Economic, Monetary and Financial Developments in 2021

40 Box Article: An Anatomy of Inflation: Effects from the Prolonged Pandemic

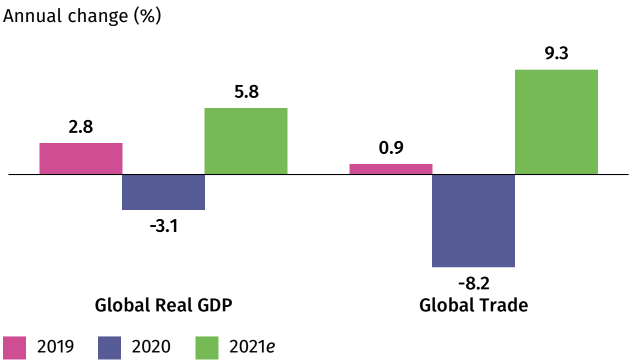
Economic, Monetary and Financial Developments in 2021

2021: MODERATE RECOVERY AMID A PROLONGED PANDEMIC

An uneven global economic recovery following periodic resurgences of COVID-19 and varying vaccinations coverage

In 2021, the global economy recovered from the pandemic-induced recession in the previous year. Developments related to the COVID-19 pandemic continued to shape the recovery path, with periodic resurgences of COVID-19 dampening the pace of the recovery. For many economies, progress in COVID-19 vaccinations facilitated the reopening and recovery of the global economy. This was further supported by a strong rebound in global trade, despite the worsening of supply chain issues. Global economy and global trade rebounded by 5.8% and 9.3%, respectively, in 2021 (2020: -3.1% and -8.2% respectively) (Chart 1.1).

Chart 1.1: Global Real GDP and Trade Growth



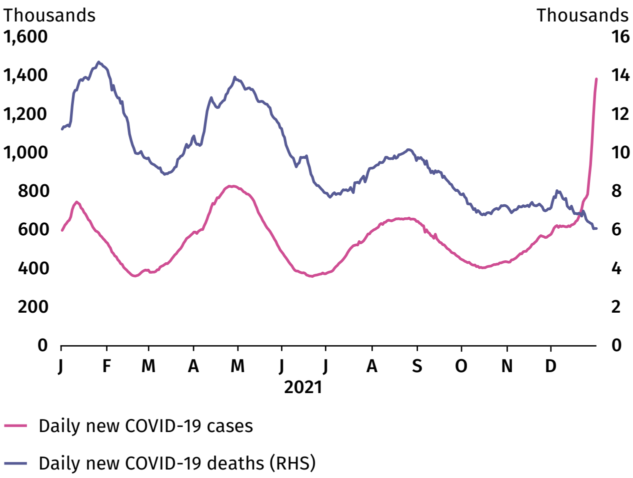
e Estimate

Source: International Monetary Fund (IMF) January 2022 World Economic Outlook and Bank Negara Malaysia estimates

The year started with elevated COVID-19 cases that affected many major economies. The emergence of the Delta variant in the second quarter of 2021 led to resurgences that continued throughout the rest of the year. Approaching year-end, a newer variant of concern, Omicron, caused yet another sharp resurgence in cases. Containment measures, albeit less strict than measures imposed in the second quarter of 2020, were reintroduced to manage these resurgences, affecting the pace of the recovery. The introduction of vaccines beginning December 2020, which were effective in reducing incidences of severe symptoms and deaths from COVID-19 (Chart 1.2), allowed a more sustained reopening of the global economy. However, the pace of recovery between advanced economies (AEs) and emerging market economies (EMEs) was uneven, reflecting differences in access to COVID-19 vaccines and progress of domestic vaccinations, the stringency of containment measures to curb resurgences and the degree of economic policy support.

In AEs, containment measures were tight during the first few months of the year. Nevertheless, more

Chart 1.2: Daily New Global COVID-19 Cases and Deaths (7-Day Moving Average)

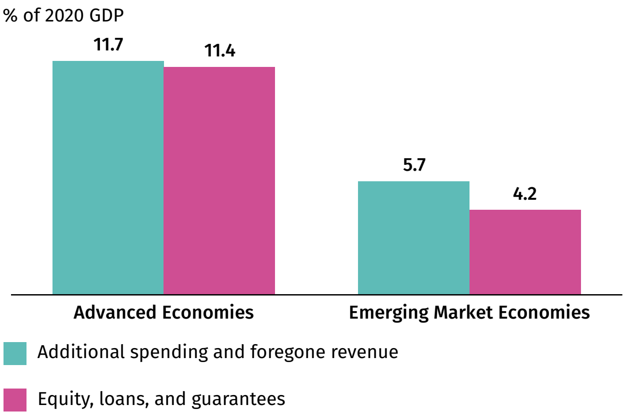


Source: Our World in Data

rapid progress in vaccinations allowed major AEs, such as the United States (US), the euro area and the United Kingdom (UK) to ease their stringent measures in the second quarter. This facilitated an early rebound in economic activity, especially in high-touch services activities. Large fiscal support in these economies further aided the economic recovery (Chart 1.3). In the US, there were additional cash handouts and enhanced unemployment benefits, while the European Union (EU) introduced their Multiannual Financial Framework (MFF) and NextGenerationEU recovery plan.[1]

Meanwhile, EMEs maintained tighter containment measures over a longer period, given the relatively slower pace of vaccinations, delaying their economic recovery. Fiscal support among EMEs was also relatively more limited compared to AEs (Chart 1.3). In addition, several economies adhered to a 'Zero-COVID' policy, which saw tight containment measures introduced whenever cases were detected locally. This led to frequent disruptions to economic activity, which dampened sentiments. This was observed in the People's Republic of China, where retail sales remained sluggish especially in the second half of the year amid repeated resurgences of COVID-19 cases. Production was also affected, albeit to a limited extent.

Chart 1.3: Discretionary Fiscal Response to COVID-19 Crisis

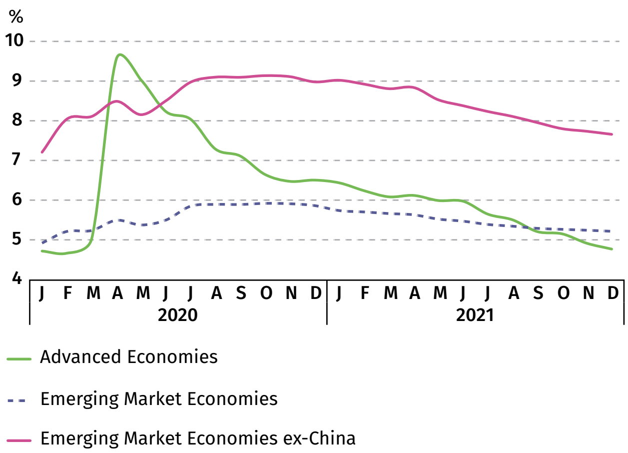


Note: Covers fiscal responses from January 2020 to September 2021

Source: International Monetary Fund (IMF) Fiscal Monitor Database of Country Fiscal Measures in Response to the COVID-19 Pandemic

Labour market conditions in AEs and EMEs recovered, albeit at different paces. Following an earlier economic reopening and more rapid rebound in domestic demand, labour conditions in AEs improved strongly in 2021. Meanwhile, unemployment remained elevated for some time in EMEs but improved towards the end of the year, following a steadier economic reopening (Chart 1.4). Nevertheless, AEs and EMEs experienced similar challenges, namely, a weaker recovery in labour force participation among vulnerable segments. Women's participation was affected by their higher employment in the *services* sector, which was more impacted by the pandemic. In addition, this was compounded by increased familial and childcare needs, following closures of schools and care facilities during the pandemic.[2] Labour market conditions were also particularly challenging for youth, as employment among youth in many countries remained weaker than prime-age workers. Employment losses among youth not only translated into higher unemployment, but also, higher rates of discouragement and inactivity.[3]

Chart 1.4: Unemployment Rate



Note: Unemployment rate aggregated using PPP-weights

Source: National authorities, International Monetary Fund (IMF) and Bank Negara Malaysia calculations

[1] The MFF is the 7-year long-term budget for the European Union, with the latest MFF outlining spending between 2021 and 2027. The latest MFF includes the NextGenerationEU recovery plan, which provides additional funds to support the recovery of the EU from the COVID-19 pandemic. The budget includes fiscal support for the green and digital transitions, research and development, agricultural subsidies, and economic development support to reduce disparities between different EU regions.

[2] A policy brief ("An uneven and gender-unequal COVID-19 recovery: Update on gender and employment trends 2021") published by the International Labour Organisation (ILO) provides evidence that the employment of women have been more severely affected by the pandemic. The policy brief suggests that more gender-specific policies may be needed to support a more inclusive recovery.

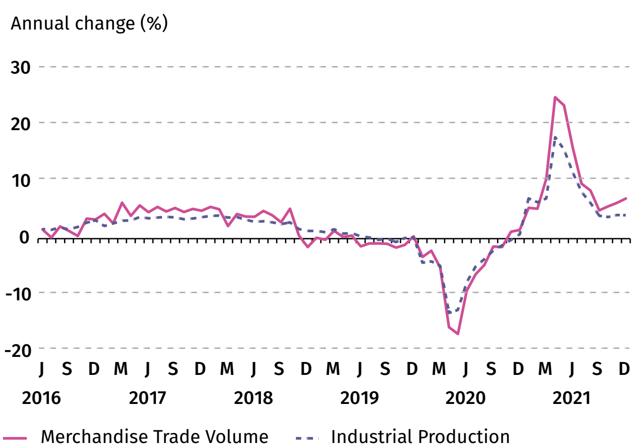
[3] For further information, please refer to "ILO Briefing Note: An update on the youth labour market impact of the COVID-19 crisis" (June 2021), and "ILO Monitor: COVID-19 and the world of work. Eighth edition" (October 2021). Discouragement and inactivity are estimated by labour market exits that were not offset by participation in education and training.

Amid the resurgences and containment measures, the demand for goods was strong, especially for electrical and electronics (E&E) and commodities products. The restrictions on services activity led to a partial shift in spending towards goods, while demand for commodities products was supported by the global recovery. In particular, E&E products were also supported by continued demand for work-from-home equipment. The global technology upcycle supported strong growth in manufacturing activity globally (Chart 1.5), particularly for the regional economies.

Goods trade and production in various countries along the global value chain, however, were affected by containment measures following resurgences of COVID-19 cases. This led to intermittent disruptions in factories and logistical facilities such as shipping ports. The supply chain disruptions constrained the growth in manufacturing activity due to shortages and delays in obtaining inputs for production, as well as equipment to expand production capacity. Global shortages in semiconductor chips were particularly acute, given the strong demand for digital equipment during the pandemic and long lead times for capacity expansion. Overall, while global trade and *manufacturing* sector performance remained strong throughout the year, the supply chain disruptions had a severe impact on the automotive industry globally, due to its exposure to semiconductor chips in its production.

As economic activity resumed following the lifting of containment measures and demand started to recover, inflationary pressures began to rise in the second half of 2021. Commodity prices, including global food and oil prices, rose sharply, driven by the recovery in economic activity. For oil prices in particular, there were also supply constraints due in part from past under-investment in capacity expansion. Moreover, adverse weather conditions affected the production of crude oil, increased demand for natural gas and contributed to further increases in the prices of certain food commodities. There were also labour shortages in a few advanced economies, notably the US, which led to increased wage pressures. In addition, supply chain disruptions led to an increase in global shipping and input costs, ultimately affecting the prices of consumer goods.

Chart 1.5: Global Merchandise Trade Volume and Industrial Production Growth



Source: CPB Netherlands Bureau for Economic Policy Analysis

The environment of stronger demand as economies reopened and rising cost pressures from commodity prices and supply chain disruptions led to increases in inflation. Hence, many central banks began to withdraw monetary support in the second half of 2021 to contain price pressures, while remaining cognisant of the need to support the economic recovery. The US Federal Reserve (the Fed) completed tapering off its asset purchases in mid-March of 2022, while the European Central Bank has announced a tapering of its Pandemic Emergency Purchase Programme. Several central banks in EMEs such as Brazil, Mexico and Russia had also raised their policy rates, in light of higher and rising inflation, far above their targets. Nevertheless, the magnitude of increase in inflation varied across countries, with inflation in most Asian economies remaining relatively lower. Thus, Asian EMEs such as Indonesia, Thailand and the Philippines did not increase their policy rates throughout 2021.

Tighter domestic financial conditions, but spillovers to financial intermediation were contained

Developments surrounding the pandemic was a key factor affecting both global and domestic financial markets in 2021. Financial markets began the year with a continuation of the upward momentum from 2020 amid more favourable prospects[4] in relation to the pandemic. In the US, long-term US Treasury yields surged sharply in the first quarter following

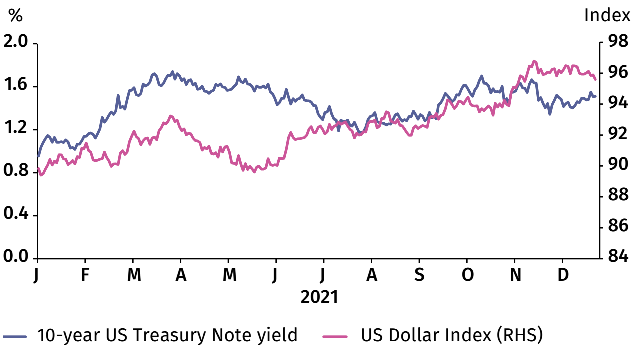
[4] In the fourth quarter of 2020, investor sentiments were lifted. This was amid better outlook over the health crises and economic recovery following news of successful vaccine trials and subsequent vaccine rollouts in selected major economies.

increased market expectations of a faster economic recovery and higher inflation (Chart 1.6). This led to the corresponding steepening of yield curves in the other AEs and EMEs. The US dollar also strengthened (Chart 1.6), resulting in currency depreciation for most EMEs against the US dollar. Nevertheless, bond yields in the US and subsequently across other countries moderated in April amid the Fed's reiteration to maintain its monetary policy stance to support economic recovery. The decline in yields contributed to easing in financial conditions, which mitigated adverse implications of a premature tightening to the economic recovery, especially for economies that continued to face challenges in managing the impact from the pandemic.

The global outbreak of the Delta variant started affecting sentiments towards the end of the second quarter. The resulting increase in risk aversion induced portfolio rebalancing towards safe-haven assets, such as the US Treasury securities and the US dollar. Equity markets globally also recorded some declines amid uncertainties in the economic outlook. In the EMEs, the ensuing bouts of outflows, which weighed on the broader inflows trend for the year, resulted in increased market volatility. As the extent of the pandemic disruption was uneven, the impact on individual financial markets differed across EMEs. Sentiments were more affected in economies that experienced higher COVID-19 resurgences and stricter implementation of containment measures.

Developments in the financial markets were also influenced by the increased investors' expectations over faster US monetary policy normalisation, which led to further episodes of increases in US bond yields and a stronger US dollar. This was particularly

Chart 1.6: 10-year US Treasury Note Yield and US Dollar Index



Source: Bloomberg

prominent towards the end of the year, following the increased indication by the Fed for a quicker pace of monetary policy normalisation.[5] During such episodes, global financial markets experienced bouts of tightening, although the adjustments mostly remained orderly amid the Fed's more active communication. During the year-end period, other global factors such as rising inflationary concerns and emergence of the new Omicron variant led to further market adjustments, reflecting the fluctuating risk sentiments.

For Malaysia, while the domestic financial markets were largely affected by the global developments, market conditions were also influenced by domestic factors, primarily in relation to the pandemic and its implications for the economic outlook. The confluence of these external and domestic factors contributed to intermittent volatility in portfolio flows, elevated pressure on the Malaysian Government Securities (MGS) yields, subdued equity prices, and ringgit depreciation.

Movements of domestic equities were particularly sensitive to developments related to the containment measures, given their impact on the outlook for corporate earnings. The equity market was subdued throughout periods of resurgences in cases during the year (Chart 1.7). Nevertheless, significant progress in vaccinations allowed for

Chart 1.7: 10-year MGS Yield and FBM KLCI

Source: Bank Negara Malaysia and Bloomberg

[5] Signs of increasing willingness by the Fed to start, and quicken, the tapering of its asset purchase programme were evident in the Federal Open Market Committee (FOMC) decisions and meeting minutes, and through communications by individual Fed officials, mainly in the second half of the year. The projection from the 'dot plot' published in December 2021 also indicated an upward revision to at least three rate hikes in 2022, compared to only one rate hike in the September 2021 'dot plot'.

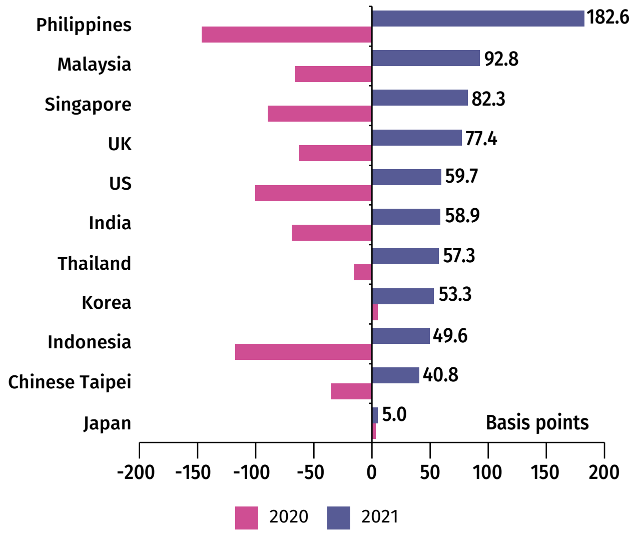
easing of containment measures in August. The subsequent improvement in sentiments provided some support in the equity market, offsetting part of the earlier declines. Despite the rebound in the latter half of 2021, for the year as a whole, the FTSE Bursa Malaysia Kuala Lumpur Composite Index (FBM KLCI) declined by 3.7% (2020: +2.4%) to close at 1,567.5 points. Correspondingly, the equity market recorded non-resident outflows of RM1.1 billion in 2021 (2020: -RM23.9 billion), primarily reflecting the risk aversion due to domestic pandemic resurgences.

