BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

Ref. No.: 03/09/10

EMBARGO: Not for publication or broadcast before 1800 hours on Wednesday, 25 March 2009

PRESS RELEASE

Bank Negara Malaysia Annual Report 2008

The Malaysian Economy in 2008

The Malaysian economy registered a growth of 4.6% in 2008, amidst the international financial turmoil and rapid deterioration in global economic environment. Robust domestic demand, in particular sustained private consumption and strong public spending, supported growth during the year. While external demand was strong in the first half, the sharp deterioration in the global economic conditions and correction in commodity prices led to significant decline in external demand in the second half of 2008. As a result, growth expanded by 2.4% in the second half-year, compared with 7.1% in the first half of 2008.

During the year, **aggregate domestic demand** expanded by 6.9%, underpinned by strong private consumption and public expenditure. High commodity prices, stable employment and supportive financing environment sustained the strong growth in private consumption in the first half-year. Support also came from the bonus payment for the civil servants and cash rebates for fuel subsidy in the second half-year. The rapidly worsening global economic conditions, however, resulted in a decline in private investment activity in the second half of the year.

GDP by Expenditure Components (% change)

	2007	2008*p*
Domestic Demand [1/]	**9.8**	**6.9**
Private sector expenditure	10.6	7.1
Consumption	*10.8*	*8.4*
Investment	*9.8*	*1.5*
Public sector expenditure	7.9	6.5
Consumption	*6.6*	*11.6*
Investment	*9.3*	*0.7*
Net exports of goods and services	**-3.8**	**-3.8**
Exports	4.2	1.5
Imports	5.4	2.2
Real GDP	**6.3**	**4.6**

[1] Excluding stocks
p Preliminary

On the **supply side**, the services sector maintained its robust performance in the first half of the year, driven by strong demand and the expansion in trade and tourism activities. The manufacturing sector also expanded, benefiting from strong external demand from the non-US markets and higher exports of resource-based products. Meanwhile, growth in the agriculture sector was supported by stronger palm oil production as well as higher output of fisheries and livestock. In the construction sector, growth emanated mainly from the civil engineering sub-sector, driven by projects under the Ninth Malaysia Plan (9MP) as well as those in the oil and gas industry. In the second half-year, all economic sectors were affected by the global downturn and the sharp correction in commodity prices. In particular, growth in the manufacturing sector turned negative due to the significant contraction in the export-oriented industries. The services sector remained the key driver, although a number of the services sub-sectors that were related to trade and capital market-related activities were affected.

Real GDP by Sector (2000=100)

	Annual change (%)	
	2007	2008
Agriculture	2.2	3.8
Mining & quarrying	3.3	-0.8
Manufacturing	3.1	1.3
Construction	4.6	2.1
Services	9.7	7.3
Real GDP	**6.3**	**4.6**

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

The **labour market** conditions weakened in the second half of 2008 as businesses, particularly in the manufacturing sector, turned cautious in the face of the increasingly uncertain business environment. The unemployment rate increased to 3.7% in 2008.

Headline **inflation** was higher at 5.4% in 2008, due mainly to the sharp increase in global food and fuel prices. Inflation peaked at 8.5% in July after retail fuel prices were adjusted by 40.4% in June. Inflation, however, began to moderate in the fourth quarter as global commodity prices fell significantly, which led to declines in domestic food and fuel prices.

Inflation and Unemployment

	2007	2008
Inflation (% change)		
CPI (2005=100)	2.0	5.4
Core CPI	1.8	4.0
Unemployment (% of labour force)	3.2	3.7

The **external position** continued to remain strong in 2008. During the first half of the year, this trend was supported by a significantly larger trade surplus arising from stronger growth in both commodities and resource-based manufacturing exports, as well as higher tourism receipts and strong inflows of foreign direct investment. While the current account continued to remain in significant surplus in the second half of the year, the overall external position recorded a net outflow as the large net outflows in the financial account more than offset the surplus in the current account. This was caused mainly by the large reversal of portfolio investment flows arising from the deleveraging activities by foreign financial institutions following the deterioration of the global financial crisis.

In 2008, the **net international reserves** of Bank Negara Malaysia declined by RM18.2 billion to RM317.4 billion (equivalent to USD91.5 billion) as at 31 December 2008. While the reserves increased substantially in the first half-year due to higher repatriation of export earnings and significantly larger inflows of portfolio capital as well as foreign direct investment, the reversal of portfolio capital flows due to the deleveraging activities by foreign financial institutions led to a decline in reserves in the second half of the year. As at 13 March 2009, the reserves remained at a comfortably high level of RM314 billion (equivalent to USD90.6 billion), adequate to finance 7.7 months of retained imports and cover 3.9 times the short-term external debt.

