2010

ECONOMIC DEVELOPMENTS IN 2010

THE INTERNATIONAL ECONOMIC ENVIRONMENT

In 2010, the global economic recovery continued, albeit at an uneven pace, after exiting from the sharpest post-war economic contraction in the second half of 2009. The recovery accelerated in the first half of the year due to inventory restocking, continued policy support as well as the low base effect, but the momentum tapered off in the second half as these temporary factors waned. Global growth was led by strong economic activity in the emerging market economies, while the advanced economies continued to face crisis-induced and structural issues. Of significance, the emerging economies contributed more than two thirds of global growth in 2010.

The global economic recovery continued in 2010, led by the emerging market economies

In the advanced economies, recovery in the first half of the year was supported by factors such as the ongoing fiscal stimulus and inventory restocking. The pace of recovery, however, moderated towards the latter part of 2010. Domestic demand conditions in the advanced economies remained modest due to lingering effects of the financial crisis on private sector balance sheets. The escalation of sovereign debt crisis in the euro area and the announcements of impending fiscal austerity measures in several advanced economies weighed further on consumer and business sentiments in these countries. The emerging economies, notably in Asia, on the other hand, experienced a very strong recovery, particularly in the first half of the year. Growth in these economies was boosted by robust domestic demand activity, rapid expansion in intra-regional trade and to a certain extent, inventory restocking. After registering an exceptional growth performance in the first half of the year, most Asian economies continued to sustain a firm recovery in the second half, but at a more moderate pace, due to the slower improvement in external demand and the dissipating low base effect. The Asian economies also faced rising inflationary pressures towards the second half arising from increasing commodity prices, in particular food prices.

The divergence in the growth performance and the consequent differences in policy responses in the advanced and emerging economies had significant implications on global capital flows, asset prices and exchange rates during the year. In the advanced economies, authorities continued to pursue expansionary monetary policy by introducing further quantitative easing measures to stimulate economic growth. In contrast, many emerging economies have started to normalise their monetary policy in response to a better growth outlook and rising inflation. As a result of the widening interest rate and growth differentials, and the large injections of global liquidity from quantitative easing measures, capital flows into the emerging economies intensified. This exerted upward pressure on asset prices and exchange rates in these economies, prompting the monetary authorities to adopt wide-ranging measures to mitigate the impact of the capital flows on macroeconomic and financial stability.

International financial conditions were affected by periodic volatility associated with the sovereign debt crisis in the euro area, particularly in April, July and November. The escalation of government funding crisis in Greece in late April heightened the contagion risk to other euro area economies. In response, the EU-IMF extended a €110 billion bailout package to Greece on 2 May. To calm the financial markets, the EU-IMF also announced the creation of a €750 billion temporary financial saftey net which included the €440 billion European Financial Stability Facility on 9 May to assist euro area countries that were in economic difficulties. On the same day, the European Central Bank (ECB) announced several measures to purchase euro government bonds through its Securities Market Programme and to provide emergency liquidity to euro area banks. However, persistent concerns on the health of the banking sector in the euro area over the following months triggered a stress test by the ECB in July. Global financial markets came under pressure again in November following uncertainty over Ireland's ability to raise funds. This eventually led to an EU-IMF €85 billion bailout package for Ireland on 28 November aimed at restructuring the Irish banking system and safeguarding its fiscal position. Notwithstanding the episodic stress in the euro area financial markets, global financial markets continued to register favourable performance during the year. Most major and regional equity markets recorded positive double-digit growth for the second consecutive year, with emerging markets being buoyed by large capital inflows. In the global bond market, large corporate issuers were able to raise funds cheaply given the low long-term yields.

Table 1.1

World Economy: Key Economic Indicators

	Real GDP Growth (%)		Inflation (%)	
	2009	2010e	2009	2010e
World Growth	**-0.6**	**5.0**	**-**	**-**
World Trade	**-10.7**	**12.0**	**-**	**-**
Advanced Economies				
United States	-2.6	2.8	-0.4	1.6
Japan	-6.3	3.9	-1.4	-0.7
Euro area	-4.1	1.7	0.3	1.6
United Kingdom	-4.9	1.3	2.2	3.3
East Asia	**5.4**	**9.2**	**0.3**	**3.2**
Asian NIEs[1]	**-0.8**	**8.3**	**1.3**	**2.3**
Korea	0.2	6.1	2.8	2.9
Chinese Taipei	-1.9	10.8	-0.9	1.0
Singapore	-0.8	14.5	0.6	2.8
Hong Kong SAR[2]	-2.7	6.8	0.5	2.4
The People's Republic of China	**9.2**	**10.3**	**-0.7**	**3.3**
ASEAN-4	**1.1**	**6.9**	**2.3**	**3.8**
Malaysia	-1.7	7.2	0.6	1.7
Thailand	-2.3	7.8	-0.9	3.3
Indonesia	4.5	6.1	4.8	5.1
Philippines	1.1	7.3	3.2	3.8
India[3]	**7.0**	**8.6**	**2.1**	**9.4**

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

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

In the **United States (US)**, real GDP expanded by 2.8% in 2010 (2009: -2.6%), with about 50% of the growth coming from inventory restocking, following two years of inventory drawdown beginning in early 2008. Domestic demand remained modest, with private consumption growing at 1.8% (2009: -1.2%), supported by a drawdown in personal savings and a gain of USD3.2 trillion in net worth from the buoyant equity markets. However, households were constrained by a weak recovery in the job market with average monthly job creation of 78,000, a pace which could not meaningfully reduce the rate of unemployment. Thus, the unemployment rate remained elevated at 9.4% at end-year with the share of long-term unemployment rising further to 44.3% of total unemployment. The labour market conditions also exerted downward pressure on house prices, with residential investment remaining sluggish. In contrast, business investment in equipment and software expanded strongly by 15.1% (2009: -15.3%) as firms accelerated the replacement of obsolete machinery after postponing their investment plans during the financial crisis.

Against the backdrop of a gradual improvement in the economy in the first half of the year, and with the normalisation of conditions in the financial markets, the Federal Reserve (the Fed) allowed the automatic expiry of several quantitative easing programmes that were introduced during the crisis. While the federal funds rate was maintained at 0 - 0.25%, the Fed raised the discount rate by 25 bps to 0.75% on 18 February in an effort to normalise lending facilities. In addition, the Fed ended the purchase programmes for USD1.25 trillion agency mortgage-backed securities and USD175 billion agency debt at the end of the first quarter. However, as the economy showed signs of slowing in the second half of the year, the Fed announced on 10 August that it would keep its holdings of securities constant by reinvesting the proceeds from maturing securities in longer-term Treasury securities. Heightened risks arising from deflationary pressures and growing concerns over the possibility of a double-dip recession prompted the Fed to introduce a second round of quantitative easing amounting to USD600 billion on 3 November. The measure involves the purchase of US Treasuries by approximately USD75 billion a month, by the end of second quarter of 2011. This was aimed at easing financial conditions through the lowering of long-term yields and increase in equity prices in order to lower mortgage rates and increase the wealth effect in order to spur consumption and investment. In December, the US government also unveiled a USD858 billion tax relief package (5.9% of GDP), in which the bulk of the measures will be implemented in 2011-2012. The package includes the extension of the expiring tax cuts, unemployment benefits, and investment tax allowance incentives.

In the **euro area**, real GDP expanded modestly by 1.7% (2009: -4.1%) amid periodic episodes of sovereign debt problems in the peripheral economies. The recovery was uneven, largely due to the strong export-led growth in the core economies, in particular Germany, while the peripheral economies experienced weak domestic demand conditions. In Germany, real GDP expanded by 3.6% (2009: -4.7%) as the double-digit export growth had positive spillover effect on private consumption through a large expansion of jobs in the export-oriented industries. In contrast, domestic demand in the peripheral economies was weighed down by the imposition of fiscal austerity measures and the consequent deterioration in consumer confidence amid large layoffs in the public sector. Furthermore, high structural unemployment, fragile banking sectors and falling house prices continued to exert recessionary pressures on these economies. In view of the divergence in growth among the euro member countries and the persistent financial market uncertainty surrounding the ability of the peripheral economies to raise funding, the ECB decided to maintain an accommodative monetary policy stance throughout the year. The outbreak of the Greek crisis prompted further quantitative easing in May through the introduction of the Securities Market Programme to purchase both government and private sector bonds in the euro area. The ECB also reintroduced several of its liquidity facilities to extend unlimited short-term funds to the banking sector to ease funding strains given the banks' exposure through holdings of sovereign papers.

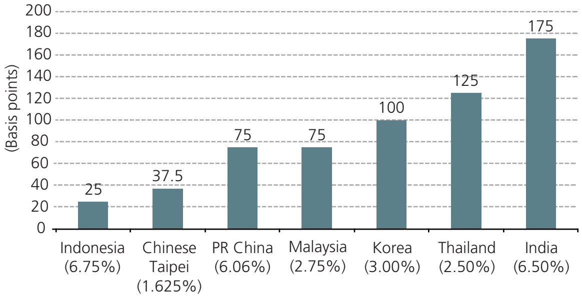
In the **United Kingdom (UK)**, real GDP expanded by 1.3% (2009: -4.9%), but growth was mainly contributed by inventory restocking while domestic demand continued to remain subdued. Private consumption growth was modest, in line with weak consumer sentiment following the announcement of planned fiscal austerity amounting to 5.6% of GDP over the next four years. Private investment was constrained by an overhang of spare capacity, low demand and tight credit conditions. In balancing between the fragility of economic recovery and markedly stronger headline inflation, the Bank of England (BOE) decided to keep the policy rate unchanged at 0.5% and maintained the size of its asset purchase programme at £200 billion.

The **Japanese** economy rebounded strongly by 3.9% in 2010 (2009: -6.3%), supported by double-digit growth in exports and industrial production. In the first half of the year, exports registered its fastest expansion in 30 years following strong demand for vehicles and semiconductors from Asia. Private consumption, posted a modest growth of 1.9% (2009: -1.9%), supported by fiscal stimulus in the form of subsidies for environment-friendly cars and electrical appliances. Notwithstanding the export-led recovery, the deflation threat in the domestic economy, coupled with a strong yen, prompted the Bank of Japan (BOJ) to expand its six-month lending facility to ¥20 trillion in March, in order to provide more loans to financial institutions at lower interest rates. The facility was first introduced in December 2009 with the initial amount of ¥10 trillion. As the recovery began to lose momentum in the second half of the year, the BOJ further expanded the lending facility to ¥30 trillion in August. As the strong yen and weakening of the US economy continued to weigh on the recovery, the BOJ reduced the overnight call rate in October to a range of 0 - 0.1% from 0.1% and established a ¥5 trillion asset purchase programme to purchase government and corporate bonds.

In the **Asian region**, growth was exceptionally strong in the first half of the year, driven by robust domestic demand, intra-regional trade, inventory restocking in the advanced economies as well as the low base effect. The strength in domestic demand was anchored by improving household and business sentiments, favourable labour market conditions and continued access to financing. The growth momentum was further reinforced by the double-digit expansion in exports for most regional economies, benefiting from strong intra-regional trade activity led by PR China, and demand associated with inventory restocking in the global economy. As a result, Singapore, Chinese

Chart 1.1

Cumulative Movements of Policy Rates since 2010

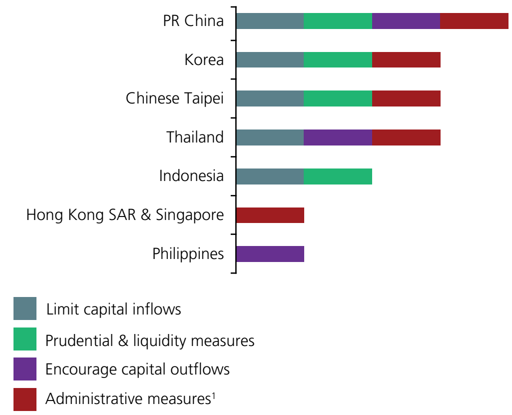


Note: Current policy rates in parentheses, as at mid-March 2011

Source: National authorities

Chart 1.2

Measures Introduced in the Region to Manage Capital Flows



[1] Real estate measures

Source: National authorities

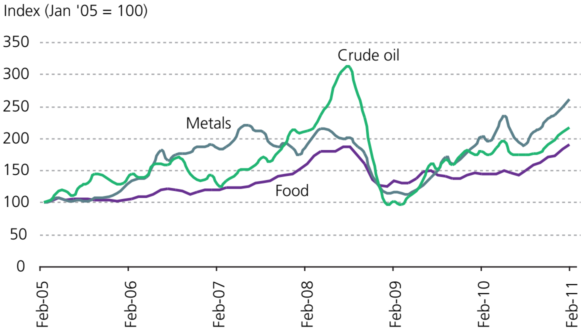
Taipei, PR China and Thailand recorded strong double-digit economic growth in the first half of the year. Growth in most regional economies, however, began to moderate towards the latter part of the year following the slower pace of improvement in external demand, reduced inventory restocking activity and waning low base effect. Nevertheless, domestic demand, particularly private consumption, continued to remain resilient, providing support to overall growth. Amid relatively favourable growth prospects, coupled with rising inflationary pressures associated with increasing commodity prices, several central banks in the region began to normalise their policy rates to levels consistent with the prevailing economic conditions. Malaysia, Chinese Taipei, Korea, Thailand, PR China and Indonesia increased their benchmark policy rates by cumulative hikes of between 25 and 125 basis points since 2010. In PR China, the People's Bank of China (PBOC) also raised the reserve requirement ratio eight times to 19.5% and imposed a quota on new bank lending to manage inflationary pressures and limit credit growth.

The pace of monetary policy normalisation in the region, however, was complicated by the large capital inflows experienced by several regional economies, exacerbated by further quantitative easing in the advanced economies. Several monetary authorities such as those in Thailand, Indonesia, Korea, Hong Kong SAR and PR China, used a number of instruments to mitigate the effects of capital inflows on domestic asset prices and exchange rates. These measures include the imposition of levies and taxes on the foreign holdings of domestic debt instruments and the income derived, and in some cases, limits on the holdings. Macroprudential measures were also adopted to limit the domestic banking institutions' exposure to foreign currency volatility. As large capital inflows also contributed to speculative activity in the domestic real estate sector, several authorities tightened the mortgage lending requirements and imposed stamp duties or levies to curb the speculative activity.

Global inflation was characterised by the apparent divergence in inflation trends between the advanced and regional economies. In the advanced economies, low resource utilisation rates and weak domestic demand resulted in a subdued inflationary environment as these economies treaded on a path of gradual and uneven recovery. Although headline inflation in the advanced economies picked up in the second half of the year due to rising energy prices, core inflation remained low in the US, euro area and Japan, generally reflecting the negative output gaps in these economies. There were also concerns on the risk of deflation in the US and euro area, with the former brought on by weaker-than-expected growth. The regional economies, however, experienced rising inflationary pressures arising mainly from higher commodity prices. Prices of metals, crude oil and food rose beyond peaks recorded in the second quarter. Global food prices, which remained subdued in the first half of the year, increased sharply in the latter part of the year attributable to stronger demand from

Chart 1.3

Indices of Primary Commodity Prices



Source: International Monetary Fund

the emerging markets and adverse weather conditions in different parts of the world. The impact of rising commodity prices was particularly a concern in the emerging market economies as their consumption baskets have a larger share of food and energy. The significant capital inflows into the Asian region have also raised concerns over the formation of asset bubbles, given that these flows were mainly channelled into domestic equity, bond and property markets.

In the **foreign exchange markets**, the US dollar depreciated during the year against most major currencies except the euro and the pound sterling. The broad dollar weakness was attributable to the nascent economic recovery in the US and the quantitative easing by the Fed. However, the dollar strengthened against the euro due mainly to periodic outbreaks of sovereign debt crisis in the euro area. Following concerns over the health of the banking sector in the euro area in June, the euro plunged below USD1.20, its lowest level against the dollar since March 2006. The US dollar also gained on the pound sterling due to expectations that the fiscal austerity in the UK will have a significant effect on its recovery process. The yen continued to strengthen against the US dollar to reach a 15-year high of ¥80 in October, benefiting from its role as a safe haven currency amid heightened investor risk aversion in the global financial markets. The yen remained firm in spite of interventions by the BOJ in September. Similarly, most regional currencies also appreciated against the US dollar supported by optimism over the relatively brighter growth prospects for the region vis-à-vis the advanced economies. The strengthening of regional currencies was also partly a result of the surge in short-term capital inflows, following the quantitative easing in the advanced economies and the increased investor appetite for higher-yielding financial assets in the emerging markets. The appreciating trend, however, was interrupted sporadically in the second and fourth quarters, as investors reduced their exposure in the emerging markets when there were renewed concerns over sovereign debt in the euro area. This resulted in a temporary weakening of regional currencies against the US dollar. Among regional currencies, the ringgit recorded the largest appreciation against the US dollar during the year while the yuan rose to a 17-year high as PR China moved to increase the flexibility of its exchange rate. The Singapore dollar and New Taiwan dollar also reached record highs following tightening measures by their respective monetary authorities.

THE MALAYSIAN ECONOMY

In 2010, the Malaysian economy experienced a strong resumption of growth, recording an expansion of 7.2% following the downturn in 2009. Growth was driven mainly by robust domestic demand; and primarily by private sector activity. In particular, private consumption expanded firmly during the year, underpinned by the improvement in labour market conditions, a steady increase in income, more optimistic consumers and continued access to credit. The improvement in labour market conditions was reflected in the stronger growth of employment, lower retrenchments and lower unemployment rate. Additionally, after a sharp contraction in 2009, private investment rebounded strongly to register a double-digit growth in 2010, reflecting the expansion of capital spending across all sectors, particularly the manufacturing, mining and services sectors, following favourable domestic economic conditions amidst an improvement in external demand. The public sector continued to play a crucial role in supporting the domestic economy during the year through the implementation of programmes to further enhance infrastructure and the public sector delivery system. External demand rebounded strongly in the first half of the year, underpinned by strong regional

Table 1.2

Malaysia - Key Economic Indicators

	2008	2009	2010*p*	2011*f*
Population (million persons)	27.5	27.9	28.3	28.6
Labour force (million persons)	12.0	12.1	12.2	12.5
Employment (million persons)	11.6	11.6	11.8	12.1
Unemployment (as % of labour force)	3.3	3.7	3.2	3.2
Per Capita Income (RM)	26,041	23,841	26,219	28,175
(USD)	7,812	6,764	8,140	9,204[6]
NATIONAL PRODUCT (% change)				
Real GDP at 2000 prices[1]	4.7	-1.7	7.2	5.0 ~ 6.0
(RM billion)	530.2	521.1	558.4	587.8
Agriculture, forestry and fishery	4.3	0.4	1.7	3.4
Mining and quarrying	-2.4	-3.8	0.2	2.0
Manufacturing	1.3	-9.4	11.4	5.7
Construction	4.2	5.8	5.2	5.4
Services	7.4	2.6	6.8	5.9
Nominal GNI	14.2	-7.3	11.4	8.8
(RM billion)	717.2	665.0	740.7	806.1
Real GNI	2.1	0.7	4.2	5.6
(RM billion)	493.2	496.5	517.2	546.0
Real aggregate demand[2]	6.8	-0.5	6.3	6.7
Private expenditure[2]	7.0	-2.7	7.8	7.4
Consumption	8.5	0.7	6.6	6.9
Investment	1.0	-17.2	13.8	9.7
Public expenditure[2]	6.1	5.2	2.5	5.1
Consumption	10.7	3.1	0.1	7.2
Investment	0.5	8.0	5.5	2.7
Gross national savings (as % of GNI)	38.0	31.7	34.2	34.1
BALANCE OF PAYMENTS (RM billion)				
Goods balance	170.6	141.7	136.6	144.3
Exports (f.o.b.)	664.3	554.1	639.8	674.8
Imports (f.o.b.)	493.8	412.3	503.3	530.5
Services balance	0.2	4.7	0.9	0.2
(as % of GNI)	…	0.7	0.1	…
Income, net	-23.7	-14.6	-25.2	-23.7
(as % of GNI)	-3.3	-2.3	-3.4	-2.9
Current transfers, net	-17.5	-19.6	-21.7	-20.2
Current account balance	129.5	112.1	90.5	100.7
(as % of GNI)	18.1	17.5	12.2	12.5
Bank Negara Malaysia international reserves, net[3]	317.4	331.3	328.6	-
(in months of retained imports)	7.6	9.7	8.6	-
PRICES (% change)				
CPI (2005=100)[4]	5.4	0.6	1.7	2.5 ~ 3.5
PPI (2005=100)[5]	10.3	-7.1	5.6	-
Real wage per employee in the manufacturing sector	-4.8	1.9	6.4	-