Notwithstanding the development in the equity market, the domestic bond market recorded sizable non-resident inflows of RM56.2 billion in 2021 (2020: RM35.0 billion) amid the continued ample liquidity globally. The inflows were also supported by improvement in investors' risk appetite following the reopening of domestic economy and other favourable developments such as Malaysia's retention in the FTSE World Government Bond Index (WGBI), increase of Malaysia's weightage in other major bond indices and the affirmation of Malaysia's sovereign rating[6] by credit rating agencies. In line with the higher regional bond yields, domestic bond yields increased despite the inflows, mainly reflecting the spillovers from increases in US bond yields (Chart 1.7 and 1.8). This was, to some extent, exacerbated by expectations of higher MGS issuances in relation to the additional pandemic-related fiscal support. As a result, the 3-year, 5-year and 10-year MGS yields increased by 92, 103 and 93 basis points, respectively (2020: -113, -106, and -66 basis points, respectively).

Movements in the ringgit exchange rate largely reflected the strengthening of the US dollar, with the ringgit depreciating by 3.9% to end the year at RM4.1760 against the US dollar (Chart 1.9). This was in line with the movements in most regional currencies, which depreciated between 10.3% and 0.9% against the US dollar. Overall, the Nominal Effective Exchange Rate (NEER) depreciated by 1.2%, reflecting the depreciation of the ringgit against the currencies of Malaysia's key trading partners, including the Chinese renminbi and the Singapore dollar.

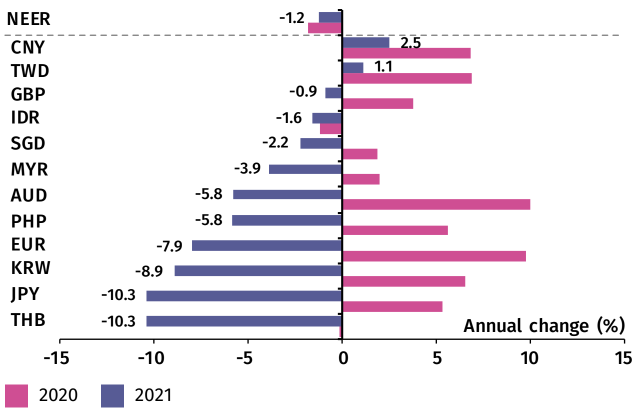
[6] Affirmation of Malaysia's sovereign rating of "A3" by Moody's Investors Service and "A-" by S&P Global Ratings in January and June 2021, respectively.

Chart 1.8: Change in 10-Year Government Bond Yields of Selected Economies



Source: Bank Negara Malaysia and Bloomberg

Chart 1.9 : Performance of Major and Regional Currencies against the US Dollar and Ringgit Nominal Effective Exchange Rate (NEER)



Note: (+) indicates an appreciation of currencies against the US dollar.
NEER shows the value of the ringgit against a trade-weighted basket of Malaysia's major trading partners' currencies.

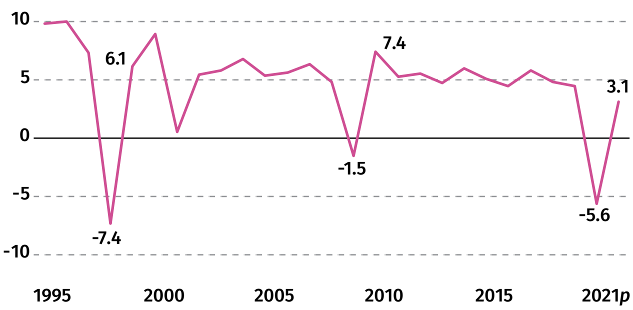
Source: Bank Negara Malaysia and Reuters

Despite tighter financial conditions and periodic market volatility, adjustments in the domestic financial markets have remained orderly, underpinned by Malaysia's deep and liquid financial markets. The Bank's liquidity and foreign exchange operations provided further support in mitigating excessive market volatility and preserving orderly market conditions. Importantly, spillovers to financial intermediation were contained despite the adjustments in financial conditions. Financing remained supportive of economic recovery, with sustained fundraising activity in the capital market and continued flow of bank credit. The strength and resilience of domestic banking system, in particular, was integral in anchoring an effective intermediation of funds within the economy. Banks' cost of funds were largely unaffected by the higher bond yields given their low reliance on market-based funding instruments.[7] Active risk management[8] by banks further mitigated revaluation losses from their bond holdings. This was crucial as financing of the economy remained dominantly bank-based even as market-based financing had been increasing over the years.[9] More broadly, the impact of external shocks on the domestic economy was also cushioned by the continued flexibility in the ringgit exchange rate, which facilitated the appropriate adjustments in the external sector.

The Malaysian economy grew by 3.1% in 2021, as the recovery was affected by the reimposition of containment measures

After experiencing significant supply and demand shocks triggered by the COVID-19 pandemic in 2020, economic activity improved moderately in 2021 (Chart 1.10). An incipient recovery which began in the second half of 2020 resumed in the first five months of 2021 (Chart 1.11), despite the imposition of the Second Movement Control Order (MCO 2.0) and the Second Conditional Movement Control Order (CMCO 2.0), as most businesses were allowed to operate during these phases. Thus, together with continued policy support, domestic demand gradually improved. The recovery was further supported by robust exports performance amid favourable external demand. The labour market also rebounded, as the unemployment rate fell from 4.9% in January to 4.5% in May and underemployment declined, amid a decline in jobless claims and an increase in the pace of hiring.

Chart 1.10: Malaysia's Real GDP Growth (1995-2021)



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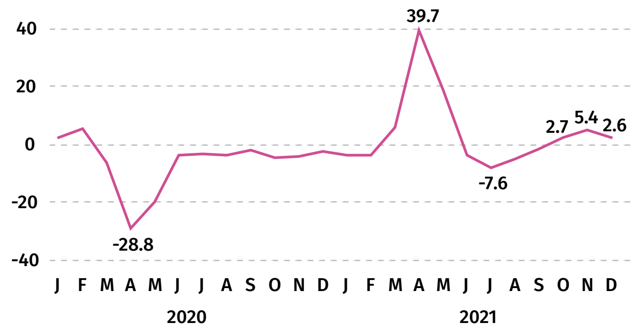
Source: Department of Statistics, Malaysia

Chart 1.11: Real GDP growth (Jan 2020 - Dec 2021)



Source: Department of Statistics, Malaysia

The recovery momentum, however, was affected by the reimposition of nationwide containment measures under the first phase of the National Recovery Plan (NRP)[10] in June 2021, following a rapid resurgence of cases due to the Delta variant. These measures weighed on household spending and investment activity in the third quarter, particularly affecting the *services* and *construction* sectors. Nevertheless, the severity of containment measures in 2021 was smaller compared to the first MCO in the second quarter of 2020, as essential

[7] Funding via equity and interbank financing, and bond issuances accounted for 17.4% and 2.4% of total banking system funding, respectively, as at December 2021.

[8] For example, banks' hedging strategies and their own internal limits on extent of exposure to bond holdings on their balance sheet.

[9] Private sector financing by the banking system and in the corporate bond market accounted for 72% and 28% of total net financing, respectively, as at end-2021 (2010: 77% and 23%, respectively).

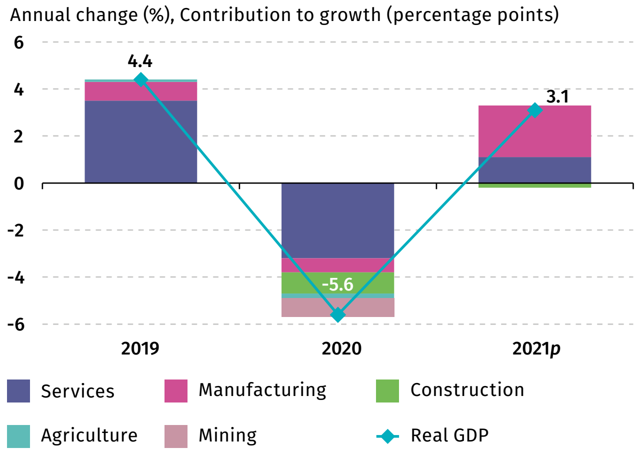
[10] NRP replaced the Full Movement Control Order (FMCO) that was originally announced on 28 May 2021. The four phases of the NRP allows for a safe reopening of the economy based on three indicators, namely daily symptomatic hospital admission cases, healthcare capacity and vaccination rate. The first phase is the most stringent with strict restrictions on sectors allowed to operate and community mobility. Under this phase, only essential services and industries integral to the supply chain were allowed to operate, while only two individuals per household could travel no further than 10km from their residence, and interstate travel was not allowed. This was followed by gradual relaxations in restrictions across the second, third and fourth phases.

economic sectors were allowed to operate. Additionally, businesses and households adapted better to the containment measures and standard operating procedures (SOPs) during the NRP Phase 1 period. Greater adoption of technology and digitalisation, more effective remote working arrangements, and increased automation helped mitigate further losses arising from the lockdowns. Meanwhile, the rapid progress of domestic vaccinations[11] and phased lifting of restrictions under the NRP supported a safe economic reopening and gradual normalisation in economic activity towards the end of the year.

External demand provided robust support to growth in 2021. Strong global trade activity boosted Malaysia's gross exports (2021: 26.0%, 2020: -1.1%). Recovery in economic conditions in advanced and regional economies resulted in strong demand from key trade partners. Similarly, the continued global technology upcycle and robust demand for semiconductors led to strong growth in electrical and electronic (E&E) products. As a key player in the global supply chain, Malaysia was also affected by the supply disruptions, although to a much lesser extent, as trade and manufacturing performance remained resilient during the year.[12] This is mainly attributed to firms having taken proactive measures to mitigate the impact of supply disruptions on their operations.[13] Meanwhile, exports of services contracted for a second year in a row (-9.4%, 2020: -48.0%), reflecting weak tourist arrivals (2021: 0.1 million persons, 2020: 4.3 million persons[14]), as most international borders remained closed.

In terms of developments across economic sectors, the improvement in the domestic economy was

Chart 1.12: Real GDP by Economic Sectors



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Source: Department of Statistics, Malaysia

fairly uneven, as the pace of recovery differed across sectors. Strong external trade supported the exceptional performance of the *manufacturing* sector (Chart 1.12). Meanwhile, the *services* sector remained constrained by weak demand amid restrictions on mobility and high-touch activities (such as dine-ins and tourism), while activity in the *construction* sector was hampered by labour and operating capacity restrictions. Additionally, adverse weather conditions and continued foreign worker shortages affected output in the *agriculture* sector.

From the demand perspective, economic activity continued to be underpinned by household spending, as labour market conditions improved. Continued investments, particularly in machinery and equipment as firms increased their efforts in automation and digitalisation, as well as expansion in production capacity provided further support to growth (Chart 1.13). In the labour market, employment improved amid a return of workers into the labour force. Underemployment also improved, albeit it remained at a slightly elevated rate compared to long-term averages. Overall conditions, however, remained subdued during the year, as the unemployment rate remained elevated and wage growth was modest amid an uneven recovery across labour market segments.[15] Supportive measures continued to remain in place to enable businesses and households to better withstand the impact of these shocks, support incomes, and mitigate

[11] As at 31 December 2021, 97.2% of Malaysia's adult population had been fully vaccinated, while 27% of them had received booster shots. Vaccines are also being rolled out to adolescents aged 12 to 17 and children aged 5 to 11.

[12] Although manufacturing production declined in the third quarter, this was attributed to the reimposition of containment measures, rather than disruptions in the global supply chain.

[13] BNM's industrial engagements revealed that Malaysian firms have taken key mitigation strategies including building inventories by placing advanced bookings and paying expedited fees to secure supplies, expand production capacity by investing in new plants and machinery, as well as opting to use alternative modes of transport which are costlier, such as air cargo or land trucking, to avoid shipment delays. Some firms have taken proactive steps to negotiate with their clients to spread out orders and avoid "bunching" during peak periods, while others have diversifed their supplier base. For more detailed analysis on impact of global chip shortages to Malaysia's E&E sector, please refer to the box article titled 'The Global Chip Shortage: Implications and Opportunities for Malaysia' in the BNM Quarterly Bulletin in 2Q 2021.

[14] The bulk of the tourist arrivals in 2020 were in the first quarter, before international borders were closed (1Q 2020: 4.2 million persons).

[15] See white box on "Moderate Recovery in Labour Market Conditions in 2021" for more details.

Table 1.1

Malaysia - Key Economic Indicators

	2019	2020	2021*p*	2022*f*
Population (million persons)	32.5	32.6	32.7	32.7
Employment (million persons)	15.1	15.1	15.3	~ 15.6
Unemployment (as % of labour force)	3.3	4.5	4.6	~ 4.0
Per Capita Income (RM)	45,311	42,598	45,874	49,673
(USD)	10,938	10,134	11,066	11,799[4]
NATIONAL PRODUCT (% change)				
Real GDP at 2015 prices	4.4	-5.6	3.1	5.3 ~ 6.3
(RM billion)	1,424.3	1,343.9	1,386.0	1,466.6
Agriculture, forestry and fishery	2.0	-2.2	-0.2	1.5
Mining and quarrying	-0.6	-10.6	0.7	2.5
Manufacturing	3.8	-2.6	9.5	5.2
Construction	0.4	-19.4	-5.2	6.1
Services	6.2	-5.5	1.9	6.9
Nominal GNI	5.1	-5.8	7.9	8.5
(RM billion)	1,473.7	1,388.0	1,498.0	1,626.0
Real GNI	5.0	-5.2	2.4	5.0
(RM billion)	1,402.5	1,330.2	1,362.3	1,430.0
Real aggregate domestic demand[1]	4.3	-5.8	1.9	7.2
Private expenditure	6.3	-6.0	2.0	8.2
Consumption	7.7	-4.3	1.9	9.0
Investment	1.6	-11.9	2.6	5.3
Public expenditure	-2.8	-4.7	1.6	3.2
Consumption	1.8	3.9	6.6	1.2
Investment	-10.7	-21.3	-11.4	9.6
Gross national savings (as % of GNI)	25.2	24.5	26.5	23.8
BALANCE OF PAYMENTS (RM billion)				
Goods balance	124.7	138.7	170.2	227.9
Exports	817.3	777.7	977.4	1,086.3
Imports	692.5	639.0	807.2	858.4
Services balance	-10.9	-47.4	-61.1	-62.3
Primary income, net	-39.5	-28.6	-46.2	-69.2
Secondary income, net	-21.4	-2.7	-9.5	-20.7
Current account balance	52.9	60.0	53.5	75.8
(as % of GDP)	3.5	4.2	3.5	4.2 ~ 4.7
Bank Negara Malaysia international reserves, net[2]	424.0	432.3	486.8	-
(in months of imports of goods and services)[3]	5.8	6.7	6.1	-
(in months of retained imports)	7.5	8.4	7.7	-
PRICES (% change)				
Consumer Price Index (2010=100)	0.7	-1.2	2.5	2.2 ~ 3.2
Producer Price Index (2010=100)	-1.4	-2.7	9.5	-

[1] Exclude stocks.
[2] 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 Negara Malaysia's audited accounts.
[3] For further details, please refer to "Expansion of the Measure on Reserves Coverage of Imports – from Retained Imports to Imports of Goods and Services" article in BNM's Quarterly Bulletin for the Fourth Quarter of 2021.
[4] Based on average USD exchange rate for the period of January-February 2022.

p Preliminary
f Forecast

Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

Table 1.2

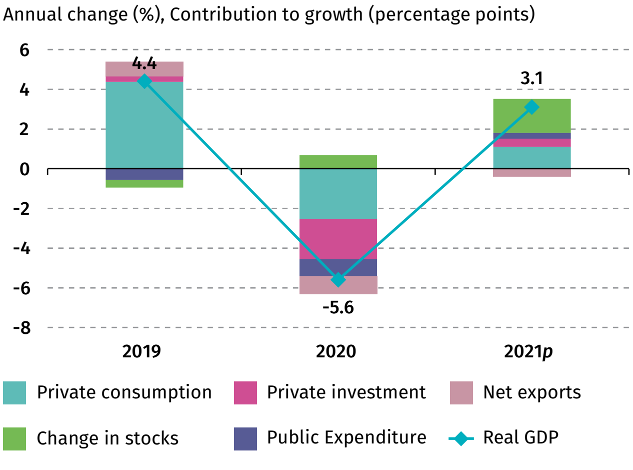
Malaysia - Financial and Monetary Indicators

FEDERAL GOVERNMENT FINANCE (RM billion)	2019		2020		2021	
Revenue	264.4		225.1		233.8	
Operating expenditure	263.3		224.6		231.5	
Net development expenditure	52.6		50.1		63.3	
COVID-19 Fund	-		38.0		37.7	
Overall balance	-51.5		-87.6		-98.7	
Overall balance (% of GDP)	-3.4		-6.2		-6.4	
Public sector net development expenditure	134.5		117.5		141.8	
Public sector overall balance (% of GDP)	-3.4		-7.0		-4.4	
EXTERNAL DEBT						
Total debt (RM billion)	947.4		958.1		1,070.3	
Medium- and long-term debt	557.9		590.7		676.1	
Short-term debt	389.5		367.5		394.2	
Debt service ratio[1] (% of exports of goods and services)						
Total debt	12.6		13.6		10.8	
Medium- and long-term debt	12.0		13.3		10.6	
	Change in 2019		**Change in 2020**		**Change in 2021**	
MONEY AND BANKING	**RM billion**	**%**	**RM billion**	**%**	**RM billion**	**%**
Money supply M1	24.8	5.8	71.1	15.7	54.6	10.4
M3	67.0	3.5	79.4	4.0	130.8	6.4
Banking system deposits	55.5	2.9	88.9	4.4	132.4	6.3
Banking system loans[2]	65.8	3.9	59.6	3.4	82.6	4.5
Loan to fund ratio (%, end of year)[3,4]	83.2		82.5		81.2	
Loan to fund and equity ratio (%, end of year)[3,4,5]	72.8		71.9		70.9	
INTEREST RATES (%, AS AT END-YEAR)	**2019**		**2020**		**2021**	
Overnight Policy Rate (OPR)	3.00		1.75		1.75	
Interbank rates (1-month)	3.08		1.82		1.83	
Commercial banks						
Fixed deposit 3-month	2.90		1.58		1.57	
12-month	3.09		1.75		1.71	
Savings deposit	0.97		0.48		0.56	
Weighted average base rate (BR)	3.68		2.43		2.43	
Base lending rate (BLR)	6.71		5.49		5.49	
Malaysian Treasury Bill (3-month)[6]	2.98		1.72		1.79	
Malaysian Government Securities (1-year)[6]	2.96		1.73		1.85	
Malaysian Government Securities (5-year)[6]	3.18		2.12		3.15	
EXCHANGE RATES (AS AT END-YEAR)	**2019**		**2020**		**2021**	
Movement of Ringgit (%)						
Change against SDR	1.9		-1.8		-1.4	
Change against USD	1.1		2.0		-3.9	

1 Excludes prepayment.
2 Includes loans sold to Cagamas.
3 Loans exclude loans sold to Cagamas and loans extended to banking institutions. Beginning July 2015, loans exclude financing funded by Islamic Investment accounts.
4 Funds comprise deposits (excluding deposits accepted from banking institutions and Bank Negara Malaysia) and all debt instruments (including subordinated debt, debt certificates/sukuk issued, commercial paper and structured notes).
5 Equities comprise ordinary and preferred shares, share premium and retained earnings.
6 Refers to data from Fully Automated System for Issuing/Tendering (FAST), Bank Negara Malaysia.

