Accordingly, fiscal policy in 2008 is focused on expediting the implementation of projects and programmes identified in the 9MP. In terms of development expenditure, special attention was given to both the economic and the social sectors in an effort to generate higher value-added economic growth, strengthen human capital development, and address socio-economic inequalities.

**Economic expansion to continue**

Uncertainties in the global economic environment remain, with the overall global growth is expected to moderate further going forward. In this environment, the Malaysian economy is expected to continue to expand, supported by continued domestic demand and reinforced by expanding intra-regional trade. The SME sector can continue to thrive by accelerating its re-invention and repositioning of business strategies to find new markets and avenues of growth. Reengineering of processes would also be required to better manage the higher costs of production. The key is for the SMEs to use their inherent flexibility and agility to create new products and reorient themselves to better reap the gains from these developments.