[1] Beginning 2007, real GDP has been rebased to 2000 prices, from 1987 prices previously
[2] Exclude stocks
[3] All assets and liabilities in foreign currencies have been revalued into ringgit at rates of exchange ruling on the balance sheet date and the gain/loss has been reflected accordingly in the Bank's account
[4] Effective from 2011, the Consumer Price Index has been revised to the new base year 2010=100, from 2005=100 previously
[5] Effective from 2010, the Producer Price Index has been revised to the new base year 2005=100, from 2000=100 previously
[6] Based on average USD exchange rate for the period of January-February 2011
p Preliminary
f Forecast
... negligible

Note: Numbers may not necessarily add up due to rounding

Table 1.3

Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2008		2009		2010*p*	
Revenue	159.8		158.6		159.7	
Operating expenditure	153.5		157.1		151.6	
Net development expenditure	41.9		49.0		51.3	
Overall balance	-35.6		-47.4		-43.3	
Overall balance (% of GDP)	-4.8		-7.0		-5.6	
Public sector net development expenditure	124.4		111.3		112.3	
Public sector overall balance (% of GDP)	-5.6		-6.8		-7.4	
EXTERNAL DEBT[1]						
Total debt (RM billion)	236.3		233.1		226.3	
Medium- and long-term debt	156.6		155.4		146.9	
Short-term debt[2]	79.7		77.8		79.4	
Debt service ratio (% of exports of goods and services)						
Total debt	2.6		6.5		7.6	
Medium- and long-term debt	2.5		6.4		7.5	
	Change in 2008		**Change in 2009**		**Change in 2010**	
MONEY AND BANKING	**RM billion**	**%**	**RM billion**	**%**	**RM billion**	**%**
Money Supply M1	14.0	8.3	17.9	9.8	23.5	11.7
M3	99.1	11.9	85.4	9.2	71.2	7.0
Banking system deposits	103.4	11.9	90.7	9.3	77.9	7.3
Banking system loans[3]	82.3	12.8	57.0	7.8	99.8	12.7
Loan-deposit ratio (end of year)[4]	77.7		77.9		81.3	
Financing-deposit ratio[4, 5]	85.8		84.6		87.7	
INTEREST RATES (AVERAGE RATES AS AT END-YEAR)	**2008**		**2009**		**2010**	
	%		%		%	
Overnight Policy Rate (OPR)	3.25		2.00		2.75	
Interbank rates						
1-month	3.30		2.00		2.73	
Commercial banks						
Fixed Deposit 3-month	3.04		2.03		2.74	
12-month	3.50		2.50		2.97	
Savings deposit	1.40		0.86		1.00	
Base lending rate (BLR)	6.48		5.51		6.27	
Treasury bill (3-month)	3.39		2.05		2.60	
Malaysian Government securities (1-year)*	2.89		2.12		2.85	
Malaysian Government securities (5-year)*	2.99		3.79		3.39	
EXCHANGE RATES	**2008**		**2009**		**2010**	
Movement of Ringgit (end-period)	%		%		%	
Change against SDR	-2.7		0.2		13.1	
Change against USD[6]	-4.5		1.2		11.1	

1 Effective from the first quarter of 2008, the external debt data of Malaysia has been redefined to treat entities in Labuan International Business and Financial Centre (Labuan IBFC) as residents
2 Excludes currency and deposits held by non-residents with resident banking institutions
3 Includes loans sold to Cagamas
4 Exclude financial institution transaction
5 Refers to the ratio of loans and holdings of PDS by the banking system to deposits of the banking system
6 Ringgit was pegged at RM3.80=USD1 on 2 September 1998 and shifted to a managed float against a basket of currencies on 21 July 2005
p Preliminary
* Refer to end-year

demand and to some extent, the low base effect. However, the growth momentum softened in the second half-year, in tandem with the moderation in global trade and a diminishing base effect.

In 2010, the Malaysian economy experienced a strong resumption in growth, recording an expansion of 7.2% following the downturn in 2009

On the supply side, all economic sectors registered strong performance in 2010, in line with the robust domestic demand and rebound in exports. The services sector in particular, benefited from the strengthening of both domestic and external demand, and remained as the largest contributor to growth. All services sub-sectors recorded higher growth in the first half-year but growth moderated in the second half following the slowdown in external demand, which affected the trade- and manufacturing-related services sub-sectors. Nevertheless, the sustained expansion in domestic consumption, continued to benefit the sub-sectors that are dependent on domestic demand. The manufacturing sector recovered firmly, with the electronics and electrical cluster and domestic-oriented industries registering double-digit growth rates. The pace of growth, however, moderated towards year-end due to slower external demand and the diminishing base effect. Similarly, the commodity sectors expanded at a stronger pace in 2010, supported by sustained high production of natural gas and food crops. The construction sector moderated due partly to the slower growth in the second half-year following the completion of projects financed by the second stimulus package.

Headline inflation averaged 1.7% in 2010 (2009: 0.6%), driven by supply factors arising from higher food and commodity prices and adjustments to administered prices. Domestic supply factors were relatively more dominant in driving inflation in 2010. During the year, there were a series of upward adjustments to the retail prices of RON95 petrol, diesel, LPG and sugar, as part of the Government's subsidy rationalisation programme announced in May. The impact of external factors on domestic prices were more modest in 2010, and confined to selected food items. This reflected the substantial increase in global prices of wheat and corn due to adverse weather conditions in key wheat and corn producing countries. Core inflation, which is an indicator of demand-driven pressures on prices rose at a more modest pace of 1.5% in 2010 (2009: 2.7%).

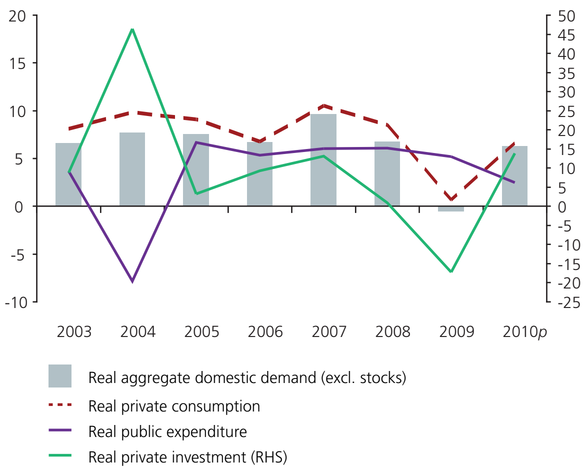
Malaysia's external position remained resilient in 2010. The current account surplus remained sizeable, but narrowed from 2009, while the financial account recorded a lower net outflow. The smaller current account surplus reflected the lower trade surplus as imports growth accelerated in response to the strong domestic demand during the year and outpaced the growth of exports. In addition, the income account deficit widened due to the higher profits accruing to foreign direct investors in Malaysia, while the services account remained in surplus, albeit by a smaller amount, supported by higher tourist arrivals. The financial account recorded a smaller net outflow in 2010, reflecting largely the higher inflow of portfolio investment and foreign direct investment following the improvement in both global and domestic economic conditions. These inflows partly offset the higher outflows of direct investment abroad as Malaysian companies continued to tap opportunities abroad. Other investment outflows, which reflected mostly trade credits and placements of deposits abroad by residents, moderated during the year. After adjusting for the errors and omissions, net international reserves declined by RM2.6 billion to RM328.6 billion, equivalent to USD106.5 billion, as at 31 December 2010.

DOMESTIC DEMAND CONDITIONS

Domestic demand recorded a strong growth of 6.3% in 2010 (2009: -0.5%). Despite the moderation in the global economy in the second half-year, domestic demand conditions remained robust throughout the year, driven by private sector activity. Private consumption increased at a faster pace, while private investment rebounded strongly to record a double-digit growth. The public sector continued to play a crucial role in supporting the domestic economy during the year through the implementation of programmes to further

Chart 1.4

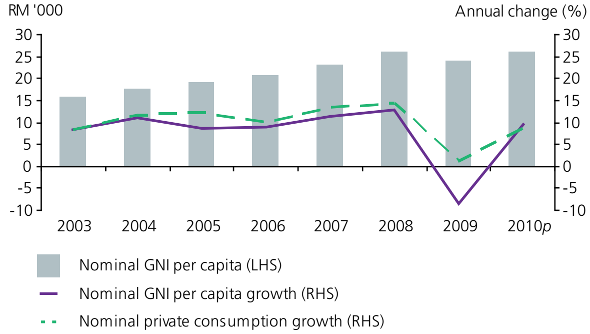
Real Domestic Demand Aggregates



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

Chart 1.5

GNI per Capita



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

enhance infrastructure and the public sector delivery system.

Robust domestic demand, driven by strong expansion in private sector activity amid an improvement in external demand

Private consumption expanded firmly by 6.6% (2009: 0.7%). This was reflected in the strong performance of major consumption indicators, such as passenger car sales, retail sales and imports of consumption goods. Improved consumer confidence, as reflected in the higher MIER Consumer Sentiments Index during the year, had led to a significant increase in discretionary spending on items such as food away from home, communications and recreation. Consumer spending activity was supported by better labour market conditions and the steady increase in incomes. The more favourable labour market conditions were reflected in higher job vacancies, lower retrenchments and low unemployment. The average private sector salary increased by 4.5% in 2010 (2009: 4.3%), while stronger prices of crude palm oil and rubber supported higher expenditure by households in the rural areas. The average monthly gross income of FELDA households in the palm oil scheme rose to RM3,236 per month (2009: RM2,457), while the rubber smallholders earned, on average, RM3,071 per month in 2010 (2009: RM1,812). Other developments such as the salary increments for bank employees and selected groups of civil servants, as well as the one-time special cash payment to civil servants, further provided additional impetus for consumption spending.

Consumer spending was also supported by continued access to credit as the monetary environment remained accommodative during the year. Household credit expanded further, with loans disbursed to households increasing by 11.1% in 2010. Nevertheless, the household debt remained stable at 75.9% of GDP as at end-2010 (2009: 76%). The household balance sheet remained sound, with a low household debt of 41.9% of total financial asset (2009: 42.1%), high individual deposits of RM407.8 billion and non-performing loans ratio for household loans declining to 2.3% as at end-2010 (2009: 3.1%).

Private investment rebounded strongly to register a double-digit growth of 13.8% in 2010 (2009: -17.2%). Capital spending expanded across all sectors, particularly in the manufacturing, mining and services sectors, following favourable domestic economic conditions and improvement in external demand. In addition, businesses also resumed investment activity that had been deferred due to the uncertainties arising from the global economic crisis.

The strong performance of investment activity was reflected in the improvement of major investment indicators. Imports of capital goods

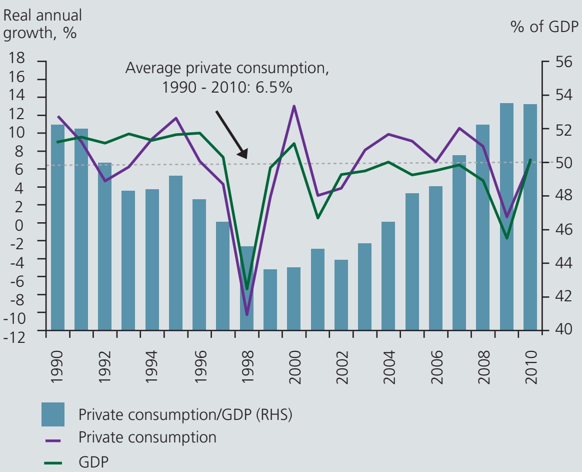
The Growth and Evolution of Consumer Spending in Malaysia

Introduction

Private consumption is increasingly becoming an important component of the Malaysian economy. It was the main driver of economic growth in this recent decade, increasing at an annual average of 7.4% during the period of 2000-2009[1], which exceeded the 4.8% average growth of real gross domestic product (GDP), and contributed more than two thirds of total GDP growth. As a result, the share of real private consumption in GDP increased steadily from 43.8% in 2000 to 53.5% in 2009.

Chart 1

Private Consumption and GDP



Source: Department of Statistics, Malaysia

In tandem with the robust growth of private consumption, there were clear shifts in the composition of private consumption over the last decade. This article analyses and explains the changing patterns of private consumption by main expenditure groups between 2000 and 2009, and concludes with insights on private consumption trends moving forward.

Changing Patterns of Consumption Expenditure

Based on the data of household consumption by purpose[2] during the period of 2000-2009, expenditure on food and non-alcoholic beverages formed the largest component, accounting for about 23% of total household expenditure. This was followed by expenditures on housing and utilities; transport; restaurants and hotels; and miscellaneous goods and services. These five largest components of consumption expenditure accounted for 75.6% of total household spending.

Table 1

Household Consumption by Purpose

	2000	2009	2000-09
	% of total household consumption		
Food and non-alcoholic beverages	24.1	21.8	23.0
Alcoholic, beverages and tobacco	2.2	2.3	2.1
Clothing and footwear	3.5	2.4	2.7
Housing, water, electricity, gas and fuels	21.7	16.7	18.9
Furnishings, household equipment and maintenance	5.9	5.2	5.4
Health	2.1	2.1	2.0
Transport	12.6	13.1	13.4
Communication	4.9	7.4	6.3
Recreation and culture	4.3	4.9	4.5
Education	1.5	1.6	1.5
Restaurants and hotels	5.8	9.7	7.5
Miscellaneous goods and services	11.6	12.7	12.8

Source: Department of Statistics, Malaysia

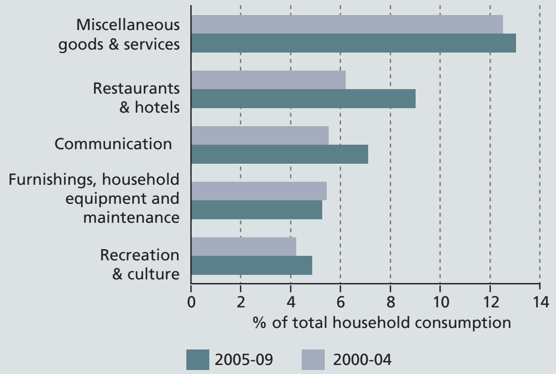
[1] Detailed information on private consumption for 2010 is not available at the time of publication of this article.

[2] Follows the domestic concept of consumption expenditure where it measures purchases of goods and services by all households in Malaysia. The analysis on consumption patterns in this article refers to nominal household spending.

Two clear shifts in consumer spending patterns have emerged since 2000. First, the share of expenditure on discretionary[3] items has increased relative to spending on basic necessities[4]. Expenditure on discretionary items (such as restaurants and hotels, communication as well as recreation and culture) was particularly strong, followed by the expenditure on miscellaneous goods and services such as personal care, financial, insurance and other services. The share of these four components of income-sensitive spending rose from 26.5% of total household expenditure in 2000 to 34.7% in 2009 (Chart 2).

Chart 2

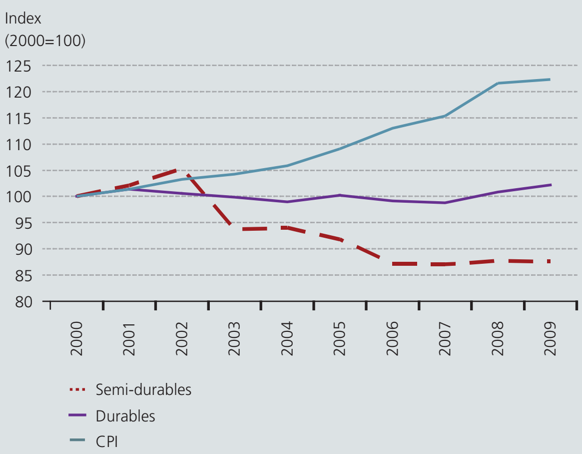
Household Consumption of Discretionary Items



Source: Department of Statistics, Malaysia

Chart 3

Prices of Consumption Expenditure



Source: Department of Statistics, Malaysia

In contrast, the proportion of household expenditure on basic necessities has declined gradually since 2002, attributable mostly to the decline in the shares of expenditure on food and non-alcoholic beverages, and housing and utilities. Spending on food items as a share of total household expenditure decreased from 24.1% in 2000 to 21.8% in 2009. Similarly, the average household spending on housing and utilities fell from 21.7% in 2000 to 16.7% in 2009.

Second, consumption of services has outpaced expenditure on goods[5]. Between 2000 and 2009, household consumption of services grew by about 10% annually, compared to the 8.4% growth of consumption of goods. Accordingly, the share of expenditure on services increased from 46.2% of total household spending in 2000 to almost 50% in 2009. Expenditure on services includes spending for services rendered by restaurants and hotels, financial and insurance intermediaries, education, healthcare and other intermediaries. As the ratio of spending on services rose, the share of household spending on goods declined gradually, accounted for mainly by the declines in expenditure on durable and semi-durable goods. Together, the share of expenditure on durable and semi-durable goods decreased[6] from 15.1% of total expenditure in 2000 to 12.5% in 2009, reflecting mainly the lower price levels of both durable and semi-durable goods in comparison with the overall consumer prices (Chart 3). For example, during the period of 2000-2009, price of clothing and footwear category declined by 1.6% annually. As a result, the share of expenditure on clothing and footwear decreased from 3.5% of total household spending in 2000 to 2.4% in 2009. Consumer spending on non-durables, which constituted 38.7% of total household spending in 2000, remained stable at 38% in 2009.

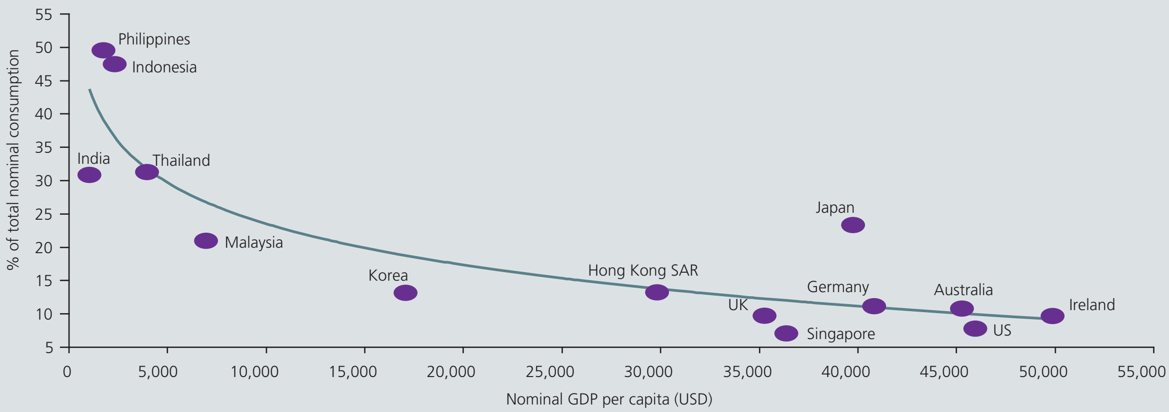
[3] Spending on non-essential goods and services, which typically can be postponed and often consists of luxury items.
[4] Comprises of essential categories, such as food consumption at home, clothing, rent and utilities.
[5] Consist of items which are tangible and can be divided into sub-groups such as durable, semi-durable and non-durable goods. Durable and semi-durable goods can be used repeatedly and have an expected lifetime of more than one year. Durable goods usually have longer lifespan and cost substantially more than semi-durable goods. Durable goods include furniture, household appliances and consumer electronics.
[6] The declining trend in the ratio is largely a nominal development. In real terms, the share of expenditure on durable and semi-durable goods has risen gradually since 2000, indicating an increase in the volume purchased under both categories.

These two changing patterns of household spending over this recent decade reflected several factors that influence consumers' preferences and decision-making. The main factor is the growing affluence of Malaysians, supported by the steady rise in disposable income and accumulation of wealth. Between 2004 and 2009, nominal per capita GDP increased by 6.8% annually, with mean monthly gross household income rising by 4.4% annually from RM3,249 in 2004 to RM4,025 in 2009. Similarly, household financial assets[7] grew at an annual rate of 14% during 2004-2009 to account for 180% of GDP in 2009 (2004: 167% of GDP).

These trends are consistent with consumer spending trends observed in other countries, which indicate that as income rises, the share of expenditure on basic necessities tends to decline while that on services tends to increase. Given the lower level of income in developing economies, the proportion of household expenditure on food is usually higher in developing economies and lower in high income economies (Chart 4). In contrast, advanced economies typically have a higher share of expenditure on services relative to developing economies (Chart 5).