Source: Ministry of Finance, Malaysia and Bank Negara Malaysia

Chart 1.13: Real GDP by Expenditure



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Source: Department of Statistics, Malaysia

displacements in the labour market. These comprise in large part a continuation of measures put in place in 2020, including *Bantuan Prihatin Rakyat*, the Targeted Repayment Assistance (TRA) and the Wage Subsidy Programme.

The current account in the balance of payments remained in surplus during the year. While exports recorded a robust performance, the improvement in external and domestic demand also resulted in a strong rebound in imports in 2021 (23.3%; 2020: -5.8%). In tandem with higher manufacturing production and exports, intermediate imports registered a double-digit growth. Capital and consumption imports also recovered during the year, due to the pickup in investment and consumer spending. Overall, the goods account registered a higher surplus as exports growth outpaced imports growth. A larger decline in travel receipts, however, resulted in a higher services deficit,[16] while the primary income deficit widened due to higher income accrued to foreign investors in Malaysia amid strong external demand for manufactured goods. These factors more than offset the larger goods surplus, contributing to a lower current account surplus of RM53.5 billion or 3.5% of GDP in 2021 (2020: RM60.0 billion or 4.2% of GDP).

Following the trough in the third quarter of 2021, economic activity resumed towards the end of the year in line with the lifting of restrictions. As containment measures were gradually eased during the third quarter, most economic activities restarted, and labour market conditions improved further. This enabled a quick recovery in mobility and consumer spending in the fourth quarter. The lifting of interstate travel bans in October, in conjunction with the year-end holiday season, also provided support for domestic tourism activities. Towards the end of the year, Malaysia also detected growing cases involving the new and highly transmissible Omicron variant.

[16] Malaysia is a net services importer, recording deficits in the services account since 1947, except for 2007 until 2011. Other than travel and manufacturing services, Malaysia customarily records deficits in all other services accounts (e.g., transport, business services, and telecommunications, computer and information services) during the pre-pandemic years.

Domestic demand anchored growth in 2021

In 2021, the Malaysian economy rebounded by 3.1% (2020: -5.6%), mainly supported by a turnaround in private sector spending. The recovery momentum, however, was affected by the imposition of containment measures during the year. These include the Second Movement Control Order (MCO 2.0) in January 2021 and the National Recovery Plan (NRP) in June 2021. Nevertheless, less restrictive restrictions compared to 2020 as well as better adjustments to the new norm, improved compliance to the standard operating procedures (SOPs) and rapid vaccination progress had minimised the adverse impact on households and businesses. The gradual improvement in income and labour market conditions during the year had provided support to household spending. Meanwhile, investment activity benefitted from continued capital spending, particularly by private firms in the export-oriented sectors. Importantly, policy support remained available for impacted households and businesses. On the external front, the robust exports performance was driven by the rebound in world growth and trade activity, lifted further by the global technology upcycle. However, net exports contracted, as import growth outpaced the growth in exports.[17]

Table 1

Real GDP by Expenditure (2015=100)

	2021*p*	2020	2021*p*	2020	2021*p*
	% of GDP	Annual change (%)		Contribution to growth (percentage point)	
Domestic Demand[1]	**92.7**	**-5.8**	**1.9**	**-5.4**	**1.8**
Private sector expenditure	74.3	-6.0	2.0	-4.5	1.5
Consumption	58.8	-4.3	1.9	-2.5	1.1
Investment	15.6	-11.9	2.6	-2.0	0.4
Public sector expenditure	18.3	-4.7	1.6	-0.9	0.3
Consumption	13.8	3.9	6.6	0.5	0.9
Investment	4.5	-21.3	-11.4	-1.3	-0.6
Gross Fixed Capital Formation	20.1	-14.5	-0.9	-3.3	-0.2
Change in stocks	**1.3**			**0.7**	**1.7**
Net Exports of Goods and Services	**6.0**	**-13.0**	**-5.8**	**-0.9**	**-0.4**
Exports	69.2	-8.9	15.9	-5.7	9.8
Imports	63.2	-8.4	18.5	-4.8	10.2
Real Gross Domestic Product (GDP)	**100.0**	**-5.6**	**3.1**	**-5.6**	**3.1**

[1] Excluding stocks
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Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia

Private consumption registered a modest recovery of 1.9% in 2021 (2020: -4.3%). This was primarily supported by the improvement in wages and employment, as well as less restrictive containment measures compared to 2020. Household spending on both necessities and discretionary items improved in 2021. The recovery in household spending was temporarily halted by the containment measures under the NRP in June 2021. However, as restrictions were gradually relaxed beginning mid-August, private consumption turned around to register positive growth in the fourth quarter. Notably, discretionary spending on high-touch segments such as restaurants, hotels and recreational services increased due to the materialisation of some pent-up demand. Throughout the year, various policy measures remained in place to assist affected households, particularly those in the lower-income group. These measures include Bantuan Prihatin Rakyat (BPR) and targeted loan repayment assistance.

[17] Despite larger trade surplus and nominal net exports, real net exports contracted due to higher export deflator as compared to import deflator.

Gross fixed capital formation (GFCF) registered a smaller contraction of 0.9% in 2021 (2020: -14.5%). This was mainly driven by higher capital spending by the private sector and a smaller decline in public investment. By type of asset, machinery and equipment (M&E) investments rebounded strongly (2021: 13.0%, 2020: -8.6%) underpinned by capacity expansion in the export-oriented sectors. Meanwhile, investments in structures continued to contract, albeit by a smaller pace (2021: -10.0%, 2020: -18.3%) as the implementation of containment measures had affected the commencement and progress of construction projects.

Private investment grew by 2.6% (2020: -11.9%), lifted by higher capital spending particularly in M&E. The high M&E investment reflected capacity expansion by export-oriented manufacturers to fulfil the strong global demand. During the year, approved investment remained encouraging, mainly in the electrical and electronics (E&E) and metal sub-sectors. Notwithstanding this, the reimposition of containment measures had led to continued weakness in structures-related investments, especially the construction of residential and non-residential buildings.

Public investment registered a smaller decline of 11.4% (2020: -21.3%). This was supported by increased spending on fixed assets by the Federal Government. The continued progress of large infrastructure projects provided some support to growth, as these projects were allowed to operate during the lockdown period. Capital spending by public corporations, however, remained weak across most sectors, weighed by the restrictions due to the containment measures.

Public consumption rose by 6.6% (2020: 3.9%), mainly on account of higher spending on both supplies and services and emoluments. This reflected higher Federal Government expenditure related to COVID-19, including on vaccine procurement and logistics services, purchases of medical equipment and services, and special allowances for frontliners.

Growth supported by *manufacturing* and *services* sectors

The recovery in 2021 was mainly driven by expansion in the *manufacturing* and *services* sectors. The *mining* sector recorded marginal growth while the *agriculture* and *construction* sectors contracted. The uneven pace of recovery across sectors reflected several factors. First, the reimposition of various containment measures had affected high-contact segments such as tourism-related industries and *construction* sectors more than others. Nonetheless, rapid vaccination progress, greater firm adaptability and more widespread adoption of digitalisation and automation had enabled firms and households to partly mitigate the negative impact. Second, export-oriented sectors benefitted from strong external demand arising from the continued global technology upcycle and demand for healthcare-related products. Third, labour shortages and adverse weather conditions hampered activity in the *agriculture* sector.

Table 1

Real GDP by Kind of Economic Activity (2015 = 100)

	2021*p*	**2020**	**2021*p***	**2020**	**2021*p***
	% of GDP	Annual change (%)		Contribution to growth (ppt)[1]	
Services	57.0	-5.5	1.9	-3.2	1.1
Manufacturing	24.3	-2.6	9.5	-0.6	2.2
Mining and quarrying	6.7	-10.6	0.7	-0.8	0.0
Agriculture	7.2	-2.2	-0.2	-0.2	0.0
Construction	3.7	-19.4	-5.2	-0.9	-0.2
Real Gross Domestic Product (GDP)	**100[1]**	**-5.6**	**3.1**	**-5.6**	**3.1**

[1] Figures may not necessarily add up due to rounding and exclusion of import duties component
p Preliminary

Source: Department of Statistics, Malaysia

The *services* sector recovered gradually in 2021, expanding by 1.9% (2020: -5.5%). Activity, particularly within the high-touch sub-sectors (e.g. retail, dining out and recreational activities), continued to be affected by the containment measures implemented during the year. The impact, however, was partially mitigated by higher firm and consumer adaptability to the new operating environment. For example, previous experience with operating procedures such as rearrangement of dining areas and limits to the number of customers at any one time helped reduce frictions for reopening businesses. These were further supported by the increased use of delivery services and greater adoption of e-commerce. Consequently, online retail trade activity grew on average by 18.4% in 2021. Meanwhile, the transport and storage subsector continued to be weighed by international travel restrictions. Nevertheless, as operating restrictions eased towards the end of the year, including on interstate travel, services activity gradually picked up. The finance and insurance sub-sector expanded throughout the year driven by sustained net interest income and strong growth in premiums less claims respectively. The information and communication subsector also continued to grow, supported by stronger demand for broadband data amid greater digitalisation in the economy.

The *manufacturing* sector expanded by 9.5% (2020: -2.6%) as the recovery in global and domestic demand supported production activity. The overall effect of global supply chain disruptions on production activity was partly mitigated as manufacturers were able to implement measures to cushion the impact. This included building inventory buffers, negotiating with clients to spread orders, paying for expedite fees and using alternative modes of transportation to avoid shipment delays. For the year as a whole, growth was mainly driven by the expansion in E&E, primary, and consumer-related clusters. Aided by structural shifts towards digitalisation, the E&E sector recorded a robust growth of 14.6% (average: 2010-2019: 6.4%) driven by strong demand for products associated with remote working, e-commerce, cloud-based services, and medical devices. In addition, E&E firms' ability to adapt to SOPs and the highly automated nature of many large semiconductor firms lessened the impact of operating restrictions imposed during the NRP, enabling firms to continuously meet demand. Meanwhile, production in the primary sector benefited from pandemic-induced demand (e.g. rubber gloves and pharmaceuticals) while the consumer-related cluster (e.g. food and beverages and passenger cars) was supported by improvement in domestic household spending and continued fiscal support (e.g. PEMERKASA+ extended SST exemption on passenger cars).

The *agriculture* sector contracted by 0.2% (2020: -2.2%) due to weaker oil palm output. This was amid acute impact from labour shortages and floods in the earlier part of the year which continued to affect harvesting activities. Furthermore, weaker production in the rubber and fisheries subsectors also contributed to the decline in growth. Nonetheless, the decline was partially offset by the expansion in livestock and other agriculture sub-sectors amid a turnaround in domestic demand.

The *mining* sector registered its first positive growth since 2017 (0.7%; 2020: -10.6%). The turnaround was mainly attributed to the gradual recovery in global oil demand and new output from the PETRONAS Floating Liquefied Natural Gas DUA (PFLNG2) facility located in offshore East Malaysia, which commenced operations in February 2021. These factors had more than offset the impact of facility closures such as the Gumusut-Kakap field for maintenance purposes, and production disruptions in the other mining sub-sector due to restrictions from containment measures.

The construction sector declined by 5.2% (2020: -19.4%), as the industry faced limitations on operating capacity and the stop-start nature of construction works, due to the movement restrictions. Special trade was the sole subsector with positive growth, supported by end-works[18] from selected commercial and civil engineering projects, as well as implementation of small-scale projects. Meanwhile, construction activities in the residential and non-residential subsectors remained subdued following extended periods of lockdown and reduced operating capacity. Nevertheless, the easing of the containment measures since August and the reopening of the economy supported the gradual improvement across all subsectors towards the end of the year.

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[18] Include works such as electrical, plumbing, heat, air conditioning and other construction installation, as well as building completion and finishing.

Moderate Recovery in Labour Market Conditions in 2021

After experiencing significant disruptions in 2020, conditions in the Malaysian labour market improved moderately in 2021. The labour market was in recovery in the first five months of the year, in line with the pick-up in economic activity. The recovery momentum, however, slowed in conjunction with Phase 1 of the NRP in June.

Following the reimposition of nation-wide containment measures, unemployment increased, from 4.5% in May, to 4.8% in July 2021, alongside a decline in employment levels. Restrictions on movement and economic activity led to some exits from the labour force, as the population outside the labour force increased during this period. Similar to MCO 1.0, most of the increase was due to reasons such as housework and family care, as well as going for further studies. Underemployment also increased, but rebounded rapidly with the relaxation of restrictions starting in August 2021. Overall, the impact of containment measures to labour market conditions in 2021 was much smaller compared to MCO 1.0 in 2Q 2020.

The difference in impact was likely due to a few factors. First, labour capacity restrictions were less restrictive during Phase 1 of the NRP.[19] Second, having experienced lockdowns before, firms and workers had greater adaptability to labour capacity restrictions, health-related standard operating procedures (SOPs), and remote work. Third, the efficient rollout of the national vaccination drive saw 90% of the adult population being fully inoculated by October 2021, allowing for a rapid and safer reopening of the economy. Throughout the pandemic, the labour market also benefitted from the continuous support from key Government measures, such as the continuation and expansion of the Wage Subsidy Programme, and hiring incentives under *PenjanaKerjaya*.

The labour market resumed its recovery towards the end of the year, following the lifting of restrictions. For 2021 as a whole, the labour force participation rate improved slightly to 68.6% (2020: 68.4%), while the labour force and employment grew at a faster pace of 1.4% (2020:1.1%) and 1.3% (2020: -0.2%) respectively. Time-related underemployment[20] declined to 315,000 persons, or 2.0% of the labour force (2020: 367,000 persons or 2.3%, 2017-2019 average: 1.4%)[21]. While the unemployment rate remained elevated at 4.6% for the year (2020: 4.5%), this was mainly due to the re-entry of workers into the labour force, as employment conditions improved amid the gradual normalisation of economic activity.

The improvement in employment growth was attributed to the net increase of employment in skilled and mid-skilled occupations, which increased by 1.7% and 1.5% respectively.[22] This was partially offset by decline in employment in the low-skilled occupation at 0.9%, as this segment remained affected by the reimposition of containment measures, as well as the shortages of foreign workers in selected sectors in the economy. From a sectoral perspective, the improvement in employment growth was driven mainly by the *services* sector, supported by growth in the wholesale and retail trade, food and beverages as well as other services subsectors. Employment in the *manufacturing* sector also increased, driven mainly by higher employment in the vegetable and animal oils & fats and food processing, the petroleum, chemical, rubber and plastic products, as well as the E&E subsectors. Meanwhile, retrenchments reported to the Ministry of Human Resources declined to 63,321 persons during the year (2020: 104,432 persons).

Aggregate nominal wages in the private sector[23] grew marginally in 2021 (0.4%; 2020: -2.4%), driven mainly by *manufacturing* sector wages. During the year, *manufacturing* sector wages rebounded and grew by 3.0% (2020: -1.1%), driven mainly by the export-oriented sectors. The *services* sector wages, on the other hand, continued to record a contraction, albeit at a smaller rate of 1.0% (2020: -3.1%). The weakness in *services* sector wages was

[19] The private sector was allowed to operate at 60% of headcount, while the agriculture sector was allowed to operate at 'optimal capacity'. Under MCO 1.0, a 50% limit was imposed on all essential sectors that were allowed to operate.

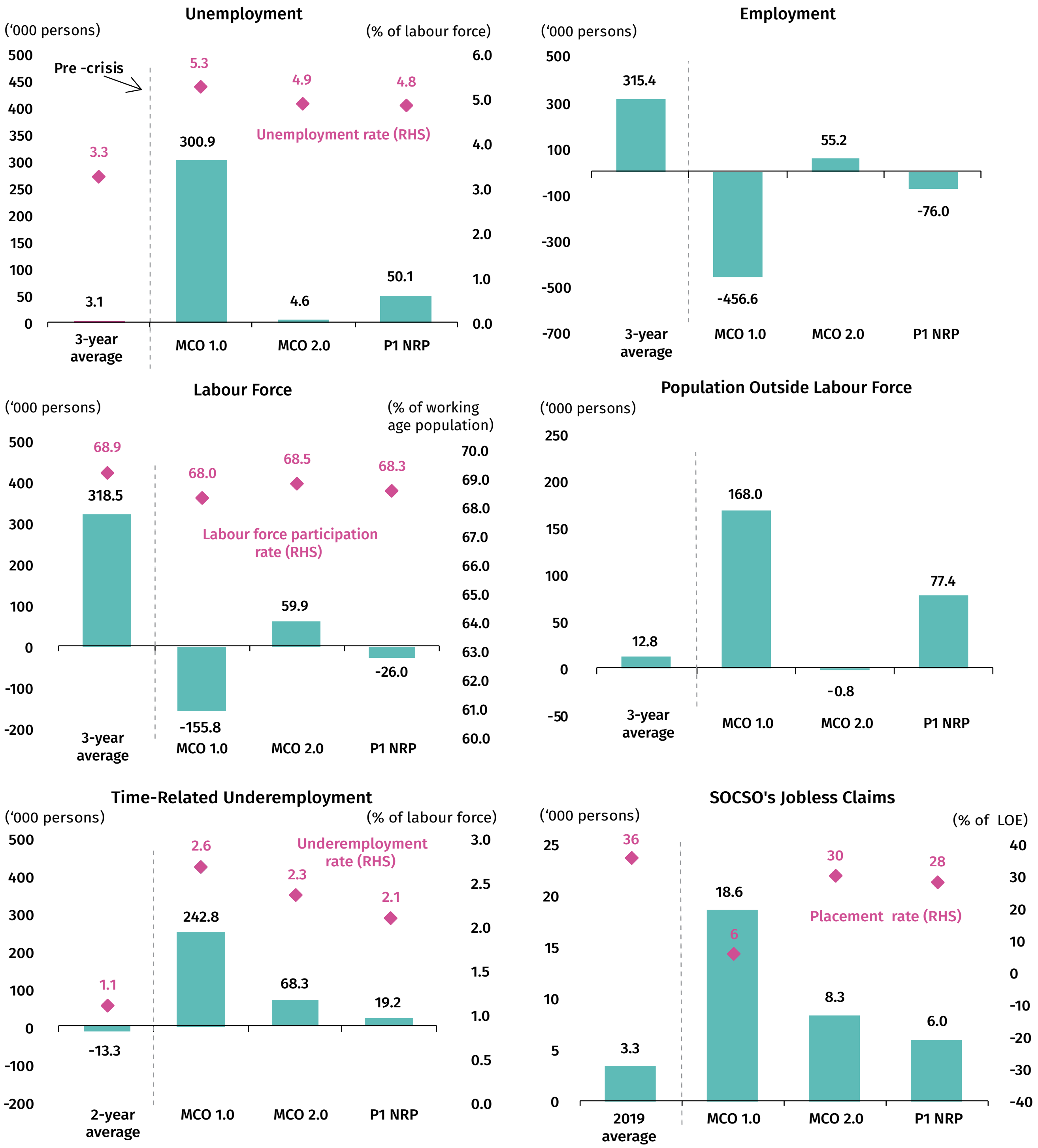
[20] Time-related underemployment is defined as those who are employed less than 30 hours per week due to the nature of their work or because of insufficient work. Additionally, they are able and willing to accept additional hours of work.

