DEVELOPMENTS IN THE FOURTH QUARTER OF 2008

INTERNATIONAL ECONOMIC ENVIRONMENT

Global recession deepened with feedback loop impacting financial sector

The global economy came under severe stress in the fourth quarter as the deepening recession in the advanced economies intensified the feedback loop from the real economy to the already fragile financial sector. While the initial measures were concentrated at reviving the financial sector, there was a distinct shift in emphasis towards the use of massive fiscal stimuli to counter the impact on growth. The dynamic interaction between firms cutting jobs, the loss of confidence and consumers holding back spending has led to severe contraction in private sector demand, accelerating the drop in global demand for goods and services and the correction in commodity prices. The more open emerging economies experienced double-digit declines in exports, resulting in a deterioration in growth. This has prompted aggressive policy responses in the form of large fiscal stimuli and monetary easing.

In the **US,** real GDP contracted for the second consecutive quarter by an annualised 3.8% in the fourth quarter (3Q 08: -0.5%), registering the biggest drop in 26 years. Private consumption expenditure declined further by 3.5% (3Q 08: -3.8%) but the more significant factor was the double-digit decline of 20.1% in fixed investment (3Q 08: -5.3%). The broad-based decline in fixed investment was due mainly to a large drop of 27.8% in business equipment investment. Meanwhile, headline inflation fell sharply to 1.5% in the quarter (3Q 08: 5.2%), due to the large fall in gasoline prices and weaker demand.

Recession in **Japan** deepened further when the economy contracted sharply by an annualised 12.7% in the fourth quarter (3Q 08: -2.3%) following the record fall of 23.5% in exports during the quarter (3Q 08: 3.1%). The increasing breadth and depth of the decline in exports reflected the sharp fall in global demand for automobiles, electronics and other products amidst the sharp appreciation of the yen. Highlighting the strong reliance of Japan's manufacturing sector on exports, industrial production fell by 14.4% in the fourth quarter of 2008 (3Q 08: -1.9%), accompanied by shorter working hours and job cuts especially among the contract workers. This, among other factors, has pushed the consumer confidence index to an all-time low of 26.2 in December 2008, putting downward pressure on consumption. Inflation eased further to 1% in the fourth quarter (3Q 08: 2.4%).

Growth in the **euro area** contracted by 1.2% (3Q 08: 0.6%) in the fourth quarter, due to a combination of the further decline in exports in Germany and the intensifying of the credit crunch in other European economies. Domestic demand weakened further due to tighter bank lending conditions impacting both households' consumption and firms' investment activities.

Industrial Countries: Real GDP Growth

	2007		2008			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
US[1]	-0.2	2.0	-0.5[r]	-3.8[a]	1.3[a]	Sharp contraction in fixed investment mainly in business equipment.
UK	3.0	3.0	0.3	-1.9[a]	0.7[a]	Broad-based slowdown in services and manufacturing sectors.
Euro area	2.1	2.6	0.6	-1.2[p]	0.7[p]	Sharp contraction in Germany as well as deeper-than-expected decline in France and Italy.
Japan[1]	4.5	2.4	-2.3[r]	-12.7[p]	-0.7	Third consecutive annualised contraction following record fall in exports.

[1] Annualised basis
[r] Revised
[p] Preliminary
[a] Advance estimate

Source: National authorities

On the inflation front, prices moderated further to 2.3% in the fourth quarter (3Q 08: 3.8%). Meanwhile, the **UK** economy experienced a negative growth of 1.9% in the fourth quarter (3Q 08: 0.3%), its first decline since 1991. The contraction was broad-based across all sectors, particularly services (-1%). Inflation, meanwhile, continued to trend downwards to 3.9 % in the fourth quarter (3Q 08: 4.8%).

Against the backdrop of severe deterioration in growth prospects, worsening financial turmoil and falling commodity prices, central banks in the advanced economies continued with aggressive monetary easing. In the **US,** the **Federal Open Market Committee** (FOMC) lowered its Federal Funds rate from 1% to a range of between zero and 0.25% in December, effectively adopting a zero interest rate policy. The US authorities also adopted wide-ranging quantitative easing to improve market liquidity of debt instruments and to provide support for the housing market which had continued to weaken. Elsewhere, the **Bank of Japan** cut its overnight call rate by 20 basis points to 0.1% while the **European Central Bank** (ECB) reduced its overnight rate in December by 75 basis points, its largest cut in a decade, to 2.5%. The ECB again cut its interest rate on 15 January 2009 by 50 basis points to 2% as the recession deepened. Similarly, the **Bank of England** (BoE) eased its base lending rate in December by 100 basis points to 2%. The BoE cut interest rate further by 50 basis points to 1.5% in January 2009 and reduced another 50 basis points to 1% in February, a record low in the central bank's history.

