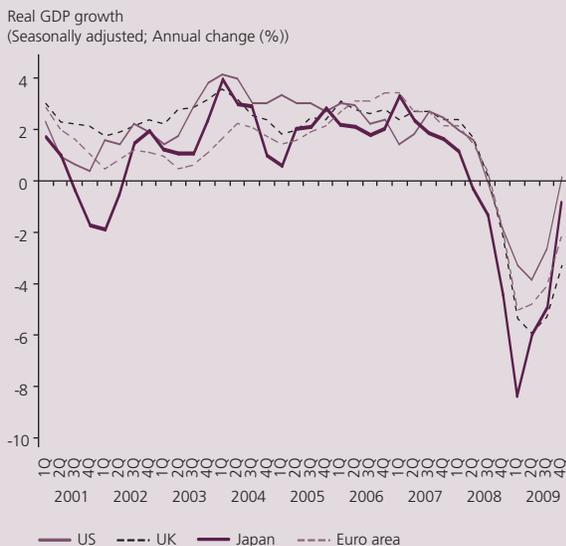


How Did the Recent Global Recession Affect the Malaysian Economy?

Introduction

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

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



Source: Haver Analytics

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

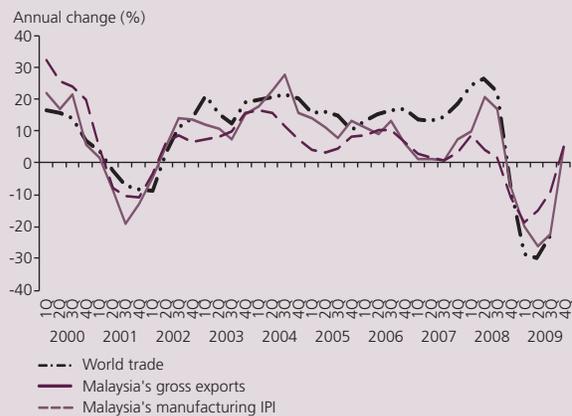
The Effects of the Global Recession on Malaysia

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

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

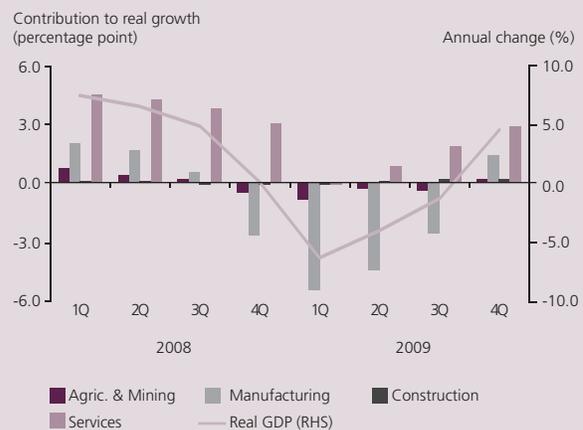
As Malaysia is a highly open economy, the impact of the global recession was felt strongly in the external trade-related sectors. The recession in the advanced economies started to impact the Malaysian economy in the fourth quarter of 2008. Exports and manufacturing production declined by 7.4% and 11.1%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

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



Source: Haver Analytics; Department of Statistics, Malaysia

Chart 3
Export-oriented Manufacturing Sector was the Worst Affected



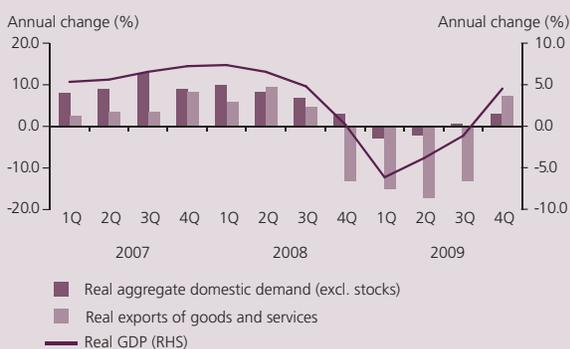
Source: Department of Statistics, Malaysia