[21] Time-related underemployment rates are estimated based on the quarterly averages from the Department of Statistics Malaysia's Labour Force Survey. These figures do not include workers who could not work at all due to labour restrictions in the second quarter.

[22] Mid-skilled workers continued to account for the largest share of total employed persons at 59.0% (2020: 58.8%), followed by high-skilled workers at 29.1% (2020: 28.9%).

[23] Private sector wages are derived from the salaries and wages data published in the Monthly Manufacturing Statistics and Quarterly Services Statistics by the Department of Statistics Malaysia. It covers 66% of total employment.

Chart 1: Impact of Movement Controls on Labour Market Conditions



Note:
[1] Impact is measured by changes in respective indicators in the months corresponding closest to various phases of containment measures, with the exception of jobless claims from SOCSO. MCO 1.0 includes CMCO: 18 March 2020 - 10 Jun 2020. MCO 2.0: 13 Jan 2021 - 4 Mar 2021. Phase 1 of the NRP includes MCO3.0: 12 May 2021 - 31 July 2021.
[2] For underemployment, increases correspond to periods of tightening restrictions. MCO 1.0: 1Q 2020 - 2Q 2020. MCO 2.0: 4Q 2020. P1 NRP includes MCO 3.0 and CMCO 3.0: 2Q 2021. Data on quarterly underemployment only available since 1Q 2017.
[3] Markers (diamonds) refer to highest/lowest rates reached during the period. Pre-crisis refers to December 2019 or 4Q 2019 figures.

Source: Department of Statistics, Malaysia (DOSM), Bank Negara Malaysia estimates

Table 1

Selected Labour Market Indicators

	2016	2017	2018	2019	2020	2021*p*
Employment ('000 persons)	14,180	14,459	14,810	15,126	15,096	15,290
Annual change (%)	0.6	2.0	2.4	2.1	-0.2	1.3
Unemployment rate (% of labour force)	3.4	3.4	3.3	3.3	4.5	4.6*
Labour force participation rate (% of working age population)	67.7	68.0	68.3	68.7	68.4	68.6
Retrenchments (persons)	37,699	35,097	23,168	29,605	104,432	63,321
Non-Malaysian citizens employment ('000 persons)	2,209	2,274	2,239	2,254	2,214	2,149

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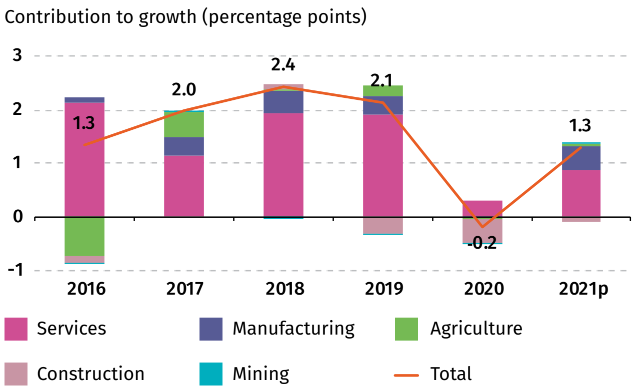
Note: Annual employment, unemployment, and non-Malaysian citizens employment (a proxy for foreign workers) for 2021 were estimated based on quarterly figures from the Labour Force Survey.

*The slight increase in the unemployment rate in 2021 is mainly due to a faster growth in labour force relative to employment, following the re-entry of workers into the labour force during the year.

Source: Department of Statistics, Malaysia, Ministry of Human Resources and Bank Negara Malaysia estimates

Chart 2: Employment Growth by Sector, 2016 - 2021



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Source: Labour Productivity Statistics published by the Department of Statistics, Malaysia

attributed to the consumer- and tourism-related industries such as food and beverages, accommodation, as well as arts, entertainment and recreation, which continued to face relatively stricter restrictions for the most part of the year. Meanwhile, public sector wages increased by 5.4% (2020: 4.5 %).

Developments surrounding labour productivity were mixed, and partly reflected the impact of containment measures on the labour market in 2020 and 2021. As measured by real value-added per hour, productivity declined by 2.6% in 2021 (2020: 3.4%). This was due mainly to the larger increase in total hours worked compared to output, relative to the significant decline in hours worked in 2020, particularly during MCO1.0. Nevertheless, labour productivity as measured by real value-added per worker increased by 1.8% in 2021 (2020: -5.5%) due to the more significant increase in output relative to employment. The *manufacturing* sector recorded the largest improvement by 6.8%, driven mainly by the E&E as well as petroleum, chemical, rubber and plastic products subsectors. *Services* sector productivity also improved slightly, registering a marginal positive growth of 0.5% in 2021 (2020: -6.0%) amid the gradual normalisation of economic activity.

Strong external sector performance in 2021

Malaysia continued to register a healthy current account surplus despite the challenging global and domestic economic landscape in 2021. The surplus amounted to RM53.5 billion or 3.5% of GDP (2020: RM60.0 billion or 4.2% of GDP), supported mainly by a larger goods surplus.

Table 1

Balance of Payments[1]

Item (Net)	2019	2020	2021*p*
	RM billion		
Current account	**52.9**	**60.0**	**53.5**
Goods[2]	124.7	138.7	170.2
Services	-10.9	-47.4	-61.1
Primary income	-39.5	-28.6	-46.2
Secondary income	-21.4	-2.7	-9.5
Capital account	**0.4**	**-0.4**	**-0.8**
Financial account	**-38.0**	**-76.2**	**29.7**
Direct investment	6.6	2.8	32.9
Portfolio investment	-32.4	-48.2	18.9
Financial derivatives	-0.5	0.4	-0.2
Other investment	-11.7	-31.1	-21.9
Net errors and omissions[3]	**-6.8**	**-2.7**	**-36.7**
Overall balance	**8.4**	**-19.3**	**45.6**

[1] In accordance with the Balance of Payments and International Investment Position Manual, Sixth Edition (BPM6) by the International Monetary Fund (IMF)
[2] Adjusted for valuation and coverage of goods for processing, storage and distribution
[3] As at 1Q 2018, the net E&O excludes reserves revaluation changes. This practice is backdated to 1Q 2010

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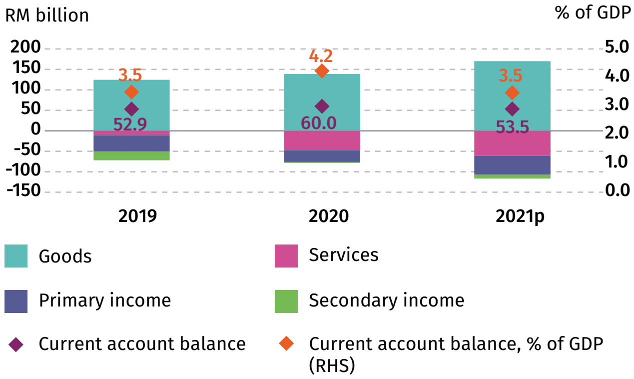
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In the goods account, exports increased faster relative to imports resulting in a higher goods surplus of RM170.2 billion (2020: RM138.7 billion). This was mainly on account of strong external demand for both manufactured goods and commodities, amid the recovery in global growth and higher commodity prices. The services account recorded a larger deficit of RM61.1 billion in 2021 (2020: -RM47.4 billion). This mainly reflected a larger travel account deficit of RM14.6 billion (2020: -RM7.7 billion) following prolonged international border restrictions.

In the income account, the primary income deficit widened to RM46.2 billion (2020: -RM28.6 billion), due mainly to higher investment income accrued to foreign investors in Malaysia, amid robust export performance. The secondary income account recorded a larger deficit of RM9.5 billion (2020: -RM2.7 billion), due mainly to the lower transfers received amid continued foreign workers' outward remittances.

Chart 1: Current Account Balance



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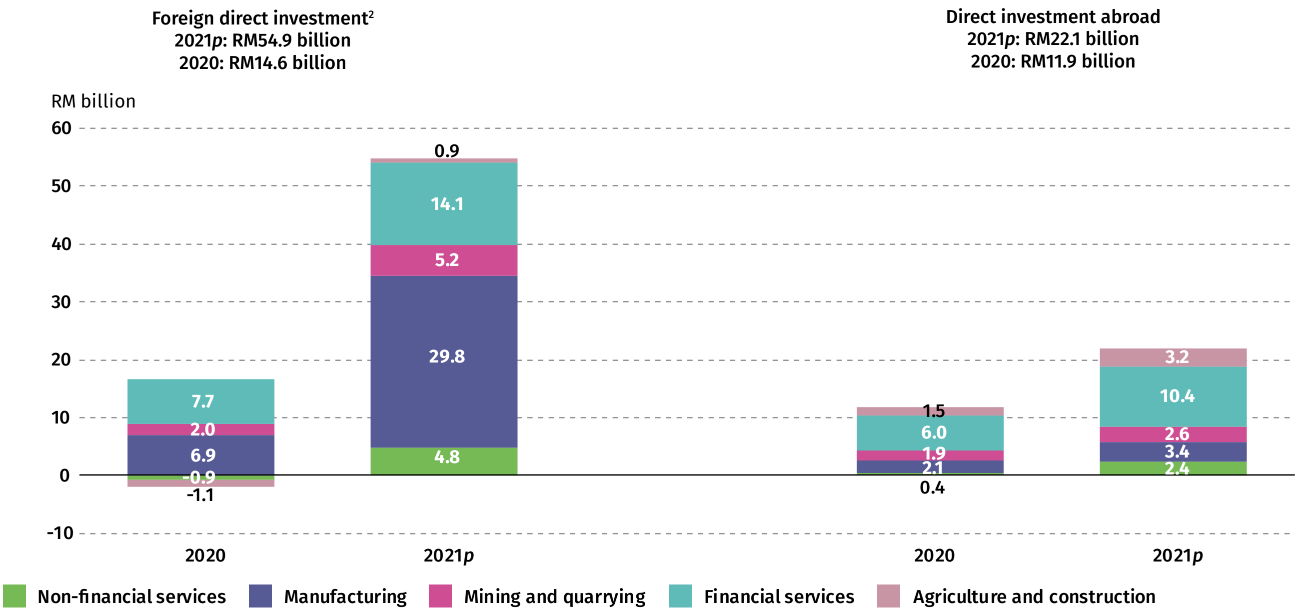
Source: Department of Statistics, Malaysia and Bank Negara Malaysia

In 2021, the financial account turned around to record a net inflow of RM29.7 billion (2020: -RM76.2 billion). This was due mainly to higher inflows in the direct and portfolio investment accounts.

Chart 2: Net Foreign Direct Investment and Direct Investment Abroad[1] by Sector



[1] Foreign direct investment and direct investment abroad as defined according to the Balance of Payments and International Investment Position Manual, Fifth Edition (BPM5) by the International Monetary Fund (IMF).
[2] Negative values refer to net outflows.

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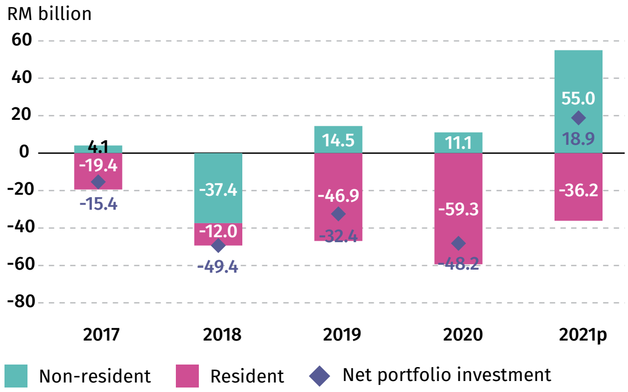
Note: Figures may not necessarily add up due to rounding.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The direct investment account registered a larger net inflow of RM32.9 billion (2020: +RM2.8 billion) as net FDI inflows improved to RM54.9 billion in 2021 (+3.7% of GDP; 2020: +RM14.6 billion, +1.0% of GDP). The higher FDI was driven by the recovery in global and domestic economies, which encouraged global MNCs to expand capacity and undertake new investment in the country. Malaysia's FDI was also supported by the continued global technology upcycle as foreign firms invested to meet rising demand for E&E related products. By economic activity, the increase in net FDI inflows was broad-based, driven mainly by the *manufacturing* sector and financial services sub-sector. Firms from United States (28.9% of net FDI for the year), Singapore (15.1%) and Netherlands (10.2%) were the top contributors to FDI in the year.

DIA outflows were also higher at RM22.1 billion (-1.5% of GDP; 2020: -RM11.9 billion, -0.8% of GDP). These investments abroad were mainly channelled into the financial services sub-sector as well as the *manufacturing* and *mining* sectors. Netherlands (33.3% of net DIA for the year), Canada (21.7%) and Indonesia (15.8%) were the major recipients of DIA in 2021.

Chart 3: Portfolio Investments



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Source: Department of Statistics, Malaysia and Bank Negara Malaysia

The portfolio investment account turned around to register a net inflow of RM18.9 billion (2020: -RM48.2 billion), due mainly to sizeable non-residents (NR) portfolio inflows (RM55 billion; 2020: RM11.1 billion). These investments were mainly in domestic debt market, particularly in Government bonds. This was supported by the improvement in investor sentiment and ample liquidity amid continued policy support from central banks globally. Resident portfolio investment abroad recorded a smaller net outflow of RM36.2 billion (2020: -RM59.3 billion). This was primarily driven by domestic institutional investors in equity markets abroad, in line with their continued efforts to diversify risks and enhance portfolio returns.

The other investment account recorded a lower net outflow of RM21.9 billion (2020: -RM31.1 billion) as outflows from net interbank lending abroad by the domestic banking system were partially offset by the additional allocation of Special Drawing Rights (SDR) (RM20.8 billion) by the International Monetary Fund (IMF).[24] Net errors and omissions (E&O) amounted to -RM36.7 billion or -1.6%[25] of total trade during the year (2020: -RM2.7 billion, or -0.2% of total trade).

[24] The overall IMF additional allocation of SDRs amounted to SDR456.5 billion (equivalent to about USD650 billion) and took effect on 23 August 2021. The SDR allocation will provide additional liquidity to the global financial system, bolster reserves, build confidence, and enhance the resilience of the world economy. The allocation is distributed to all member countries in proportion to their respective quota share in the IMF.

[25] The E&O level remains below 5% of total trade, which is the threshold of acceptable E&O as per the guidelines on balance of payments compilation issued by the IMF.

Malaysia's international investment position remained favourable

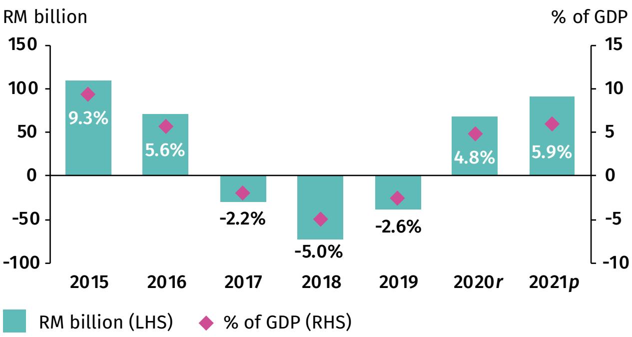
Malaysia's international investment position (IIP) registered a second consecutive year of net external asset position, amounting to RM91.0 billion, or equivalent to 5.9% of GDP as at end-2021 (end-2020: RM67.5 billion or 4.8% of GDP). External assets increased by RM212.1 billion in 2021, largely on account of three main factors. First, there was an increase in reserve assets with close to half attributed to the additional allocation of SDR by the IMF. Second, banks and corporates registered a net portfolio investment abroad during the year. Third, higher external assets also reflected exchange rate valuation effect of the weaker ringgit as well as price valuation gains following better performance in global equity markets during the year. External liabilities increased by RM188.7 billion, partly reflecting net inflows of foreign direct and portfolio investments by non-resident investors, amid Malaysia's improving economic prospects.

The net foreign currency (FCY) external asset position, as measured by external assets denominated in FCY less FCY external liabilities, increased to RM1.1 trillion, or 74.2% of GDP (2020: RM1.0 trillion, or 74.1% of GDP). Given this position, periods of ringgit exchange rate depreciation will result in a larger increase in external assets compared to external liabilities, thus further increasing Malaysia's net creditor position in ringgit terms.

Malaysia's external debt amounted to RM1,070.3 billion as at end-2021, or 69.3% of GDP (2020: RM958.1 billion or 67.6% of GDP). The higher external debt reflected primarily increased non-resident holdings of Government domestic debt securities, net issuance of bonds and notes by corporates, and an additional allocation of SDRs to Malaysia by the IMF.[26] These were partially offset by the lower interbank borrowings and external loans.

Risks surrounding Malaysia's external debt remained manageable and were well contained given the favourable maturity and currency profiles, coupled with the Bank's prudential and hedging requirements[27] on corporates and banks. As at end-2021, the external debt-at-risk for corporates[28] and banks[29] amounted to RM29.2 billion and RM55.9 billion, respectively (2020: RM26.4 billion and RM62.1 billion). Cumulatively, these amounted to 7.9% of Malaysia's total external debt and 17.5% of international reserves. This was relatively lower than the position in 2020 (9.2% and 20.5% respectively), due partly to lower banks' external debt-at-risk and higher international reserves.