Monetary and Financial Conditions in 2008

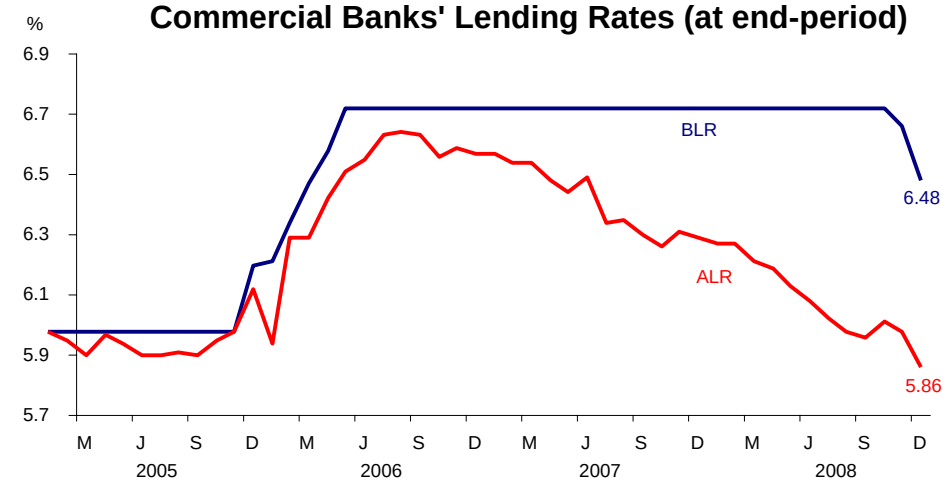
In 2008, international financial markets were characterised by increased volatility arising mainly from the two-fold concern of rising global inflation in the first half of the year and the deepening global financial crisis in the second half of the year. Nevertheless, domestic financial markets continued to function normally despite the extreme volatility in the global financial markets. The ample liquidity situation, minimal direct exposure to the global financial crisis and a strong banking sector, enabled domestic financial institutions and markets to perform the intermediation function effectively. Nevertheless, domestic financial markets were subject to significant volatility created by the large reversal of capital flows arising from increased global deleveraging in the latter part of the year.

Monetary policy in 2008 operated in a complex environment characterised by supply-driven inflationary shocks, financial market contagion and decelerating global growth. From the monetary policy perspective, the risks to growth and inflation in the first half of the year were relatively balanced. The monetary policy challenge however intensified significantly when inflation surged following the significant fuel price adjustment in June with growth prospects being negatively affected by the ensuing deflationary effect on the economy and by the global financial crisis. Given the magnitude of the increase in fuel prices, the first round effects on the prices of goods and services were expected to be large. While there were limitations to what monetary policy could do under these circumstances, there was the concern that this might fuel inflationary expectations.

There were negligible indications that wages were increasing disproportionately or evidence of second-round effects on inflation. The sharp increase in prices had, however, eroded the purchasing power of consumers, leading to cutbacks in discretionary spending. There was also increasing indication that the ongoing financial turmoil in the advanced economies had become more acute and had begun to negatively affect global economic activity, posing downside risks to Malaysia's external sector. At the same time, forecasts indicated that the elevated inflation levels were transitory with inflation expected to moderate significantly in the second half of 2009. Monetary policy therefore was left unchanged.

Global conditions deteriorated markedly and rapidly towards the end of the year, with global growth prospects worsening beyond what was earlier anticipated. The Malaysian economy was negatively impacted by these adverse developments, as reflected in the rapid slowdown in export performance and industrial production. Although domestic demand remained resilient, there were clear indications of slower private sector activity. As inflation pressures abated, the policy focus turned to containing the severity of the domestic economic slowdown. Monetary policy was significantly adjusted to frontload the monetary stimulus to ensure that monetary conditions remain accommodative and supportive of consumption and investment activity. Between November 2008 and February 2009, the Overnight Policy Rate (OPR) was lowered by 150 basis points and the Statutory Reserve Requirement (SRR) reduced by 300 basis points.