Chart 4

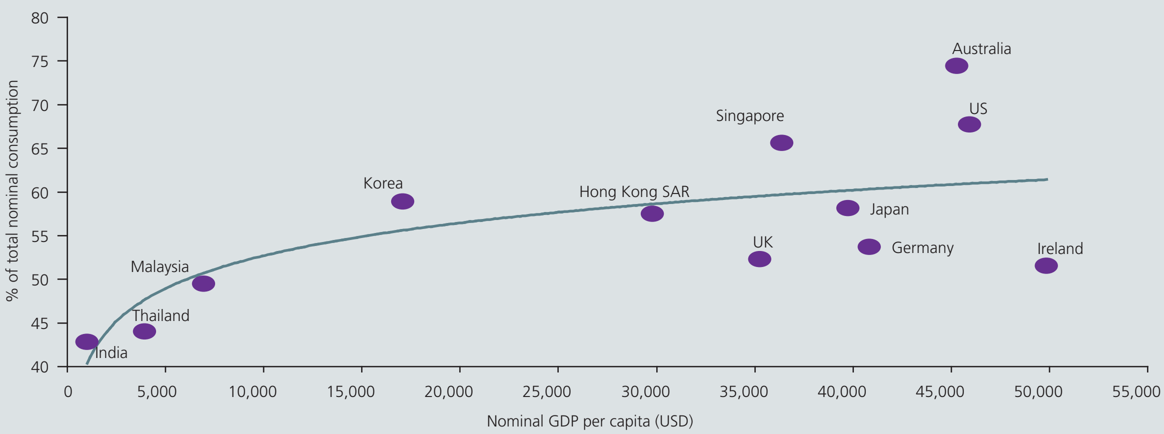
Consumer Spending on Food Items



Source: IMF, Eurostat and National Statistical Offices

Chart 5

Consumer Spending on Services



Source: IMF, Eurostat and National Statistical Offices

[7] Consists of deposits held in the banking system, total assets of life insurance funds, household direct holdings of equity, Employees Provident Fund contributions and net asset value of unit trust funds for the period of 2003-2009.

Three other factors also contributed to the last decade's growth and evolution of consumer spending towards increased consumption of non-essentials. The demographic characteristics of Malaysians, given the relatively young and large working-age population[8] provide support for income growth. Younger people, who generally have a higher marginal propensity to consume, tend to spend more on non-essential goods and services. This is further supported by the increasing urbanisation[9] of the population. With higher income levels compared to rural households, households in the urban areas would normally have a higher proportion of spending[10] on discretionary items. This is especially true for services such as financial, recreation and entertainment, where the demand and the supply tend to be higher in urban areas.

Increased financial deepening and inclusion also influenced changes in consumer spending patterns. The financial sector plays an integral role in supporting private consumption by facilitating greater access to credit for households. In particular, greater access to credit allows individuals to fund discretionary expenditure, particularly that on durable goods, the purchase of which is generally financed more through borrowing as compared to other types of consumption. During the period 2000-2009, household debt grew at an annual rate of 13.5%. Household debt-to-GDP ratio increased from 46% in 2000 to 76% in 2009. Credit disbursed for consumption, which consists of loans for personal uses, credit card spending and the purchase of consumer durable goods, expanded by 20.5% annually between 2000 and 2009. Similarly, total loans disbursed to households for purchases of residential property and passenger car increased by 13.4% annually. The strong performance of these loans is indirectly translated into higher consumer spending as purchases of residential properties and passenger car are closely linked to spending on housing and transport-related items, which include furnishings and the maintenance of transport equipment. Although the ratio of household debt to GDP is relatively high, overall household balance sheet remained sound and debt repayment capacity continued to be intact. Household financial assets were more than two times of total household debt and the non-performing loans ratio of the household sector continued to trend downwards.

In addition, technological developments have affected trends in consumer spending, as evident from the increasing share of expenditure on communication and recreation. Technological innovations have encouraged consumer spending in technology-related goods and services, such as internet services, mobile communication equipment and data services, cable television services and audio visual equipment. Furthermore, the strong demand for technology-related goods and services was supported by the country's relatively young and educated population that expedited the adoption of newly available technological innovations.

Conclusion

The sustainability of private consumption growth is an important aspect of the transformation of the Malaysian economy moving forward. As the sources of growth shift towards domestic demand, private consumption will continue to play a significant role in contributing to economic growth. The pre-requisites to support sustainable growth in private consumption are already in place, namely rising income and wealth, favourable demographic, greater financial deepening and technological developments.

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[8] 68% of the total population fall in the 15 – 64 age group.

[9] The urban population increased from 62% of total population in 2000 to 63.3% in 2009.

[10] Based on the Household Expenditure Survey 2004/05, households living in urban areas spent 1.8 times more than households in rural areas.

Growth and Changing Trends of Private Investment in Malaysia

Introduction

Investment has an important role in the growth and development of the Malaysian economy. It ensures continuous enhancement and expansion of the country's productive capacity for the future development of the economy. While the public sector has an important overall supportive role, private sector capital spending is key to replenish and raise the capital stock to drive the performance of the various sectors in the economy. This article describes the growth and changing trends of private investment expenditure in Malaysia over the recent decade, and concludes with a brief outlook on the medium-term trends of private sector capital spending.

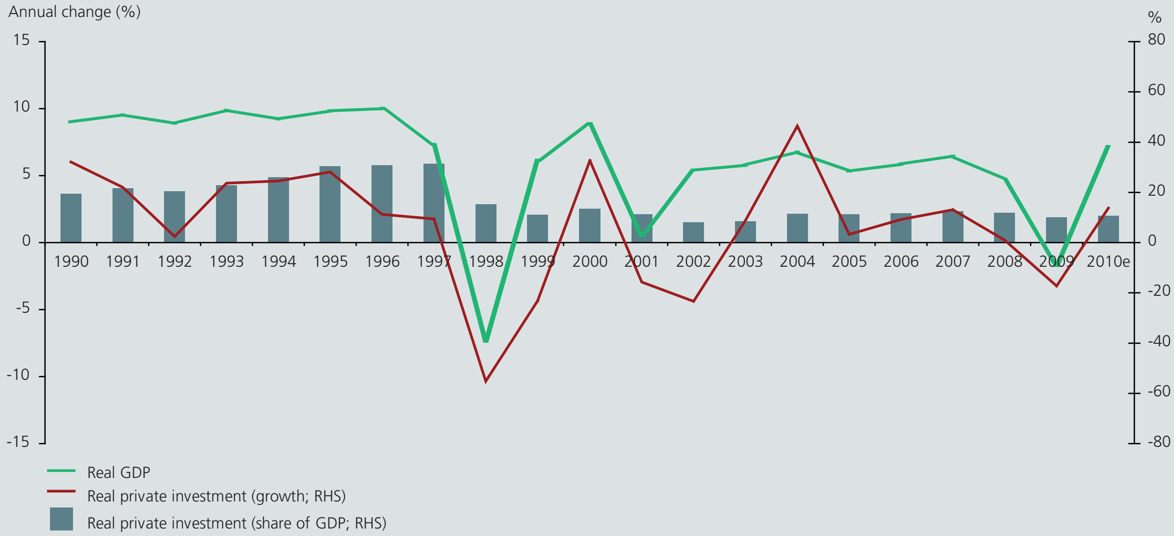
Developments over the Recent Decade

Private investment rebounded to register strong growth in 2010. The resumption of private capital spending is evident across all sectors, particularly in the manufacturing, mining and services sectors. Given the positive medium-term economic outlook and new government initiatives to promote investment, growth in private investment is expected to continue with contributions from both foreign and domestic investors. Of importance, strong investment activity will increasingly be driven by capital spending in new growth areas, such as renewable energy and financial services. This development not only contributes to economic growth in the short term, but more importantly, lays the foundation for future growth of the Malaysian economy.

Over the recent decade, private investment has recorded an average growth rate of 6.7% per annum in 2000-2010, with its performance closely tracking the overall performance of the economy (Chart 1). After the 1997/98 Asian Financial Crisis, investment activity began to recover in 2000 amid improving business confidence. Progress, however, was interrupted by the 2001 bursting of the Tech Bubble, and the negative impact on capital spending lasted for two years. Private investment subsequently recovered and peaked at a growth rate of 46.5% in 2004. However, towards the end of the decade, the global financial crisis led to a recession in the domestic economy in 2009. Private investment had weakened considerably during this period.

Chart 1

Private Investment and GDP (2000=100)



e Estimate

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In terms of share, throughout the recent decade, private investment averaged 11% of real GDP, compared with the average share of 22.9% during 1990-1999. A key explanatory factor for the lower level of private investment is the emergence of less capital-intensive new growth areas in the services sector. Also, in the 1990s, especially in the period leading to the Asian Financial Crisis, there were periods of very high investment, predominantly in infrastructure. This trend is not sustainable in the long run.

Over the recent decade, Malaysia attracted net FDI inflow averaging 3% of GDP per annum, which is more moderate compared with the 1990s (average of 6.4% of GDP), due mainly to the changing nature of investment. A growing share of these investments have been channelled into less capital-intensive, higher value-added activity. Furthermore, higher competition for FDI from emerging economies, particularly low labour cost countries such as PR China and Vietnam have also contributed to the lower net inflows. Nonetheless, the average share of foreign investment to total private investment has remained stable (Table 1).

Table 1

Average Net FDI Inflow

	1990-1999	2000-2010
	% share	
Net FDI to GDP ratio	6.4	3.0
Net FDI to total private investment ratio	27.0	28.5

Source: Department of Statistics, Malaysia

Foreign investment has contributed significantly to the growth and transformation of the Malaysian economy. The large presence of multinational corporations (MNCs) has provided direct benefits in the form of employment creation and capital formation. It also provided opportunities for local firms to perform the role of vendors by supplying parts and services to the large MNCs, which has benefited the small and medium enterprises (SMEs). More importantly, FDI can also lead to the transfer of knowledge, technology and skills in developing local firms and human capital. Particularly, in the manufacturing sector, Malaysia has steadily climbed up the value chain with improved productivity levels. The real value-added per worker in the manufacturing sector has increased from RM49,013 in 2000 to RM78,707 in 2010 (equivalent to USD12,898 in 2000 to USD24,435 in 2010).

In terms of sectoral distribution, net FDI inflows during 2000-2010 were channelled mainly into the manufacturing, services, and oil and gas sectors. While the manufacturing sector remains the major recipient of the net inflows, the services sector has been a significant beneficiary of foreign investment. This is particularly evident in the financial services and wholesale and retail trade sub-sectors, following liberalisation efforts undertaken by the Government. In the oil and gas sector, capital spending for exploration, production and development activity remained high, driven mainly by PETRONAS and its foreign partners.

Despite the significance of foreign investors, domestic investment still constitute the larger share of total private capital spending, particularly in the services, agriculture and construction sectors. This is largely due to the capacity expansion activity of large domestic- and export-oriented enterprises to fulfil the growing demand for their products and services. Some of these companies have grown large enough and have developed the necessary expertise to expand into other regional economies to take advantage of more competitive supplies of land and labour, as well as to gain access into bigger markets. Moreover, capacity expansion by the SMEs that supply parts, components and related services have also contributed towards total investment, given the constant need to upgrade the equipment, technology and labour skills, to meet the higher quality standards and more advanced requirements by the larger corporations.

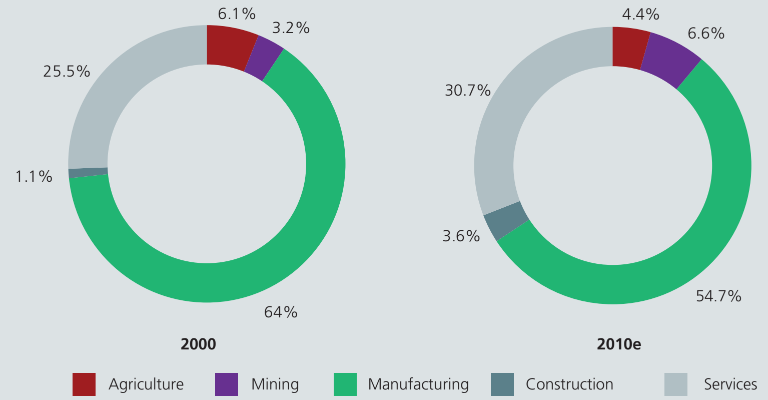
Changing Trends of Private Investment

Two distinct changes can be observed from the investment trends in the recent decade. First, there is increasing diversity in the investment spending across the various economic sectors. Second, more capital expenditure has been channelled into higher value-added, technologically-intensive projects across the different sectors of the economy.

The sectoral distribution of investment has become more diversified. In particular, the share of manufacturing sector investment has generally declined from 64% of total private investment in 2000 to 54.7% in 2010 (Chart 2). On the other hand, the share of services sector investment has increased from 25.5% of private investment in 2000 to 30.7% in 2010. This is also in tandem with the trends in FDI flows, as more foreign investment has been channelled into the services sector. These include the financial services, shared services and outsourcing (SSO), communication and wholesale and retail trade sub-sectors. Government policies promoting the growth and development of key services sub-sectors, especially through liberalisation and pro-competition policies, have contributed significantly towards higher capital spending in the services sector.

Chart 2

Private Investment by Sector



e Estimate

Source: Bank Negara Malaysia

In addition, the shares of investment in the mining and construction sectors have also increased. Investment in the mining sector was driven mainly by the exploration and production of oil and natural gas resources, as high and rising crude oil prices increased the viability of capital-intensive activity including the exploration and development of deepwater oilfields. Also, the share of investment in the construction sector has risen, but at levels well below those observed in the 1990s, when large infrastructure projects were under way. In the early 2000s, investment in the construction sector was lower, as selected construction and infrastructure projects were postponed and cancelled during and immediately after the 1997/98 Asian Financial Crisis. However, the subsequent revival of some of these projects, and the construction of new privatised roads and highways from the mid-2000s to enhance domestic transportation network connectivity had led to the rising share of capital spending in the construction sector.

Although the share of investment in the manufacturing sector is lower, it remains the largest contributor to overall investment. Capital spending in the sector continues to be underpinned by the large presence of foreign MNCs, particularly in the electrical and electronics (E&E) industries. The Government, as indicated in the medium- and long-term plans formulated for Malaysian economic development covering the recent decade[1], had underlined strategies to further deepen and widen the country's industrial base. This was to be achieved through attracting and promoting investment in new growth areas and targeted industrial clusters. Under this strategy, although the E&E sub-sector remains significant, shares of other sub-sectors have also risen. The average share of approved investment in the

[1] Second and Third Industrial Master Plans (1996-2020), as well as the Eighth and Ninth Malaysia Plans (2000-2010).

Table 2

Approved Manufacturing Investment by Selected Industries

	2000-2004	2005-2010
	% share of total	
Export-oriented industries	**69.3**	**60.9**
Primary-related cluster	36.9	32.2
Chemicals & chemical products	5.5	11.3
Petroleum products	12.9	11.8
Paper products	8.6	2.2
Textiles	2.0	1.4
Others (e.g. rubber products)	7.9	5.7
E&E cluster	32.3	28.7
Domestic-oriented industries	**30.7**	**39.1**
Consumer-related cluster	13.9	12.4
Transport equipment	7.8	4.4
Food	4.2	4.6
Others (e.g. medical supplies)	1.5	3.1
Construction-related cluster	16.8	26.7
Iron and steel	8.7	16.1
Non-metallic mineral products	4.0	6.0
Fabricated metal	4.2	4.5

Source: Malaysian Industrial Development Authority (MIDA) and Ministry of International Trade & Industry

E&E industries has dropped to 28.7% of the total amount, from 32.3% during 2000-2004 (Table 2). Other industries in the manufacturing sector that have attracted more capital spending towards the end of the decade were chemicals and chemical products, scientific and medical instruments, as well as domestic-oriented industries such as the construction-related cluster.

This development reflects the second key trend in private investment, namely rising investment into higher value-added and high technology activity. Capital-intensive projects in the manufacturing sector have expanded, as indicated by higher capital investment per employee (CIPE) of RM484,767 in 2010 compared with RM381,450 in 2000 among the approved manufacturing projects, an improvement of 27.1%. At the same time, labour-intensity has declined, as shown by lower average employment per project approved in the manufacturing sector during the past decade (95 persons per project in 2000-2010) compared with 1990-1999 (132 persons per project).

Following the Government's efforts to promote the development of selected new growth areas, capital spending in selected industries has increased, especially in the second half of the decade. The industries include the renewable energy, high-end electronic products, machinery and equipment as well as the medical devices industries.

In particular, the renewable energy industry, most notably in the solar industry cluster, has attracted major investment from several international firms. This contributed to higher capital spending in the sub-sectors involved in the production chain of photovoltaic solar cells, namely the E&E, chemicals and chemical products as well as non-metallic mineral products sub-sectors. When fully operational, Malaysia is set to become among the largest solar cell producers in the world, together with PR China, Japan, Chinese Taipei, and Germany. Moreover, the manufacture of higher value-added, specialised machinery and equipment, as well as medical instruments and devices has also attracted growing investment in Malaysia following rapid growth in demand and technological advancements.

Beyond the manufacturing sector, the Government has also aggressively promoted the development of the services sector, by offering attractive incentive packages and liberal policies on equity participation and employment requirement to encourage investment. Although less capital-intensive, these industries have higher value-added and hence provide high-skilled employment opportunities in comparison with the traditional manufacturing sector.

The SSO industry has attracted investment from global MNCs and large firms to establish international and regional offices in Malaysia. In the latest 2011 AT Kearney's Global Services Location Index (GSLI) report, Malaysia is ranked as one of the top three locations for outsourcing businesses in the world. The report also pointed out that the top three economies (India, PR China and Malaysia) have maintained their positions as the most attractive locations since the GSLI was introduced in 2003, due mainly to deep talent pools and cost advantages. In this regard, Malaysia has to keep developing and improving these factors, as well as other relevant infrastructure, in order to remain competitive and attractive among the international investor community.

In addition to the SSO industry, investment in the financial services industry has also expanded significantly in the last few years, partly due to the rapid development of Islamic finance. Further support to investment was provided through policies to further strengthen and liberalise the domestic financial sector, including the issuances of new licenses to financial institutions and service providers.

The Way Forward

The positive developments in private investment in the recent decade is expected to continue into the next decade. Improvements in the world economy will also lead to the resumption of higher FDI flows globally. Although competition for FDI flows will likely intensify further, particularly from the emerging regional economies, foreign investment to Malaysia is likely to remain given Malaysia's attractiveness and competitiveness. As outlined in the Economic Transformation Programme (ETP), more aggressive efforts to attract investment are being proposed and implemented. This includes revamping and expanding the role of the Malaysian Industrial Development Authority (MIDA) to include targeted outreach activity, which complements the broader marketing campaigns for identified key economic areas. Overall, foreign investment is still expected to account for about 30% of total private investment in the coming decade.

In addition, capital spending will likely continue to be channelled into diverse sectors of the economy. In particular, investment in the services sector are expected to be higher, indicating its growing importance as reflected by services sub-sectors being identified in seven out of the 12 National Key Economic Areas (NKEAs) in the ETP. These include higher value-added activity in the financial services, business services, wholesale and retail trade, education, healthcare, tourism-related industries and communication services. In the manufacturing sector, selected sub-sectors producing high technology equipment such as renewable energy, light emitting diodes (LEDs), as well as precision equipments and medical devices are also expected to attract higher investment. Furthermore, investment in the oil and gas sector is expected to increase, driven by continued exploration and extraction activity.

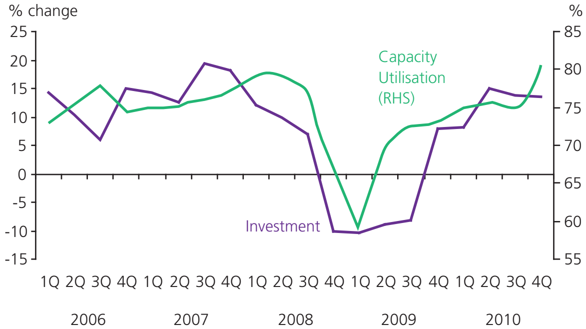
Going forward, given the appropriate combination of pro-growth policies, attractive incentive packages and liberalisation measures, as well as a vibrant external environment, private investment is expected to become an important catalyst for the growth and transformation of Malaysia towards a high-income, high value-added economy.

recorded a strong growth of 16.2% in 2010, while sales of construction-related materials increased by 11%. Moreover, accommodative financing conditions, as indicated by the higher loans disbursed to businesses (2010: 9.8%, 2009: -3.4%) and private debt securities issued for new activities (2010: 54.7%, 2009: -73.8%), provided further support for private investment activity. Gross FDI inflows rose to RM89.2 billion (2009: RM70.8 billion), reflecting the more favourable investment climate following improvements in the global economic environment as well as several key initiatives announced by the Government. Of significance, the MIER Business Conditions Index (BCI) remained above the 100-point confidence threshold for the most of 2010.

Investment in the manufacturing sector rose strongly in 2010 as demand for manufactured exports recovered. Higher production activity to meet the recovery in demand resulted in a higher capacity utilisation rate of 80% as at end-2010 (end-2009: 73%), leading to an increased need for firms to undertake capacity expansion activities. Capital spending in other sectors also grew in 2010. In the mining sector, capital spending was higher, mainly for oil and gas investment in upstream production facilities and exploration activity. Investment activity in the services sector also increased significantly, reflecting mainly the ongoing capacity expansion and upgrading of the broadband infrastructure in the communication industry, as well as the establishment of new retail outlets in the wholesale and retail trade sub-sector.

