

Chapter 2

The Changing Business Environment



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Following the financial crisis in a number of the advanced economies, 2008 will see a moderation in world growth as most economies are expected to grow at a slower rate compared to 2007. Malaysia with strong economic fundamentals and a diversified economy, is expected to weather the impact as high commodity prices and higher intra-regional trade helping sustain growth. The economy also faces inflation from rising fuel and food prices. To help SMEs take advantage of the changing economic environment both domestically and abroad, the Malaysian Government will focus on programmes to enhance SME competitiveness.

1. Slower Global Growth

The global economy expanded by 4.7% in 2007, slightly below the growth rate of 4.9% recorded in 2006. The robust growth in emerging market economies as well as the above-trend growth seen in most industrial economies to some extent had helped offset the impact of the downturn in the US economy, higher oil prices and the onset of the financial market turbulence.



The US housing downturn, financial market turmoil and the strong surge in the prices of oil and other commodities were dominant themes for the global economy in 2007. Wider strains from the fallout of the US subprime mortgage sector began to intensify in the second half of 2007. Although most industrial economies experienced above-trend growth in 2007, some signs of weakening emerged in these economies in the latter half of the year. In Europe, including the United Kingdom (UK), business and consumer confidence indices fell as the US subprime problems triggered tighter credit conditions and the housing markets in several European economies began to soften. In Japan, housing investment was significantly affected by tighter building standards imposed by the authorities on the construction industry.

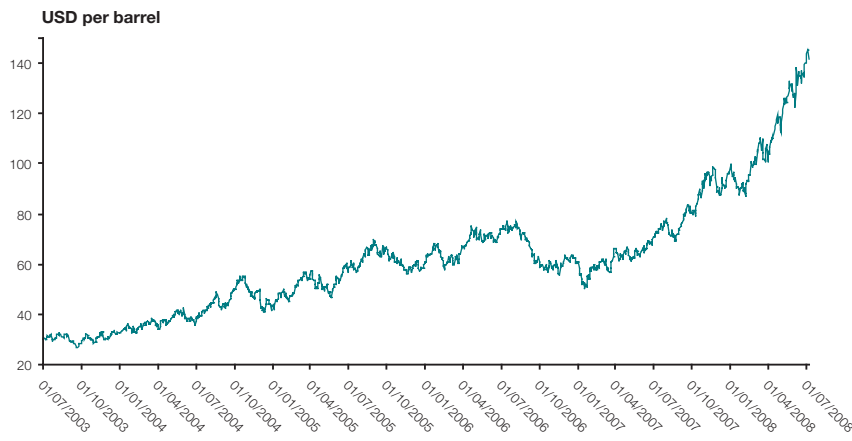
In contrast to the moderating trends in the developed markets, the emerging market economies experienced robust growth in 2007. Economies such as The People's Republic of China (PR China), India, Brazil and Russia increased their contribution to global growth, spurred by strong consumption and rising investment activity. Buoyant domestic demand was also seen in the Asian region, which more than compensated for the lower external demand due to the adjustment in the global electronics cycle and the developments in the US. The strong domestic demand was sustained by favourable labour market conditions, rising commodity prices and increased infrastructure spending.



Inflationary Pressures From Rising Commodity Prices

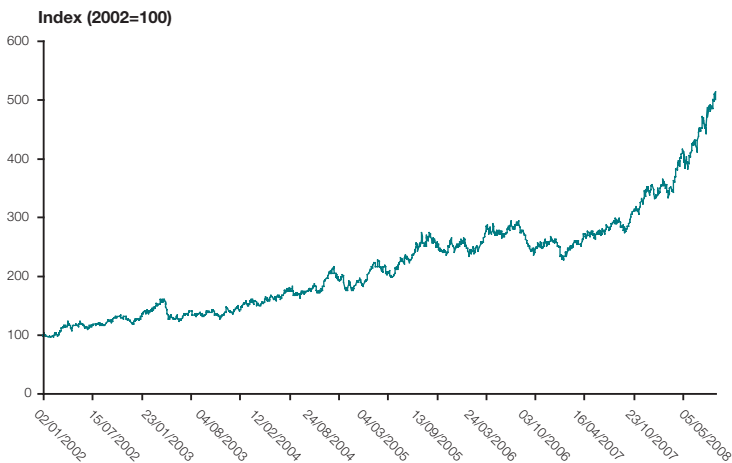
The prolonged period of high global growth since 2003 has created pressures on resource utilisation and resulted in the high price of commodities. Oil prices have surged to record highs and have also contributed to higher food prices due to increasing demand for substitutes to conventional fuels, including renewable energy sources such as biodiesel and ethanol. Adverse weather conditions have also contributed to rising food prices. Going forward, commodity prices are expected to remain elevated, supported by sustained demand growth, supply constraints and the emergence of commodities as a growing asset class for investment diversification. Thus in 2008, global and regional inflation is expected to remain elevated due to the pass-through effects from higher prices in 2007 and the expectation of continued high oil and food prices.