Chart 1: Net International Investment Position (IIP)

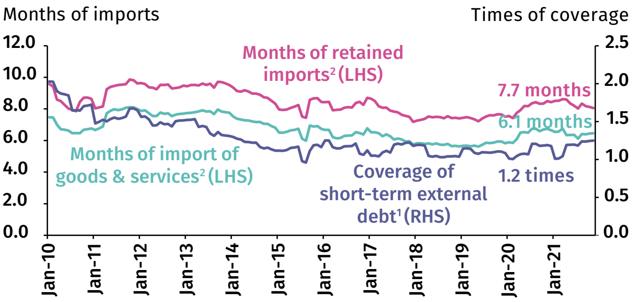


p Preliminary

r Revised

Source: Department of Statistics, Malaysia

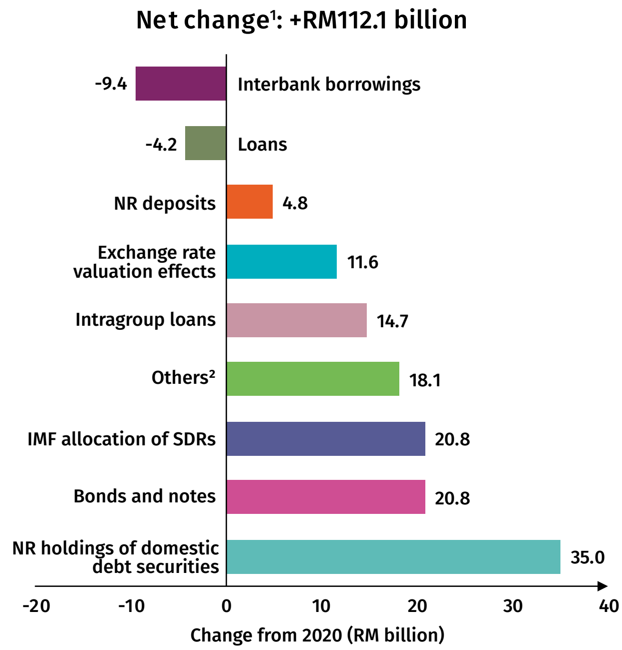
Chart 3: International Reserve Adequacy Indicators



¹ Adequacy threshold of 1-time.
² Adequacy threshold of 3-months.

Source: Department of Statistics Malaysia and Bank Negara Malaysia

Chart 2: Changes in External Debt



¹ Changes in individual debt instruments exclude exchange rate valuation effects.
² Comprises trade credits and other debt liabilities.

Note: Figures may not add up due to rounding.

Source: Ministry of Finance Malaysia and Bank Negara Malaysia

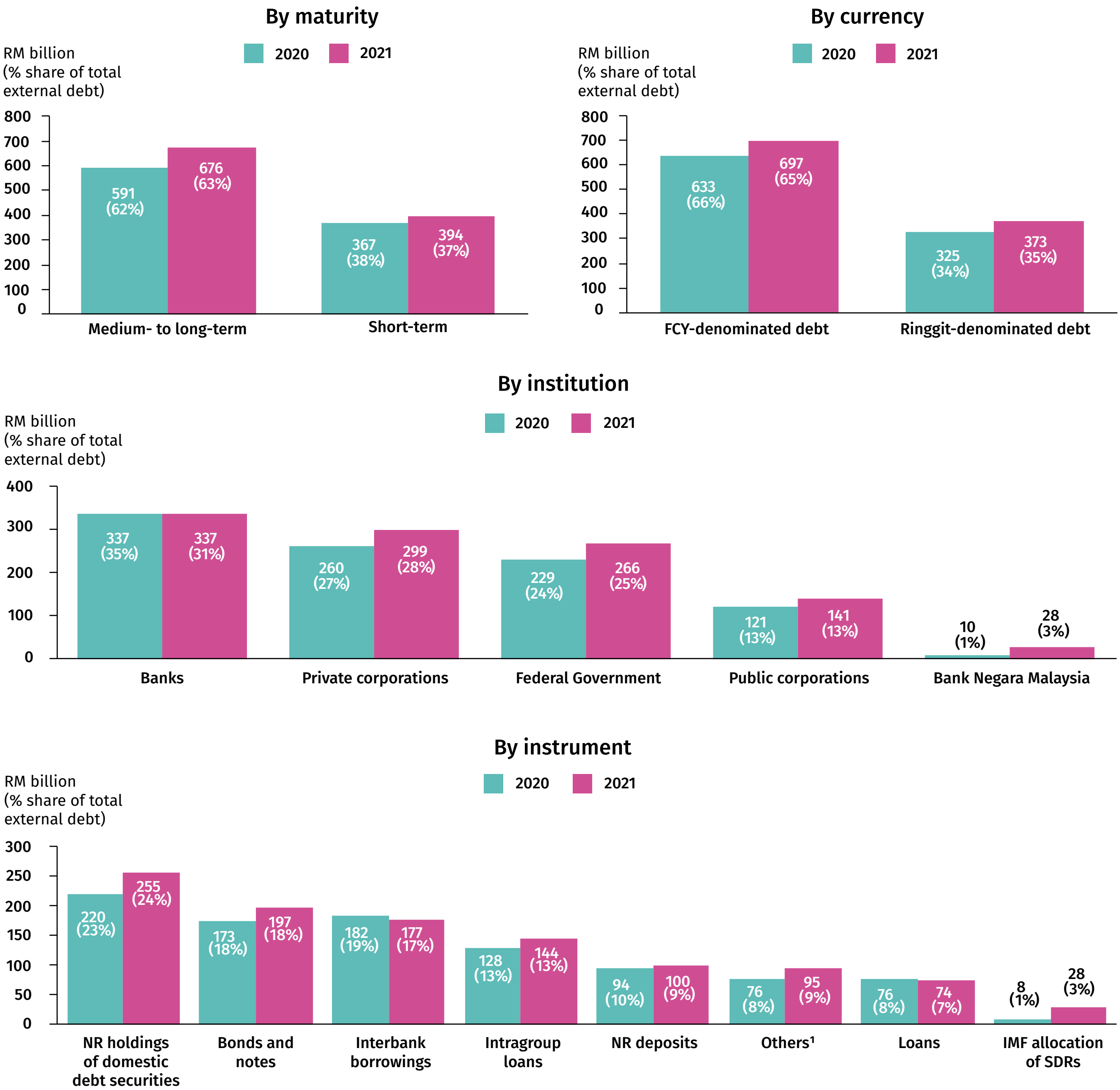
[26] The IMF additional allocation of SDRs to Malaysia amounted to SDR3.5 billion (equivalent to about RM20.8 billion) and took effect on 23 August 2021. According to the IMF Balance of Payments and International Investment Position Manual – Sixth Edition (BPM6), new allocations of SDRs are to be recorded as increases in the respective member countries' gross international reserves (holdings of SDRs), with an equal increase in the countries' long-term debt liabilities (allocation of SDRs).

[27] For more details on Malaysia's external debt management, please refer to "Malaysia's Resilience in Managing External Debt Obligations and the Adequacy of International Reserves" box article in BNM's Annual Report 2018 on external debt.

[28] Based on offshore loans raised and bonds issued by high-risk corporate borrowers.

[29] Refers to the portion of banks' external debt that were more susceptible to sudden withdrawal shocks. These include interbank borrowings (RM33.9 billion), financial institutions' deposits (RM17.3 billion) and other short-term debt (RM4.6 billion) from unrelated counterparties.

Chart 4: Profile of Malaysia's External Debt (% share)



[1] Comprises trade credits and other debt liabilities, such as insurance claims yet to be disbursed and interest payables on bonds and notes.

Note: Figures may not necessarily add up due to rounding.

Source: Bank Negara Malaysia

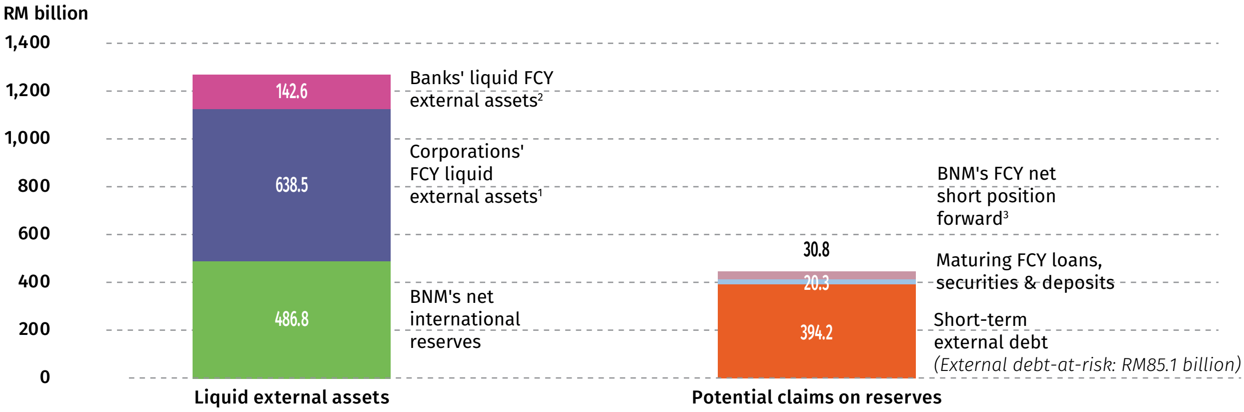
The net issuance of international long-term bonds and notes in 2021 primarily reflected prudent and strategic capital management efforts by corporates to refinance at lower interest rates while extending the debt maturity profile, amid the highly accommodative global and monetary conditions. This partly contributed to the rising share of medium- to long-term external debt during the year (end-2021: 63.2% share of total external debt; 2020: 61.6% share), and thus reducing rollover risks.

More than one-third of external debt was denominated in ringgit (34.8%; 2020: 33.9%), and therefore not affected by fluctuations in the ringgit exchange rate. The remainder of external debt that was denominated in FCY was largely subject to prudential requirements on liquidity and funding risk management.[30] Moreover, intragroup borrowings[31] accounted for 35.5% of FCY external debt, which were generally more stable and on concessionary terms.

BNM's international reserves increased to USD116.9 billion as at end-2021 (2020: USD107.6 billion), sufficient to finance 7.7 months of retained imports and was 1.2 times the short-term external debt[32]. The international reserves were also adequate to finance 6.1 months of imports of goods and services, a new reserves adequacy indicator communicated by BNM since the release of fortnightly reserves position of 15 February 2022.[33] Additionally, Malaysia's international reserve is deemed adequate by the IMF, exceeding 100% of the IMF Reserve Adequacy Metric (ARA), under a floating exchange rate regime. In 2021, the gross short position of FCY swaps increased to USD7.6 billion (2020: USD5.8 billion), reflecting the Bank's operations to manage liquidity in the domestic financial system.

It is important to emphasise that international reserves are not the only means to meet external obligations. In particular, BNM's progressive liberalisation of the foreign exchange policy[34] has facilitated the accumulation of FCY external assets by banks and corporates. These assets, particularly the liquid portion amounting to RM781.1 billion, can be drawn down to meet resident entities' external debt obligations without creating a claim on international reserves.

Chart 5: Liquid External Assets and Potential Claims on International Reserves



[1] Consist of portfolio investments and currency and deposits
[2] Consist of deposits and interbank placements, bonds and notes and money market instruments
[3] Including the forward leg of currency swaps

Source: Bank Negara Malaysia

[30] Including requirements imposed on banks under local banking regulations.
[31] Comprises intragroup loans and intragroup interbank borrowings.
[32] For more details on BNM's international reserves, please refer to "Building Buffers: Roles and Functions of BNM's International Reserves" feature article in BNM's Annual Report 2020.
[33] For more details, please refer to "Expansion of the Measure on Reserves Coverage of Imports – from Retained Imports to Imports of Goods and Services" article in BNM's Quarterly Bulletin for fourth quarter of 2021.
[34] A set of prudential measures related to the foreign exchange market to promote monetary and financial stability conducive to the sustainable growth of the economy and safeguarding the balance of payments position.

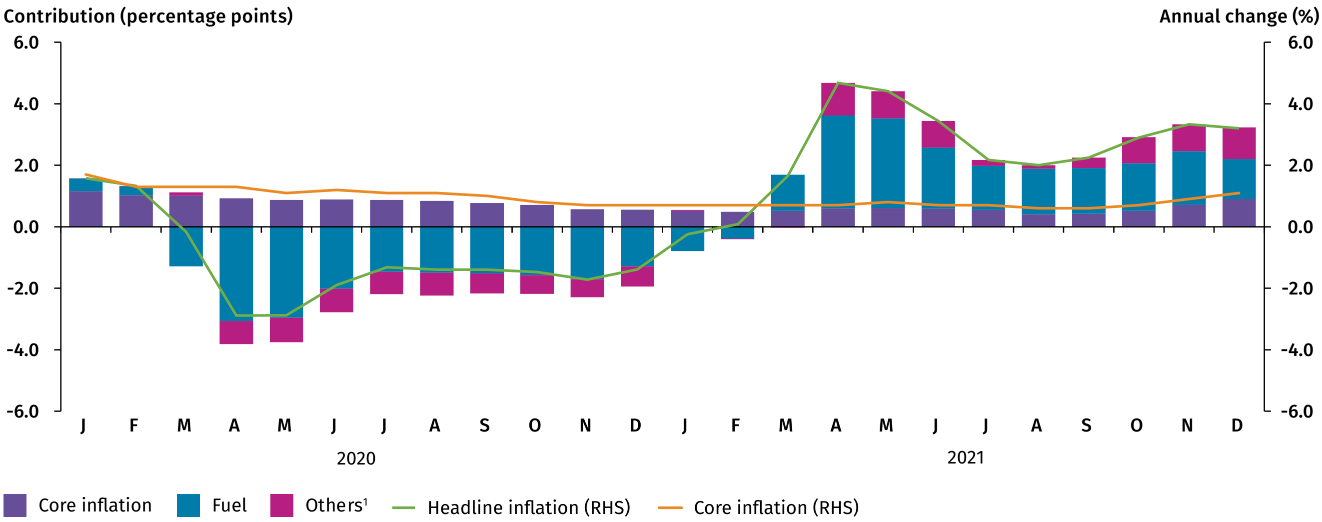
Headline inflation turned positive in 2021 while core inflation remained subdued

Headline inflation increased in 2021, averaging at 2.5% for the year (2020: -1.2%). The higher inflation was driven mainly by fuel inflation[35] (Chart 1.14), which largely reflected the base effects from the low retail fuel prices in 2020. Furthermore, the lapse in the effect from the tiered electricity tariff rebate[36] also contributed to increased inflation.

Global supply-side disruptions[37] also contributed to the upward price pressures. The impact on domestic consumer prices, however, was mostly limited, due in part to the absorption of rising cost prices along the supply chain amid the uncertain demand environment. In particular, despite the increase in the Producer Price Index (PPI) for crude and intermediate materials throughout 2021, the pass-through to finished goods and consumer prices was dampened for most of the year.[38] Administered prices on selected goods[39] also partly contained the impact. Nevertheless, towards year end, there was some uptick in prices attributed to supply-related factors, particularly for fresh food items. Domestic seasonal factors, including the adverse weather conditions, were also at play in driving the higher prices of selected food items such as *fresh vegetables*.

Despite the higher headline inflation in 2021, price pressures were not broad-based for the most part of the year. Towards the end of the year, however, upward pressure on prices was more pervasive as economic activity picked up amid an environment of higher input costs[40] (Chart 1.15). This led to some pressure on households' cost of living, as selected items that recorded higher inflation were essential and frequently-purchased items, such as *fresh meat* and *eggs*. Nevertheless, mitigating factors remained in place to alleviate households' cost burdens, including subsidies on key consumer items, income transfers to vulnerable segments, and festive season price controls on certain necessities.[41]

Chart 1.14: Contribution to Headline Inflation by Components



[1] Others include price-volatile items and other price-administered items (excluding fuel).

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

[35] The extent of fuel inflation was capped due to the fuel price ceiling (RON95: RM2.05/litre; Diesel: RM2.15/litre) despite the rising global oil prices throughout the year. The fuel price ceiling was reintroduced in February 2021, and was lower from the previous ceiling of RM2.08/litre for RON95 and RM2.18/litre for Diesel.

[36] The tiered electricity tariff rebates were implemented under the Bantuan Prihatin Elektrik scheme from April to December 2020, with rebates ranging from 2% to 50% depending on monthly electricity consumption.

[37] These included disruptions in factories and shipping ports due to resurgences of COVID-19 and higher operating costs due to pandemic-containment measures.

[38] For further details, please refer to BNM EMR 2021 Box Article on 'An Anatomy of Inflation: Effects from the Prolonged Pandemic'.

[39] For example, fuel price ceiling, cooking oil subsidy and the Festive Season Maximum Price Control Scheme on selected fresh food items.

[40] The higher input costs were reflective of the higher global commodity prices, which contributed to higher feed costs and fertiliser costs domestically.

[41] For further details, please refer to Spotlight article in BNM Annual Report 2021 on 'Cost of Living Revisited: Causes and Consequences'.