Chart 1.6

Total Nominal Investment and Manufacturing Sector Capacity Utilisation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Public investment increased by 5.5% in 2010 (2009: 8%), supported partly by the continuation of the second stimulus package amounting to RM5 billion in the first half of the year. Development expenditure was channelled mainly towards improving rural infrastructure and urban public transport as well as enhancing the provision of public education and healthcare services.

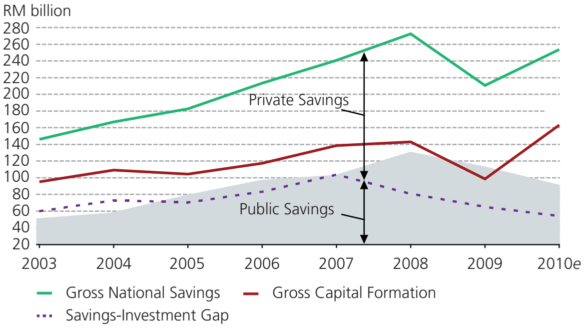
Investment by the non-financial public enterprises provided significant support to public investment in 2010, mainly in the mining, transportation, utilities and communication sectors. Capital spending in the mining sector reflected the ongoing upstream oil and gas exploration activity, while focus in the transportation sector was on upgrading and expanding the rail and air transport facilities. Additionally, investment in the utilities sector was channelled towards new power generation projects and the enhancement of the transmission and distribution network. Capital spending in the communication sector was also evident from the further development of the broadband infrastructure.

Public consumption moderated to 0.1% in 2010 (2009: 3.1%), attributable largely to lower spending on supplies and services. This is in line with the Government's initiative to reprioritise spending programmes and reduce non-essential expenditures. Nevertheless, expenditure on emoluments was higher following the improved salary scheme for selected segments of the civil service.

Private sector savings increased to RM199.4 billion (equivalent to 26.9% of GNI) in 2010 (2009: 21.9%), reflecting sound household and corporate sector balance sheets. Banking sector deposits held by households and businesses rose to RM821.8 billion in 2010 (2009: RM772.9 billion). In contrast, public sector savings declined to RM54.2 billion (equivalent to 7.3% of GNI, 2009: 9.8%), attributable mainly to the lower operating surpluses of the NFPEs during the year. Overall, **gross national savings (GNS)** increased markedly by 20.4% to RM253.6 billion (equivalent to 34.2% of GNI). However, the increase in GNS was offset by stronger investment spending by the private sector, resulting in a lower savings-investment surplus of RM90.5 billion (equivalent to 12.2% of GNI, 2009: RM112.1 billion or 16.9% of GNI).

Chart 1.7

Gross National Savings and Savings-Investment Gap



e Estimate

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

SECTORAL REVIEW

All economic sectors registered strong performance in 2010, in line with robust domestic demand and the rebound in exports. In particular, the manufacturing sector recovered firmly, with the electronics and electrical products cluster and domestic-oriented industries registering double-digit growth rates. Meanwhile, the services sector benefited from the strengthening of domestic demand over the year. Growth in all sectors, however, moderated in the second half of the year, reflecting the moderation in external demand and the diminishing statistical base effect. Nevertheless, overall growth was sustained by continued robust activity in the domestic-oriented sectors.

Robust growth in all services sub-sectors

The **services sector** registered a higher growth of 6.8% in 2010 (2009: 2.6%), with robust growth across all sub-sectors, amid the strengthening of both domestic and external demand. The services sector was the largest contributor to growth, contributing 3.9 percentage points to overall GDP growth. The sector expanded by 7.9% in the first half of the year, driven by higher growth in all sub-sectors, particularly the finance and insurance; wholesale and retail trade; communication; and transport and storage sub-sectors. In the second half, growth moderated to 5.8%, in response to the slowdown in external demand which affected the trade- and

Table 1.4

Services Sector Performance at Constant 2000 prices

	2009	2010*p*	2009	2010*p*
	Annual change (%)		Share to GDP (%)	
Services	**2.6**	**6.8**	**57.6**	**57.4**
Intermediate services	3.4	7.0	25.1	25.1
Finance and insurance	5.1	6.1	11.7	11.6
Real estate and business services	2.4	7.8	5.4	5.5
Transport and storage	-2.8	6.9	3.8	3.8
Communication	6.0	8.5	4.1	4.2
Final services	2.0	6.6	32.5	32.3
Wholesale and retail trade	1.2	7.9	13.3	13.4
Accommodation and restaurant	2.8	5.0	2.5	2.4
Utilities	0.4	8.2	3.0	3.0
Government services	2.0	6.5	7.6	7.6
Other services	4.4	4.0	6.1	5.9

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

manufacturing-related services sub-sectors. The expansion in domestic consumption activity, nevertheless, continued to benefit the services sub-sectors that are dependent on domestic demand, particularly the wholesale and retail trade; and communication sub-sectors.

The **finance and insurance** sub-sector grew by 6.1% (2009: 5.1%) as a result of increased net interest and fee-based incomes in the finance segment, which benefited from higher loan growth and the vibrant capital market during the year. In addition, the rise in premium income in the insurance segment lent further support to growth. The **wholesale and retail trade** sub-sector registered a stronger growth of 7.9% (2009: 1.2%), supported by higher household consumption spending, including for durable goods such as motor vehicles. The **transport and storage** sub-sector turned around to register a growth of 6.9% (2009: -2.8%), following improvements in trade activity and robust growth in passenger travel. However, growth in the sub-sector tapered off in the second half, as international trade slowed.

The robust performance of the **communication** sub-sector in 2010 is of notable significance.

Table 1.5

Selected Indicators for the Services Sector

	2009	2010*p*
	Annual change (%)	
Utilities		
Electricity production index	0.8	8.8
Wholesale & Retail Trade and Accommodation & Restaurant		
Consumption credit disbursed	13.2	12.6
Tourist arrivals	7.2	3.9
Total sales of motor vehicles	-2.1	12.8
Finance & Insurance and Real Estate & Business Services		
Loans outstanding in the banking system	7.8	12.7
Insurance premiums	9.1	10.6
Bursa Malaysia turnover (volume)	60.6	2.1
Transport & Storage and Communication		
Total container handled at Port Klang and PTP (TEUs)	-1.8	15.6
Airport passenger traffic	6.9	12.2
Air cargo handled	-13.7	14.2
SMS traffic	22.1	8.3
	%	
Penetration rate:		
- Broadband[1]	31.7	55.6
- Cellular phone[2]	106.2	117.6
- Fixed line[1]	44.0	42.5

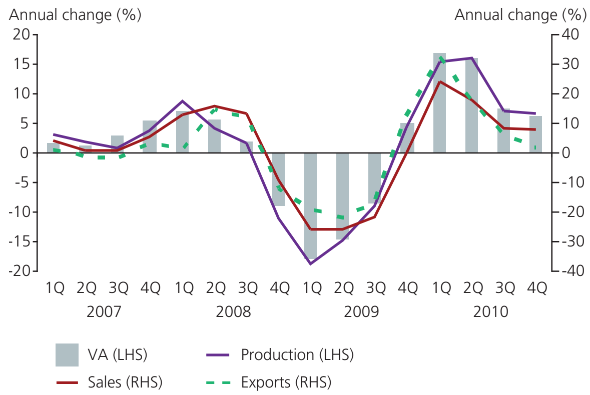
[1] of household
[2] of population
p Preliminary

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

The sub-sector grew by 8.5% (2009: 6%), registering consistently high growth in every quarter. Growth was spurred by the increased affordability of both mobile devices and data subscription packages. Furthermore, increased consumer preference for data services as well as the various initiatives to boost broadband connectivity, particularly in the rural areas and among low-income households, led to higher demand for broadband services. The broadband penetration rate stood at 55.6% of households as at end-2010 (end-2009: 31.7%), surpassing the Government's target of 50%.

Chart 1.8

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



Source: Department of Statistics, Malaysia

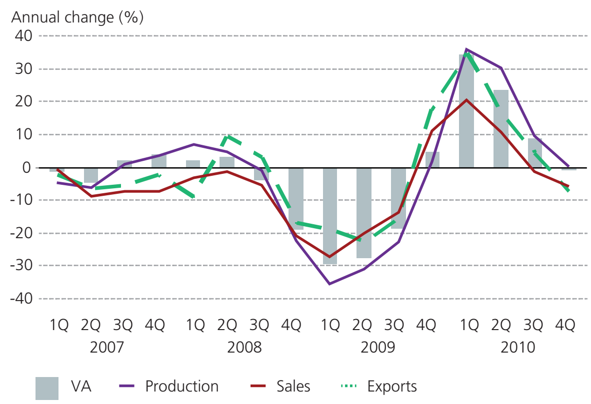
The **manufacturing sector** rebounded strongly in 2010, driven largely by the strong growth in the first half of the year with expansion in both the export- and domestic-oriented industries. The pace of growth, however, moderated towards year-end due to slower external demand and the diminishing base effect.

Strong recovery in the manufacturing sector

Growth in the export-oriented industry turned positive in 2010, driven by the strong rebound in the

Chart 1.9

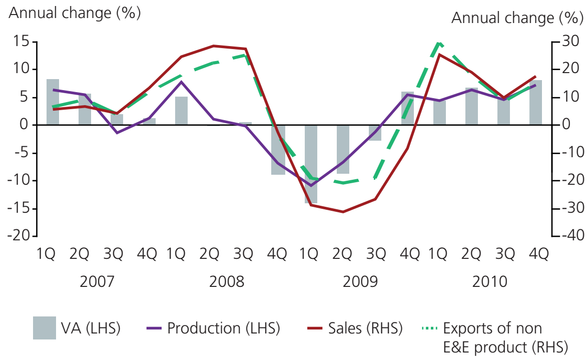
E&E Cluster: Value-added, Production, Sales and Exports



Source: Department of Statistics, Malaysia

Chart 1.10

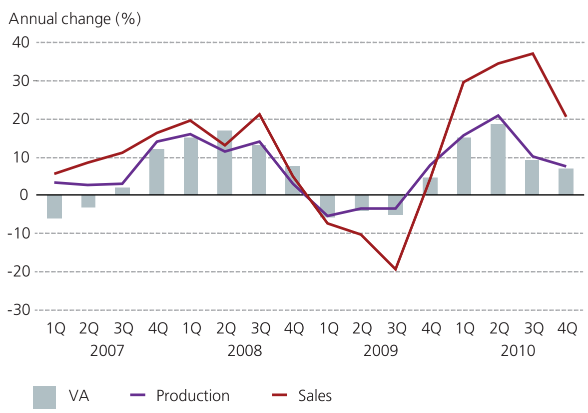
Primary-related Cluster: Value-added, Production, Sales and Exports



Source: Department of Statistics, Malaysia

Chart 1.11

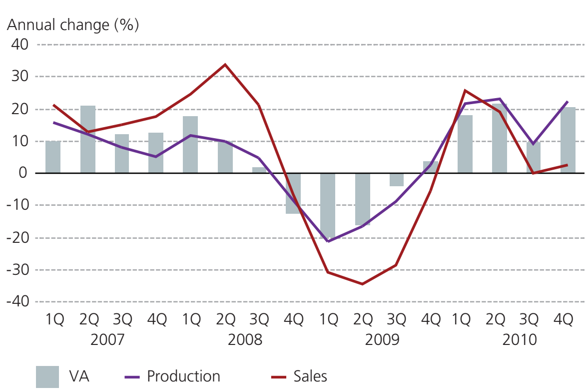
Consumer-related Cluster: Value-added, Production and Sales



Source: Department of Statistics, Malaysia

Chart 1.12

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



Source: Department of Statistics, Malaysia

electronics and electrical products (E&E) cluster. The E&E output growth was underpinned by the revival of global corporate IT investments and higher consumer spending on electronics, resulting in higher demand for semiconductors and audio-visual products, particularly in the first half of 2010. In the **primary-related cluster**, growth was in line with the recovery in the external environment, particularly from robust regional demand. Expansion in the cluster was driven primarily by the chemicals and rubber products industries.

The domestic-oriented industry grew by 15.6% (2009: -5.7%), supported mainly by strong domestic consumption activity. Output in the **consumer-related cluster** was driven by robust

Table 1.6

Performance of the Manufacturing Sector

	2009	2010
	Annual change (%)	
Value-added (RM million at 2000 prices)	**-9.4**	**11.4**
Overall Manufacturing Production[1]	**-10.0**	**11.1**
Export-oriented industries	**-11.1**	**9.7**
Electronics & electrical products cluster	**-22.8**	**17.4**
of which:		
Electronics	-24.6	3.2
Electrical products	-18.8	47.4
Primary-related cluster	**-3.5**	**5.7**
of which:		
Chemicals and chemical products	-1.7	11.5
Petroleum products	-0.8	-2.4
Rubber products	-3.0	20.8
Off-estate processing	-2.1	-2.3
Domestic-oriented industries	**-5.7**	**15.6**
Consumer-related cluster	**-1.2**	**13.4**
of which:		
Transport equipment	-12.4	29.7
Food, beverage & tobacco products	1.5	8.8
Construction-related cluster	**-11.4**	**18.9**
of which:		
Construction-related products	-18.1	21.9
Fabricated metal products	-1.1	15.0
Exports	**-12.3**	**13.0**

[1] Production data are based on the new Industrial Production Index (2005=100)

Source: Department of Statistics, Malaysia

growth in the transport equipment industry given the strong demand for vehicles throughout the year and the sustained performance in the food, beverage and tobacco industry. The **construction-related cluster** benefited from continued construction activity in the economy and implementation of the Government's stimulus measures. The major beneficiaries were the iron and steel and non-metallic mineral products industries. Nevertheless, growth in the second half moderated as the stimulus measures tapered off.

The agriculture, forestry and fishing **(agriculture) sector** expanded at a stronger pace of 1.7% in 2010, supported by sustained growth in the production of food crops such as livestock, fish and fruits. The industrial crops production registered a slower decline due to the rebound in **natural rubber** production, which increased by 9.6% to 939,241 tonnes as higher prices spurred tapping activity. The production of **crude palm oil**, however, declined further by 3.3% to 17 million tonnes amid unfavourable weather conditions. Palm oil stocks were lower by 28.1% to 1.61 million tonnes as at end-2010.

Table 1.7

Agriculture Sector: Value Added and Production

	2009	2010*p*
	Annual change (%)	
Value added	**0.4**	**1.7**
Industrial crops	**-4.6**	**-2.6**
Production of which:		
Crude palm oil	-1.0	-3.3
Rubber	-20.1	9.6
Saw logs	-8.7	-2.2[2]
Cocoa beans	-35.1	-13.8
Food crops	**7.2**	**7.0**
Production of which:		
Fish	12.2	2.7
Livestock[1]	7.6	2.4
Vegetables	3.1	-17.6
Fruits	0.6	8.3

[1] Refers to Peninsular Malaysia only
[2] Jan-Nov 2010
p Preliminary

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

Better performance in the agriculture sector due to high production of food crops

The agriculture sector benefited from higher prices in 2010. Global agricultural commodity prices increased significantly in the year following stronger demand, particularly from the emerging economies, while supply was constrained by adverse weather conditions. Rubber prices exceeded the historical high of RM10.71 per kg in April and recorded new highs since October 2010. On 30 December 2010, rubber prices closed at RM15.01 per kg (end-2009: RM9.58 per kg). Similarly, prices of crude palm oil also increased considerably during the year to reach RM3,770 per tonne by the end of 2010 (end-2009: RM2,571 per tonne).

The mining sector expanded marginally as higher natural gas production offset lower crude oil production

Value-added of the **mining sector** increased by 0.2% in 2010. Output of **natural gas** increased by 4.4% to 6,065 million standard cubic feet

Table 1.8

Mining Sector: Value Added and Production

	2009	2010*p*
	Annual change (%)	
Value added	**-3.8**	**0.2**
Production		
of which:		
Crude oil and condensates	-4.5	-3.5
Natural gas	-1.6	4.4

p Preliminary

Source: PETRONAS
Department of Statistics, Malaysia

Table 1.9

Malaysia: Crude Oil and Natural Gas Reserves[1]

	As at 1 January	
	2009	2010*p*
Crude oil (including condensates)		
Reserves (billion barrels)	5.52	5.80
Reserve/Production (year)	22	24
Natural gas		
Reserves (billion barrels of oil equivalent)	14.66	14.76
Reserve/Production (year)	36	38

[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

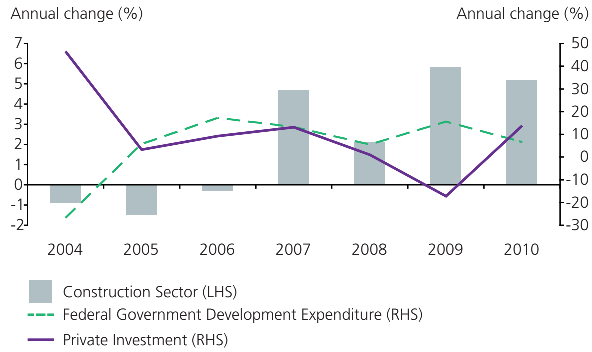
per day, as 2010 was the first full-year of exports to PR China and there was higher demand from the major importers such as Japan and Chinese Taipei. However, crude oil output continued to decline due mainly to lower production from the maturing oil fields and the shutdown of several oil fields for maintenance. The production of **crude oil (including condensates)** averaged 635,890 barrels per day in 2010, lower by 3.5% compared to 2009.

Moderate growth in the construction sector

The **construction sector** expanded by 5.2% in 2010 (2009: 5.8%), with some moderation in the second half, due partly to the completion of projects financed by the second stimulus package. Growth was supported mainly by the **non-residential** sub-sector, reflecting the construction of commercial properties, particularly purpose-built office and retail space, and the upgrading and repair of public buildings. The **civil engineering** sub-sector continued to grow amid continued progress in the implementation of infrastructure projects, such as the construction of the new Low Cost Carrier Terminal (LCCT), Second Penang Bridge, double-track rail project and several highways. However, construction activity in the **residential** sub-sector declined, with fewer units of new residential properties being launched by developers, particularly in the early part of 2010.

Chart 1.13

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



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

House prices, as measured by the Malaysian House Price Index (MHPI), increased by 6% on an annual basis during the first three quarters of 2010, almost doubling the average increase of 3.4% during

Table 1.10

Demand and Supply Indicators of the Residential Property Market

	1H '09	2H '09	1H '10	2H '10*p*
Annual change (%)				
Demand indicators				
Residential property transactions				
Value (RM million)	-14.3	17.1	30.7	13.6
Volume	-10.4	5.7	12.6	2.6
Finance for purchase of residential property				
Loan applications	11.1	54.9	40.6	18.0
Loan approvals	0.3	44.2	31.5	10.7
Supply indicators				
New launches	**-21.1**	**55.6**	**8.8**	**-25.8**
New sales and advertising permits	**-16.8**	**57.8**	**22.1**	**10.9**
Housing approvals	**-23.7**	**66.7**	**11.1**	**36.5**
Loans for construction				
Loan applications	-31.4	36.5	63.9	76.5
Loan approvals	-38.2	4.2	42.2	61.9
Price				
Malaysian House Price Index	1.6	3.5	5.9	6.2[1]

[1] Jul-Sep 2010
p Preliminary

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

2000-2009. The strong increase in prices was driven in large part by higher demand, due to continued growth in household incomes, improving consumer sentiments and the accommodative financing environment. By the middle of the year, prices of residential properties in specific locations, particularly in the Klang Valley, had increased by more than 10% on an annual basis but the pace of growth moderated towards end-year.

EXTERNAL SECTOR

Balance of Payments

Malaysia's external position remained resilient in 2010, underpinned by a sizeable current account surplus and a lower net outflow in the financial account. The trade surplus narrowed as import growth outpaced export growth, but nevertheless, remained large. The services account recorded a small surplus, supported by higher receipts from tourism as well as computer and IT services. However, the income account deficit widened due mainly to the higher profits of foreign direct investment in Malaysia. The lower net outflows in the financial account were largely attributable to the higher inflows of portfolio investments and FDI given the improvement in both global and domestic economic conditions. Outflows of direct investment abroad increased as Malaysian companies continued to tap opportunities in the regional and other markets. Other investment outflows, which mainly comprise trade credits and placements of deposits abroad by residents, moderated during the year.