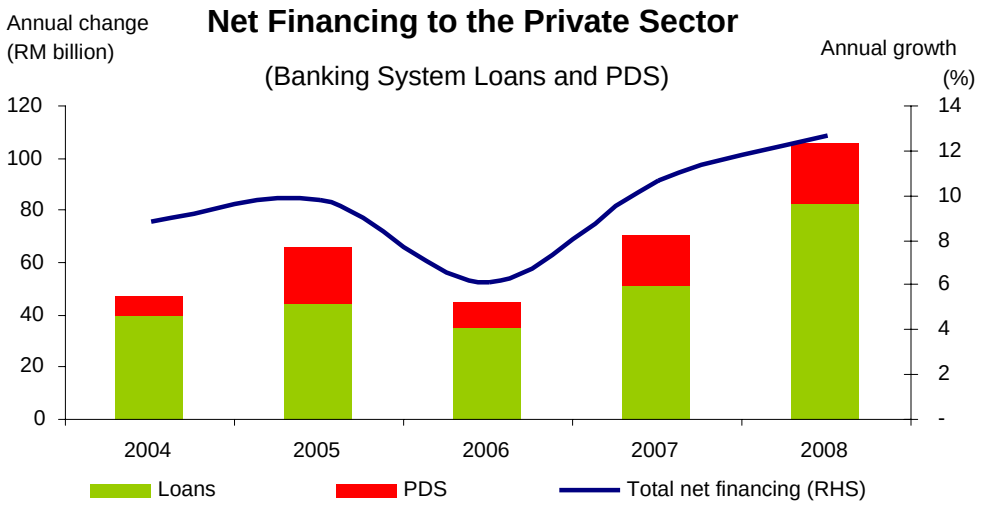
Retail lending rates in 2008 were already near historical lows due to the low cost of funds, the ample liquidity situation, as well as intense competition among banks. Following the OPR reduction in November, the average lending rate declined further to end the year at a new historic low of 5.86%.



Source: Bank Negara Malaysia

Reflecting the continued favourable domestic credit conditions during the year, the increase in **net financing** channeled to both the public and private sectors was sustained at 11.3% (2007: 8.2%). The increased financing to the private sector was mainly to support private consumption activity and working capital requirements of the business sector.

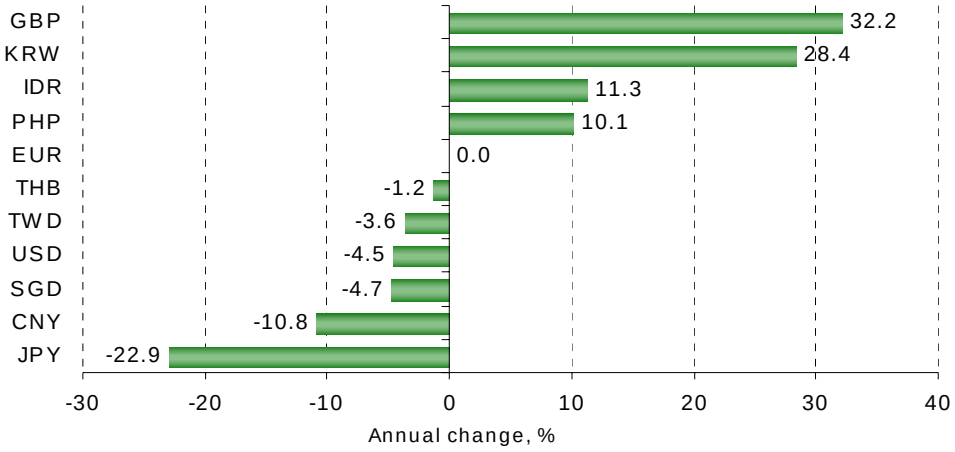
The higher bank financing to households was attributed mainly to strong demand for residential properties and passenger cars, underpinned by rising income from high commodity prices and various incentives introduced by the Government for the property sector in 2007. Loans to the business sector were mainly channeled to fund working capital. Outstanding loans of the overall business sector increased by 13.2% in 2008 (2007: 10.3%). Loans to SMEs, which account for 42.2% of total business loans in particular expanded at a sustained rate of 9.4% (2007: 9.1%). PDS financing during the period was used to finance new investment projects, mainly by firms in the services sector.



Towards year-end, however, the demand for financing slowed due to the moderation in economic growth and the more cautious outlook of the private sector. Loan applications by businesses and households declined across most economic sectors in the fourth quarter. Funds raised through the equity and PDS market also declined. Lower bond issuances in the PDS market was also due to the higher cost of raising funds as investors demanded higher risk premiums.