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

Although the income of households in the other sectors that were not directly exposed to external demand remained relatively unaffected, their spending behaviour was affected by the weak sentiment following the overall weaker economic conditions and uncertainties over their income outlook and job

security. This resulted in a marginal decline in private consumption spending by 0.7%. Total investment also weakened significantly (-10.8%), following the sharper contraction in private investment spending, as capacity expansion activity was affected by the considerable decline in external demand, lower-than-normal capacity utilisation and deteriorating business confidence. As a result, aggregate domestic demand declined by 2.9% and the economy contracted sharply by 6.2% in the first quarter of 2009 (Chart 4), the first contraction since the third quarter of 2001. A large inventory drawdown during the quarter, particularly in the manufacturing and commodity sectors, further contributed to the decline in growth.

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



Source: Department of Statistics, Malaysia

Policy Response and the Recovery of the Malaysian Economy

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

second quarter of 2009, and subsequently recovered to record a positive growth of 1.7% in the second half of the year. Of significance is the improvement in private consumption, which recovered to post a growth of 0.5% in the second quarter, before strengthening further to 1.7% in the fourth quarter.

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

Conclusion

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

Table 1: Policy Responses to Mitigate Economic Downturn

Policy Responses	Measures
Two Economic Stimulus Packages of RM67 billion (direct fiscal injection: RM22 billion), with a primary focus on supporting domestic demand as well as mitigating the impact of the global downturn on the affected segments of the economy	<ul style="list-style-type: none"> ➤ First package (RM7 billion) <ul style="list-style-type: none"> • Construction, upgrade, repair and maintenance of facilities • Construction of low and medium cost houses • Human capital development programmes • Accelerated improvement to telecommunication services • Assistance to Private Sector ➤ Second package (RM60 billion) <ul style="list-style-type: none"> • Reducing unemployment and increasing employment opportunities • Easing people's burden, in particular, the vulnerable groups • Assisting the private sector in facing the crisis • Building capacity for the future
Monetary stimulus to reduce the cost of intermediation	<ul style="list-style-type: none"> ➤ Reduced Overnight Policy Rate by 150 basis points between November 2008 and February 2009 to 2.0% ➤ Reduced Statutory Reserve Requirement by 300 basis points to 1.0%
Comprehensive measures to ensure continued access to financing as well as to minimise the impact of the economic downturn on specific affected sectors	<ul style="list-style-type: none"> ➤ Ensure continued access to financing <ul style="list-style-type: none"> • Financing and guarantee schemes for SMEs and businesses • Establishment of Financial Guarantee Institution (Danajamin Nasional Bhd) ➤ Restructuring and Rescheduling of Credit Facilities <ul style="list-style-type: none"> • Flexibilities to restructure and reschedule loans to deal pre-emptively with borrowers • Enhanced Corporate Debt Restructuring Committee and expanded Small Debt Resolution Scheme ➤ Pre-emptive measures to sustain confidence in financial sector <ul style="list-style-type: none"> • Full guarantee of all deposits until end-2010 • BNM's liquidity facility was extended to insurance and takaful operators ➤ Avenues for borrowers to seek assistance & redress <ul style="list-style-type: none"> • Integrated Contact Centre: BNMLINK, BNMTELELINK, Complaints Management and Advisory Unit • Expanded outreach of Credit Counselling & Debt Management Agency • ABMConnect Toll Free Channel • Complaint units at financial institutions • Financial Mediation Bureau • Small Debt Restructuring Committee
Other Measures	<ul style="list-style-type: none"> ➤ Voluntary reduction of EPF employees' contribution by 3 percentage points from 11% to 8% in 2009 and 2010 ➤ Allow purchase of commercial properties above RM500,000 by foreigners for own use without FIC approval ➤ Increase vehicle loan eligibility for civil servants