Malaysia's external position remained resilient in 2010

During the year, errors and omissions excluding the cumulative foreign exchange revaluation loss amounted to RM38.4 billion. This represented 3.3% of Malaysia's total trade. After adjusting for

Table 1.11

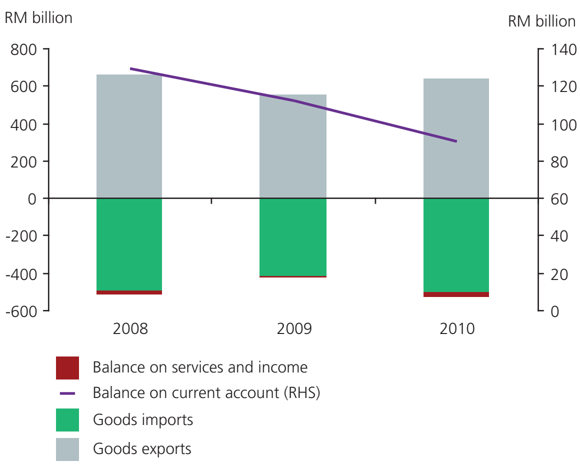
Balance of Payments

Item	2009			2010*p*		
	+	-	Net	+	-	Net
	RM billion					
Goods	554.1	412.3	141.7	639.8	503.3	136.6
Trade account	*553.3*	*434.9*	*118.4*	*639.4*	*529.2*	*110.2*
Services	101.3	96.6	4.7	104.7	103.8	0.9
Balance on goods and services	**655.3**	**508.9**	**146.4**	**744.5**	**607.1**	**137.4**
Income	39.3	54.0	-14.6	38.1	63.4	-25.2
Current transfers	3.7	23.3	-19.6	1.8	23.5	-21.7
Balance on current account	**698.4**	**586.3**	**112.1**	**784.5**	**694.0**	**90.5**
% of GNI			**17.5**			**12.2**
Capital account			-0.2			-0.2
Financial account			-80.2			-21.9
Direct investment			-22.9			-15.0
Portfolio investment			-1.7			44.9
Financial derivatives			2.5			-0.8
Other investment			-58.1			-51.1
Balance on capital and financial accounts			**-80.4**			**-22.1**
Errors and omissions			-17.9			-71.0
of which:						
Foreign exchange revaluation gain (+) or loss (-)			*10.7*			-32.6
Overall balance			**13.8**			**-2.6**
Bank Negara Malaysia international reserves, net			**331.3**			**328.6**
USD billion equivalent			**96.7**			**106.5**

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

Chart 1.14

Current Account



Source: Department of Statistics, Malaysia

the errors and omissions, the overall balance of payments recorded a small deficit of RM2.6 billion. Consequently, the net international reserves of Bank Negara Malaysia amounted to RM328.6 billion, equivalent to USD106.5 billion, as at 31 December 2010. As at 28 February 2011, the reserves remained at a comfortably high level of RM338.6 billion (equivalent to USD109.8 billion), adequate to finance 8.1 months of retained imports and cover 4.3 times of the short-term external debt. Malaysia's external reserves remain usable and unencumbered.

Current account surplus narrowed, reflecting the lower trade surplus as the growth of imports outpaced exports

Current Account

The **current account** surplus narrowed to RM90.5 billion or 12.2% of GNI in 2010 (2009: RM112.1 billion or 17.5% of GNI). Trade activity recovered during the year as global economic conditions improved, particularly among regional countries. Nonetheless, the acceleration of domestic demand also provided an impetus for the strong growth in gross imports which outpaced the growth in gross exports, leading to a smaller trade surplus. The services account recorded a surplus for the fourth consecutive year, albeit by a smaller amount. The surplus was supported by robust tourist arrivals and higher receipts from computer and IT services. The deficit in the income account widened as higher profits and dividends accruing to foreign direct investors operating in Malaysia more than offset the increase in profits and dividends accruing to Malaysian companies investing abroad.

Total exports and imports amounted to RM1.17 trillion (157.8% of GNI), approaching the levels reached before the crisis (2008: RM1.18 trillion). In line with the robust growth in regional countries, **gross exports** expanded by 26.1% in the first half, underpinned by strong regional demand and to a certain extent, the low base effect of the previous year. However, the growth momentum moderated in the second half, weighed down by the slower growth of manufactured exports, which offset the strong growth in commodity exports. The performance

Table 1.12

Gross Exports

	2009	2010*p*
	Annual change (%)	
Gross exports	**-16.5**	**15.6**
Manufactures	**-12.3**	**13.0**
of which:		
Electronics	*-8.6*	*8.6*
Semiconductors	*3.4*	*5.3*
Electronic equipment and parts	*-18.8*	*12.2*
Electrical products	*-16.2*	*13.3*
Resource-based products[1]	*-17.1*	*20.0*
Commodities	**-28.2**	**26.9**
Agriculture	**-21.8**	**30.8**
of which:		
Palm oil	*-20.9*	*25.4*
Rubber	*-45.0*	*106.5*
Minerals	**-33.1**	**23.4**
of which:		
Crude oil and condensates	*-41.8*	*21.3*
LNG	*-24.8*	*22.1*

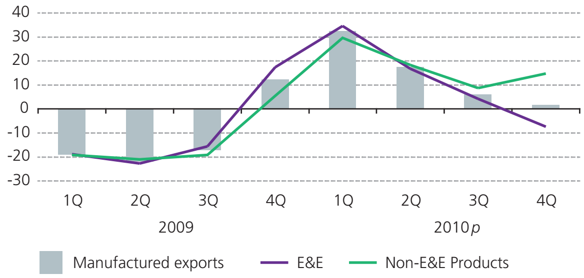
[1] Refers to food, beverages and tobacco products, wood products, furniture and parts, rubber products, petroleum products, chemicals and chemical products and non-metallic mineral products

p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.15

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

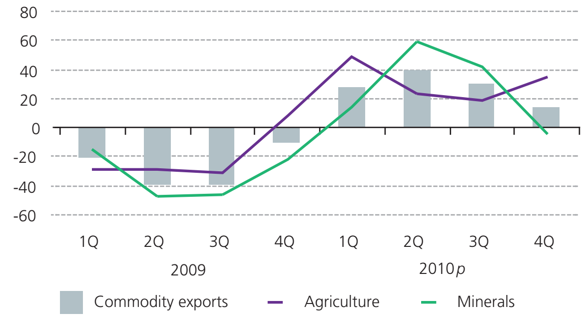


p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.16

Commodity Export Performance



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

of manufactured exports mainly reflected the external demand for electronics and electrical products (E&E), which moderated towards the second half of the year. Commodity exports, on the other hand, remained resilient throughout the year, supported by robust regional demand and high commodity prices.

Manufactured exports expanded by 13% in 2010, with strong growth recorded across major products in the first half of the year. E&E exports, particularly semiconductors, rose significantly in the first half, benefiting from inventory restocking in the global electronics industry. Moving into the latter half of the year, the moderation in regional demand led to the softening of electronics exports. Similarly, the robust growth of non-E&E exports eased in the second half of the year, but continued to be supported by firm regional demand for resource-based products such as chemicals, petroleum and rubber products, and optical and scientific equipment.

Table 1.13

Direction of External Trade

	2010*p*				
	Exports		Imports		Trade balance
	RM billion	Annual change (%)	RM billion	Annual change (%)	RM billion
Total	**639.4**	**15.6**	**529.2**	**21.7**	**110.2**
of which:					
United States	**61.0**	**0.6**	**56.3**	**15.8**	**4.7**
European Union (EU)	**68.7**	**14.5**	**54.2**	**6.7**	**14.5**
Selected ASEAN countries[1]	**160.6**	**13.9**	**142.6**	**30.9**	**17.9**
Selected North East Asia countries	**157.5**	**19.7**	**131.6**	**19.6**	**25.9**
The People's Republic of China	*80.6*	*19.9*	*66.4*	*9.5*	*14.2*
Hong Kong SAR	*32.5*	*12.8*	*12.7*	*17.3*	*19.9*
Chinese Taipei	*20.2*	*39.9*	*23.8*	*29.0*	*-3.6*
Korea	*24.2*	*14.7*	*28.7*	*42.6*	*-4.5*
West Asia	**22.3**	**4.0**	**18.9**	**27.6**	**3.4**
Japan	**66.3**	**21.8**	**66.5**	**22.6**	**-0.3**
India	**21.0**	**23.3**	**8.0**	**1.4**	**13.0**

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

Source: Department of Statistics, Malaysia

Table 1.14

Imports by End-Use

	2009	2010*p*
	Annual change (%)	
Capital goods	**-5.9**	**16.2**
Capital goods (except transport equipment)	-8.2	16.1
Transport equipment	10.5	17.1
Intermediate goods	**-21.6**	**22.1**
Food and beverages, mainly for industry	-16.8	22.6
Industrial supplies, n.e.s.	-21.8	24.5
Fuel and lubricants	-36.0	34.1
Parts and accessories of capital goods (except transport equipment)	-19.0	19.6
Consumption goods	**-2.7**	**10.1**
Food and beverages, mainly for household consumption	7.8	9.1
Consumer goods, n.e.s.	-9.1	10.0
Re-exports	**35.1**	**32.2**
Gross Imports	**-16.3**	**21.7**

n.e.s. Not elsewhere specified
p Preliminary

Source: Department of Statistics, Malaysia

Commodity exports turned around to register a growth of 26.9%, buoyed by firm regional demand and stronger commodity prices. Of significance, agriculture exports sustained robust growth rates throughout the year, supported by rising prices of crude palm oil, natural rubber and continued demand from the region. While mineral exports also recorded strong expansion in the first half of the year, the pace of growth moderated in the second half as the decline in export volume of crude oil in the fourth quarter more than offset the gains from higher oil prices.

Gross imports grew by 21.7%, with expansion across all major import categories. Intermediate imports grew by 22.1%, led by imports of industrial supplies, fuel and lubricants, in tandem with the pick-up in manufacturing activity. Capital imports surged by 16.2%, as imports of machineries increased substantially in consonance with the revival of domestic investment activity. Likewise, imports of consumption goods expanded by 10.1%, driven mainly by imports of food and beverages, reflecting positive consumer spending. The pace of expansion in capital and consumption imports remained strong despite moderating slightly in the second half of the year.

The **services account** remained positive, albeit by a smaller amount, supported by strong tourism activity and higher receipts from computer and IT services. The surplus in the travel account was sustained as the improvement in global economic conditions continued to spur greater tourist arrivals. In 2010, tourist arrivals totalled 24.6 million visitors (2009: 23.6 million visitors), with Asian countries providing the largest number of visitors. The expansion of travel

Table 1.15

Services and Income Accounts

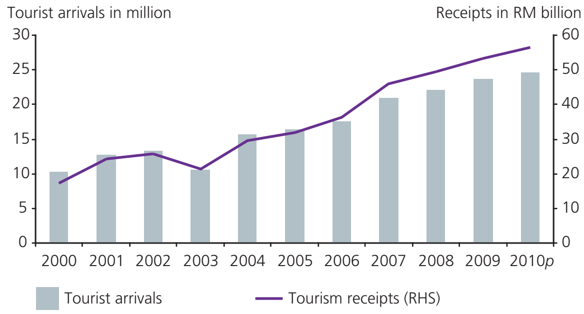
	2009	2010*p*		
	RM billion			
	Net	+	-	Net
Services Account	**4.7**	**104.7**	**103.8**	**0.9**
% of GNI	*0.7*			*0.1*
Transportation	-17.0	15.1	38.2	-23.0
Travel	32.7	57.4	25.4	32.0
Other services	-10.4	31.9	39.5	-7.6
Government transactions n.i.e.	-0.6	0.3	0.8	-0.5
Income Account	**-14.6**	**38.1**	**63.4**	**-25.2**
% of GNI	*-2.3*			*-3.4*
Compensation of employees	-1.5	3.6	5.6	-2.1
Investment income	-13.1	34.6	57.7	-23.2

n.i.e. Not included elsewhere
p Preliminary
Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia

Chart 1.17

Tourist Arrivals and Tourism Receipts



p Preliminary

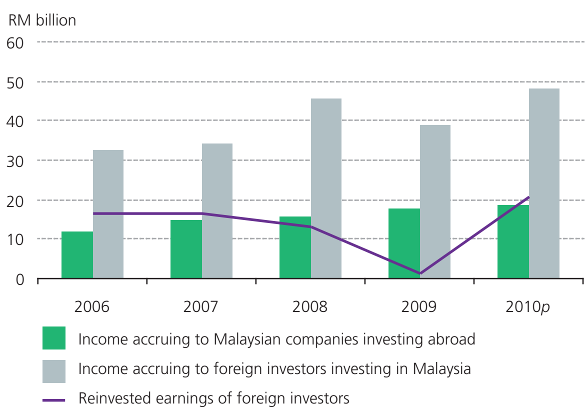
Source: Malaysia Tourism Promotion Board and Department of Statistics, Malaysia

routes and the increase of flight frequencies by low cost carriers were the main contributing factors. The deficit in other services account declined due mainly to higher receipts from computer and IT services. Meanwhile, the transportation account deficit widened as, in line with the acceleration of imports, higher freight payments exceeded the sustained receipts from passenger and cargo fares.

The **income account** deficit widened to RM25.2 billion or 3.4% of GNI. This largely reflected the higher profits and dividends accruing to portfolio and foreign direct investors in Malaysia, which more than offset the higher earnings from portfolio and direct investment abroad. In particular, foreign direct investments in the manufacturing and oil and gas sectors recorded significantly higher profits due to improved export performance in both manufactured products and crude minerals.

Chart 1.18

Direct Investment Income



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Source: Department of Statistics, Malaysia

Financial Account

In 2010, the financial account recorded a smaller net outflow of RM21.9 billion (2009: -RM80.2 billion). Of significance was the return of large scale portfolio inflows into Malaysia, a trend experienced across the region, given the prospects for strong growth of regional economies. There were also expectations for stronger regional currencies and higher interest rates, which in turn led to further inflows of foreign capital into the region. The improving global economic conditions and corporate profitability led to higher inflows of foreign direct investment (FDI). Similarly, direct investment abroad (DIA) rose as Malaysian companies continued to tap profitable opportunities in other regions. Other investment outflows, which largely reflected trade credits and placement of deposit abroad by residents, moderated during the year.

For the year as a whole, **portfolio investment** recorded a much larger net inflow of RM44.9 billion. The inflows of foreign portfolio funds were channelled into both the equity and debt securities markets, with the bulk of the funds flowing mainly into long-term debt securities. Despite the larger

Table 1.16

Balance of Payments: Financial Account

	2009	2010*p*
	RM billion	
Financial Account	**-80.2**	**-21.9**
Direct Investment	**-22.9**	**-15.0**
Abroad	-27.9	-42.6
In Malaysia	5.0	27.6
Portfolio Investment	**-1.7**	**44.9**
Financial Derivatives	**2.5**	**-0.8**
Other Investment	**-58.1**	**-51.1**
Official sector[1]	6.6	0.2
Federal Government	*-0.6*	*-0.4*
NFPEs	*0.5*	*0.6*
Bank Negara Malaysia	*6.6*	*0.0*
Private sector	-64.6	-51.4

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

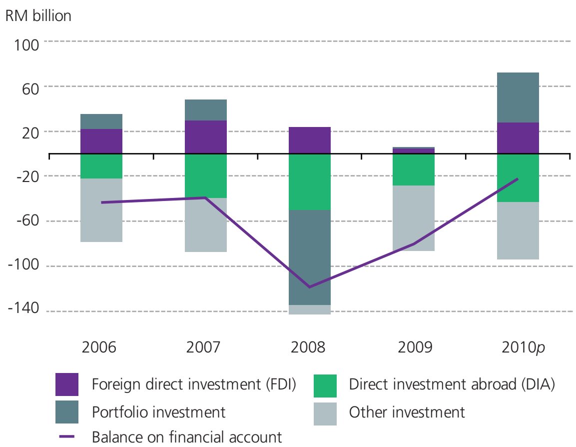
p Preliminary

Note: Numbers may not necessarily add up due to rounding

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.19

Financial Account



p Preliminary

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

inflows, the level of foreign holdings in these asset markets remained below the pre-financial crisis levels of 2008/09.

The lower net outflows in the financial account largely reflected the higher inflows of portfolio investment and foreign direct investment

These inflows have not created economic and financial imbalances. Importantly, Malaysia has the policy capacity to manage these inflows. The presence of a robust monitoring and surveillance system has provided near real time information on the size and nature of these inflows and allows for early detection of any emerging risks inherent to these short-term flows. The more diversified financial sector, the stronger and resilient financial institutions as well as the deeper and broader financial markets have been able to absorb the volatility in capital flows such that orderly financial markets was preserved. The availability of a wide range of monetary instruments has allowed for effective sterilisation of excess liquidity in the system arising from these capital inflows.

Gross inflows of **FDI** increased further to RM89.2 billion, accounting for 12% of GNI in 2010 in tandem with the global economic recovery. Amid improvements in domestic economic conditions, higher corporate profitability contributed to the larger inflows of FDI into the country during the year. This was evident through the significantly higher amount of earnings retained for investments by existing multinational companies (MNCs) in Malaysia. In addition, several new Government initiatives, notably the Entry Point Projects (EPPs) under the Economic Transformation Programme (ETP) which provided business opportunities for the private sector to drive growth. The empowerment and corporatisation of MIDA to negotiate directly with investors and undertake real-time decision making on investments proposals is expected to contribute significantly in sustaining investors' confidence in the Malaysian economy.

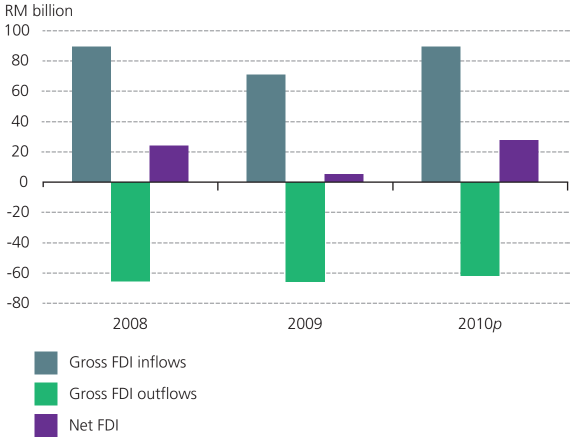
Positive investor sentiments to investing in Malaysia was further buoyed by improvements in the country's rankings for competitiveness and ease of doing business in the reports released by the International Institute for Management Development (IMD), UNCTAD and the World Bank, respectively. This, together with the continued efforts of the Government to further liberalise investment policies in the manufacturing and services sectors have helped to attract more FDI into Malaysia during the year. After taking into account the adjustments for outflows due largely to loan repayments to parent companies and to a certain extent, repatriation of working capital by some oil and gas companies, net inflows of FDI increased significantly to RM27.6 billion or 3.7% of GNI.

FDI in Malaysia continued to be broad-based. The manufacturing (60.2% share), services (30.2% share) and oil and gas (8.9% share) sectors were the main beneficiaries during the year. In the manufacturing sector, FDI was mainly into the E&E industries, largely by existing MNCs, for upgrading equipment and technology in a move towards higher value added activities and greater product sophistication. There were also investments undertaken by companies in the solar industry, which subsequently boosted the expansion of the solar value chain in Malaysia. Other investments in the manufacturing sector were in petroleum refining and petroleum-related products industry which continued to remain sizeable.

In the services sector, FDI inflows were channelled primarily into the finance and insurance sub-sector,

Chart 1.20

Foreign Direct Investment (FDI)



p Preliminary

Source: Department of Statistics, Malaysia

followed by the wholesale and retail sub-sector. Of significance, the bulk of investments in the finance and insurance sub-sector were undertaken by foreign financial institutions, mainly through reinvested earnings. The FDI in the wholesale and retail sub-sector was undertaken mainly by distributive companies related to telecommunication and electronic products. Investments in the oil and gas sector were mainly for extraction operations and production activities. Major contributors of FDI inflows in 2010 were mainly the advanced economies, particularly the United States, Japan and Netherlands.

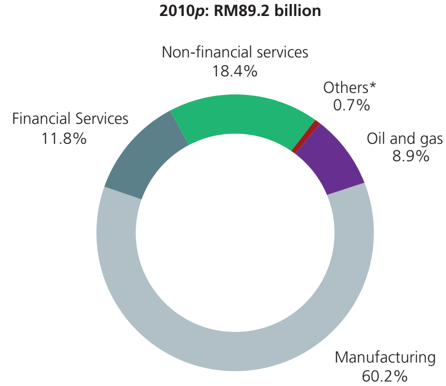
In 2010, gross outflows of **DIA** by Malaysian companies increased to RM67.9 billion, accounting for 9.2% of GNI. The larger DIA outflows reflected the continued investment by Malaysian companies in their existing operations and expansion into new businesses, as evidenced by higher outflows of equity capital, retained earnings, and larger extension of inter-company loans. After taking account the gross inflows, which was largely attributable to repayments of loans by subsidiaries abroad, net DIA amounted to RM42.6 billion or 5.8% of GNI.