Crude Oil Prices: WTI 1-month



Source: Bloomberg

S&P Goldman Sachs Commodity Index



Source: Bloomberg



External Environment Expected to Moderate

As the financial crisis that emerged from the US in 2007 continues to unfold, the external environment is likely to continue to moderate in 2008. The crisis has increased uncertainty and risk aversion in the financial markets, while the large scale liquidity strains and consequent constraints on credit conditions have led to declining asset prices. Nevertheless, the extent of the impact these developments would have on the global economy remains unclear, as much depends on the length and depth of the US slowdown. At the same time, the rise in global inflationary pressures have also increased on the back of high energy and food prices. This may in turn dampen domestic demand going forward. Taking all of these factors into consideration, expectations are for some moderation in global growth in 2008.

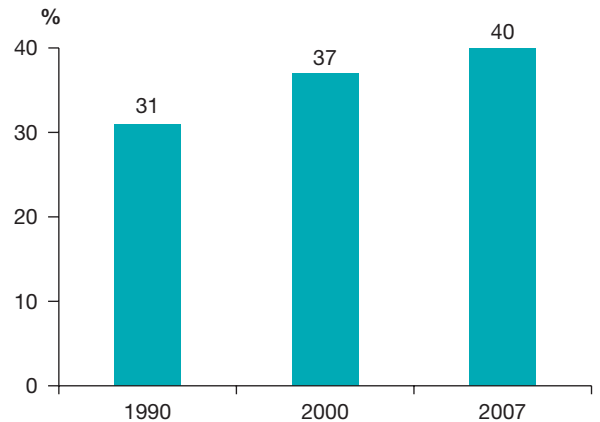
Less Impact on Asian Economies

Although developments in the major industrial economies will have an impact on the Asian economies, the slowdown in the external environment is somewhat mitigated by the relatively high growth in the PR China and India, on-going infrastructure investment as well as support from high commodity prices for the commodity-exporting countries. In addition to this, domestic demand has remained firm due to favourable labour market conditions, rising commodity prices and increased infrastructure spending. Regional growth will also be supported by growing intra-regional trade activities.

Commodity prices are expected to remain relatively high, adding to the growth impetus for the commodity-producing countries. A modest recovery is expected in the global semiconductor industry as consumer electronics demand typically strengthens in a year coinciding with the Olympics. Implementation of infrastructure projects across the region is adding support to investment activity whilst the fiscal measures undertaken by regional authorities, for example targeted cash subsidies, tax rebates as well as reduction in import tariffs, would to some degree cushion the impact from higher consumer prices in 2008.

The high growth momentum in the large economies in the region such as the PR China and India is also expected to help support regional trade growth. Trade among Asian economies has risen substantially in recent years and the expansion of domestic demand regionally has also enlarged the cumulative market in the region significantly. This increases the prospects for mutually reinforcing intra-regional trade.

Region: Share of exports to regional countries, %



Source: IFS, WTA

Although the Asian region has strong inter-linkages to the global economy and the international financial system, the dominance of domestic demand and increasing regional economic integration have reduced the implications of external developments on the region. Thus, while the region is not entirely insulated, these factors will, to some extent, lessen the spillover effect from the slower external environment.

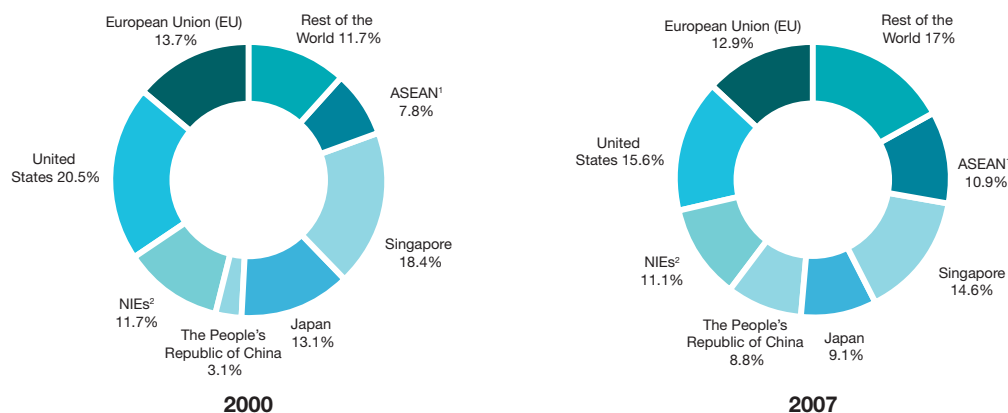
2. Increased Resilience of the Malaysian Economy

As a very open economy, Malaysia's economic growth will be influenced by a global economic slowdown. However, Malaysia enters this period of heightened global uncertainty from a position of strength, after recording three consecutive years of steady economic growth. The quality of growth has also improved becoming more balanced between domestic and external sources of growth and across the different economic sectors.