An Anatomy of Inflation: Effects from the Prolonged Pandemic

Introduction

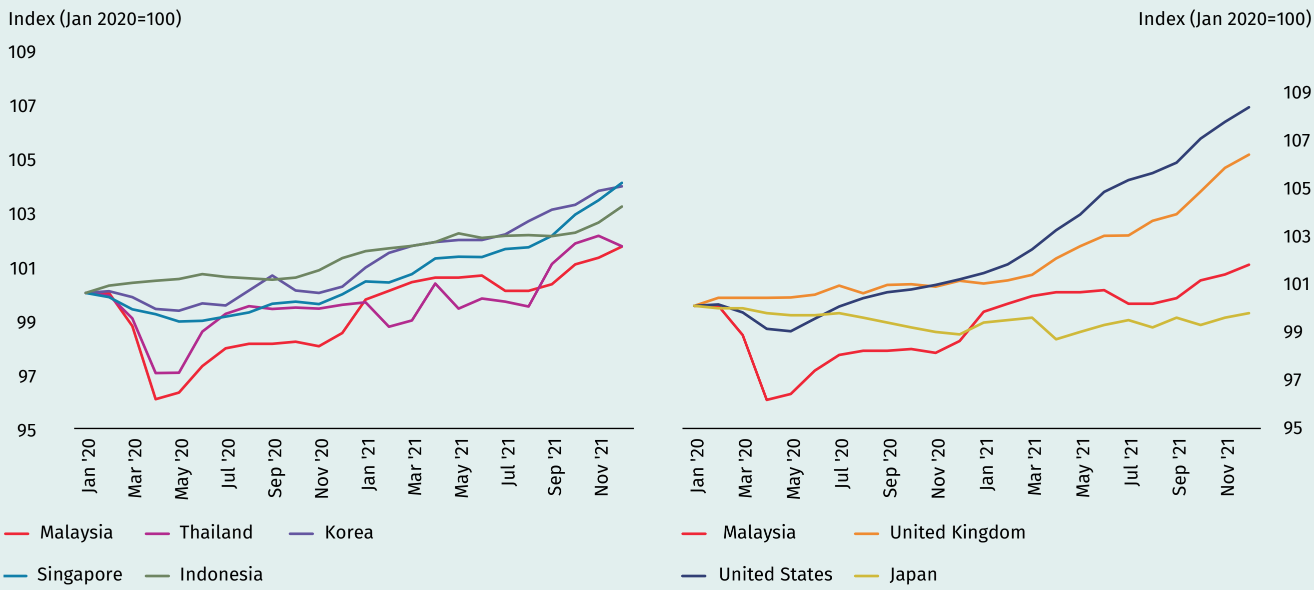
In Bank Negara Malaysia's 2Q 2020 Quarterly Bulletin[1], an interim assessment of how the COVID-19 pandemic would impact consumer inflation was outlined. Since then, the pandemic impact has not just persisted, but also evolved. Globally, the risks to consumer inflation have turned from being deflationary at the onset of the pandemic, to inflationary at present. With the uneven pace of the global economic recovery, the extent of inflationary pressures have also varied in magnitude across countries (Chart 1).

This article provides an update on the pandemic effects on consumer inflation in Malaysia. Given the highly uncertain outlook, it also contextualises the risks to consumer inflation from pandemic disruptions going forward by exploring potential country-specific factors. The findings suggest that some of the pandemic disruptions driving high consumer inflation in some other countries are either less severe or partly mitigated in Malaysia. Nonetheless, vigilance continues to be warranted. With some staple food segments more exposed to acute upward price pressures, concerns over rising cost of living remain prominent.

Breaking down the pandemic's impact on consumer inflation

In assessing the pandemic impact to consumer inflation, a framework adapted from Shapiro (2020a) is utilised.[2] Selected items in the Consumer Price Index (CPI) basket[3] are placed into two mutually exclusive groups: COVID-

Chart 1: Evolution of Consumer Price Indices since January 2020



Source: Bloomberg

[1] This article is an extension to the Box Article on *COVID-19: Impact on Inflation*, published in Bank Negara Malaysia's Quarterly Bulletin 2Q 2020. The previous box article highlighted that Malaysia had experienced muted inflationary pressures since the onset of the pandemic. It also outlined the mechanisms by which the pandemic could affect inflation going forward, including changes in labour market conditions and competitive dynamics.

[2] A complete replication is not possible due to data limitations. In particular, while Shapiro (2020a) considered both price and quantity adjustments in the empirical exercise, this article only considered price adjustments, due to unavailability of granular and frequent personal consumption expenditure data. A framework based on difference-in-difference is used.

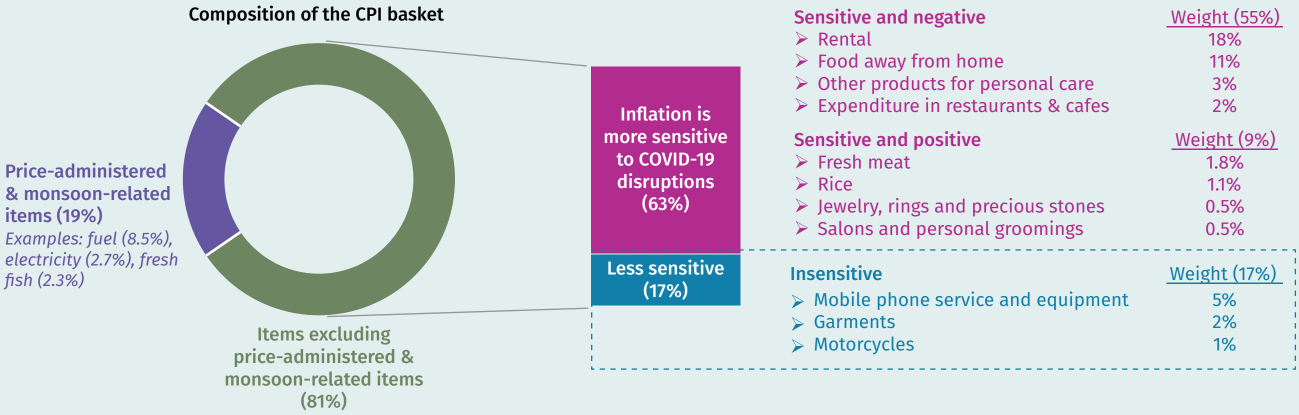
[3] At the 4-digit level of the CPI basket.

sensitive[4] or COVID-insensitive. This classification is designed to capture the direct effects of the pandemic. Namely, inflation for COVID-sensitive items would correspond more with disruptions from the pandemic, such as social distancing, supply chain constraints, or pent-up demand. As these disruptions intensify, so will the impact on consumer inflation. Conversely, as they fade away, the impact would likely moderate in tandem.

In contrast, COVID-insensitive items are less likely to be directly influenced by such factors. An implication of this is that if excessive and persistent price pressures have begun to spread in the less sensitive items, it could signal price pressures becoming more entrenched (Casselman, 2021).

The classification is summarised in Chart 2. Sensitive categories comprise around 63% of expenditures in the CPI basket. A closer look shows that the pandemic disruptions can be either negative or positive to inflation on a net basis, reflecting the balance of demand and supply. For instance, items such as *rental* had exhibited reduced inflationary pressures relative to pre-pandemic trend at the onset of the pandemic outbreak, suggesting their greater sensitivity to demand conditions. This group of items is referred to as "sensitive and negative". Conversely, some items had exhibited increased inflationary pressures relative to pre-pandemic trend at the onset of the pandemic outbreak, potentially reflecting their greater sensitivity to supply and cost pressures[5] (e.g. disrupted supply chains and standard operating procedures (SOP) costs). These items are referred to as "sensitive and positive". As the balance of demand and supply induced by the pandemic evolves, so likely would the inflation of these sensitive items.

Chart 2: CPI Items by Pandemic Sensitivity



Note: To ensure an assessment that is reflective of the pandemic shocks only, the classifications according to COVID-sensitivity exclude items that are price-administered (e.g. water bill, sewerage bill, gas, fuel, rail tickets). Furthermore, given exceptional monsoon season in 2021, directly affected items (i.e. fresh fish) have also been excluded. Together, these form the "Price-administered and monsoon-related" items (19% of the CPI basket). Numbers may not add up due to rounding.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

As of 2021, the pandemic impact to overall consumer inflation has remained broadly contained, although a few segments have experienced acute upward pressures

Equipped with this framework, the evolution of the pandemic impact to inflation can be dissected (Chart 3). Firstly, the pandemic effects are most obvious in the "sensitive and positive" items, where prices tend to be more affected by cost pressures. At the onset of lockdown in early 2020, its higher inflation partly reflected supply-related pressures on selected food items. Namely, this included disruptions to production amid movement restriction measures, as well as some shortages in imported inputs, leading to higher prices of food

4 Sensitive categories are those that, following the outbreak of the COVID-19 pandemic, recorded price changes – either positive or negative – that are statistically significantly different from pre-pandemic trends. To ensure an assessment that is reflective of the pandemic shocks only, these classifications exclude items that are price-administered, and items whose prices have been largely affected by monsoon seasons. Furthermore, given that the classification was a data-driven empirical exercise on the 4-digit CPI basket in the periods following the initial pandemic outbreak, it is mainly focused on the shorter-term direct effects of the pandemic, and may miss out on longer-term structural changes arising from the pandemic.

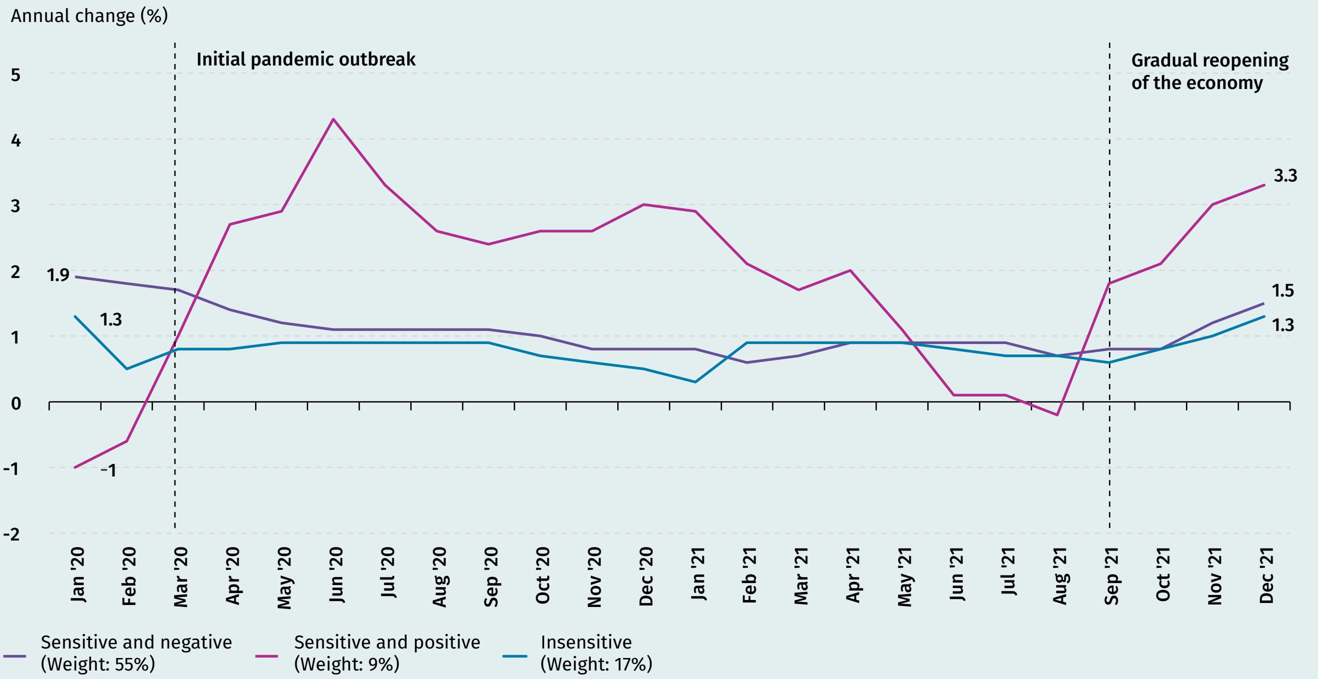
5 Another reason for why these items showed increased inflationary pressures at the onset of the pandemic is due to higher demand relative to supply. For instance, the pandemic led to higher global demand for safe assets such as gold, which spilled over into higher jewelry prices in Malaysia.

such as fresh chicken and eggs. These disruptions also occurred amid large-scale substitution in consumers' spending to food at home. With global supply disruptions re-intensifying towards the end of 2021, together with improving demand amid the economic reopening, its inflation has again risen in tandem.

Secondly, "sensitive and negative" inflation has been more slow-moving, broadly corresponding with domestic demand conditions. After declining for most of 2020, it has modestly increased towards the end of 2021 in line with the reopening of the economy, though remaining below the pre-pandemic level. An example of items in this category is rental inflation, which has remained subdued.[6]

Thirdly, with inflation for the "insensitive" group remaining relatively stable, there has been limited evidence of the spread of inflationary pressures beyond pandemic-related items.

Chart 3: Inflation by Pandemic Sensitivity



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Ultimately, to get a better sense of how each series affects headline inflation, Charts 4 and 5 show the contributions of each category to headline inflation. Notwithstanding higher COVID-sensitive inflation at end-2021, its contribution to headline has thus far been limited (Chart 4), and somewhat close to pre-pandemic averages (Chart 5). Instead, most of the movements of headline inflation in 2021 were attributable to price-administered items, mainly reflecting the unwinding of policy measures introduced during the height of the pandemic (i.e. electricity rebates), and the base effect from fuel prices.[7]

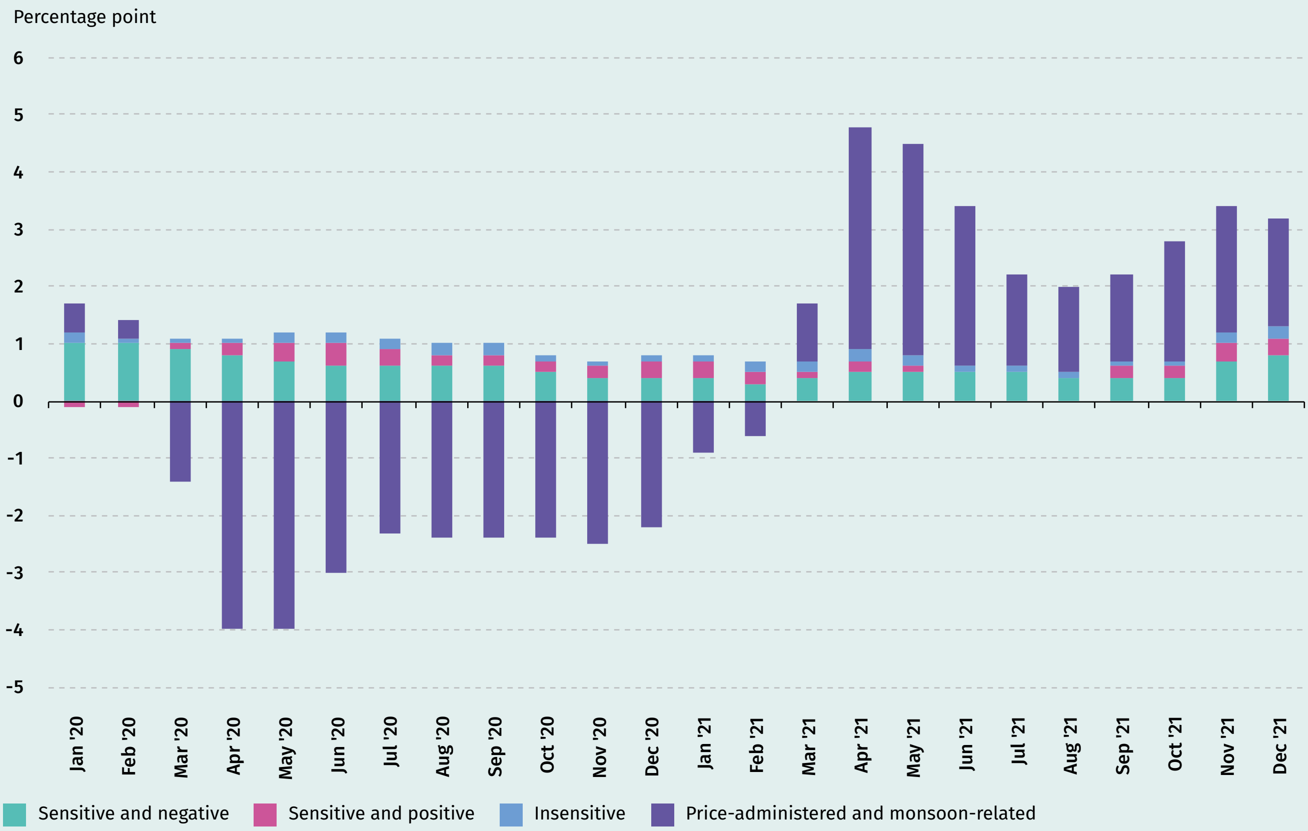
Explaining differences in consumer inflation across countries

The category-level analysis suggests that the pandemic effects to consumer inflation have so far been broadly contained, with most price pressures limited to a few segments. As demand continues to recover going forward, and with supply disruptions remaining acute, consumer prices could experience greater increases. But how high could consumer inflation be? Amid elevated uncertainty, emerging studies could provide some guidance.

6 Rental inflation in December 2021 is 0.6% (2011-2019: 2.5%).

7 The administered ceiling price of RON 95 has remained unchanged at RM2.05/litre from March 2021 to December 2021. The increase in fuel inflation was instead largely due to the low base in 2020.

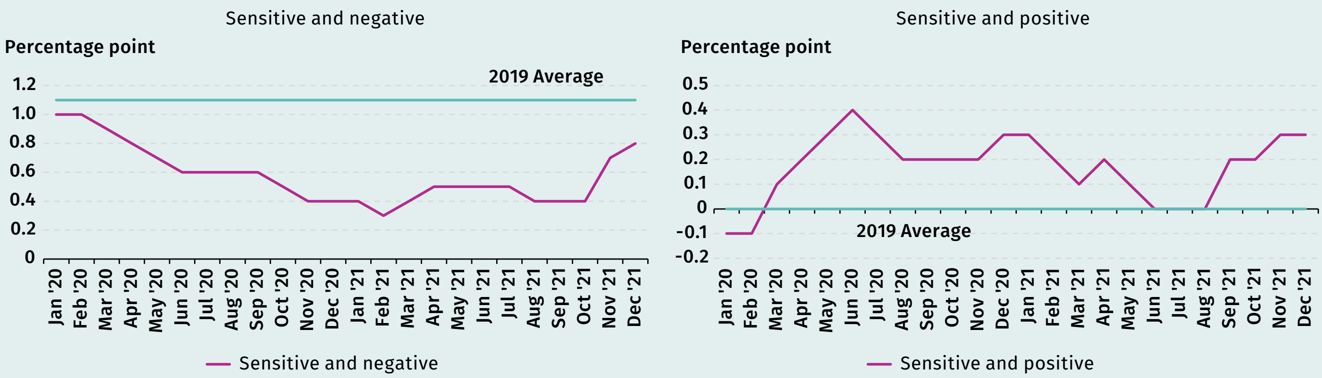
Chart 4: Contribution to Headline Inflation



Note: To ensure an assessment that is reflective of the pandemic shocks only, the classifications according to COVID-sensitivity exclude items that are price-administered. Furthermore, given exceptional monsoon season in 2021, directly affected items (i.e. fresh fish) have also been excluded. Together, these form the “Price-administered and monsoon-related” items (purple bar).