The DIA by Malaysian companies was largely channelled into the services (67% share), oil and gas (19% share) and manufacturing (11% share) sectors. Investments in the services sector were led mainly by domestic financial institutions, utilities and telecommunications companies which were expanding their existing operations abroad in an effort to further tap high growth markets in the region, and to remain competitive on a regional scale. A significant part of investments in the services sector reflected strategic investments in healthcare, leisure and entertainment sub-sectors.

In the oil and gas sector, the DIA continued to be driven by Malaysian oil companies, primarily in the exploration and production (E&P) businesses as well as downstream processing activities. Investment abroad in the manufacturing sector reflected primarily reinvestments in the integrated agribusiness model, particularly

Chart 1.21

Gross FDI Inflows by Sector



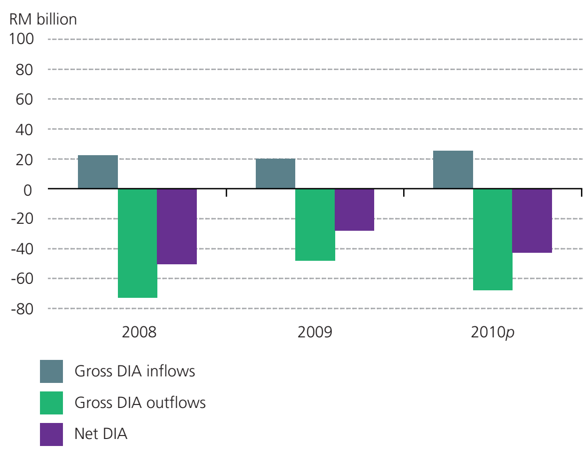
Note: *Refers to agriculture and construction sectors

p Preliminary

Source: Department of Statistics, Malaysia

Chart 1.22

Direct Investment Abroad (DIA)



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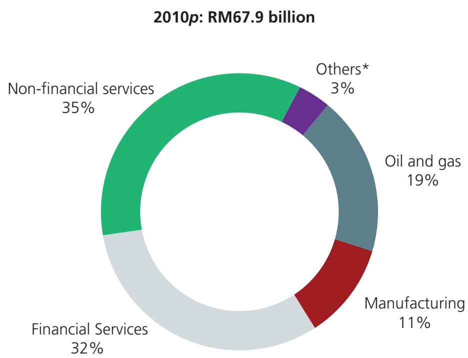
Source: Department of Statistics, Malaysia

Chart 1.23

Gross DIA Outflows by Sector



Note: *Refers to agriculture and construction sectors
p Preliminary

Source: Department of Statistics, Malaysia

relating to palm oil, which captures the entire value chain of the agricultural commodity processing. Most of DIA during the year were within the region, particularly in ASEAN, the Asian Newly Industrialised Economies (NIEs) and the West Asian economies. There were also sizeable investments abroad by Malaysian companies in the advanced economies, notably Australia and United Kingdom.

Other investment recorded a smaller net outflow of RM51.1 billion in 2010 due to a moderation in the private sector outflows and net inflows in the official sector. Despite higher net placements of deposits abroad by the banking sector, private sector outflows were lower on account of lower net trade credits. Unlike in 2009, Malaysian exporters extended less trade credit while Malaysian importers received more trade credit as foreign importers and exporters' access to trade financing improved as the global economic recovery gained traction. The higher outflows in the banking sector largely reflected the liquidity management strategy of the banks. Meanwhile, the official sector recorded a small inflow as external loan drawdown by the non-financial public enterprises (NFPEs) more than offset the external loan repayments by the Federal Government.

International Reserves

The **international reserves** held by Bank Negara Malaysia comprise holdings of gold and foreign exchange, the reserve position with the IMF and holdings of Special Drawing Rights (SDR). In 2010, net international reserves amounted to RM328.6 billion, equivalent to USD106.5 billion, as at 31 December 2010.

International reserves amounted to RM328.6 billion in 2010, supported mainly by continued surplus in the current account as well as inflows of FDI and portfolio investment

During the year, the international reserves were largely supported by the current account surplus following the surplus in the trade account arising from strong commodity and manufactured exports. The movement of the international reserves during the year was also to a large extent influenced by larger inflows of portfolio investment and FDI, reflecting improved economic prospects and strengthened investor sentiments. These inflows, however, were partly offset by direct investment abroad as well as net outflows of other investments.

Excluding the revaluation changes, reserves remained relatively stable in the first six months, with the net inflow of funds being reflected in the gradual appreciation of the ringgit. In the second half-year, reserves registered a modest increase following the intensification of portfolio inflows, particularly in the third quarter. For the year as a whole, the increase of reserves was however offset by the cumulative unrealised foreign exchange revaluation loss of RM32.6 billion arising from the strengthening of the ringgit against most major currencies.

Malaysia remains a participating member in the Financial Transactions Plan of the IMF. Under this plan, a member will provide resources to member countries that face short-term balance of payments difficulties. Notwithstanding a purchase of currency transaction by a member country under the Financial Transactions Plan, the **reserve position with the IMF** and the international reserves held in the form of **SDRs** declined in 2010 mainly due to the exchange

Table 1.17

Net International Reserves

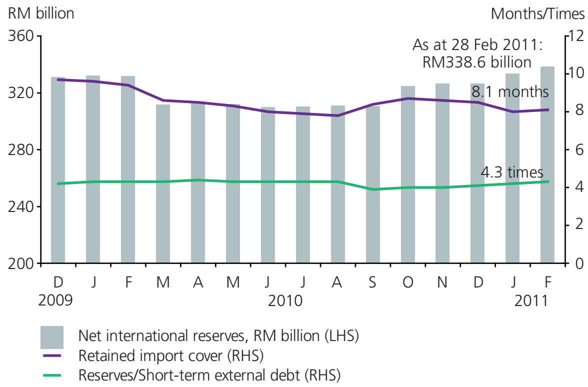
	As at end		Change
	2009	2010	2010
	RM million		
SDR holdings	7,279.2	6,442.5	-836.7
IMF reserve position	1,515.8	1,453.5	-62.3
Gold and foreign exchange[1]	322,505.6	320,774.5	-1,731.1
Gross International Reserves	**331,300.6**	**328,670.5**	**-2,630.1**
Less Bank Negara Malaysia external liabilities	23.9	21.4	-2.5
Net International Reserves	**331,276.7**	**328,649.1**	**-2,627.6**
USD million equivalent	96,688.1	106,518.2	9,830.1
Months of retained imports	9.7	8.6	
Reserves/Short-term external debt (times)	4.2	4.1	

[1] 'Other Foreign Currency Claims on Residents' is reclassified from 'Gold and Foreign Exchange' to 'Other Assets' of Bank Negara Malaysia
Note: Numbers may not necessarily add up due to rounding

Source: Bank Negara Malaysia

Chart 1.24

Net International Reserves (end-month)



Source: Bank Negara Malaysia

revaluation loss following the appreciation of ringgit against SDR.

Given the multifaceted challenge of shifting global liquidity flows, the reserves portfolio strategy and risk management practices were adapted accordingly. In particular, there was increased emphasis and caution on sovereign risk following heightened concerns about the funding capacity of some European sovereigns. Further diversification of currency holdings and assets to enhance the risk-adjusted returns of the portfolio remain a key investment strategy.

As at 28 February 2011, the reserves level amounted to RM338.6 billion (equivalent to USD109.8 billion), adequate to finance 8.1 months of retained imports and is 4.3 times the short-term external debt. The international reserves held by the Bank are usable and unencumbered. There are no foreign currency loans with embedded options and no undrawn, unconditional credit lines provided by or to other central banks, international organisations, banks and other financial institutions. Bank Negara Malaysia also does not engage in ringgit-related options activity in the foreign currency markets.

External Debt

Malaysia's external debt management strategy had progressed amid the shifting global financial landscape and ongoing transformation of the Malaysian economy to a high-value added and high income economy. The strategy in essence, is geared towards creating a facilitative business environment to enhance competitiveness and flexibility of the economy. To facilitate greater mobility of capital to enhance management of financial resources, resident companies are free to source foreign currency borrowing within the same corporate group which includes foreign subsidiaries, branches, ultimate holding or parent companies, associate or sister companies. In safeguarding monetary and financial stability, the emphasis is to ensure that the management of the nation's external debt is continuously supported by a comprehensive, well-functioning and robust debt monitoring system that covers the overall debt level, the structure of the debt, and the debt-servicing obligations of the country.

Malaysia's external debt remained low at 30.2% of GNI

As at end-2010, Malaysia's total external debt declined to RM226.3 billion (or USD72.6 billion), or 30.2% of GNI (2009: RM233.1 billion). This reflected the decline in the medium- and long-

Table 1.18

Outstanding External Debt

	2009	2010*p*	2009	2010*p*
	RM billion	RM billion	USD billion	USD billion
Total debt	**233.1**	**226.3**	**67.4**	**72.6**
Medium- and long-term	155.4	146.9	44.9	47.1
Short-term[1]	77.8	79.4	22.5	25.5
As % of total debt	*33.4*	*35.1*		
As % of net international reserves	*23.5*	*24.2*		
As % of GNI				
Total debt	35.1	30.2		
Medium- and long-term debt	23.4	19.6		
As % of exports of goods and services				
Total debt	35.6	30.4		
Medium- and long-term debt	23.7	19.7		
Debt service ratio (%)	**6.5**	**7.6**		

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

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

term debt. The appreciation of the ringgit against major currencies during the year also contributed to the moderation in the overall external debt level. In the case of **medium- and long-term external debt**, the improvement was also due to the net repayment position of the private sector. As at end-year, Malaysia's external debt profile continued to be skewed towards a longer maturity structure with medium- and long-term debt accounting for 64.9% of total external debt.

In May 2010, the **Federal Government** issued a USD1.25 billion 5-year global *sukuk*, the first market loan raised in the international capital market since 2002. The *sukuk* issuance was aimed at promoting Malaysia as a global Islamic financial hub and to establish a new US dollar benchmark for Malaysian corporates. As at end-year, the outstanding external debt of the Federal Government rose to RM16.7 billion (2009: RM13.8 billion), as higher gross borrowings more than offset repayments and exchange revaluation gains during the year. External debt of the **NFPEs** declined to RM66.6 billion in 2010 (2009: RM71.6 billion). Although the NFPEs continued to drawdown long-term external loans, mainly to finance their capital investments, the amount was significantly lower. In addition, the repayment of external loans remained large, following the maturity of several bonds as well as continued loan repayments throughout the year.

Similarly, following significantly larger repayments during the year, the medium- and long-term debt of the **private sector** declined to RM63.6 billion (2009: RM70 billion). This largely reflected the larger repayments of debt by companies in the retail, communications and mining sectors.

During the year, the **short-term external debt** outstanding increased to RM79.4 billion (2009: RM77.8 billion), attributed primarily to higher non-bank private sector borrowings. The bulk of the short-term debt continued to be held by the banking sector (85.6% share) while short-term external debt of the non-bank private sector, comprising mainly revolving credits and overdraft facilities, remained low. As at end-2010, the short-term external debt remained relatively small, accounting for only 10.6% of GNI, 24.2% of international reserves and 10.7% of exports of goods and services.

LABOUR MARKET DEVELOPMENTS

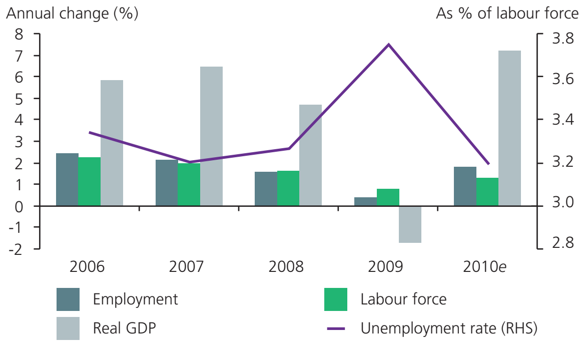
Labour market conditions improved in 2010, as reflected in lower retrenchments, higher number of vacancies and gains in employment. The unemployment rate declined to 3.2% of the labour force (2009: 3.7%), following stronger growth in employment (1.8%; 2009: 0.4%), compared to the growth in the labour force (1.3%; 2009: 0.8%).

Labour market conditions improved amid better economic performance

During the year, **employment** expanded by 1.8%, equivalent to a net addition of 204,400 jobs. The services sector remained the major source of employment, with net addition of 96,800 jobs, accounting for 47% of total job creation. Job creation in the services sector was driven mainly by new jobs in distributive trade and restaurants (47,600 jobs), finance and business services (15,900 jobs), and transport, storage and communication (8,000 jobs) sub-sectors. The manufacturing sector recorded gains in employment of 102,400 jobs, reversing the net job losses in 2009 following

Chart 1.25

Output and Employment



e Estimate

Source: Economic Planning Unit and Department of Statistics, Malaysia

Chart 1.26

Retrenchments in Selected Sectors

Source: Ministry of Human Resources

strong labour demand in the E&E and consumer-related industries. The E&E sector in particular, accounted for about two-thirds of total job creation in the manufacturing sector.

In terms of **skill levels**, the bulk of the jobs created were in the mid-skill (55% or 112,300) and the high-skill (51% or 104,600) category, while the low-skill category recorded job losses. Of significance, the number of high-skill jobs had been growing at a faster pace (3.2%) compared to the mid-skill (1.6%) category, while the number of low-skill jobs had declined (-1%). As at the end of 2010, 3.4 million or 28% of total employment was in high-skill jobs, 7.2 million or 61% in mid-skill jobs and 1.3 million or 11% in low-skill jobs.

Retrenchments declined by 72% to 7,085 persons (2009: 25,064 persons), due mainly to significantly fewer layoffs in the manufacturing sector. All sectors recorded improvement in retrenchments, except for the agriculture sector, which was affected by the closure and sale of a company in the first quarter. The E&E sub-sector in particular, remained resilient, as retrenchments were substantially lower (390 persons; 2009: 9,337 persons) reflecting the vast improvement in external demand. **Vacancies** posted on JobsMalaysia Portal increased to 1.8 million positions (2009: 1.5 million positions), attributable to higher number of job openings in the manufacturing (39% of total positions)

Table 1.19

Selected Labour Market Indicators

	2006	2007	2008	2009	2010e
Employment[1] ('000 persons)	11,159.0	11,398.0	11,576.5	11,620.5	11,824.9
Annual change (%)	2.4	2.1	1.6	0.4	1.8
Labour force[1] ('000 persons)	11,544.5	11,775.1	11,967.5	12,061.1	12,216.8
Annual change (%)	2.2	2.0	1.6	0.8	1.3
Retrenchments (persons)	15,360	14,035	24,033	25,064	7,085
Unemployment rate[1] (% of labour force)	3.3	3.2	3.3	3.7	3.2
Real labour productivity growth[2] (%)	3.3	4.2	3.1	-2.1	5.8

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

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

and services (29% of total positions) sectors. Hiring activity in the manufacturing sector was particularly strong in the first half year, supported by the expansion in both the export- and domestic-oriented industries.

In 2010, total registered foreign workers (including expatriates) in Malaysia declined by 5.6% to 1.8 million workers (2009: 1.9 million). The decline was in line with the Government's effort to further reduce the dependency on low-skilled foreign workers. Foreign workers accounted for 15.5% of employment in Malaysia in 2010 (2009: 16.5%) and were mainly employed in the manufacturing, construction and agriculture sectors.

Labour productivity, as measured by real value-added per worker, grew strongly by 5.8%, reversing the negative growth of 2.1% in 2009. Growth was underpinned by the strong productivity growth in the manufacturing (9.5%) and services (5%) sectors. Gains in productivity were supported by higher investment in capital, greater participation from high-skilled workers and from skills-upgrading through technical training schemes provided by the Government and the private sector. According to a survey conducted by Bank Negara Malaysia, the average **salary** increment in the private sector was 4.5% (2009: 4.3%), with an average increment of 3.8% and 5.5% in the manufacturing and non-manufacturing sectors respectively. In addition, both executives and non-executives received higher salary increments of 4.3% and 4.4%, respectively (2009: 4.1% and 3.5%).

PRICE DEVELOPMENTS

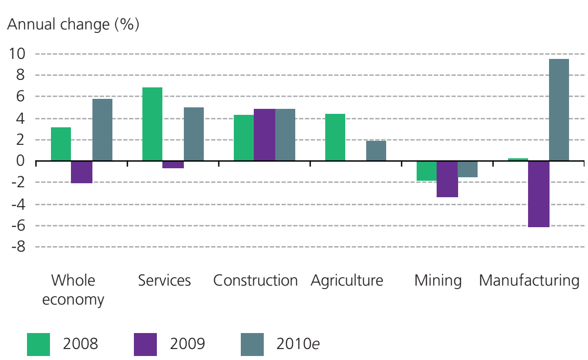
Consumer prices

Headline inflation, as measured by the annual percentage change in the Consumer Price Index (CPI), averaged 1.7% in 2010 (2009: 0.6%). The increase in inflation during the year was driven by supply factors arising from higher food and commodity prices and adjustments to administered prices. The actual headline inflation was below the Bank's forecast range of 2.0 – 2.5% partly due to the difference between the actual and expected adjustments - both in terms of timing and magnitude of the Government's subsidy rationalisation programme. Core inflation, an indicator of the demand-driven pressures on prices, rose at a more modest pace of 1.5% in 2010 (2009: 2.7%).

The main contributors to inflation in 2010 were the *food and non-alcoholic beverages* and *transport* categories, which together comprised 59.2% of the overall increase in domestic prices during the year. Inflation in the *food and non-alcoholic beverages* category averaged 2.4% mainly on account of higher price increases in the *vegetables*, *meat* and *sugar, jam, honey, chocolate and confectionery* sub-categories. Inflation in the *transport* category registered a substantial turnaround from -9.4% in 2009 to 1.6% in 2010 due to higher fuel prices. The increase in inflation during the year was mitigated by further declines in the prices for the *clothing and footwear* and *communication* categories, which averaged -1.4% and -0.2% respectively (2009: -0.9% and -0.5% respectively). There was no broad based increase in inflation across all CPI sub-groups

Chart 1.27

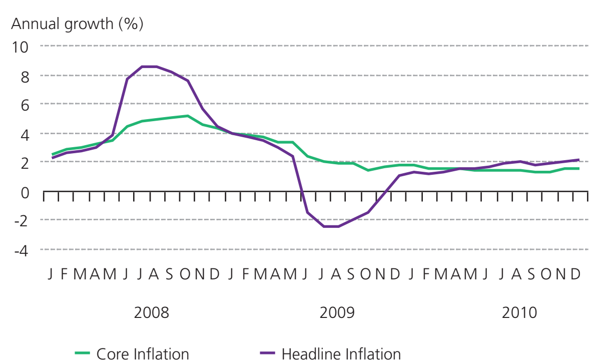
Labour Productivity Trends



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

Chart 1.28

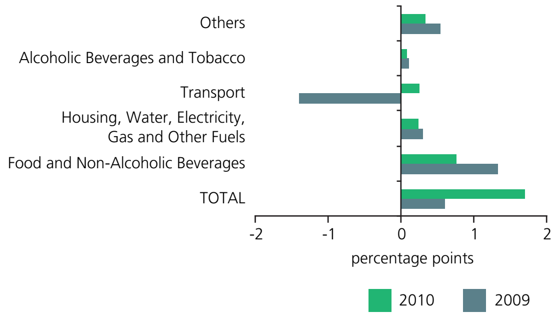
Consumer Price Inflation



Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Chart 1.29

Contribution to Inflation

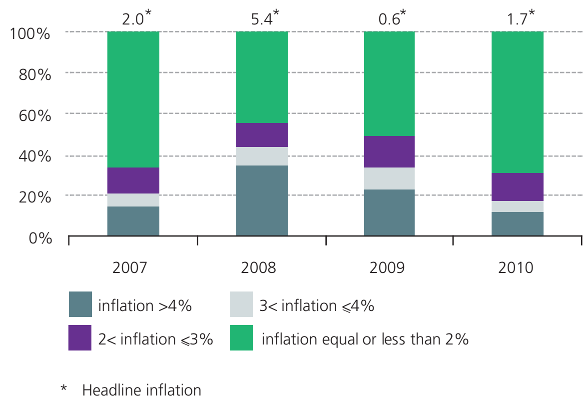


Note: Others refer to *communication; clothing and footwear; health; education; recreation services and culture; furnishings; household equipment and routine maintenance; restaurant and hotels;* and *miscellaneous goods and services*

Source: Bank Negara Malaysia

Chart 1.30

Percentage of CPI Components Above Specified Threshold



Source: Bank Negara Malaysia

during the year. Approximately 70% of CPI components recorded an inflation rate of less than 2% in 2010 compared to 45% in 2008. This suggests that the higher prices of food and fuel were not transmitted more broadly to other items in the CPI.