The **ringgit** exchange rate was influenced by both domestic and external factors. The strengthening of ringgit in the early part of 2008 reflected positive domestic economic fundamentals, including the continued positive net trade balance, the sound financial system, the relatively resilient economic growth outlook as well as Malaysia's limited direct exposure to the global financial crisis. The broad weakness of the US currency and large inflows of portfolio funds also reinforced the ringgit. Subsequent global developments, however, led to the broad downward trend in ringgit against the US dollar. These included the failures of key financial institutions in the developed economies, which heightened risk aversion and triggered the unwinding of investments in emerging economies. Between May and December 2008, the ringgit oscillated around a broad depreciating trend similar to other regional currencies following rapid change in sentiments in the financial and currency markets. In a volatile and uncertain global environment, the managed float exchange rate regime gives flexibility for the ringgit to adjust to global economic and financial developments. At the same time, the current regime has also accorded a level of stability against the currencies of Malaysia's major trading partners.

Ringgit Performance against Major and Regional Currencies in 2008



Note: (+) indicates an appreciation of the ringgit against foreign currency
Source: Bank Negara Malaysia

Ringgit **bond yields** were mainly influenced by inflation expectations and concerns over the growth outlook. Yields were generally trending upwards in the first half of the year over concerns of higher domestic inflation, but mitigated by the large inflows of capital and expectations for a further strengthening of the ringgit. MGS yields, however, began to decline in the latter part of the year as inflation expectations eased. PDS yields increased on account of domestic market developments, including the reallocation of portfolios in favour of sovereign papers. In the equity market, falling commodity prices,

increased risk aversion and deleveraging activities by international financial institutions brought the Kuala Lumpur Composite Index (KLCI) down by 39.3% to 876.8.

Outlook for the Malaysian Economy in 2009

The outlook for the Malaysian economy is affected by the highly uncertain global economic conditions. The problems in the global financial sector continue to remain, with losses by the financial institutions projected to increase further. The global economy continues to be affected by the credit crunch, job losses, declining asset prices and excess capacity prevailing in most advanced economies, with adverse repercussions on global trade. With many economies already in recession, the global economy is not expected to record any growth in 2009 (2008 : 3.4%).

The weak global outlook is likely to have an adverse impact on the growth of the Asian economies, given the strong trade and investment linkages. Countries with high trade dependence will be more vulnerable, while foreign direct investment flows will be curtailed in view of increasing spare capacity and reduced trade financing. Several regional economies have already felt the impact, as evidenced from the sharp contraction in exports as well as large decline in industrial production and investment. The easing of monetary policy and the countercyclical fiscal measures that have been undertaken by most economies in the region would, however, provide some support to regional growth in 2009.

The Malaysian economy is expected to experience the full impact of the global downturn in 2009. In response, several policy measures have been put in place with a primary focus on supporting domestic demand as well as mitigating the impact of the global slowdown on the affected segments of the economy. These included two economic stimulus packages of RM67 billion, amounting to almost 10% of GDP, aimed at supporting private sector demand, creating employment and training opportunities, easing the burden of the affected sectors as well as building long-term capacity of the economy. On the monetary policy front, Bank Negara Malaysia reduced the OPR by 150 basis points since November 2008 to 2.0%, while the SRR by 300 basis points to 1.0%, to reduce the cost of intermediation, including monthly loan repayments.

In addition, several measures have also been introduced to ensure that SMEs and businesses continue to have access to credit as well as to minimise the impact of the economic downturn on specific affected sectors. These include the setting up of four new funds to facilitate access to financing by the small and medium enterprises (SMEs) and micro enterprises as well as measures by the financial institutions to lessen the burden on the affected groups through loan restructuring. Under the second economic stimulus package, two loan guarantee facilities, namely the Working Capital Guarantee Scheme and Industry Restructuring Loan Guarantee Scheme were established, to provide working capital and to encourage investment by businesses respectively. In

addition, the Financial Guarantee Institution will also be established to provide credit enhancement to companies that raise funds from the bond market.

Taking into account the prospect for a deepening global downturn and the support to the economy provided by the policy measures, real **GDP performance** of the Malaysian economy in 2009 is projected to be between -1% to 1%. The timely implementation of the economic stimulus is important to ensure that growth will be in this projected range. **Domestic demand** is expected to provide the main support to the economy, with public spending and private consumption as the main anchors. Public sector expenditure is projected to increase substantially following the implementation of the economic stimulus packages. In addition, the policy responses will also provide important support to household consumption given the anticipated weakness in the labour market and relatively lower commodity prices. Private investment is expected to slow in an environment of a more broad-based slowing of economic growth. Given the very weak global economy, **external demand** is projected to be contractionary on the economy, reducing growth in 2009 by an estimated 4 percentage points.