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Chart 5: Contribution to Headline Inflation from COVID-sensitive Items



Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

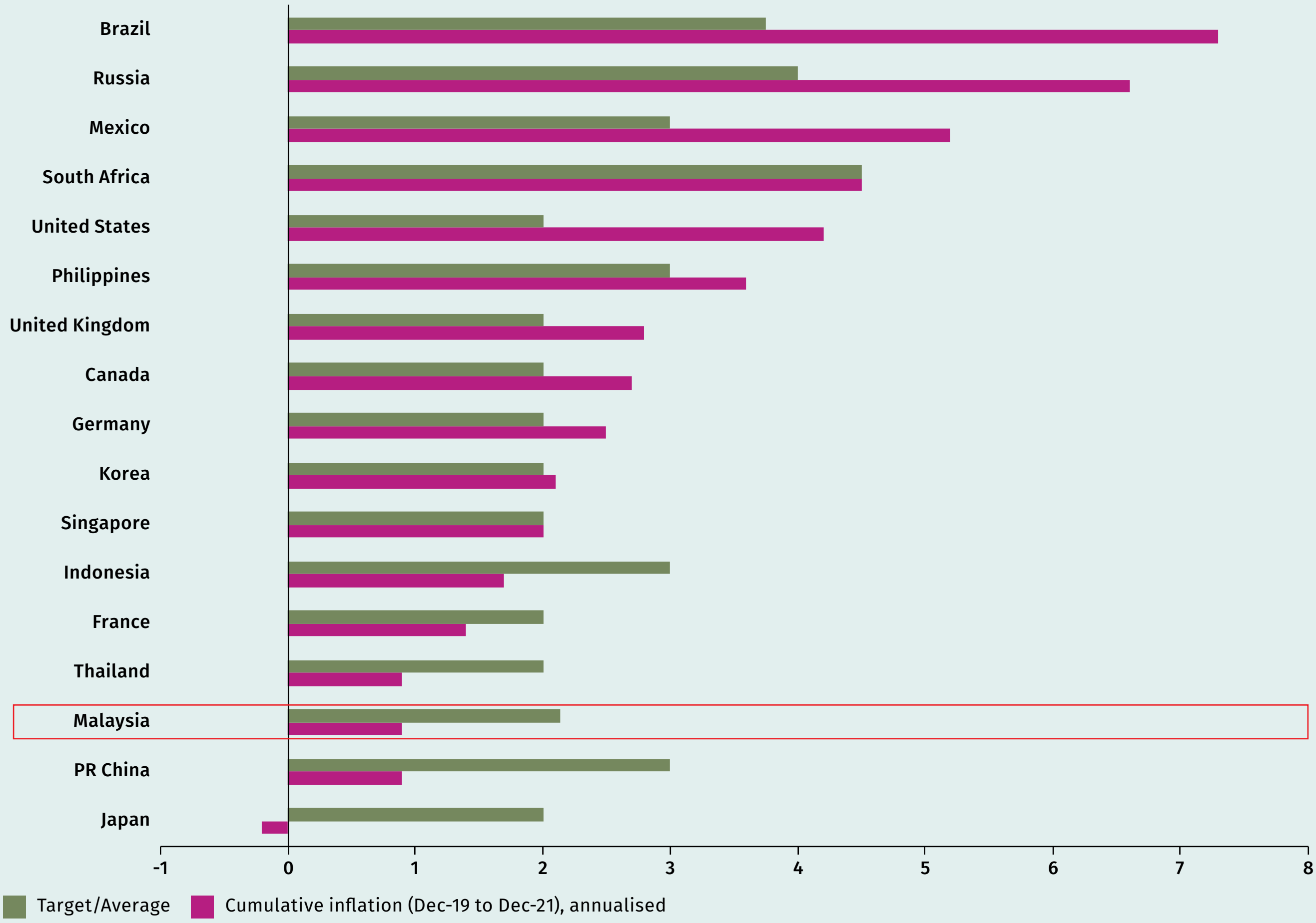
Chart 6 shows that while higher consumer inflation is common worldwide, it is more severe in some countries than others.[8] This observation suggests country-specific factors at play, which have hindered or amplified the inflationary effects. Namely, on the demand side, these include the pace and magnitude of recovery, the strength of labour market (i.e. spare capacity), and the magnitude of policy support to the economy. On the supply side, these include price interventions by authorities, the proximity to global manufacturing hub, and the extent of labour supply disruptions.

[8] Annualised cumulative inflation is used because some of the increase in inflation in 2021 reflects the unwinding of Government measures in 2020.

On the demand side, a factor identified by Adrian and Gopinath (2021) to be the source of this variance is the pace and magnitude of demand recovery. In several countries, economic activities have rebounded exceptionally quickly. It is in these countries, where the economy has recovered sharply, that underlying inflation[9] has tended to increase the most (Chart 7). For some countries such as Malaysia, where economic activities remain substantially below its pre-pandemic trend, there remains spare capacity and the upside risks to underlying inflation are relatively more muted.

Partly, this reflects the differences in labour market conditions, which have recovered more sharply in some countries, contributing to stronger wage and demand pressures in these countries (Chart 8). This was in addition to the exceptional degree of policy support, for instance in the US, which has lifted demand for goods at a time when supply has not commensurately recovered, leading to greater price pressures (Chart 9) (Gopinath and Adrian, 2021; Goodhart and Pradhan, 2020). Correspondingly, a measure of COVID-sensitive items in the US has seen significant inflation throughout 2021 (Chart 10). By contrast, such recovery in demand and labour market conditions has been more gradual amongst regional economies, including Malaysia.

Chart 6: Cumulative CPI Inflation (Dec '19 to Dec '21, annualised %)

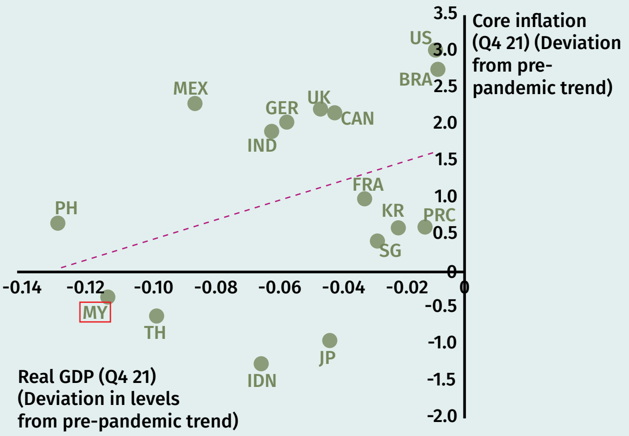


Note: For countries with a range of inflation targets, the midpoint is used. For those without explicit inflation target, inflation deemed as consistent with overall price stability as stated by respective central banks is used. Otherwise, as is the case for Malaysia, historical (2011-2019) average is used. Some countries, like the US, target core inflation. Annualised cumulative inflation is used because some of the increase in inflation in 2021 reflects the unwinding of Government measures introduced in 2020. In such a case, using a year-on-year comparison can be misleading.

Source: International Monetary Fund, FRED, national authorities and Bank Negara Malaysia estimates

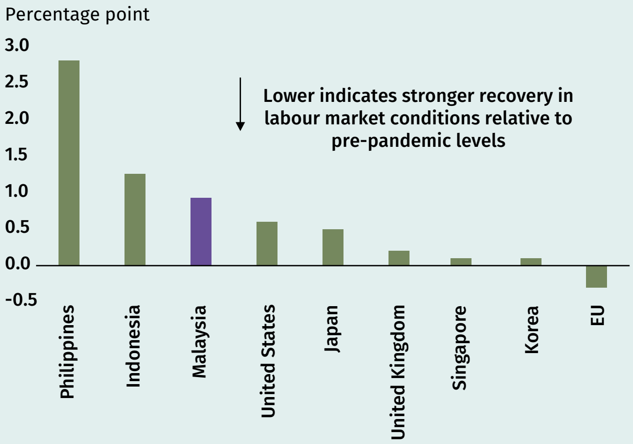
[9] Measured by core inflation, defined as inflation excluding fuel and food inflation components.

Chart 7: Core Inflation and Economic Recovery



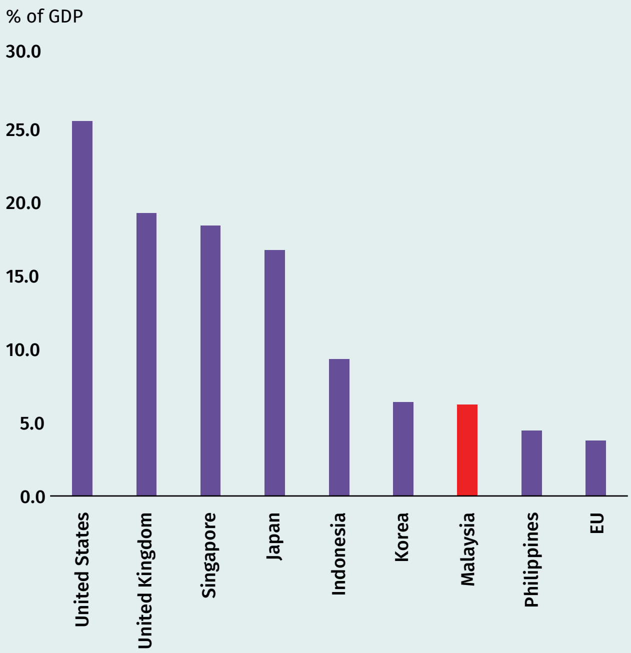
Source: Bank Negara Malaysia estimates based on Department of Statistics, Malaysia, national authorities and Adrian and Gopinath (2021).

Chart 8: Change in Unemployment Rates (percentage point change between end-2021 and end-2019)



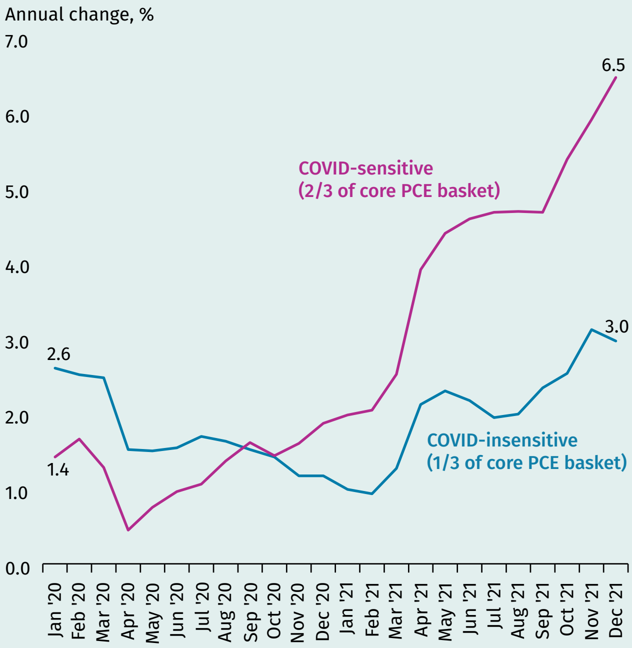
Source: Macrobond

Chart 9: Additional Spending / Foregone Revenues in Response to COVID-19



Source: International Monetary Fund

Chart 10: US Core Inflation by COVID-Sensitivity

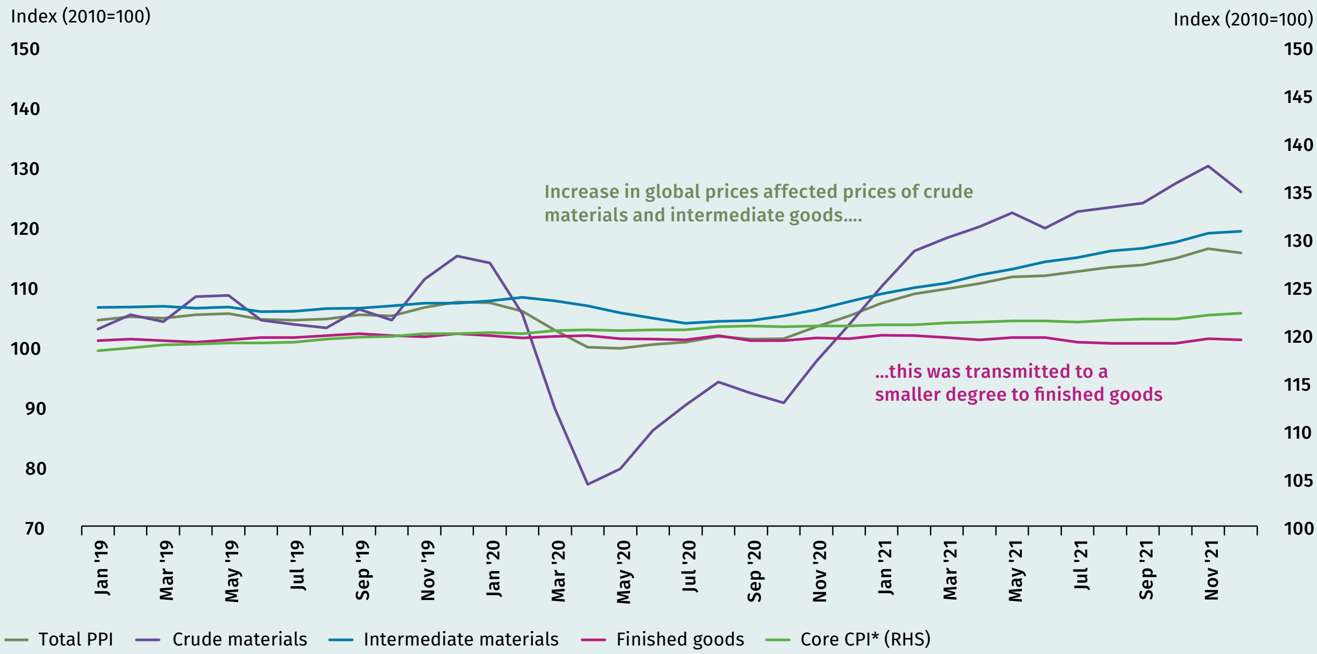


Source: Shapiro (2020a)

Nonetheless, global supply disruptions have made production inputs, from shipping to energy and commodities more expensive. At this juncture, these global supply disruptions have already been more prolonged than expected (Adrian and Gopinath, 2021). While these factors have materialised in elevated Producer Price Index (PPI) globally, the extent of pass-through to consumer prices has varied across countries. For Malaysia, the pass-through to CPI has thus far remained limited, with costs having been largely dampened along the supply chain (Chart 11). [10] Should these cost pressures persist, they could be passed on to consumers to a greater degree going forward.

[10] Based on recent engagements by Bank Negara Malaysia's Regional Economic Surveillance, many firms continued to cite upward pressures on costs of raw and input materials. However, most firms did not expect to fully pass on cost increases given the need to remain conservative due to demand conditions.

Chart 11: Producer Price Index: Local Production by Stage of Processing



* Core CPI excludes the direct impact from consumption tax policy changes.

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

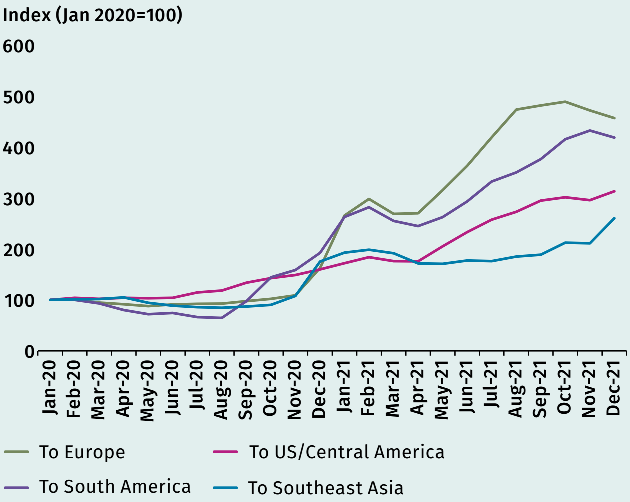
However, key structural factors suggest that the impact to Malaysia's consumer inflation would likely be relatively contained at this juncture. Firstly, while higher global energy prices have contributed significantly to inflation in many countries, the direct impact has been contained in Malaysia.[11] This is due to price interventions, namely price controls on retail fuel and electricity tariff regulations, which have mitigated the impact to consumer prices despite surging global crude oil and coal prices.[12] More recently, price controls on key food items have further alleviated price pressures for consumers.[13]

Secondly, shipping costs have risen globally, but the severity has been less in regional Asian economies (Chart 12). In part, this reflected the sharp rebound in import demand from the US, relative to other countries.[14] Such surge in demand has put upward pressure on long-distance costs, affecting other regions too. The shipping cost from China to Europe and South America has quadrupled in 2021 (Leather, 2021). In contrast, cost increases to regional Asian economies have been relatively contained, in part reflecting the proximity to the global manufacturing hub.

Thirdly, supply disruptions in labour workforce – workers leaving the workforce in large numbers, particularly the US, in what is being called the "Great Resignation" – generally do not appear to be as evident in Malaysia. For economies facing such disruptions, the resulting labour shortages could lead to stronger wage pressures as employers seek to attract workers through higher compensation.[15] Notably, the majority of those who left the Malaysian labour force during phase 1 of the 2021 National Recovery Plan (NRP) cited transient factors, such as "household or family care" and "going for further studies", as reasons for not seeking work[16], rather than

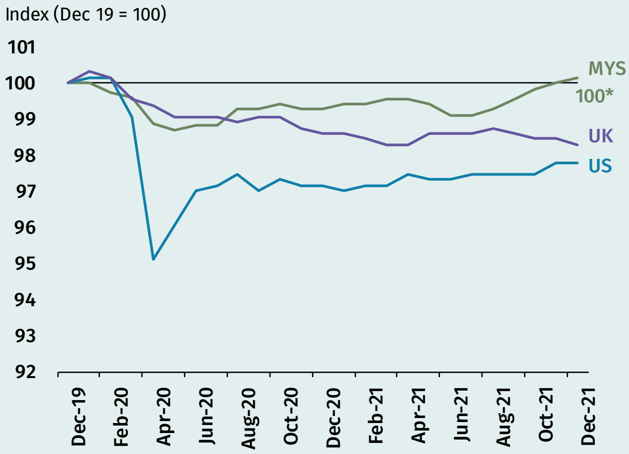
[11] While fuel inflation was a major driver of higher headline inflation for Malaysia in 2021, this largely reflected base effects following the exceptionally low fuel prices in the previous year. The full extent of impact from higher global oil prices, however, was partly mitigated by the fuel price ceiling in place throughout most of the year (RON95: RM2.05 per litre; Diesel: RM2.15 per litre).
[12] Nonetheless, there remain ways by which the higher global energy prices could indirectly affect Malaysian inflation. For instance, fertilisers, which are by-products of natural gas, are a cost component of agricultural products, and could transmit energy costs to food inflation.
[13] Across different countries, there are various measures undertaken to soften the impact from rising energy prices, which may not necessarily involve price controls. These include transfers to low-income households, energy tax cuts and excess profit taxes on energy companies.
[14] For instance, over the course of 2021, annual US ocean retail imports are on track to set a new record, up more than 20% compared to 2019 according to estimates by the US National Retail Federation (NRF, 2021).
[15] Furman (2021) partly attributes the high nominal compensation growth in the US to the reduction in labour supply coinciding with a surge in labour demand, as reflected by record-high job openings.
[16] Staff assessment based on Quarterly Labour Force Survey, Department of Statistics Malaysia.