Domestic supply factors were relatively more dominant in driving inflation. During the year, there were a series of price adjustments as part of the subsidy rationalisation programme announced in May. Upward adjustments to the retail prices of RON95 petrol, diesel, LPG and sugar contributed approximately 0.18 percentage points to headline inflation in 2010. Other notable adjustments in retail prices in 2010 included the increase in prices of RON97 petrol and kerosene. In July, the Government announced that the price of RON97 petrol was to be determined by global market forces under a managed float mechanism. As a result, the price of RON97 petrol increased by a total of 25 sen/litre during the year. Prices for premium cigarettes have also risen as a result of an increase in excise duties. In addition to changes in administered prices, disruptions in supply due to adverse weather conditions and

Table 1.20

Price Adjustments in 2010

Item	Previous price (RM)	New price (RM)	Percentage change (%)	Impact on 2010 headline inflation (percentage points)
RON95 (per litre)	1.80	1.85	2.78	0.085
	1.85	1.90	2.70	0.015
RON97 (per litre)	2.05	2.10	2.44	0.007
	2.10	2.15	2.38	0.003
	2.15	2.30	6.98	0.004
Diesel (per litre)	1.70	1.75	2.94	0.001
	1.75	1.80	2.86	0.001
LPG (per kg)	1.75	1.85	5.71	0.013
	1.85	1.90	2.70	0.001
Sugar (per kg)	1.45	1.65	13.79	0.043
	1.65	1.90	15.15	0.022
	1.90	2.10	10.53	0.003
Cigarettes (premium 20-pack)	9.30	10.00	7.53	0.020

Source: Bank Negara Malaysia

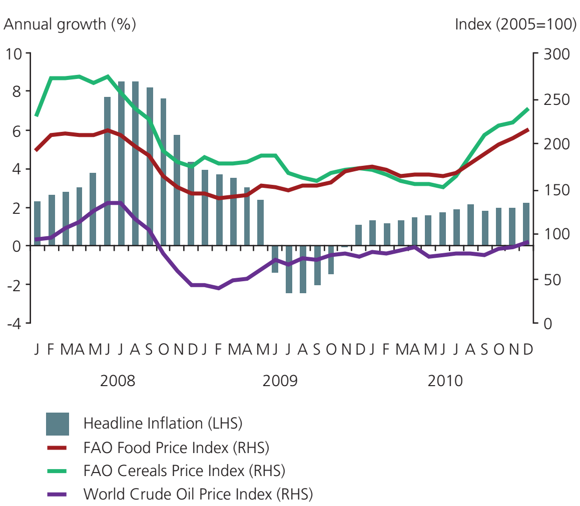
labour shortages also led to higher domestic prices, particularly for food. Prices in the *vegetables* sub-category increased on average by 7.8% in 2010 (2009: 1.0%).

Demand factors, on the other hand, were somewhat subdued in 2010. Consumer sentiments were stable during the year while economic output remained below its potential. Wages increased, albeit at a stable rate during the year. The increase in wages coincided with a stronger increase in productivity amidst rising employment and investment. This led to a narrowing of the wages-productivity gap, providing support to the view of a limited second round impact on inflation.

Compared to previous years, the impact of external factors on domestic prices were more modest in 2010 and confined to selected food items, specifically cereals and meat. This reflected the substantial increase in global prices of wheat and corn, particularly towards the second half of the year, due to adverse weather conditions in key wheat and corn producing countries. The higher global price of corn also led to an increase in prices of poultry feed, which in turn raised the price of poultry in Malaysia.

Chart 1.31

Headline Inflation and World Commodity Prices



Note: 1. FAO stands for Food and Agricultural Organisation of the United Nations.
2. The FAO Food Price Index consists of a weighted average of 55 food commodities considered by FAO specialists as representing the international prices of food

Source: FAO and Bloomberg

The movement in global crude oil prices also had a minimal impact on domestic inflation as it remained contained within the range of USD75 and USD85 per barrel between September 2009 and September 2010. This relative stability reflected the adequacy of oil supplies amidst rising oil demand following the economic recovery in emerging market economies. From November 2010, however, global crude oil prices began to increase sharply as investors rebalanced their portfolio into commodities due to the perception of further US dollar depreciation and higher global liquidity.

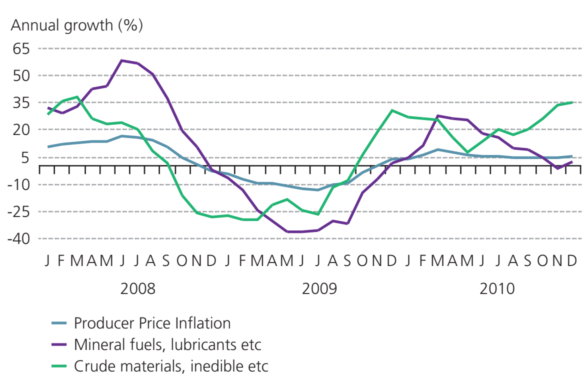
The higher inflation experienced by countries that are key sources of Malaysia's imports also contributed to the increase in domestic inflation during the year. Import partners from the emerging economies experienced higher inflation mainly on account of higher food and energy prices and stronger-than-expected recovery in domestic demand. The upward price pressures from the emerging economies, however, were partly offset by more muted inflationary pressures from the advanced economies. Most advanced economies experienced subdued demand conditions, slack capacity, sustained high unemployment and weak consumer and business confidence. External price pressures were also mitigated in part by the ringgit appreciation in 2010.

Producer prices

Producer price inflation, as measured by the Producer Price Index (PPI) rose in 2010 in line with the increase in global commodity prices. The annual change in the PPI averaged 5.6% during the year compared with a decline of

Chart 1.32

Producer Price Inflation



Source: Department of Statistics, Malaysia

-7.1% in 2009. Overall, the PPI for commodity-related components saw a significant increase of 15.4% in 2010 (2009: -20.0%). Meanwhile, non-commodity related producer prices increased at a much more moderate pace, averaging 1.6% in 2010 (2009: 0.1%).

In terms of composition, both the local and imported components of the PPI rose during the year. The annual growth of the PPI for local components increased to 7.7% in 2010 (2009: -10.4%), reflecting the effects of higher global commodity prices. Meanwhile, the PPI for imported products also registered an increase of 1.4% in 2010 compared to 0.5% in 2009.

The increase in global commodity prices during the year saw higher prices for commodity-related products of the PPI. In particular, prices for the *mineral fuels, lubricants etc*. and *crude materials, inedible* sub-categories rose by 12.8% and 22.4% respectively (2009: -22.0, -11.8) reflecting the rise in the prices of crude petroleum and crude palm oil during the year.

Determinants of Inflation in Malaysia

Introduction

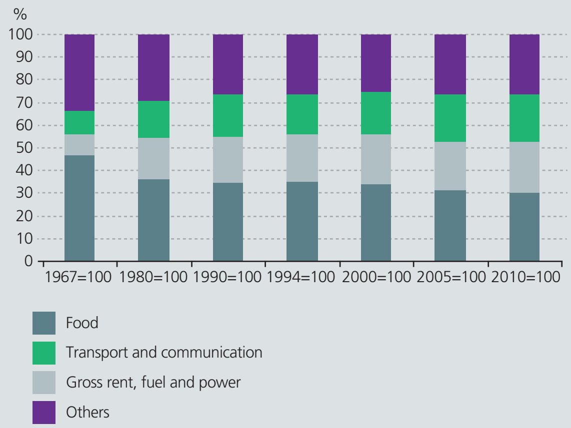
The drivers of inflation changes over time with the evolution of the structure of the economy, the behaviour of economic agents and economic cycles. This article looks at the structural determinants of inflation in Malaysia and how these determinants have evolved, the key supply and demand forces driving periods of high inflation, and concludes on the future challenges in managing domestic inflation.

Structural Determinants of Inflation

Since independence, the Malaysian economy has witnessed rapid evolution from being agriculture-based to manufacturing-driven and then to being service-based. As the economy developed and incomes grew, household expenditure patterns that underlie the Consumer Price Index (CPI[1]) have also evolved. In the early 1960s, a large portion of household expenditure was allocated to food and consequently, the item had a higher weight in the CPI basket. As the economy advanced and average income increased, the proportion of expenditure on food has decreased, while that on housing, transport and communication has risen.

Chart 1

CPI Weights



Source : Department of Statistics, Malaysia

A key feature affecting the transmission of inflation in Malaysia is the administered price mechanism. The prices of some essential goods are administered by the Government as changes in prices of these goods will have a significant impact on the cost of living for the low and middle-income group. Currently, price administered items constitute 29.3% of the CPI basket. In general, there are two types of price administered items. The first group comprises of items listed under the Price Control Act (1946), where the Government determines the retail prices for these goods. Examples of these items would be fuel and sugar. The second group are items which require Government approval for changes to be made on their prices, for example electricity tariff and public transport fares. With the administered price mechanism in place, the impact of supply shocks and external price developments on domestic prices is less direct and less immediate.

[1] The Consumer Price Index (CPI) measures the change across time in the cost of purchasing a basket of goods and services that represents the average pattern of purchases made by a particular population group across both urban and rural areas. The CPI is calculated according to 4 zones for Peninsular Malaysia (i.e. northern, middle, southern and eastern) and combined with Sabah and Sarawak to produce the Malaysia index. The Malaysia index is a composite index, weighted by regional expenditure weights of the three regional indices.

Being a small and highly open economy, domestic inflation has also been influenced by developments abroad. Global inflation moderated to historically low levels during the phase of "great moderation" whereby average inflation globally fell from 15.4% during the 1990 - 1999 period, to 3.9% during the 2000-2008 period. Changes in economic institutions, technology and business practices have improved the capacity of the economy to absorb shocks to output and inflation. For example, advances in computer technology and communications have improved the management of business inventories and allowed a reduction in costs. The shift of production to low cost centres in the emerging market economies (EMEs) also contributed to lower inflation globally. The lowering of global inflation in turn translated into lower imported inflation for Malaysia and coincided with a period of below average domestic inflation. Domestic inflation between 2000 and 2004 averaged 1.5% which was significantly below the long-term average of 2.9% (1960 – 2010).

Table 1

Price administered goods*	
Price Control Act, retail price determined by the Government	**Items where any changes in prices require Government approval**
Items	**Items**
Food	**Alcoholic beverages & tobacco**
Rice	*Beer*
Flour & other cereal grains	*Wines*
Bread & bakery products	*Spirits & liquors*
Fresh meat	*Cigarettes, cigars etc*
Evaporated/ condensed milk	*Tobacco*
Oils	**Housing, water, electricity, gas and other fuels**
Sugar	*Water supply*
Non-food	*Electricity*
Gas	**Communication**
Fuels & lubricants	*Telephone and telegraph services*
	Telephone and telegraph equipment
	Postal services
	Transport services
	Passenger transport - rail
	Passenger transport - road
	Passenger transport - air
	Passenger transport - sea
	Other transport charges

*Classification is based on 4 digit level of the CPI

Inflation Determinants during Periods of High Inflation

Historically, at a long-term average of 2.9%, inflation in Malaysia has been one of the lowest in the region. The low inflation environment over the course of 50 years, however, was punctuated by four episodes of high inflation, that is in the mid-1970s, early 1980s, 1990s and late-2000s.

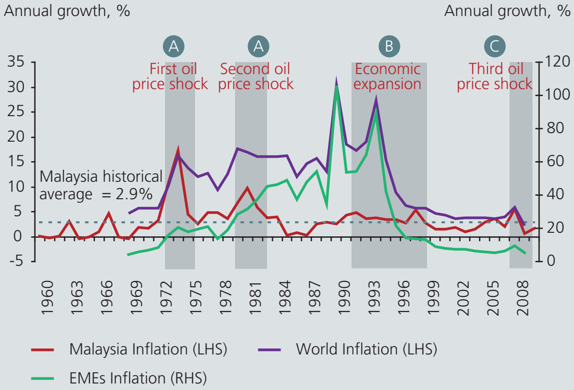
A. 1970s and 1980s : Global oil price shocks and surging food prices

The 1970s and 1980s saw significant increases in global energy and food prices due to disruptions in supply. Global oil prices rose sharply due to the Egypt-Israeli War and Iranian Revolution in 1973 and 1979 respectively. The global oil shocks resulted in domestic retail fuel[2] prices rising by 9.3%

[2] Fuel is reflected in the *transport and communication* category.

Chart 2

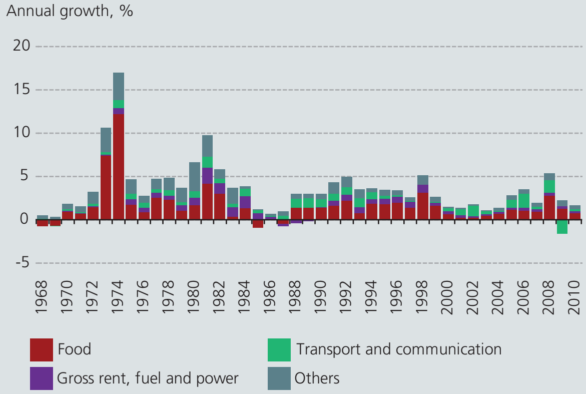
Episodes of High Inflation



Source: Department of Statistics, Malaysia and International Monetary Fund (IMF)

Chart 3

CPI by Category



Source: Bank Negara Malaysia

and 7.9% in 1974 and 1981, respectively. Global food prices rose strongly due to shortages of food supplies globally. This was a reflection of weak distribution linkages, a reduction in land for cultivation amidst urban development and industrialisation as well as adverse weather conditions. The impact was amplified by the high weight of food in the CPI basket, which was as high as 47% in the late 1960s. Food price inflation surged to double digit rates of 26.2% and 11.4% in both years mainly due to the significant increase in prices of *rice, bread and other cereals* and *fruits and vegetables* subcategories. As a result, there was a broad-based increase in domestic inflation to 17.3% and 9.7% in 1974 and 1981 respectively.

B. 1990s : Period of robust domestic demand and large capital inflows

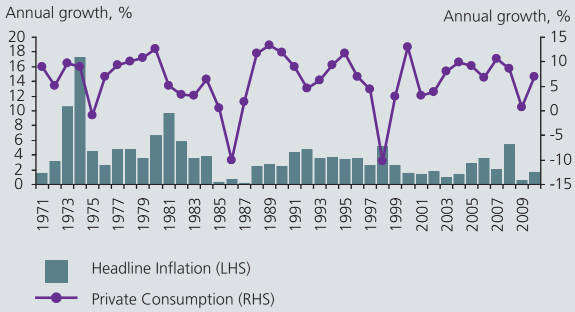
Inflation during the 1990s remained above 3%, with the exception of 1997 and 1999. Price increases were broad-based, driven by both demand and supply factors. During this period, domestic demand was particularly resilient, following robust income and employment growth. Substantial increases in the prices of property and equity, supported by strong growth in domestic liquidity and credit amid large capital inflows, led to increased net wealth and hence, supported domestic economic activity. The Kuala Lumpur Stock Exchange (KLSE) main index surged to a historical high of 1,314 points in early 1994 while the Malaysia House Price Index (MHPI) increased by an average of 7.6% per annum during the decade with a record high increase of 25.5% in 1991. As a result of the buoyant property market, average rental rates increased persistently, leading to the *gross rent, fuel and power* category of the CPI recording a 13-year record inflation rate of 4.4% in 1998.

Domestic supply factors also contributed to inflation, particularly in the *food* category. Food supply was constrained by adverse weather conditions, continued shortage of cultivated land, adjustments in administered prices by the Government, labour shortages and high capacity utilisation. Prices of the *fruits and vegetables, fish* and *meat* sub-categories increased throughout the 1990s. Inflation in the *transport and communication* category was also higher as bus and taxi fares as well as postal charges were increased.

Inflation peaked at 5.3% in 1998, reflecting rising cost pressures arising from higher import prices as the ringgit depreciated by 28.3% against the US dollar towards the end of 1997 and due to cyclical shortage of essential food items. Owing to the higher import cost, the Government increased the ceiling prices of five price administered items, namely cooking oil (5% increase), chicken (5% increase), flour (20% increase), sugar (21% increase) and milk (6% increase).

Chart 4

Inflation and Private Consumption



Source: Department of Statistics, Malaysia

C. 2000 – current : More persistent increases in global commodity prices

In the early 2000s, inflation moderated to very low levels as the demand and supply pressures that characterised the 1990s dissipated. Inflation in Malaysia, however, began rising in 2005, reaching a peak of 8.5% in July 2008. The higher inflation during this period was driven mainly by external factors, in particular, due to higher global commodity and food prices. In contrast to the supply shocks of the 1970s and 1980s, the increase in global commodity prices was underpinned by both supply and demand factors. Demand for commodities increased as emerging market economies such as the BRIC (Brazil, Russia, India and PR China) countries became more industrialised. Food prices rose on increasing use of biofuels in developed countries and increasing demand for a more varied diet across the expanding middle-class population of Asia. In addition to real demand, demand from increased speculative activity in the commodity markets also exerted upward pressures on global commodity prices as commodities became financialised amidst excess global liquidity.

At the same time, the global supply of commodities was strained. Limited land was allocated for agriculture as food producing countries shifted their focus to industrialisation. Global warming further exacerbated weather related food shortages. Geopolitical developments and concerns over disruptions to oil supply also played a role in the surge of global crude oil prices. All these events led to a broad-based increase in global commodity prices.

The sharp rise in global commodity prices and the consequent strain on Government finances due to the significant subsidy cost resulted in a series of upward adjustments in the prices of fuel products. In 2008, fuel prices increased by an average rate of 14.5% while food inflation rose to a 10-year high of 8.8%. Other than fuel and subsidised food items, the electricity tariff has also been revised upwards.

Future Challenges

Going forward, the drivers of inflation will continue to evolve in line with structural changes in the economy. As Malaysia transitions to a high value-add and higher income economy, the composition of household expenditure will also change. The inflation process could also change as a result of Government policies such as the introduction of Goods and Services Tax (GST), minimum wages and the reduction of subsidies. Domestic inflation may be more affected by external forces, especially global commodity prices, as the price mechanism gradually becomes more market driven. Supply shocks could become more persistent and may no longer be transitory as global demand for resources and food continue to rise as a result of population growth, rapid urbanisation and supply constraints. These factors suggest that the task of managing inflation would become more challenging as the same domestic and external shocks occurring today have increasingly different implications for inflation when they occur in the future.

Rise of Economic Integration in East Asia: The Malaysian Perspective

Introduction

Over this recent decade, intra-regional linkages in East Asia[1] have strengthened significantly, and more recently during the global financial crisis, it has provided crucial support to the region's robust recovery. Economic integration in East Asia has been led by the vertical integration of production chains as multinational companies (MNC) seek lower-cost manufacturing facilities beyond national boundaries and capitalise on supportive local policy initiatives in foreign countries. In addition to the rising trend in shared production networks, the growing importance of domestic demand in East Asia has also spurred further economic integration in the region. This provides not only additional sources of demand for goods to economies within the region but also vast investment opportunities. As one of the most open economies in East Asia, Malaysia benefits significantly from the rising level of regional economic integration, through both the trade and investment channels.

Trade integration

In the 1980s, more than half of Malaysia's exports was channelled to the advanced economies[2] , while regional demand accounted for only 29.7% of gross exports. Following the intensification of trade integration, East Asia is currently the main export market for Malaysia, accounting for 47.7% of exports in 2010, while the market share of the advanced economies is lower at 30.1% of exports (Chart 1). Of importance, the emergence of East Asia as Malaysia's top export market illustrates the potential for the region to boost demand for Malaysia's exports as evidenced by the rebound from the recent global financial crisis. Malaysia's export growth recovered to 6.6% in the fourth quarter of 2009, supported by the strong export growth to East Asia of 25.1% (Chart 2).

Chart 1

Share of Exports to East Asia have Increased at the Expense of the Advanced Economies

Malaysia's Gross Exports: Composition of Trade Partners

*ROW refers to Rest of the World

Source: Department of Statistics, Malaysia

Chart 2

Improvements in Export Performance Post Global Financial Crisis were Led by Exports to East Asia

Growth of Malaysia's Exports to Major Trading Partners

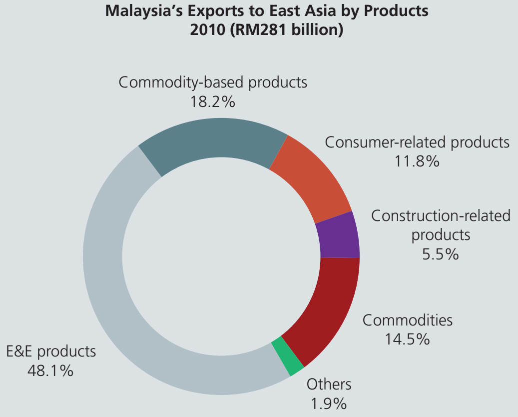
Source : Department of Statistics, Malaysia

[1] East Asia refers to PR China, Hong Kong SAR, Chinese Taipei, Korea, Singapore, Thailand, Indonesia and the Philippines.