Real GDP by Expenditure (2000=100)

	2009*f*	
	Annual change (%)	Contribution to real GDP growth (percentage point)
Domestic Demand [1/]	**2.9**	**2.6**
Private sector expenditure	-0.3	-0.2
Consumption	*3.5*	*1.8*
Investment	*-17.7*	*-2.0*
Public sector expenditure	11.4	2.8
Consumption	*7.3*	*1.0*
Investment	*16.6*	*1.8*
Change in stocks		**1.4**
Net exports of goods and services	**-29.7**	**-4.0**
Exports	-16.6	-19.7
Imports	-14.9	-15.7
Real GDP	**-1.0 ~ 1.0**	**-1.0 ~ 1.0**

[1] Excluding stocks
f Forecast

On the **supply side**, sectors that are directly exposed to external demand will be significantly affected in 2009. Output in the manufacturing sector is expected to decline due to the contraction in the export-oriented industries as well as weaker support from the domestic-oriented industries. The services sector will remain the main contributor to growth, though its growth is likely to moderate given the weaker performance in the trade-related industries. The agriculture and mining sectors will register negative growth arising from lower production of palm oil, rubber and crude oil, in part affected by lower prices. Meanwhile, the construction sector is expected record a stronger growth, benefiting from the implementation of projects under the two stimulus packages.

Real GDP by Sector (2000=100)

	2008[p]	2009[f]
	Annual change (%)	
Agriculture	3.8	-2.0
Mining & quarrying	-0.8	-0.4
Manufacturing	1.3	-8.0
Construction	2.1	3.0
Services	7.3	4.5
Real GDP	**4.6**	**-1.0 ~ 1.0**

[p] Preliminary
[f] Forecast

Source: Department of Statistics, Malaysia
Bank Negara Malaysia

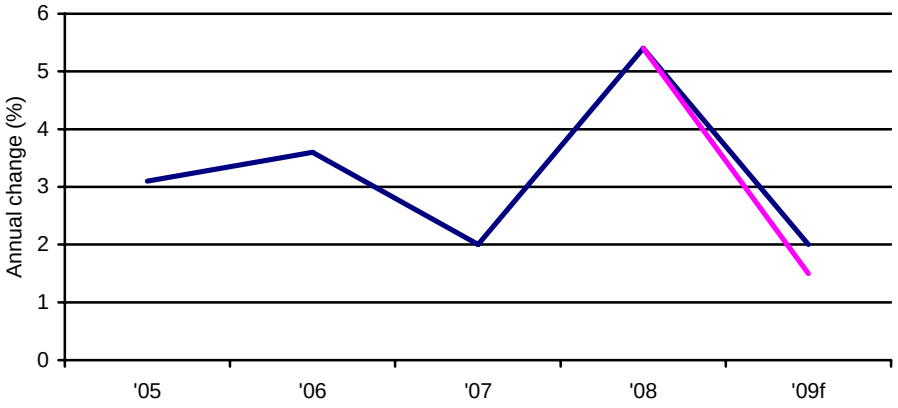
Labour market conditions are expected to weaken further, with the unemployment rate projected to increase to 4.5% in 2009. While businesses affected by the sharp deterioration in external demand are likely to continue to implement cost-cutting measures, including temporary layoffs and retrenchments, measures to increase employment in the public sector and incentives provided to the private sector to retain employees will partially offset the overall weak employment prospects.

On the **external front**, the current account surplus is projected to moderate, but remain sizeable at 11.5% of GNI in 2009. Although gross exports are expected to decline substantially due to the significant weakness in external demand and the lower commodity prices, the trade surplus will remain significant as export contraction will largely be offset by import compression. The services account is expected to record a

deficit in 2009 due to lower travel surplus. On the financial account, gross inflows of foreign direct investment are anticipated to moderate further in 2009, as multinational corporations postpone their investment plans until there are clearer signs of recovery in demand have emerged.

Headline inflation is expected to average between 1.5 – 2% in 2009, reflecting the sharp reversal of global commodity prices from their peaks in 2008 and slowing global inflation. The impact of the downward adjustments in administered prices by the Government and the expected slowdown of economic activity will also reduce price pressures.