The emergence of domestic demand as a key driver of growth will help Malaysia weather the slowdown in external demand to some extent. Although there may be some moderation in domestic demand growth in the second half of 2008 following the subsidy restructuring and related measures, it may be partially offset by the strong external position and the implementation of investments by the Government. Malaysia's exports are diversified, with almost 54% of total exports in 2007 going to Asian economies (excluding Japan) compared to 46% in 2001. As a commodity producer, Malaysia will also continue to benefit from high prices of crude oil, palm oil and rubber. The strong base of the commodity sector would further strengthen the linkages with downstream activities, including the resource-based industries.

The external sector still plays a significant role in Malaysia's GDP, with exports accounting for over 94% of GDP in 2007, while imports make up 79%. The weaker external environment suggests that export growth may moderate in 2008 due to the slower increase a reduction in global demand this year. Malaysia has, however, diversified its export market, with Malaysia's total exports to the US now declining to a 15.6% share in 2007 and trade with other Asian and emerging economies continuing to rise. Thus, the expected slowdown in exports to the US, and to a lesser extent, Europe and Japan, will be somewhat cushioned by rising exports to Asia and other emerging markets, which are projected to experience stronger economic growth.

Direction of Exports (% share)



¹ Thailand, Indonesia, Philippines, Brunei Darussalam and Vietnam

² Hong Kong SAR, South Korea and Chinese Taipei

Source: Bank Negara Malaysia Annual Report 2007

New Opportunities and Challenges for SMEs

The current environment brings new challenges to SMEs. SMEs able to improve their competitive levels and strategise their business focus will be in a position to shift strategies according to the changing economic environment, both domestically and externally.

In order to minimise the impact of a slowdown in the US's demand for Malaysia's exports, new opportunities would need to be found within the regional market and other emerging markets such as the PR China, India, South America and the Middle East. Growth in these markets is expected to come from the domestic-based and resource-oriented industries, and SMEs involved in the related downstream and upstream linkages activities could potentially benefit from this trend.

SMEs that are able to enhance productivity and competitiveness as well as develop new products and services will be better able to weather this trend of rising prices



On the domestic front, the focus of monetary policy in 2008 will be on sustaining the economic growth momentum while maintaining price stability over the medium term. The 2008 Budget outlined wide ranging tax and non-tax measures to enhance the nation's competitiveness, strengthen human capital development and ensure the well-being of all Malaysians. Fiscal policy in 2008 also focused on expediting the implementation of projects and programmes that had been identified under the Ninth Malaysian Plan (9MP) and the Third Industrial Master Plan (IMP3). Given the high priority of SME development in the country, key strategies for SME development have been outlined under both the 9MP and IMP3. Furthermore, to help SMEs position for and capitalise on the key economic trends expected in 2008, a range of Government programmes are in place to assist SMEs enhance their competitiveness through strengthening their capacity and capability, strengthening the enabling infrastructure and broadening access to financing.



In 2008, 37 programmes will be put in place to enhance SMEs' accessibility to the domestic and international market through the provision of loans, grants and other assistance programmes worth RM118 million. Programmes have also been put in place to encourage SME participation in the commodities sector as well as to increase the competitiveness of SMEs within the commodities sector through the adoption of technologies and the provision of training in the rubber, palm oil and wood based sector through training courses and seminars. Market expansion programmes, which help SMEs develop linkages with large corporations, government linked companies and hypermarkets, will also continue in 2008, helping SMEs develop marketing and networking opportunities. Expositions such as SMIDEX 2008, SME Convention and Malaysia International Halal Showcase (MIHAS) are also planned for 2008, providing opportunities for SMEs to showcase their products and increase market penetration.

SMEs need to rise to the challenge of having the capability, capacity and flexibility to meet changing demand patterns both domestically and abroad and competition from regional firms. The rising price of fuel and other raw materials will also be a key economic trend impacting Malaysian SMEs in 2008. SMEs that are able to enhance productivity and competitiveness as well as develop new products and services will be better able to weather this trend of rising prices. To sustain growth in the medium term, productivity needs to be enhanced and SMEs need to move further up the value chain into new areas of competitive advantage as well as use new and more efficient delivery channels.

The slowdown in the US, the rising cost of fuel and buoyant demand regionally are some of the key economic trends taking place in 2008. To ensure that SMEs are well positioned to face the changing economic environment, both domestically and abroad, a wide range of programmes will be implemented to help SMEs improve their competitiveness, expand to new markets and enhance product quality.