Chart 12: Shipping Costs from PR China



Source: Macrobond

Chart 13: Labour Force Participation Rate



* Note: Malaysia's labour force participation rate in Dec-21 is 69%

Source: Macrobond and Bank Negara Malaysia estimates

retirements, as is the case in the US.[17] Reflecting this, Malaysia's labour participation rate has returned close to pre-pandemic levels in November 2021 (Chart 13), as supply of labour broadly remains forthcoming, albeit with foreign labour shortages remaining in selected sub-sectors.[18] In tandem, wages continue to exhibit moderate recovery and have not outpaced productivity growth, reducing the risk of second-round inflationary impact.[19]

Vigilance is warranted despite the expectations of manageable inflationary pressures

As domestic economy recovers, the normalisation of underlying price pressures is expected.[20] The analysis by CPI segments, however, implies that excessive inflation pressures from pandemic disruptions have thus far remained contained. Moreover, country-specific factors suggest that overall consumer inflationary pressures in Malaysia are likely to be relatively manageable in the medium term, given some structural and policy factors. Nonetheless, vulnerabilities remain, especially given recent geopolitical developments. Of note, some essential food items, such as fresh meat, are COVID-sensitive and could see larger price pressures that bring negative consequences to households' cost of living.[21]

It is important to remain watchful for signs of price pressures spreading persistently to the rest of the economy. More broad-based and persistent price increases could cause long-term inflation expectations to become unanchored, leading to second-round effects as businesses keep increasing prices in anticipation of higher inflation, or wages increase in an upward spiral, as workers persistently demand for higher wages to make up for the expected losses in purchasing power. Nonetheless, this remains a tail risk. For 2022, while the inflation outlook is subject to upside risks, headline inflation is projected to remain manageable.

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[17] IMF (2021) found that the drop in labour participation in the US was driven by more persistent factors such as increased inactivity among older workers and shifting worker preferences.

[18] For example, the agriculture sector and selected manufacturing sub-sectors have experienced shortages of foreign labour due mainly to pandemic containment measures, though these are expected to gradually ease in 2022.

[19] Such a phenomenon, also called "wage-inflation spiral", occurs when stronger workers' bargaining power leads to wage pressures and, in the absence of corresponding productivity improvements, firms in turn pass on the extra labour cost by increasing consumer prices. As workers in response push for even higher wages, this creates a self-fulfilling cycle of rising inflation.

[20] For more details on the inflation outlook for the year, refer to Chapter 2: Outlook and Policy in 2022.

[21] Nonetheless, the introduction of fresh chicken ceiling price from 5 February 2022 would help contain the upward pressures on consumer prices. For more details on cost of living in 2021, refer to the box article Cost of Living Revisited: Causes and Consequences in the 2021 BNM Annual Report.

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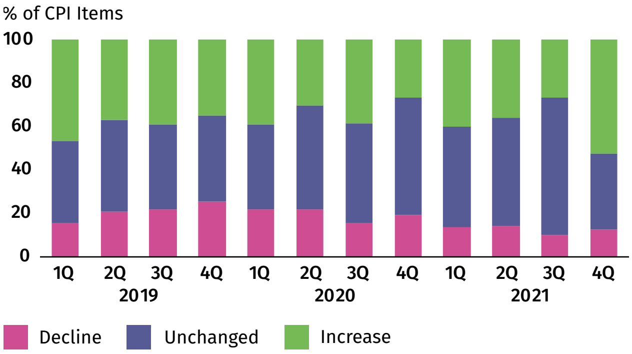
Chart 1.15: Month-on-Month Price Changes of CPI Items*



* Based on the month-on-month inflation for 125 CPI items at the 4-digit level (average for the quarter).

Source: Department of Statistics, Malaysia and Bank Negara Malaysia estimates

Underlying inflation, as measured by core inflation[42], remained subdued throughout the year, averaging at 0.7% (2020: 1.1%) (Chart 1.14). The more muted underlying inflation reflected the spare capacity in the economy amid a moderate recovery in the labour market. This was following the reimposition of domestic containment measures during the year, which led to reduced economic activity. Nevertheless, underlying inflation edged up towards the end of the year, in line with the improved demand conditions following the resumption of economic activity (4Q 2021 average: 0.8%; 1Q – 3Q 2021 average: 0.7%).[43]

Accommodative monetary policy supportive of economic recovery

Monetary policy remained accommodative in 2021, with the Overnight Policy Rate (OPR) unchanged at the historical low of 1.75% throughout the year. The thrust of monetary policy for the year was towards ensuring sustainable economic growth in an environment of manageable price pressures. The accommodative monetary policy was maintained to provide continuous broad-based support for the economic recovery over the prolonged pandemic period.

The Monetary Policy Committee (MPC) assessed that the domestic economy remained on track for a broad recovery in 2021. In early 2021, the economy continued to show signs of resilience, with the growth trajectory projected to improve, driven by the stronger recovery in global demand and increased public and private sector expenditure amid continued support from policy measures. By mid-year, however, the prospects for domestic recovery were dampened by the reimposition of more stringent nationwide containment measures. Nonetheless, the economy was expected to resume its recovery path into 2022 as economic activity gradually normalised following the economic reopening towards the year end. The recovery was also expected to be underpinned by continued support from the external sector amid the strength in global demand. Notwithstanding the ongoing recovery, domestic growth outlook remained subject to downside risks throughout the year, particularly due to uncertainties surrounding the developments of the pandemic, and a weaker-than-expected global growth recovery.

Meanwhile, the risks to inflation were assessed to remain manageable. Despite some upward cost pressures from higher global commodity prices and supply-side disruptions, the spillovers to consumer prices were relatively moderate. The price increases were also from a relatively low base in the previous year and were normalising towards its long-term average in line with the improving demand conditions. Risks to inflation arising from second-round effects amid the cost-push pressures from global commodity prices were assessed to be limited. In addition, there had not been indications of significant wage pressures amid an uneven recovery across labour market segments, while longer-term inflation expectations remained anchored. Importantly, underlying inflation was subdued for most of 2021 and was projected to remain modest in 2022 given the continued spare capacity in the economy and slack in the labour market.

Given the balance of risks to the outlook for both domestic growth and inflation, the MPC therefore considered the stance of monetary policy to be appropriate and accommodative. As the pandemic evolved during the year, the MPC was faced with uncertainties surrounding the outlook for growth and inflation. Nonetheless, the ongoing monetary policy support was deemed necessary as the recovery was uneven with considerable uncertainty owing to developments surrounding the pandemic. Such accommodative stance reflected the MPC's

[42] Core inflation is computed by excluding price-volatile and price-administered items.
[43] The increase in core inflation towards the end of the year was largely contributed by discretionary items such as *food away from home*, *restaurants and hotels*, and *furniture and furnishings*.

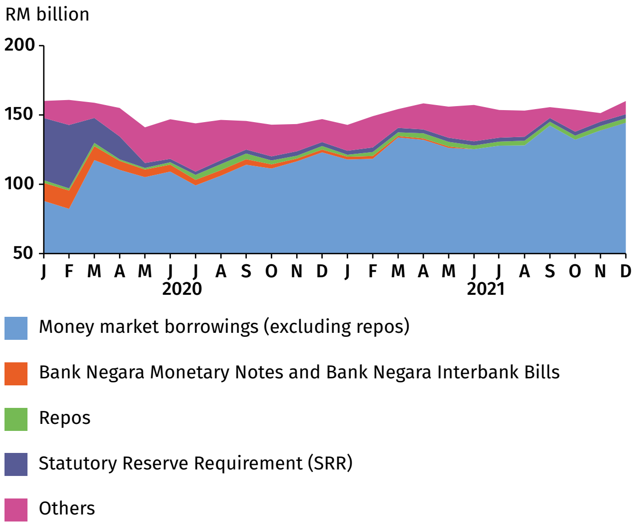
intention to avoid a premature withdrawal of policy support until the economic recovery is more entrenched and sustainable. This was feasible amid the relatively modest outlook on inflation and limited risks to financial imbalances.

In considering the appropriate degree of monetary accommodativeness, the MPC also took into account the fiscal and financial measures that had been put in place, as well as the broad policy toolkit available to the Bank. While monetary policy was crucial in providing broad-based support, it was also complemented with the other targeted policies that were better tailored to provide support to segments of the economy that were experiencing an uneven recovery. At the same time, the MPC was mindful that other measures, including structural reforms, are needed to enhance potential growth for the economy and secure sustainable growth in the medium term.

In line with the accommodative monetary policy, the Bank's monetary operations have continued to ensure conducive domestic liquidity conditions. At the system level, aggregate outstanding liquidity placed with the Bank remained ample at RM160.1 billion (2020: RM147.0 billion) (Chart 1.16) amid net capital inflows and continued trade surplus for the year. At the institution level, almost all banking institutions continued to maintain surplus liquidity positions with the Bank, with a funding preference for shorter maturities to better manage their liquidity needs. The Bank also conducted liquidity injection operations through various instruments, including reverse repos, the outright purchase of Government securities and foreign exchange swaps to ensure orderly market conditions during episodes of bond yield volatility and intermittent periods of portfolio outflows. The extension of the Statutory Reserve Requirement (SRR) flexibility[44] further provided sustained liquidity support for financial intermediation during the year. Collectively, this has ensured the orderly functioning of the domestic financial markets and uninterrupted intermediation activity to the real economy.

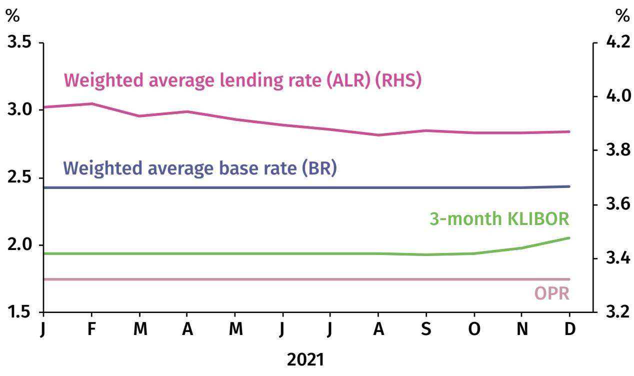
Consistent with the unchanged level of OPR, money market rates were broadly stable throughout the year. Interbank rates and the Kuala Lumpur Interbank Offered Rate (KLIBOR) were stable for the most part of the year despite some gradual increases towards year-end, particularly at the longer tenures[45] (Chart 1.17) as banks sought to bolster their stable funding sources. Banks also built up precautionary liquidity buffers in anticipation of deposit withdrawals following the expiry of tax exemption for non-individual investors' income in retail money market funds on 1 January 2022. The tighter interbank market conditions, however, was temporary, with interbank rates normalising after December. Fixed deposit (FD) rates were also stable for tenures across 1 to 12 months. As such, banks' average cost of funds

Chart 1.16: Outstanding Ringgit Liquidity Placed with Bank Negara Malaysia (at end-period)



Source: Bank Negara Malaysia

Chart 1.17: Policy, Interbank and Lending Rates (at end-period)



Source: Bank Negara Malaysia and Bloomberg

[44] The flexibility was provided for banking institutions to recognise MGS and Malaysian Government Investment Issues (MGII) as part of the SRR compliance. This SRR flexibility was initially available until 31 May 2021, and subsequently extended to 31 December 2022 in January 2021.

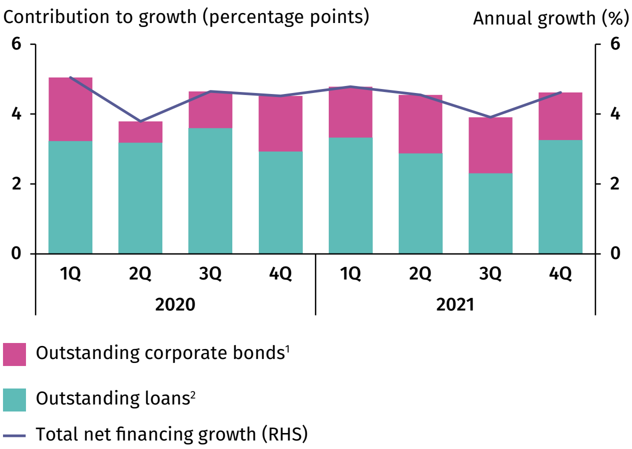
[45] Referring to rates for tenures above 1 month.

remained low (end-2021: 1.08%; end-2020: 1.21%), with continued pass-through from the earlier OPR reductions in 2020 as deposits repriced upon maturity. Amid the favourable funding conditions as well as the maturity of fixed-rate loans with higher rates, weighted average lending rate (ALR) on outstanding loans declined from 3.99% at end-2020 to 3.87% at end-2021 (Chart 1.17). Meanwhile, weighted average Base Rate (BR) was sustained at 2.43% as at end-2021 (end-2020: 2.43%). Overall, the accommodative interest rates continued to foster a conducive environment for financing economic activity.

Continued flow of credit to the private sector, with ongoing policy support

Financing to the private sector remained supportive of economic activity in 2021, underpinned by the sound banking system, orderly functioning of capital markets and ongoing policy support. The sustained growth in net financing (2021: 4.6%; 2020: 4.5%) (Chart 1.18) was driven by higher outstanding loan growth (2021: 4.3%; 2020: 3.9%) (Chart 1.19) amid a more moderate growth of outstanding corporate bonds (2021: 5.5%; 2020: 6.5%). While the growth of net financing was affected by the reimposition of movement restrictions in the middle of the year, the flow of credit rebounded subsequently, following the gradual reopening of the economy.

Chart 1.18: Total Net Financing through Banks, Non-Bank Financial Institutions and Corporate Bonds

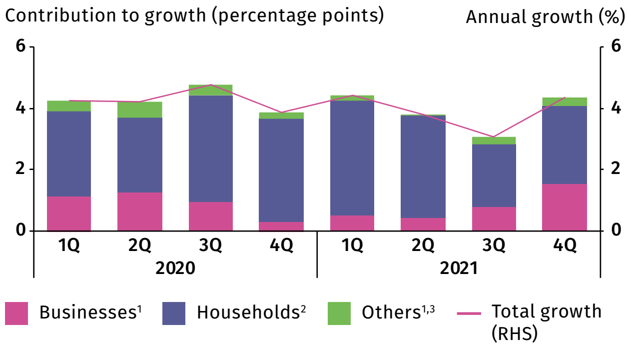


[1] Excludes issuances by Cagamas and non-residents.
[2] Loans from the banking system, development financial institutions (DFIs) and major non-bank financial institutions (NBFIs).

Source: Bank Negara Malaysia

The impact of movement restrictions was relatively more evident for the household segment, with outstanding household loan growth moderating to the trough of 3.3% in September before recovering to 4.1% by year end (2020: 5.5%). Nonetheless, the recovery was broad-based across all loan purposes, with improvements in both the demand and supply of credit. Stimulus measures, including the Home Ownership Campaign (HOC) and the sales tax exemption on new vehicles, also continued to provide support for household loans, especially for the purchase of residential properties and passenger cars.

Chart 1.19: Outstanding Loans by Borrower Type



[1] Loans from the banking system and development financial institutions (DFIs) only.
[2] Loans from the banking system, DFIs and major non-bank financial institutions (NBFIs).
[3] Includes loans of financial institutions, NBFIs, Government, domestic other entities and foreign entities.

Source: Bank Negara Malaysia

For businesses, outstanding loan growth was generally sustained throughout the first eight months and picked up strongly to 4.8% by end-2021 (2020: 0.9%). Of note, financing support in the form of working capital loans was especially robust, with strong loan disbursements throughout the year (2021: RM833.4 billion; 2020: RM639.3 billion) for both small- and medium-sized enterprises (SMEs) and non-SMEs. This facilitated businesses in bridging their financing needs and tiding over the periodic disruptions to economic activity during the year. Amid the prevailing economic uncertainties, however, loans for the purpose of capital expenditure were less forthcoming, given the more moderate recovery in firms' capital expansion. Similarly, the improvement in corporate bond activity for the broader market was more gradual, with some signs of nascent recovery closer towards year end.

Policy support and financing facilities have remained in place to ensure continued flow of credit across segments of the economy. These measures provided further targeted support for segments that were facing a more uneven recovery. These included the various facilities under the Bank's funds for SMEs, which allocations were increased and flexibilities extended[46] to benefit more SMEs. In addition, new facilities were established, namely, the Business Recapitalisation Facility (BRF) to facilitate a more sustainable financing structure through blended equity scheme and the Low Carbon Transition Facility (LCTF) to encourage the transition to low carbon practices for SMEs. Financing support in the form of credit guarantees[47] also remained available for businesses, which played a crucial countercyclical role in mitigating the lower risk appetite by banks. For existing borrowers who faced difficulties in servicing their debt obligations, continued repayment assistance was provided by banks, while various debt advisory and resolution arrangements remained in place. Collectively, these measures cushioned the impact of the pandemic on businesses and individuals while promoting financing conditions that supported the economic recovery.

[46] Greater flexibility provided under the Targeted Relief and Recovery Facility (TRRF) and PENJANA Tourism Financing (PTF) to enable SMEs to refinance existing debt at lower costs while tapping fresh funds.

[47] These include the Danajamin PRIHATIN Guarantee Scheme (DPGS), and credit guarantees provided by Credit Guarantee Corporation Malaysia Berhad (CGC) and Syarikat Jaminan Pembiayaan Perniagaan Berhad (SJPP).