Consumer Prices



The projected economic performance of -1% to 1 % for Malaysia in 2009 is based on the weaker global conditions expected during the year that will be partially offset by the implementation of policy measures to support domestic demand. There remains however, significant uncertainties regarding the global economic outlook. First, the turmoil in the international financial markets may be more protracted and extend beyond this year, with problems in the financial sectors in a number of countries remaining unresolved, thereby further exerting downward contractionary influence on the global economy. Second, the large stimulus measures that are being implemented by several countries would take some time to take effect. Thirdly, there is the risk of trade and financial protectionism. These factors will influence the depth and length of the recession in the advanced economies and the overall performance of the global economy.

Economic and Monetary Management in 2009

Despite the massive stimulus efforts and after almost two years into the global financial crisis, the global economy has yet to see signs of recovery with indicators suggesting further downside. Under this very difficult global economic environment, the challenge is

to provide the necessary and sufficient policy support to the domestic demand in order to mitigate the impact of the decline in external demand.

The Federal Government's 2009 Budget announced in August 2008 was initially formulated with the principal objective of further strengthening the nation's economic resilience in the face of rising inflation and increased uncertainties. As the global economic situation worsened in the fourth quarter of 2008, fiscal policy was directed at countering the cyclical downturn. The RM7 billion first Economic Stimulus Package announced on 4 November 2008 is aimed at compensating the shortfall in private sector demand and reinvigorating private spending. The fund is being spent on small-scale construction, maintenance of social infrastructure and public amenities and development projects that included the building of low- and medium-cost houses as well as measures to boost private consumption. The RM60 billion second Stimulus Package announced on 10 March 2009 include wide-ranging measures to support domestic economic activities and strengthen capacity for future growth. Of the total, RM15 billion would be in the form of fiscal injection, RM25 billion for Guarantee Funds, RM10 billion for equity investments, RM7 billion for private finance initiative and RM3 billion in the form of tax incentives.

Although the fiscal deficit is expected to widen from 4.8% of GDP in 2008 to 7.6% of GDP in 2009, the Government will continue to finance it from non-inflationary domestic sources, mainly through the issuances of Malaysian Government Securities (MGS) and Government Investment Issues (GII). In addition, the Government would issue a retail bond, the Government Savings Bond, amounting to RM5 billion, to finance its expenditure. With ample liquidity and high domestic savings in the domestic financial sector, higher public sector spending would not crowd out the availability of financial resources to the private sector.

With the risk of inflation abating, the focus of monetary policy has shifted firmly towards supporting economic growth in the context of pronounced weakening of global demand. As a pre-emptive measure, the Bank has reduced the OPR by 150 basis points between November 2008 and February 2009 to support economic activity. The SRR was also lowered to reduce the cost of intermediation and thus encouraged the banks to pass on the lower interest rates to borrowers.

It is noteworthy that Malaysia is entering this challenging period from a position of strength with a strengthened banking system and a strong external position. Prudent policies and the substantial progress in developing and strengthening the domestic financial system since the Asian Financial Crisis have also contributed to the relative resilience of the Malaysian financial system. This is important to ensure that the financial intermediation process is uninterrupted and to facilitate the transmission of monetary policy.

The Bank remains mindful of the need to mitigate the impact of lower interest rate on the segment of population who depended on income from savings. The Bank also announced the issuance of the Bon Simpanan Merdeka amounting to RM2 billion on 28 January as an additional savings instrument for Malaysian citizens aged 56 and above. Meanwhile, the Government has announced the issuance of syariah-compliant Savings Bonds amounting to RM5 billion for citizens above 21 years old. With a nominal return of 5.0% per annum, the real return on both these bonds is expected to average above 3.0% in 2009.

The collective impact of monetary and fiscal policies, as well as targeted structural measures should contribute towards containing the effects of the global economic downturn on domestic economic activity and provide a firm base for the economy to return to its medium-term growth path once global economic and financial conditions stabilise.

Bank Negara Malaysia's Audited Financial Statements for 2008

Bank Negara Malaysia's financial position and its operations in 2008 have been examined and certified by the Auditor General. Total assets of the Bank stood at RM344.5 billion as at end-2008 (end-2007: RM424.9 billion). The Bank registered a net profit of RM6.5 billion for the financial year ended 31 December 2008 and declared a dividend of RM1.5 billion to the Government.

Bank Negara Malaysia
25 March 2009