Given the severity of the slowdown, the authorities, particularly in the advanced economies, have embarked on large fiscal stimuli to provide support to the real economy. The US announced a fiscal stimulus of USD787 billion or 5.7% of its GDP in February 2009. Similarly, large fiscal stimuli were also announced by the regional countries, including PR China (USD586 billion or 16% of GDP) in November 2008, and Singapore in January 2009 (USD13.7 billion or 8.4% of GDP).

In the fourth quarter, global **crude oil prices**[1] continued to decline to close at USD44.6 per barrel at the end of 2008 as the recession in advanced economies deepened. Oil price hit a 5 year low of USD31.41 per barrel in mid-December 2008, a level not seen since December 2003, before stabilising between USD35 – 50 per barrel in the early part of 2009.

In the Asian region, the more open economies slipped into recessions while the growth of other regional economies decelerated sharply in the fourth quarter. Following the significant declines in their exports, growth in Singapore and Korea contracted by 4.2% (3Q 08: 0%) and 3.4% (3Q 08: 3.8%) respectively. The growth in PR China moderated sharply to 6.8% in the fourth quarter (3Q 08: 9%), following the slump in exports to the advanced economies. This has led to the subsequent sharp fall in PR China's imports from the rest of the region. The sharp fall in commodity prices and weaker external demand have, however, led to lower inflationary pressures in the region. In response, central banks across Asia have also reduced their interest rates to record lows to cushion their economies from the worsening global prospect. The Bank of Korea has eased its interest rate by 325 basis points since early October 2008 while PR China cut interest rates by 216 basis points since September 2008.

Selected Economies: Policy Responses

Country	Fiscal Stimulus		Monetary Policy	
	Amount (USD bn)	% of GDP[1]	Cumulative change since Jan 08' (basis points)	Current Rate (%)
Industrial				
US	787	5.7	-400 to -425	0 to 0.25
UK	31	1.5	-450	1.0
Euro area[2]	271.3	2.7	-200	2.0
Japan	54	0.9	-40	0.1
Regional				
PR China	586	16	-216	5.31
Hong Kong SAR	1.4	0.7	-525	0.5
Indonesia	6.1	1.9	+25	8.25
Korea	11	1.6	-300	2.0
Malaysia	2.0	1.0	-125	2.0
Chinese Taipei	18	4.6	-212.5	1.25
Philippines[3]	6.3	4.5	-25	5.0
Thailand	10	4.1	-175	1.5
Singapore	13.7	8.4	n.a.	n.a.

[1] Calculated based on 2007 nominal GDP
[2] Refers to Germany, France, Italy and Spain
[3] Fiscal stimulus proposal to be finalised

Source: National authorities, Bank Negara Malaysia calculations

[1] Refers to WTI one-month futures on NYMEX

Regional Countries: Real GDP Growth

	2007		2008			Key contributing factors for 4Q growth
	4Q	Year	3Q	4Q	Year	
	Annual change (%)					
PR China	11.2	13.0r	9.0	6.8	9.0	Lower growth from weaker exports and investment.
Indonesia	6.3	6.3	6.4r	5.2	6.1	Growth supported by consumption and exports.
Philippines	6.4	7.2	5.0r	4.5	4.6	Growth supported by consumption despite declines in exports and investment.
Hong Kong SAR	6.9	6.4	1.7	-2.5	2.5	Due to weaker exports and domestic demand.
Korea	5.7	5.0	3.8r	-3.4p	2.5	Broad-based declines in manufacturing, construction and services sectors.
Singapore	5.5r	7.8r	0.0r	-4.2r	1.1	Due to decline in manufacturing especially electronics and chemicals sectors.
Thailand	5.7	4.9	3.9r	-4.3	2.6	Sharp contraction due to negative contribution from net exports.
Chinese Taipei	6.4	5.7	-1.1r	-8.4p	0.1	Sharp contraction in growth due to significant decline in exports and private investment.

r Revised
p Preliminary

Source: National authorities

In the **foreign exchange market,** the US dollar continued to appreciate against the euro and the pound sterling due to the de-leveraging process as well as market perception that the adjustments in the other advanced economies were lagging the US. The Japanese yen also strengthened against the US dollar due to the continued unwinding of carry trade activities and repatriation of funds back to Japan. Meanwhile, regional currencies depreciated against the US dollar, affected by the de-leveraging activities as well as the pull back of funds and credit from the region by investors and financial institutions amidst large loan writedowns in the developed economies and weaker balance sheets.

Going forward, with financial markets remaining under severe stress and the real economy taking a sharp turn for the worse in spite of policy measures, the downside risks to global growth remain. The direction and magnitude of global economic crisis in the near term hinges critically on the effectiveness of the advanced economies to effectively implement policy measures to reflate demand and re-establish a functioning financial system, as well as the stimulus measures being introduced in the major emerging economies.