[2] Advanced economies refer to the US, euro area and Japan

Chart 3

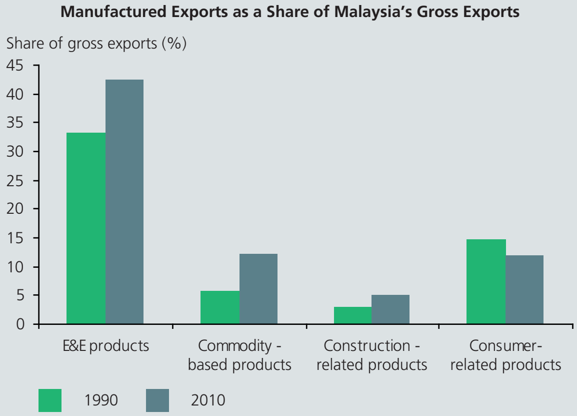
Manufactured Exports Account for the Bulk of Malaysia's Exports to East Asia



Source : Department of Statistics, Malaysia

Chart 4

Export Share Increased for All Major Manufactured Goods except Consumer-Related Products



Source : MATRADE and Department of Statistics, Malaysia

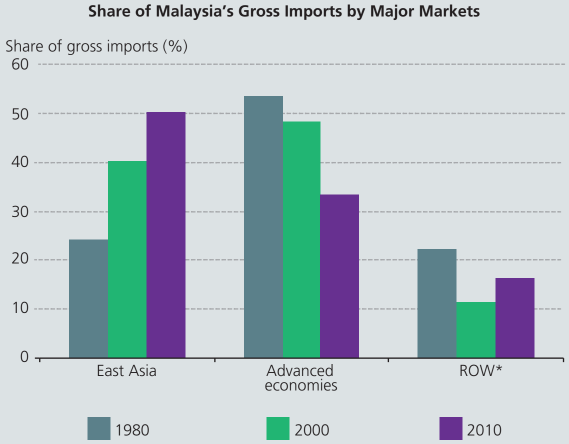
Within the regional production network, Malaysia is positioned as a producer and assembler of the parts and components of manufactured goods. This has provided impetus to the expansion in the exports of manufactured goods, which accounted for 72.1% of gross exports in 2010, compared to only 18.9% in 1980. In tandem with the region's role as the production and assembly hub for electronic and electrical (E&E) products, semiconductors as well as computer parts and components comprise the bulk of Malaysia's manufactured exports to the region, accounting for 48.1% of total exports to East Asia (Chart 3). In addition, Malaysia has also seen a significant increase in the exports of commodity-based manufactured goods, particularly chemicals and chemical products (Chart 4). This trend reflects the steady shift in Malaysia's economic activity from extracting crude commodities to manufacturing downstream products. Since 1990, the exports of commodity-based products have expanded at an annual average rate of 13.3%, supported mainly by firm regional demand. Thus, regional integration not only provides effective diversification of Malaysia's export destinations, it also creates higher demand for Malaysia's exports.

Malaysia's changing export structure has also been complemented by a diversification in import sources. The integration of production networks has led to a discernable trend, where more goods are sourced from the region instead of the traditional markets, particularly Japan. This is reflected by the rise in Malaysia's imports from the regional countries to 50.2% of total imports in 2010 from 24.3% in 1980 (Chart 5). In contrast, the market share for Japan almost halved to 12.6% over the same period (1980: 22.9%). In addition, 52.6% of Malaysia's imports of parts and components are from East Asia, compared to 44.8% a decade ago.

Although the bulk of imports continue to be intermediate goods, its share has diminished over the years (Chart 6). This has been matched by an increase in the imports of final goods. In 2010, imports of final goods accounted for 29.9% of gross imports (2000: 21.9%), consisting mainly of motor vehicles, optical and scientific instruments as well as jewellery. It is noteworthy that the imports of final goods are also increasingly being sourced from regional countries, such as PR China, Singapore and Thailand.

Chart 5

Imports are Increasingly Being Sourced from East Asia

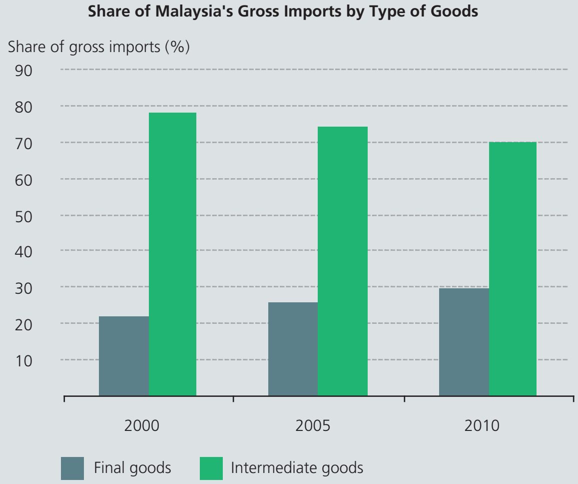


*ROW refers to Rest of the World

Source: Department of Statistics, Malaysia

Chart 6

Share of Final Goods Imports has been Increasing in Recent Years



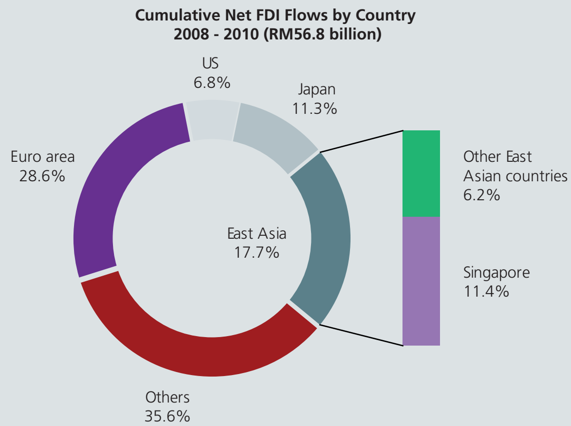
Source: Department of Statistics, Malaysia

Investment integration

Another key development in East Asia is the expansion of investment opportunities within the region. Benefiting from the vertical integration of Asia's production networks, Malaysia has also been receiving a steady rise in foreign direct investment (FDI) inflows. Following the temporary decline in 2009 given the global economic downturn, FDI flows into Malaysia resumed in 2010, amounting to RM27.6 billion. While FDI flows continue to be mainly sourced from the advanced economies, FDI flows from the regional countries have increased in recent years, accounting for almost 30% of total FDI flows to Malaysia in 2009 (2003: 10.1% of total FDI flows). Among the regional countries, Singapore is the main investor in Malaysia (Chart 7), with investments totalling RM46.2 billion as at end-2009 (51.4% of total FDI stock from the region). Similar to the trend of overall FDI flows, investments from the regional countries are also channelled mainly to the manufacturing and the finance and insurance sectors (Chart 8).

Chart 7

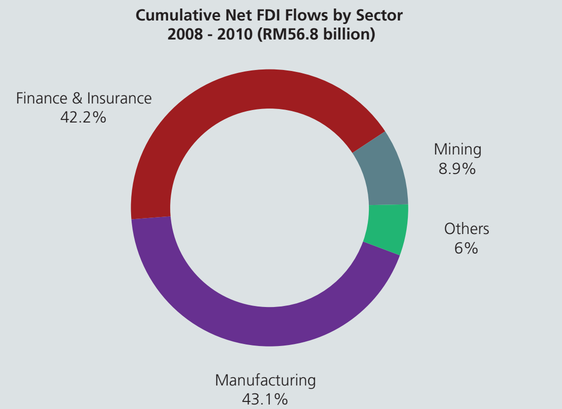
Among Regional Countries, Singapore is the Main Investor in Malaysia



Source: Department of Statistics, Malaysia

Chart 8

FDI Flows are Mainly Channelled into the Manufacturing and Services Sectors



Source : Department of Statistics, Malaysia

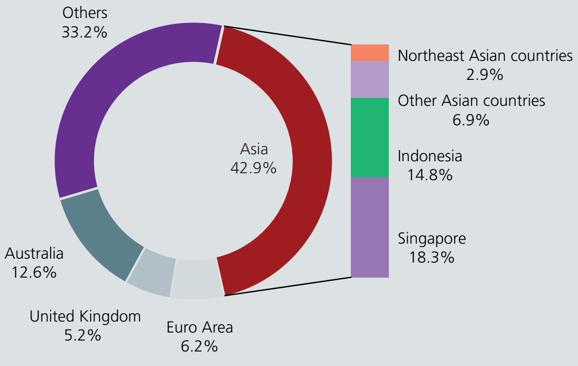
Strong economic growth and regional integration in East Asia also intensifies competition in attracting FDIs. In particular, the emergence of lower-cost competitors in the region - notably PR China, Indonesia and Vietnam – has affected Malaysia's competitive advantage in labour-intensive industries. In this regard, foreign investments received in recent years have shifted towards higher value-added economic activities. Of significance, existing MNCs are spurred to reinvest in new production technology and high quality designs to move up the value chain. In addition, Malaysia has received a sizeable amount of new FDIs in new growth areas, such as renewable energy, aerospace, pharmaceutical and medical equipment. A large share of the new investments have also been channelled into the less capital intensive but high-skilled services sector, such as financial services and shared services operations. Although investments into the services sectors are of smaller value, they generally create a higher multiplier on the domestic economy, thereby contributing to a larger impact on domestic employment and income. In recent years, the Malaysian Government has also undertaken various initiatives to promote FDIs into high value-added sectors, in line with Malaysia's vision for private sector-driven economic growth. These measures include customising incentives for high-impact investments, introducing administrative reforms, and corporatising the Malaysian Investment Development Authority (MIDA) to facilitate foreign investors' access to the vast investment opportunities in Malaysia. Going forward, FDI inflows into Malaysia are expected to increase, given the more favourable investment climate as well as the improvement in global economic conditions.

Malaysian companies have also been actively capitalising on the opportunities arising from the deepening regional integration and the expansion in regional economic activity. Net direct investment abroad (DIA) by Malaysian companies has been increasing since 2005, and reached a high of RM50.2 billion in 2008. Of significance, a large share of DIA by Malaysian companies has been channelled to Asia, particularly the ASEAN countries (Chart 9).

Chart 9

Asia Accounts for Almost Half of Malaysia's DIA Outflows

Cumulative Net DIA Flows by Country
2008 - 2010 (RM120.8 billion)

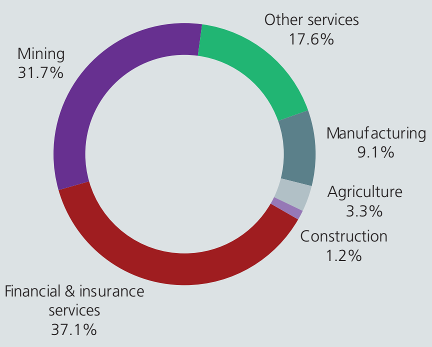


Source: Department of Statistics, Malaysia

Chart 10

A Large Share of Malaysia's Investment Abroad is in the Services Sector

Cumulative Net DIA Flows by Sector
2008 - 2010 (RM120.8 billion)

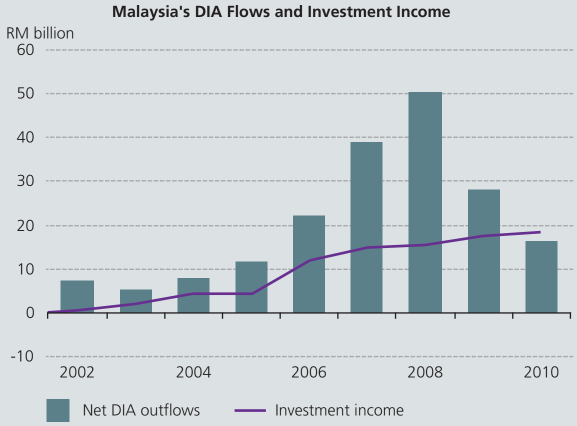


Source : Department of Statistics, Malaysia

The range of activities of DIA by Malaysian companies has also widened in recent years. In the early 1990s, DIA was undertaken mainly by Government-linked companies, particularly in the agriculture and the oil and gas sectors. However, in recent years, DIA has focused on gaining greater access to natural resources and tapping the vast opportunities in the fast growing regional economies. While the oil and gas sector continues to account for the largest share of Malaysia's investment abroad, there has been a significant rise in investments by the telecommunication and financial and insurance sectors, mainly through mergers

Chart 11

Higher Investment Income Arising from DIA



Source: Department of Statistics, Malaysia

and acquisitions (Chart 10). The direct investment by Malaysian companies contributes towards creating growth and employment opportunities in the regional economies while at the same time establishes stronger relationships between these economies and Malaysia. The expansion of DIA also benefits the Malaysian economy by developing more competitive and globalised Malaysian companies, as well as generating higher inflows of profits and dividends into Malaysia. Income accrued to Malaysian companies investing abroad doubled to RM11.9 billion in 2006, and has continued to increase since, rising to RM18.6 billion in 2010 (Chart 11).

Conclusion

The intensification of regional integration in East Asia has resulted in a broader trading base for Malaysia in terms of both markets and products. East Asia is currently Malaysia's main trading partner and a major consumer of both manufactured products and commodities. Although the advanced economies will remain an important source of final demand, the East Asian market has become an increasingly important source of external demand for Malaysia. From the investment perspective, Malaysia has strengthened its ties with regional countries through various investment ventures. In addition to receiving higher value-added FDIs that will spur Malaysia's transition into a high income economy, the increasing overseas investments by Malaysian firms will also benefit the domestic economy through the development of more competitive domestic firms. With increasing intra-regional trade and investment, the economic ties within the region will be further strengthened.

Liberalisation of Foreign Exchange Administration (FEA) to Strengthen Malaysia's Linkages with Regional and Global Economies

Over this recent five years, strong growth in intra-regional trade supported by resilient domestic demand and sustained recovery in investments have underpinned the region's performance. For Malaysia, economic flexibility has allowed the economy to adapt to the changing environment and sustained ventures into new areas of competitive advantage. Malaysia has continuously heightened its international linkages with the global and regional economies. The country has progressively liberalised its foreign exchange administration rules based on a balanced and sequenced approach that promote monetary and financial stability. Malaysia has always maintained the balanced need to ensure adequate prudential safeguards while creating a conducive business environment that enhances the competitiveness and flexibility of the economy. During this decade, a series of FEA liberalisation were implemented to enhance the competitiveness of the Malaysian economy in a rapidly globalised economic and financial environment.

Liberalisation of FEA rules to enhance competitiveness and promote cross border trade and investments
In 2010, Malaysia has further liberalised its FEA rules aimed towards achieving the following objectives:

(i) Promote international trade of goods and services using local currencies for settlement
Asia's diversification of the export markets towards increased intra-regional trade has been a critical factor to the region's rapid recovery from the recent global financial crisis. Today, intra-regional trade in Asia has increased to an average of 50% of the region's total trade as compared to 32% in 1995. Malaysia's inter-linkages with the global economy and the Asian region, in particular, has remained robust as reflected through the increase in total trade by 18.3% in 2010.

In further promoting intra-regional trade through minimising exchange rate risks and eliminating currency conversion costs, strategic initiatives have been undertaken by several countries in the region to promote the use of local currency for the settlement of trade in goods and services. Being Malaysia's largest trading partner at 12.6% of total trade, a cost effective bilateral arrangement was entered into between Malaysia and the People's Republic of China (PR China) to provide options for exporters and importers to settle international trade in the countries' respective local currencies.

Consistent with this development, flexibility was granted for the settlement of international trade for goods and services in ringgit in addition to foreign currency. With the liberalisation, resident exporters and importers were given additional choice to determine the currency of settlement for their trade in goods and services, thereby facilitating better management of currency mismatch and eliminating currency conversion costs. At the same time, PR China's decision to allow ringgit to be traded on the China Foreign Exchange Trade System will further enhance the use of local currency for settlement of international trade.

(ii) Enhance risk management
The expansion of intra-regional trade amidst challenging business environment also calls for flexible policies to support more effective risk management of trade transactions by residents. In facilitating residents to hedge their foreign currency risks in relation to trade, the remaining limit[1] applicable to anticipatory hedging on current account transactions was abolished.

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[1] Previously, residents were free to hedge on anticipatory basis for the import or export of goods and services only up to the total amount paid or received in the preceding 12 months.

The abolition is timely given the implementation of the Financial Reporting Standard 139 in January 2010 requiring companies to report financial assets and liabilities at fair value which would enhance the discipline of companies in assessing their financial exposures as it will have direct impact on their financial statements.

(iii) Facilitate accessibility to competitive financing

One of the necessary preconditions for the internationalisation and energising the private sector through the expansion of their productive frontiers is a flexible regulatory framework which promotes greater efficiency for companies to manage their financial resources through greater capital mobility.

In providing a competitive enabling environment, resident companies were accorded greater flexibility in sourcing of foreign currency financing within a corporate group which includes parent company, ultimate holding company, foreign subsidiary, branch as well as associate or sister company. This is a further extension of the liberalisation undertaken in 2008, whereby flexibility was granted for resident companies to access financing from companies within their corporate group, but only within the context of a parent–subsidiary relationship.

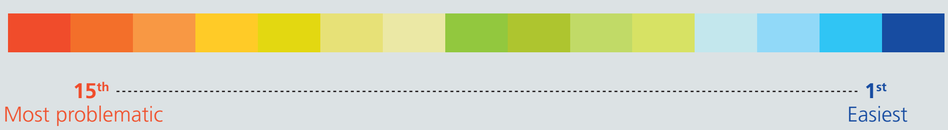
Impact of liberalisation

The continuous and progressive liberalisation of the FEA rules has contributed to a conducive environment for foreign direct investment. For 2010, foreign direct investments into Malaysia increased to RM27.6 billion from RM5 billion in 2009.

Given the progressive liberalisation of the FEA rules undertaken since 2005, FEA's ranking on ease of doing business in Malaysia has significantly improved by 11 notches from 13th place (considered as most problematic) in 2005/2006 to 2nd place (least problematic) in 2009/2010.

FEA's ranking on ease of doing business in Malaysia

	2005-06	2006-07	2007-08	2008-09	2009-10
Foreign exchange administration	13th	11th	7th	3rd	2nd



Source: Global Competitveness Report, World Economic Forum 2009/2010

2010 has also seen the upgrading of Malaysia into the Advanced Emerging market status from Secondary Emerging market status in the FTSE Global Equity Index arising from collaborative efforts amongst the relevant authorities to comply with FTSE's assessment criteria which includes flexible regulatory environment on cross border capital mobility. Malaysia's upgrading is a significant catalyst towards enlarging the market capitalisation of the FTSE Bursa Malaysia KLCI.

Policy approach in a dynamic global landscape

Amid greater global liquidity shifts and the increased potential effects of volatile capital flows which rapidly transmitted from one country to another, policy makers are faced with the challenge of developing a comprehensive and effective policy framework.

In Malaysia, the policy approach has been directed towards implementation of a flexible FEA framework that promotes real sector economic activities and enhancing the development of the domestic financial market. This approach has facilitated the economy to manage the impact of the volatile capital inflows through increased two-way flows and robust financial system to effectively intermediate the inflows and outflows through enhanced risk management and surveillance framework supported by strong corporate governance. With the current environment of heightened volatility and greater mobility of capital to this region, there is a need for greater vigilance and rigorous surveillance to avoid the build-up of excessive risks in the economy.

Regional cooperation continues to be accorded significant priority. The strengthening of regional cooperation is not only to preserve regional financial stability but also to enhance the prospects of the region as an investment destination whilst accelerating intra-regional trade. Asia is leveraging on existing intra-regional groupings and networks to forge greater cooperation and collaboration in areas of common interest, including the current platform for collaboration on capital account liberalisation for the region through the Working Group on Capital Account Liberalisation under the ambit of the Asean Economic Community.

Conclusion

Malaysia's regulatory framework will be continuously reviewed to support the country's transition into a high value-added, high income, sustainable and inclusive economy by 2020. Policy liberalisation of the FEA will provide an enabling environment in which high productivity, competitiveness and innovation will drive the country's economic transformation. The liberalisation will take into account the risks and global challenges and will be undertaken in a holistic approach, integral to the fundamental objective of achieving a financial sector which supports and drives the next phase of Malaysia's economic development. Progressive liberalisation with adequate safeguards and supported by a comprehensive and well functioning surveillance mechanism will continue to be the policy approach that will be pursued towards strategically enhancing Malaysia's linkages with global and regional economies.

Details of prudential FEA measures can be obtained from http://www.bnm.gov.my/fxadmin.